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Impact Of The Opinion Given Out By The Auditor And Of His Reputation On Discretionary Accruals

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The aim of this paper is to examine the effect of the nature of the audit opinion and the reputation of the audit firm on the earnings management measured by the discretionary accruals in the tunisian capital market context. In particular, we investigate whether abnormal accruals are influenced by modified audit opinions and the presence of auditors Big Four. From a sample of 53 no-financial firms on the period 2002-2007, we find that the probability to manage earnings management to the increase is related to the issuance modified audit opinion and the presence of No-Big Four auditors.

Field of Research: Earnings Management, Corporate Governance, Audit Report

1. Introduction

The annual financial statements constitute a synthesis of the activity of firm exploitable by the outside. They serve to the different actors in decision making. Thus, these statements must be established in the respect of principles of regularity and sincerity (Hatfield, Agoglia and Sanchez, 2008). However being given that they are considered a product of management, the latitude of which they arrange can let hover a doubt on the sincerity of communicated information. The importance to arrange some reliable data on the annual accounts explains the necessity to resort to an external auditor, who warns the earnings management. At the end of that mission of audit, auditor is held to prepare their report in which he expresses their independent opinion on the financial statements. Thereafter, this report is communicated to shareholders, read in Annual General Meeting (AGM) and published to investors. The report of certification is therefore an important information source that helps to the decision making. However, since the recent financial scandals (Enron, 2002 to the United States, Parmalat, 2003 in Italy, Ahold, 2002 in the low countries and Batam, 2003 in Tunisia), several shapes of earnings management adopted by firms to camouflage their real financial situation of these last. Him in spring that the auditor can be brought to certify the improper accounts, under the effect of pressures of their auditees. These conditions increase the degree of the doubt on the quality of audited financial statements.

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These recriminations also dragged a discount in question important of the quality of services provided by the external auditors that are called, in principle, to give of mannered objective, exact and precise the financial information to the profit of investors. The Enron business is only a good example, has been accused to have used various methods of earnings management. In the wake of the collapse of Enron and Andersen, several study (Krishnan, Raghunandan and Yang, 2007;…) interrogated themselves therefore on the accounting of Enron and the behavior of its auditors. They report lower discretionary accruals for ex-Andersen clients compared to other clients, suggesting that ex-Andersen clients were treated more conservatively by their new auditors. The new laws carrying on the auditor's role increased thus following the financial scandals (Sarbanes-Oxley law to the United States, law of the financial safety in France and in Tunisia). They established some more coercive rules therefore on the different aspects of the independence of the external auditor screw to screw of their client. The issue of auditor independence is of serious concern to regulators, investors, creditors and the general public. In these conditions, the auditor is held to resist pressures of managers, and to express his independent opinion on the financial statements prepared by management which should help to reduce the information asymmetry between the company and its potential investors.

However, in the setting of interest divergences between shareholders and managers (or between creditors and managers), a negative opinion rendered by auditor is often interpreted like a discount in reason of the leader management. To avoid this situation can affect their reputation, managers can exercise pressures on their external auditors, in order to bring them to formulate unqualified opinions. He doesn't perfectly fill the role of control in order to preserve his mandate, under light of the theory of the dependence towards resources (Nichols and Price, 1976 and Kato, 1989). In the setting of this scenario, several recent papers, mainly in anglo-saxon countries test the hypothesis that the discretionary accruals are managed to the decrease when audit opinions are modified, and when audit firms have a good reputation (Hunt and Lulseged, 2007 and Charito, Lambartides and Trigeorgis, 2007). From then on, it seems applicable to fear the possible interaction between these concepts in an emergent country as Tunisia. The present tunisian market some meaningful differences in relation to the anglo-Saxon markets (american, british,…). These differences are not only owed to the economic, institutional and cultural factors, but as they are bound to practices accountants and audits.

