Audit Quality, Auditor's Follow-up Recommendations (Emphasis on Specific Point Paragraph) and Auditor's Opinion

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Abstract

Considering the importance of the audit objective, which creates reasonable assurance about the financial statements and the importance of the audit process to collect sufficient and adequate audit evidence, the audit quality is considered one of the audit process's main features. Therefore, to improve the audit and review process quality, there is a need for a framework for judging. Using the financial data of 114 companies from different industries from 2012 to 2017, this study analyzes the relationship between audit quality and auditor's follow-up recommendations (emphasis on specific point paragraph) and the relationship between auditors' follow-up recommendations (emphasis on specific point paragraph) and auditors' opinions. The results show that there is a meaningful relationship between the audit quality and the auditors' follow-up recommendations (emphasis on specific point paragraph); this shows that the auditors' greater accuracy and their control on processing financial information provide better and more accurate points on the quality improvement of financial statement reports. Moreover, the results show no significant relationship between auditors' follow-up recommendations (emphasis on specific point paragraphs) and the type of auditor's opinion in the years to come.

Keywords: Audit quality, auditor's follow-up recommendations, emphasis on specific point paragraph, auditor's opinion.

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Iranian Journal of Accounting, Auditing & Finance

1. Introduction

One of the most fundamental strategic mechanisms to protect shareholders' rights as the main corporate finance suppliers is corporate governance. Therefore, in order to achieve its main objectives, several criteria and components such as conceptual framework, financial reporting standards, internal monitoring mechanisms, internal audit process, as well as legal and independent audits, and the ownership structure and non-executive directors have been used to ensure the long-term durability and transparency of the company's operations (Hassas Yeganeh, 2015). The role of independent auditors in implementing effective corporate governance can be a significant and considerable issue. In fact, as an independent profession, auditing has a critical role in validating financial reports to a reasonable extent for the users of financial information (Pereira, 2009).

According to Watkins et al. (2004), audit quality could include the auditor's monitoring strength and reputation. The auditor's monitoring strength reflects the auditor's ability to validate that it can minimize the agency problems and conflicts between managers and users of financial statements. On the other hand, the auditor's reputation can affect the credibility of the information and the perception level. The important point about audit quality is that auditors 'reputation is a general characteristic of all auditors' work. Still, the auditor's supervisory power in each audit work may vary according to the amount of audit evidence collected in the process of each different audit work. As one of the world's leading and international auditing institutions, the failure of Arthur Andersen can be one example of which high-reputable auditors can provide weak monitoring in particular engagements (Setyaningrum et al., 2017).

Since the professional competence of auditors can be considered as one of the main components of audit quality (López and Peters, 2012), Chen et al. (2016) with emphasizing the link between audit quality and the professional competence of auditors, believe that the existence of an efficient audit process can be emphasized on critical issues in a way that helps to expose financial events in financial statements. Indeed, auditors' follow-up recommendations (emphasis on specific point paragraph) in the audit process, which in some way derives from the level of expertise and individual experience of auditors, can play a significant role in overall audit quality. Therefore, it is expected that auditors' more wariness and their control in reviewing corporate financial information will provide better tips on how to improve the quality of financial statement reports. On the other hand, it is also suggested that in higher quality audit firms, there are individuals with a higher level of expertise that improve audit opinion and the quality of financial statements (Setyaningrum et al., 2017).

As discussed, auditors emphasize specific point paragraphs or other explanatory clauses in their report to help users of financial statements better understand the specific issues and the ambiguities described in the financial statements. Accordingly, these points can be the basis for the audit of subsequent periods. Auditors examine the emphasis on specific point paragraphs of past years to use them as a basis for a qualified and adverse opinion if they repeated. Although other explanatory clauses' content indicates that disclosure of such explanations is not mandatory in financial statements, this information may include important cases depending on the nature of their information to attract users' attention (Auditing Standards Committee, 2017). The auditor's purpose of inserting the emphasis on specific point paragraphs and other explanatory clauses is to attract users' attention to a better understanding of financial statements and ambiguities and issues and consider the auditor's responsibilities by reflecting in the auditor's report. Therefore, the auditors include these issues in their report and comments, which will be the basis for the report's change and the type of auditor's opinion in future opinions about financial statements. Thus, it is expected that the items contained in the paragraphs emphasizing specific points in the auditor's opinion may, in each financial period, be the basis for

changing his opinions in the next financial periods.

