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# **RELATIONSHIP BETWEEN AUDIT QUALITY AND OVERVALUED EQUITY IN LISTED COMPANIES IN TEHRAN STOCK EXCHANGE**

# Riza Hajbani Lahroudi and \*Mohsen Hamidian

Department of Accounting, College of Management and Accounting, South Tehran Branch, Islamic Azad University, Tehran, Iran \*Author for Correspondence

# ABSTRACT

Managers under increasing pressure from stockholders side, have tendency to supply whole desires of investors. One of these methods to consent investors is showing high levels of earnings. Managers can manage earnings to reach their goal. One important mechanism of counteracting earnings management methods, like this, is high quality auditing, but in the other hand, equity overvaluation tangibly had bad effects on auditing quality. This paper aims to study the relationship between Audit Quality and Equity Overvaluation. To reach the target, we choose 250 firms listed in Tehran Stock Exchange during years 2007 through 2012 as sample and study the effects of Equity Overvaluation on the relationship between Audit Quality and Discretionary Accruals to extract this result as Equity Overvaluation mitigates the inverse relation between Audit Quality and Discretionary Accruals or not. In order to carry out this examination, we use panel data regression model with fixed effects model evaluating method. Discretionary Accruals is considered as dependent variable and independent variables are Overvaluation and three factors of Audit Quality as Industry Specialist, Audit Tenure, and Industry Specialist-Audit Tenure and Discretionary Accruals is mitigated when the firm is in the highest quintile of P/E categories.

# *Keywords: P/E*, *Audit Quality, Equity Overvaluation, Discretionary Accruals.* **INTRODUCTION**

Classical agency theory affirms that alignment of management-shareholder interests increases the tendency for value creation (Jensen and Meckling, 1976). Jensen (2005) argues that when a firm becomes overvalued, i.e. the price of the firm becomes greater than its underlying economic value, managers desire to perpetuate overvaluation. As an overvalued firm, by definition, lacks the operational capability to achieve performance levels reflected in its price, managers are motivated to use aggressive accounting policies to maximize earnings. Although numerous reporting alternatives are available to achieve earnings management goals, accruals are an especially attractive choice since they are a normal part of the financial reporting process and their amounts require forward looking estimates over which managers have considerable discretion.

In a study Houmes and Skantz (2010) assert that incentives associated with overvalued equity induce managers to support extreme valuations by using discretionary accruals to manage earnings higher. They conclude that overvalued firms in contrast with other firms report higher levels of discretionary accruals. In another research, Houmes *et al.*, (2013) expand findings in Houmes and Skantz (2010), and study the effects of overvaluation on the relationship between audit quality and discretionary accruals and conclude that equity overvaluation mitigates the inverse relation between audit quality factors and discretionary accruals.

Following Houmes *et al.*, (2013) subject of research, in this research we study the relationship between Audit Quality and Equity Overvaluation, and examine the effects of Equity Overvaluation on relationship between Audit Quality and Discretionary Accruals in listed companies in Tehran Stock Exchange (TSE). We use high price-to-earnings firms to proxy for highly valued equity and the level of income increasing discretionary accruals to proxy for earnings quality. Our results show that, in accordance with prior studies, high quality auditors generally limit accruals. By contrast, however, accruals for highly valued clients of high quality auditors are statistically significantly higher. In particular, accruals for clients of

