Investigation the effect of audit size on Earnings Management in Tehran stock exchange

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Abstract
The purpose of this study was to Investigation the effect of Audit size and on Earnings Management in The 116 companies listed in Tehran Stock Exchange for the period 1387 to 1392 that using multiple regressions with controlling determinants earning management has been tested. This study has been applied in terms of purpose and terms of the nature after event. And a sample of 5 companies listed on the Stock Exchange for the systematic removal. In all the techniques of statistical software were used Excel and Eviews. In this study, audit size and audit tenure, that is three hypotheses based on the finding show that significant correlations between audit size, audit tenure with earning management and real earning management.

Keywords: audit size, audit tenure, earning management.
1. Introduction

Accounting earnings are the most important indices of performance applied in many economic decisions such as stock evaluation, performance assessment, determination of managers’ rewards and appropriation of retained earnings. These decisions affect the transfer of resources between different people and for this reason, they receive special attention in the capital market. In an economic environment with situations of conflicting interests, including those between shareholders and managers, there is always the possibility that managers attempt to manipulate earnings. Management or manipulation of earnings is a deliberate action of managers to achieve desired financial results that may exist for various reasons. In the decision-making process, investors choose companies whose earnings are of higher sustainability and of greater quality indeed. In cases where entities are economically volatile, managers influence the earnings figures reflected in the financial statements leading to the positive views of those using financial statements, particularly investors. Because information is the life resource of market and the investors take the risk of investment in the capital market, they rely on the information published by the companies and invest therein. They require timely, understandable information in analyzable forms. Accordingly, the market will have to be able to manage earnings. The ability of market in detecting earnings management has two important implications. First, potential benefits reduce earnings management due to the weakening of altered components, and the second consequence is an increase in the costs of earnings manipulation. Additionally, the separation of ownership from management creates conflicts in the representatives, which may actuate managers towards opportunism and self-interest.

This study aimed to assess the ability of auditors in detecting and reporting earnings management, the size effect of audit firm, and the auditors’ opinions on the management of earnings.

Research literature

Foreign countries

Wan Qi et al. (2011) examined the relationship between advanced audit quality and actual earnings management in 1800 companies during the period from 2002 to 2010. In their research, they primarily found that industry auditing experts and large auditors (N large) receive more fees than other auditors.

Alastair et al. (2011) focused on the issue whether the differences in audit quality of four large institutions against four non-large firms could be attributed to the profiles of clients. The results showed that the difference in this case between the auditors of four large and four non-large institutions were greatly in accordance with the characteristics of clients specifically with the size of the clients.

In an Australian research, Carson et al. (2012) found that there was an inverse relationship between qualified assessments (because of an uncertainty in the continuation of activities) and accruals. Their results showed that management of earnings was not a reason for the auditors’ qualified opinions.

Tsiporido and Espatis (2014) showed that auditors’ opinions were not significantly related to earnings management. The financial characteristics of the clients such as profitability and firm’s size were more effective than earnings management on the auditors’ decisions about...
the modification of their reports concerning the uncertainty of sustaining activities. In other words, earnings management had no roles in this regard.

Using data from a total of 392 Chinese firms, Sun (2014) studied the relationship between remunerations paid to the directors and the manipulation rate of earnings. They concluded that increased amount of bonuses paid to the companies’ executives amplified the possibility of earnings manipulation.

Iranian investigations

Jan Jani (2011) examined the relationship between earnings management and profitability of the companies listed in the Tehran Stock Exchange. They found that companies with earnings management had weaker operations in earnings levels and net income, higher growth in earnings levels before taxes and net earnings levels, greater amounts of net earnings levels, and finally larger interest rates in the amounts of earnings per share compared to the companies with no earnings management.

Rahmani and Montazerghaem (2013) experimentally evaluated the motivations of cash flow management resulting from operations in companies listed in the Tehran Stock Exchange. Their results suggested significant relationships between the cash flow management resulting from the operations, decreased earnings stability, and the divergence between earnings and cash flow management resulting from the operations. No effects of financial disability were found on the cash flow management resulting from the operations.

