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THE EFFECT OF CORPORATE OWNERSHIP ON THE RELATIONSHIP BETWEEN AUDITS QUALITY AND REAL EARNINGS MANAGEMENT

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Abstract: *The conflict of interests between stakeholders and management is one the important issues considered by many scholars in recent decades. According to the studies done in relation to corporate ownership, the aim of the present study was to investigate the effect of corporate ownership on the relationship between audit quality and real earnings management. 122 companies were selected as sample of the study from the period between 2000 and 2013. Richard's model was used to estimate the real earnings management (abnormal cash flow operation). The elements of audit firm size, and auditor industry specialization were used as two criteria of "audit quality" and "Institutional ownership" as the element of the ownership structure. Multivariate regression model was used to test the statistical hypothesis. The result of the study showed that corporate ownership has a significant and positive effect on the relationship between audit size and real earnings management (abnormal cash flow).*

Keywords: *Corporate Governance, Audit firm size, Instaitutonal ownership Email:ali. afruzianazar@yahoo.com*

INTRODUCTION

Freeman (1984) proposed stakeholder theory. According to this theory: Corporations have grown a lot and their effect on the society is so profound that due care should be given to different parts of the society and the corporations are liable to these parts. Corporations are established with the aim of performing big economical activities. One of these corporations which are amply found is stock companies. In these corporations, microfinance is equipped to perform big works. Due to lack of expertise, adequate time, and even in some cases the lack of owner's need for governance of their own corporate, people called managers took the governance of corporations as the owner representatives. This relationship

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is named agency relationship. Based on it, the owner appoints the agent and delegates the responsibility of decision making to him. However, managers don't have much share in taking possessions, so the problem is that managers don't decide on the favour of stakeholders. The researches have shown that if two sides of the contract (owner, agent), try to maximize their benefits; there is a good reason for agent to provide the owners with benefits. These facts raised the main questions for leading and controlling the corporation. The following are examples of these questions:

1. How should corporations be managed? How it is guaranteed that the corporations follow the aims for which they are founded? Are resources being utilized properly? Do mangers carry their responsibilities with due care?

The answer to these questions creates issues such as corporate governance, ownership structure, shareholders, observing the managers performance, and so on.

The word "governance" has a considerable and evolving concept in today's business. James Wolfenshon the ex-president of the World Bank says: "Corporate governance is more important than country governance in global economic growth".

Regarding the theoretical assumptions of agency, managers have more information than stakeholders and might make some decisions which aren't in favour of stakeholders. The audit process is one of important approaches in reducing conflicts between agencies and opportunistic behaviours of managers in manipulating financial statements. Real Earnings Management potentially incurs heavy long term costs than accruals to stakeholders, because manipulating real activities have negative consequences for cash flow operations and may have negative effects on the value of corporate in the long run.

The first motivation is the negative concept of manipulating the actual activities that are thought to be one of the most serious forms of real earnings management. Cash-based earnings management (real) may have an adverse effect on both short-term and long-term cash flow by reducing optional costs. Real earnings management includes management of an the interest which is generated through the manipulation of cash flows, sales, and operational activities of the firm (Okolie et al., 2014)

Regarding the issues raised, the users of financial statements always worry about financial statements of stockholders of company and doubt about the quality and reliability of the information provided in them, to meet the needs of the financial statements they should be audited. An independent auditing enterprise with adequate professional skill and qualification is able to identify incorrect items in financial statements, and can be effective to its users and provide reliable financial information. Achieving this desired goal is directly related to properties of audit institutions, and it could be related positively or negatively to audit quality. Tateman (1986) stated that high-quality audit improves the accuracy of the provided information and permits investors to have more accurate estimate of the value of the company.

One of the most common definitions of audit quality is a definition presented by Di Angelo (1981). He defined audit quality as: assessment of the market (1) to discover major misstatements of financial statements or user's accounting system and (2) report major misstatements. The possibility that the auditor find major financial misstatements depends on the ability and the possibility that the auditor's report discovered cases of material misstatement depends on the independence of the auditor. This definition is based on the assumption that users understanding of the quality of the audit (market's perception), shows the actual quality of the auditor (Okolie et al., 2014).

