

Full Length Research Paper

Effect of executive board and family control on audit opinion

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In this study the relation and effect of corporate governance on audit opinion of CPAs is investigated. The companies investigated are listed in Tehran Stock Exchange and are selected using the systematic elimination method. They are 104 companies. The time period is 2008-2010. The statistical methods used are logistic regression and Wald test. The data were collected from the companies' annual financial statements and independent auditors' opinion. The results indicated a significant relation between the ratio of the executive board and type of independent auditors' opinion. Therefore, in companies with higher ratio of executive board members, the right opinion of an independent auditor is taken along with an explanatory paragraph. Moreover, there was a positive and significant relation between family control and type of CPA's opinion; that is, if a company has higher rank in terms of ownership, then the independent auditor's opinion will have a fewer number of paragraphs and vice versa; in companies with more stockholders dispersion, the independent auditor's opinion is unqualified and has more audit paragraphs. Adding the corporation's size to the research model, the research results were approved.

Key words: Audit opinion, executive board, family control.

INTRODUCTION

Today, there is no doubt about the significance and role of corporate governance in companies' success since this topic has gained more importance due to the recent events and financial distresses of companies. By investigating the causes and pathology of collapses of large companies, which causes them serious losses, especially their stockholders, it is seen that such events

occur due to the weakness in their corporate governance systems (Ghirmai, 2011; Hesiang and Li, 2010). Studies show that corporate governance could promote companies' standards, provide and equip investments and investors, and improve executing issues; it is also one of the major elements in improving companies' economic efficiency, since it oversees the relations

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among stockholders, board members, managers, and other shareholders (Chen et al., 2007; Derek and Zhein, 2011). CPAs as reliable and expert individuals are representatives of stockholders that confirm the correctness and honesty of information published by managers. They have independence and assess managers' performance and their reports; they report any important and meaningful departure from the accepted principles of accounting and management, and the constraints in providing documents and information by managers to the stockholders (Watts and Zimmerman, 1986; Fama et al., 1983; Aslani, 2002). This prevents any moral hazard among stockholders and managers, and increases the reliability of companies' financial statements (Hasasyeganeh, 2008; Muatz and Sharaf, 1961, Nikkhakazad, 2005). The corporate governance system, due to its supervisory components, could be related to the auditor's opinion type; for instance, the dispersed stockholders have different impacts on CPAs' behavior compared to the combined stockholders (Ghosh et al., 2010; Chan et al., 2007; Hungchan et al., 2010).

The current study aims to investigate the effect of the executive board members and family control in companies on CPAs' opinion.

LITERATURE REVIEW AND DEVELOPMENT HYPOTHESES

Salaki (2009) concluded in a study that there is no significant difference among internal auditors and the ratio of the non-executive board members and information asymmetry criteria. But there is a negative significant relation between the family investors ownership percentage and information asymmetry. Shoja'e (2010) stated that family stockholders in combined stockholders and supervising their efficiency have significant reduction effect on sample member companies' cost of debt while audit quality does not have such an effect.

Ghorbani and Golmohammadi (2010) mentioned that the quality of audit is effective on all three levels of income manipulation. Namazi et al. (2010) found out in their studies that there is a positive weak relationship between audit size and time of auditing with earnings management. Nonahal et al. (2010), in their study on companies active in Tehran Stock Exchange, concluded that the stability ratio of the discretionary accrual items in companies with higher quality CPAs is higher; therefore, there is more reliability concerning their accrual items. Ibrahim (2001) indicated that the auditor's skill has a positive effect on the process effectiveness and improving the auditors' informing performance. Also, the results showed no proof that the client might affect the independence of the auditor or the auditors might allow the major clients to have more authority in the earnings report. Ibrahimikodlor and Seyedi (2008) concluded that

an auditor has a relationship with the discretionary accrual items and the CPAs opinion does not have an effect on the discretionary accrual items. Johl et al. (2007) investigated the relationship between the earnings management and the auditors' opinion in Malaysia. They found out that the earnings management level in companies where their audit is carried out by world's 5 big auditors is different from companies whose audit is not carried out by these institutions. Francis and Michel (2005), in their studies, concluded that companies with more accrual items intend to employ auditors with higher quality and ranks. Nagy and Carcello (2004) and Falateh (2006) believe that auditors with more time for auditing have higher quality opinions. Chambers and Payne (2008) found out that higher quality audit and employing Sarbanes-Oxley law improve reliability of the accrual items. Chen et al. (2005), in an investigation on Taiwanese companies, concluded that earnings management had occurred in them and there is a significant reverse relationship between earnings management and audit quality. Ahmad et al. (2011) investigated the impact of auditors, board members and family stockholders on aggressive financial reporting. They found out that there is a significant relationship between the CPA's independence and discretionary accrual items. They reported that this relationship was weak in years prior to the issuance of Sarbanes-Oxley law. Also they found that companies with weak governance system have more discretionary accrual items.

