The investigation of audit quality on the cost of financing

Yazdan Bagheri[1], Mohsen Nikseresht[2], Ali Reza Rouzbahani Pari[3]

[1] Department of Accounting, Mazandaran Science and Research Branch, Islamic Azad University, Sari, Iran; [2] Young Researchers and Club Elite, Ayatollah Amoli Science and Research Branch, Islamic Azad University, Amol, Iran; [3] Department of Accounting, Khomein Science and Research Branch, Islamic Azad University, Khomein, Iran

Abstract

Audit quality and its components are factors that play an important role in the financing costs of firms, and consider many studies regarding financial decisions about methods of financing. In this study, ,we will investigate the relationship between audit quality and cost of financing in Listed Companies in Tehran SEC with examining the importance of financing costs (interest expense) . Naturally, Audit quality creates a trust and confidence in investors, which in turn reduces the information risk and certainly will affect the cost of financing of firms. This study examines the relationship between audit quality (size of the audit firm) and the cost of financing in Iran. Therefore, members of certified public accountants for auditing the auditor considered small audit firms and the audit staff of auditors is much more ancient one. The results of the survey of 221 companies listed in Tehran Stock Exchange during the years 2006 to 2011 show that audit quality has a significant effect on the cost of financing.

Keywords: audit organizations, audit quality, cost of financing, firm size

Introduction

So far, much research has been done in this context (the firms of financing decisions and the factors affecting on the capital structure (. In recent years, there has been considered many discussions about the need for the quality of audits in the world, perhaps it is the reason that creditors emphasize on the properly portfolio market to grant the facility. Audit quality plays an important role in the reducing of agency problems. Discussion of audit quality is very hot debate around the world, including America's largest auditing firms in this country that offer quality services highly, although more attention has been considered about the audited quality in recent years, since it is derived from information asymmetry between managers and investors there. The audit of financial statements is one way to determine the validity of the information and take into account the growing competition in the profession. It is required to be felt for better quality of audit services market. With regard to the issue of globalization and the information revolution, audit profession gradually tries to move in order to keep pace with the changing technology needs of society. In this environment, users need to various information, including financial information of businesses entities. Financial statements are the most complex financial information; but the important question is doubts about the reliability of the information that comes from a conflict of interest. Except conflict of interest, other issues such as lack of direct access to the information users have led to demands for an independent audit service, which in turn will affect the reduction in interest payments.

Theoretical basis of Research

A lot of efforts have been carried out to define the "quality of audit". Although none of them did not find public acceptability. Specifically, a concept of audit quality is a complex and multifaceted.

Davidson and Neo (1993) believe that the quality of audit will detect in the auditor's ability and remove the significant distortions and manipulations are performed on the reported profits. Thus, the auditor's ability to audit quality is an impor-

Corresponding author: Mohsen Nikseresht, Young Researchers and Club Elite, Ayatollah Amoli Science and Research Branch, Islamic Azad University, Amol, Iran. E-mail: m_nikseresht@yahoo.com

tant issue from different perspectives and interpret extensively which is connected with internal and external auditors properties, like the experience, competence, ethics and independence of auditors (independent of the employer, and market competition) and the legislature (replace mandatory audit and non-audit services, etc.).

De-Angelo(1981) believes that larger audit institutions and stronger incentive provide higher quality audits because they are interested in the market to gain a better reputation and if the number of customers is high, it doesn't need to be worry about losing customers. It is thought that such institutions of higher education, access to resources and their auditors and the various tests, the auditor of higher quality offer. Davidson and Neo (1993) shows that larger audit clients are large institutions, therefore, expect the market to detect distortions in the financial statements and the auditor's increases. Furthermore, empirical evidence suggests that the larger audit institutions are of higher audit quality; because better resources are for training the auditors in performing audits than smaller firms.

Beatty, Weber and Scott Shows that Large audit firms instead of small audit institutions are more motivated to issue a report honestly. His research shows that the greater the amount of funds in the sample audit, the auditor independence is increasingly important. (Myers, Majluf2004 , & Pittman, Fortin2004).

Some of the other researchers show the reducing cost of funding for public institutions, according to the reputation for auditing (sajadi, 2004).

