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The Relationship between Institutional Ownership and Financial Leverage with Audit Quality in Companies Listed on Tehran Stock Exchange

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Abstract: *The present research aims to investigate the relationship between institutional investors' ownership and financial leverage with audit quality in companies listed on Tehran Stock Exchange. it seeks to provide criteria for investors and creditors to describe the audit quality, so that by recognizing these features, they will realize audit quality and make their decisions in audited financial reports with more confidence. The population studied in the research includes companies listed in Tehran Stock Exchange during 2010-2014. The selected sample contains 90 companies with the described special features in this research. Analyzing the collected data through logistic multiple regressions based on the integrated data technique indicates a significant positive relationship between institutional investors' ownership with audit quality of firms. Also companies with higher financial leverage are more interested to employ high quality auditors. The findings can be useful for managers, investors, policy makers of exchange and other stakeholders to make their decisions, in addition to fill research gaps in this area.*

Keywords: *institutional investors' ownership, financial leverage, audit quality, stock exchange, Iran*

INTRODUCTION

In Iran, as most of companies' shares are owned by the government and due to implement the Article 44 of the Constitution and privatization, we can see organizations and institutions that are known as institutional investors that allocate more shares of the transferred companies as owners of new shares. Some of these companies and institutional investors include insurance companies such as Social Security Organization, Pension Fund, trading insurance companies and investment companies. Independent audit is considered as an appropriate mechanism to control the contractual relationship between managers and shareholders. In most studies about the mutual relationship between agency theory and auditing, there have been examined the effects of corporate governance mechanisms on probability of selecting high quality audit firms. Previous studies on the reasons for requesting audit suggest that institutional investors include groups that play an effective role in ownership structure. Some evidence indicates that large audit institutions do not always provide higher audit quality than small auditing firms (Hassas Yeganeh,et al.2010).

Since economic units are always striving to increase company value and wealth of shareholders as well as reduce their capital costs, they can achieve their goals by presenting high-quality financial statements because without auditing or by performing a poor quality auditing, investor and creditors outside of company will doubt respect to the provided information by management; as a result, they whether do not investor demand high efficiency rate due to risks (Ahmed, A,et al.2008). In the past 20 years, large audit firms have increased their market share in certain industries, so that industry expertise has become a very important issue to survive auditing profession (Hogan,et al.1999). Results of most studies in field of

representation theory suggest that demand for quality of audit and accreditation services to the disclosed information by management will be increased by increasing representation conflicts (Mahdavi,et al.2010).

Recently, institutional investors have increased their large investments. In the US, half of shares represent institutional ownership. Institutional investors are interested to reliable and sophisticated mechanisms of investments, more than other groups (Gompers,et al.2001). Employing the expert auditors in companies for financial reporting makes that institutional investors invest in these companies with more confidence. So the expert auditors can be considered as a reliable source for audit quality (Krishnan.2003).

Almutairi et al (2009) showed that asymmetry information is lower in companies that their audit has been conducted by expert auditors. Research in markets shows that institutional investors prefer companies for investment that are audited by professional auditors (Velury,et al.2003). It seems the ownership structure contains of several motives for overseeing financial reporting and influence on independent auditor. One of these motivations is the fact that the audited financial statements are important sources of information about companies and investors have a potential impact on audit quality in analyzing accounting information and financial decisions. Some decision making in companies transfer wealth from bondholders to managers and owners (shareholders) (Skinner.1993, Deli,et al.2000). However, managers may change accounting methods such as specific numbers (earnings manipulation) to violate restrictions or lack of delays in debt contracts (Haka,et al.1990). Managers are interested to increase profits and believe that value of company's shares will be reduced in period of violating contract debts. So they change accounting methods for preventing breach of contract liability (Haka,et al.1990).

Companies are interested to industry specialist auditors to increase their credit quality (DeFond,et al.2000) and provide credit signal for their creditors to reduce information risk (Mansi,et al.2004, Lennox,et al.2011, Kim,et al.2011). Companies with higher leverage employ industry expert auditors to improve quality of their accounting information and monitoring creditors' pressure on management of these companies (Shleifer,et al.1997). For example, Gilson (1990) found that information banks in the United States affect changing policies of large companies that face to financial problems. Therefore, since management of leverage companies is pressured by creditors, it is more likely to employ industry specialist auditors. However, major studies on this subject have been ignored and there is a gap for research in financial accounting literature that it is an incentive to conduct the present research. Therefore, in this research, we try to examine the relationship between institutional investors' ownership and financial leverage of enterprise with audit quality in companies listed on Tehran Stock Exchange. The research main question is as follows: is there a meaningful relationship between institutional investors' ownership and financial leverage with corporate audit quality? And if the answer is positive, how is the relationship?

