

THE RELATIONSHIP OF AUDITOR INDEPENDENCE IN ADJUSTMENTS TO ANNUAL FINANCIAL STATEMENTS AND THE RELEVANT EFFECT ON ACCRUALS BEFORE AND AFTER FINANCIAL RESTATEMENT

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ABSTRACT

The present study analyzed annual adjustments from two voluntary and forced perspectives and the effect of annual adjustment on restated accruals. For this purpose, the difference in operating cash flow, firm size, financial leverage, return on assets and growth volatility were used as independent variables while accruals was used as the dependent variable. Such criteria as corporate governance and audit quality and characteristics of the firm were used as control variables. The required data was collected from sixty stock companies during 2007-2012 financial period. Data analysis showed that financial restatement resulting from the auditor proposal improved quality of accruals after a period of restatement compared to the period before restatement. The results also show that improving the quality of corporate governance increases quality of accruals in the companies with forced financial restatement.

Keywords: *Annual Adjustments to Financial Statements, Accruals, the Importance of Auditor*

Introduction

Correct decisions on the capital market require reliable, relevant and timely information, so that available resources can be allocated properly. Improperly provided and processes information negatively affects the decision-maker. An atmosphere of mistrust in the capital market, unreliable financial statements, an attempt to access information outside the stock, etc. are several consequences of this negative effect. One of the national largest automotive companies reduced profit allocation and did not allocate profits to shareholders with annual adjustment despite profitability in 2008 fiscal year. The market value of corporate shares was equivalent to 10% of stock market in Tehran. This raised serious questions for the corporate shareholders (Taherkhani, 2009). On the other hand, large volumes of accounting scandals in recent years led to public mistrust in large companies and auditing institutions (Abdoli and Nazemi, 2013).

JaffariBorkez (2008) believed that increased financial restatement is due to diligent monitoring efforts of managers, the board of directors and auditors, which improves transparency and investor confidence. The importance of this study lies in the fact that the effect of annual adjustments on accruals was explained from two voluntary and forced perspectives, which help investors and shareholders to accurately assess the stock market and make the right investment decisions. The present study examined the effect of auditor independence in adjustments to annual financial statements and the relative effect on the accruals before and after financial restatements.

Theoretical Principles

The Importance of Auditor

In current professional societies, a reliable information is obtained when an independent organization monitors reporting process of the companies, especially the center of this process, i.e. financial statements from the perspective of users. Auditing institutions are noted as instances of these independent organizations. Auditing organizations mainly investigate and monitor internal control structure of the reporting unit and final product of the internal control system, i.e. financial statements, in business units (HasasYegane and Jafari, 2010). Users of financial statements used the information contained in auditing reports as a criterion to measure the enterprise management performance and determine corporate stock price. Therefore, validity and reliability of this information is important for current and future investors,

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creditors and other users of financial statements since this information invokes quality of validity and reliability of financial statements. In other words, independent auditors play an important role in improving the quality of financial reporting through adjusting audacious profits management styles (IsmailzadehMoqhari, 2010). In addition, independent auditors have a special position in the structure of corporate governance in developing markets and significantly improve the quality of financial reporting (HasanYegane and Baghumian, 2005).

Mojtahedzadeh and Babai (2012) argued that auditing with high quality increases the probability of detecting questionable accounting practices, limiting excessive profits and disclosing mistakes.

Accruals Quality

Accruals are an important indicator to detect profit quality. Accruals are used to estimate value of shares. Accruals either change or modify the cash flow. According to the first Statement of Accounting Concepts, accruals are better criteria for measuring corporate performance. The quality of accruals and profit decreases based on error of estimation (Haghighat and Homayun, 2004). Highly positive accruals indicate that profits are much higher than the corporate cash flows. This difference is due to the revenue recognition principle and the matching principle. According to accrual-based approach, the profits can be reported when revenues and expenses are realized. Recognition of revenues and expenses on accrual basis is not necessarily accompanied by payment and receipt in cash. Forecasts and estimates are used to calculate the profit. Hence, it is wondered how much accruals can be trusted when important decisions are made. Accruals quality refers to liquidity of profit accruals. Francis *et al.*, (2004) used Dichev and Dechow Model (2002), which shows current accruals in operating cash flow during last year, current year and the next year. This model was developed with the assumption that realization of revenues and expenditures of the company are often different from the receipt and payment of cash. It was also assumed that accruals are generated and reported because of this difference. This model is based on two items of working capital and operating cash flows due to ease of tracking them because these accruals are settled after one year.

