Investigating the relationship between client importance and audit quality: Evidence from TSE

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Abstract

The purpose of this study is to investigate the effect of client importance on audit quality in Tehran Stock Exchange (TSE). The results of previous researches in some countries suggest that the auditor independence may be affected by the economic importance of certain clients, which can affect audit quality. The results of this study, using a sample comprising of 1164 year-company observations during 2005 to 2012 from among listed companies in TSE and using logistic regression analysis showed that there is no significant relationship between the client importance and qualified audit opinion (as a measure of audit quality). In other words, it can be said that the independence and audit quality in Iran's capital market is not affected by the economic importance of clients. The results after controlling other factors that based on the previous researches can affect the qualified audit opinion showed that the probability of revealing qualified audit report has a positive relationship with financial leverage and performance of the previous year and has a negative relationship with the concentration of ownership, the size of the auditor, returns on assets and liquidity ratios.

Keywords: audit quality, corporate governance, auditor report, client importance.

Introduction

This study examined the relationship between the clients' economic importance and the audit quality in the Iranian capital market. Large audit firms are trying to maintain their reputation and certainly do not want to do anything that will hurt their independence and credibility, on the other hand, auditing larger firms has more benefits for auditors (service fee) (Ansari *et al.* 2013). Thus, two opposing views are proposed regarding the impact of the economic importance of clients on the independence of the auditors: the hypothesis of maintaining the reputation and economic dependence hypothesis. This study sought to answer this question that whether or not the auditors' independence is respected in auditing the larger and economically more important companies. The results of this study using the criteria of the clients' sales rate in order to measure client importance (according to Reynolds and Francis, 2001; Chung and Kallapur, 2003) and using logistic regression analysis, based on 1164 sample of year - company collected from among the firms listed in Tehran Stock Exchange during 2005 to 2012, showed that there is not a significant relationship between the client importance with qualified audit opinion. In other words, it cannot be stated that economic importance of client in Iran's capital market impairs audit quality. The results after controlling other factors that can affect the qualified audit opinion showed that the probability of revealing qualified report has a positive relationship with financial leverage and performance of the previous year and has a negative relationship with the concentration of ownership, the size of the auditor, returns on assets and liquidity ratios. In general, these results support the hypothesis of maintaining the reputation and show that the client importance is not a reducing agent for auditor independence and thus audit quality in Iran's capital environment.

The remainder of this paper is divided into four sections. In the first part, the discussion is focused on the research literature and hypotheses development. In the next section, the research methodology is presented. Then, the descriptive statistics and research results are presented, and the paper ends with conclusions and recommendations.

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Literature and research hypotheses

Previous researches suggest that by receiving the going concern, clients experience negative market reaction and the risk of business failure increases. As a result, clients who receive going-concern are more likely to change their auditors with the hope of achieving a more flexible auditor and more favorable reports (see Li, 2009). The impact of the loss of a major client is important for audit firms, because it can significantly reduce the income of these institutions. However, a low quality audit can also affect auditor reputation, retain and gain new clients (Reynolds and Francis, 2001). Thus, two opposing views are presented regarding the impact of the economic importance of clients on the independence of the auditor: the hypothesis of maintaining the reputation and economic dependence hypothesis.

A large number of theoretical and empirical researches suggest that due to the issue of audit firms' reputation and cost of claiming against them, auditors have market-based and intrinsic incentives to act independently (see Li, 2009). For example, Craswell *et al.* (2002) investigated the relationship between auditor fee dependence, as measured by the ratio of the client audit fees to total audit firm fees, and tendency towards revealing qualified audit report using data from Australian companies over the period of 1994 to 1996. They found no relationship between audit fees and qualified audit opinion. Reynolds and Francis (2001) also used data through 1996 to study the issue whether the big client's authority affects the 5-Big auditor reporting decisions or not. Client authority is measured as the net ratio of client sale over total net sales of all clients audited by that auditor. They found that client's authority is negatively related to discretionary accruals and positively related to auditor's going-concern. This suggests that the 5-Big auditors are more conservative than larger clients in expressing opinion. Chung and Kallapur (2003) also used the ratio of audit and non-audit fees to audit firm's total income and found no significant relationship between the client importance and earnings management. Chen *et al.* (2010) also used a sample company in china for periods before and after the enactment of the rule of governance in 2001, and found that the client importance was negatively related before the situation changes and after that positively related to auditor's adjusted opinion.

Despite the issue of reputation maintenance for the audit institutions, yet there are pressures that can threaten the independence of the auditor. There are researches on this issue that indicate that the cli-ent economic importance reduces audit quality. For example, Ferguson *et al.* (2004) used data from UK companies and found that the amount of non-audit services' fees of certain clients with discretionary accruals and the probability of further renewal are more dependent. Similarly Basioudis *et al.* (2006) found that the more non-audit fees are more dependent on lower audit qualified opinion for firms with financial stress.

