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## Investigation of Relation Between Quality of Audit as a Corporate Governance Tool with Profit of Registered Firms in Tehran Stock Exchange

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### ABSTRACT

**Background:** Profit as final result of financial activities is influenced by different procedures of management in different firms. Managements are trying to boost their profits for fulfilling their goals with use of different methods of accounting. **Objective:** The purpose of this study is to investigate the relation between quality of audit as a corporate governance tool with profit of registered firms in Tehran Stock Exchange. The sample of this study is 91 registered firms in Tehran Stock Exchange in the period of 2008-2011. **Results:** Results shows that quality of audit with optional committed tools, informational content of committed tools, future profitability and the ability of committed tools all have direct significant influence on prediction of operational cash flow. **Conclusion:** We conclude that financial leverage of the firm has a reverse and significant effect on earning management measurement factors and there was no effective relation between systematic risk and earning management factors.

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## INTRODUCTION

An increasing part of accounting research tries to examine the different factors that affect earnings management behavior of managers. Because part of the financial reporting process depends on the judgment of managers, they have the opportunity to manage reported earnings to achieve their own goals. Scott, W. (1997) defined earning management by the choice of accounting policies so as to achieve some specific managers' objective. Because this behavior may have a significant effect on the quality of information provided to investors, the SEC recently is more concerned with earnings management behavior of firms' managers (Healy & Wahlen, 1998).

Many of the previous accounting studies examined the different motivations of earnings management and the factors that induce managers' incentives to manage reported earnings. Specifically, managers try to manage the reported earnings as a result of bonus plans motivations (Healy 1985), the motivations to satisfy the debt covenants (Sweeny 1994, Defond & Jiambalvo 1994), or the motivations to reduce the political costs (Cahan 1992, Jones 1991). The earning management motivations may exist also around the time of CEO change (Cahan 1992, Jones 1991).

In one hand, the CEO of a poorly performing firm may try to increase the reported earnings to prevent or postpone being fired. On the other hand, consistent with the findings of DeAngelo *et al.* (1994), a new CEO may take a "big bath" in the year of change to increase the probability of higher future earnings when his/her performance will be measured, especially when low earnings in the change year can be blamed on the previous CEO. Firms may also try to manage reported earnings before going public. Because these firms usually do not have an established market price, their managers may try to increase the reported earnings to receive higher price for their shares. For example, Friedlan (1994) reported that IPO firms made income-increasing discretionary accruals in the latest period prior to IPO relative to accruals in a comparable previous period (Friedlan, 1994).

On the other hand, the concern about the quality of accounting numbers and its relation with the quality of the auditing process is increasing over time following the periodical clusters of business failures, frauds, and the litigation (Tie 1999, Chambers 1999). The main objective of this paper is to examine the relation between audit quality and earnings management behavior after considering the effect of other variables like the auditor's tenure and the client importance. The auditing process is supposed to serve as a monitoring device (Wallace, 1980) that will reduce managers' incentives to manipulate reported earnings. Therefore, it is hypothesized that

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the higher the auditing quality the lower the earnings management activities by managers, *Ceteris Paribus* (Wallace, 1980).

The purpose of this study is to investigate the relation between quality of audit as a corporate governance tool with profit of registered firms in Tehran Stock Exchange. Therefore, the rest of the article is structured as follows. At the second section literature review will be presented and hypotheses will be developed. At the third section methodology is introduced and at the fourth section results will be presented.

#### *Literature review:*

##### *Earnings management:*

Various definitions exist for earnings management. Schipper (1989) appears to have captured the essence of earnings management by defining it as 'purposeful intervention in the external financial reporting process with the intent of obtaining private gain'. Likewise, Healy & Wahlen (1999) state that 'earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers.' Regardless of the definition adopted, earnings management is inherently unobservable (Healy and Wahlen, 1999).

##### *Corporate governance:*

The concept of corporate governance emphasizes the need for monitoring of management of the firm with considering the separation of the ownership of the firms different sections and their management for sake of stakeholders profit (Messier *et al.*, 2008: 36). The system of corporate governance with emphasize on improvement of responsiveness of the managements and boost of clarity and transparency in information is looking for limiting the negative profit taking behaviors of the managements (Messier *et al.*, 2008: 36). Therefore, will lead to improvement of the quality and accountability of the accounting reports.

