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Capital Market Reaction to Auditors' Expertise[1]

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Research Paper

Introduction

Researchers have emphasized the issue of audit quality due to increasing attention to the market of audit services and the occurrence of some disabilities and problems. The occurrence of financial crises in recent years has highlighted the essential role of credible and quality reporting. These crises have increasingly focused on the role of audit quality in reporting. Due to the reassuring nature of the audit, high (or low) audit quality can impose less (or more) costs and time. Researchers have emphasized audit quality due to increasing attention of market to audit services and the occurrence of some weaknesses and problems. Achieving high-quality financial statements depends on the correctness of the auditor's practice and expertise. Auditing is a helpful way in contractual relationships to reduce the power of managers in a representation issue among managers and shareholders. This study aimed to investigate the reaction of the capital market to the expertise of auditors in conducting audits. The hypotheses presented in this research entitled:

Hypothesis 1: In companies with more specialized auditors, earnings significantly affect stock prices.

Hypothesis 2: A change to an auditor with higher expertise results in a significant positive capital market reaction.

Hypothesis 3: Auditing by highly specialized auditors significantly affects the ability to receive credits.

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Methodology

We collected the required data from the Tehran Stock Exchange dataset. The statistical population of this study, included all companies listed on the Tehran Stock Exchange between 2016 and 2020. As of matter of data availability, companies that did not meet the specific minimum requirements, have been eliminated and finally 120 listed companies have been studied in a 5-year horizon. The results were obtained using the multivariable cross-sectional and hybrid regression models.

Results and Discussion

The results of the first hypothesis show that an audit presented by highly qualified auditors has a more significant impact on stock prices. Auditing by highly qualified auditors increases the transparency and trust of financial information users, improving the company's competitive position and ultimately increasing revenue. On the other hand, highly specialized auditors can reduce information asymmetry, which reduces agency problems because proper auditing by highly qualified individuals can streamline management efforts and actions controlling the manipulation likelihood. Highly specialized auditors strive to perform their duties to the best of their ability and to reassure users about reporting, protect the interests of shareholders and enhance their interests. Auditing by highly qualified auditors enables management to be prudent in its decisions and make decisions regarding the efficiency of resource use and avoid any action that would encounter an adverse reaction from the capital market.

Testing the second hypothesis, we documented that the market reaction is partially due to insufficient information; in other words, the seller does not have enough accurate knowledge about the buyer's reaction to the auditor's change. Besides, the buyer does not dominate the reason for this change, indicating that in a competitive situation, as the general efforts of auditors become more targeted, the abnormal return will decrease. Therefore, we found that the market reaction to the selection of a more specialized auditor is positive.

The results of testing the last hypothesis associated with debt commitment show that by entrusting the audit to highly specialized auditors, which results in increased audit quality, the associated risks of potential claims will be minimized, and the ability to receive credits will increase, so, investors choose companies that have information transparency. As one of the primary users of financial statements, creditors consider the reports issued by the auditors and the internal controls of the company in assessing the status and credit of the customer and decisions related to granting credit and facilities. Such decisions and credit assessments are critical and vital, and if aren’t done correctly, will

aggravate bank arrears and receivables. The improved audit quality imposed by highly qualified auditors will increase information transparency and reduce the costs of processing the company's general and specific information. We suggested that companies employ highly specialized auditors to increase shareholders' attitudes toward the transparency of their information and gain their trust. Specialized auditors avoid erroneous decisions of creditors' analysts and clarify financial information, and prevent additional costs. Other beneficiaries of employing specialized auditors include reducing abnormal returns, significantly positively affecting firms' creditors, gaining investor confidence and low financing risk assessment.

Keyword: Auditors' Expertise, Capital Market Reaction, Auditors' Change, Debt Commitment.

JEL Classification: M42, G41.