Relationship between Audit Reputation and Related Party Transaction

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Abstract

The main purpose of this research is investigating relationship between audit reputation and related party transactions in companies listed in Tehran Stock Exchange. Audit institute size is used as audit reputation index and so that its influence on the volume of related party transactions is investigated. Research statistical population includes the companies listed in Tehran Stock Exchange during 2008 to 2012. Sample size was specified as 128 companies considering screening method following elimination of outlier observations. In this research, data fusion and panel data with fixed effects were used. Results obtained from data analysis using multivariate regression at confidence level 95 percent indicate audit reputation has inverse influence on related party transactions.

Keywords: Audit Reputation, Related Party Transactions, Audit Institute Size

Introduction

Auditing as social mechanism is used to help monitoring and controlling management behavior and it is regarded as a monitoring tool of the government (Yasaee, 2010). According to Torenton, quality of accounting information and financial reporting is shared product of at least four main products, one of which is audit quality. DeAngelo(1981) discussed that reputation of audit institute can represent audit quality. He believed that audit institutes with reputation provide higher quality audit services, because they are interested in gaining better reputation in the labor market and since the number of their employers are high, they tend to show higher quality of accounting information and implement more transparent accounting procedures. Thus, the managers have lower opportunities to pursue profit manipulation strategy and it leads to reduced agency costs and information asymmetry.

On the other hand, based on Article 55 in Iranian Audit Standards, related party transactions may be done with motivations other than usual commercial considerations such as profit transfer or even fraud (International Accounting Standards Committee, 2000), as many of great financial frauds in recent years were done through related party transactions (Henry et al., 2006). Related party transactions include transfer of resources or obligations or performing services, regardless of demanding or not demanding the price. The criterion for defining related parties varies in accounting fields and academic research works and financial regulations of the states. However, they often consider the ability to influence financial conditions of financial reporting institutions. Regulators and formulators of standards have not adopted a stance regarding harm or benefit of transactions of related parties for the company and its shareholders.

Audit quality as well as audit reputation is one of control and limitation mechanisms of transactions with related parties. In other words, previous works such as works by Henry et al. (2006), Bennouriet al. (2012) showed related party transactions is related to the size and reputation of audit institute, and if agency problem in the companies is more sever and corporate governance mechanisms are poorer, the probability to use these transactions for wealth transfer in these companies is higher. Considering mentioned facts, the main purpose of current research is investigating influence of audit reputation on related party transactions in companies listed in Tehran Stock Exchange.

Theoretical Framework and Review of Literature

Bennouriet al. (2013) studied role of audit reputation on volume of related party transactions. Their findings indicated companies with high reputation auditors have low related party transactions. Nekhili&Cherif (2011)investigated relationship between related party transactions and value of company on French companies and studied structure of corporate governance mechanisms in these companies. they found related party transactions is mainly influenced by voting shares of the company's major shareholders, board size, degree independence of the audit committee and board of executive directors, selection of independent auditors, corporate debt ratio, and simultaneous acceptance of the company in U.S. Securities and Exchange. They also found that those related party transactions with major shareholders, board members or executives would have highest negative impact on the market value of the company. Lei and Song (2011) studied role of related transactions in profit management and found companies transfer wealth to the major owners using related party transactions. Investors also do not tend to invest in these companies and market value of them is considerably low. Bhaumik&Gregoriou (2010) found that major shareholders are motivated to own assets and profit using wealth transfer through related parties. Abdul Wahab et al. (2010)studied relationship between related party transaction and corporate performance in Malaysia. Their findings suggest negative relationship between two variables. They also found corporate governance mechanisms can reduce severity of this relationship and thus may have protective role for corporate performance.

Etemadi (2011) in his study entitled Role of Lifecycle in Relationship between Transaction with Related Parties and Performance of Companies Listed in Tehran Stock Exchange showed negative or positive impact of related party transaction on corporate performance depends on a stage of lifecycle where the company is. In growth stage, related party transaction is positively and significantly related to the corporate performance. In maturity stage, there is negative significant relationship between transaction with related parties and corporate performance, and in decline stage there is no significant relationship between transaction with related parties and corporate performance. Mehrabani (2006) in his work entitled Optimal Delivery of Related Party Transaction in the View of Financial Statement Users studied disclosure of related party transactions in the view of financial statement users and studied relationship between disclosure of these transactions and article(s) of reports of independent auditors and legal inspector in companies listed in stock exchange. He states: there is significant relationship between information disclosure and decision of financial statement users and providers of financial statements should observe all requirements of information disclosure according to the accounting regulations and standards in disclosing related party transactions, since these information paly significant role in decisions of users of financial statements. Also, there is significant relationship betweeninappropriate information disclosure with related parties and article(s) of reports of independent auditors and legal inspectors.

