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The Relationship between two Dimensions of Audit Committee on Financial Reporting Quality in Tehran Stock Exchange

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Abstract: The credibility and relevance of financial reporting information is evaluated by the audit committee in collaboration with internal auditors and external auditors. The aim of this study is to investigate whether or not the accounting experts and independence of audit committee suggested in theory and required by law are associated with the financial reporting quality in Tehran Stock Exchange. Thus, data from 2015 to 2016 are used for 54 Iranian companies that have established an audit committee. This empirical study showed a positive and significant association between the proportion of audit committee members concurrently holding more than three directorships and financial statement quality. It also finds evidence that audit committee independence is significantly related to financial reporting quality.

Keywords: Audit Committee, Corporate Governance, Accruals, Financial Reporting Quality, Tehran Stock.Exchange.

Introduction

In February 2005, the European Commission recommended the establishment of an audit committee for all listed firms. The European Parliament and the Council of the European Union developed this into legislation in December 2005 (European Parliament and the Council of the European Union, 2006). The implementation of this recommendation by member states is occurring through changes to laws or through corporate governance codes based upon the 'comply or explain' principle. In the United States (US), compliance to the Sarbanes–Oxley Act is mandatory. The audit committee is empowered by the board of directors to gain expertise and resources that aim to enhance the quality of financial statements. The objective is to increase the visibility and credibility of the information released by companies, which has become an important issue in the aftermath of several well-known fraud scandals.

The credibility and relevance of financial statement information is evaluated by the audit committee in collaboration with both internal auditors (especially in large organizations) and external auditors (Piot & Janin 2007). The objective of this study is to investigate whether or not the audit committee characteristics suggested in theory, recommended in the Corporate Governance Code guidelines and required by law are associated with the financial statement quality of Iran companies.

The Iran Corporate Governance Code was published in 2011 to provide standards of good practice. Other countries such as Belgium has reinforced corporate governance via the law of 17 December 2008 that requires each company's board of directors to establish an audit committee for all listed companies, including insurance, credit and investment companies (Moniteur Belge, 2008). Companies are only exempted if they meet two of the three following criteria:

• 250 employees;
• 43,000,000 euros of total assets; or
• 50,000,000 euros of net earnings.

In these cases, the board of directors undertakes the audit committee's duties. The Iran Corporate Governance Code recommends that the audit committee is comprised primarily of independent directors. Additionally, the Code recommends that at least one member of the audit committee is competent in accounting and audit. Previous studies, such as those by Carcello et al (2006) and Krishnan and Visvanathan (2008), find that members with expertise in accounting and audit are in a better position to monitor the quality of financial information. Furthermore, the Iran Corporate Governance Code recommends not appointing directors that have more than five directorships. Aside from the directors' profiles, there are two essential characteristics to study: the size of the audit committee and the number of committee meetings. The Code stipulates that the audit committee should have at least three members, whereas the law remains silent on this matter. The Code also recommends four meetings each year, while this is not covered by the law (Moniteur Belge, 2008). This study extends the existing literature by examining whether audit committee characteristics are related to financial statement quality in the Iran context. This context differs from that of prior research. Previous studies indicate that the Sarbanes–Oxley Act and continental European corporate governance mechanisms differ.

This means that the other half has created an audit committee either in the 6 years before the enactment of the corporate governance law, or immediately after it, which clearly shows the limited maturity of audit committees in Iran. Given the predominance of young audit committees, in theory there is still room for improvement. Therefore, this study can be seen as forming the first objective evaluation of the added value of audit committees, which may be very helpful for those audit committees seeking to improve their composition and way of working.

In other words, the findings of this study are potentially relevant to both audit committees and policy-makers. These studies suggest that audit committees are able to reduce earnings management and therefore increase the quality of financial information. Audit committee members, in collaboration with external auditors and management, provide supervision of financial statement quality. The objective of the current study is to examine the characteristics of audit committees more closely in order to determine which of these influence the quality of financial statements. These characteristics can be divided into three categories:

1. The audit committee directors' profiles;
2. The audit committee's meeting frequency;
3. The size of the audit committee.