Owing to the separation of ownership and control (and the resulting agency problems) in the modern business world, a system of corporate governance is necessary, through which management is overseen and supervised to reduce the agency costs and align the interests of management with those of the investors (Messier *et al.*, 2008: 36). While there is no generally accepted definition, corporate governance may be defined as a system 'consisting of all the people, processes and activities to help ensure stewardship over an entity's assets' (Messier *et al.*, 2008: 36).

A good corporate governance structure helps ensure that the management properly utilizes the enterprise's resources in the best interest of absentee owners, and fairly reports the financial condition and operating performance of the enterprise (Messier *et al.*, 2008: 36). For corporations in the US, the body primarily responsible for management oversight is the board of directors and its designated committees. The audit committee, consisting of members of the board, assists the board in its oversight of the financial reporting process (Messier *et al.*, 2008: 36).

The role of the corporate governance structure in financial reporting is to ensure compliance with generally accepted accounting principles (GAAP) and to maintain the credibility of corporate financial statements. The corporate governance mechanisms that are the focus of recent regulations and prior studies are attributes related to the organization and functioning of the board in general and its audit committee in particular (Peasnell *et al.*, 2005). Properly structured corporate governance mechanisms are expected to reduce earnings management because they provide effective monitoring of management in the financial reporting process. Unfortunately, empirical research to date provides inconsistent evidence on the relationship between measures of corporate governance effectiveness and earnings management (earnings quality or the lack thereof). For example, while Davidson *et al.* (2005) and Klein (2002) report a significantly negative relationship between board independence and earnings management, Park & Shin (2004) and Peasnell *et al.* (2005) fail to find any significant relationship. Such inconsistency also exists in empirical evidence on the relationships between earnings management and other attributes related to board effectiveness in monitoring management in the financial reporting process (Peasnell *et al.*, 2005).

Often the board of directors delegates work on important tasks to its standing committees. For example, the audit committee is charged with overseeing financial reporting. The audit committee's primary role is to help ensure high quality financial reporting by the firm (Xie *et al.*, 2003). Therefore, a properly structured and functioning audit committee is expected to reduce opportunistic earnings management. A number of recent studies examine the effect of an audit committee's characteristics on earnings management but have provided mixed evidence as is the case in research on effectiveness of the board of directors in reducing earnings management (Xie *et al.*, 2003). For example, while Abbott *et al.* (2000) document that occurrence of earnings management decreases with independence of the audit committee, Choi *et al.* (2004) find no such effect. Also, Xie *et al.* (2003) find no significant association between the number of directors on the audit committee and earnings management (Xie *et al.*, 2003).

Similarly, Abbott *et al.* (2004) find no impact of audit committee size on earnings restatements. In contrast, Yang & Krishnan (2005) report that audit committee size is negatively associated with earnings management (using abnormal accrual as proxy), implying that a certain minimum number of audit committee members may be relevant to quality of financial reporting. There is also concern that compensating audit committee directors with stock and stock options may result in impairment of their independence (Millstein, 2002); however, empirical evidence on this issue has been limited until recently. Bédard *et al.* (2004) document that the more stock options that can be exercised in the short run relative to the total of options and stocks held by audit committee directors, the higher the likelihood of aggressive earnings management. Yang & Krishnan (2005) report that stock ownership by board members on the audit committee is positively associated with earnings management. These results contradict the findings by Beasley (1996) that the likelihood of fraud decreases as stock ownership by outside directors (not necessarily audit committee directors) on the board increases (Beasley, 1996).

#### *Audit quality:*

The agency problems associated with the separation of ownership and control, along with information asymmetry between management and absentee owners, create the demand for external audit. External auditors are responsible for verifying that the financial statements are fairly stated in conformity with GAAP and that these statements reflect the 'true' economic condition and operating results of the entity. Thus, the external auditor's verification adds credibility to the company's financial statements. Also, the external auditors are required by auditing standards to discuss and communicate with the audit committee about the quality, not just the acceptability, of accounting principles applied by the client company. Therefore, a quality audit is expected to constrain opportunistic earnings management as well as to reduce information risk that the financial reports contain material misstatements or omissions (Beasley, 1996).