Since auditing is a branch of social knowledge, it is a judicial process. Professional judgment in every stage of the audit process, such as planning, implementation, review, and reporting, is of particular importance. As a result, the higher the audit quality, the more commonly expected complete and thorough review of auditors' financial performance. Thus, the present research seeks to answer the question of whether there is a relationship between the audit quality and the auditors' follow-up recommendations (emphasis on specific point paragraph) and also between the auditors' follow-up recommendations (emphasis on specific point paragraph) and audit opinion among companies listed on Tehran Stock Exchange or not. In the next sections, the relevant literature and conceptual framework to develop research hypotheses are discussed. Then, the research methodology, including the research population and sample selection, is explained. The research results are analyzed in the next section, and finally, the conclusions of the study and suggestions for future researches are discussed in the final section.

2. Literature review and hypotheses development

Audit quality is a significant issue that is highly important for users' financial statements and reports. The implementation of higher quality audits means that the audit risk is reduced, and the audit firm feels less likely to comment inappropriately. Even though audit firms are interested in higher quality audits, periodic supervisors' reviews of auditors' work indicate that audit works are not always performed by adequate quality. One of the main definitions of audit quality is provided by De Angelo (1981). In her opinion, audit quality includes the overall market outlook that the auditor can detect errors and misstatements in the financial statements or the client's financial system and the probability of reporting these errors and misstatements. The probability that the auditor can understand these misstatements is related to the level of expertise, and the probability of reporting misstatements is linked to the auditor's independence (De Angelo, 1981).

According to auditing standards, if the auditor concludes that it is necessary to draw the attention of users to the subject presented or disclosed in the financial statements that are of particular importance to them in understanding the financial statements, he should insert an emphasis on a specific point paragraph in the audit report. Such a paragraph should only refer to information disclosed in financial statements. These items can be used as auditors' follow-up recommendations for future audit works (Auditing Standards Committee, 2017). Typically, the auditor's follow-up recommendations are recorded to emphasize the specific point paragraph in the audit report and immediately after the auditor's opinion paragraph. This paragraph refers to that specific issue and disclosure items in the financial statements that fully describe and state that the auditor's opinion is not adjusted to this specific issue. It is necessary to explain that if the auditor intends to insert this paragraph on the particular issue or other explanatory clauses into the audit report, the content of these paragraphs and the proposed sentence should be considered by the entity's management. In general, most of the auditors' follow-up recommendations that are identified as some emphasis on specific points may include ambiguity over the future outcome of unusual lawsuits or specific supervisory actions, applying a newly authorized accounting standard before the date of implementation, which has an impact on financial statements, the occurrence of an event that has a significant effect on the financial position of the entity or a significant ambiguity about the continuity of the activity (Francis, 2011).

Reporting is an essential part of an audit because auditors' findings are passed on to the users through the audit report. The users of the financial statements rely on the auditor's report to make decisions. The auditor's opinion should provide appropriate

information for users so that the auditor will ensure the audit service's reliability. Due to the importance of the auditor's opinion that is the most audible product of audit work, it requires a special look by the accounting profession, in the academic and research sector, as well as in the accounting and auditing profession (Azad and Kazemi, 2013). Due to the importance of audit quality, the study of its related components is one of the most significant issues explaining audit work quality. Since the measurement of audit quality is based on the auditor's abilities and expertise, human capital competence can be considered one of the main components of audit quality (López and Peters, 2012). Considering the relationship between audit quality and professional qualifications of individuals, it is expected that an efficient audit process could able to address the significant issues involved in financial statement processing and help to suitable disclosure of financial information in financial statements (Chen et al., 2016). Therefore, auditors' follow-up recommendations (emphasis on specific point paragraph) in the investigation process explain the significant issues and ambiguities derived from the level of expertise, knowledge, and experience of the individual auditors and can play a special role in the overall audit quality.

Nikbakht et al. (2016) investigated the relationship between audit fees, auditor's experience, and the audit quality of 109 companies listed on the Tehran Stock Exchange from 2007 to 2014. The results show that if the audit firm carries out audit work at a lower price than other audit firms or previous work, they need to explain why and those that may undermine or distort their services' quality. Poorheidari et al. (2017) also investigated audit quality's impact on the audit report's timeliness among companies listed on the Tehran Stock Exchange. In this research, a multivariate linear regression model was used to test the hypotheses. The audit report's timeliness was the dependent variable, and the auditor's industry specification and size of the audit firm were independent variables. The results show a significant relationship between the auditor's industry specification and the auditor's report's timeliness. The results also indicate no significant relationship between the audit firm size and the audit report's timeliness.

