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Auditor's Attributes and Cost of Capital in Iran Capital Market

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ABSTRACT

This research aims to examine the impact of audit quality (auditor's quality evaluation, auditor size, auditor industry specialization, and auditor tenure) on Iran capital market. The result of the analysis of 1140 years of the company during 2006-2015 has shown that there is a significant negative relationship between the auditor expertise and auditor tenure. Although the negative relationship between all of the criteria of audit quality and cost of capital is not confirmed, it cannot be claimed that high audit quality does not cause reduction in cost of capital in Iran capital market.

Keywords: Audit Quality, Cost of Capital, Auditor's Quality Evaluation, Auditor Size, Auditor Expertise, Auditor tenure.

INTRODUCTION

Investor's trust in practicality and effectiveness of the acts of world financial markets and achievement of financial growth and its consistency is a fundamental act (Arner, 2007; Pike & Neale, 2006). Investment is a fundamental need in order to move from an underdeveloped economy to a developed one (Blaikie, 2016). Investors need auditors and audit opinion about financial statement in order to understand if financial information based on which they decide on their financial sources are trustworthy and reliable (Baah & Fogarty, 2016; Knechel & Salterio, 2016). Financial auditors play an important role in improving the reliability of financial information provided by private firms, state-run and non-state-run enterprises, and other business unites through lending credibility to financial statement (El Ghouli, Guedhami, & Pittman, 2016; Jacobides & Croson, 2001). Auditors provide logical assurance that financial statement are free from any distortions and errors, and also auditing reduces the adverse effects of the separation between ownership and management to minimum by reducing asymmetric information between the clients of financial statement and their suppliers (Piot & Missonier-Piera, 2007). Thus, audit is a means to reduce information risk and increase financial reporting quality. The reduction of information risk decreases the investors' lack of trust, and this causes less rate of return demand from investors, and based on this we can deduce that auditing quality causes a reduction in

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shareholder's equity which eventually reduces cost of capital (Dye, 1993; Gimbar, Hansen, & Ozlanski, 2016; Louis, Robinson, Robinson, & Sun, 2015). Moreover, one of the methods of generating value is to reduce the cost of financing in firms, and firms tend to reduce their cost of capital, because this reduction increases the wealth of shareholders and reduces the cost of capital of the needed fund. According to the researches done in this field, auditing is a kind of monitoring which is used in firms to reduce asymmetric information and restrain managers' freedom of act (Hanwen, Chen, Lobo, & Wang, 2008; Houqe, Ahmed, & Zijl, 2017; Lennox, Wu, & Zhang, 2016). Auditing is a monitoring mechanism which helps shareholders to collect reliable information (Jacobides & Croson, 2001).

Firm capital structure can be defined as the mixture of debt and shareholders' equity for funding the capital of corporation, and cost of capital can be considered as the sum of shareholders' equity cost and debt cost (Vätavu, 2015). One of the noticeable factors in choosing methods of financing by business units is cost of capital. Firms' plan is to minimize the costs, and if it is realized the firm value will maximize. The reduction of cost of capital can provide the opportunity for firms' managers to select investment projects more broadly and increase firms' profitability (Altig, Christiano, Eichenbaum, & Linde, 2011; Drover et al., 2017; Zikmund, Babin, Carr, & Griffin, 2013). High audit quality can cause the reduction of cost of capital by increasing financial statement credit which causes investors and creditors submit their resources to the firms with more confidence (Chen, Hope, Li, & Wang, 2011). On the whole, the main purpose of auditors is to protect shareholders' interest against distortions and error in regard to the current importance of financial statement; moreover, auditors also want to increase audit quality in order to support their career credit and avoid litigation. A lot of researches have shown that firms can increase their cost of capital by increasing audit quality. This research aims to investigate if firms can reduce their cost of capital and gain their financial resource in a cheaper way by using famous and expert auditors.