A research by Bani Mahd et al. (2014) showed statistical relationships among earnings management, size of company, profitability, ratio of liabilities, audit fees, and governmental ownership with the number of auditing paragraphs located above the opinion ones. In addition, their results revealed no significant relationships among complexity of the company and changes in auditor and management with the number of auditing paragraphs located above the opinion ones.

Asadi and Ashkan (2014) studied the relationship between quality (size) and assessments of audit firms with earnings management. The earnings management was not correlated to the audit quality, but a significant correlation was detected between the audit opinions and earnings management.

Mohammadpur (2015) investigated the association between the auditors’ reports and earnings management in the companies listed in the Tehran Stock Exchange. For this purpose, they studied a sample of 65 companies over the period 2004 to 2013. The findings suggested no significant relationships between the auditors’ reports and earnings management in the companies listed in the Tehran Stock Exchange.

1-1. Hypotheses

In this study, the following hypotheses have been developed.

1. Audit opinion has a significant impact on earnings management.
2. The size of audit firm has a significant effect on earnings management.
3. The size of audit firm has a significant influence on the relationship between earnings management and audit opinion.
Methods

This research is based on the actual data of the stock market and the audited annual financial statements in the companies listed in the Tehran Stock Exchange. The financial information required was obtained from the audited financial statements and associated notes about the companies studied with the help of CDs provided by the Tehran Stock Exchange.

First, samples were chosen from the companies listed in the Tehran Stock Exchange from the beginning of 2010 until the end of 2014. After collecting the required data, the Excel and Eviews 8 programs were employed to analyze the data. Then the research hypotheses were tested using multiple regression and simultaneous relationships between independent and control variables with the dependent variable were verified.

The model

According to the theoretical background and research literature, the following model was used to test research hypotheses.

Research model:

\[ da = \beta_0 + \beta_1 AO + \beta_2 BIG4 + \beta_3 BIG4 \ast AO + \beta_4 SIZE + \beta_5 LEVE + \beta_6 ROA + \beta_7 LOSS + \beta_8 CFO + \varepsilon \]

In this model:
DA: earnings management; AO: audit opinion; BIG4: (Big 4 Merger) size of audit firm; SIZE: size of the company; LEVE: financial leverage; ROA: return on assets; LOSS: losses; CFO: Operating cash flow ratio

Statistical sample

The statistical sample was chosen from a total of 455 companies listed in the Tehran Stock Exchange during the years 2010-2014. The study sampling was started on the exchange website through looking up the year when the company was listed on the stock exchange.

Testing hypotheses by the research model

Table (4-5) shows the results of the research model parameters. For this model, the Durbin-Watson’s statistic is equal to 1.862, which rejects the disruption autocorrelation at a level of 0.05. The probability associated with the F statistic to specify the model is 0.000, which is less than 0.05. Hence, the null hypothesis is rejected based on the model specification error. As a result, the model is accepted to be significant at a confidence level of 0.95. The adjusted coefficient of determination of the model is equal to 0.363. This statistic indicates that approximately 36 percent of changes in the independent variable can be explained by both the dependent variables and the control. Since the model statistics are not rejected, it is possible to examine the hypotheses of the study.
Table (4-5): The results of research model

<table>
<thead>
<tr>
<th>Variable</th>
<th>Factor</th>
<th>Test statistic</th>
<th>Error probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Auditor’s opinion</td>
<td>-0.736</td>
<td>-4.276</td>
<td>0.000</td>
</tr>
<tr>
<td>Size of auditing firm</td>
<td>-1.148</td>
<td>-6.136</td>
<td>0.000</td>
</tr>
<tr>
<td>Size of audit opinion</td>
<td>-0.001</td>
<td>-0.962</td>
<td>0.14</td>
</tr>
<tr>
<td>Size of company</td>
<td>0.805</td>
<td>6.236</td>
<td>0.002</td>
</tr>
<tr>
<td>Financial leverage</td>
<td>0.031</td>
<td>0.451</td>
<td>0.030</td>
</tr>
<tr>
<td>Return on assets</td>
<td>-0.169</td>
<td>-1.029</td>
<td>0.304</td>
</tr>
<tr>
<td>Losses</td>
<td>0.422</td>
<td>3.048</td>
<td>0.002</td>
</tr>
<tr>
<td>Operating cash flow ratio</td>
<td>0.117</td>
<td>1.058</td>
<td>0.291</td>
</tr>
<tr>
<td>Intercept</td>
<td>16.552</td>
<td>38.152</td>
<td>0.000</td>
</tr>
<tr>
<td>Coefficient of determination</td>
<td>0.377</td>
<td>Adjusted coefficient of determination</td>
<td>0.363</td>
</tr>
<tr>
<td>F statistic</td>
<td>27.065</td>
<td>Probability of F statistic</td>
<td>0.000</td>
</tr>
<tr>
<td>Durbin-Watson’s statistic</td>
<td>1.862</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Test of the 1st hypothesis**