Literature review and development of hypotheses

Previous studies focus on a similar association in different contexts. Cernat (2004) argues that there is no convergence in Europe because the European and Anglo–Saxon models of corporate governance are weakly compatible, and the European Commission is poorly equipped to propose a well-articulated governance model. The study by Collier and Zaman (2005) confirmed that in several countries—Belgium, Greece, Spain and Switzerland—the audit committee concept does not always conform to the Anglo–Saxon model. Later, Enriques (2006) reports that the European Commission, despite its ability to legislate incorporate law matters, has traditionally had a much lower impact on European companies' corporate governance than its US counterpart. To the researchers' knowledge, this is the first study on this topic in the Iran context. Audit committees are a relatively new phenomenon in Iran, which makes this study unique, given that in most other studies audit committees have a longer history and may have already improved their way of working based on the findings of previous academic studies. A previous study on the drivers of voluntary audit committee adoption in Belgium by Willekens et al (2004) has shown that at the start of this century (2001–2002), only half of all Iran listed companies had an audit committee despite the recommendations of the Brussels Stock Exchange. First, in a sample of state-owned Canadian firms, Bozec (2007) shows a reduction in earnings management when an audit committee is established. This outcome suggests that the creation of an audit committee diminishes intentional earnings management. Second, Piot and Janin (2007) investigate the same relationship in France from 1999 to 2001, and also find that the constitution of an audit committee is positively associated with the quality of financial statements. Third, Baxter and Cotter (2009) report a relationship between audit committees and improved earnings quality for a sample of Australian listed firms.

Three aspects of the profile of each director can be studied: independence, expertise and busyness. Independent audit committee members and quality of financial statements Audit committee independence is considered crucial in monitoring financial statement quality. According to the Iran Corporate Governance Code, the audit committee should be composed of a majority of independent members. Iran law is less strict, and requires at least one independent member in the audit committee (Moniteur Belge, 2008). In the US, all members are required to be independent. This attribute was studied by Klein (2002) in a sample of 687 US-listed companies. The results show a negative relationship with earnings management; in other words, a higher proportion of independent audit committee members seem to improve the quality of financial statements. The explanation that Klein (2002) provides is that independent members are more resistant to management pressure and are better able to maintain their objectivity.

Be´dard et al (2004) examine whether a majority of independent members is associated with a reduction in earnings management. They found evidence that independence allows reduced earnings management only when the entire audit committee is composed of independent members, rather than only a majority of the committee (Be´dard et al., 2004). More recently, an Australian study by Kent et al (2010) finds a significant negative association between independence and earnings management. The more independent members appointed to the audit committee, the less management is able to manipulate financial statements (Kent et al., 2010). Other studies, such as those of Xie et al (2003), Piot and Janin (2007) and Baxter and Cotter (2009) do not report a significant relationship between independent audit committee members and earnings management. Therefore we hypothesis a negative relationship between independence and earnings management:

H1: There are relationship between independent audit committee members and the magnitude of earnings management.

Financial expertise of audit committee members and quality of financial statements The Iran Corporate Governance Code and the Iran law require that at least one audit committee member has a background in audit and accounting. In the US, the regulation requires the audit committee chair to have audit and accounting expertise. Be´dard et al (2004) use a sample of US firms to determine whether there is an association between the audit and accounting expertise of audit committee members and financial statement quality. Baxter and Cotter (2009) examine the same relationship in an Australian setting. Carcello et al (2006) find a relationship between audit committee accounting expertise and reduced earnings management. These three studies report a negative relationship between the audit and accounting expertise of audit committee members and measures of earnings management. DeFond et al (2005) examine market reactions when new directors are appointed to the audit committee. They focus on 3 days of the abnormal returns of 850 companies that had appointed a new member to the audit committee between 1993 and 2002, and find that the market reacts positively only when a new nominated member has audit and accounting expertise. They explain this by the fact that these experts are supposed to be more effective in monitoring financial statement quality (DeFond et al., 2005). However, the study by He et al (2008) shows that if all audit committee members have an audit and accounting background, the audit committee is less productive, as the audit committee members do not have a sufficiently broad range of competencies to achieve their goals. Since the results of these prior studies are mixed, we do not predict the sign of the relationship. This leads to the following hypothesis:

H2: There are relationship between audit and accounting experts in the audit committee and the magnitude of earnings management.