1. Research Theoretical Literature

2-1 Institutional Ownership

How to distribute ownership (stocks) between owners of trading units (shareholders) is called ownership structure. It can be examined from two aspects: from standpoint of ownership concentration, and in terms of combining ownership. Ownership concentration refers to distribute amount of stock holdings owned by a certain number of people, institutions or families, which is divided into two categories: concentrated ownership and dispersed ownership. The ownership composition is related to present certain institution or groups including government, institutional shareholders, individual shareholders and foreign partners among shareholders.

Institutional shareholders include large investors such as banks, insurance companies and investment firms. According to Pourheydari and Hemmati (2004),type of stock of investment companies and

governmental foundations, institutions and agencies is considered as institutional investors because of their long-term horizons. There are two competing hypotheses about institutional ownership as follows:

- *Stewardship Hypothesis*

According to this hypothesis, because of importance of the invested wealth, institutional investors are likely managing their investments actively. According to this view, institutional investors are the skilled people who have a comparative advantage in collecting information. Institutional investors typically seek to provide accurate and timely information about company and question the company to provide accurate and correct future profits. They analyze the related data to shares' value, which has not been reflected, and include them in current stock prices (Nasrollahi,et al.2010). In general, by efficient monitoring, interests of shareholders will be maintained against abuse of management and reduce risk of small shareholders.

- *Private Benefits Hypothesis*

In contrast to active stewardship hypothesis, there is private benefits hypothesis. Its proponents believe that institutional investors are more likely interested to access confidential information for commercial objectives. Access of institutional owners to confidential information will increase information asymmetry. In such a situation, institutional owners may be less inclined to encourage management to report high-quality profits. As a result, inadequate institutional oversight will increase institutional uncertainty in the future cash flows and stock risk associated with stock liquidity (Nasrollahi,et al.2010).

In recent years, owners have been increasingly considered as one of mechanisms of corporate governance. There have been conducted several studies on subject of institutional investors that indicate such owners force company's management to focus on economic performance and avoid opportunistic behaviors (McConnell,et al.1990). Two underlying motivations of institutional investors include trust responsibility and access performance indicators of higher investment (Mitra.2002). However, previous studies suggest that institutional investors are not similar and they don't have the same motivations on the adopted monitoring procedures by company (Del Guercio,et al.1990, Nesbitt.1994, Navissi,et al.2006, Smith.1996). Based on investment time, they are classified as temporary (short-term) and long-term investors. Depending on their landscape, they support from short-term managerial behavior, while they are actively participating in company administration (Froot,et al.1992, Porter.1992) and restrict freedom of management (Navissi,et al.2006).

Some thinkers believe that institutional investors have a long-term outlook and emphasize on long-term profits because purchase, sale and transfer of ownership of blocks and large corporate shares are costly that often require foreclosure incentives for sales and spending on communication and transfer costs, which they are usually not profitable in short- term. In their view, long-term institutional investors do not focus on performance of current profits in terms of working, but their investments can limit executive power of companies with strong motivation and good ability to manage profits for achieving profit goals (Mitra.2002, Bange,et al.1998, Bushee.199, Chung,et al.2002). They have a supervisory role that reduces possibility of earnings management and false indicators using their monitoring (Bushee.1998). Opponents of this view believe that most of institutional investors are temporary investors; as a result, in stock exchanges and management of companies, they often consider current benefits, instead of long-term profits (Bushee.1998).

According to agency theory, the structured corporate governance mechanisms such as institutional owners should lead to higher quality financial reporting and therefore, one of the results of attending institutional owners in companies is to provide accounting information with higher quality. According Ashbaugh et al (2003) banks' ownership will increase the possibility of selecting large audit firms. Carcello et al (2004) also believe that companies with higher levels of institutional ownership are more likely to be audited by larger auditing firms that offer high-quality audit services. Chan et al (2007) believe that enhancing institutional

ownership will increase demand for high quality audit services. Institutional owners are separated from other investors because of considerable professional financial analysis; for this reason, institutional investors consider quality of information and need to it more than other investors.