Research Hypotheses

Research hypotheses include as follows:
Audit reputation influences related party transaction.
Research Model and Variables
Model for first main hypothesis

$$RPT = \beta0 + \beta۱ \text{Audit Reputation} + \beta۲ Size + \beta۳ LEV$$

Model for first main hypothesis In above models, indices related to company (i) and year (t) were eliminated and used denotations and their measurement are described as follows:
Bi = Influence of each variable on related party transaction
$\beta0$= Constant factor, intercept or constant value.
Ɛ it = Random error of company i in year t.
Dependent Variable
RPT = Related Party Transaction
In this research, related party transaction is measured from sum of related party transaction during current year financial period divided by sum of book value of company's assets at the end of financial period of transactions in the current period. According to Accounting Standard 12, related party transaction includestransfer of assets or debts by performing services between related parties, regardless of demanding or not demanding price (Bennouriet al., 2012).
Related Party
According to Accounting Standard 12, related party includes two or more parties, if during financial period:
One can directly or indirectly control the other one, or
They are jointly controlled, or
In performing a transaction, they are so under shared influence that independent interests of one of them is affects by the other one's interests in the transaction.
Independent Variables
Audit Reputation
It is a dummy variable. If the auditor is Audit Organization or MofidRahbar Audit Institute, it is 1, otherwise, it is considered as 0 (HasasYeganeh and Azinfar, 2010).
Control Variables
Size = company size
It is measured as natural logarithm of sum of book value of the company's assets at the end of financial period. The reason for using this control variable is eliminating effects related to difference in size of companies under study (Mahdavi et al., 2011).

LEV = financial leverage of company

It is obtained from ratio of sum of debts to sum of assets. The reason for using this control variable is eliminating effects related to difference in financial leverage of companies under study (Mahdavi et al., 2011).

Research Methodology

This research is an applied research in terms of purpose. Research design is Ex post facto research (using data from the past). Data collection method includes library sources and information from Tehran Stock Exchange website.

Research statistical population includes all companies listed in Tehran Stock Exchange during 2008 to 2012, and 128 companies were selected as sample using systematic elimination method.

Research Findings

To evaluate reliability of the variables, Im et al.(1997) was used. The results of this test are shown in Table 1.

Table 1: Im, Pesaran, Shin test (IPS)

Variable	RPT	Audit Reputation	Size	LEV
w-stat	-11.543	7.231	-16.832	10.121
p-value	0.002	0.031	0.00081	0.00191

Considering results for IPS test (Table 1), since P value for all variables is smaller than 0.05, thus these variables were reliable during research period. Therefore, results for IPS test indicate mean and variance of variables over the time and covariance of variables over different years were fixed. Hence, use of these variables in the model does not cause false regression.

Determining Appropriate Model for Estimating Regression Model

In order to determine appropriate model (fusion or panel with fixed or random effects) to test research hypotheses, Chow and Hausman tests were used.

Regarding first model, considering sig level of Chow test results, panel data should be used for estimating research regression model.

Following specifying that intercept is not the same for different years, the method use in estimation of model (fixed or random effects) should be determined. Thus, Hausman test is used. Considering Hausman test, fit of regression models of the research using panel data in fixed effects is suitable.

Testing first main hypothesis

Audit reputation influences related party transaction.

$RPT = \beta 0 + \beta 1 Audit\ Reputation + \beta 2 Size + \beta 3 LEV$

Following testing regression assumptions and assurance of their establishment, results of regression equation fit are given in Table 1. F statistics (13.675) suggests significance of the whole regression model. Coefficient of determination and adjusted coefficient of determination include 51.8 and 44.9 percent, respectively. Thus, it can be concluded that in above regression equation, only about 44.9 percent of changes in related party transaction in companies under study is described by independent and control variables.

According to Table 2, sig level of reputation variable (0.041) is smaller than the sig level consideredin this work (5%); also, absolute value of t statistics related to this variable (2.302) is larger than t statistics obtained from the table with the same degree of freedom. Thus, H0 is rejected at confidence level 95 percent and H1 is supported. That is, audit reputation influencesrelatedparty transaction.

Table 2: Results from regression equation fit

Variable		Coefficient of Variable	Coefficient Value	T statistics	Sig level
Constant		β_0	1.709	2.909	0.002
Audit Reputation	Audit Reputation	β_1	-0.567	-2.302	0.041
Size	Company Size	B_2	0.991	3.121	0.0089
LEV	Financial Leverage	B_3	1.678	3.432	0.0097
Coefficient of Determination		0.518	F statistics		13.675
Adjusted Coefficient of Determination		0.449	Significance (P-Value)		0.0015
			Durbin – Watson Statistics		1.753

Conclusion

Audit reputation influences related party transaction.

Conclusion and Interpretation: According to Table 2, reputation variable was significant at confidence level 95 percent in the research regression model, thus the research hypothesis is supported and audit reputation influences related party transaction. On the other hand, considering value and sign of coefficient of audit reputation variable (-0.567) it can be concluded related party transaction is reduced by 0.567 units by one unit increase in audit reputation. It is consistent with findings byBenouri et al. (2013), Nekhili and Cherif (2011), Lei and Song (2011), Pang et al. (2011), Abdul Wahab et al. (2010), Kelbeck and Brian (2010), and Jiang et al. (2008). They found audit reputation inversely influences related party transaction.

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