

## Audit Quality Criteria and Their Effect on the Characteristics of Profit Sensitivity and Precision<sup>1</sup>

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Research Paper

### INTRODUCTION

Considering the existence of conflicts of interest between managers and owners of economic enterprises, it is necessary to conduct the audit process despite the costs it imposes on the company. According to DeFond and Zhang (2014), when the audit process is implemented based on audit standards and maintains suitable quality, financial statements gain credibility and are more relied upon in the decision-making process. Profit is one of the most significant and important items in financial statements, consistently attracting the attention of users. Creditors, investors, analysts, managers, company employees, the government, and other stakeholders use profit as a basis for investment decisions, granting loans, setting interest payment policies, evaluating companies, calculating taxes, and other company-related decisions. Most current reward plans and contracts are based on accounting profit; however, a reward plan focused solely on accounting profit tends to place less emphasis on value creation (Namazi and Sirani, 2013). The purpose of profit accuracy as a performance measure is that it aligns with real activities, remains independent of external fluctuations and disturbances beyond the manager's control, and is free from profit manipulation and opportunistic managerial motives, which can distort performance measurement and reduce profit accuracy

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(Pandher and Patek, 2014; Zakaria, 2012; Parsaiyan, 2010). Greater fluctuations and changes in profit, resulting from low profit accuracy, are associated with higher risk and stem from multiple factors. In other words, if net profit is calculated to accurately reflect managerial performance, with minimal influence from factors beyond the manager's control and sufficient sensitivity to managerial efforts, it can effectively evaluate managerial performance. When net profit is intended to serve as a measure of managerial achievement during the financial year for rewarding purposes, it must consider profit indicators and concepts that are independent of external fluctuations and disturbances beyond the manager's control, as well as free from profit manipulation. In essence, it should be more accurate meaning the net profit figure should reflect the impact of the manager's actions on the company's value and enhance profit sensitivity (Parsaian, 2012; Zakaria, 2012). Given that the presence of an auditor influences managerial performance by overseeing accounting activities, thereby affecting profit accuracy and sensitivity, it is expected that companies employing higher-quality audits will experience improvements in profit accuracy and sensitivity.

## **MATERIALS AND METHODS**

This research is applied in terms of its objective, descriptive in terms of its method and nature, and falls within the category of accounting deductive research in terms of philosophy. It is quantitative in its implementation process, adopts a comparative-inductive approach in its logic, and is longitudinal-retrospective in its time dimension, utilizing historical information from sample companies. The statistical population under investigation consists of companies listed on the Tehran Stock Exchange, covering the period from 2012 to 2022. Due to the large size of the statistical population and heterogeneity among its members, a subset of companies was selected as samples. Companies meeting the desired research conditions and characteristics such as having a financial year ending on March 31 each year, availability of all necessary data to calculate variables, full tax exemption, and no interruptions in activities during the study period were chosen. The remaining samples were filtered based on these conditions and restrictions to achieve more accurate results and enhance the comparability and generalizability of the sample findings to the broader population. Using the systematic elimination method (screening of companies), a total of 105 companies (1,050 company-years) were selected as the statistical sample for this research. Data were collected through document mining, processed using the 2016 version of Excel

software for categorization, sorting, and measurement of research variables, and analyzed using EViews (version 16) econometrics software to estimate the research model and conduct research tests.

## **RESULTS AND DISCUSSION**

One of the primary tasks of accounting and financial reporting is to reflect management performance evaluation through accounting profit. Accounting profit can demonstrate management's commitment to its stewardship responsibilities as representatives of shareholders only when it is presented fairly and with acceptable quality. Management bonus theories suggest that profit can serve as the basis for annual bonuses if it possesses quality, with quality profit indicators encompassing two components: profit accuracy and sensitivity (Waez and Banabi al-Kadim, 1400). Profit accuracy refers to its independence from external uncontrollable factors, as these are not influenced by managerial policies or traits, while profit sensitivity reflects management's efforts and honest business endeavors to generate profit. Naturally, opportunistic managerial behavior diminishes profit quality by obstructing the truthful representation of business efforts. Audit quality can mitigate agency problems between shareholders and managers by controlling such behavior. This research examined the usefulness of various audit quality criteria on profit accuracy and sensitivity. Test results indicate a significant positive relationship between the size of the audit firm, the auditor's industry expertise, the continuity of audit tenure, auditor independence, and both profit accuracy and sensitivity. However, no significant relationship was observed between audit fees and profit accuracy or sensitivity.

In other words, large, industry-specialized audit firms with sufficient independence and audit tenures exceeding one year effectively prevented the presentation of inaccurate profits while compelling managers to honestly reflect their business efforts. However, high audit fees did not deter managers from presenting low-quality profits. The conclusion drawn from the research hypotheses is that, within the statistical population (when considering profit accuracy and sensitivity as indicators of profit quality), audit fees alone cannot be regarded as a reliable indicator of audit quality, as they do not enhance the quality of company profits. In contrast, the size, expertise, tenure continuity, and independence of the auditor can be considered reliable indicators of audit quality.

## CONCLUSION

The results showed that, among various audit quality criteria, the size of the audit firm, auditor industry specialization, auditor tenure, and auditor independence enhance profit accuracy and sensitivity. However, no significant relationship was found between audit fees and profit accuracy or sensitivity. Auditors can improve audit quality, profit quality, and their precision and sensitivity by enhancing audit quality and reducing agency costs.

**Keywords:** Audit Quality, Profit Sensitivity, Profit Accuracy, Audit Fees.

**JEL Classification:** O40, M4, M41.

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