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Auditor-management alignment and audit opinion: Evidence from Iran

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A B S T R A C T

This study investigates the effect of auditor-management alignment on audit opinion over the period 2003- 2011 on 81 firms listed on the Tehran Stock Exchange using logistic regression analysis. Results indicate that in companies with auditor-management alignment, auditor change level is low. In addition, the results indicate there is no relationship between auditor-management alignment, debt ratio, ownership percentage, firm size and auditor change with unqualified audit opinion. However, research evidences show that auditor's opinion type at previous year, audit fees, auditor type and return on assets ratio influence unqualified audit opinion. Among above variables, auditor's opinion types at previous year, audit fees and return on assets ratio have direct relationship with unqualified audit opinion but auditor type has a negative and inverse relationship with unqualified audit opinion.

1. Introduction

Auditing is one of the monitoring tools for carefully investigating managers' performance. Auditing plays an important role to control managers' opportunistic behavior and limit their motivation to manipulate earnings. Audit report is also one of the most effective reports on accounting information users' decisions. Furthermore, auditing reports are used for decision making about dividend payments and loan lending. However, there are always some conflicts of interest among managers, shareholders and lenders, audit aims to assure shareholders, lenders and other users about reliability of accounting information. In addition, other issues like lack of direct access to accounting information for users have caused to request independent audit services. In fact, audit plays role of information quality evaluation for users (Hassas Yeganeh & Dadashi, 2010). Agency theory recognizes the auditor as an independent agent from shareholders and other beneficiaries to control accuracy, reliability and relevancy of information prepared and presented by firms' managers. However, since auditing requires close relationship of auditor with firm's managers, thereby in this theory it is assumed that auditors may not preserve their independence and may not do their duties, properly. In other words, they perform along their own and manager's interests so

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that an alignment would be made among them and firms' managers (Walker, 2003). This study tries to investigate the impact of auditor-management alignment on audit opinion using agency theory. We assume that where auditor of parent and subsidiary companies are the same and there are common members in board of directors of the above firms, this may cause a kind of alignment between interests of managers and the auditors. In other words, the manager seeks for an auditor who presents unqualified audit report about his/her performance and thereby, auditors tend to continue his/her work and earn more audit fees. Lack of sufficient studies about alignment between interests of managers and auditors as well as competition in audit market of Iran create a motivation to conduct present study.

This study contributes to the audit literatures as follows: First, result of the research can improve the theoretical fundamentals of previous studies about determinants of auditor's opinion in developing countries. Second, evidences will indicate that whether privatization of Iranian audit market and thereby increased authority to change the auditor will result in auditor-management alignment or not. This could provide useful information for the auditing market regulatory oversight board. Third, the results of this paper propose new ideas to conduct new studies in auditing field. The main question of this research is to find out how an auditor of parent and subsidiary companies can be effective on unqualified audit opinion in subsidiary company and this is the first objective of this survey. In addition, the second goal is to provide the determinants of audit opinion for users of accounting information, regulators of accounting and auditing standards, Iranian association of certified public accountants and stock exchange organization. In the following, theoretical fundamentals, variables and hypothesis testing are investigated.

2.Theoretical framework and literature review

Theoretical framework of this research roots in auditor-management alignment hypothesis. This hypothesis refers that manager chooses his/her desired auditor who meets his/her audit requirements. In this regard, auditor change phenomenon is lower in the firms with such an alignment. This hypothesis states that the relationships between auditor and manager result in reduction of auditor's independence and his/her professionalism. According to this relationship, auditor prefers his/her economic interests rather than independence, hence he/she will issue desired audit reports of managers particularly unqualified audit reports (Meyer et al., 2007; Malek & Ahmad, 2011).