According to most of the above results, it can be predicted that the economic importance of the client not only does not reduce the probability of auditor qualified opinion, but also to support the hypothesis of maintaining the reputation, it would increase the likelihood of issuing auditor qualified report. In other words, auditors are expected to try to maintain their independence in the contrast between reputation maintenance (Theory of reputation maintenance) and client maintenance (economic dependency theory). Thus, the research hypothesis is presented as follows:

The client importance has a positive and significant relationship with providing qualified audit opinion.

Materials and Methods

The population of this research in terms of classifying researches based on objective is applied research; because applied researches are aimed at developing practical knowledge in the particular field. On the other hand, it is descriptive (non-experimental) based on the way of data collection. Implementation of descriptive researches can be simply learning more about the current situation or to assist the decision making process. According to different categories of descriptive research, this study is correlational and research hypothesis testing is done based on logistic regression.

Research data collection

The present study includes listed companies in Tehran Stock Exchange during the period of 2004 to 2012 (8-year period). In this study, the choice of sampling method according to most studies was convenient purposeful sampling. In the convenient sampling scheme, those members are selected from the target population that conform criteria or researcher's desired specific criteria. In this study, the sample started with the whole population and after considering the following criteria it was selected:

- companies that are listed before 2004;
- have not changed their financial year during the research period;
- are not a member of investment and (financial) holding companies;

• The required information of the companies is available.

According to the set of above conditions, 1164 year-company observations were selected as the sample in the time domain of the study from 2004 to 2012. For hypothesis testing, cumulative regression of data was estimated for an 8-year period. Research data was gathered from Rahavarde Novin database as well as the financial statements of the companies included in the RDIS website and was analyzed using SPSS 18 software.

Research model

The following logistic model is used to test the research hypothesis. All variables are identified at the end of each year, unless otherwise is stated.

$$\text{Opinions}_t = \beta_0 + \beta_1 \text{Import}_t + \beta_2 \text{Block}_t + \beta_3 \text{AuSize}_{t-1} + \beta_4 \text{SAudit}_t + \beta_5 \text{FmSize}_t + \beta_6 \text{ROA}_t + \beta_7 \text{WC}_t + \beta_8 \text{LEV}_t +$$
$$+ \beta_9 \text{Loss}_{t-1} + \beta_j \sum_{j=10}^{23} \text{Industries} + \beta_k \sum_{k=24}^{31} \text{Years} + \varepsilon_t.$$

According to previous researches, in addition to the client importance, there are other variables that can affect the probability of providing qualified audit report, which are included in the study as control variables. These variables include factors related to audit quality (auditor size and auditor change), the governance factor (ownership concentration) and internal factors (firm size, return on assets, liquidity ratio, and leverage and bad debt of the company).

Research variables

The dependent variable in this study is a qualified audit opinion, which is shown with one and zero. If the company has received a qualified audit opinion in the current year, then it is shown with number one, otherwise it is defined as zero (Opinions). Independent variables are as follows.

Importance of client (Import): According to Reynolds and Francis (2001) also Chung and Kallapur (2003) the natural log of firm's sales[2], as a measure of economic importance of client, is used to measure this variable using the following equation:

$$CI^o = \frac{\text{Ln}TAST_i}{\sum_{i=1}^{n} \text{Ln}TAST_i},$$

Where, LnTASTi is the natural logarithm of the sum of sales of client i, and their sum is the sum of the natural log of sales of all clients audited by a specific auditor in the specific year.

Ownership concentration (Block): According to Chung and Kallapur (2003) auditors' motivation to violate their independence is reduced by strengthening corporate governance. Omidfar and Atashi Golestani (2014) in a study that examined the impact of ownership concentration on auditor change; reported that by increasing the largest shareholder's ownership the likelihood of a negative change of auditor (chang-ing from auditing organization to a small institute) increases. This suggests that ownership structure can affect audit quality. In this study, a negative relationship is anticipated between ownership concentration and probability of qualified opinion. To measure the concentration of ownership in this study, the total percentage of ownership owned by major shareholders of the company (owners of more than 5% shares) is used.

Auditor size (AuSize): Piri *et al.* (2013) conducted a research and showed a significant negative correlation between the size of the audit firm and audit quality. According to them, this negative correlation indicates that large audit firms with higher number of clients have lower audit quality compared with small audit firms with a low number of clients. Hassas Yeganeh and Azinfar (2010) also reported a significant negative relationship between auditor size and audit quality. However, Li (2009) reported a positive relationship. Thus, we can expect a negative relationship between the auditor size and receiving qualified opinion. In this research, if the firm's auditor is "audit organization" in the current year, it is defined with number one, otherwise zero is defined.

