

# Independent Auditor Opinion, Corporate Governance and Financial Reporting Quality in Firms Listed in Tehran Stock Exchange

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**Abstract**—The aim of this research is to investigate the relationship between the independent auditor, the Corporate Governance (CG) and accounting information quality of firms listed in Tehran Stock Exchange (TSE). In the study, 90 firms investigated during 2003-2012. Researcher-made questionnaire is applied based on CG codes of TSE to measure the CG quality. Dechow and Dichev model is used for calculating of the accounting information quality. The findings of study indicate the unqualified opinion ratio is not more than the qualified opinion ratio in the companies with the strong quality level of the CG, and the accounting information quality too. However, in the companies with the low and average quality levels of the CG, and the accounting information quality, the qualified opinion ratio is more than the unqualified opinion ratio. Also, the results show that there is the positive strong correlation between CG and the accounting information quality.

**Keywords**—Accounting Information Quality, Corporate Governance, Qualified Opinion, Tehran Stock Exchange, Unqualified Opinion

**Abbreviations**—Corporate Governance (CG), Tehran Stock Exchange (TSE)

## I. INTRODUCTION

**D**YNAMIC capital market relies on investor's confidence on financial reporting quality. After corporate scandals of in early 2000s and the recent financial crisis, policy makers and regulators have turned their attentions for improved quality of financial reporting and greater transparency [Bardos, 2011]. One of these regulations is passing Sarbanes-Oxley Act and changes to stock exchange listing standards aiming to improve the quality of financial reporting [Carcello et al., 2006]. On the other hand, efficient capital markets require high-quality financial reporting, which in turn facilitates the efficient raising and allocation of corporate capital and thus creates benefits for investors [Wang & Wub, 2011].

There are many factors may affect financial reporting quality such as CG which is our concern in this study. The emphasis of CG is changed from stockholders' rights to stakeholders' rights [HasasYeganeh, 2004]. One of the important roles of CG is assurance about the quality of financial reporting in firms. The effect of good CG on

increasing financial reporting quality is a subject that received many attentions in regulation settings and the firms listing conditions of stock exchange listing. It is highly expected that good CG increases financial reporting quality because it serves as tool for supervising management affairs. This may consequently lead to impact independent auditor opinion as firms with high financial reporting quality is more likely to receive unqualified independent auditor opinion. However, simply stated, CG is expected to impact on independent auditor opinion.

On the other hand, independent auditor opinion may also affect financial reporting quality in the way that with issuance of qualified or adverse opinion, firms manager try to coherent with GAAP to avoid such opinions leading to increasing financial reporting quality. Bradshaw et al., (1999) argue that firms with high accruals are more likely to experience future earnings reversals and SEC enforcement actions for GAAP violations, but that investors do not appear to anticipate these consequences. This enforcement is based on audit opinion on firm's financial statements. However, it is expected that firms that taken qualified or adverse opinion has not a good

financial reporting quality. These relationships are presented in figure 1.



Figure 1 – The Relationships between Independent Auditor, CG and Financial Information Quality

However, taking these arguments, the purpose of this study is to investigate the interaction between three variables of independent auditor opinion, CG and accounting information quality in firms listed in TSE. More precisely, this study tries to find out if accounting information quality affect qualified audit opinion or unqualified audit opinion and whether high rank of CG codes increase accounting information quality and whether good (weak) CG results in unqualified (qualified) audit opinion.

## II. LITERATURE REVIEW

Bradshaw et al., (1999) examined earnings quality and financial reporting credibility. They find no evidence that auditors signal the higher likelihood of GAAP violations through their audit opinions.

Chtourou et al., (2001) investigated as to whether a firm's CG practices have an effect on the quality of financial information. They find that earnings management is significantly associated with some of the governance practices by audit committees and boards of directors. For audit committees, income increasing earnings management is negatively associated with a larger proportion of outside members who are not managers in other firms, a clear mandate for overseeing both the financial statements and the external audit, and a committee composed only of independent directors that meet more than twice a year. They also find income decreasing earnings management is negatively associated with the presence of at least a member with financial expertise and a clear mandate for overseeing both the financial statements and the external audit. For the board of directors, they find less income increasing earnings management in firms whose outside board members have experience as board members with the firm and with other firms. They finally find that larger board, the importance of the ownership stakes in the firm held by non-executive directors, and experience as board members reduce income decreasing earnings management.