A study led in the tunisian context proves to be crucial, in order to study the real capacity of the external auditor to resist pressures of managers, to express his independent opinion, being given that his nomination decided by the AGM, depends managers who solicited him the most often, on the one hand. On the other hand, view that the report of audit is the account given back visible of the mission of audit and the unique vector of communication between auditors and investors, the protection of this audit quality constitutes an essential confidence element thus for the whole of users. Finally, our study permits us to target firms that present information no reliable, since the objective of the audit report, and in particular the paragraph of audit opinion is to specify that the annual financial statements have been established in all their meaningful aspects in accordance with a referential applicable accountant. In this study, we seek evidence of the nature of the audit opinion and the reputation of the audit firm affect the earnings management measured by the discretionary accruals in the tunisian capital market context. The remainder of the paper is organized as follows. The second section synthesizes the literature review. In the third section the legal context of auditing in Tunisia is presented. The fourth section details our sampling methodology. The fifth section reports and discusses the results, and the final section contains the conclusions of the study.

2. Literature Review

The extant literature (Jensen and Meckling, 1976) suggests that auditing is an important means of mitigating agency conflict between managers and outside shareholders. Auditing is a monitoring device for the shareholders because auditors would report detected material misstatements in audited financial statements. In short, auditing is also a bonding device of the managers who engage auditors to signal to the shareholders that they will not behave opportunistically. But then, while referring to the theory of the dependence towards resources to the profit of the firm, partisans of this theory (Nichols and Price, 1976 and Kato, 1989) advanced that the firm keeps still the possibility to change his auditor by others providing the same level of benefit. Auditee's loss will result for the auditor in a loss of the business number, which can be with difficulty changeable. In this situation, the auditor doesn't become more independent and this while undergoing pressures of managers. He sacrifices the quality of his audit opinion to the profit of his personal interest in order to preserve his mandate.

In order to determine the level of information to reveal in the audit report, a model of balance can be constructed while driving the auditor to arbitrate between to preserve his reputation close to investors and its economic interests, by reason of the risk to lose to term the mandate. Indeed, the reputation of a cabinet would act like a system of signalling an offer of quality audit for the public (DeAngelo, 1981). Several studies (Francis and Krishnan, 1999; Bartavo, Gul and Tsui, 2000 and Johl, Jubb and Houghton, 2007) argue that modified audit opinions are influenced by more pervasive earnings management. In essence, these studies test the hypothesis that earnings management increases the likelihood of receiving a modified audit opinion. Among those, the study of Francis and Krishnan (1999), it presents evidence of conservative auditor behaviour by examining the relationship between the issuance of modified audit reports and the reported level of accruals for a large sample of United States publicly listed companies. Specifically, Francis and Krishnan (1999) find that auditors of firms reporting high levels of accruals are more likely to issue modified audit reports for asset realisation uncertainties and for going concern problems than auditors of low accrual firms, even after controlling for client-specific and market risk variables. However, they also find that their results only apply for the Big Six group of auditors. They conclude that this latter finding is consistent with the argument that Big Six auditors have greater reputation capital at risk and, therefore, greater incentives for acting conservatively.

As for, Bartov, Gul and Tsui (2000) show that the association between audit opinion and abnormal accruals is negative. Their results appear to be due to severely distressed firms (with going concern opinions), rather than due to firms engaging in extreme earnings management. In the vein of Bartov, Gul and Tsui (2000), Johl, Jubb and Hougthon (2007) examine auditor reporting behaviour in the presence of aggressive earnings management in the context Malaysia. They find that Big Five auditors in

