Joint Audit and the Financial Reporting Quality: Empirical Study on Iraqi Voluntary Joint Audits

Khalid Sabah Ali[a], Hussein Ali Mohaisen[b], Ayad Abed Hameed[c], [a]Lecture at finance and banking department, College of Administration and Economics, Mustansiriyah University, Iraq, [b,c]Assistant Lecture at Control and Internal Audit Department, Presidency of Mustansiriyah University, Iraq, Email: [a]khalidsabah83@uomustansiriyah.edu.iq, [b]Hussein_aslan85@uomustansiriyah.edu.iq, [c]aiydabd80@uomustansiriyah.edu.iq

This study examines the impact of voluntary joint audit on the financial reporting quality; captured by two ways. First, using the abnormal accruals model, and second, using the earnings conservatism model. The study sample consists of 233 observations for many firms listed in the Iraqi stock exchange and cover the period 2014-2018. The study results revealed an insignificant relationship between voluntary joint audit on the Iraqi stock exchange and the financial reporting quality and a significant positive relationship between the independent variables and the dependent variable of financial reporting quality. This means that depending on joint audit forms (big 4 parties – one party big 4) increasing the financial reporting quality where the voluntary joint audit without any big 4 auditors doesn't affect the financial reporting quality.

Key words: *Voluntary joint audit, Big 4 pair auditors, One party of Big 4 auditors, Financial Reporting Quality, Earnings Conservatism.*

Introduction

The financial crisis of 2008 caused the emergence of a Green Paper which was issued by the European Commission (2010), for increasing the audit quality and developing the market competition. Consequently, appeared the joint audit term which allowed more than one auditor to share auditing of a client, which lead to improving competition and strengthened audit quality. Following the emergence of the Green Paper conflicting the views of the effect of mandatory joint audits where the Big 4 audit firms (European Commission 2011a). Although mandatory joint audits may achieve several benefits, it also may increase the audit cost and workload, so mandatory joint audits became a great criticism for the countries which mandated the approach (European Commission 2011b).

In this regard, numerous researchers agreed with the concerns of the European Commission (2011b) about increasing the cost of audit when conducting the voluntary joint audit (Zerni, et al., 2012; Holm & Thinggaard 2014). On the other side, the Big 4 firms participating in the voluntary joint audits may increase the financial reporting quality (Francis, et al.,2009; Zerni et al. 2012).

There is no doubt that most privately listed firms on the stock exchange need different incentives for financial reporting, one of these incentives is mitigating the bad effects of agency theory by reducing the information asymmetry level between the external users of financial statements and managers preparing these statements (Ball & Shivakumar, 2005; Burgstahler, et al., 2006). For achieving this quality, it requires hiring high quality auditors as guarantor between mangers and all stakeholders, because it may preventing earnings overstating or understating for borrowing or reducing taxes (Caramanis & Lennox 2008; Ke et al. 2014).

A bulk of literature agreed to exist individual differences among auditors. These differences are expertise knowledge levels and risk preference (Knechel 2012; Baldauf & Steckel, 2012; Kermiche & Piot, 2018). These differences related to industry and its trends in accounting and auditing, so it can be exchanged by sharing through joint audit engagement. Thus, achieving an effective audit may lead to improved financial reporting quality (Vera-Munoz, Ho, and Chow 2006). Accordingly, Joint audit may be one of the forms that guarantees high quality financial reporting through network linkages which allow exchanging expertise and knowledge and the forming of professional ties (Bianchi, 2018).

The supporters of joint audit argue that audit quality may increase the quality of financial reporting by addressing two features of audit quality; competence and independence of the auditor (DeAngelo 1981). First, the joint audit procedure becomes more accurate than

individual audit because of the opportunity to conduct benchmarking of the procedure with the other auditor. Thus, joint audit can improve the judgment quality by insuring justification of their decisions and providing the advice from another peer of audit (Gibbins & Emby, 1985; Danos et al. 1989). Consequently, the main advantages of joint audit are the communication and informal benchmarking and peer consultation among the parties of joint audit. This allows every partner of joint audit a high level of client knowledge, hence allowing the high quality of audit and financial reporting. In addition, exchanging experience and information improves the performance of the audit task and the judgment quality (Brown & Johnstone 2009; Chin & Chi, 2009).