Literature

Rahmani and Tomrayi (2012) examined the effectiveness of restatement figures and informational risk. They concluded that arbitrary informational risk increases after financial restatement. In addition, restatement of main accounts in comparison with extraneous accounts significantly increases informational inherent risk but is not associated with an increased arbitrary informational risk. Companies with more than once financial restatement experience increased inherent informational risk compared to companies with one time financial restatement. BaharMoqhadam and Dowlatabadi (2012) compared the quality of reported and restated earnings. The results showed that the restated profits have higher predictability and restated earnings have higher stability in comparison with reported earnings.

Hashemi *et al.*, (1391) compared incremental informational content of cash and accrual ratios to evaluate financial performance. The results showed that incremental informational content of cash ratios predict financial performance significantly more than accrual ratio. Nazemi and Saemi (2014) studied financial restatement and concluded that profit before adjustments to financial statements was directly correlated with return on investment. However, profit after adjustments to financial statements was inversely correlated with return on investment. On the other hand, profit had high explanatory power before annual adjustment. Nevertheless, both explanatory power and reliability of financial statements decreased after adjustment. DalioMarcioKitit *et al.*, (2009) used a sample of companies with earnings restatement from 1997 to 2003. They found out that voluntary restatement had a positive relationship with independent members of the Board of Directors and the Audit Committee.

Yun *et al.*, (2010) proved that forced restatement by the SEC and other external agencies reduced about 20% after SOX Act compared to the past. The former research also examined discretionary accruals before and after the SOX Act. The results showed significant decrease in the share of discretionary accruals after SOX Act.

Research Hypothesis

According to above-mentioned materials, theoretical hypothesis tested in this study is as follows.

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“Restatement due to auditor proposal enhances quality of accruals before restatement”

MATERIALS AND METHODS

This was a quasi-experimental research with retrospective approach (through past events). On the other hand, this was a descriptive-correlational study. Paired mean comparison test was performed using SPSS in order to test the significant effect of operating cash flow, firm size, debt ratio, firm performance and growth volatility on the dependent variables.

Sample

The statistical population consisted of stock companies during the period under study (2003 to 2013) among which 60 companies were selected as the research sample. These companies had restated their financial statement just once in the period between 2005 and 2010. At least three years before and after restatement, they had not significantly restated their financial statements. The data relevant to origin of financial restatement, i.e. voluntary or forced financial restatement, was obtained from records. In addition, auditing report of the last year and the notes attached to financial statements records (annual adjustment note in the year financial statement were restated) were collected. In the period under study, 19 forced restatement (the audit proposal) (33%) and 41 voluntary restatement (corporate management proposal) (67%) were identified.

Table 1: Breakdown of restatements to voluntary and forces categories in the period under study

Description	2005	2006	2007	2008	2009	2010	The final sample	Percentage
Forced restatement	1	0	2	4	9	3	19	33
Voluntary restatement	5	3	7	12	9	5	41	67
Sum	6	3	9	16	18	8	60	100

The Research Model

Dichu and DochuModel (2002) is based on the cash flows in the past, present and future. The model was estimated according to study design and the period under study (three years before and three years after the restatement) using the combined data for the period before and after restatement:

$$ACC_{it} = \beta_0 + \beta_1 CFO_{it-1} + \beta_2 CFO_{it} + \beta_3 CFO_{it+1} + \epsilon_{it} \quad (1)$$

where CFO represents operating cash flow while Accdenotes accruals amount.

Accrual was obtained through the difference between operating profit (accounting profit) and cash flow from operating activities (Mashayekhi *et al.*, 2010).

An indirect method was used for cash flows variable, i.e. net income plus depreciation cost of tangible and intangible fixed assets. After estimating model (1) for profits before and after restatement, standard error of remaining in model (1) was respectively considered as quality of accruals after restatement (AQ-post) and quality of accruals before restatement (AQ-pre). The dependent variable is calculated as follows:

$$AQ\text{-}pre - AQ\text{-}post = \Delta AQ_i \quad (2)$$

Main model of the hypothesis is as follows:

$$\Delta AQ_i = \beta_0 + \beta_1 AUD_{it} + \beta_2 \Delta SIZE_{it} + \beta_3 \Delta Sales_{it} + \beta_4 \Delta CFO_{it} + \beta_5 \Delta ROA_{it} + \beta_6 MAT_{it} + \beta_7 \Delta LEV_{it} + \beta_8 \Delta M/B + \beta_9 \Delta manage\text{-}attrib + \beta_{10} \Delta AUD\text{-}Size + \beta_{11} \Delta SIZE_{it} * AUD_{it} + \beta_{12} \Delta Sales_{it} * AUD_{it} + \beta_{13} \Delta CFO_{it} * AUD_{it} + \beta_{14} \Delta ROA_{it} * AUD_{it} + \beta_{15} MAT_{it} * AUD_{it} + \beta_{16} \Delta LEV_{it} * AUD_{it} + \beta_{17} \Delta M/B * AUD_{it} + \beta_{18} \Delta manage\text{-}attrib * AUD_{it} + \beta_{19} \Delta AUD\text{-}Size * AUD_{it} + \epsilon_i \quad (3)$$