Tendello and Vanstraelen (2008), in their study on European companies, reported that audit quality and earnings management are significantly related. Kamwah and Ferdinand (2008), in their investigation on "Lavantal" auditing company's bankruptcy, found out that the clients of this auditing company had more discretionary accrual items than other auditing companies' clients. Bartov et al. (2000) found out that the unqualified audit opinion has a direct relationship with the companies' amount of discretionary accrual items. However, Bradshaw et al. (2001) reported that companies with qualified opinion had more discretionary accrual items than companies with unqualified discretionary accrual items.

According to the results obtained from researches carried out in countries with different legal and economic conditions from Iran, and because there is no work on the effect and relationship of corporate governance components in Iran with audit opinion, this study focuses on the effect of corporate governance components, such as the effect and role of executive board in companies and the role of ownership and stockholders combination on CPAs' behavior and opinion in Iranian companies.

The following hypotheses are formed: There is a significant relationship between the companies' ratio of executive board members and audit opinion. There is a significant relationship between the companies' ownership concentration rank and audit opinion.

RESEARCH METHODOLOGY

Statistical population and sample

This is an applied (practical) research which investigates the correlation of variables, and since it deals with past events, it is also ex-post facto. Therefore, the statistical population of this research consists of the companies listed in Tehran Stock Exchange in 2003-2008. In order to extract the required data, financial information especially financial statements, CPAs' reports and notes of financial statements were available. In this study, the systematic elimination was used as the sampling method. Companies included in the statistical population meeting the following features were selected as samples, and the rest were eliminated:

1. Companies with steady activity and whose stocks were traded during the research period.
2. Companies which are not investing firms and financial and insurance intermediaries.
3. Companies whose fiscal year is February.

By applying the companies' selection terms, 104 companies were selected as samples whose financial information was used in the analyses.

Research model

Considering the research hypotheses, the research model was formulated as follows:

$$\text{Audit opinion} = \alpha_0 + \beta_1 * \text{EXE BOARD} + \beta_2 * \text{FAM CONT} + \beta_3 * \text{CONT VAR} + \varepsilon \quad (\text{Equation 1})$$

Where, **audit opinion** is the CPA's opinion, **EXE BOARD** is the ratio of the executive board members, **FAM CONT** is the family control, and the **CONT VAR** refers to control variables, which include auditors' characteristics, companies' financial characteristics, and auditors' problems.

Variable definitions and their measurement and collection method

CPAs' opinion

Based on Iran's audit standards, CPAs must present their reports and financial statements to companies' stockholders; they should frankly give their opinion on all the financial statements. If a company, in 4 years out of 6 years, has qualified audits (with explanatory paragraph), it receives number "1"; if otherwise, number "0" is allocated to it. To do so, the CPAs' reports attached to the companies' financial reports are considered.

The executive board ratio

According to Iran's trade law, companies and stockholders can elect companies' board members biennially. These members except for the CEO, who is executive and full-time, could be from inside or outside of the company. The board members who are active inside the company are referred to as employed, executive and full-time members. In order to measure this ratio, the number of executive board members is divided by the total number of the company's board members. The figure for this index is derived from the 6-year average activity report of each company. According to Iran's trade

law, presenting annual activity report by board members in addition to the financial statements and auditor's report is mandatory.

Family control

Family control refers to the presence of family stockholders in the company's stockholders combination, and the family stockholder is determined according to the Iran Stock Exchange Organization's regulations in which the amount of free float is exchanged publicly, and includes all the block stocks related to a holding. In order to obtain the index and rank of each company, the Herfindahl-Hirschman Index (HHI) was used. It is calculated using the following equation:

$$\text{HHI} = \sum (\text{pi} / \text{p} * 100)^2 \quad (\text{Equation 2})$$

The above index is obtained from the sum of the root of stocks percentage belonging to companies' stockholders. As this index increases, the ownership concentration amount increases, and reaches its maximum value when all the stocks belong to one person and are equal to 10000 units. If the ownership structure is dispersed and each stockholder has equal share, the HHI is minimum and equal to $N/10000$.

Variable control

The CPAs' characteristics

Size of audit institutions: The size of institutions is calculated based on the number of personnel and employees.

The auditor's knowledge about the client's industry: If, during the last 6 years, the auditor had had any experience of auditing in the client's industry, it is given number "1"; if otherwise, number "0" is allocated to it. The audit firms' size is disclaimed by the Iranian Association of Certified Public Accountants which is obtained by reviewing the reports presented by audit firms.