Second, auditor independence is another important feature of audit quality and it will be higher in the case of joint audit because they may be more resistant of client pressure and allow for more aggressive accounting treatments. Moreover, joint audit allows continuous rotation for individual partners of joint audit with the maintenance of the other party controlled by a fellow auditor who is more understanding and knowledgeable. This means a higher degree of independence without any disruption caused by rotation which leads to more quality of judgment than a single audit (DeAngelo 1981; Johnson, et al., 2002; Ashbaugh, et al., 2003; Myers, et al., 2003; Carcello & Nagy 2004; Ghosh & Moon 2005; Mazars 2010)

This research will contribute to at least three issues. First, the dominance of the big 4 auditors, on the audit market, may lead to a lot of risks in the case of audit failure, so joint audit may reduce the audit market concentration because it will allow for non-big 4 auditors to share clients with the big 4 auditors, which means exchanging experience and knowledge. In this vein, I will examine the effect of pairing between the big 4 auditors and non-big 4 auditors on the quality of financial reporting. Second, the results could benefit the regulators, investors, companies and other stakeholders. Third, the results may introduce empirical evidence for academics about the effects of joint audit on the financial reporting quality.

Finally, this study tries to present an answer about the relationship direction between voluntary joint audit in Iraq and the financial reporting quality, as well as it examines the impact of joint audit on the financial reporting quality?

Literature Review and Hypotheses development:

Francis et al. (2009) studied the relationship between mandatory joint audit and the quality of audit in France, and they found increasing demand on employing high quality auditors and increasing quality of financial reporting. This is in contrast to firms that didnt employ high quality auditors.

Numerous studies agreed that joint audit can achieve credibility of financial reporting and increase its quality in two ways. First, joint audit leads to safe rotation by retaining the one who has more knowledge and understanding about the client firm. This safe rotation guarantees more independence and competence (Carcello & Nagy, 2004; Carey & Simnett, 2006; Deng, et al., 2014; Lobo, et al., 2017). Second, joint audit overcomes the economic threat of auditor independence by splitting audit fees and consulting fees between the two auditors, which means that the two auditors will be stronger in the face of management pressure and will do their best to control management and report their opinions fairly (Mazars, 2010; Zerni et al., 2010; Lesage, et al., 2017).

Another bulk of literature refuses the idea that joint audit can increase the quality of financial statements for two main reasons. First, joint audit causes the free-rider problem which occurs when one of the auditors fully depend on the other during the audit activity. Second, competitive environment among auditors may impede the cooperation atmosphere between the joint audit parties which prevents information exchange between them (Hardin, 1968; Olson, 1968; Oliver & Walker, 1984; Whisenant, et al., 2003; Neveling, 2007; Thinggaard & Kiertzner, 2008; Deng et al., 2014; Audousset-Coulier, 2015; Andre´ et al., 2016; Kermiche & Piot, 2018).

In brief, the relationship between joint audit pairs and the financial reporting quality measured by abnormal accruals has become more controversial among academics, whereas some of them conclude that joint audit could increase the financial reporting quality (Zerni et al., 2012), but on the other side, some academics suggest that there is no relationship between joint audits and the financial reporting quality (Andre´ et al., 2016). Francis et al. (2009) added that big 4 pair of joint audit is the best pair of joint audit because it's the highest pair affecting positively on the quality of financial reporting. The controversy among academics about the impact of joint audit on the quality of financial reporting, has led to the development of these hypotheses (in the null form) as follow:

H1: There is no relationship between joint audit and the financial reporting quality captured by abnormal accruals.
H2: There is no relationship between big 4 pairs of joint audits (big 4 pair; one party big 4) and the quality of financial reporting captured by abnormal accruals.