In the late 1990s, effective stewardship hypothesis was raised for institutional owners. Due to their inherent characteristics, institutional investors have certain influences and can use it to monitor and direct management performance towards interests of shareholders. Presence of institutional investors in ownership structure of company affects how to monitor business operations. In order to implement effective monitor, high quality of auditing is considered as an important factor. Previous studies show that the audit report and quality of financial statements are important indicators of company's health and performance; as a result, institutional investors are trying to use high-quality auditing services (Azibi,et al.2010). Ownership structure includes several motivations to monitor financial reporting and influence independent auditor. One of these motivations is the fact that the audited financial statements are important sources of information about company and investors consider certain importance for analyzing accounting information and financial decision making for auditing quality and auditor report type. In institutional ownership field, research shows that institutional owners have particular advantages to gain and process corporate data (Bartov, et al.2000). They request transparent disclosure on risks and strengths of company, in order to better assess their dividends.

2-2 Audit Quality

According to auditing literature, researchers have considered multiple dimensions for audit quality, which have led to apparently different definitions (Zureigat.2011). One of the most common definitions of audit quality is the presented definition by De Angelo (1981). He has defined audit quality as follows: "assessment (inferred) of market on the possibility that firstly, auditor detects important misstatement items in financial statements or accounting systems of stakeholder, and secondly, report the found important misstatement. The likelihood of detecting any important misstatement by an auditor depends on his eligibility and independence. De Angelo (1981) definition on real quality audit is based on perceptions of consumers or so-called market perception of audit quality. Such a definition to express real quality of audit is used by the underlying hypothesis that perceptions of audit quality reflect actual quality of audit.

Palmrose (1988) defines audit quality based on accredit level of auditor. Since auditor's objective is to achieve confidence in financial statements, therefore, quality of auditing means lack of important misstatement in the audited financial statements. In fact, this definition emphasizes on audit results; in other words, reliability of the audited financial statements reflects high quality of auditing.

Titman and Trueman (1986) have defined audit quality as accuracy of the provided information for investors after auditing. This definition is similar to the proposed definition by Palmrose (1988) about audit quality. Davidson and Neu (1993) defined audit quality as auditor's ability to detect and discover material misstatements as well as detecting the reported manipulation in net income. However, Lam and Chang (1994) believe that quality of audit services should be examined separately for each audit project rather than be examined together (Al-Ajmi.2009).

A fundamental problem to define audit quality is the distinction between audit quality and auditor quality. Many studies have not considered any difference between the two terms and they often consider them as similar terms. Auditor quality is defined overall quality of audit services in all audits of an auditing firm; while audit quality should be defined separately for each audit project (based on service to serve) because the audit firm may not run all of its auditing in the same quality level. In other words, auditor quality is a concept based on qualitative audits of an auditor firm, while audit quality is based on concept of actual

quality of each audit project. Therefore, it is necessary to distinct between these two concepts in studies for audit quality (Dang.2009). Perceptions of actual quality of audit and audit quality are two different concepts. Although considering to actual quality of audit rather than perceptions of audit quality is more important, but we should not forget that it is not simply possible to measure actual quality of audit. The actual quality of audit is invisible and it can only be assessed after implementing audit. For example, Palmrose (1988) uses lawsuits against auditors to measure actual quality of audit.

The conducted studies have presented different proposals to measure audit quality. Turner and Godwin (1999) have measured audit quality using auditors' proposals to correct net profit. Some other studies have also evaluated quality of audits directly. For example, Lam and Chang (1994) have examined supervision of work and implementation of quality control standards during works as the differences of audit quality. Davidson and Neu (1993) have considered the difference between the predicted profits and the reported earnings in Canadian companies as measure of audit quality. The more amount of the differences, the higher quality of auditing, and the lower amount of the differences, the lower quality of auditing. The basic hypothesis is that predicting profits is independent of audit quality because when the authors reviewed audit quality in that period, auditors put overview the predicted profits of Canadian companies briefly. Therefore, if audit quality is high, management ability will be reduced in achieving the anticipated profits; as a result, deviations between the expected profits and the reported earnings will be increased. Many studies have tested perception of audit quality because of difficulties in measuring actual quality of audit. De Angelo (1981) argues that large firms have less motivation to show opportunistic behaviors; as a result, users have better perception about audit quality of such audit firms. Hogan (1999) believes that perception of high quality of audit is related to fair pricing in the initial offering shares to the general public. In their research, Balsam et al (2000) concluded that auditor industry specialization increases market perception on audit quality (Dang.2009).