Palmrose (1988) defines audit quality in terms of auditor's accreditation. Since the auditor's objective is to create confidence in the financial statements, the audit quality means it is free from material audited misstatement. This definition emphasizes the results of the audit.

The Audit Size

Considering the different definitions given in the audit quality, it can be seen that the definitions have different levels of appropriateness and independence in auditing (real independence) as well as user's perception of their independence. Although, perceived audit quality may be related to real audit quality, but they aren't necessarily identical. Therefore, professional care should be used to keep the actual audit quality and perceived quality. Then, auditor's reputation and professional care were used to keep the real qualities of audit quality and perceived quality. Then, it can be said that auditor's reputation affects how the stakeholders perceive aforementioned information, and also it is related to market perception of reputation and impartiality (nominal independence). This shows the ability of the auditor to increase the credibility of financial statements (even in the absence of quality data).

Audit Specialization:

Recent studies showed that there is a positive significant relation between auditor specialty in industry and the quality of auditor's report. In other words, because the auditors who are expert in the industry have more capability of identifying and solving the problems, they can audit with higher quality. Furthermore, the more experience audit institution gains, because of creating great positive fame, the more interest it gains for high presenting high quality service (Mojtahedzade & Aghayi, 2003, p. 56).

Independent variable of the study is audit quality. The study used audit specialty in industry and market share as the criteria. The more the share of the market, the more auditors' specialty in industry and experience compared to the opponents. Also, having higher share in the market (major market share) refers to this point that the auditor successfully distinguished himself from the other opponents because of his audit quality.

Market Share is Calculated as the Following:

$$\text{Market share of the auditors} = \frac{Total\ properties\ of\ all\ clients\ of\ every\ institution\ in\ industry}{Total\ assets\ of\ all\ clients\ in\ industry}$$

The institutions were considered as specialized in the industry that their share in the market were more than (1/2) (firms in an industry) (Etemadi et al, 2009).

Earning Management

Earning management is the manipulation of interests within accepted principles of accounting and happens when managers use their own judgment of financial reports and transactions to change financial reports and mislead stockholders regarding economic situation of the company. Using judgment in accounting procedure selection, managers obtain required flexibility to use accounting standards in financial information reporting. This flexibility provides the opportunity of earning management to the managers (Zangin and Ozkan, 2010).

Schipper (1989) in his research stated that, Earning management can include real activities too. This type of earnings management through changes in operational activities is carried out with the aim of misleading the stockholders.

Manipulation of the real activities affects cash flows and accruals in some cases.

The present study can help investors to have better understanding of the relationship between economical part (stock market is the agent of this part) and real part of the economy. It finally helps the users adjust the credibility of financial statements and their plans. The effect of ownership structures were used in the relationship between audit quality and the real earnings management as the moderating variable. This study can be useful in determining effective factors in the future performance of factories and help further research.

Principles of Research

Okolie et al (2014) studied audit quality and real earnings management in listed companies in Nigeria's Stock Exchange. His research included a sample of 342 companies in Nigeria's Stock Exchange. The results of their study showed that audit quality has a significant negative relationship with the real earnings management in companies listed in Nigeria's Stock Exchange.

Ozibi and et al (2010) studied the French corporations between 2001 and 2007; the result of their study showed that there is a significant relationship between institutional investors and audit quality.

Richordi (2006) in a research studied profit management through manipulating real activities. He found that the corporations use activities such as presenting discounts to increase sales, overproduction, and reduction of voluntary expenses to prevent loss report and gain more profit. However, these activities increase corporate value in the long run. Institutional investors cause lesser use of these activities.

Advani and Fagbami (2010) studied the effects of corporate factors in Nigerian corporation, and they couldn't find significant relationship between institutional ownership and audit quality.

Ting et al (2010) provided evidences which showed institutional investors strained auditors to report high quality audits.