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industry specialist and long tenure auditors increase for clients in the previous year's highest quintile of price-to-earnings ratios. Hence, the widely documented tendency for high quality audit firms to reduce accruals is mitigated when the firm is highly valued. We rationalize these findings within the context of traditional audit quality literature and Jensen's (2005) overvalued equity hypothesis by asserting that the accruals decreasing effect of high quality auditors on earnings is reduced as informed managers of highly valued firms with greater tendency to perpetuate values prevail upon auditors to report higher levels of income increasing discretionary accruals, as Houmes et al., (2013) showed the same results and rationale. Since the value of a firm is a function of its prospective performance, and the greater the performance expectations the higher the value and expectations are greater when a firm is richly priced, investors' reactions to unexpectedly negative performance outcomes should also be greater. As an example, Skinner and Sloan (2002) document that the market's reaction to negative earnings surprises is greater than that for positive earnings surprises and that this asymmetric reaction increases for high market-to-book firms. Given that shareholder disappointments will be greater when the market's expectations are the highest, the potential findings of this study have implications for audit practitioners as they conduct audits for highly valued firms. Prior studies report that shareholder suits are a common source of auditor litigation (Palmrose, 1988; Goldwasser and Eickemeyer, 2004). Probable results of this study also warn the boards of highly valued firms. If overvaluation induces lower earnings quality and by extension lower audit quality, boards should be especially vigilant in their internal control function. This should be particularly true for the audit committee.

Currently, great many of works exists on audit quality and more recent studies have examined factors related to highly valued equity. By now only one paper (Houmes et al., 2013) exists that have considered audit quality within the valuation context. It synthesize and provide additional insight into both streams of research by investigating the accruals constraining effect of high quality auditors vis-à-vis other auditors when the client is highly valued.

#### Literature

#### Highly Valued Equity

A long-standing anomaly of efficient equity markets is the tendency for highly valued, high price-toearnings firms to earn lower returns going forward. Beginning with Jensen (2005), a significant stream of research has developed regarding the overvalued equity hypothesis. Chi and Gupta (2009) report that overvaluation-induced earnings management as proxied for by discretionary accruals is negatively related to following year abnormal returns. They document that, in the following year, abnormal returns of firms with high discretionary accruals are 11.88 percent lower than the returns of firms with lower discretionary accruals. Notwithstanding these conjectures, however, the tendency for high price-to-earnings firms to underperform is well documented (Basu, 1977; Chopra *et al.*, 1992; Campbell and Shiller, 2001).

From a market value perspective and relative to other companies, the very firms that are expected to perform the best, on average, tend to perform worse. Since expectations are particularly high for highly valued firms, when managers foresee the operational inability of their firms to meet expected performance targets, incentives to manage earnings increase. An important deterrent against these incentives is the audit.

#### Audit Quality

The value of accounting information is a function of its credibility. Central objective of auditors is to protect stockholders' benefits against significant mistakes and distortions that may be in financial statements. In order to preserve their fame and good reputations, and avoid litigation from stockholders side, auditors seek to enhance audit quality and as a result, accounting information credibility (Tendello and Vanstralen, 2008). Audit quality that is the indicator of auditing performance, is a function of various factors, as: auditor's competence including: knowledge, experience, independence in verification, objectivity, due professional care, conflict of interest, and judgment (Mojtahedzade *et al.*, 2004).

Prior researches have various definitions for audit quality. One common definition of audit quality is presented by DeAngelo (1981) under the title of "Market Valuation". In fact, Market Valuation is subject to: the probability that auditor 1) detect significant distortions in client's financial statements and/or

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information system, either 2) report detected significant distortions. The probability that auditors detect significant distortions is related to auditors' competence and the probability that auditor's report detected significant distortions is related to auditors' independence (HassasYegane *et al.*, 2006). Since various factors impact audit quality, determining a frame to define audit quality is an important subject (Mojtahedzade *et al.*, 2004). Prior studies have provided several empirical surrogates to measure audit quality. These include audit firm size, audit industry specialization, and the length of the auditor-client relationship.