2. Research Hypotheses

To answer the research questions, the following hypotheses are tested based on the research theoretical principles and the conducted empirical studies by Almutairi (Almutairi.2013) and Ertimur (Ertimur.2004):

- There is a significant relationship between institutional investors' ownership with audit quality of companies.
- There is a significant relationship between financial leverage with corporate audit quality.

3. Research Methodology

The present research is an applied research, in terms of classifying objectives; while in terms of classifying method, it is a descriptive-correlational research because it reviews the relationship between the dependent and independent variables. Due to lack of controlling all unrelated variables and using historical data to test the hypotheses, the present research can be classified in semi experimental-post event research. In such designs, the data is provided from natural environment or an event that happened without direct involvement of researcher.

4-1 Statistical Population and Research Sample

The research statistical population includes companies listed in Tehran Stock Exchange during 2010-2014. In this research, companies with the following characteristics are selected as the final sample:

- They should be accepted before 2010 in Tehran Stock Exchange and be activated in the stock until end of 2014;
- To increase their comparison, their fiscal year should be ended on March each year;
- They should not change their activity or fiscal year;

- They should not be included on investment firms and financial intermediaries (investment firms were not included in the statistical population because of their different activity nature with other firms);
- They should have no stop trading more than 6 months during the studied years;

After applying the above limitations, there were selected 90 companies as sample.

4-2 Collect and Analyze Data

In the research, there were firstly used library methods and documentary studies to collect the required data. Then the required data was extracted to test the research hypotheses by referring to financial statements, board activity reports, compacted disquiets of visual and statistical archives of Organization for Tehran Stock Exchange and other websites of Tehran Stock Exchange as well as Tadbirpardaz and Rahavard Novin Software. The data was prepared for analysis after collecting and transmitting to a spreadsheet of Excel and applying necessary calculations. Eviews econometric software was used to analyze the data.

4-3 The Used Pattern to Test the Hypotheses

In order to test the research hypotheses, we used the following multivariate regression model that has been taken from the conducted research by AlMutairi (2013):

$$=\beta_0+ \beta_1 INST_{i,t}+ \beta_2 LEV_{i,t}+ \beta_3 SIZE_{i,t}+\beta_4 GWTH_{i,t}+ \beta_5 AGE_{i,t}+ \beta_6 LOSS_{i,t}+ \varepsilon_i SPEC_{i,}$$

Where in the above-mentioned models:

$SPEC_{i,t}$: auditor industry specialization of company i in year t;

$INST_{i,t}$: institutional investors' ownership of company i in year t;

$LEV_{i,t}$: financial leverage equal to debt ratio to total assets of company i in year t;

$SIZE_{i,t}$: firm size that refers to sales normal logarithm of company i in year t;

$Gwth_{i,t}$: growth opportunities, which is the ratio of market value to book value of equity of company i in year t;

$AGE_{i,t}$: company age that is time between the date of establishing company to the end of the research period for company i in year t;

$LOSS_{i,t}$: loss of company i in year t;

$\varepsilon_{i,t}$: error component of the regression model

4-4 The research Variables and How to Measure Them

Institutional investors' ownership: to calculate institutional ownership, total shares owned by banks, insurance companies, investment companies, pension funds, finance firms, investment funds and governmental organizations and institutions were divided on total number of the issued shares by company.