Nikumaram and Mohamadzade (2000) conducted an experiment to present a pattern for the relationship between corporate governance and profit quality. The result of their findings showed that individual relation of each six factors of corporate governance with profit management criteria showed no significant relation between the ability of corporate governance, the percentage of members of board, the percentage of institutional investors, the type of auditor, the type of corporate governance, and the percentage of free float shares.

Sohrab Osta (2011) conducted an experiment with the title of the study of the relationship between ownership structure and profit management. He found that there is a significant negative relation between institutional ownership and governmental ownership with profit management and also there is a positive relationship between profit management and corporate ownership.

Nahandi et al (2013) conducted an experiment on the effect of audit quality on profit management.

The present study investigates the relationship between audit quality and artificial and real profit management in the companies listed in stock exchange of

Tehran. Jones modified model was used to measure artificial profit management and also chuddar's division model was used to measure real profit management. The result of the study showed that there is a negative relationship between audit quality and artificial profit management. Also the findings showed that there is a positive relation between the audit quality scales.

Methodology

The aim of the present study is to investigate the effect of corporate ownership on the relationship between audit quality and the real earnings management of the companies listed in Tehran Stock Exchange.

Since the study is operational in the method, because its results can be used in the establishment of the rules and principles of the stock exchange. And also, regarding that the study is seeking to find the relation between several variables is correlational and post hoc in method.

Sample and Population

Since companies listed in Tehran Stock Exchange are subject to special regulations of to Stock Organization, it is expected data provided by these companies to have higher reliability and quality. Therefore, the population of the study is the companies which are active in stock exchange.

To select samples of the study, systematic elimination method is used on the basis of following criteria:

1. With the exception of financial institutions.

Research Hypothesis

The main hypothesis

Corporate governance has an effect on the relationship between audit quality and real earnings management.

The Subsidiary Hypothesis

1. Corporate ownership has a significant effect on the relationship between audit firm size and real earnings management (abnormal cash flow operation)
2. Corporate ownership has a significant effect on the relationship between Audit tenure and real earnings management (abnormal cash flow operation)

Models and Research Variables

Statistical model used in this study is multiple regression models. They study used dependent variable of abnormal cash flow operation from Zarvin & Cohen model (2010), and independent variable was firm size, auditor tenure, and auditor industry specialization.

In continuation, the methods of independent variable calculation were used. Also, to test the hypothesis of combined data were used. F test Lymr and the selection panel to determine the method of estimating models (Integration or painting method), and Hausman test was used to select one of the fixed effects or random effect. Data analysis was conducted by using f,t test and correlation coefficient.

Measurement of Abnormal Cash Flow Operation

In this study, according to Cohen and Zarvin, model (1) was used to estimate abnormal cash flows, so that the rest of the model was considered as a measure of abnormal cash flow operation (AB COST).

$Cfo_{i,t}/TAi,_{t-1} = \alpha0(1/TAi,_{t-1}) + \alpha1(salesit/TAi,_{t-1}) + \alpha2\ (\Delta SALES_{i,t}/TA_{i,t}) + \varepsilon_{it}$

CFO_{it}: cash flow operation of company/$_{i}$ in the end of year/ $_{t}$

TA_{it}: total amount of companies' assets in the end of t-1/year

$Sales_{it:\ i}$/Companies' sale in the end of $_{t-1}$ year

$Sales_{it}$: changes of sales of company/$_{i}$ in the end of year/ $_{t}$

€: Rest of the model (abnormal cash flow operation)

The Main Model

$CBEMi,t = a0 + AQ + (\beta1\ os\ {*}AFS_{i,t}) + AQ + (\beta2\ os\ {*}AT_{i,t}) + AQ + (\beta3\ os\ {*}AudInd_{i,t}) + \beta4CFO_{i,t} + \beta5Gwth_{i,t} + \beta6Size_{i,t} + \beta7Lev_{i,t} + \varepsilon_{it}$

Corporate Ownership (CO)

Corporate ownership is defined as the ratio of the percentage of kept shares by stakeholder firms from the total capital and it includes all firms except ownership of foreign firms.