The most that can be said about financial reporting quality from the financial theory perspective is that quality means higher credibility for all stakeholders which means building a good reputation for the firm and reducing the information risk for all stakeholders

especially investors and lenders, thus reducing the capital cost (Jensen & Meckling, 1976; Coles & Lowenstein, 1988; Botosan, 1997; Lambert et al., 2007). The auditors have a great role in building this reputation by insuring the accounting conservatism on the financial statement and protecting all stakeholders from managerial bias related to disclosure about only good news (Jensen & Meckling, 1976; Titman & Trueman, 1986; Watts & Zimmerman, 1986; Teoh & Wong, 1993; Datta et al., 1999; Pittman & Fortin, 2004).

In this regard, the auditors present the final assurance to all stakeholders about the credibility of financial statements, this means the auditors are the main source of confirmation and insurance for all stakeholders. By this way, in the case of joint audit, it is supposed to provide higher assurance and higher confirmation about the credibility of financial statements. In addition, in the case of joint audit, realized higher insurance for all stakeholders is a matter of importance because stakeholders can sue auditors, for the existence of misstated financial statements, to recover their losses (Zerni et al., 2012). Based on the previous viewpoint the big 4 pairs of joint audits (big 4 pair; one party big 4) will introduce more assurance and insurance for all stakeholders, increasing the level of accounting conservatism and protecting all stakeholders from biased disclosure about good news only (Zerni et al., 2010). In this regard this study can develop these hypotheses on the alternative form as follow:

H3: Joint audit leads to increasing the level of accounting conservatism.
H4: The big 4 pairs of joint audits (big 4 pair; one party big 4) lead to increasing the level of accounting conservatism.

Research Design:

Following the majority of previous literature (e.g., Zerni, et al., 2012; Ittonen & Tronnes, 2015; Bisogno & Luca, 2016; Lesage, et al., 2017; Bianchi, 2018) and consistent with my research hypotheses I measure the dependent variable using two models. One of them will depend on the discretionary accruals and the other depends on the accounting conservatism level.

This study uses the Jones model (1991) cross sectionally to measure the absolute value of discretionary accruals for determining the financial reporting quality. For doing this, the study runs the following model:

$$ACC / LagAS = \beta 0 + \beta 1(1/LagAS)i,t + \beta 2(\Delta REV - \Delta REC)/LagAS\ i,t + \beta 3(LagROA)\ i,t + \beta 4(ABD/LagAS)\ i,t + \varepsilon \qquad (1)$$

Where:

ACC = the difference between net income and the cash flow from operations, which is equal total accruals;

ΔREV = sales revenue change;

ΔREC = accounts receivables change;

Lag ROA = last year return on assets;

ABD = Total assets of the current year before subtracting the depreciation;

Lag AS = last year total assets.

In addition, we use earnings conservatism as a proxy for financial reporting quality according to Basu (1997), which determines the asymmetric behaviour of loss recognition. In this model positive returns of stocks are indicators for the good news and negative returns indicate the bad news. The philosophy of earnings conservatism depends on recognizing more quickly the losses than the earnings. In this way the level of information asymmetric will be reduce (LaFond & Watts, 2008; Watts, 2003). So, this study runs the following model of earnings conservatism as a proxy of financial reporting quality:

$$Earn = \beta_0 + \beta_1 R + \beta_2 DR + \beta_3 R \times DR + \varepsilon \qquad (2)$$

Where:

Earn = earnings per share deflated by opening price of stock;

R = stock returns in period t;

DR = indicator takes 1 in the case of negative returns (bad news).

Consequently, based on these previous two models, the financial reporting quality measures are determined, so it is important now to determine the independent variables and how to measure them.

