An Investigation of the Relationship Between Audit Quality Through Measure of Auditor Size and Earnings Management in Firms Listed in Tehran Stock Exchange (TSE)

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Abstract: According to the Literature Background, Audit Quality is Directly is Directly Associated With Reliability of Financial Reports. The Present Study is Mainly Intended to Investigate the Relationship Between Audit Quality Through Metric of Auditor Size and Earnings Management in Firms Listed in Tehran Stock Exchange (TSE). To Determine Audit Quality From measure of Auditor Size and in Order to Measure Earnings Management, Discretionary Accruals and Adjusted Jones Model Have Been Used in This Study in the Present Study, a total of 122 Listed Firms in TSE Were Investigated During the Time Period (2005- 2009). Linear Regression Models, MC Fadden Test, and SPSS 21 Software Were Used For Hypothesis Testing, findings Show that There is a Significant Relationship Between Independent Audit Quality and Earnings Management. Also, there is a Positive Yet Weak Relationship Between Metric of Audit Quality, That is auditor Size, and Earnings management,Which is Statistically Insignificant; The Positive Relationship Indicates the Positive Impact of an Audit Organization as an Audit Firm With Good Reputation and Credibility on the Level of Earnings Management in Firms. The Weakness of This Relationship Indicates The Influence of Different Structures on Earnings Management in Firms.

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1. Introduction:

Global Events Including Economic Crises Have Highlighted the Essential Role of Reliable and Quality Financial Reports. These Events Also Indicate the Importance of Audit Quality in Other aspects and Areas of Financial reporting. Achieving the Quality of financial Reporting is Dependent on the Accuracy of Each ring of financial Reporting Chain One of These rings Which Plays a Significant Role in Supporting the Quality of Financial Reporting All Over the Word – Whether in the Area of Public Sector Capital Market or on in that of Private Sector –is Independent Audit. Independent Audit is Main Part of Underlying Inspection and Monitoring in any Organization as Well as a Significant Activity Based on public Interests, Ensuring That the information Contained in financial reports is Provided Fairly Accurately.

One Objective of Financial reporting is providing Information Which is Useful For Investors, Creditors and Other Current and Potential Users in Other Decisions Associated With Investment and Attestation and Other Decisions One of the Main Criteria Used By the Above Groups For Estimating the Power of Firm Profitability, Predicting Future Earning and its Associated Risks as Well as Evaluating the Management Performance is a Company`s Current and Past Earnings.

Earnings in Turn are Consisted of Accruals and Cash Items, Where Accruals are Largely Controlled By The Management. the Manager Could manipulate the Accruals (Accrual Items) in Order to Show the Firm performance Better Than What it Actually is and Increase the Capability of Predicting Future Earnings; This is What Nowadays they Call Earnings Management. In Other Words, managers Try to Create Consistent and predictable Results By Selecting Permissible Methods of Accounting, Since Most Investors and managers Hold that Firms Having a proper Profitability than Similar Companies. On the Other hand, According to agency Theory, Managers may Be Motivated Enough to Manipulate Earnings So as to Maximize Their Interests.Investment is Among Basic Needs For Transition From an Undeveloped Economy to a Developed One Undoubtedly, We Need to Gain the Confidence of Those Interested in Investing in Order to Direct Their Investments, To do This,, Investors Want Data Which Helps Them Conduct a Successful Investment. Accounting Earnings and its Components are Among Data Considered By Individuals While Making Decisions. This Figure is measured and identified Based on Accruals (Accrual Items). Pointing out That Audit Quality Increases the Reliability of Information, the Present Study deals With investigating the Relationship of Audit Quality and earnings prediction, The Information Needed By Investors.

2: Theoretical Framework and Background of the research:

(2-1) Theoretical Framework: Audit Can Be One of The Ways to Prevent and Reduce Earnings Management, Since The Reported Earnings in Audited Financial Statements Have Information Content and high Quality (Hanif, 2010). Earnings Management is One of the Factors Distorting the Quality of Financial Reporting and All Firm Stakeholders Take it Into Account, Since Any Intervention That Distors The Accuracy of Reported Earnings Would Affect The Users` Decisions (Zangin and Ozcan,2010).