Review of Literature

According to American institute of accounting, accounting is defined as: "Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria, and communicating the results to interested users" (Fung, 2014; Salifu & Mahama, 2015).

Also, according to Wallace (1980), auditing is a cause for increasing reliability and credit of financial reporting, reducing risks related to economic decisions, and other advantages such as preventing window dressing and other exploitations and following regulations and instructions, upgraded monitoring systems, information and practicality, and helping to evaluate managers' performance.

Perception of audit quality: if audit quality is defined as general attributes of a product or a provided service in regard to client's demand in order to gain client's satisfaction, thus auditing profession services are not different from this. There have been a number of attempts to define "audit quality" in the past. However, none has resulted in a definition that has achieved universal recognition and acceptance. Audit quality is, in essence, a complex and multi-faceted concept.

Audit quality in audit standards is inferred as: publishing suitable audit reporting about observing the accepted public audit principles by employer. DeAngelo (1981) provides a frequently cited definition of audit quality, defining it as the joint probability that an auditor will both discover and report a breach in the client's accounting system. Titman and Trueman (1986) define audit quality as the accuracy of information supplied to investors. Davidson and Neu (1993)

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in a more comprehensive definition, consider audit quality as the auditor's ability to detect and eliminate significant breaches and manipulations in reported interest.

Palmrose (1986) defines audit quality as financial statement which contains no breach and material misstatement.

Law draws a distinction between two forms of audit quality: 1) gross negligence 2) non-gross negligence. In fact, adopting this approach to audit quality divides audit quality continuum into two simple levels. Limitations of this perspective cause us to choose a framework for measuring audit quality in this continuum (from poor audit quality to high audit quality). This framework starts with micro level procedures in auditing, and ends in macro level motivations. Although all the above mentioned factors are important in our understanding of audit quality, it seems that its significance is in contrast to presented current (Cameran, Prencipe, & Trombetta, 2016; Francis, 2004). Firms create the motivation for audit institutes to conduct high audit quality, and this also affects the inspection team and its decisions about gathering and evaluating evidence.

Quality which determines the audit's performance follows several factors such as auditor's abilities (including knowledge, experience, adaptation power, and technical efficiency), and professional performance (including independence, objectivity, professional care, and conflict of interest) (Lee, Su, Tsai, Lu, & Dong, 2016). Audit quality is associated with auditor's quality in detecting breaches in financial reporting, and auditor tends to present an appropriate audit report based on audit findings. Any changes in the auditor's role, audit market structure, and adaptation framework can happen only if it has no adverse effects on audit quality (Albeksh, 2016; Andon, Free, & O'Dwyer, 2015).

Auditor industry specialization: Kend (2008), defines auditor industry specialization as: "auditor industry specialization includes creating constructive ideas to help employers, and also provide new solutions for issues that employers confront in their own industry". Hogan and Jeter (1999), found out that audit firms with a brand have made efforts to increase their specialization level. They concentrate on industry rules and industrial attributes which do not have many lawsuits, but have rapid growth, with powerful employers. Specialization is frequently deemed synonymous with quality. Experts are expected to supply higher quality and more services, along with audit services, compared to non-experts.

Market share and Portfolio share are considered as indexes to measure auditor expertise in industry. In market share approach, organizations which own greater share in market have higher specialized knowledge in that industry, and in portfolio share approach, the relative distribution of auditor's service in different industries for each audit firm is considered, and the greater share of portfolio indicates that significant investment has been done by audit firms in expanding auditing technologies associated with that industry (Gunny, Krishnan, & Zhang, 2007; MINUTTI-MEZA, 2013).