Malaysia appear to issue modified audit reports more frequently than their No-Big Five counterparts when high levels of abnormal accruals are present. However, Butler, Leone and Willenborg (2004) regress discretionary accruals on audit opinion type. They examine whether certain modified audit opinions (scope limitations, departures from Generally Accepted Accounting Principles (GAAP)) are associated with discretionary accruals. They find that the documented relation between modified opinions and abnormal accruals rests with companies that have going concern opinions. These firms have large negative accruals that are likely due to severe financial distress. Overall, they find no evidence to support inferences in previous research that firms receiving modified audit opinions manage earnings more than those receiving clean opinions. In addition, Butler, Leone and Willenborg (2004) show that abnormal accruals are more negative for going concern companies audited by the Big Five than for those audited by the No-Big Five would support the auditor conservatism explanation. If accruals are not different for Big Five versus No-Big Five audited going concern companies, or if accruals are more negative for going concern companies audited by the No-Big Five, then the relation between accruals and troubled firms is less likely due to auditor conservatism.

In a context of financial distress, Hunt and Lulseged (2007) examine the link between client size, abnormal accruals and the going concern report. Their study supplements Reynolds and Francis (2000) by extending their analysis to the clients of No-Big Five auditors, a relatively small but important and growing segment of the audit market. Hunt and Lulseged (2007) find that No-Big 5 auditors, like Big 5 auditors do not allow their larger clients greater leeway to manage earnings. In addition, they find that larger clients are at least as likely, if not more likely, to receive a going concern report as are otherwise similar smaller clients. Still in the same financial distress context, and in the same furrow of ideas, Charito, Lambartides and Trigeorgis (2007) examine the earnings behaviour of managers during the distressed period by looking at sources of abnormal accruals prior to the bankruptcy-filing year, for 859 United States bankruptcy-filing firms. Their Results show that managers of highly distressed firms shift earnings downwards prior to the bankruptcy filing. They specified that one of factors that explains this result is qualified audit opinions exert pressure on managers to follow more conservative earnings behaviour during the distressed period.

In sum, the theoretical and the empirical development whole exposed above permits us to show the role of auditors in the process of improvement of the quality of the financial information distributed to the external users. In particular, auditors are susceptible to attenuate the earnings management, and to express his opinion in all independence. For it, he seems desirable to reinforce their independence and to assure the control of the quality of their work. Arrangements foreseen by the law of the financial safety of October 2005 go in this sense. Thus, in the setting of the following section we explore this track of research on the basis of a sample of the tunisian firms. For it, we consider to test the validity of our hypotheses:

Hypothesis 1. Firms with qualified audit report manage the discretionary accruals to the decrease.
Hypothesis 2. Firms with qualified audit report will be more susceptible to manage the discretionary accruals to the decrease audited by Big Four audit firms that those audited by No-Big Four.

3. Framework of Auditing in Tunisia

In Tunisia, the auditor's mission was organised by the code of commerce published in 1959. In order to improve the quality of the audits several laws were promulgated in 1982, 1988 and 2000. Indeed, the law of 1982 is characterised by a real entrance of the legal audit in the economic environment. This law carried the creation of the Tunisian Institute of Certified Public Accountants. For the 1984-1999 period, this Institute published standards on accounting and auditing. However, these standards presented serious insufficiencies and hiatuses that pushed auditors to use the international standards as referential complementary. More lately, another law was promulgated in 1988. The objective of this law was to improve the function and work of tunisian's auditors, who are held to express audit opinion in all independence.

Besides, National Standards on Auditing n°7 and n°15 of the Tunisian Institute of Certified Public Accountants and International Standards on Auditing n°700 and n°701 of the International Federation of Accountants put in evidence the importance of the opinion paragraph expressed by the statutory auditors, since it sums up findings of the audit mission. They stipulate that the expression used by the auditor to formulate his opinion must be simple and don't vary an exercise to the other. They define the different categories possible of the audit opinions. According to the National Standard on Auditing, the auditor concludes expressly either to the unqualified opinion, either to qualified opinion, and either to disclaimer opinion. As for the International Standard on Auditing, the ISA 700 treated the standard audit report where the audit opinion is unqualified. The ISA 701 treated the modified audit report. In this case audit opinions are three categories according to circumstances: *qualified opinion*, *adverse opinion* and *disclaimer*.