Audit Quality: Great Efforts Have Been Made to Define The Term "Audit Quality", though None of Them has Gained Public Acceptance. Audit Quality is Defined as Auditor`s Reputation and Professional Care. Thus Auditor`s Reputation Would Increase the Credibility of Financial Statements and His Professional Care Would increase The Quality of Information Contained in Financial Statements (Nownahal, Nahr Et AL,2010). De Angelo (1981) Defines Audit Quality as the Probability of Discovering and Reporting Errors in Financial Statement. He Theoretically Suggested The Association Between Audit Quality and Audit Firm Size and Believed That Large- Sized Audit Firms Would Be Able to Audit More Companies and Their Total Fees are Separated Between Employer Companies and they are Not Separated Between Employer Companies and They are Not Dependent o Employers. Large Audit Firms Have More Independence, So They Perform a Higher Quality Audit. Davidson (1993) Also Believes That Managers Have Various Incentives to Manipulate Earnings, So That They Could Realize The Predictions of Financial analysts Thus, if The Audit Performed By Large Audit Firm is of Higher Quality, One May Expect More Errors in analysts` Predictions in Companies Audited By Smaller Audit Firms; in His Research, Davidson Confirms This. DYE (1993) and Lennox (1999) Also Reached the Same Conclusion in Their Studies.

***Earnings Management:**

The Philosophy of Earnings Management is to Utilize the Flexibility of Standard Procedures and Accepted Principles of Accounting. However, Various Interpretations Which Can Be Made From Methods of Implementing an Accounting Standard are Among Other Reasons For Earnings Management. This Flexibility is the Main reasons For the Existing Variety Seen in Accounting Procedures.When the Interpretation of a Standard is highly flexible, the Integrity of data Presented in Financial Statements Would Be Reduced. Matching and Conservatism Principles Also Could Lead to EarningsManagement. According to Getsho the Employer Firm Should Increase the First Quarter Profit of its Fiscal Year Without Adding to its Cash Balance and Only By Using accrual Methods of Depreciation Accounting, Tax Exemptions For Investments and Capitalization of interest. Firm managers have Approved That it Was Performed in Order to Provide More Realistic Financial in Order to Provide More realistic Financial Statements and Make The Firm`s Financial Statements Comparable to This of Other Firms in the Same industry. Financial Analysts and auditors Refer to This Phenomenon as " Accounting Trick". However, all These Measures Have Been Carried out Within the Framework of Accepted Accounting Principles. research Shows that Corporate Managers purposefully manipulate the reported Earnings By Selecting Their Own Accounting Policies to Change Accounting Estimates and Accruals, So That They Could Achieve Their Desired Objectives (Miller and John, P 402, 2001).

(2-2) Research Background:

Davis, So and Trumpeter (2002) in Their Study Concluded That There is a Negative Significant relationship Between audit Quality and Earnings Management. Tangelo and Vanstraelen (2005) Concluded That Audit Quality is Negatively Associated With Abnormal Accruals.results of a Research Conducted By Gore, Pope and Singh (2001) Confirms a Negative Relationship Between Audit Quality and Earnings Management in the Process of Initial Offering of Shares. Elder and Zhou (2001) in Their Study Concluded That the Presence of Audit Committee and its Size Would Reduce Earnings management in Their study, Fairuzanand and rashidah (2006) investigated the Impact of Audit Firm Size (a Sample of 5 Large Firms) and the Presence of Audit Committee on Accruals. results Suggested that Audit Firm Size Would Not Reduce the Amount of Discretionary Accruals,However, the Presence of and Active Audit Committee Within the Firm Would Reduce Them. Namazi, Mohammad; Bayazidi, Anvar and JabbarZadehKangarloui, Saeid (2010) in a Study investigated the Association Between Audit Quality and Earning Management in Firms Accepted in Tehran Stock Exchange (TSE). Their Findings Indings Indicated That Generally There is a Positive Yet Weak Relationship Between the Metrics of Auditor Size (Auditor Reputation) and Auditor Tenure, and Earnings Management, However it is Not Statistically Significant. Ebrahimi and Seyedi (2008) in Their Research on 71 Companies

Listed in TSE Investigated the Impact of Audit Firm Type (audit Organization and Other Institutions) and Type of Audit opinion in the Audit Report on Discretionary Accruals.They Concluded That Only Type of Audit Firm is Associated With Discretionary Accruals. Leuz (2001) and Bhattacharya (2001) and Bhattacharya (2001) Used Four Different Sizes of Earnings Management - Without Relying on Estimating Discretionary Accruals_ in Order to The Amount of Earnings Management, Because they Believed That Previous Models Were Not Able To Accurately Estimate The discretionary Part of Accruals and Might Cause Some Problems in Results.