Auditor change (SAudit): Chena *et al.* (2009) in study on the Taiwanese companies found that auditor change is directly related to issuing qualified audit report. They showed that managers change their auditor in order to show good performance, so as to receive qualified audit reports as a result of this change; and in this way, they try to present an optimal performance of the company. Banimahd (2011) reported that there is a direct relationship between the auditor change and receiving qualified audit report. In another study, Banimahd *et al.* (2013) used a sample of active firms in Tehran Stock Exchange during 2002 to 2010 and found a direct relationship between auditor change and the change of audit opinion; they believed that this shows selection of opinion in auditing market of Iran. Therefore, one can expect that the probability to receive an unqual-

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[2]Because of inflation in Iran, the amount of total assets is not used.

ified report (qualified) decreases with the auditor change.

Client size (FmSize): This variable represents the firm size. Banimahd (2011) reported that the firm size is one of the factors affecting the release of qualified audit report. In another study, Banimahd *et al.* (2013) reported a positive relationship between firm size and changes in the audit opinion. According to Li's argument (2009), larger firms have more bargaining power in the decision making process of auditors. They showed a negative relationship between firm size and the possibility to receive going-concern. Thus, a negative relationship between firm size and qualified audit opinion is expected. This variable is measured by the natural logarithm of the sum of sales.

Return on assets (ROA): According to Li (2009), this variable indicates the status of the company's performance and is obtained by dividing the net profit (loss) of a period over its asset's sum. According to the results of Li (2009), a negative relationship between these variables can be predicted.

Liquidity ratio (WC): According to Li (2009), this variable indicates the company's liquidity risk that is obtained by dividing the current assets to current liabilities. He found that companies who receive going-concern have higher liquidity risk, so a negative coefficient can be predicted.

Leverage ratio (LEV): is an index to measure a company's financial risk. It is obtained by dividing the sum of the debt to total assets. According to the research of Bagherpour *et al.* (2013), debt ratio is concerned as one of the most important variables in predicting the auditor's opinion. According to the results of Li (2009), a positive relationship is expected between leverage and qualified opinion.

Loss report (Loss): Li (2009) showed a positive relationship between the firm's loss and qualified audit opinion. Banimahd *et al.* (2013) also showed that there is a negative correlation between bad-debt firm and auditor's opinion change. According to previous researches, if the company has reported net losses at the end of last year, it is defined as one; otherwise its value is zero, and it is expected to have a positive relationship with qualified opinion.

Results

Descriptive statistics

Table 1 shows the descriptive statistics of the variables. This table shows that among 1164 observation of year-company during the research period, on average 64 percent (N=744) qualified opinion has been issued. According to this table, the average of major ownership is about 74 percent. According to Mahdavi and Meidari (2005) the ownership structure is concentrated in Iran. In relation to the auditor size, this table shows that on average, 24 percent of firms have used independent audit services of "auditing organization" and 17% (N = 201) auditor change have occurred. Other information relevant to research variables can be seen in this table.

In Table 2, the results of hypothesis testing are presented. In the table, the coefficients of the variables related to the hypotheses and significance level of each variable are reported. According to the research hypothesis, there is a significant positive relationship between the economic importance of client and qualified audit opinion. The results showed no significant relationship between importance of client and qualified audit opinion (p-value = 0.325).

Table1. Descriptive statistic between research variables

		Opinions	Import	Block	AuSize	SAudit	Fmsize	LEV	Loss	ROA	WC
N		1164	1164	1164	1164	1164	1164	1164	1164	1164	1164
Mean		0.64	0.317	74.07	0.24	0.17	12.71	0.715	0.09	0.087	0.74
Std. Deviation		0.48	0.364	18.243	0.424	0.378	1.36	0.325	0.289	0.169	0.751
Min		0	0	0	0	0	9.41	0.09	0	0.00	0
Max		1	1	100	1	1	18.49	4.29	1	3.3	7
Sum		744	370.067	36218	274	201	14800.4	832.26	107	135.7	861
Percentiles	25	0	0.023	64.07	0.00	0.00	11.78	0.55	0.00	0.035	0.00
	50	1	0.132	78.54	0.00	0.00	12.56	0.68	0.00	0.094	1
	75	1	0.551	87.28	0.00	0.00	13.43	0.81	0.00	0.174	1

The results of this research are consistent with the results reported by Reynolds and Francis (2000) and Croswell *et al.* (2002), as well as Li (2009) and are different from the results of Ferguson *et al.* (2004), and Basioudis *et al.* (2006). These evidences suggest that, unlike the theory of economic dependence, the audit

opinion is not affected by the importance of client; therefore, it cannot be stated that independence and audit quality in Iran's capital market is distorted due to the economic importance of the client. In other words, the results obtained are in accordance with the hypothesis of reputation maintenance. According to this hypothesis, low quality audit endangers auditor's reputation, maintenance and acquiring new clients (Reynolds and Francis, 2001).