Control Variables

CFO: Cash flow operation which is the ratio of cash flow to total assets of the company (i) in the year (t)

Growth: company growth, the ratio of market value to total value of the company

Size: Firm size, the ration of log of the total asset of the firm

LEV: Financial leverage, the ratio of total liabilities to total assets

The Main Model of Research

$CBEM_{i,t}$ = a0+ AQ +(β1 os *$AFS_{i,t}$) + AQ +(β2 os *$AT_{i,t}$) + AQ +(β3 os *$AudInd_{i,t}$) + β4$CFO_{i,t}$ + β5$Gwth_{i,t}$ +β6$Size_{i,t}$ + β7$Lev_{i,t}$ + ε_{it}

Results

Tables 1 and 2 show the description of the variables of the study.

Descriptive statistics of the variables includes mean, median, minimum, maximum, standard deviation and frequencies.

Table 1
Descriptive statistics- quantitative data

Variable	*Symbol*	*Observations*	*Std. Deviation*	*Minimum*	*Mean*	*Maximum*
Abnormal cash flow	ABSCAH	976	.107	.000	.1161	.722
Corporate Ownership	Co	976	28.215	.000	28.71	96.990
Cash flow Operation	Cfo	976	.1408	-.497	.1325	.773
Firm Size	Size	976	1.457	9.880	13.380	18.550
Firm Growth	Growth	976	1.236	.033	1.225	9.462
Financial Leverage	Lev	976	.2142	.111	.635	1.443

Table 2
Descriptive statistics. Qualified data

Variable	*Symbol*	*Observations*	*Results*	*Frequency*	*Percent*
Auditor Specialization	AIS	976	Auditor Specialization	630	64/5
Audit Firm Size	AFS	976	Audit Organization and (1)	222	22/7
			Audit Institutions	754	77/3

Mean is the primary index which shows the balance point and the central distribution, and is a good index to show centrality of the data. For example, mean for the variable ABSCASH is equal to 0.1611 which shows that most of the data is concentrated on this point. Standard deviation is one of the most important parameters of scatteredness and is a parameter of the amount of scatteredness. The amount of this parameter for the variable ABSCASH is 0.107.

Correlation Table Between Variables

Pearson correlation was used in this study. Correlation coefficient shows the amount and type of the relation (positive or negative). It is a number between -1 and 1, and if there was no relation, it would be 0.

Table 3
Pearson Correlation results

Variable	*Symbol*	*Coeffici ent* / *sig*	*ABSCASH*	*cfo*	*Size*	*growth*	*Lev*
Abnormal cash flow operation	ABSCASH	*Coefficient*	1				
		sig					
Cash flow Operation	cfO	*Coefficient*	.088	1			
		sig	.007				
Firm Size	Size	*Coefficient*	-.213	-.008	1		
		sig	.000	.815			
Firm Growth	growth	*Coefficient*	.118**	.380	-.122	1	
		sig	.000	.000	.000		
Financial Leverage	Lev	*Coefficient*	-.044	-.215**	.064*	-.318	1
		sig	.171	.000	000.	.000	

Signifant level of 95%, Significant level of 99%

The Result of Hypothesis Test

Hypothesis test requires that the data be of a normal distribution of independent variables, uniformity of the variances, correlation itself. Because if they weren't normal, the results obtained, wouldn't be reliable and this could rejects the hypothesis. After being sure of regression, hypothesis of the study were tested.

Results of the First Hypothesis

The result of the table 4 shows that corporate ownership interaction and audit size with index of (-0.001) and significance of (0.107) has no correlation with real earnings management (abnormal cash flow operation). From other control variables of the model cash flow with coefficient (0.064) and significant level of (0.018) has a positive relation with real earnings management. Firm growth with coefficient of (0.018) and significant level of (0.000) has a positive relation with real earnings management (abnormal cash flow operation).