Beginning with DeAngelo (1981), decades of research have shown that large audit firms with greater resources and more reputation at stake perform higher quality audits (Palmrose, 1986; Beatty, 1989; Craswell and Taylor, 1995; Lennox, 1999; Teoh and Wong, 1993; Houmes et al., 2012, etc.). Using accruals to proxy for earnings quality, Becker et al. (1998) show that clients of large (Big 6) audit firms report lower discretionary accruals. Krishnan (2003) provides evidence that investors ascribe higher values to the discretionary accruals of Big 6 clients than non-Big 6 clients. Heninger (2001) documents that the likelihood of litigation increases with levels of total and discretionary accruals, but decreases if a Big 5 auditor. One of indices of measuring auditor due professional care and supervising ability is auditor-client relationship tenure. More the length of auditor-client relationship, more knowledge auditor will have from clients' common accounting trends, and it will result in higher audit quality (Hassas et al., 2006). Balsam et al., (2003) shows that clients of within Big 6 and Big 5 auditor industry specialists have lower accruals and higher earnings response coefficients. Myers et al. (2003) document that discretionary accruals decrease with the length of audit firm-client relationship. Mansi et al., (2004) show that the cost of debt decreases with tenure and Carcello and Nagy (2004) document an increase in the incidence of financial reporting fraud when audit firm tenure is less than three years. Agaei and Nazemi (2012) in a research, use industry specialist auditors criterion in order to study effects of audit quality on earnings management in companies listed in Tehran Stock Exchange. They conclude that clients which their auditors are industry specialists, report lower levels of discretionary accruals management.

Although audit opinions enhance the credibility and reliability of financial reports, they also reflect a negotiation dimension and, within the ethical and technical confines of accounting standards, a firm's published financial report may be perceived as a joint statement from the manager and auditor (Antle and Nalebuff, 1991). Gibbons et al., (2001) use a sample of 93 experienced audit partners to report that auditor-client negotiation occurs on a regular basis. In particular, results show that negotiation is common, with 67 percent of audit partners experiencing negotiation with 50 percent or more of their clients. Hence, the final reporting product is often the result of a compromise between management and auditors (Ellingsen et al., 1989). Since managers of highly valued firms are under increased pressure to meet optimistic earnings forecasts, they have incentives to assume a more aggressive negotiating stance, prevailing on auditors, within the confines of existing accounting standards, to report higher earnings. Hence, income increasing negotiations that bias earnings upward should be more prevalent for highly valued firms. If the auditor relents, earnings quality will be impaired. Consequently, audit quality for highly valued firms could be negatively affected. Antle and Nalebuff (1991) demonstrate that when joint auditor-client welfare is maximized, ex post income reporting is biased upward. Although executives have numerous opportunities to manage earnings, accruals are particularly appealing since they are a normal, frequent, and expected component of the financial reporting process. Numerous prior studies provide evidence that earnings are managed with discretionary accruals (Subramanyam, 1996; Bergstresser and Philippon, 2006). Houmes et al., (2013) study the inverse relationship between audit quality and discretionary accruals in overvalued and non-overvalued firms. They show that the magnitude of inverse relation between audit quality and discretionary accruals in overvalued firms is significantly lower than of non-overvalued firms. Since highly valued firms are under greater pressure to meet earnings expectations, we expect that managers will assume a more intransigent negotiating stance with the auditor and utilize accruals to increase earnings. Consequently, the tendency for high quality audit firms to constrain accruals will be diminished for highly valued firms as auditors acquiesce towards the upper bounds of accounting standards constraints in the face of increased client pressure.

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Finally, auditors may suffer, at least in some measure, from the same information asymmetry that characterizes the relationship between managers and owners. While the asymmetry may not be as great, managers nevertheless are closer to the firms they lead than external auditors. At the very least, since managers of highly valued firms have better knowledge of their company's economic performance, they will be inclined to accept undetected statement errors in their favor and protest only those that are adverse.

We test these assertions with the following hypotheses stated in alternative form:

H1. The magnitude of the inverse relation between the discretionary accruals of the clients of industry specialist audit firms and clients of other audit firms decreases if the clients are highly valued.

H2. The magnitude of the inverse relation between the discretionary accruals of audit firms' clients with long audit tenure and clients with shorter audit tenure decreases if the clients are highly valued.