In fact, the role of audit is assessment of the information quality for users of the creditors and so on. Audit quality can influence the cost of financing in two ways. For example audit quality can be a major source of shareholders to monitor managers (Bushman, 2001). Thus, audit quality which reduces agency problems can increase the ability of shareholders to monitor managers, and it can help to improve the efficiency of investments because of the increasing the ability of shareholders to monitor managers which can improve project selection and financing costs are reduced.

On the other hand, Verrecchia states that audit quality which reduces the information asymmetry between firms and investors will be reducing costs adverse selection. On the other hand, the existence of information asymmetry between firms and investors can lead to capital suppliers, and the company's stock price will decrease and increase the cost of finance. (Mautz, 1984). Thus, if audit quality reduce adverse selection costs, financing costs will also decrease. However, in other studies it was noted that internal auditors play an important role in improving the reliability of financial information (Mautz, 1961).

Review of Literature

Hashemi et al (2010) began to evaluate the investment of Listed Companies in Tehran SEC. In order to test the research hypothesis, they were used multiple regression analysis and financial data of 107 participants registered between 1999 and 2008. The results indicate that firms with large positive accruals, investment in capital assets, are more sensitive to internal cash flows. Moreover, the results obtained has implies the negative relation between current accruals and future returns on assets. Other results indicate that market pricing of accruals is not under the influence of external financing. Also, test the hypothesis, among the industries studied, led to different results.

Ahmad-poor et al (2011) were reviewed the impact of corporate governance and audit quality on the cost of financing. They show that audit quality (used in) of the famous auditors not only reduces the cost of financing but also show a significant correlation between the costs of financing.

Chang et al (2008) investigated the relationship between audit quality and auditor reputation of the financial decisions in firms. They found that the quality and reputation impact on the audit firm's financial decisions and also the high quality of the audit reduce the impact of market conditions on the financial decisions of firms and their capital structure.

Beatty et al (2007), in their study showed that lenders are an important reason of reduced quality of accounting information, but limited in finance, and increase the investment efficiency and effectiveness of accounting quality on the reducing of investment performance.

Fortin (2007), studied the impact of auditor reputation on the financing costs, but on this study they couldn't find evidences related to financing costs and the selection of the renowned auditors.

On the other hand, Mansi , Maxwell, Miller (2004) couldn't find evidences of related inancing costs and the selection of the renowned auditors.

Pittman (2004) have been investigating a number of American companies during the years 1977 to 1998 in terms of the impact on the cost of financing the reputation of Auditors during the nine years in which registered Stock Exchange Commission. It found that the companies that the big institutions have taken to audit service, the average cost is less than the financing.

Research hypothesis

This study has been used the creation of audit size to measure audit quality and investigated financing cost because we can state the main hypothesis according to below expression;

Hypothesis 1: There is a significant relationship between audit quality and financing cost.

Materials and methods

This study, from data gathering method is descriptive, Causal comparative. This study directed towards practical application of knowledge. Also, classification is based on a method and nature is a kind of correlation research. As noted above, this type of research is the investigation of events, it means, the research studied the possible cause and effect relationships through observation of existing conditions, and in this method the cases of study occurred in the past and they are not able to manipulated by researcher.

The population is all of Tehran Stock Exchange listed companies. To select the sample, the following criteria have been considered:

1. before 2006 to be accepted in Tehran Stock Exchange and till the end of 2011 to be active.

2. In order to comparable information, companies during the study period did not have any changes in fiscal period and their end of year are in Esfand (February).

3. In order to homogenize information, companies should not be investing companies or financial brokerages include insurance and bank.

4. Their stocks to be traded during the year. After considering the above criteria, 221 firms were eligible for statistical community that 140 firms among population of research during 2006 to 2011 have been selected randomly.

$$\mathrm{DebtCost}_{it} = \beta_0 + \beta 1 \mathrm{Audquality}_{it} + \beta 2 \mathrm{LnAssets}_{it} + \varepsilon_{it}$$

Debt cost $_{it}$: Cost of debt of i firm in t year
Audquality: Audit quality
InStblock: Major institutional shareholder
LnAsset $_{it}$: size of i firm in t year
ε_{it}: the error for i firm in t year

Methods of data collection

In this study, the method of data gathering was library method that essays and documents relating to study and audited financial statements of companies, financial reports and companion notes that published with Tehran Stock Exchange have been studied. These types of data are secondary data that are reliable and valid; the tool of data gathering in this study is document survey. Tools that used to gathering data included, observation, statistical tests, databases and Excel and EVEIWS software.