Materials and Methods

The data analyzed in this study was collected from company annual reports from 2015 to 2016, and included 54 listed Iran firms that have an audit committee because they exceed the mandatory size thresholds for number of employees, total assets or net earnings. Financial institutions were excluded from the study. The audit committees' characteristics were found in their financial statements or were obtained directly via e-mail if this information was not publicly available. This empirical study demonstrates a positive and significant association between the proportion of independent audit committee members and financial statement quality. It also finds that the proportion of audit committee members concurrently holding more than three directorships is positively related to financial statement quality. The following model used in this paper:

$$DA = \alpha + \beta_1 ACind + \beta_2 ACacc + \beta_3 ACsize + \beta_4 SIZE + \beta_5 ROA + \beta_6 LEV + \varepsilon$$

Where:

DA = discretionary accruals,

ACind = the proportion of independent directors in the audit committee,

ACacc = the proportion of audit and accounting experts in the audit committee,

ACsize = the number of directors in the audit committee,

SIZE = the natural logarithm of total assets,

ROA = return on assets,

LEV = total liabilities to total assets ratio,

Result

Table 1 presents descriptive statistics for the dependent and independent variables in the study.

Table 1. Descriptive statistics.

	Mean	Median	SD	Min	Max
Valid Data	54	54	54	54	54
DA	-0.019	-0.004	0.077	-0.2	0.14
ACind	66%	66%	0.24	0 %	100 %
ACacc	39%	33%	0.24	0 %	100 %
ACsize	3.3	3	0.75	2	5
SIZE	15	13.68	1.9	12.39	18.66
ROA	4 %	5.5 %	1	-29.5 %	38.8 %

Table 2 shows the Pearson and Spearman correlation coefficients and their significance. Two significant correlations were found between the dependent variable and independent variables.

Table 2. Correlation matrix.

	DA	ACind	ACacc	ACsize	SIZE	ROA
DA						
Pearson's corr	1					
Sig. (bilateral)						
ACind						
Pearson's corr	-0.29	1				
Sig. (bilateral)	0.016					
ACacc						
Pearson's corr	-0.121	-0.055	1			
Sig. (bilateral)	0.19	0.364				
ACsize						
Pearson's corr	-0.9	-0.228	0.231	1		
Sig. (bilateral)	0.238	0.5	0.064			
SIZE						
Pearson's corr	0.33	-0.19	0.255	-0.68	1	
Sig. (bilateral)	0.37	0.098	0.05	0.225		
ROA						
Pearson's corr	0.019	-0.161	0.156	0.233	0.44	1
Sig. (bilateral)	0.48	0.161	0.174	0.042	0.004	

Conclusions

The credibility and relevance of financial reporting information is evaluated by the audit committee in collaboration with internal auditors and external auditors. The aim of this study is to investigate whether or not the accounting experts and independence of audit committee suggested in theory and required by law are associated with the financial reporting quality in Tehran Stock Exchange. This study investigates the relationship between audit committee characteristics and earnings manipulation, inspired by prior research. The time period for the study corresponds with the implementation of the Iran Corporate Governance Code and law. Piot and Janin (2007), Bozec (2007) and Baxter and Cotter (2009) have investigated this topic in France, Canada and Australia respectively. They find that the constitution of an audit committee improves the quality of financial statements.

Based on an analysis of 54 Iranian listed companies that are legally required to have an audit committee, two main conclusions can be drawn. First, evidence is found for a significant positive association between the proportion of independent audit committee members and the quality of financial statements released by companies. Independent directors seem to have a greater ability to resist management pressure and maintain objectivity. This finding is consistent with those of Klein (2002), Be´dard et al (2004) and Kent et al (2010). Second, support is found for a positive and significant relationship between the proportion of audit committee members concurrently holding more than three directorships and the quality of financial statements. This finding reveals an experience effect on the part of directors.

Conflict of interest
The authors declare no conflict of interest

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