Nurul Houqe et al. (2012) studied the relationship between governmental economic power and auditor selection in 46 different countries. They indicated that the higher governmental quality in terms of political and economic aspects, the higher probability to select 4 great audit organizations. They also confirmed that in powerful economic countries that adopted international financial reporting standards, probability of the big 4 audit firms selection was higher. In addition, powerful government request more quality audit services . Malek and Ahmad (2011) investigated the effect of auditor-management alignment on 759 listed firms in Malaysia. They indicated that, the higher auditor-management alignment, the higher probability to issue unqualified audit report. Wang and Xin (2012) studied the relationship between auditor selection and earnings quality in listed firms in Hong Kong and reported that the firms that audit by the big 4 audit firms had higher earnings quality than other companies did. In addition, results confirmed that companies audited by small audit firms reported their profit understatement.

Chen et al. (2010) reported that Chinese audit firms issued more unqualified audit reports compared with foreign ones for governmental firms. They also concluded that some companies choose local audit firms after receiving qualified audit report. Zhang et al. (2010) found that the firms with lower transparency chose small audit firms with low quality as auditor. They also indicated that the firms with political managers usually selected small audit firms as auditor. Lin and Liu (2009) investigated the impact of corporate governance system on auditor selection. They reported that firms with poor governance system select the small audit firms with lower quality than big 4 audit firms. In addition, they found that with improved corporate governance system, probability to select big 4 audit firms as auditor would be increased. Chena et al. (2009) reported that auditor change had direct relationship with issuing unqualified audit report. They also reported that managers changed their auditor to show their performance desired through and they could receive unqualified audit report and demonstrated a suitable performance for company. Bewley et al. (2008), in a survey about deselecting Anderson audit firm as the auditor after declared bankrupt of Enron company, found some firms having Anderson as their auditor had changed this audit firm and had selected another before the lawsuit against the firm in court. However, most of firms had not changed their audit firms from Anderson to another. They concluded that the managers who changed their audit firm from Anderson to another had restated immediately their financial statements to improve their financial statements quality. Nevertheless, firms with delayed change of Anderson to another had lower quality financial statements. Berger and Hann (2007) declared that firms having high profitability were more interested in hiding their private information; therefore, they normally have more motivation to select lower quality auditors. Of course, managers of unprofitable firms may also intend to hide poor performance of the company from shareholders and investors through deceiving the auditors. Abidin (2006) indicated that developing countries normally choose big audit firms and explained that the firms with high debt ratio would not choose big audit firms as their auditors. He could not find any relationship between governance system and audit selection, but he showed there is a correlation between audit fees and auditor selection.

3. The proposed study

3.1. Variables

In this study, dependent variable is a dummy audit opinion type shown by one and zero. In case of unqualified audit report, the value is set to one and zero, otherwise. Independent variables are as follows:

Audit report type in the previous year : A dummy variable shown by 0 and 1. In case of unqualified audit report, the value is set to 1 and 0, otherwise.

Auditor-Management Alignment : A dummy variable shown by 0 and 1. The value is set to 1 when both below conditions are met and 0, otherwise (Malek & Ahmad, 2011):

A) A common member of board of directors should be in both parent and subsidiary companies.
B) Auditor of both parent and subsidiary companies should be the same.

Audit fees : This is a scale variable, which is calculated through natural logarithm of the audit expense of each company during each year.

Auditor change : A dummy variable shown by 0/1. In case of auditor change during a year, the value is set 1, otherwise it is 0.

Company size : A scale variable showing size and magnitude of company. This is calculated based on natural logarithm of sale in each company during each year.

Leverage : including total debt to total assets ratio.

Auditor type: A dummy variable shown by 0/1. In case of private firm the value will be set 1; and zero, otherwise.

Return on Assets: A ratio showing performance and profitability of a company. This variable is calculated by dividing net profit to total assets of a company.

Ownership Percentage: A scale variable composed of shares percentage owned by parent company in subsidiary company shares.

Industry type: A dummy variable shown by 0/1 for each industry. It is to explain that, industry type variable is considered as control variable in present study.