Financial leverage: in the present research, financial leverage will be calculated by dividing total liabilities to total assets of company, as follows:

$$LEV_{i,t}= \frac{TD_{i,t}}{TA_{i,t}}$$

Where:

$LEV_{i,t}$: financial leverage of company i in year t;

$TD_{i,t}$: total debt of company i in year t; and

$TA_{i,t}$: total assets of company i in year t

Audit quality: follow the conducted studies by AlMutairi (2013) and Ertimur (2004), there has been used auditing industry specialization to assess quality of audits. The industry expertise refers to scientific and educational experience and skills of auditing in a particular industry. This specialized knowledge increases the likelihood of errors and irregularities in financial statements by auditors. The mentioned variable has been considered as a dummy variable of zero and one that if a firm auditor has at least 25% of the market share in a particular industry, he will be considered as an expert auditor in the industry and the company will get number 1, and otherwise, there will be assigned number 0 for it. The following equation is used to calculate the market share of the audit firm i in industry *k* (Ms_{ik}):

$$MS_{ik} = \frac{\sum_{j=1}^{J_{ik}} ClientSales_{ijk}}{\sum_{i=1}^{I_k}\sum_{j=1}^{J_{ik}} ClientSales_{ijk}}$$

Where:

$ClientSales_{ijk}$: total sales of employer firm j in industry K that has been audited by auditing company I;

i = 1, 2, ..., I: index of audit firm;

j= 1, 2, .., J: index of employer firm;

k= 1, 2, .., K: index of employer industry;

I_k: number of audit firms in industry k; and

J_{ik}: number of the audited employer companies by the audit firm i in industry k

Control variables: in the present research, we have considered some of the most important variables as control variables, which based on previous studies, have been identified as factors affecting quality of auditing. The variables include:

- ✓ *Firm size:* AlMutairi (2013) and Beattie and Fearnley (2004) suggest that employing the expert auditor in large industrial companies, in compared to small companies, is more important because of complexity of operations of these companies. As a result, larger companies are more incentive to employ the specialized auditors in the industry. Hence, in this research, firm size, which is

calculated using normal logarithm of the net sales of the company, is considered as the control variable, so that:

$$Size_{i,t} = Log\ S_{i,t}$$

Where:

$Size_{i,t}$: size of company i in year t;

$S_{i,t}$: net sales of company i in year t

- ✓ *Growth opportunities:* AlMutairi et al (2009) believe that companies with high growth opportunities, in compared to other companies, are more interested to employ specialist auditors in the industry because of information asymmetry. In this way, they can reduce their information asymmetry and financial costs, so that:

$$GWTH_{i,t} = \frac{MV_{i,t}}{BV_{i,t}}$$

Where:

$GWTH_{i,t}$: growth opportunities of company i in year t;

$MV_{i,t}$: the market value of equity of company i in year t;

$BV_{i,t}$: Book value of equity of company i in year t

- ✓ *Company age:* the new born companies are less interested to employ specialist auditors in the industry because of limited financial benefits and inability to pay higher audit fees to industry specific auditors (Almutairi,et al.2009). So in this research, company age has been considered as control variable that is calculated based on the time interval between the date of establishing company and end of the research period.
- ✓ *Losses of company:* AlMutairi (2013) and Ertimur (1995) state that employing the expert auditors in loss-making companies can transmit good news about risk reduction of these companies to the market. Hence, loss-making companies are more interested to employ more qualified auditors in the industry. Therefore, this variable is also included as another control variable. The mentioned variable is a virtual variable that if the company reports losses in each studied years, it will be assigned number 1 to the company, and otherwise, it will be assigned number 0 for it.

4-5 The Used Statistical Methods to Test the Hypotheses

In the present research, we use logistic regression models to estimate the model. Regression logistic is used in cases where the dependent variable only includes one of the two is likely states. In the present research, in cases of revision, the dependent variable is 1, an otherwise, its value is zero.

4. Results and Discussion

5-1 Data Descriptive Statistics

Results of the data descriptive analysis included measures of central tendency and dispersion of the research variables that are shown in Table 1. The descriptive statistic is for 90 sample companies during a five-year period (2010-2014). Results of the data descriptive analysis can be summarized as follows:

Institutional investors' ownership in the sample companies has been from 0% to 99%, which its average for the companies is about 36% that represents active participation of the investors in the stock and securities. Also considering amount of financial leverage mean values (0.598) suggests that averagely 60% of assets of the studied companies have been provided from debt financing.