The information about literature and theoretical debates were collected from library resources such as books, Persian and English periodicals and internet sites.

Methods of data analysis and definition of variables in this study for data analysis have been used with two methods.

Descriptive and inferential statistics

In descriptive statistic, mean, variance and standard deviation and inferential statistic, Pearson correlation factor, T test, F test, in multiple regression method with Panel Data to examine research model have been used. In order to efficiently estimate, a regression model with Panel Data is needed that an appropriate tests, one of the common effects, fixed effects and random effects can be selected for this purpose to choose between common effects models and fixed effects have been used F test. If we select fixed effects, we have to use Hasuman test to select between fixed effects and random effects. If the results of F test verify, by using the common effects method, Hasuman test is not needed for the model estimated with common effects. In this research, to check the independence of regression model errors, Watson test was used and to accept or reject the main hypothesis of research, the Student test was used. To test the hypothesis research multiple regression model will be used.

Debt cost $_{it}$: Cost of debt of i firm in t year
Control: Control shareholders
BrdInd: Independence of board of directs
InStblock: Major institutional shareholder
LnAsset $_{it}$: size of i firm in t year
€$_{it}$: the error for i firm in t year

Dependent variable

Costs of financing of business activities are the concern of many activists. Financing costs may be prepared with merchant or his/her partners personal properties and/or by bank loan and co-operation with active companies in the field of financial, that the successful merchant accepts the combination of both choose.(Raymond, 1995). So, costs of financing can be calculated using debts such as bank loans and issuance of stock. It seems that corporate governance can affect the cost of financing of companies. Financing cost in this study is equal to the ratio of financing cost to total of long- term and short- term receivable facilities of companies.

Independent Variable

In this study, if the auditor of company to be a member of audit organization and the size of audit firm selected as audit quality , we consider 1 and otherwise we consider 0 (zero).

Control Variable

LNASSETS, (size of company): calculated with natural logarithm of total assets of the sample.

Results

Statistical tests

As the result of table (1) shows, the P-Value of F Limer test is equal 0.000.

As a result, the common effects method rejected. Results of F Limer test showed that the common effects method is not appropriate for estimating the regression models. So, the Hausman test uses to select an appropriate method. The P-value of Hausman test shows that fixed effects method is a better option for estimate model.

Table 1.The results of F test and Hausman test

Tests	Test statistic	Degrees of freedom	p-value	Test Result
F Limer test	4.4116	139.698	0.0000	Fixed effects method
Hausman test	30.6890	2	0.0000	Fixed effects method

The results of testing hypotheses

The results of regression model that has been done with fixed effects method, showed in table 2. P-value statistic of F fisher test is equal 0.000 and it means that model has overall adequacy. Adjusted R-squared is equal 0.8335, and it indexes that more than 83 percents of independent variable changes explained with independent and control variables. Statistic of Dor bin-Watson (2.0307) indicates that there is no error in component of correlation. The main hypothesis of study investigated the relationship audit quality and financing cost. As the result of table 2, the level of significant of this variable is 0.0322, and the acceptable error level is 5 percepts, thus, It's represented that there is a significant relationship between audit quality and financing cost , as a result, the main hypothesis confirmed.

The result of control variables has been showed that financing cost has a significant positive relationship between the variable of size of company (LnAssets).

Table 2. Regression Results

Variables	Coefficient	t-Statistic	Prob.
C	-0.343011	-14.52510	0.0000
AUD	-0.008867	-2.146315	0.0322
LNASSETS	0.036642	20.87457	0.0000
Adjusted R-squared		0.8335	
F-statistic		30.8046	
Prob(F-statistic)		0.0000	
Durbin -Watson stat		2.0307	

Conclusion

In this study, the effect of audit quality on the financing cost has been investigated, it means, whether the creditors consider the audit quality about companies that applicant creditability or not. High auditing improve the accuracy of the provided information and allow investors till have more accurate estimate about company value; therefore, the high quality of auditing causes companies provide more transparent and quality information that it decreases the information risk of creditors and influences the financing cost.