Where AUD_{it} is divalent dummy variable. When financial statements were restated due to independent auditor proposal, $AUD_{it}=1$; otherwise $AUD_{it}=0$. Negative coefficient of the variable indicates a positive

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relationship between forced restatement and increased accruals quality (decreased standard deviation of remaining regression in accruals quality model).

Measuring Research Variables

Dependent Variable

Accruals (ΔAQ_i): changes in quality of accruals (changes in quality of accruals are calculated through the standard deviation of remaining regression in Dichu and Decho accruals quality model) before and after restatement.

Independent and Control Variables

AUD is divalent dummy variable. When financial restatement was due to audit proposal, AUD=1; otherwise, AUD=0.

Operating cash flow (CFO): Cash flow from operating activities can be calculated directly and indirectly (Rahimian, 2010).

In the direct method, cash receipts and payments for operating activities are shown. In the indirect method, the calculations start with a profit before tax rather than sum of the items relating to cash flows. Then, this figure is adjusted by non-cash items, which are considered in calculations of operating profit in the period. The main advantage of direct method lies in the fact that operating cash receipts and payments are shown. The advantage of indirect method lies in the fact that the difference between operating profit and cash flow from operating activities are considerably shown. Thereby, the indirect method was used for cash flows in this study, i.e. net income plus depreciation cost of tangible and intangible fixed assets.

Firm size ($\Delta SIZE$): corporate total assets can be used to calculate the firm size. Logarithm of these values should be taken before and after restatement (Shahiki *et al.*, 2012).

Financial Leverage ($LEVA$): resulting from changes in average debt ratio (total debts to total assets) in the period after restatement compared to the period before restatement (D'Souza *et al.*, 2000)

Return on assets (ΔROA): changes in the rate of return on assets in the period after restatement compared to the period before restatement

Growth volatility ($\Delta B / M$): Changes in market value to book value of equity in the period after restatement compared to the period before restatement

Components of corporate governance ($\Delta \text{manage-attrib}$): combined index of corporate governance like Gompers (2003) was used to measure this variable. The index included six features of board of directors including independent board of directors, CEO tenure, CEO duality task, size of the board of directors, irresponsible head of board of directors and financial expertise of members of the board of directors.

Audit Quality (AUD-Size): the components of audit institutions size was used to measure audit quality. Audit organization was considered as a large institution (better quality) while other auditing firms (member of Iranian Association of Certified Public Accountants) were considered as small enterprises. Artificially, a larger firm was given one value while other variables were given zero value.

Level of significance (MAT): represents the effect of restatement on net profit, which is obtained by dividing the difference between restated profit and the initial profit to sum of assets at the beginning of the restatement period.

Hypothesis Testing and Analysis

First, accruals quality of every company was calculated before and after restatement according to profit accruals quality base models. Changes in profit accruals quality were considered as the dependent variable in the model used to test the hypotheses.

$$\Delta AQ = AQ_{\text{post}} - AQ_{\text{pre}}$$

Then, AUD variable was added as the variable indicating forced restatement to profit accruals quality model, which is shown in the research model. The effect of this variable and other control variables was evaluated on changes in profit accruals quality. AUD was considered as 1 for the companies with forced

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restatement (independent auditor proposal). On the other hand, AUD was considered as zero for other companies. The results are shown in the following figure.