4. Methodology and Research Design

4.1. Sample Data

We attempt to collect and classify the 435 audit reports of 137 tunisian firms from 2002 to 2007 as having 311 unqualified opinions, 123 qualified opinions and only one case of *disclaimer*. The accounting variables were derived from the relative published financial statements to years 2002-2007, and data bound to the audit (audit opinions and audit firms) were derived from the relative audit reports to years 2001-2006. These data were obtained from the council of financial market official bulletin. For the 123 qualified opinions, we clear 8 types of qualifications: non conformity with accounting principles, error or irregularity, scope limitations of an audit, absence of provisions, insufficiency of provisions, absence of follow-up rigorous of engagements out balance, failing of the system of the internal control and going concern. Of the 435 audit opinions, 247 relate to utilities and financial firms that we eliminate because of inherent differences associated with accounting accruals for these firms. We lead to a final sample of 188 audit reports relative to 53 no-financial firms.

Table 1. *Number of audit opinions*

Type of opinions / Years	Unqualified opinions		Qualified opinions		Totals
	Big Four	No-Big Four	Big Four	No-Big Four	
2002	5	6		1	**12**
2003	8	18	2	4	**32**
2004	6	16	5	9	**36**
2005	5	18	5	9	**37**
2006	7	22	5	8	**42**
2007	5	16	3	5	**29**
Totals	**36 (19.15%)**	**96 (51.06%)**	**20 (10.64%)**	**36 (19.15%)**	**188**

Results of this table show that the majority of audit reports in Tunisia is unqualified (70. 21%), on the one hand, and are on the other hand audited by No-Big 4 auditors. It can be explained by the fact that the majority of the economic cloth in Tunisia is formed by the small and averages enterprises, these last generally choose that their financial statements are audited by No-Big 4 auditors.

4.2. Variables of the Analysis

Dependent Variable: Abnormal accruals (**ABAC**) represent that part of total accruals that is more susceptible to manipulation by managers and are frequently used in prior studies as a proxy for earnings management (Jones, 1991 and DeFond and Jiambalvo, 1994). Abnormal accruals are the difference between total accruals and non-discretionary accruals. Total accruals are the difference between operating income and cash flows from operations. No-discretionary accruals are the expected portion of total accruals in Jones model modified that regresses total accruals on changes in revenue, gross property plant and equipment, and return on assets (Kothari, Leone and Wasley, 2005).

$$ACCR_{it}/ASET_{it-1} = \alpha_1\left(1/ASET_{it-1}\right)+\alpha_2\left(\Delta REVE_{it}/ASET_{it-1}\right)+\alpha_3\left(GPPE_{it}/ASET_{it-1}\right)+\alpha_4\left(ROA_{it}/ASET_{it-1}\right)+\varepsilon_{it}$$

Where

$ACCR_{it}$: total accruals for sample firm i for year t.

$ASET_{it-1}$: total assets for sample firm i for year t-1.

$\Delta REVE_{it}$: change in net revenues for sample firm i for year t.

$GPPE_{it}$: gross property, plant, and equipment for sample firm i for year t.

ROA_{it}: return on assets for sample firm i for year t.

ε_{it}: unexpected portion of total accruals for sample firm i for year t.

The residuals ε_{it} from this equation are the discretionary accruals.

Independent Variables:

- **AUOP**: audit opinion is the variable of interest, variable dummy who takes the value one if the firm receives modified audit opinion and zero otherwise (Al-Thuneibat, Khamees and Al-Fayoumi, 2008). However, some authors replace the audit opinion variable with variables corresponding to the audit opinion categories (Leone and Willenborg, 2004 to the United States and Pucheta, Vico and Benau, 2004 in Spain).

