

Audit Opinion and Earnings Management: Empirical Evidence from Iran

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Abstract: The external auditor plays a vital role in the corporate governance mosaic through its influence on promoting the quality of financial reporting. From this optic, the audit opinion acts as a guardian of the management's behavior, especially when there is an increased tendency of earnings manipulation. In this paper, in order to examine the relationship between qualified audit opinion as independent variable and earnings management as dependent variable is used, and the main objective of this study determining the presence, amount and the kind of relationship between the mentioned variables which use actual and historical data of the companies' Metal and non-metallic minerals industry member companies of Tehran Stock Exchange in 2009 to 2013 is used. We divide the qualified audit opinions into two categories: qualified for the going-concern uncertainty and qualified for other reasons. The results indicate that audit opinions are not related to earnings management. Client financial characteristics, such as profitability and size are determinants of the going-concern audit opinion decision. The decision of auditors to issue qualified opinions for other reasons is explained by the type of audit opinion issued in the previous year.

Keywords: Audit Opinion, Earnings Management, Discretionary Accruals, Tehran Stock Exchange.

Introduction

The separateness of ownership from management provide this potential for managers to make decisions that are in line with their own interests and against the shareholder ones, conflict of interests which is interpreted as representation issue is the result of differences in the utility function of stakeholders. Considering the theory of conflicts between managers and owners interests one can argue that business managers may have the needed incentive to manipulate the benefits in order to maximize their benefits. On investigations on earning management, discretionary accruals meaning the items which management can manipulate the, have a great role. Accruals make difference between profit and cash flow, so supposing no manipulation occurs the only possible way is to manipulate the discretionary accruals. One of the affective ways in controlling discretionary accruals manipulation by manager which is the same as profit management is audit. This ways that a communication make a bridge between audits findings with people inside and outside the company, are made as audit opinion that play an important role in alerting financial statements consumers about identifying problems that may encounter the company.

The main philosophy of audit is validating the reflected information in financial statements. Because, this information is the main basis of different groups decisions like shareholders, potential investors, brokers, managers, financial consultants, analysts, creditors and government. Therefore, from the point of view of users, especially

shareholders, audit is beneficial when auditors spend time on assessing and analyzing the continuity of contact, the financial statements are free of error, fraud, illegal acts which are effective on the aimed company and announce their rate of success with respect to the mentioned tips. Considering the different result of past studies, two opposing viewpoints have been made. According to the first view, the companies which are encountering a crisis and their activity continuing is faced with ambiguity, may use earnings management to hide their status. In such a situation, the auditor chooses a conservative approach to minimize the risk of litigations and loss of reputation. The first group are more believed in increasing the level of auditor's conservativeness while encountering important ambiguity in the company's activity's continuity and mention that there is a direct relationship between reports on the subjects and discretionary accruals in such cases. In this approach, the main reason of reporting on the subject is considered to be uncertainty of activity's continuity not earning managements (lack of relationship between opinions and earning managements). In other words, according to this approach, some situations like activity continuation uncertainty increase the auditors' sensitivity and conservativeness due to increasing the auditors' risks. And in this kind of situations the probability of reports on the events is more than the cases that earning managements done and such a sensitive situation (not being sure of activity continuation) is not possible.

According to the second approach, earnings management is the cause of reports on the cases (for any reason like ambiguity in the activity continuation or some other reasons). That is why, due to increasing discretionary accruals which are the result of manipulation in income items, is considered a cost, the probability of reports on the case increases and this case is not necessarily related with companies' activity (Tsipouridou & Spathis, 2012). So, considering the importance of auditor's opinion and earning management in this study the relationship between the auditor's report on the issue and earning management is being analyzed. For this reason, in order to examine this relationship qualified audit opinion as independent variable and discretionary accruals as dependent variable is used, and the main objective of this study determining the presence, amount and the kind of relationship between the mentioned variables which use actual and historical data of the companies' Metal and non-metallic minerals industry member companies of Tehran Stock Exchange is used.