Table 4
The result of the first Hypothesis

$$\mathbf{ABSCASH}_{\ it} = \beta_0 + \beta_1 AFS_{\ it} + \beta_2 CFO_{\ it} + \beta_3 SIZE_{\ it} + \beta_4 \mathbf{Growth}_{\ it} + \beta_5 LEV_{\ it} + \varepsilon it$$

Independent Variable: Real Earnings Management (Abnormal cash flow operation)

Variable	*Symbol*	*Non-standard values*		*T statistics*	*Prob.*
		Value	*Error*		
Fixed Amount	C	0.05870	0.0335	1.74819	0.0808
Audit Firm Size	AFS	–.002077	0.0112	0.9519	0.3414
Corporate governance & Audit size	AFS*CO	-0.0014	0.0012	-1.6119	0.1073
Cash Flow Operation	CFO	0.06150	0.0260	2.35689	0.0186
Firm Size	SIZE	0.00284	0.0023	1.2359	0.2168
Firm Growth	Growth	0.0185	0.0030	6.1559	0.0000
Financial Leverage	LEV	-0.0180	0.016372	-1.1025	0.2705
F Statistics	12.0519	R squared		0.070045	
F significant	0.00000	R Squared Coefficient Value		0..064233	
		Durbin-Watson Statistics		1.748077	
Test Type		**Statistics**		Prob significant level	
Chow Test		5.436282		0.0000	
Hausman Test (Fixed Random Effects)		25.086240		0.0003	

Results of the Second Hypothesis Test

The result of table 5 shows that corporate ownership and auditor specialization with coefficient of (-0.001) and significant level of (0.0432) has a negative relation with real earnings management (abnormal cash flow). And also, from the other control variables applied to cash flow operation model with coefficient of (-0.060) and significant level of (0.019) has a positive effect on real earnings management (abnormal cash flow). Firm growth with coefficient of (0.002) and significant level of (0.000) has a positive relationship with real earnings management (abnormal cash flow).

Table 5
The results if the second Hypothesis

$$ABSCASH_{it} = \beta_0 + \beta_1 AFS_{it} + \beta_2 CFO_{it} + \beta_3 SIZE_{it} + \beta_4 Growth_{it} + \beta_5 LEV_{it} + \varepsilon it$$

Independent Variable: Real Earnings Management (Abnormal cash flow operation)

Variable	*Symbol*	*Non-standard values*		*T statistics*	*Prob.*
		Value	*Error*		
Fixed Amount	C	0593.0	.00332	1.78527	0.074
Auditor Specialization	AFS	-0.211	0.0129	-1.6417	0.1010
Corporate governance*Auditor specialization	AIS*Co	-0.0012	0.0002	-0.7858	0.0432
Cash Flow Operation	CFO	0.0608	0.0259	2.3431	0.0193
Firm Size	SIZE	0.0033	0.0023	1.43943	0.1504
Firm Growth	Growth	.0179	0.0029	6.00027	0.0000
Financial Leverage	LEV	-0.0176	0.0162	-1.0857	0.2778
F Statistics	12.8588	9.254112		0.07438	
F significant	0.000000	R Squared Coefficient Value		0.06860	
		Durbin-Watson Statistics		1.65515	
Test Type		Statistics		Prob Significant Level	
Chow Test		5.926551		0.0000	
Hausman Test(Fixed Random Effects)		41.412155		0.0000	

The Result of the Study

The present study investigated the effective factors in corporate governance; corporate governance was tested in terms of the relationship between audit quality and real earnings management by the companies listed in Tehran stock exchange in a period of 8 years. Generally, the results of the study showed that there is no significant relation between audit firm size and real earnings management, however there is a negative significant relation between corporate governance and its effect to the relationship between auditor's specialty in industry and real earnings management. These results are quite similar to researches done in foreign countries. Regarding corporate ownership, as stated in the second hypothesis, in significant level of 95%, has a significant negative relation. This showed that corporate investors has more active supervisory role in the relation between audit qualities by audit institutions in profit management of managers.

SUGGESTIONS FOR FURTHER STUDY

1. Considering that the study used an element of real earnings management, it is suggested, researchers use other elements of real earnings management (abnormal production cost and abnormal discretionary expenses).
2. It is also suggested another studies to be conducted from other elements of ownership structure (institutional ownership, free flow share and management share).
3. The study suggest further research on the effect of of ownership structure on the relation of audit quality and profit management for a short period of one year.

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