The companies' financial characteristics

Leverage is the company's 6-year average of total liabilities to total assets ratio. Size is the logarithm of 6-year average sales.

Auditors' special problems

The nature of auditing is intended. Two components were considered in this research: The 6-year average of company's inventory and assets ratio. The inventory is both diversified and different parts of a company are engaged in it. Therefore, it is more sensitive. It includes the 6-year average of company's receivables to assets ratio.

All of the above cases are derived from the companies' annual financial statements.

Descriptive statistics results

The results from the descriptive statistics are shown in Table 1. The results show that about 61% of companies had qualified opinions. The average ratio of executive board was 45% and in companies with qualified opinion, this ratio was 61%. The family ownership

Table 1. Descriptive statistics of variables.

Variance of observation	Mean of observation	Variables	Type of variable
0.115	0.481	Executive board ratio	dependent
0.097	5872	Ownership concentration ratio	
0.242	68	Audit firm size - number	
0.191	0.611	Acquaintance to client	Controls
0.151	0.629	Leverage ratio	
0.274	3541	Corporation size	
0.175	0.368	Inventory ratio	
0.319	0.216	Accounts receivable ratio	

Table 2. Information about the first hypothesis and the results of the Wald Test.

Confirm/reject	EXP(B)	sig	Wald	S.E	B	Variables
Confirm	0.0416	0.0291	3.712	1.266	2.348	Executive board ratio
Reject	1.000	0.441	0.595	0.000	0.000	Audit firm size - number
Reject	1.015	0.621	0.244	0.031	0.015	Acquaintance to client
Confirm	0.029	0.041	4.188	1.243	2.545	Leverage ratio
Confirm	0.0406	0.0423	4.050	2.439	2.098	Corporation size
Confirm	0.0309	0.037	3.850	2.012	2.805	Inventory ratio
Reject	6.487	0.246	1.345	1.612	1.870	Accounts receivable ratio

concentration rank in companies with qualified audit opinion was 7349 which was higher than the average 5872. That is, the family ownership in such companies is higher and the majority of the companies' stocks are owned by limited natural and legal personalities who have extensive and accurate supervision on CEO and board's performance. The size of such companies is larger than the average size, and also their auditors are well-known and more experienced among Iranian Association of CPAs. Moreover, about 70% of their capital is provided using banks' facilities. The inventory percentage of such companies is higher than the average 36% and is around 47%; and since they almost have the monopoly of their services in Iran (they are governmental or quasi-governmental), they have cash sale market and their receivables percentage is not large and is 5% lower than the companies' average.

Hypothesis test results

Table 2 presents the information about the first hypothesis and the results of the Wald test.

In order to examine the relationship and effect of each independent variable and control on auditor's opinion, the logistic regression was used. As it is shown in the table, the relationship between the executive board ratio, companies' size, and inventories average ratio with auditor's opinion is directly and positively confirmed. That is, each sign of variables and also Wald's statistic for these variables approve their relationship with type of auditors' opinion (their sign level is less than alpha error acceptance level of 5%). But the leverage has a negative, inverse relationship and effect on the type of auditor's opinion. Which means by increasing the company's leverage, its effect on auditor's opinion type would be significant and inverse. Confirming the relationships between the above-mentioned variables with CPA's opinion type means that the

success chance in issuing opinions by CPAs is approved. For example, when the ratio of the executive board is higher in a company, it is expected that its CPAs opinion should be different from a company in which this ratio is lower. Hence, companies with different size, leverage, or inventory could have different CPA's opinion. As shown in Table 2, there is no relationship between size of auditing institutions, the acquaintance level with the client's industry, and clients' receivables with type of auditors' opinion; also companies could not have different auditor's opinion from this point of view.

In the research's second hypothesis, investigating the auditor's opinion relationship with family ratio in companies' ownership, auditor and client's size, companies' leverage, receivables average, and their inventories, using the Wald test and logistic regression, the following results were obtained, as shown in Table 3.

As shown in Table 3, the relationship of family ratio in companies' ownership, companies' size, and inventories averages with the auditor's opinion type is confirmed; the sign level of each variable and also the Wald's statistic for each variable approve their relationship with the auditor's opinion type (their sign level is less than alpha error acceptance level of 5%). But the leverage has a negative, inverse relationship and effect on the auditor's opinion type. The table shows that the effect of auditor's size, acquaintance level with client's industry, and client's receivables average on the auditor's opinion type is not accepted; which means that any increase or decrease in these factors does not affect the CPA's opinion, whether qualified or unqualified.