Literature review and hypotheses

Our study revisits the potential link between earnings management and the likelihood of receiving a qualified opinion. Prior studies, mostly from the US, provide mixed evidence on the nature of this relationship. Francis and Krishnan (1999), using a large sample of US listed firms and after controlling for client-specific financial and market risk variables, find that auditors of firms with high levels of accruals in absolute terms are more likely to issue qualified opinions for asset realization uncertainties and for going-concern problems, than auditors of firms with low absolute levels of accruals. These relationships stronger for firms with large negative accruals. Similarly, Bartov et al (2001), in a study examining the ability of various accruals models to detect earnings management, find that a significant positive link exists between the absolute value of discretionary accruals and the likelihood of receiving a qualified opinion. However, this relationship is significant for only two of the models tested – the cross-sectional Jones (1991) model and the cross-sectional modified Jones (Dechow et al., 1995) model. By contrast; Bradshaw et al (2001) find no evidence that the frequency of qualified audit opinions is higher in firms with sizeable accruals. They conclude that auditors do not alert investors to the increased incidence of future earnings declines and GAAP violations that are often associated with high levels of accruals on a timely basis. The rationale is that such earnings quality issues are beyond the scope of the audit. In other words, auditors may understand that inflated accruals imply a greater likelihood of future earnings declines and GAAP violations, but they are not required to communicate this information to investors through their audit opinions. Butler et al (2004) support this view and conclude that auditors are unlikely to issue qualified opinions for earnings-management reasons. More specifically, based on over 7000 qualified opinions of US firms for the period 1994–1999, they examine the relationship between abnormal accruals and audit opinion type. They find a positive association between modified opinions and abnormal accruals, when accruals are measured in absolute terms. When they change the dependent variable from the absolute level to the actual amount of abnormal accruals, they discover that qualified opinions are negatively related to accruals. They attribute this negative association to the fact that firms with large negative accruals tend to receive GC opinions, which are motivated more by their distressed status and not by earnings management. Overall, they find no evidence that auditors use the audit opinions to alert financial statement users of either excessive earnings management or the consequences of high levels of positive accruals. The above studies are conducted in the US. Few investigations from countries with different institutional settings and auditor reporting regimes have investigated this issue. Herbohn and Ragunathan (2008) investigate whether a negative association exists between actual abnormal accruals and the probability of receiving a qualified audit opinion in Australia. They focus on a sample of firms listed on the Australian Stock Exchange over the period 1999–2003. Consistent with Butler et al (2004), they document a negative link between the likelihood of a qualified opinion and accruals that is driven by

going-concern issues for firms with a greater risk of financial distress and audit litigation. Their results suggest that earnings management is not the cause of audit opinion qualifications. Arnedo et al (2008) test this relationship in a Spanish context for a sample of private pre-bankrupt firms. They separate the qualified opinions into two groups – qualified based on going-concern issues and qualified for other reasons. Their evidence, consistent with Butler et al. (2004), reveals a negative association, which stems from reports containing uncertainty about the likelihood of a firm continuing as a going-concern. A positive relationship is found, however, when the reasons for the qualification are other than the going-concern. Unlike Butler et al (2004), they claim that auditor reporting is a positive response to earnings management and that the negative relationship in going-concern cases is a consequence of auditor conservatism rather than a result of the distressed status of the firm and its liquidity tactics for survival. The inconclusive evidence of prior studies raises a question regarding the association between earnings management and the issuance of a qualified audit opinion in Greece. In contrast to the US, where most audit reports are qualified based on the going-concern uncertainty, Greek qualified audit reports are frequently issued for reasons other than going-concern. This implies that auditors have the opportunity to convey different warning signals to users of the financial statements. As Lam and Mensah (2006) state, it is an empirical question of whether auditors, when granted a greater degree of flexibility by both a more limited litigation-risk environment and the option to issue a wider range of audit reports, attempt to convey more information to the public. In an effort to examine this relationship in detail, we divide qualified opinions into two categories– qualified based on the going-concern uncertainty and qualified for reasons other than the going-concern uncertainty. Our hypotheses, stated in the null form, are as follows: Hypothesis: Qualified audit opinions for going-concern uncertainty are not associated with discretionary accruals, other things being equal.