Carcello et al., (2006) examined the associations between audit committee financial expertise and alternate CG mechanisms and earnings management. They find that both accounting and certain types of non-accounting financial expertise reduce earnings management for firms with weak alternate CG mechanisms, but that independent audit committee members with financial expertise are most effective in mitigating earnings management. They also find

that alternate CG mechanisms are an effective substitute for audit committee financial expertise in constraining earnings management.

Kelton & Yang (2008) examined the association between CG mechanisms and disclosure transparency measured by the level of Internet Financial Reporting (IFR) behavior. They measured CG by shareholder rights, ownership structure, board composition, and audit committee characteristics. Their results indicate that firms with weak shareholder rights, a lower percentage of blockholder ownership, a higher percentage of independent directors, a more diligent audit committee, and a higher percentage of audit committee members that are considered financial experts are more likely to engage in IFR.

Rainsbury et al., (2009) examined the association between the quality of audit committees on financial reporting quality and external audit fees in an environment where the formation of audit committees was unregulated. Their results show no significant association between the quality of an audit committee and the quality of financial reporting. They also indicated that the quality of audit committees has little impact on the level of fees paid to external auditors.

He et al., (2009) examined two oversight components, board characteristics and audit committee characteristics. Their results highlight the role of different CG variables in enhancing different aspects of financial reporting quality.

HasasYeganeh & Dadashi (2010) investigated the effect of CG mechanisms on independent audit opinion for 90 firms listed in TSE for the period during 2001 to 2008 applying the rank of these firms CG. Their results show that there is a significant relationship between CG and qualified audit opinion in firms with moderate and weak CG rank. However, they could not find such a relationship between unqualified audit opinions in firms with high CG rank.

Rahman et al., (2010) investigating financial reporting quality in international settings provide evidence to support the view that with varying business settings, there may be diversity in accounting practices that result in different levels of accruals or accruals based earnings quality.

Wang & Wub (2011) show that poor-quality financial reporting is more likely among firms that have weaker profitability and a shareholder base that is state-controlled, with diffused ownership and a relatively low proportion of shares held by institutional investors. Furthermore, they find the market to be relatively insensitive to such admissions. They show that investors' reactions capture only the earnings information of the current reported year, rather than also reflecting the concurrently revealed correction of past financial reporting. However, the equity market does not completely ignore the earnings information.

Bardos (2011) examined the relationship between liquidity and quality of financial information and find that for most income decreasing restatements illiquidity increases several months before restatement announcement and remains at elevated levels one year after restatement.

Ball et al., (2012) examined the “confirmation” hypothesis that audited financial reporting and disclosure of managers’ private information are complements, because independent verification of outcomes disciplines and hence enhances disclosure credibility. They indicated that committing to higher audit fees (a measure of financial statement verification) is associated with management forecasts that are more frequent, specific, timely, accurate and informative to investors.

Habibzadeh Baygi et al., (2012) investigated the effects of corporate governance mechanism on the audit report. Their results indicate that non-executive members and internal auditors have a negative impact on the likelihood of receiving modified audit opinions. The results also reveal that CEO duality is positively associated with the likelihood of receiving modified audit opinions. They also show that there is no statistically significant relationship between institutional ownership and the type of audit opinions.

Habib & Hossain (2013) studied regarding the importance of considering CEO/CFO characteristics as an important determinant of financial reporting outcomes. Their study offers insights to policy makers interested in enhancing the governance function to enhance the credibility of financial reporting. Their review suggests that regulators designing governance structure should regard CEO/CFO characteristics.