Opinion of auditor has a significant impact on earnings management.

The level of error probability related to the null hypothesis indicating no effects of auditor’s opinion on the earnings management is 0.000, which is smaller than 0.05; so null hypothesis is rejected with a confidence level of 0.95. The variable coefficient is -0.736. Due to the negative coefficient, it can be concluded that the auditor’s opinion has a significantly negative impact on the earnings management.

**Test of the 2nd hypothesis**

Size of the audit firm (Big 4 Merger) has a significant effect on earnings management.

The level of error probability related to the null hypothesis indicating no effects of auditing institute on the earnings management is 0.000, which is smaller than 0.05; so null hypothesis is rejected with a confidence level of 0.95. The variable coefficient is -1.148. Because the coefficient is negative, it can be concluded that the audit size has a significantly negative impact on the earnings management.

**Test of the 3rd hypothesis**

The size of audit firm has a significant influence on the relationship between earnings management and audit opinion.

The level of error probability related to the null hypothesis indicating no effects of relationship between earnings management and audit opinion is 0.14, which is greater than 0.05; so null hypothesis is confirmed with a confidence level of 0.95. It can, therefore, be concluded that audit firm size has no significant effects on the relationship between earnings management and audit opinion.
Conclusion
The 1st and 2nd hypotheses in this study were to investigate the size effect of audit firm and audit opinion on the earnings management. According to the results presented in Tables 4-6, both the first and second hypotheses of this study have been confirmed to show significant impacts of audit firm size and audit opinion on the earnings management.

Given the test and analysis of regression, it is concluded that there is a negative correlation between the size of audit firm and audit opinion with the earnings management in the companies listed in the Tehran Stock Exchange, that is, the size of audit firm and audit opinion have significantly negative impacts on the earnings management in the above-mentioned companies. In other words, increasing the size of audit firm and qualified audit opinions result in reduced earnings management in the companies listed in the Tehran Stock Exchange.

Given the working quality of auditors and their opinions can improve the quality of financial reports and reduce earnings management, the negative relationship between qualified audit opinions and the earnings management of companies listed in the Tehran Stock Exchange has been predictable.

Furthermore, the negative relationship between auditor size and earnings management implies a negative influence of the Audit Organization as a reputable audit firm on the level of earnings management by the companies. The overall objective of auditors is to protect shareholders’ interests in the face of important distortions and errors in financial statements. Auditors keep the quality of audit to maintain their own professional reputation, the status of their profession, and to avoid litigation against them. Meanwhile, the motives of managers to exert their own interests in the quality of earnings hinder auditors reaching their goals. In contrast, auditors can discover earnings management by managers through increasing audit quality thereby monitor managers for the manipulation of earnings.

The third hypothesis of this study was to investigate the size effect of audit firm on the relationship between audit opinion and earnings management. The results of testing this hypothesis represents that the size of audit firm has no significant impacts on the relationship between audit opinion and earnings management. The results of this hypothesis suggest that it is not necessary to believe that if the audit is carried out by the Audit Organization, it will intensify the negative relationship between earnings management and audit opinion.
References


A "The role of Asset Reliability and Audit Quality in Equity Valuation"Fallatah, Y . 2006. this submitted in partial fulfillment of the requirements for the degree of Doctor of Philosophy, Florida Atlantic University.