3. Methodology:

(3-1) research Hypotheses: 1- There is a Significant Relationship Between Independent Audit Quality and Earnings Management. 2-there is a Significant Relationship Between Auditor Size and earnings Management.

(2-3) – Research Method: This is an Applied Research With Includes all Research in Which The Association Between Various Variables is Determined Using Correlation Between Variables is Determined using Correlation Coefficient.

(3-3) – Population and Sample: Population and Sample of the Present Study Consist of Firms Listed in TSE in a Time Period Beginning in (2005) and Ending in (2009) among a Total of 122 Firms, a Sample Was Selected For Model Estimation and Hypothesis Testing. The Selected Sample Includes Firms With the Following Qualifications:

1 – Firms Should Be Listed in TSE.

2-Their Fiscal Year Should Be Ended at The end of March

3- They Should Not Change Their Activity With Fiscal Year

Change During the Research Period.

4- They Should Not Be Among Financial Institutions

5-Their Information Should Be Available.

Accordingly, Total of 122vFirms Were Selected Through Stage Sampling.

(4-3) – Research Variables and Models: (1-4-3)- measuring the Independent Variables: The Independent Variable of the Current Study is Audit Quality. Various Definitions Have Been Suggested For The Term " Audit Quality " For Example, De Anglo Defined Audit Quality as " The Possibility of MarketAssessment of Significant Distortions I Financial Statements Discovered By Auditing and Reports on These Distortions ". in This Study, audit Quality is Measured Based on Audit Firm Size.

(2-4-4)- Measuring Dependent Variables: After Data Collection and Preparation, Firstly The Adjusted Jones Model (1991) Presented By Kothari, Leone and Wasely (2005) is Used to Decompose Accruals Into Discretionary and Non- Discretionary Components (Representative of Earnings Management), as Follows:

In the Above Equation, $TACC_{it}$ = Total Accruals (Net Income Before Extraordinary items Minus Net Cash Flows From Operating Activities); (TA_{it}) = Total Assets in Year (t) For (i) TH Firm;Δ REV= Change in Revenues From year (t-1) To Year (t) For (i) TH Firm; PPE (Property, Plant and Equipment)= Gross Value of Fixed Assets in Year (t) For (i) TH Firm;E_{it} = Residual of Regression Which is Cross – Sectionally Uncorrelated and Normally Distributed With Zero Mean.

Model (1) Was Separately Estimated For Each Industry and Year and the Estimated Coefficients Obtained From The Model (Regression)Were Used For Estimating The Level of Discretionary Accruals As Below:

Where, $DACC_{it}$ = the Component of (Discretionary)= Managed Accruals For Firm (i) in Year (t); Δ REV_{it} = Changes in Receivables From Year (t-1) to Year For (i)TH Firm.

(3-4-3)- Models For Hypothesis Testing: The Following Model Was Used For Hypothesis Testing:

Where, $DACC_{it}$ =Absolute Discretionary Accruals; AUD = Indicator (1) Was Considered For Audit Firms With High Quality, and O (Zero) For Other Audit Firms; BETA= Systematic Rick (Obtained From TSE Database); BM = Book to Capital Market Value Ratio; Lev = Total Liabilities (Debts) Divided By Total Assets; Size =Log of Capital Market Value; CFO = Cash Flow From Operating Activities Divided By Total Assets at the Beginning Fiscal Years; T/PT= in Case the Company Has Seen Two Consecutive Years of Losses, it is (1) and Otherwise, it is 0(Zero); Percentage of Ownership For Institutional Shareholders; INDIR = Percentage of Non – Executive Directors.

4. Data Analysis:

(4-1) – Descriptive Statistics:Fig (1)

Shows Descriptive Statistics of the Research. Among Variables of the Present study, the Variable Auditor Size in Company Has the Maximum Dispersion Coefficient (Ranging From Level 1 Audit Firms to Level 2 Ones and Vice Versa). This Indicates Further Tendency of Employers to Change Auditors (From audit Organization to Other Audit Firms and Vice Versa) Over the Study Periods, Since in Recent Years Audit Work Has Been Transferred to Private Organizations Which are Members of the Practices to Be Transferred to Private Firms.