H3. The magnitude of the inverse relation between the discretionary accruals of the clients of audit industry specialist audit firms with long tenure and of other clients decreases if the clients are highly valued.

#### MATERIALS AND METHODS

#### Sample and Methodology

Our sample includes 250 firms listed in TSE during years 2007 through 2012. We acquired data of financial statement variables for the sample firms from *Rahavard Novin* files of Securities and Exchange Organization (SEO). We put data of 250 firms during 6 years in the model, so that, our observations in total include 1500 firm-years.

#### **Discretionary Accruals**

Our dependent variable is discretionary accruals  $(DAC_{it})$ . For all firms, discretionary accruals are estimated using the cross sectional version of the modified Jones model (Jones, 1991). The modified Jones model has been used in a variety of research settings (Becker et al., 1998; Francis et al., 1999; Reynolds and Francis, 2000, etc.). The model is specified as follows:

 $TAC_{it} = \beta_0 + \beta_1 (1/AT_{it-1}) + \beta_2 (\Delta REV_{it} - \Delta AR_{it}) + \beta_3 PPE_{it} + \varepsilon_{it}$  (1) Where  $TAC_{it}$  is the difference between firm *i*'s year *t* earnings before extraordinary items and net cash flow from operations scaled by beginning of year (*t*-1) assets;  $AT_{it-1}$  is firm *i*'s beginning of the year *t* total assets;  $\Delta REV_{it}$  is the difference in year *t* and year *t*-1 sales;  $\Delta AR_{it}$  is the difference between year *t* and year *t*-1 trade account receivables; and  $PPE_{it}$  is net property plant and equipment both scaled by  $AT_{it-1}$ . For each year discretionary accruals ( $DAC_{it}$ ) are estimated cross-sectionally as the residuals from the above regression. Discretionary accruals are the difference between each firm's actual and predicted accruals, i.e.:

$$DAC_{it} = TAC_{it} - [\beta_0 + \beta_1 (1 / (1/AT_{it-1})) + \beta_2 (\Delta REV_{it} - \Delta AR_{it}) + \beta_3 PPE_{it}]$$
(2)  
Control Variables

Relative to other companies, certain industries or firms may tend to generate higher accruals. In addition, it is natural that growth companies with increasing earnings and investments in working capital are more likely to produce greater accruals, and prior studies show that growth firms report higher accruals (McNichols, 2000). To control for the possibility that companies with greater total accruals may also have larger discretionary accruals that our accruals model does not capture, we include total accruals ( $ACRL_{it}$ ) in our multivariate tests measured as the difference between firm *i*'s year *t* earnings before extraordinary items and net cash flow from operations scaled by beginning of year assets.

Accruals studies typically control for size effects. Dechow and Dichev (2002) show that larger firms record larger accruals. Also, larger firms with larger investor following and more developed and sophisticated financial reporting systems may affect accrual levels (Becker *et al.*, 1998; Reynolds and Francis, 2000). For each firm *i* we include the end of fiscal year *t* natural *log* of total assets (*LnASSET<sub>it</sub>*).

Reynolds and Francis (2000) provide evidence that the tendency to manage earnings increases with leverage. DeFond and Jiambalvo (1994) show that accruals are related to debt covenant breeches. In addition, debt may serve as a monitoring mechanism that constrains earnings management. To control for

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the effect that high debt levels may have on accruals, we include the variable  $LEV_{it}$  measured as firm *i*'s end of year *t* long term debt scaled by *t*-1 total assets.

Operating cash flows are a component of earnings and their levels correspond inversely with accruals. Further, the level of cash flow may affect the ability and/or need to use accruals, causing firms with higher (lower) operating cash flows to report lower (higher) discretionary accruals (Becker *et al.*, 1998). We control for these effects by including operating cash flow deflated by the beginning of the year total assets ( $OCF_{it}$ ). Kothari *et al.*, (2005) show that discretionary accruals are impacted by financial performance. Accordingly, we include  $ROA_{it}$ , income before extraordinary items divided by the beginning of the year total assets.