Following a great bulk of literature (e.g., Zerni, et al., 2012; Ittonen & Tronnes, 2015; Al-Hadi, et al., 2016; Bisogno & Luca, 2016; Holm & Thinggaard, 2016; Paananen, 2016; Guo, et al., 2017; Lesage, et al., 2017; Bianchi, 2018) we can measure voluntary joint audit as an indicator; take the value 1 in the case of joint audit and the value 0 otherwise. In the same way we can measure the other independent variables of my research which are the big 4 pairs of joint audits (big 4 pair; one party big 4).

But analyzing the relationship between the research variables (i.e. independent & dependent) differ by the difference of dependent variable measurement tools. Whereas using the model (1) for measuring the financial reporting quality requires rebuilding the model link between the independent variables and the absolute value of discretionary accruals extracted from

model (1). While using model (2) doesn't require this rebuilding model because it only will depend on analyzing the moderating effect of the independent variables of my research.

Consequently, rebuilding model for testing H1, H2 require inserting a group of control variables, following an aray of previous literature (e.g., Febrianto & Sugiri, 2011; Deng, et al., 2014; Elder, et al., 2015; Lesage, et al., 2017; Lobo, et al., 2017) which are:

Log Size = total assets after computing the natural log.
Lev = total liabilities deflated by owners' equity.
Roa = net income deflated by total assets.

By this way we can develop the following model for testing H1, H2 in particular the majority of prior literature (Deng, et al., 2014; Bisogno & Luca, 2016; Lesage, et al., 2017; Lobo, et al., 2017; Bianchi, 2018) considered the accruals is the relevant measure of financial reporting quality:

$$\text{Abs ACC} = \beta 0 + \beta 1\ \text{J\_audit} + \beta 2\ \text{big 4 pair} + \beta 3\ \text{one big 4} + \beta 4\ \text{Log Size} + \beta 5\ \text{Lev} + \beta 6\ \text{Roa} + \varepsilon \qquad (3)$$

Where:
J_audit = Indicator, take the value 1 in the case of voluntary joint audit and 0 otherwise;
big 4 pair = Indicator, take the value 1 in the case of the two parties of voluntary joint audit are big4 and 0 otherwise;
one big 4 = Indicator, take the value 1 in the case of one of the two parties of voluntary joint audit are big4 and 0 otherwise;

on the other side, examining the moderating effect of independent variables on the earnings conservatism for testing H3, H4 require developing the following model:

$$\text{Earn} = \beta 0 + \beta 1\ \text{R} + \beta 2\ \text{DR} + \beta 3\ \text{R} \times \text{DR} + \beta 4\ \text{J\_audit} + \text{J\_audit}\ [\beta 5\ \text{R} + \beta 6\ \text{DR} + \beta 7\ \text{R} \times \text{DR}] + \beta 8\ \text{big 4 pair} + \text{big 4 pair}\ [\beta 9\ \text{R} + \beta 10\ \text{DR} + \beta 11\ \text{R} \times \text{DR}] + \beta 12\ \text{one big 4} + \text{one big 4}\ [\beta 13\ \text{R} + \beta 14\ \text{DR} + \beta 15\ \text{R} \times \text{DR}] + \varepsilon \qquad (4)$$

Sample and Descriptive Statistics:

The primary source of the data for Iraqi listed companies are those listed on the Iraqi stock exchange from 2014 to 2018 and the sample started from 2014 due to multiple recommendations about the importance of joint audit. In addition, the proposed laws of Iraqi stock exchange related to committing certain sectors with the joint audit which encourages a lot of listed companies to engage in joint audit voluntary. Consequently, my initial sample

period consisted of 342 firm years observations, by excluding 82 observations related to banks and financial firms which engage in joint audit in a mandatory form by law, in addition excluding 27 omitted observations; the final sample becomes 233 firms, observations distributed on sectors as shown in table (1) below.

Table 1: observations distribution on the Iraqi stock market sectors

Sector	2014	2015	2016	2017	2018	Total
Services	5	3	4	5	9	26
Industries	10	16	18	20	20	84
Hotels and tourism	12	11	12	14	12	61
Agriculture	4	2	1	5	5	17
Communications	1	1	1	2	3	8
Financial Transfer	3	4	5	8	17	37
Total	35	37	41	54	66	233

As shown in table (1) the observations increased gradually along the time series of my sample due to the increased importance of the Iraqi stock exchange and joint audit. So, it is important now showing the descriptive statistics of studied variables on the sample period, as shown in table (2).

