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Investigating the effect of the Board of Directors characteristics on auditor selection in the companies listed in Tehran Stock Exchange

Abolfazl Ghadiri Moghadam[1]* , Mahdi Filsaraei[2] , MalihehDorostkar[3] , Arezou Rezvani[4] , Fatemeh Yeganeh Pahlavanlou[5]

[1,2,3,4] Department of Information Technology Management, Electronic Branch, Islamic Azad University, Tehran, Iran

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ABSTRACT

Objective: Increasing the number of users of the audit report, as customers of this public good, has caused the quality of the auditors‟ job to be put under observation. **Methodology**: Quality of the auditors‟ work and their opinion can lead to improving the financial information system of countries and finally optimal economic decision-making. **Result**: The results of studying the research variables among 74 companies in 6 industries, using multiple linear regression and panel data, showed that the Board size has a significant inverse relationship with auditor tenure. But this variable has no significant relationship with auditor size. So, it is suggested that acceptable standards be considered for auditor selection in order to improve the audit procedures so that the auditor tenure will be less affected by the Board size and also personal judgments. In addition, the proportion of outside directors has no significant relationship with auditor tenure and auditor size. **Conclusion**: The results indicated that the company size has a significant positive relationship with the auditor size. Thus, larger companies use larger firms for auditor selection. Accordingly, it is recommended that larger organizations should employ larger audit firms to enhance audit quality.

1. Introduction

Increasing expansion of communities and the complexity of transactions and trade exchanges in capital markets on one hand and conflicts of interest between the two groups of producers and users of information on the other have revealed the need for selecting independent auditors in order to monitor and validate the financial information (Moradzadefard & Rahmannezhad, 2011). An independent auditor is a person who, invited by the shareholders, interested natural or legal persons or as provided by law, examines the accounts in question and reports the result in writing to the caller or any other natural or legal person who has appointed him (ArbabSoleimani & Nafari, 2009). Audit profession plays an important role in improving the information system and ensuring the reliability of financial reporting of countries. Increasing the number of users of the audit report, as customers of this public good, has caused the quality of the auditors‟ job to be put under observation. Quality of the auditors‟ work and their opinion can lead to improving the financial information system of countries and finally optimal economic decision-making. Therefore, it is essential to investigate the factors affecting the quality of auditors‟ work (KhosraviCharmi, 2006). In recent years, with the formation of Certified Public Accountants Association, part of the activities of the audit organization has been assigned to the private institutions that are members of that association. On the other hand, the results of previous studies such as the research on earnings quality and earnings management index indicate a reduction in the quality of financial reporting and one reason for the decline in the quality of financial reporting can be the type of auditor (Moradzadefard & Rahmannezhad, 2011). Several factors may influence the auditor selection. Among these factors are the Board characteristics. Board of Directors is one of the internal mechanisms of corporate governance, which has a great impact on corporate performance and respecting the rights of the business stakeholders. The Board's role is crucial in monitoring the method of corporate governance in order to achieve the set goals and conducting the executive management so that in some occasions, good corporate governance is measured by the composition and performance of the Board of Directors. In addition to strategic guidance of the company, the Board of Directors has major

* *Corresponding author:* Ghadiri_Moghadam@iauT.mail.edu
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responsibility for monitoring managerial performance, achieving an appropriate return for shareholders, observing the rules, preventing conflicts of interest and creating a balance between conflicting demands from the company (Rahmani, 2008). Based on the foregoing, this paper attempts to answer the question as to whether the Board characteristics have a significant impact on selecting a particular type of auditor in the companies listed in Tehran Stock Exchange.

1.1 Audit and its types

Audit refers to investigative inspection of accounting documents and other evidence underpinning the financial statements. Auditors collect the necessary evidence through gaining knowledge of the internal control system, inspecting the documents, observing the assets, examining the sources inside and outside the company and implementing other audit methods in order to determine whether financial statements provide a good and relatively perfect image of the company's financial situation and its activities during the period under audit. In fact, audit is a regular and systematic process to objectively gather and evaluate evidence about the claims related to economic activities and events in order to determine the degree of compliance of these claims with predetermined criteria and report to the stakeholders (Fili, 2012).

1.2 Types of Auditors

1. Independent Auditor: A person who, invited by shareholders or interested natural or legal persons or as provided by law, examines the accounts in question and reports the result in writing to the caller or any other natural or legal person who has appointed him.

- Legal inspector: A person who, under the provisions of the Commercial Code, is designated by General Assembly of the shareholders under certain conditions. In addition to the financial statements, the provisions of the Commercial Code and the provisions of the Statute of the company, legal inspector also comments on the report about the activities of the Board of Directors. Legal inspector is obliged to present all the crime reports to General Assembly of the

Shareholders.

- Internal auditor: The main objective of internal auditors is to inspect and assess the effectiveness of performing the tasks assigned to different units of the company. Much of the work of the internal auditors includes operational audits. But additionally, they may conduct various compliance audits. Unlike independent auditors to whom approving financial statements items are assigned each year, internal auditors are not obliged to annually repeat their audits (ArbabSoleimani & Nafari, 2009).

1.3 Auditor tenure

Proponents of the auditor change believe that, in case of mandatory change, auditors are placed in a position in which they can resist the pressures and demands of managers and apply more detached judgment. Long-term presence of the auditor beside the client creates tendencies to maintain client management; a situation that undermines his independence and impartiality (Rajabi, 2006). Also, they introduce auditors" desire to maintain the client through supporting him as another reason for passing restrictive laws since the auditor incurs initial costs in the early years of activity for the new client and is therefore inclined to maintain his client in order to compensate them.