# Variables of Interest; Audit Quality and Highly Valued Equity

Using our initial all accruals sample, we identify highly valued clients  $(HV_{it-1})$  as firms in the highest quintile of P/Es (i.e.  $P/E \ge 11.45$ ) and assign an indicator variable equal to 1 if the client is in this quintile of prior fiscal year end price-to-earnings ratios and 0 otherwise. Our audit quality variables are as follows:  $SPEC_{it-1}$ , equal to 1 and 0 otherwise if the audit firm is an industry specialist; and  $TEN_{it-1}$  equal to 1 and 0 otherwise if the length of the auditor-client relationship is equal to or over four years. We also include an additional audit quality indicator variable if the auditor is both an industry specialist and has a long tenure auditor-client relationship ( $SPECTEN_{it-1}$ ).

$DAC_{it}$	are Firm <i>i</i> 's fiscal year <i>t</i> income increasing discretionary accruals
ACRL <sub>it</sub>	are Firm <i>i</i> 's fiscal year <i>t</i> total accruals
LnASSET <sub>it</sub>	are Firm <i>i</i> 's fiscal year <i>t</i> natural <i>log</i> of total assets
$LEV_{it}$	are Firm <i>i</i> 's fiscal year <i>t</i> long term debt divided by fiscal year <i>t</i> -1 total assets
$OCF_{it}$	are Firm <i>i</i> 's fiscal year <i>t</i> cash flow from operating activates divided by fiscal
	year <i>t-1</i> total assets
$ROA_{it}$	are Firm <i>i</i> 's fiscal year <i>t</i> income before extraordinary items divided by fiscal
	year <i>t-1</i> total assets
$HV_{it-1}$	are An indicator variable equal to 1 for firms in the highest quintile of fiscal
	year <i>t-1</i> price-to-earnings ratios
$AQ_{it-1}$	are Three measures of audit quality defined as follows
SPEC <sub>it-1</sub>	are An indicator variable equal to 1 if at the end of fiscal year <i>t</i> -1 the auditor is
	an industry specialist
TEN <sub>it-1</sub>	are An indicator variable equal to 1 if at the end of fiscal year $t-1$ the auditor
	tenure is greater than or equal to four years
SPECTEN <sub>it-1</sub>	are An indicator variable equal to 1 if at the end of fiscal year <i>t</i> -1 the auditor is
	an industry specialist and tenure is greater than or equal to four years
SPEC*HV <sub>it-1</sub>	are An interaction term between $SPEC_{it-1}$ and $HV_{it-1}$
TEN*HV <sub>it-1</sub>	are An interaction term between $TEN_{it-1}$ and $HV_{it-1}$
SPECTEN*HV <sub>it-1</sub>	are An interaction term between SPECTEN <sub>it-1</sub> and HV <sub>it-1</sub>

**Table I: Variables Definition** 

Taking model from Houmes *et al.*, (2013), to investigate the relation between high valuations and the tendency of high audit quality auditors to mitigate accruals, we interact the audit quality variables with our highly valued equity dummy. Statistically significant and lower negative coefficients for the audit quality, highly valued equity interaction terms:  $SPEC *HV_{it-1}$ ,  $TEN *HV_{it-1}$  and  $SPECTEN *HV_{it-1}$ , relative to audit quality variables:  $SPEC_{it-1}$ ,  $TEN_{it-1}$  and  $SPECTEN_{it-1}$  provide support for hypotheses that incentives associated with high valuations reduce the tendency of high quality audit firms to constrain accruals. Following Houmes *et al.*, (2013), we use following models to examine hypotheses: (3)