Materials and Methods

The present study is practical in term of objective and descriptive and correlational considering nature and method. Also in terms of time is after the events type. Moreover, this is a correlational one in term of nature and method. This study is regression (after the event) in term of study nature. In the present study, the needed data about company members of metallic and non-metallic industry during the year 2009 to 2013 have been collected by electronic archives of Tehran exchange market and financial information cds of the accepted companies. In order to analyze data and test the hypothesis, multiple regression analysis and Pearson correlation are used, this means that first needed information to perform the calculation mode and then regression tests are done to explore the relationship between audit opinions and earning management (discretionary accruals) in the metallic and non-metallic industry. Also, Excel and EVEIWS soft wares are used to analyze the information and statistical tests. In order to examine the statistical hypothesis, first derived regression model accuracy is analyzed and then using T and F tests the amount of effect of independent variable on the dependent variable as tested.

Results

Table 1. Results of the regression model analysis.

$$GC_{it} = \beta_0 + \beta_1 DA_{it} + \beta_2 TURN_{it} + \beta_3 INVREC_{it} + \beta_4 TLE_{it} + \beta_5 ROA_{it} + \varepsilon_{it}$$

Dependent variable: audit opinion on activity continuation(GC)					
Independent variable	Symbol	Ratio	Z statistics	Significant level	Result
	β_0	0.553533	0.651066	0.5150	-
Earning management	DA	2.902767	0.847314	0.2968	Rejected
Ratio of total sales to total asset	TURN	2.184032	1.482926	0.1381	Rejected
Ratio of inventory, accounts and received notes to total asset	INVERC	-6.381104	-2.613417	0.009	Approved
Ratio of total debt to total salary of shareholders	TLE	-13111102	-2.774844	0.0055	Approved
Assets output	ROA	-2.078601	-0.675062	0.4996	Rejected
McFan determination sufficient		0.159488	LR statistics(significant level)		26.54280 (0.000070)

As it is shown, LR, the coefficient of mc fan is 0.159 and the Circumstantial evidence value is 26.542 and the probability statistics LR is 0.000 and since its value is less than 0.05, and the model significance is approved. Hasmer-Lamsho tests results and also the percentage of prediction accuracy are provided in below table, given that the value of prediction accuracy are relatively high for and also total value of prediction accuracy is 25.62, so the utility of the model is approved. On the other hand, Hasmer-Lamsho and Androz probability value are more than 0.05, so the null hypothesis is accepted and the model proper explaining capability is approved.

Table 2. Hasmer-Lamsho test and Accuracy prediction percentage

Hasmer-Lamsho test		Accuracy prediction percentage	
Androz statistics(possibility amount)	Hasmer-Lamsho statistics(H_L) (possibility amount)	84.00	Dep=0
3.5097 (0.8984)	4.1196 (0.8622)	24.33	Dep=1
		76.90	Total

According to the results of 2, coefficient value, z statistics and the significance level for the first hypothesis, are respectively 2.902767, 0.847314 and 0.3968. Since significant level is more than 0.5 so the null hypothesis of ineffectiveness of audit qualified opinions about doing audit with respect to activity continuation, with the discretionary accruals in metallic and non-metallic minerals industry is accepted (first hypothesis rejection).

Conclusion

In this paper, in order to examine the relationship between qualified audit opinion as independent variable and discretionary accruals as dependent variable is used, and the main objective of this study determining the presence, amount and the kind of relationship between the mentioned variables which use actual and historical data of the companies' Metal and non-metallic minerals industry member companies of Tehran Stock Exchange is used. The hypothesis states that qualified audit opinion has a significant effect on activity continuation with metallic and non-metallic minerals industry discretionary accruals. These results can be interpreted in a way that the auditors is not sensitive to discretionary accruals and in the cases that the company's activity continuation is possible, there is no possibility of issuing opinions. Since uncertainty about the activity continuation of the company, cause increasing the natural risk of auditing and the possibility of financial crisis and rising legal crisis in this cases is possible. In other words, the amount of client discretionary accruals in cases which there is uncertainty about company's activity's continuation, it has no relationship with issuing qualified opinions.

Conflict of interest

The authors declare no conflict of interest

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