Table 2 shows that the coefficient of significant level of audit quality are -0.0089 and 0.032 respectively so it can be stated that debts are significant negative relationship between audit quality and financing cost. The result indicates that the company's financial statement was audited by large organization or high quality organization, which financing cost of the company's will be reduced. The supplier capital companies for funding to applicants considers the audit quality as an important factor.

The result of this study, Chang, Sudipto, Gilles (2008), investigated the relationship between audit quality and auditor reputation of the financial decisions in firms. They found that the quality and reputation of auditors have a positive impact on the audit firm's financial decisions.

The results of this study have consistent with the result of Fortin, Pittman (2007) which studied the impact of auditors reputation on the financing costs. They found, that companies that have taken the big audit organization, the average of their financing cost is lower; but the result of this study isn't consistent with the result of pito and missonierpiera(2007). They didn't found any evidence that support to the choose of auditor and financing cost of companies.

Suggestions based on research results

According to the result of hypothesis that showed a negative relationship between audit quality and financing cost from debts, we suggest that financing companies in their financing consider more to the size of audit organization. Also, the breakdown of company's value annually and monthly, and investigation of the relationship among each of these components with financing cost of listed companies in Tehran stock Exchange may effect on financing cost.

Reference

Ahmad Pour, A,. Kashani-Poor, M., & Shojaei, M. (2010). The effect of corporate governance and audit quality on the financing cost, *Journal of Accounting and Auditing Reviews, 62*, 17

Ahmadpoor, A., Maleki, E., & Kurdtabar, H. (2009). The effect of non-executive directors and institutional investors on earnings management behavior (earnings management based on thresholds model), *Journal of Accounting Research, 3,* 87-68.

Beatty, A., Weber, J., & Scott, J. (2007).*The Role of Accounting Quality in Reducing Investment Inefficiency in the Presence of Private Information and Direct Monitoring*. Working paper. The Ohio State University.

Clive, L. (1984). the Relationship between Auditor Accuracy and Auditor Size: An Evaluation and Deep Pockets Argument; *Accounting Review, 57,* 21-33

Davidson, R. A. & Neu, D. (1993). Note on Association between Audit Firm Size and Audit Quality; *Contemporary Accounting Research, 9*(2), 479-488

DeAngelo, L.E. (1981). Auditor's size and audit quality. *Journal of Accounting and Economics 3,* 183-199

Fortin, S. & Pittman, J.A. (2007). The role of auditor choice in debt pricing in private firms, *Contemporary Accounting Research, 24*(3), 859-896.

Hassas yeganeh.Y., & Moradi, M. (2007). The effect of the revised OECD principles of corporate governance in the financial, *Corporate governance series, 180.*

Hosseini, S.M. (2007).*Investigate the effect of institutional investors as a measure of corporate governance based on shareholder returns of listed companies on Tehran Stock Exchange,* Master's thesis, Tehran University

Mansi, S.A., Maxwell, W.F., & Miller, D.P. (2004). Does auditor quality and tenure matter to investors? Evidence from the bond market, *Journal of Accounting Research, 42*(4), 755-793

Mautz, R. K. & Sharaf, H. A. (1961). *The philosophy of Auditing,* American Accounting Association, Sarasote.

Myers, S. C. Majluf, N. S. (1984). Corporate financing and investment decisions when firms have information those investors do not have. *Journal of Financial Economics 20*, 293–315.

Piot, C. & MissonierPiera, F. (2007). *Corporate governance, audit quality and the cost of debt financing of French listed companies* Working Paper.

Pittman, J.A. & Fortin, S. (2004). Auditor choice and the cost of debt capital for newly public firms, J*ournal of Accounting and Economics, 37,* 113-136.

Raymond P. (1995). *Neveu,* translated with Jhankhany, Ali and Parsaeian, Ali, Volume II, published by the Tehran.

Verrecchia, R. (2001). Essays on disclosure. *Journal of Accounting and Economics 32*, 91-180.

Xin C., Sudipto D., Gilles H. (2008). *The Effect of Auditor Quality on Financing Decisions,* Hong Kong University of Science and Technology.