The guidelines and measures for the quality of the external auditor's performance are set forth in generally accepted auditing standards, such as competence, independence and exercise of due professional care (Balsam *et al.*, 2003: 71). Obviously, the quality of the auditor's performance is multi-dimensional as set forth in the auditing standards, and differences in audit quality are to be expected. 'Audit quality differences result in variation in credibility offered by the auditors, and in the earnings quality of their audit clients. Because auditor quality is multidimensional and inherently unobservable, no single auditor characteristic can be used to proxy for it' (Balsam *et al.*, 2003: 71). Since audit quality may be affected by a number of factors, it is not surprising that researchers have used various measures to proxy for audit quality in prior studies (Balsam *et al.*, 2003: 71).

For example, researchers have examined the effects of auditor brand name (auditor size) and industry specialization, auditor tenure, provision of various services by the auditor and auditor independence on a number of issues directly or indirectly related to financial reporting. Empirical evidence on these audit quality measures has been mixed. For example, while many existing studies show that the use of brand name (i.e., Big 4/5/6) auditors reduces earnings management (e.g., Becker *et al.*, 1998; Francis *et al.*, 1999; Lin *et al.*, 2006), many others fail to report such findings (e.g., Bédard *et al.*, 2004; Davidson *et al.*, 2005).

As another example, Frankel *et al.* (2002) report that the ratio of non-audit service fees to total auditors' fees (proxy for impaired auditor independence) is positively associated with small earnings surprises and with the magnitude of discretionary accruals (proxies for earnings quality or earnings management). Their results provide support to the SEC's position that non-audit fees can impair auditor independence and hence audit quality. On the other hand, Chung & Kallapur (2003) find no significant relationship between discretionary accruals and audit fees or non-audit fees. Similarly, Raghunandan *et al.* (2003) find no evidence supporting the claim that non-audit fees or total fees inappropriately influence the audit of financial statements that are subsequently restated (Raghunandan *et al.* 2003).

#### *Previous studies on earnings management and audit quality:*

Some prior papers have looked at the relation between earnings management and audit quality and examined the effect of auditor quality on management incentives to manipulate the reported earnings. For example, Hirst (1994) used an experimental design to test the effect of auditors' belief that managers may have incentives to manage reported earnings on their expectation of material misstatements in financial statements. His results show that auditors' assessed probability that material misstatements exist is higher if auditors think that managers have incentives to manage reported earnings whether upward or downward (Hirst, 1994).

Dechow (1993) has reported that firms that changed the auditor after a client-auditor disagreement are highly leveraged and more likely to have debt covenant violation. These firms also are more likely to have a decline in reported earnings. His results also show that if the questionable accounting procedures were applied, this would result in smoothed earnings numbers or flat earnings growth. The study used a sample of matched pairs of firms that changed auditors because of client-auditor disagreement and other firms that simply changed the auditor. These results show that auditors usually disagree on earnings management activities and lead to

hypothesize that higher audit quality will be associated with less magnitude of earnings management (Defond, 1993).

Burilovich (1997) looked at specific incentives to manage reported earnings in the case of alternative minimum tax. She used a sample of 72 regulated life insurance firms during the period 1984-1989 and found that income decreasing discretionary accruals (DA) differ significantly across the companies audited by big auditing firms. She also argued that auditing firms with the greatest market share appear to allow greater discretion to the client in determining accruals. To explain these results, she argued that auditing firms with higher market share will have more experience in the industry and, therefore, they can allow more discretion to their clients. In this study, Burilovich (1997) didn't use any model to measure the DA but used the items that may affect the difference between taxable income and reported income in this special case of AMT considering the regulations of life insurance industry. On the other hand, it is difficult to accept the argument that big auditing firms that usually have larger market share will allow their clients more discretion in accounting reporting (Burilovich, 1997).

Becker *et al.* (1998) used the cross-sectional version of Jones model (Jones 1991) for estimating DA and found that income increasing DA for the clients of non-big auditing firms are higher than big auditing firms. Their paper also looked at the variation in DA in addition to its sign and magnitude and found that the variation was lower for big auditing firms' clients and higher for non-big auditing firms' clients. In their study, Becker *et al.* (1998) focused on the income-increasing DA and excluded firms that changed the auditor during their test period (1989-1992) from the analysis. Therefore, they didn't examine the auditor's tenure effect. Francis, *et al.* (1999) applied the cross-sectional Jones model using a sample of NASDAQ companies and found evidence that the clients of big auditing firms have lower amounts of estimated DA. In this paper, I use a time series version of the Modified Jones model and control for the effects of both the auditor's tenure and client importance on the magnitude of earnings management using the absolute value of DA (Francis *et al.*, 1999).