 $DAC_{it} = \alpha_0 + \alpha_1 ACRL_{it} + \alpha_2 LnASSET_{it} + \alpha_3 LEV_{it} + \alpha_4 OCF_{it} + \alpha_5 ROA_{it} + \alpha_6 SPEC_{it-1} + \alpha_7 HV_{it-1} + \alpha_8 SPEC^*HV_{it-1} + \varepsilon_{it}$ (4)

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 $DAC_{it} = \alpha_0 + \alpha_1 ACRL_{it} + \alpha_2 LnASSET_{it} + \alpha_3 LEV_{it} + \alpha_4 OCF_{it} + \alpha_5 ROA_{it} + \alpha_6 TEN_{it-1} + \alpha_7 HV_{it-1} + \alpha_8 TEN * HV_{it-1} + \varepsilon_{it}$ (5)  $DAC_{it} = \alpha_0 + \alpha_1 ACRL_{it} + \alpha_2 LnASSET_{it} + \alpha_3 LEV_{it} + \alpha_4 OCF_{it} + \alpha_5 ROA_{it} + \alpha_6 SPECTEN_{it-1} + \alpha_7 HV_{it-1}$ 

 $+\alpha_8 SPECTEN*HV_{it-1}+\varepsilon_{it}$ 

Table I shows definition of variables used in the models.

# **RESULTS AND DISCUSSION**

#### Results

#### Descriptive Statistic

Table II and III provide descriptive statistics of variables. Table II shows the mean, median, maximum, minimum and other descriptive statistics of variables. Mean Total Accruals (*TAC*) and Discretionary Accruals (*DAC*) for the sample are 0.23 and 1.04E-15 respectively.

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	ASSET	DAC	TAC	OCF	ROA	LEV
Mean	15036469	1.04E-15	0.232646	0.168098	0.400743	36.84978
Median	703069.5	-0.23442	0.02711	0.097283	0.147485	0.083374
Maximum	5.33E+09	21.34733	19.04143	12.58758	31.62901	35033.46
Minimum	22404	-4.6866	-3.95764	-0.68143	-2.62881	0
Std. Dev.	1.76E+08	1.255666	1.076611	0.49352	1.357078	1107.878
Skew	27.75743	9.495227	11.54098	17.21688	15.69432	31.56845
Kurtosis	831.2537	141.9025	191.1709	408.4562	321.9456	997.7107
Sum	1.50E+10	9.84E-13	232.6457	168.0976	400.7434	36849.78

#### **Table II: Descriptive statistics of variables**

Table III shows the univariate correlations of variables. We can observe that independent variables aren't in great correlation with each other. It is important as if independent variables were in great correlation with each other, describing coefficients wasn't possible, because in describing coefficients, already condition and other variables are supposed as fixed. Hence, great correlation between independent variables violates this conception.

Univariate correlations in Table III reveals that size  $(ASSET_{it})$  is inversely related to discretionary and total accruals. *LEV<sub>it</sub>* positively (negatively) related to discretionary (total) accruals.

Correlation	DAC	TAC	ASSET	LEV	OCF	ROA
$DAC_{it}$	1.000000	0.885995	-0.005356	0.004472	0.360985	0.834163
$TAC_{it}$		1.000000	-0.007730	-0.007811	0.413122	0.943568
ASSET <sub>it</sub>			1.000000	0.455391	-0.009832	-0.009708
$LEV_{it}$				1.000000	-0.008176	-0.009170
$OCF_{it}$					1.000000	0.591406
ROA <sub>it</sub>						1.000000

#### Table III: Univariate correlations of variables

# Model Estimation

Since our models are panel data models, we use fixed effects method to fit out it. In fixed effects method, it is supposed that each observation has Y-interest by itself.