Table 1. Descriptive statistics of the research variables

Variable	Average	Median	Min	Max	Standard deviation
SPEC	0.060000	0.000000	0.000000	1.000000	0.237751
INST	0.362513	0.228000	0.000000	0.990000	0.325186
LEV	0.598158	0.621500	0.096000	0.970000	0.174066
SIZE	13.47287	13.35600	8.899731	18.49227	1.431256
GWTH	2.171022	1.750000	0.040000	19.61000	1.843242
AGE	35.25778	37.00000	8.000000	61.00000	13.00146
LOSS	0.062222	0.000000	0.000000	1.000000	0.241828

SPEC: industry expertise auditor; INST: institutional ownership level; LEV: financial leverage of company; SIZE: firm size; GWTH: opportunities for company growth; AGE: firm age; LOSS: loss of company

5-2 Test of Research Hypotheses

Due to the fact that the dependent variable is binary; we need to use logistic regression. Results of statistical test of the research hypotheses are provided in Table 2 and 3.

Table 2. Results of Covariance Analysis

Correlation							
t-Statistic	SPEC	INST	LEV	LOSS	SIZ	GWTH	AGE
SPEC	1.000000						

INST	0.110623	1.000000					
	2.355912	-----					
LEV	-0.014006	0.052730	1.000000				
	-0.296487	1.117645	-----				
LOSS	0.051133	-0.079849	0.252621	1.000000			
	1.083694	-1.695495	5.526219	-----			
SIZ	0.532295	0.207681	0.166025	0.037323	1.000000		
	13.30867	4.493762	3.563547	0.790539	-----		
GWTH	0.003976	-0.048660	0.009529	0.051871	-0.065048	1.000000	
	0.084163	-1.031154	0.201709	1.099372	-1.379718	-----	
AGE	0.086490	-0.067887	0.100980	0.023930	0.185188	0.032493	1.000000
	1.837529	-1.440220	2.148328	0.506649	3.988690	0.688110	-----

Table 3. Results of testing the research hypotheses

Variables	Coefficients	SD	t-statistics	VIF	P-Value

SPEC	-28.0396	4.305876	-6.51195	-	0.0000
INST	-0.57682	0.118011	-5.51593	1.121	0.0059
LEV	-1.02085	1.515961	-0.67340	1.071	0.5007
SIZE	1.71457	0.268949	6.375087	1.204	0.0000
GWTH	0.219622	0.153015	1.435304	1.101	0.1512
AGE	0.012066	0.024830	0.485927	1.048	0.6270
LOSS	-1.50206	1.213379	-1.23791	1.131	0.2157
R^2	0.549850	statistic		112.318	

The research first hypothesis states that there is a significant relationship between institutional investors' ownership with audit quality of companies. As seen in the above Table, at error level of 1%, the estimated coefficient and t-statistic in the variable of institutional investors' ownership (INST) is negative and significant that suggests a significant negative relationship between institutional investors' ownership and audit quality of the companies. Accordingly, the research first hypothesis is confirmed at error level of 1%.

The research second hypothesis argues that there is a significant relationship between financial leverage with quality audit of the companies. As it is also evident from results of the image, the estimated coefficient and t-statistics of LEV variable is negative and it is not significant at error level of 10%. According to these evidences, the research second hypothesis is not accepted at error level of 10%.

5-3 Conclusions

The research first hypothesis states that there is a significant relationship between institutional investors' ownership with audit quality of companies. Confirming this hypothesis suggests that institutional investors require high quality data because of their ability to analyze financial data. Due to their certain influence in company, they can put pressure managers to use services of high quality audit firms. The obtained results in this study are consistent with the findings of Almutairi (2013) and Chan et al (2007) because the studies have approved the relationship between institutional ownership with audit quality of companies. The research second hypothesis argues that there is not a significant relationship between financial leverage with quality audit of the companies. This finding means that in leverage companies, creditors put pressure managers to ensure compliance with the written terms in debt contracts with them. They force the mangers to use audit firms with higher quality. In this way, through effective imposed monitoring by auditors, there will be limited any opportunistic behavior and violation of terms of the debt contract. In a research, Almutairi (2013) achieved similar results with the research findings. According to the present research findings, it is recommended to investors and capital market players to consider financial leverage variables and investors' ownership and regard them as factors affecting audit quality of corporate in their decision-making models, when making investment decisions. In addition, since institutional owners are active and conversant investors with selecting high quality audit firms, it is recommended to maintain supply state-owned companies on the Stock Exchange by Privatization Agency (subsequently acquiring ownership of the company by institutional investors).

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