### III. HYPOTHESES DEVELOPMENT

According to theoretical framework, firms with high CG provide high quality financial information and consequently it is more likely that they receive qualified opinion and vice versa. However, to capture these arguments, following hypotheses are posited:

1. There is a significant relationship between high CG quality and unqualified opinion of independent auditors in firms listed in TSE.
2. There is a significant relationship between moderate CG quality and qualified opinion of independent auditors in firms listed in TSE.
3. There is a significant relationships between weak CG quality and qualified opinion of independent auditors in firms listed in TSE.
4. There is a significant relationship between the rank of CG and financial reporting quality in firms listed in TSE.
5. There is a significant relationship between high financial reporting quality and unqualified opinion of independent auditors in firms listed in TSE.
6. There is a significant relationship between moderate financial reporting quality and qualified opinion of independent auditors in firms listed in TSE.
7. There is a significant relationship between weak financial reporting quality and qualified opinion of independent auditors in firms listed in TSE.

### IV. METHODOLOGY AND DATA COLLECTION

Since the study aimed to investigate the relationship between audit opinion, CG and financial reporting quality in firms listed in TSE, the study is considered as descriptive-correlation study. The population of the study consists of the listed firms in TSE for the period of 2003-2012. Sample firms must have following characteristics:

1. Financial information must be available,
2. Fiscal year must be ended at the end of year,
3. Must not change their fiscal year during studied period,
4. Must not be investment and brokerage firm,
5. Transactions intervals must not be more than 3 month.

As a result of these characteristics, a sample of 90 firms is obtained. In order to collect research data, TSE database is used and then the ratios using collected data for each firm and year is calculated using Excel software. Finally, SPSS software is used to test hypotheses.

### V. VARIABLES DEFINITION AND MEASUREMENT

#### 5.1. CG

GMI publishes research and ratings for 4,207 companies in 45 countries. GMI ratings are scaled from 1.0 to 10.0, with 10.0 being the highest [see <http://www3.gmiratings.com/index.php>] and cover about 500 accepted measures of CG world widely. This measures are grouped into 6 category including board of director accountability, discloser and internal controls, shareholders right, bonus, market controls and firms behavior which ultimately is combined to create a comprehensive index.

In this study, to capture CG, a questionnaire including 25 questions about three category of information transparency, board of director’s structure and institutional ownership based on TSE codes of CG are used. Each question takes 1 point amounting to 25 point in the maximum level. Firms with weak rank of CG range 0 to 10. Firms with moderate CG range 16 to 25 and firms with high rank of CG range 16 to 25.

#### 5.2. Financial Reporting Quality

In this study, financial reporting quality is measured through accruals quality based on Dechow & Dichev (2002) model as following:

$$WCA_{it}/AA_{it} = \beta_0 + \beta_1 CFO_{it-1}/AA_{it} + \beta_2 CFO_{it}/AA_{it} + \beta_3 CFO_{it+1}/AA_{it} + \varepsilon_{it}$$

Where:

WCA is working capital in firm i at time t. working capital is calculated by subtracting the sum of changes in cash, cash equivalent and current debts from changes in current assets.

CFO is cash flow from firm *i* operation in times *t*, *t*+1 and *t*-1.

AA is average total assets in firm *i* at time *t*.

1/*ε* is a measure of financial reporting quality in firm *i* during studied period.

In this study, to classify firms according to their accounting information quality, firms in first quarter (23 firms) are considered low accounting information quality, firms in fourth quarter (23 firms) is considered high accounting information quality and firms between these two quarters are considered as moderate accounting information quality (44 firms).

### 5.3. Audit Opinion

There are four types of audit opinion namely unqualified opinion, qualified opinion, disclaimer opinion and adverse opinion. The review of independent audit reports revealed that independent auditors only used two types of reporting which are unqualified opinion and qualified opinion. However, in hypotheses development, two types of audit reports (disclaimer opinion and adverse opinion) are not considered.

**Unqualified Opinion:** The unqualified opinion has no reservations concerning the financial statements. This is also known as a clean opinion meaning that the financial statements appear to be presented fairly.