Table 2: Regression model for hypothesis testing

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.2246	0.0449	5.0033	0.0000
AUD	-0.4495	0.1607	-2.7971	0.0077
ΔSIZE	-0.0697	0.1183	-0.5891	0.5590
ΔSALE	-0.1880	0.1200	-1.5661	0.1248
ΔCFO	0.4056	0.3996	1.0150	0.3159
ΔROA	0.3231	0.4849	0.6663	0.5089
MAT	0.0732	0.0579	1.2653	0.2127
ΔLEV	-0.3648	0.1473	-2.4775	0.0173
ΔB/M	-0.1257	0.0621	-2.0231	0.0495
ΔMANAGE_ATTRIB	0.0520	0.0338	1.5395	0.1312
ΔAUD_SIZE	-0.2775	0.0723	-3.8401	0.0004
ΔSIZE- AUD	-0.2164	0.5146	-0.4204	0.6763
ΔSALESIT_ AUD	1.6239	0.5413	2.9998	0.0045
ΔCFO_ AUD	-3.8612	0.6348	-6.0827	0.0000
ΔROA_ AUD	1.3489	0.6818	1.9786	0.0544
MAT- AUD	0.0252	0.0595	0.4237	0.6739
ΔLEV- AUD	-0.7087	0.2134	-3.3219	0.0019
ΔB/M_ AUD	0.6499	0.1003	6.4806	0.0000
ΔMANAGE_ATTRIB_ AUD	-0.1612	0.0351	-4.5939	0.0000
ΔAUDSIZE_ AUD	1.8003	0.1664	10.8216	0.0000

Table 2: Weighted Statistics

Weighted Statistics			
Adjusted R-squared	0.7809	Mean dependent var	-0.3007
F-statistic	12.4445	S.D. dependent var	2.0549
Prob(F-statistic)	0.0000	Durbin-Watson stat	1.8340

According to the table, F statistic is equal to 12.444, which is significant at 1% level. AUD variable was equal to -0.4495 and t-statistics was equal to -2.7971, which is significant at 1% level. The negative coefficient indicates that the companies with forced financial restatement due to independent auditor proposal have increased profit accruals quality in the period after restatement compared to the period before restatement. Thereby, this hypothesis was confirmed. The results showed that profit accruals quality was significantly increased by increased size of audit institutions, increased debt ratio and increased corporate interest rate regardless of the origin of proposed financial restatement at 1% level of confidence. The importance of restatement had no significant relationship with quality of earnings in the periods before and after restatement. However, standard deviation of the remaining items in Dicho and Decho Model (2002) declined by improving internal corporate governance, increasing debt ratio and changing operating cash flows in companies with forced financial restatement due to independent auditor proposal. Thus, profit accruals quality had increased. These relationships were significant at 1% level of confidence. On the other hand, profit accruals quality had decreased by increase in modified sales, the rate of corporate growth, and the rate of return on assets in the company compared to other companies with financial restatement. Furthermore, profit accruals quality had increased by changing the audit institutions in audit organizations to those audit institutions member in Iranian Association of Certified Public Accountants (among institutions offering financial restatement). Nevertheless, changing the audit institutions in audit organizations to those audit institutions member in Iranian Association of Certified

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Public Accountants had increased profit accrual quality regardless of forced financial restatement. These relationships were significant at 1% and 5% levels. These results were in line with those obtained by Yoon *et al.*, (2010). The latter examined discretionary accruals in the period before and after SOX Act. The results showed significant decrease in the share of discretionary accruals after SOX Act. Queen (2008) selected profit stability to measure profit quality in the periods before and after restatement. The effect of forced financial restatement due to independent auditor proposal was not significant. Palmers *et al.*, (2001) showed that cumulative abnormal returns had decreased one day after notice of financial restatement in companies with forced financial restatement due to the independent auditor proposal.

Conclusion

Financial restatement due independent auditor proposal indicates a weakness in internal controls and corporate management for preventing and detecting accounting errors. This also has negative consequences for investors before financial restatement. Then, financial restatement due to independent auditor proposal (forced financial restatement) motivates the investors to negatively react to the stock market. It is expected that the companies with financial restatement due to auditor proposal have lower profit quality in the period prior to financial restatement. As a result, the quality of profits in the period after restatement would increase in such companies (with forced financial restatement). The results also showed profit accruals quality increased in the companies with forced financial restatement due to independent auditor proposal in the period after restatement compared to the period before restatement. The findings suggested that forced financial restatement due to independent auditor proposal had positive relationship with increased profit accruals quality in smaller audit institutions compared with larger audit institutions. The impact of other variables was considered too. The findings showed that standard deviation of remaining items in Dicho and Decho Model (2008) decreased by improving internal corporate governance, increasing debts ratio and increasing the variability of cash flows in the companies with forced financial restatement due to independent auditor proposal. Thus, profit accruals quality increased. These relationships were significant at 1% level of confidence. The results also showed that the factors leading to restatement such as incorrect interpretation of tax and financial laws and regulations and incorrect application of accounting standards indicate internal control weaknesses or create managerial opportunities, which will lead to poor quality of financial reporting. This also inevitably leads to such critical mistakes as financial restatement proposal submitted by other people outside the company such as independent auditors (forced financial restatement). Thereby, strengthening internal control structures through attention to the role of an internal audit and organizing an audit committee may lead to less financial restatement and improve the quality of financial reporting.

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