Griffin and Lont (2016) investigated the relationship between financial reporting quality and audit quality among companies listed on the London Stock Exchange. This research's main objective was to determine the factors influencing audit work quality, whether they increase or distort the identified quality. By collecting financial data from more than 300 British companies over 10 years between 2004 and 2013, they showed that increasing the audit quality led to increased reporting financial statements quality. Setyaningrum et al. (2017) investigated the impact of audit quality on auditors' follow-up recommendations. To measure the auditor's follow-up recommendations, the emphasis on specific content has been used. The results indicate that audit quality can effectively track and resolve issues in the audit report effectively, resulting in financial reporting quality.

Cameran et al. (2018) investigated the relationship between continuing the auditor's selection and audit quality. They believe that the auditor's selection's continuity would lead the auditor to gain more specific knowledge, increasing the auditor's professional competence and increasing the quality of audit work. They suggested that the auditor's continuous relationship with the subject of the company's activity leads to greater accuracy in the various aspects of the operation and, by examining the audit report of previous years, can have better outcomes and provide a better picture of the quality assessment of financial statements and financial reporting. Based on the conceptual framework and prior literature, the research hypotheses are explained as follows:

First Hypothesis: There is a significant relationship between audit quality and the auditors' follow-up recommendations (emphasis on specific point paragraph).

Second Hypothesis: There is a significant relationship between the auditor's follow-up

recommendations (emphasis on specific point paragraphs) and the type of audit opinion.

3. Research methodology

This research is a descriptive type of post-event research that is based on the actual information of the financial statements of companies listed on the Tehran Stock Exchange. The population of this study is all companies listed on the Tehran stock exchange. For choosing samples, Purposeful *Sampling is used.* This means that companies considering the following features are selected:

- Selected companies are not financial intermediation and leasing.
- They listed on Tehran Stock Exchange until the end of 2017.
- During the research period, their stock trading has not stopped.
- In terms of increased comparability, their fiscal year ends in March.

Considering the mentioned conditions, a total number of 114 companies are selected. Thus, secondary data of these companies are gathered, and Eviews software is used for analyzing data. The logistic regression model is used in order to test the research hypotheses. The first and second research models for testing the first and second hypotheses are as follow:

$AFRecommendation_{it} = \beta_0 + \beta_1 \, AQ_{it} + \beta_2 \, AUDCHG_{it} + \beta_3 \, SPEC_{it} + \beta_4 \, SP_{it} + \beta_5 \, SIZE_{it} + \beta_6 \, LEVERAGE_{it} + \beta_7 \, ROA_{it} + \beta_8 \, LOSS_{it} + \beta_9 \, CURR_{it} + \varepsilon$ (Model 1)

$OPINI_{it} = \beta_0 + \beta_1 \, AFRecommendation_{it-1} + \beta_2 \, AUDCHG_{it} + \beta_3 \, SPEC_{it} + \beta_4 \, SP_{it} + \beta_5 \, SIZE_{it} + \beta_6 \, LEVERAGE_{it} + \beta_7 \, ROA_{it} + \beta_8 \, LOSS_{it} + \beta_9 \, CURR_{it} + \varepsilon$ (Model 2)

$AFRecommendation_{it}$ = Auditor's follow up recommendation
$OPINI_{it}$ = Audit opinion.
β_0 = Model constant.
$\beta_1–\beta_9$ = Beta coefficients of the model's independent variables.
AQ_{it} = Audit quality.
$AUDCHG_{it}$ = Audit change.
$SPEC_{it}$ = Auditor industry specification.
SP_{it} = Audit complexity.
$SIZE_{it}$ = the size of the company.
$LEVERAGE_{it}$ = leverage ratio.
ROA_{it} = Return on assets.
$LOSS_{it}$ = the loss of the company.
$CURR_{it}$ = the structure of current assets.
ε = The model residual

In general, the variables of this research are categorized into four groups of dependent variables, independent variables, and control variables, which are explained as follow:

In model 1, the auditor's follow-up recommendation is a dependent variable, equal to 1 if there is an emphasis on a specific point paragraph in the audit report and 0 otherwise. The independent variable is audit quality, which is equal to 1 if the audit firm is ranked in A category according to the official accountancy community's criteria considered high-quality audit firms and 0 otherwise. In model 2, audit opinion is a dependent variable equal to 1 if the audit opinion is adjusted opinion and 0 otherwise. The independent variable is the auditor's follow-up recommendation, explained in model 1 variables' measurement.