Cost of capital: every business unit needs some funds, which are supplied from different resources, to manage their activities. These resources can be supplied by creditors, business unit owners, and funds earned by company's interest. Every decision determining financial structure imposes some costs on the company (Freeman, 2010). Cost of capital is a concept which has been challenged by science because it is deemed to be the major cause in creating differences between accounting profit and economic profit. This concept is used from intra-organizational and inter-organizational perspective (Easley & O'hara, 2004; Lambert, Leuz, & Verrecchia, 2007; Pratt & Grabowski, 2008). From intra-organizational perspective, prime examples of functions of cost of capital are economic budgeting, financial decisions, and performance evaluation (Bierman Jr & Smidt, 2012). Evaluating company's performance and securities are prime instances of using Cost of capital from inter-organizational perspective. Cost of capital is done in different ways such as, borrowing, equity, and storing company's profit. Capital expenses, in finance literature, are called

cost of capital. The company's policy is to reduce these expenses, and if it is realized, company's value may be maximized. Fund earned by the company must provide a consistent and reliable rate of return for the fund suppliers in the form of a potential investment. The expected rate of return of cost of capital suppliers is not equal. While company's creditors wish to have a consistent and reliable rate of return, shareholders have accepted that the rate of return which they receive from companies varies based on the company's performance. In addition, investors' expectations vary according to political and economic situation, current market return, management quality, and management approach. Companies need to detect the expectations of fund supplier in order to manage their cost of capital efficiently. If the company fails to realize the expected rate of return and cost of capital, the value of company's securities will decrease.

Review of the Related Literature

According to Myers, Myers, and Omer (2003) long term audit tenure causes audit specialization in client's industry, and increases audit quality. Fortin and Pittman (2007) suggested that companies which employed Big-four, reported lower average of cost of debt.

Piot and Janin (2005) discovered that audit quality differences in Big-five had no impacts on the mismanagement of interest. Behn, Choi, and Kang (2008) showed that companies which are audited by more efficient audits had more precise predictions .

Piot and Missonier-Piera (2007) concluded that corporate governance mechanism decreases agencies problems, while audit quality had no impact on the cost of debt of French listed companies. Fernando, Abdel-Meguid, and Elder (2010) showed that increasing audit quality of investors' expected return will reduce firms' cost of capital. Moreover, the cost of capital of firms whose audits only have qualified opinion will increase.

Choi, Kim, Kim, and Zang (2010) showed that the size of the company has a significant relationship with audit quality and auditor's wage. Ahmed, Rasmussen, and Tse (2008) concluded that companies which use auditors of big audit organizations, specialized in industry, have less cost of capital and cost of debt capital.

Li, Stokes, Taylor, and Wong (2009) revealed that companies which were audited by expert auditors had lower cost of debt. Moreover, companies which received modified audit reports had a low quality accrual and higher cost of debt. Hanwen et al. (2008) found that employing high quality auditors in non-state-owned enterprises had more reduction in income management and cost of capital compared to state-owned enterprises.

METHODOLOGY

The design of the current study is descriptive and correlational in nature, due to the fact that in this study we investigate the relationship between audit quality and cost of capital. In order to collect literature and theories, library research was conducted, in which we studied articles, journals, and both English and Persian books. Research data is collected from sample firm's data, and with referring to financial statements and audit report in stock market official website, www.rdis.ir. In order to classify information and calculate variables, Excel 2010 is used, and to test and analyze the data, Eview 7 is used. In this study, the samples are all the accepted companies in Teheran Stock Exchange from 2006 to 2015, which are classified as following:

1. The end of financial year is March.
2. Companies which have not changed their financial year from 2006 to 2015.
3. Companies which have been accepted in Tehran Stock Exchange until the end of 2005.
4. Companies which have published their financial statement and information related to their auditor during the above mentioned years.
5. The audit firms of these companies

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have been checked by the quality control of Iranian Association of Certified Accountants (IACPA) within above mentioned years.

Considering the preceding conditions, among the accepted companies of Tehran Stock Exchange, the data of 114 companies is analyzed in this study.