Table 2: Descriptive statistics

Variable	Coef.	Mean	Std. Dev.	Min.	Max.
Abs ACC	233	0.108	0.195	0.000	2.627
J_audit	233	0.584	0.494	0.000	1.000
big 4 pair	233	0.296	0.458	0.000	1.000
one big 4	233	0.155	0.362	0.000	1.000
Earn	233	0.061	0.193	-0.527	2.148
R	233	0.303	1.587	0.000	21.147
DR	233	0.717	0.452	0.000	1.000
Size	233	1.200	3.340	2.007	3.850
Lev	233	1.443	3.050	11.411	31.765
Roa	233	0.094	0.355	-3.208	1.611

As shown above in table 2, the mean of joint audit is equal to 58.4% which means 58.4% from all observations inserted in the sample rely on the joint audit. This percentage is relatively high and indicates the increased dependency on the joint audit, for many firms listed on the Iraqi stock exchange.

In addition, there are 29.6%, from all observations inserted in the sample, that rely on the joint audit by two parties of big 4 auditors. This percentage is relatively high if it is compared with the 58.4% that represent all observations which apply to joint audit. Whereas there are 15.5% from the sample that rely on the joint audit by one party of the big 4 auditors. This mean that a percentage of 13.3% (58.4% - 29.6% - 15.5%) from the sample rely on the joint audit without any big 4 auditors.

Multivariate Results

Table 3 shows the results of the relationship direction between joint audit and the financial reporting quality captured by the abnormal accruals model. There is an insignificant relationship between voluntary joint audit on Iraqi stock exchange and the quality of financial reporting. Although, at the same time there is a significant positive relationship between voluntary joint audits by the big 4 pairs, this means that depending on a big 4 pair for joint audit increases the quality of financial reporting. In addition, there is a significant positive relationship between voluntary joint audit by one party of the big 4 auditors and the financial reporting quality but the effect of big 4 pairs of joint audits is greater.

Regarding control variables, we cannot find any significant relationship between them and the quality of financial reporting. In addition, the explanatory power of this model is 53.23% and it is consider a good percentage compared to its counterpart in other literature (e.g., Carcello & Nagy, 2004; Carey & Simnett, 2006; Mazars, 2010; Zerni et al., 2010; Deng, et al., 2014; Lobo, et al., 2017; Lesage, et al., 2017).

These results lead the study to accept the first null hypothesis which agrees with numerous prior literature (Carcello & Nagy, 2004; Carey & Simnett, 2006; Mazars, 2010; Zerni et al., 2010; Deng, et al., 2014; Lobo, et al., 2017; Lesage, et al., 2017) and refuses the second null hypothesis due to a significant positive relationship between the big 4 pairs and one party of big 4 auditors and the financial reporting quality captured by the abnormal accruals model (i.e. accepting the alternative form of second hypothesis) which agrees with another bulk of literature (e.g., Olson, 1968; Hardin, 1968; Oliver & Walker, 1984; Whisenant, et al., 2003; Neveling, 2007; Thinggaard & Kiertzner, 2008; Deng et al., 2014; Andre´ et al., 2016; Kermiche & Piot, 2018).

Table 3: multivariate results between voluntary joint audit and financial reporting quality captured by discretionary accruals

Variable	Coef.	t-static	Prob.
Constant	0.047	2.300	0.023
J_audit	0.032	1.230	0.220
big 4 pair	0.074	2.130	0.034
one big 4	0.139	3.160	0.002
Size	1.320	0.370	0.710
Lev	-0.001	-0.350	0.726
Roa	-0.010	-0.300	0.762
Firm Fixed Effects	*Included*		
N	233		
R2	53.23%		
VIF Max	1.85		

Table 4 shows the results of the relationship direction between joint audit and the financial reporting quality captured by the earnings conservatism model. We find in panel A the variable R*DR is significant and positive which means that the Basu model works well for the Iraqi listed companies i.e., the Iraqi listed companies recognition of loss os more timely.