**Qualified Opinion:** This means that the auditor has taken exception to certain current-period accounting applications or is unable to establish the potential outcome of a material uncertainty.

**Disclaimer Opinion:** This is a special type of audit report that should be issued when the auditor permits his or her name to be associated with financial statements that were not examined in accordance with generally accepted auditing standards.

**Adverse Opinion:** This is a type of audit opinion which states that the financial statements do not fairly present the financial position, results of operations, and changes in financial position, in conformity with generally accepted accounting principles [See <http://www.urlaubaccounting.com/typeaudit.html>].

Audit opinion is captured by a dummy variable taking 1 for unqualified and 0 for qualified opinion.

## VI. EMPIRICAL RESULTS

### 6.1. Descriptive Statistic

Descriptive statistic of research variables is shown in Table 1.

Table 1 – Descriptive Statistic

	CGR	OT	AQ
<b>Mean</b>	13.3778	0.4111	85.2985
<b>Median</b>	13.0000	0.0000	79.9283
<b>Std. Deviation</b>	2.20546	0.49238	4.14980E1
<b>Coefficient of Variation</b>	0.16486	1.197713	0.48650328
<b>Minimum</b>	8.00	0.00	28.76
<b>Maximum</b>	23.00	1.00	205.09

Notes: CGR is corporate governance rank, OT is opinion type, AQ is accounting quality

According to Table 1, audit opinion has the most coefficient of variation as a dispersion parameter and CGR has the least. The mean of CGR is 13.37 which show that TSE firms are in moderate condition of CG. Maximum statistic about CGR shows that no firms in sample could reach the top 25 score.

### 6.2. Hypotheses Test

#### 6.2.1. First Hypothesis Test

There is a significant relationship between high CG quality and unqualified opinion of independent auditors in firms listed in TSE.

To test this hypothesis Binomial Test is used which results is shown in Table 2.

Table 2 – Results of First Hypothesis Test

Audit Opinion		N	Observed Prop.	Test Prop.	Sig.
	<b>Unqualified</b>	53	0.60	0.50	0.069
<b>Qualified</b>	35	0.40			
<b>Total</b>	88	1.00			

The results of hypothesis test, as indicated in Table 2, manifest that the hypothesis is accepted at 90 percent level that means there is a significant relationship between high CG quality and unqualified opinion of independent auditors in firms listed in TSE.

#### 6.2.2. Second Hypothesis Test

There is a significant relationship between moderate CG quality and qualified opinion of independent auditors in firms listed in TSE.

To test this hypothesis Binomial Test is used which results is shown in Table 3.

Table 3 – Results of Second Hypothesis Test

Audit Opinion		N	Observed Prop.	Test Prop.	Sig.
	<b>Unqualified</b>	340	0.58	0.50	0.000
<b>Qualified</b>	244	0.42			
<b>Total</b>	584	1.00			

The results of hypothesis test, as indicated in Table 3, manifest that the hypothesis is accepted at 99 percent level that means there is a significant relationship between high moderate CG quality and qualified opinion of independent auditors in firms listed in TSE.

#### 6.2.3. Third Hypothesis Test

There is a significant relationship between weak CG quality and qualified opinion of independent auditors in firms listed in TSE.

To test this hypothesis Binomial Test is used which results is shown in Table 4.

Table 4 – Results of Third Hypothesis Test

Audit Opinion		N	Observed Prop.	Test Prop.	Sig.
		31	.65	.50	.049
<b>Unqualified</b>	17	.35			
<b>Qualified</b>	48	1.00			

The results of hypothesis test, as indicated in Table 4, manifest that the hypothesis is accepted at 95 percent level that means there is a significant relationship between weak CG quality and qualified opinion of independent auditors in firms listed in TSE.

6.2.4. Fourth Hypothesis Test

There is a significant relationship between the rank of CG and financial reporting quality in firms listed in TSE.

To test this hypothesis coefficient of correlation is used which results is shown in Table 5.