The Analytical Model of the Research

The multiple regression models were used in this research. As was mentioned before, the impact of audit quality on cost of capital is measured, thus, the relationship between these variables is calculated in the following model:

$$C \text{ Cost} = \beta_0 + \beta_1 QE + \beta_2 Exp + \beta_3 Tenure + \beta_4 Aud + \beta_5 ROA + \beta_6 Current + \beta_7 IntCov + \beta_8 Size + \beta_9 PPE.TA + \beta_{10} Lev + \beta_{11} STDebt + \beta_{12} Growth + \varepsilon$$

Research Variable and Methods to Measure Them

The analyzed variables in this study (independent variable, dependent variable, and controlling variables) are as following:

Dependent variable: In this study, the cost of capital of the companies in the population is regarded as dependent variable. Cost of capital is calculated according to weighted average of shareholder's equity and cost of debt. Cost of debt equals cost of capital divided by circulating interest-bearing liability and cost of shareholder equity, and the opportunity for investors to invest in that company; and company's rate of return is calculated by capital assets pricing model in common stock.

Independent variable: in this study, in order to calculate audit quality, auditor's quality evaluation, auditor size, auditor expertise, and audit tenure are used.

Auditor size: auditor size is synonymous with auditor's fame. In order to measure audit quality, if the firm's auditor is Audit Company, as the big company, the audit quality is considered 1, but if the audit company is a member of Iranian Association of Certified Accountants (IACPA), which is smaller than Audit Company, the variable is considered 0.

Auditor's quality evaluation (QE): ordinal scale is used (regarding quality evaluation as A, B, C, D) in order to measure quality evaluation. Davidson and Neu (1993) considers investigating quality control in firms as a criterion for evaluating the real audit quality.

Auditor Tenure: auditor tenure equals the amounts of auditor's professional care and the ability to monitor it. To measure auditor tenure, ordinal scale is used, and the auditor with four years' experience is considered as the highest quality auditor.

Auditor expertise in industry: to measure auditor expertise market share approach is used. The more auditors' market share expands, auditor expertise increases compared to competitors. Based on Palmrose (1986) market share is calculated as following:

The sum of all employers' assets of a special audit firm in industry divided by all the employers' assets in that industry, and if the market share is more than $\{1/ \text{existing companies in industry} \times 1/2\}$, is considered as industry expertise.

Controlling variables:

ROR (rate of return on assets): it is calculated as the ratio of net income to total assets.

Current: the ratio of current assets to current liability.

Interest coverage ratio: the ratio of earnings before interest and taxes to interest expense.

Size (firm size): firm size is measured as the log of the sum of total firm's assets.

Lev (Financial leverage): the ratio of total debt to total assets

PPE.TA (property plant and equipment. total assets): the ratio of the book value of tangible fixed assets to total assets of firms.

STDebt (short term debt): the ratio of current short term debt to total debt.

Growth: the sum of log 1 and the percentage change in the book value of shareholder's equity.

RESULT

In this section, by the use of collected data from the sample which includes 114 companies from 2006 to 2015, the research hypotheses are tested. The method to test the hypotheses in this study is Panel data which is conducted by Eview7. Since OLS method is used to estimate the model parameters in this study, the normal distribution of dependent variables of this study is analyzed by Jarque-Bera test, and because level of significance of Jarque-Bera test for all the dependent variables is more than 0.05, we can conclude that variable have a normal distribution.

In this study, Pearson product-moment correlation coefficient is used and its result shows that, the correlation between the variables is too weak and this shows lack of linear correlation between the variables. In order to determine whether the Panel data model is more functional in intended model or Pool, Chow test (f-statistic) was used. In this test, Null hypothesis indicates the equality of y-intercept, and in case it is rejected the fixed effect model is accepted, and it is necessary to test the random effect model in order to determine an appropriate method to estimate the model, which is done by Hausman test. If the null hypothesis is not rejected, we accept that y-percepts are equal and the preferred model will be Pool model.