Control variables in both models include audit change, which is equal to 1 if the company's auditor has changed since last year and 0 otherwise. Auditor industry specification is the control variable, which is measured by the market share approach. If the auditor's firm's contribution to a particular industry is more than half of the active

companies in that industry, the auditor's industry specification is considered 1 and 0 otherwise. Audit complexity is measured by the ratio of total receivables and inventories to total company assets. The size of the company is measured by the logarithm of the total assets of the company. Leverage is measured by the ratio of total debt to the total assets of the company. Return on assets is measured by the ratio of the company's net profit to the total assets. Loss is equal to 1 if a company has losses during the fiscal year and 0 otherwise. The current asset ratio is measured by the ratio of current assets to the company's total assets.

4. Research results

The results of the descriptive statistics are presented in Table 1. The audit quality variable (AQ), auditor's opinion (OPINI), auditor's follow-up recommendations (AFRecommendation), auditor's changes (AUDCHG), Auditors Industry specialization (SPEC), and Loss (LOSS) are binary variables (zero and one). Thus, they are excluded in descriptive statistics analysis.

Table 1. Descriptive Statistics of Research Variables

Variables	Mean	Median	Max	Min	S.D
Audit Complexity (SP)	0.43	0.43	0.89	0.05	0.16
Size (SIZE)	13.97	13.78	19.07	10.87	1.45
Leverage (LEVERAGE)	0.67	0.65	2.18	0.05	0.31
Return on Assets (ROA)	0.05	0.05	0.63	-0.66	0.15
Current Assets Ratio (CURR)	0.64	0.68	0.97	0.14	0.19

Source: Compiled by author

In addition to providing information about the descriptive statistics of the variables mentioned above, the frequency of the variables of other binary variables is presented in the following table.

Table 2. Descriptive Statistics of Binary Variables

Variables		2012	2013	2014	2015	2016	2017
Audit Quality (AQ)	ZERO	18	27	24	27	21	22
	ONE	96	87	90	87	93	92
Audit Opinion (OPINI)	ZERO	72	83	73	65	73	72
	ONE	42	31	41	49	41	42
Auditor's Follow-up Recommendations (AFRecommendation)	ZERO	44	31	34	25	26	25
	ONE	70	83	80	89	88	89
Audit Change (AUDCHG)	ZERO	0	57	91	91	87	81
	ONE	114	57	23	23	27	33
Auditor Industry Specialization (SPEC)	ZERO	104	104	104	99	99	99
	ONE	10	10	10	15	15	15
Loss (LOSS)	ZERO	85	85	91	95	88	83
	ONE	29	29	23	19	26	31

Source: Compiled by author

The purpose of testing the first hypothesis is to explain the relationship between audit quality and auditor's follow-up recommendations (emphasis on specific point paragraph). For testing this hypothesis, the Logistics regression model is used, and the results are presented in Table 3. The most important statistics used to evaluate the fitted model are the maximum LR statistics and the associated error level. The maximum truth stature is equal to 51/345 with zero error level, reflecting the rejection of the H0 hypothesis (the model's non-significance assumption) and the model's reliability. Moreover, based on the results, the obtained coefficient of audit quality (AQ) variable is statistically acceptable and meaningful, and the first hypothesis is accepted.

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Table 3. The results of the testing first hypothesis

Variables	Coefficient	Std. Error	Z-statistic	P-value
c	0.03	0.01	3.58	0.00
AQ	0.28	0.14	2.03	0.04
AUDCHG	-0.19	0.08	-2.41	0.00
SPEC	-0.14	0.16	-0.84	0.39
SP	1.91	0.43	4.36	0.00
SIZE	0.07	0.03	2.48	0.04
LEVERAGE	0.05	0.21	0.25	0.79
ROA	-0.49	0.51	-0.95	0.33
LOSS	0.29	0.19	1.50	0.13
CURR	-1.67	0.38	-4.35	0.00
McFadden R-squared: 0.439 LR Statistic: 51.345 Prob: 0.00				

Source*: Compiled by author*

The second hypothesis has explained the relationship between the auditor's follow-up recommendations and the type of audit opinion. The results are shown in Table 4. Based on the results, the obtained coefficient of auditor's follow-up recommendation (AFRecommendation**)** is not statistically acceptable and meaningful. Therefore, the second hypothesis is not accepted.