Besides, a majority of studies interests itself to only one type of audit opinion "going concern" in a context of financial distress (Citron, Taffler and Uang, 2008). In our tunisian context, we are not going to proceed to a distinction between the qualified audit opinion categories, being given that the number of modified audit opinions is weak (29.79%) of the final sample.

- **AURE**: auditor's reputation (audit firm size) is the variable dummy who takes the value one if a Big 4 audit firm and zero otherwise.

- **FISI**: firm size is natural log of auditee's total assets, which prior research majority finds is negatively related to accruals (Cameran, Prencipe and Trombetta, 2008).
- **CURR**: current ratio or liquidity as a proxy for liquidity, we consider current ratio is measured by current assets scaled by current liabilities (Butler, Leone and Willenborg, 2004).
- **DEBT**: the level of indebtedness is measured by the total of debts scaled by the total of assets. Some works find that firms the indebted more manage their results to the rise in order to improve their financial situation (Becker and *al*., 1998).

4.3. Empirical Model

$$ABAC_{i,t} = \beta_0 + \beta_1 AUOP_{i,t} + \beta_2 AURE_{i,t} + \beta_3 FISI_{i,t} + \beta_4 CURR_{i,t} + \beta_5 DEBT_{i,t} + \varepsilon_{i,t}$$

In order to clear determinants of accounting manipulations, we appraise coefficients of the multivariate regression in data of panel on the software STATA 10.

5. Discussion of Findings

According to results of our model, the statistical Wald Chi two to 5 degree of liberty is the order of 45.370, either a hopeless significance level. We keep so the presence of individual effect in the following of our work. The evaluation of our model suggests some previous tests, as the test of Hausman (1978). It serves to discriminate the fixed effect/random effect. The statistical of Chi two to 5 degree of liberty is the order of 5.270, either a level of significance of .383 superior to 5%. Thus, we keep the random effect. In order to arrive to the best results, the question of the heteroskedasticity, the autocorrelation and the normality of residues in the setting of data in panel is addressed. Indeed, while using the Breusch-Pagan (1980) test, the statistical of Chi two is the order of 29.290, either a hopeless significance level implies that the model endures the problem of heteroskedasticity. While using the test of Ramsey, we notice that the model endures the problem of correlation and dependence between terms of mistakes, because the statistical of F is the order of 53.880. And in short the distribution of residues is no normal, according to tests of distribution (Skewness and Kurtosis). Being given that conditions of OLS are not verified, the least square method generalized (GLS) seems thus most suitable, in the following of our work.

Table 2. *Results of estimation*

Variables	Coefficients	Z	Sig P>│Z│	Expected sign	Found sign
AUOP	.388	.780	.433	**(-)**	**(+)**
AURE	-1.290	(-2.780)***	.005	**(-)**	**(-)**
FISI	1.940	(11.080)***	.000	**(-)**	**(+)**
CURR	.135	1.480	.140	**(+)**	**(+)**
DEBT	.702	(4.130)***	.000	**(+)**	**(+)**
CONST	5.800	-10.550	.000		

*** Significant at the 1% level.

The estimation results for our model display a Wald Chi two to 5 degree of liberty raised, either 133. 360 with a level of lower hopeless significance to 5%, what shows that the model seems meaningful in their totality. Contrary to our first hypothesis, the coefficient on modified audit opinion is positive but statistically insignificant. Indeed, firms with modified audit reports tend to have higher abnormal accruals. The tunisian auditor inefficiency in the reduction of discretionary accruals of their clients can to our sense to explain itself by the economic business reality which proves that ties of friendship become knotted between managers and their external auditors. In the setting of this senario appeared the law of the financial safety. It reinforced the statutory auditor's independence screw to screw of his client. More explicitly, the external auditors don’t accept material misstatements in audited financial statements. This result contradicted the previous study majority (Butler, Leone and Wullenborg, 2004; Hunt and Lulseged, 2007;…), which show that firms receive qualified audit opinions have negative accounting accruals.