Regarding the result of Chow test and P-value of F-statistic (0.386), is not meaningful at the alpha level of 0.05 and the null hypothesis based on the y-percept is not rejected at the alpha level of 0.95, so the model is presented as Pool, and it is not needed to present a separate y-percept every years. The model for research hypothesis is as following:

$$Cost\ of\ capital_{it} = \alpha + \beta (Exp)_{it} + \beta (Tenure)_{it} + \beta (Aud)_{it} + \beta (Stdebt)_{it} + \beta (ROA)_{it} + \beta (PPE)_{it} + \beta (Size)_{it} + \beta (Lev)_{it} + \beta (IntCov)_{it} + \beta (Growth)_{it} + \beta (Current)_{it} + u_{it}$$

While measuring the reliability of the research model, Jarque-Bera is used to test normality of error terms. The result of Jarque-Bera test has shown that the remaining of estimating research model at the confidence level of 0.95 have normal distribution. In this study, in order to investigate the homogeneity of variance, the model was estimated as EGLS. Durbin Watson statistic indicates lack of autocorrelation in the model, so the independence of the remaining is accepted in this model. By the way, if there was a probability of autocorrelation in each model, AR (1) was used.

The result of testing research hypothesis:

Table 1. The results of testing model 1 using Pool model

Type of variable	symbol	Variable name	Coefficient	t	p
Independent variables	Aud	Auditor size	2.44	1.07	0.284
	EXP	Auditor expertise	1.137	0.32	0.741
	Tenure	Auditor tenure	-2.39	-3.17	0.001
Controlling variables	Current	Current ratio	0.65	0.18	0.853
	Lev	Financial leverage	22.53	2.28	0.022
	PPE	Ratio pf fixed assets to total assets	-6.47	-0.82	0.407
	Stdebt	Ratio of the current debt to total debt	11.61	1.36	0.173
	Size	Firm size	2.01	2.46	0.013
	ROA	Rate of return on assets	0.0005	3.74	0.0002
	IntCov	Interest coverage ratio	-0.0002	-1.24	0.214
	Growth	Growth	9.07	2.89	0.003
Durbin- watson			1.870		
F – statistic			2.445		
Prob (F-statistic)			0.005		
R Square			0.023		
Adjusted R-Square			0.013		
The model for research hypothesis is as following					
Y= -33.66-2.39Tenure + .22.53 Lev +2.01 Size 0.0005+ROA + 9.07 Growth					

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Estimating the preceding model is significant with Prob (F-statistic) which equals 0.005113. It means that it shows the significance of audit quality and cost of capital of companies.

According to the table, the probability of t-statistic for auditor tenure is at the alpha level of 0.05 with 0.95 confidences, and is confirmed with the cost of capital, and the relationship of these variables with cost of capital is negative, and there is not a meaningful relationship between auditor size and auditor expertise with cost of capital. However, we cannot certainly claim that the research hypothesis, which is the negative relationship between audit quality and cost of capital, is rejected. In fact, by considering the t statistic and Prob. scale, audit tenure was more significant in predicting cost of capital among all other variables. Moreover, R^2 equals 0.023. the R^2 scale indicates that 2.3 percentage of cost of capital changes can be determined by the variables in the model, and this scale is meaningful considering F-statistic at alpha level of 0.05.

Furthermore, Durbin-Watson statistic equals 1.87 which indicates lack of autocorrelation in the model. The results of this study are similar to Fernando et al. (2010) findings, and is similar to the findings of Ahmed et al. (2008) in terms of rejecting the relationship between audit expertise and cost of capital, but is in contrast to the findings of Li et al. (2009).

It is necessary to note that, in general, researches such as, Lee et al. (2016), Ahmed et al. (2008) and Fernando et al. (2010) confirmed the negative relationship between audit quality and cost of capital.