There are some other researches on this issue that show a significant negative relationship between the auditing firm size and audit quality (Piri *et al*, 2013; Hassas Yegane and Azinfar, 2010). According to Piri *et al.* (2013), the negative relationship indicates that large audit firms with higher number of clients have lower audit quality compared with small audit

firms with lower number of clients. Therefore, we attempt to remove the auditor size variable (AuSize) of the model and run it again. Without controlling the auditor size variable, the results indicated that the client importance has a positive and significant (p-value = 0.030) relationship with the qualified audit opinion; these evidences are consistent with the research hypothesis. In other words, the economic importance of client not only does not reduce the likelihood of qualified audit opinion, but also to support the hypothesis of maintaining the reputation, it would increase the likelihood of issuing auditor qualified report. The results again support the hypothesis of reputation maintenance and no effect of the economic importance of client on auditors' independence in Iran's capital market.

Table2. Results of the research

Variables	β Coefficient	Std. Deviation	Wald	P-Value
Importance	0.107	0.236	0.206	0.325
Block	0.021-	0.004	22.852	0.000
AuSize	0.507-	0.205	6.133	0.005
SAudit	0.163-	0.193	0.713	0.195
FmSize	0.064	0.064	0.991	0.16
LEV	1.245	0.424	8.603	0.001
Loss	2.439	0.617	15.597	0.000
ROA	1.095-	0.556	3.878	0.025
WC	0.181-	0.12	2.261	0.065
Intercept	2.102	1.506	1.18	0.082
R²		0.278	Chi-Square	263.369
Percentage Correct	71 %			

The results also show that ownership concentration is negatively related to qualified audit opinion, which is in accordance to the research expectations. These findings are also consistent with the findings of Omidifar and Atashi Golestani (2014), who found that increasing ownership of the largest shareholder, the probability of a negative change of auditor (change from auditing organization to a small institute) increases. In fact, it can be concluded that the concentration of ownership in Iran's capital market reduces audit quality. The results in Table 2 also show that the auditor size is negatively related to qualified audit opinion, which is in accordance with the predictions of research. These results are in accordance with the evidence of Piri *et al.* (2013), and Hassas Yegane and Azinfar (2010), who showed that large auditing firms' audit quality is lower compared to other institutions. Financial leverage as well as last year's performance is positively related to qualified opinion that is consistent

with the previous predictions of research. These results suggest that the poor performance of the company and financial risk are of factors affecting issuing of qualified opinion. Finally, according to research forecasts, by improving liquidity and company performance, the possibility of issuing a qualified report is reduced.

Discussion and Conclusion

Large audit firms are trying to maintain their reputation and certainly don't want to do anything that will hurt their independence and credibility, on the other hand, auditing larger firms has more benefits for auditors (service fee) (Ansari *et al.*, 2013). Thus, two opposing views are proposed regarding the impact of the economic importance of clients on the independence of the auditors: the hypothesis of maintaining the reputation and economic dependence hypothesis. The results of this study using the criteria of the clients' sales

rate in order to measure client importance (according to Reynolds and Francis, 2001; Chung and Kallapur, 2003) and using logistic regression analysis, based on 1164 sample of year - company collected from among the firms listed in Tehran Stock Exchange during 2005 to 2012, showed that there is not a significant relationship between the client importance with qualified audit opinion. In other words, it cannot be stated that economic importance of client in Iran's capital market impairs audit quality. The results after controlling other factors that can affect the qualified audit opinion showed that the probability of revealing qualified report has a positive relationship with financial leverage and performance of the previous year and has a negative relationship with the concentration of ownership, the size of the auditor, returns on assets and liquidity ratios.

The results of his study have several important dimensions. The first is that, it can reveal a fairly confident about the overall level of audit quality and also they support previous researches and confirm that audit quality in larger audit firms is lower than other institutions. Also, this study can contribute to the research literature on audit opinion. Understanding factors affecting audit opinion in the capital market of Iran can help policymakers in Tehran Stock Exchange to monitor the quality level of market. Examining other factors that affect the audit opinion with emphasis on the number and type of qualified opinion sections and using other methods of analysis can be placed on the agenda of future researches.

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