Table 4. The results of testing the second hypothesis

Variables	Coefficient	Std. Error	Z-statistic	P-value
c	1.83	0.73	2.51	0.01
AFRecommendation	0.02	0.11	0.17	0.86
AUDCHG	-0.19	0.08	-2.41	0.00
SPEC	0.28	0.12	2.26	0.00
SP	0.94	0.45	2.07	0.03
SIZE	-0.14	0.04	-3.04	0.00
LEVERAGE	-0.43	0.26	-1.65	0.09
ROA	2.14	0.58	3.69	0.00
LOSS	-0.21	0.18	-1.10	0.26
CURR	0.59	0.29	2.05	0.00
McFadden R-squared: 0.371 LR Statistic: 97.900 Prob: 0.00				

Source*: Compiled by author*

5. Conclusion

Since the auditing purpose is to provide reasonable assurance on financial statements, audit quality is one of the key financial reporting issues. The main objective of audit work is to increase the reliability of financial information. This is achieved by evaluating the auditors' adequately collected evidence to comment on financial statements' desirability. A judgment somehow accompanies the auditor's opinion on financial statements. Thus, in order to improve the quality of the inspection and review process, there is a need for a framework for judgments. This research investigates the relationship between audit quality and auditor's follow-up recommendations (emphasis on specific point paragraph), and the relationship between auditor's follow-up recommendations (emphasis on specific point paragraph) and the audit opinion of companies listed Tehran Stock Exchange.

The results of testing the first research hypothesis show a significant relationship between the audit quality and the auditors' follow-up recommendations (emphasis on specific point paragraph). Regarding the importance of audit quality issues, the study of its related components is the most important point in explaining audit work quality. Since

an efficient audit process is expected to help address significant issues in reviewing financial statements, the auditor's follow-up recommendations are based on the auditors' level of expertise, knowledge, and experience. They can play a special role in the overall audit quality. Accordingly, it is expected that more carefulness of auditors and their control in reviewing financial information provides better points for improving financial statements' quality. On the other hand, it is also suggested that higher quality audit firms have individuals with a higher level of expertise and experience. Their proficiency in auditing will help improve the quality of financial reports. This result is consistent with the results obtained by Setyaningrum et al. (2017).

The results of testing the second hypothesis show that there is not a significant relationship between auditors' follow-up recommendations (emphasis on specific point paragraphs) and audit opinion. Based on theoretical foundations, auditors emphasize specific point paragraphs on their reports to help users understand the company's financial situation and explain specific issues. These paragraphs can be the basis for the audit of subsequent periods. In such cases, auditors examine the past specific issues. If they are essential and repeated, they refer to these issues for the qualified audit report based on their professional judgment. The emphasis on specific point paragraphs may include issues that, depending on the nature of their information, are important for attracting users' attention. Since the auditor's purpose in pointing out specific issues is to attract users' attention, auditors consider these issues in their reports and comments. They will be used as a basis for modifying the audit report and type of opinion. Therefore, it is expected that the items listed as significant points and follow-up recommendations in the audit report in each financial period will be used as a basis for modifying his or her comments in subsequent periods.

One of the limitations in conducting this research is the failure to consider the effects of inflation and the change in price levels, the limited time domain, and the non-separation of various industries. Based on the results, there are some suggestions as follow:

Using efficient and expert individuals in the investigation process is one of the main components of audit quality. It is expected that auditors will point to significant issues in reviewing financial statements and revealing the desired financial information for users.

- The auditor's follow-up recommendations in the review process are based on the level of expertise, knowledge, and experience of the auditors and can play a significant role in the overall audit quality.

Future research is suggested to examine the effect of family ownership and ownership structure on the relationship between audit quality and auditor's follow-up recommendations. It is also suggested to investigate the effect of non-audit services on audit quality and financial reporting quality.

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