Table 2. Testing the relationship between audit quality assessment criteria and dependent variable- cost of capital, separately

independent variables	Durbin Watson	Adj. R^2	R^2	Hypothesis result	p	Beta coefficient	Chow test (F statistic)	
							p	F
Ranking rate	1.85	0.091	0.103	rejected	0.0005	3.45	0.480	0.900
Auditor quality	1.84	0.008	0.016	rejected	0.0409	3.41	0.948	0.377
Auditor expertise	1.84	0.011	0.018	rejected	0.4434	2.49	0.939	0.392
Audit tenure	1.86	0.018	0.026	confirmed	0.0009	-2.39	0.939	0.391

With regard to the results of the tests which were summarized in the preceding table, in the test of relationships between audit quality assessment criteria separated by the cost of capital as the dependent variable, the negative relationship between auditor quality evaluation, auditor size, auditor expertise separated by cost of capital was rejected, and only a meaningful negative relationship between auditor tenure and cost of capital was confirmed at the alpha level of 0.05.

CONCLUSION

Economic growth depends on market growth, and market growth depends on transparency and an accountable efficient system; however, they are all dependent on the quality of audit services.

According to the results of this research, the negative relationship between audit quality and cost of capital was rejected. In the other words, with regard to ineffectiveness of auditor size on the decision of clients of financial statement, and reduction of cost of capital, it seems that it is not correct to use Big-four as the criterion for measuring audit size. It is important to mention some of reasons for this, such as not having access to general and specific information about auditing (such as number of personnel), academic and professional background of auditing personnel, tenure hours, auditing hours, assigning responsibility, auditor's wage, partnership period between auditing partners, devising specific test proportional to the employer's risk, audit budgeting, accuracy of auditing opinion, cost of lawsuits, the results of internal inspection. Thus, in order lay the foundation for measuring audit effectiveness, it is recommended to use more efficient criteria

to measure auditor size, and the Association of Certified Accountants ought to take the information from audit companies and inform the clients.

With regard to the collected data, the tenure of Audit firm as a state run enterprise and Big audit firm, has had a rapid decrease from 2006 to 2015, and this can be a good sign of improvement and growth in official auditors; however, we cannot deny the role of rules and regulations. Nevertheless, the needed potentials to exploit these legal opportunities can be created, which can cause an increase in auditor quality and Iran capital market, also decrease the cost of capital of companies. One of the solutions for this is to combine firms and create a big company with a huge budget. The most important benefit of combining firms and creating a big company is to increase the independence efficiency of audit companies. Moreover, establishing big data banks which are connected to each other contributes to the accuracy and precision of the presented data. This is the route which audit profession has taken in the world. Out of Big-eight auditors in 1989, only Big-four firms are left which are combined with hundreds of small audit firms and institutes. It is recommended to set supportive regulations for combining firms, so that the partners of audit companies are attracted to combination. Furthermore, privatization and probability of the submission of big state-run companies to non-state-run audit firms can cause the tendency for combining audit firms.

Based on the results of this research, a meaningful negative relationship between auditor's quality evaluation and cost of capital was rejected. Auditor's quality evaluation has started since 2010, however, so far, the effect of this measure and ranking audit reports on reducing cost of capital have not been significant. With regard to the financial scandals of companies and financial crises in the recent years, which has pointed the finger of blame at auditors and audit quality, it is necessary for Association of Certified Accountants and audit company as the standard company to introduce this occupation, clarify the real position of auditors, expand the audit culture, pay attention to the economic situation of the country, and pursue the quality control and monitoring more seriously. By and large, the indexes used to evaluate audit firms and their consequences, must be reviewed, and items such as the condition of economic units, size of the entity, size of audit firms must be taken into account, because it is possible for the audit companies to focus lavishly on earning higher ranks, rather than allocating resources to the gradual improvement of audit quality.

According to the findings of this study, industry specialized auditors are able to conduct a higher quality audit due to being able to detect and handle the problems. In other words, using high quality auditors causes reduction in cost of capital, it is recommended that firms and companies, by the use of knowledge and awareness and experts in this field, for instance board of directors who have specialization in accounting and financing, choose industry specialized auditors as their financial statement auditors, and maintain their cooperation for four years constantly.

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