Table 5 – Results of Fourth Hypothesis Test

	CGR	AQ
CGR	1.000	
AQ	0.268**	1.000

\*\* . Correlation is significant at the 0.01 level

According to the results of Table 5, it can be concluded that rank of CG has a rather a strong effect (0.263) on financial reporting quality in firms listed in TSE.

6.2.5. Fifth Hypothesis Test

There is a significant relationship between high financial reporting quality and unqualified opinion of independent auditors in firms listed in TSE.

To test this hypothesis Binomial Test is used which results is shown in Table 6.

Table 6 – Results of Fifth Hypothesis Test

Audit Opinion		N	Observed Prop.	Test Prop.	Sig.
	Unqualified	80	.43	.50	.090
	Qualified	104	.57		
	Total	184	1.00		

The results of hypothesis test, as indicated in Table 6, manifest that the hypothesis is accepted at 90 percent level that means there is a significant relationship between high financial reporting quality and unqualified opinion of independent auditors in firms listed in TSE.

6.2.6. Sixth Hypothesis Test

There is a significant relationship between moderate financial reporting quality and qualified opinion of independent auditors in firms listed in TSE.

To test this hypothesis Binomial Test is used which results is shown in Table 7.

Table 7 – Results of Sixth Hypothesis Test

Audit Opinion		N	Observed Prop.	Test Prop.	Sig.
	Unqualified	141	.40	.50	.000
	Qualified	211	.60		
	Total	352	1.00		

The results of hypothesis test, as indicated in Table 7, manifests that the hypothesis is accepted at 90 percent level that means there is a significant relationship between moderate financial reporting quality and qualified opinion of independent auditors in firms listed in TSE.

6.2.7. Seventh Hypothesis Test

There is a significant relationship between weak financial reporting quality and qualified opinion of independent auditors in firms listed in TSE.

To test this hypothesis Binomial Test is used which results is shown in Table 8.

Table 8 – Results of Seventh Hypothesis Test

Audit Opinion		N	Observed Prop.	Test Prop.	Sig.
	Unqualified	109	.59	.50	.015
	Qualified	75	.41		
	Total	184	1.00		

The results of hypothesis test, as indicated in Table 8, manifest that the hypothesis is accepted at 95 percent level that means there is a significant relationship between weak financial reporting quality and qualified opinion of independent auditors in firms listed in TSE.

VII. DISCUSSION AND CONCLUSION

The aim of this research was to investigate the relationship between the independent auditor opinion, the CG, and accounting information quality of firms listed in TSE. In the study, 90 firms investigated during 2003-2012. Researcher-made questionnaire is applied based on the CG codes of TSE to measure the CG quality. Dechow & Dichev model (2002) is used for calculating of the accounting information quality. To capture the aim of study, seven hypotheses are developed. In the first hypothesis, it is argued that there is a significant relationship between high CG quality and unqualified opinion of independent auditors in firms listed in TSE. High CG quality may lead to unqualified opinion of independent auditors because in firms with high rate of CG financial malfunction is supposed to be recognized by CG mechanisms before independent auditor’s review. The result of hypotheses test is according to the expectation and it is accepted in 90 percent confidence level. In the second and third hypothesis, it is hypothesized that there is a significant relationship between moderate and weak CG quality and qualified opinion of independent auditors. As lower CG rate may stem from low internal control, it is reasonably expected that lower CG results in qualified opinion of independent auditors because independent auditors revisit their opinion when they discover accounting practices failures or weak internal control. Four, fifth, six and seventh hypotheses suppose that there is a significant relationship between the rank of CG and financial reporting quality in firms listed in TSE. Since good CG leads to better supervision in a firm and since we supposed that good CG results in unqualified opinion of independent auditors, high rank of CG expected to increase financial reporting quality and lower rank of CG expected to decrease financial reporting quality. The results of the hypotheses test prove theses expectations.

Taking the whole results in consideration, it can be simply stated that firms with good CG will have a high financial reporting quality which in turn leads to unqualified independent audit opinion. However, it is highly recommended to potential investors in TSE that consider independent audit opinion in their investment because it is a sign of good CG and stockholders' right protection.

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