#### *Hypotheses development:*

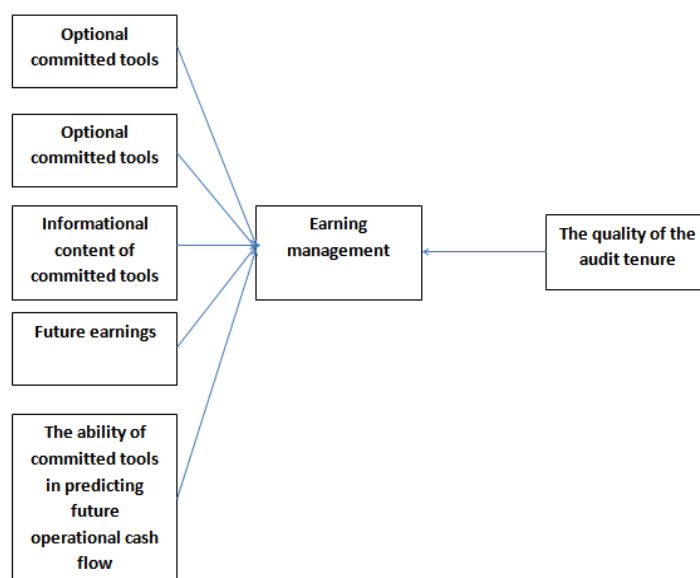
##### *Main hypotheses:*

There is a relation between quality of audit and earning management of the registered firms in Tehran Stock Exchange.

##### *Peripheral hypotheses:*

1. There is a significant relation between quality of audit and future earning
2. There is a significant relation between quality of audit and optional committed tools
3. There is a significant relation between quality of audit and the ability of committed tools for predicting future cash flow.
4. There is a significant relation between quality of audit and informational content of committed tools.
5. There is a significant relation between quality of audit

##### *Conceptual model:*



**Fig. 1:** Conceptual model.

**Methodology:**

This research is a descriptive and correlation research which regarding the goals, is a practical research due to purpose of implementing the results in capital market.

In this research the dependent variables are optional commitment tools, informational content of commitment tools, future earning and the ability of commitment tools for predicting the future flow of operational cash which all of them are variables for measuring earning management. Audit tenure as a factor for measuring quality of audit is the independent variable. Financial leverage and systematic risk are control variables.

**Analysis and Results:****Descriptive analysis:**

Descriptive analyses of the variables are as below: (quality of audit (AQ), future earning (INS), informational content of committed tools (ICA), ability of the committed tools for predicting future cash flow (ACR), optional committed tools (DAC), financial leverage (FL), and systematic risk (BET))

**Table 1:** Descriptive analysis of variables.

tension	skewness	variance	Standard deviation	average	maximum	minimum	quantity	variable
-.041	.318	.020	.14209	13	27	5	455	AQ
-.018	.294	1.104	1.13394	47388190370	3645559000	130978534175	455	FE
.655	.966	.025	.15818	.14789	1.220	-.23328	455	ICA
.229	.385	.164	.09563	.02983	.9374	-.5078	455	ACR
.655	.966	.035	.15818	.14789	332980433	1245366331	455	DAC
.354	.404	.008	.08683	.02983	3.937	-.250	455	FL
.109	-.513	.024	.15366	-2.021	4.99	-7.631	455	BET

All the observations are based on data for 91 firms in 5 years. According to descriptive study, standard deviations of the studied variables are low. The maximum standard deviation is for the future earning variable and the minimum standard deviation is for financial leverage. Studying skewness and tension shows that all the variables are distributed normally.

**Analysis of normality:**

Kolmogorov-Smirnov (K-S) analysis has been performed for analyzing normality of variables with use of SPSS software. The result of the test is depicted in below table:

**Table 2:** Test of normality.

Significance level	Z score	variables
.238	1.473	AQ
.691	1.387	FE
.549	1.926	ICA
.089	1.774	ACR
.299	1.508	DAC
.642	1.741	FL
.582	1.777	BET

As it is presented in the table 2, all the variables have significance level more than 0.05 which is the indication of normality in all the variables.