Consistent with our second hypothesis, the coefficient for audit firm size is negative and statistically significant with p-value of .005. In of other terms, the Big Four auditor is more heedful to certify the annual financial statements with qualified audit opinions when the discretionary accruals are managed to the rise, in order to avoid all risk of particular mission screw to screw of investors. Larger audit firms have greater incentives to detect and reveal management misreporting and to assure a big financial statements conformity with the generally accepted accounting principles, on the one hand, and on the other hand, when detected, to object to their use and/or to qualify the audit report. This result corroborates those of Johl, Jubb and Houghton (2007) and Francis and Wang (2008) which advance that Big Four audit firms more frequently that their equivalents give out qualified audit reports, when the discretionary accruals are managed to the rise.

For the control variables, it exists a positive and meaningful relation ($p<0.01$) between firm size, the level of indebtedness and abnormal accruals. But then, a positive relation and not significantly different from zero exists between the ratio current of the liquidity and discretionary accruals. Indeed, the tunisian firms of large size manage the accounting accruals to the rise, in order to avoid the reduction of the level of their results. Contrary to studie of Cameran, Prencipe and Trombetta (2008), they show that earnings management is weak in the big firms, because these firms possess a system of control more efficient intern, and their annual financial statements are generally verified by the Big auditors. Moreover, to avoid debt covenant violation, managers of highly leveraged firms have incentives to make income-increasing discretionary accruals in order to camouflage a bad financial situation. This result confirms those of DeFond and Jiambalvo (1994) and Becker and *al.* (1998). In short, current ratio of liquidity is not a determinant of earnings management. Contrary to the prediction of Caramanis and Lennox (2008), they find that accruals are managed to the decrease for firms in financial distress with unqualified opinion and those with going concern opinions.

6. Conclusion

The objective of our research was to examine the impact of the nature of the audit opinion and the reputation of the audit firm on the earnings management measured by the discretionary accruals, while controlling the effect of certain exogenous factors (auditee size, debt and liquidity). For tending towards our objective of research, we tested our model in the context of data in panel, on a sample of 53 no-financial firms. The most significant findings are that the probability to manage earnings management to the increase is related to the issuance modified audit opinion and the presence of No-Big 4 auditors. The inefficiency of auditors in the reduction of accounting manipulations done by managers, to our sense can explain himself by the economic business reality, that proves that ties of friendship become knotted between managers and auditors. In the setting of this script, appeared the law of the financial safety in October 2005, the major objectives of this law is to reinforce the independence of auditors screw to screw of the auditee, is to protect investors by improving the accuracy and reliability of corporate disclosures and is to restore investors'confidence in the integrity of firms' financial reporting. More explicitly, the auditor must be more conservative and more prudent when he give out audit opinion on the financial statement prepared by management, in case where the result of seems to them over-valued.

Our study is subject to some limitations. We note that our survey is restricted to the type of audit opinion, we encourage future research to proceed a distinction between the qualified audit opinion categories. Besides, we are interested to a period of the study, whose majority precedes the apparition of the October 2005 law. Thus, it proves to be strong interesting to widen the period in order to ascertain the improvement of the certification quality since the financial statements accompanied by audit reports are the main source of available reliable information for investors, in an emergent country as Tunisia. In short, additional research could extend the results to other mechanisms that improve the quality of information communicated: audit committees and internal governance mechanisms such as the size of the board of directors.

Our understanding of information communicated through the report of audit, and in particular the paragraph of opinion permitted us to clear some implications for market regulators, institutional bodies, investors, managers and large audit firms, because the audit report is often the only mean of communication observable between auditors and all users of financial statements. They brought us to propose several recommendations to improve the adopted technical and professional audit norms. it would seem primordial notably to insist on the relative norm to the structure of the audit report, being given that this report is the only visible quality for investors. The improvement of the quality of the general reports of audit between auditees, auditors and investors are therefore indispensable on our Tunisian market.

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