RESULTS AND DISCUSSION

Based on the theoretical principles, it is expected that

Table 3. Information about the second hypothesis and the results of the Wald Test.

Confirm/reject	EXP(B)	sig	Wald	S.E	B	Variables
Confirm	0.056	0.031	3.178	0.266	0.326	Ownership concentration ratio
Reject	1.000	0.416	0.435	0.000	0.081	Audit firm size - number
Reject	1.015	0.621	0.244	0.031	0.075	Acquaintance to client
Confirm	0.079	0.041	4.188	1.243	2.365	Leverage ratio
Confirm	0.056	0.023	3.050	0.439	0.298	Corporation size
Confirm	0.062	0.036	4.905	2.012	1.565	Inventory ratio
Reject	0.027	0.046	4.105	1.612	0.370	Accounts receivable ratio

there must be numerous factors, whether related to auditors or clients, based on the CPAs' opinion which affect the audit quality. CPAs are facing a kind of paradox due to the budget time pressure and various risks, such as litigation risk, and creating balance between audit efficiency and audit quality (Wanda et al., 2002). One of the factors affecting auditor's role and opinion is the full-time and working CEO and board who are assumed to be responsible by the stockholders. Auditors who are selected by the stockholders should present their opinion based on professional morals and Iranian audit standards. However, in doing so, they are faced with several pressures such as extending the contracts duration by CEO or board members; and since there is no audit committee in Iranian companies, therefore the executive CEO and board play a major role in re-selection of the CPAs. Thus, considering the client, board, and CEO opinions is a certain priority of each auditor, which our hypothesis confirms in this research and their relationship is positive and direct. Another effective factor on auditors' opinion, which is also emphasized in theoretical principles, is the role and pressure from the major stockholder and family control that select the board. In Iran's corporate governance regulations, support for the minority's benefits is neglected, and the major or main stockholder is able to select the major managers and implement financial policies, financial support; and earnings sharing as well as other important decisions is based on his/her wishes using the terms stated in Iran's trade law. Also, the stockholder could select the auditor, which according to Iran's trade law must be selected by stockholders, and determine his/her wage. Therefore, it is predicted that this may affect the auditor's opinion. In this study, this positive effect is also confirmed and the auditor is affected by the main stockholder.

In addition to the two components of the corporate governance mentioned above, factors such as client's size, client's leverage, and disclosed inventory in financial statements are effective on the auditor's opinion. This has a direct relationship with the CPA's opinion. Usually, as companies' used financial facilities and their assets volume as well as inventory items diversity increase, the

risks and hazards also increase and the auditor's opinion would be presented with more sensitivity.

Investigating the type of CPAs' opinion in the studied companies showed that the executive board ratio, leverage, assets, and inventory are higher and larger in companies with qualified auditor's opinions. Of course, the relationship between leverage and auditor's opinion is invert.

Conclusion

Based on agency theory, it is expected that the CPAs act independently of the firm's management, particularly the executive board and the chairman, and fulfill their attestation task appropriately. In this research, the relationship between the executive board and full-time managers and CPAs' audit opinion is confirmed. An analysis of the structure and procedure within which CPAs are selected in Iranian companies reveals that the CPAs are chosen by the board of directors and the chairman. Thus, they have an important effect on accountants' audit opinions, and accountants cannot include auditing paragraphs in their reports prior to coordination with the board of directors and full-time managers. Furthermore, the texture of shareholders in firms can indirectly affect CPAs' audit opinions through the effect and power they can impose on selecting the board of directors and managers and the shareholders want the CPAs to arrange their accounting paragraphs according to their wills. For larger firms, such relationship is more significant and the reason for this can be that the capital market is more sensitive about such firms, and that those firms are more susceptible to evaluations by shareholders and government; therefore, firms' managers place more importance on accountants' opinions, and a slight amount of unqualified opinion of accountants can have an effect on managers' affairs and be followed by the reaction of the capital market. An examination of Iranian firms indicated that governmental organizations and institutes own the majority of the firms' shares, and minority shareholders have not received much of a support from regulations and other criteria; and

the main shareholder can decide on all the firms' policies, including financial, financing, and operational policies.

Suggestions

Based on the results of the research the followings are suggested:

1. Due to the auditor's position as the company's stockholder representative, the role of non-executive board members and audit committee as independent elements becomes more highlighted, and therefore the corporate governance regulations for Iranian companies must be modified.
2. Iran trade law must be reconsidered due to its oldness and lack of consistency with current conditions and because it does not take into account issues related to the governance system.
3. The auditor selection method must be reconsidered in Iran so that the auditor would have more independence and companies' executive members and CEO should not affect his/her opinions.

Conflict of Interests

The authors have not declared any conflict of interests.

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