**Analyze of correlation:**

For correlation analyze we used Pearson correlation which is shown in table below:

**Table 3:** Pearson correlation.

BET	FL	DAC	ACR	ICA	FE	AQ	variables
.763	-.325*	.775*	.847*	.683*	.345*	1	AQ
.763	-.325*	.775*	.847	.165	1	.345*	FE
.763	-.325*	.775*	.447	1	.165	.683*	ICA
.196	.407	.385*	1	.447	.847	.847*	ACR
.083	.180	1	.385*	.385*	.385*	.775*	DAC
.068	1	.180	.407	.407	.407**	-.325*	FL
1	.068	.083	.196	.196	.196	.763	BET

\*\* significance level 1%

\* Significance level 5%

*Test of hypotheses:*

In this section we will test our hypotheses with use of multiple regression. First we will present prerequisites of regression model.

*Test of significance of regression:*

Regarding F statistics in all the regression tables, due to level of significance which is below 0.05, all the regression models in all the hypotheses is significance.

*Test of co-linearity:*

The results of co-linearly test is presented in table below:

**Table 4:** Test of co-linearly.

Status index	significance	row	model
1.000	5.295	1	1
2.180	1.115	2	
2.358	.952	3	
2.410	.912	1	2
2.510	.840	2	
2.819	.667	3	
2.967	.602	1	3
3.317	.481	2	
5.466	.477	3	
6.736	.453	1	4
7.984	.449	2	
8.211	.441	3	

As it is presented in the observations, significance measurement is for testing probability of existence of internal correlation between variables. Moreover, all the indexes are below 15 which is a indication of absence of co-linearly between independent variables.

*Test of auto-correlation:*

Dorbine-watson statistics has been used for detection of auto-correlation between variables. All the statistics shown to be between 1.5 to 2.5, therefore, we can say there is no auto-correlation between variables.

*Limer and Hamson test:*

For testing the ability of data to be merged, we have to first test the existence of heterogeneity. Therefore, we used Limber and Hamson test to detect this probability of heterogeneity between sections. The results are presented in table below:

**Table 5:** Test of heterogeneity of intercepts.

results	p-value	Degree of significance	F statistics	models	Null hypotheses
H <sub>0</sub> is rejected	0.035	3	2.409	Model 1	Intercept of all sections is equal
H <sub>0</sub> is rejected	0.000	3	2.216	Model 2	
H <sub>0</sub> is rejected	0.016	3	1.994	Model 3	
H <sub>0</sub> is rejected	0.000	3	1.728	Model 4	

Results show that the investigated sections are heterogenous and it is better to use Limer-Hamson test which is presented in table below:

**Table 6:** Limbe-Hamson test.

Result of hypotheses	p-value	Degree of freedom	X <sup>2</sup> statistic	models	Null hypotheses
H <sub>0</sub> is rejected	0.000	3	105.4503	Model 1	There is no difference in systematic coefficients
H <sub>0</sub> is rejected	0.000	3	101.3792	Model 2	
H <sub>0</sub> is rejected	0.000	3	106.2431	Model 3	
H <sub>0</sub> is rejected	0.000	3	102.1735	مدل 4	

As it is shown in the table, results are indicating that all the statistics are significant and all the null hypotheses will be rejected.

*Analyze of first hypotheses:*

The first hypothesis of the research is: there is a relation between quality of audit with future earnings.

$$FE = \alpha + \beta_1AQ + \beta_2FL + \beta_3BET + \varepsilon$$

**Table 7:** Results of hypothesis 1.

Level of significance	T significance	coefficient	Name of variables	sign	Type of variables
–	–	–	Future earnings	Y	Dependent variables
0/001	-1/364	-8/378	Alpha	$\alpha$	Constant value
0/000	2/893	0/576*	Quality of audit	X1	Independent variable
0/000	-2/11	-0/739*	Financial leverage		Control variables
0/332	6/179	0/715	Systematic risk		
		1/708	Dourbin-Watson		
0/001		4/539	F statistics		
		0/866	Correlation coefficient		R
		0/75	Determination coefficient		R Square
		0/74	Adjusted determination coefficient		Adjusted R Square

\*Significant level is 0.05

As it is indicated in the table, variables of quality of audit and financial leverage have a significance relation with future earnings. Coefficient of variables indicating that the relation of financial leverage is more significant than other relations.