3.2. Sample Selection and Research Method

Our sample covers listed firms in Tehran Stock Exchange (TSE) across the period from 2003 to 2011. The sample selection criteria are:

A. The end of fiscal year is March 21.
B. Data is available at least for seven years over the period 2003-2011,
C. The company is not loss frequently for three years.

Given to above criteria, 81 companies were selected from different industries. It is to explain that some companies' data have been available since middle of research study. Therefore, observation number in all companies is not the same during the research period. Research method is correlation-type. Research data and information have extracted from financial statements of the listed firms in Tehran Stock Exchange available in it's electronic database. Hypotheses' testing is conducted based on logistic regression.

3.3. Research hypotheses

Given theoretical fundamentals and literature review, following hypotheses are stated for this study :

Hypothesis 1 : There is a significant relationship between audit opinion in the previous year and audit opinion in the current year.
Hypothesis 2 : There is a significant relationship between management-auditor alignment with audit opinion .
Hypothesis 3 : There is a significant relationship between audit fees with audit opinion. Hypothesis 4 : there is a significant relationship between auditor change with audit opinion .
Hypothesis 5 : There is a significant relationship between company size with audit opinion.
Hypothesis 6 : There is a significant relationship between debit ratio with audit opinion.
Hypothesis 7 : There is a significant relationship between auditor type with audit opinion.
Hypothesis 8 : There is a significant relationship between return on assets ratio with audit opinion .
Hypothesis 9 : There is a significant relationship between ownership percentage of parent company with audit opinion.

3.4 Descriptive Statistics

Descriptive statistics of research are presented in Tables 1 and Table 2. Table 1 shows descriptive statistics for research quantitative variables.

Table 1
Descriptive statistics of research (quantitative variables)

Variables	Observations	Debit Ratio	Return on Assets	Ownership Percentage	Total Sale (Million Rials)	Audit fees (Million Rials)
Average	458	0.6950	0.0786	81.4	479437.3	262.95
Median	458	0.7073	0.0735	90.6	163626	196.5
Standard Deviation	458	0.3631	0.1895	20.81	1121840.2	239.98
Min	458	0.000	-1.600	20.3	5	2
Max	458	3.833	0.9629	100	12397704	1693

In addition, Table 2 shows descriptive statistics associated with qualitative variables of the study. It indicates that the number of sample companies with same auditor is high. Also, unchanged of the auditor is much higher than auditor change.

Table 2
Descriptive statistics of research (qualitative variables)

Year	Audit Opinion		Management-Auditor Alignment		Auditor change		Auditor type	
	Number of unqualified reports in the current year	Number of qualified reports in the current year	With alignment	Without alignment	Audit change	Unchanged audit	Private section	Public section
2003	0	4	2	2	0	13	3	1
2004	8	13	15	6	2	14	12	9
2005	11	17	19	9	2	20	16	12
2006	13	19	18	14	8	22	21	11
2007	13	31	25	19	6	54	28	16
2008	23	36	30	29	8	52	34	25
2009	33	45	44	34	12	70	52	26
2010	45	48	58	35	16	71	65	28
2011	45	54	56	43	16	72	68	31
Total	191	267	267	191	70	388	299	159

3.5. Hypotheses Testing

According to Table 3, it can be declared that variables with a significant level of fewer than five percent (i.e. opinion type in the previous year, audit fees, audit type and return on assets ratio) have a significant relationship with audit opinion in a significant level of 95 percent. Hence, hypotheses 1, 3, 7 and 8 are approved. But, since significant level of other variables is higher than 5 percent, there is a significant relationship between these variables and audit opinion. Hence, hypotheses 2, 4, 5, 6 and 9 are rejected.