Table 4: Multivariate results for the relationship direction between voluntary joint audit and the quality of financial reporting captured by earnings conservatism

Variable	Panel A: Basu Model			Panel B: Full Model		
	Coef.	t-static	Prob.	Coef.	t-static	Prob.
Constant	-0.091	-4.090	0.000	-0.082	-1.910	0.058
R	-0.001	-0.130	0.899	-0.052	-0.370	0.708
DR	-0.012	-0.650	0.515	0.067	0.230	0.817
R*DR	0.214	8.230	0.000	0.181	3.400	0.001
J_audit				0.026	0.460	0.644
J_audit*R				0.004	0.030	0.980
J_audit*DR				0.009	0.130	0.895
J_audit*R*DR				-0.030	-0.100	0.917
big 4 pair				0.032	0.480	0.635
big 4 pair*R				0.049	1.040	0.300
big 4 pair*DR				0.246	2.220	0.028
big 4 pair*R*DR				3.029	2.770	0.006
one big 4				-0.108	-1.260	0.208
one big 4*R				-0.043	-1.010	0.313
one big 4*DR				-0.204	-1.510	0.131
one big 4*R*DR				2.969	2.670	0.008
Firm Fixed Effects	Included			Included		
N	233			233		
R2	48.16%			67.18%		
VIF Max	1.25			8.9		

On the other side, we find in panel B of table 4 that the variable J_audit*R*DR is insignificant, which means that voluntary joint audit hasn't any effect on the earnings conservatism. We find that the variables big 4 pair*R*DR, one big 4*R*DR is significant and positive this means that the big 4 pairs and one party of big 4 auditors lead to increasing the level of earnings conservatism which means a higher quality of financial reporting, but the effect of the big 4 pairs is greater which is consistent with the first result of this research and agrees with the results of prior literature (e.g., Jensen & Meckling, 1976; Titman & Trueman, 1986; Watts & Zimmerman, 1986; Coles & Lowenstein, 1988; Teoh & Wong, 1993; Botosan, 1997; Datta et al., 1999; Pittman & Fortin, 2004; Lambert et al., 2007).

On another vein, I find that explanatory power of the Basu model increased from 48.16% to 67.18%. This means that joint audit improved the accuracy of the Basu model and these percentages are good compared to its counterpart in other literature (e.g., Zerni, et al., 2012).

These results lead me to refuse the third alternative hypothesis and accepting the null third hypothesis. In addition, we accept the alternative form of the fourth hypothesis due to the significant positive relationship between the big 4 pairs and one party of big 4 auditors and the financial reporting quality captured by the earnings conservatism model.

Conclusions

I examine the impact of voluntary joint audit on the financial reporting quality, captured in two ways. First one, using the abnormal accruals model, and the other using the earnings conservatism model. The study sample consists of 233 observations for firms listed on the Iraqi stock exchange and cover the period of 2014-2018.

The study results revealed an insignificant relationship between voluntary joint audit on the Iraqi stock exchange and the financial reporting quality and a significant positive relationship between the independent variables of a big 4 pair for joint audit and one party of the big 4 auditors and the dependent variable financial reporting quality captured by the abnormal accruals model. With respect to results of moderating effect for earnings, the conservatism model revealed an insignificant relationship between voluntary joint audit on the Iraqi stock exchange firms and the earnings conservatism and a significant positive relationship between the independent variables of a big 4 pair for joint audit and one party of the big 4 auditors and the dependent variable financial reporting quality captured by the earnings conservatism model. This means that joint audit forms (big 4 parties – one party big 4) increase the financial reporting quality; where the voluntary joint audit without any big 4 auditors doesn't effect the financial reporting quality.

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