*Analyze of second hypothesis:*

Hypothesis 2: there is a significant relation between quality of audit and amount of optional committed tools.

$$DAC = \alpha + \beta_1AQ + \beta_2FL + \beta_3BET + \varepsilon$$

**Table 8:** Results of hypothesis 2.

Level of significance	T significance	coefficient	Name of variables	sign	Type of variables
–	–	–	Amount of optional committed tools	Y	Dependent variables
0/000	-1/874	-3.12	alpha	$\alpha$	Constant value
0/000	-1/598	-0/463*	Quality of audit	X1	Independent variable
0/001	-1/778	-0/472*	Financial leverage		Control variables
0/294	3/496	0/387	Systematic risk		
		2/112	Dourbin-Watson		
0/000		7/946	F statistics		
		0/799	Correlation coefficient		R
		0/638	Determination coefficient		R Square
		0/631	Adjusted determination coefficient		Adjusted R Square

\*Significant level is 0.05

As it is shown in the table there is a significant relation between quality of audit and financial leverage. The coefficient of variables shows that the relation between financial leverage with amount of optional committed tools is more than other variables.

*Analyze of third hypothesis:*

Hypothesis 3: there is a significance relation between quality of audit and ability of committed tools for predicting cash flow.

$$ACR = \alpha + \beta_1AQ + \beta_2FL + \beta_3BET + \varepsilon$$

**Table 9:** Results of hypothesis 3.

Level of significance	T significance	coefficient	Name of variables	sign	Type of variables
–	–	–	Ability of committed tools for predicting operational cash flow	Y	Dependent variables
0/000	1/294	1/261	alpha	$\alpha$	Constant value
0/001	4/157	0/771*	Quality of audit	X1	Independent variable
0/000	-4/112	-0/863*	Financial leverage		Control variables
0/111	2/621	0/522	Systematic risk		
		1/739	Dourbin-Watson		
0/000		7/963	F statistics		
		0/814	Correlation coefficient		R
		0/662	Determination coefficient		R Square
		0/660	Adjusted determination coefficient		Adjusted R Square

\*Significant level is 0.05

As it is shown in the table, there is significant relation between quality of audit and ability of committed tools for predicting operational cash flow. The coefficient of variables shows that the relation of financial leverage with ability of committed tools for predicting operational cash flow is more significant in comparison with other variables.

#### Analyze of hypothesis 4:

Hypothesis 4: there is a significant relation between quality of audit and informational content of committed tools.

$$ICA = \alpha + \beta_1 AQ + \beta_2 FL + \beta_3 BET + \varepsilon$$

**Table 10:** Results of hypothesis 3.

Level of significance	T significance	coefficient	Name of variables	sign	Type of variables
-	-	-	Informational content of committed tools	Y	Dependent variables
0/000	1/571	1/980	alpha	$\alpha$	Constant value
0/000	1/417	0/399*	Quality of audit	X1	Independent variable
0/002	-3/192	-0/470*	Financial leverage	Control variables	
0/217	2/388	0/276	Systematic risk		
		1/687	Dourbin-Watson		
0/000		45/683	F statistics		
		0/781	Correlation coefficient		R
		0/61	Determination coefficient		R Square
		0/60	Adjusted determination coefficient		Adjusted R Square

\*Significant level is 0.05

As it is shown in the table there is significant relation between quality of audit and financial leverage with informational content of committed tools. The coefficient of variables shows that the relation of financial leverage with informational content of committed tools is more significant in comparison with other variables.

#### Conclusion:

In this study we investigate the relation between quality of audit as a one of the corporate governance tools with earning management of registered firms in Tehran Stock Exchange. The first hypothesis shows that there is a relation between quality of audit and future earning. Therefore, this hypothesis is indicating that manipulation of earning in financial reports could be influential on future earning of corporations.

The results of second hypothesis show that there is a significant reverse relation between quality of audit and optional committed tools. This result indicates that managements are capable to manipulate the earning section in financial reports for astray the mind of stakeholders. Thus, auditors must be fully informative about this misleading technique.

The third hypothesis shows that there is a significant relationship between quality of audit and ability of committed tools for predicting future cash flows. Therefore, this hypothesis shows that management can choose a legal accounting technique to manipulate the earnings and create predictable earnings.

Finally fourth hypothesis shows that there is a significance relation between quality of audit and informational content of the committed tools. Janin and Piot (2005) show that audit can be a one way for preventing of earning management. Because they believe that firms which have audited financial reports have a higher quality for their financial reports.

Future researches can be performed for investigating the results of this study in different industries. Moreover, corporate governance has more tools which in this study we just investigated one of them, therefore, future researches could be performed to see the influence of other corporate governance tools such as structure of board of directors on quality of audit.

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