Table 3
Logistic regression estimates for the main model (N=458)
(Dependent variable is unqualified Opinion (1) or qualified Opinion (0) in auditor report)

Variables	β	p value
Constant	- 4.091	.023
Audit report type in the previous year	2.617	.000
Alignment	-.277	.308
Audit Fees	.374	.039
Audit Change	.346	.347
Client Size	-.093	.419
Debt Ratio	-.317	.548
Audit Type	-.592	.043
Return on Assets	1.817	.040
Ownership Percentage	.828	.267
Industry fixed effects		included
Pseudo R Square	0.383	
Chi-Square	220.174	0.000

3.6. Auditor's opinion model

In this section, given the results yielded in hypotheses testing, mathematical model of auditor's opinion is used for investigated companies. In former section, it made clear that opinion type in the previous year, auditor's fees, auditor's type and return on assets ratio have effect and significant relationship with auditor's opinion type. In Table 3, the coefficients related to each of independent variables are identified. Therefore, auditor's opinion model is extracted from Table 3 as following :

$$Y = -\,4.091 + 2.617\ X_1 + 0.374\ X_2 - 0.592\ X_3 + 1.817\ X_4$$

where:

Y= Dependent variable is unqualified opinion (1) or qualified opinion (0) in auditor's report.
X_1= Audit report type in the previous year. In case of unqualified report, the value is 1 and 0, otherwise.
X_2= Auditor's fees which is composed of natural logarithm of audit fee for each company in each year
X_3= Audit type. In case of private audit , the value is set 1; otherwise, it is 0.
X_4= Return on total assets ratio which is an indicator of profitability and performance of company.

Table 4
Pearson Correlation Matrix

	Auditor Change	Audit report type in the previous year	Alignment	Audit Type	Size	Return on Asset	Debt Ratio	Audit Fees	Ownership Percentage
Auditor Change	1	-.054	-.126	.133	-.034	-.093	.071	-.063	.014
Audit report type in the previous year		1	.144	-.208	.045	.107	-.169	.098	.112
Alignment			1	-.021	.035	.020	-.086	.063	.032
Audit Type				1	-.257	-.087	.008	-.327	.000
Size					1	.335	-.196	.476	-.235
Return on Asset						1	-.448	.174	-.038
Debt ratio							1	-.015	-.024
Audit Fees								1	-.226
Ownership Percentage									1

4. Summary and conclusion

Descriptive statistics results show that auditor change, audit fees and unqualified audit report have been increased during the research period. Hypotheses testing indicate that determinants in issuing unqualified audit report in study sample are: auditor's opinion in the previous year, audit fees, auditor type, return on assets have direct and positive relationships with issuing unqualified audit report in the current year. However, auditor type had negative and inverse relationship with auditor's unqualified opinion. Given the model, auditor's opinion in the previous year had the most severe relationship with issuing unqualified audit report in the current year. If auditor issued unqualified report in the previous year, the probability of issuing unqualified audit report would be 2.617 times. In other words, auditors prepare audit report of each year in accordance with audit report of the previous year. In addition, if return on assets ratio (i.e. indicator of profitability and performance of company) is high, the probability of issuing unqualified audit report will be 1.817 times. This suggests that the companies without profitability problem, meet the accounting standards more and thereby their audit report will be unqualified. Evidences of the study have indicated that if the auditor is a private audit firm, the probability of issuing unqualified audit report will be reduced up to 0.592 times. Results also show that with higher auditing fees, the probability of issuing unqualified audit report will be 0.374. Results also indicate that there is no relationship between management-auditor alignment, debit ratio, ownership percentage, company size with issuing unqualified audit opinion.

Results show that audit fees have direct relationship with unqualified audit report. Therefore, Iranian association of certified public accountants and Tehran stock exchange organization are proposed to have more control on way of determining audit fees and audit quality of audit firms. Results indicate that auditors prepare audit report of each year in accordance with audit report of the previous year. This causes that audit firms may spend lower time and budget for audit. Hence, Iranian association of certified public accountants and Tehran stock exchange organization are proposed to pay attention on spent time and budget in evaluation of the audit firms quality. Evidences approve that issuing unqualified audit report is more than those in private audit firms are. Therefore, it is proposed to compare and survey audit quality in audit organization with private audit firms.

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