Discretionary accruals models:

Table IV shows results of main tests of our sample for models depicted in equations (3) through (5). As we can observe,  $R^2$  coefficients are 97 percent or upper. It means that 97 percent or over portion of variations in dependent variable is explained by independent variables. Durbin-Watson statistics are 1.78, 1.76 and 1.79 for equations 3, 4 and 5 respectively. As they are between 1.5 and 2.5, it means that there isn't autocorrelation in residuals.

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Table IV:	<b>Results</b> f	for	examination	for	effects	of	overvaluation	on	discretionary	accruals	of	high
quality aud	litors' cli	ent	S									

	Specialist	Tenure	Specialist and tenure
	Coefficient	Coefficient	coefficient
	(p-value)	(p-value)	(p-value)
С	0.1934 (0.0045)	-0.6897 (0.0000)	-0.7313 (0.0000)
$TAC_{it}$	0.8615 (0.0000)	0.8581 (0.0000)	0.8652 (0.0000)
LnASSET <sub>it</sub>	-0.0287 (0.0000)	0.0352 (0.0000)	0.0371 (0.0000)
$LEV_{it}$	8.06E-6 (0.0000)	-1.54E-6 (0.3587)	-3.64 E-6 (0.0438)
$OCF_{it}$	-0.0296 (0.4108)	0.01580 (0.6411)	0.01464 (0.6807)
$ROA_{it}$	0.0040 (0.0000)	0.0068 (0.0000)	0.0069 (0.0000)
$HV_{it-1}$	0.0360 (0.0163)	0.0351 (0.0019)	0.0391 (0.0000)
$SPEC_{it-1}$	-0.0932 (0.0000)		
SPEC*HV <sub>it-1</sub>	-0.0352 (0.0008)		
TEN <sub>it-1</sub>		-0.0422 (0.0535)	
TEN*HV <sub>it-1</sub>		-0.0053 (0.0177)	
SPECTEN <sub>it-1</sub>			-0.0950 (0.0159)
SPECTEN*HV <sub>it-1</sub>			-0.0280 (0.0673)
Durbin-Watson	1.78	1.76	1.79
$R^2$	0.97	0.97	0.98
F(p)	0.0000	0.0000	0.0000

Similar to prior studies, total accruals  $(TAC_{it})$  is significant and positive. Coefficients for  $ROA_{it}$  are positive. It means that discretionary accruals increase with (scaled) income.  $HV_{it-1}$  coefficients are positive. It means that as if firms are highly valued, their earnings have low quality. Table IV also shows that the coefficients for the specialist, long tenure and long tenure-specialist audit quality measures are significant and negative with estimates and p-values of -0.0932 (0.00), -0.0422 (0.0532) and -0.0950 (0.0159) respectively. It demonstrates that audit quality variables are in inverse relation with discretionary accruals.

We test hypotheses with interaction terms for our highly valued equity and audit quality variables:  $SPEC*HV_{it-1}$ ,  $TEN*HV_{it-1}$ , and  $SPECTEN*HV_{it-1}$ . Respective estimates and p-values for the sample are -0.0352 (0.0008), -0.0053 (0.0177), and -0.0280 (0.0673). For each of the three alternatives of audit quality measures, the inverse relation between audit quality and discretionary accruals mitigates as if firms are highly valued. These findings provide evidence that relative to other firms, the accruals decreasing effect of high quality auditors is reduced when the client is highly valued. Furthermore, these results are robust across several measures of audit quality with interaction term,  $SPECTEN_{it-1}$  to  $SPECTEN*HV_{it-1}$ , showing the greatest amount of decrease in coefficient of inverse relation (0.0670) between SPECTEN audit quality and discretionary accruals (from -0.0950 to -0.0280).

#### Conclusion

During this study, we use three audit quality proxies from prior literature, and examine accruals decreasing effects of high quality auditors on highly valued audit clients. We posit that management incentives associated with highly valued equity reduce tendency of high quality auditors to reduce accruals. Although results generally support hypotheses, reported increase in accruals may be affected by the particular measure of audit quality used.

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