Fig (2) Presents the results of Explaining the Relationship Between Earnings Management and

Audit Quality in the Form of Metric of Auditor Size By Using Regression Model of Maximum Likelihood – Binary Logit. As Regression Coefficients Show, There is a Positive Relationship Between Earnings Management and Metric (Measures) of Earnings quality, However These Coefficients Are Not Statistically Significant. MC Fadden Determination Coefficient Also Indicates the Insignificance of the Model in General and the Weakness of this Relationship.

Fig (1): Descriptive Statistics Associated With Research Variables:

Variables Statistics	Earnings Management	Auditor Size
Number of Samples	122	122
Mean	0/39	0/33
Standard Deviation	0/10	0/10
Dispersion Coefficient	1/03	1/13

Fig (2):Overall Regression Model of Maximum Likelihood – Binary Logit:

Earnings Management=Dependent Variable	Constant		Auditor Size	
Regression Coefficient	0/75		0/14	
Z- Statistic Value	2/24		0/23	
P- Value	0/48		0/78	
Likelihood Ratio Statistic	Degree of Freedom	LR	Value of Size	P- Value
	2		3/03	0/22
MC Fadden Determination Coefficient	0/05			

Fig (3) Shows That there is a Positive Relationship Between Earnings Management and Auditors Size, Which is Statistically Insignificant and According to MC Fadden Determination Coefficient (0/02), it is a Weak Association. Further, Likelihood RatioStatistic indicates the Insignificance of the Model in General. The positive Relationship Between the two Variables Shows That Auditor Size as One Measure of Earnings quality is Effective on the Amount of Earning management in Companies Listed in TSE, However the Weakness of This Relationship indicates That Other Factors Other Than Auditor Size are Effective on Earning management.

Fig (3) Positive Relationship Between Earnings Management and Auditors Size

Earnings Management=Dependent Variable	Constant		Auditor Size	
Regression Coefficient	0/07		0/53	
Z- Statistic Value	0/18		0/88	
P- Value	0/73		0/30	
Likelihood Ratio Statistic	Degree of Freedom	LR	Value of Size	P- Value
	1		3	0/25
MC Fadden Determination Coefficient	0/02			

5. Conclusion and Suggestions

*Conclusion Earning Management is One of the Most Popular Topics Among Investors, Legislators, analysts, and all Users of Financial Statements. According to Fisher, Earnings Management is Purposeful Intervention o Managers in the Process of External Financial Reporting " Audit Quality, Since Firms Which manipulate and Manage Earnings are More Prone to have Adjusted (qualified) audit report. The purpose of This study is to investigate the relationship Between Audit Quality Through the Metric (Measure) of Auditor Size and earnings management in listed Firms in STE (Tehran Stock Exchange).

Results of First Hypothesis Testing Show That There is Significant Relationship Between Independent Audit Quality and Earnings Management. Also,the Result of Second Hypothesis Testing Clearly Indicates That There is a Positive Yet Weak Relationship Between the Metric of Audit Quality, That is auditors Size, And Earnings Management, Which is Statistically Insignificant. This Positive Association Implies a Positive Influence of the Presence of Audit Organization as a

Reputable and Creditable Audit Firm On the Extent to Which Earning are Managed and Manipulated Within Companies. As Well, Weakness of This Relationship Indicates the Effectiveness of Various Structures on Corporate Earnings Management.

***Suggestions:**

Since the Reliability of Corporate Financial Information is One of the Reliability of Corporate Financial Information is One of the Factors in Winning the Investors` Trust, High Quality Audit Would Lead to More Transparency of Information, Which Seems Necessary For Market Success in Attracting Investors. Confirmation of the Study Hypotheses Indicates That Increased Audit Quality Would Improve the Quality of Information as Well as Financial Decisions. Accordingly We Suggest That Listed Companies in Tehran Stock Exchanges (TSE) Organization During Many Years, Use Various Auditors to Audit Financial Statements.

*Suggestions For Future Research: 1_ To Repeat the Present Study By Using Other Measures of Audit Quality 2_ To Investigate a Non_ Linear Relationship Between Earnings management and Measures of Audit Quality 3_ To Investigate how to Increase the Level of Audit Quality According to Independent Variables in Small Firm.

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