In contrast, opponents of mandatory auditor change have other ideas. According to them, there are other factors that prompt the auditors to maintain their independence. For example, the attempts made by the auditors to protect their reputation and fear of potential legal claims against them are structures that prevent the inappropriate behaviors of the auditors. They believe that over time, auditors gain a better understanding of the clients activities and obtain more experience. In this way, their ability regarding the suitability or unsuitability of reporting and accounting methods increases. Thus, long-term relationship between the auditor and the client can improve the audit quality. In their view, auditor change will reduce the investor confidence in the reliability of financial statements, which in turns leads to a reduction in audit validity. On the other hand, auditing costs, whether for the auditor or the client, will increase.

Opponents of mandatory rotation also state that current methods and standards provide the expressed interests in the view of the proponents of mandatory rotation. Normal rotation of employees and client management, second partner reviews and peer review act like mandatory rotation. In this regard, Jackson et al. (2008) provide evidence in their research that as auditor rotation can lead to lower levels of significance, staff rotation can also have a similar effect.

1.4 Auditor size

From the perspective of auditors, audit firm size is one of the features that affect audit quality (Mehrani & Naeimi, 2003). DeAngelo argues that larger audit firms provide audit services with higher quality because they are keen to gain a better reputation in the labor market and since the number of their clients is high, they are not worried about losing them.

In the studies conducted on the relationship between audit quality and audit firm size, audit firms usually are divided into two groups in terms of size: First group: Big 8/6/4 audit firms

Second group: non-Big 8/6/4 audit firms

Since the research by DeAngelo up to the present time, numerous studies have been performed in the world to investigate the relationship between audit quality and auditor size, some of which confirm the results obtained by DeAngelo and some other reject his results.

1.5 Board of Directors

Board of Directors is among the internal mechanisms of corporate governance that has a great impact on corporate performance and respecting the rights of business stakeholders. From the viewpoint of Ingley & Van der Walt (2003), Board composition refers to a group of human resources that, by coming together in a team called the Board of Directors, use their own competencies and capabilities to create collective added value for the company and stakeholders. Board of Directors is considered as the most important factor in controlling and monitoring the corporate management and protecting the resources of shareholders (Fama & Jensen, 1983). The results of the studies carried out indicate that Board characteristics play an important role in improving the corporate performance and value. Also, these studies show that Board characteristics as one of the important factors in corporate governance have a significant impact on different parts of the company, including capital structure, agency costs, earnings quality and earnings management. In corporate governance, the aim is to enjoy an effective and efficient Board of Directors. To achieve this goal requires evaluating the Board characteristics. Board of Directors composition as one of the most important issues raised in the field of corporate governance is composed of various dimensions which are influenced by several factors such as corporate, legal, market, governance and cultural factors. In this way, it can affect both the Board performance in playing its roles and also corporate performance. Indeed, Board of Directors is one of the most important mechanisms of corporate governance that can make a significant impact on various corporate dimensions such as corporate performance and value. The incidence of financial corruption in recent years and lack of comprehensive understanding of the composition of excellent teams particularly the Board of Directors team in the internal business environment have made it essential more than any other time to have a better understanding of various aspects of the Board Composition as one of the major issues in the field of the Board of Directors and corporate governance. In this research, Board characteristics are examined in terms of both the Board size and the proportion of outside directors.

1.6 Board size

Board size is considered as an important element in Board characteristics. The optimum number of board members should be determined in such a way that ensures the existence of enough members to meet the duties of the Board of Directors and perform the different tasks of the Board. Whereas proposals have been provided for finding a relationship between Board size and firm performance, there is no consensus regarding the direction of this relationship. Proponents of the shareholders‟ view believe that larger Board of Directors leads to more balance, acceleration of more effective decision-making and increased coordination among the shareholders. Furthermore, larger Board of Directors raises the quality of information provided by the Director through an increase in the possibility of processing more information (Ahmadpour et al., 2012).

1.7 Proportion of outside directors

Outside members are those members of the Board who have no employment or consulting contract with the company. Outside members are not physically present in the company and only participate in decision-makings. The mentioned members are the company's shareholders and except for the relationship with the manager, have no other working relationships with the company. These directors act as the company's lawyer and trustee, who apply the rights and powers of the company in accordance with the statutes and the Articles of Association and in this way, their actions are considered a kind of participation. Therefore, they are regarded as the master of the company. Accordingly, the relation between outside members and the company is not an employment relationship. If any of them resigns from the Board of Directors or is dismissed, they cannot refer to the authorities' subject to the labor law for the mentioned member and therefore are not liable to any of the protections contained in it and their claim in not plausible.

1.8 Research literature review Foreign literature

DeAngelo (1981) defines audit quality as the possibility of discovering and reporting significant errors in financial statements. Theoretically, he proposed the relationship between audit quality and audit firm size and believed that large firms audit more companies and their total remuneration is divided among the client companies. They are not affiliated to the clients. Large audit firms have more independence, so they audit with higher quality.

Zhou & Elder (2002) conducted a study entitled "Investigating the relationship between audit firm size, industry expertise and earnings management in initial public offering companies". According to the results, they found that there is a relationship between the auditors of big five audit firms and industry specialist auditors with less earnings management in initial public offering companies. Dahya & McConnell (2007) stated that the Board of Directors should have at least three outside (non-executive) members so that the aforementioned members have the power to influence the decisions of the Board of Directors. In addition, it has been argued that the majority of outside (non-executive) directors must be independent of corporate management and should not have any relationship (except for receiving the salaries and benefits and the right of being a shareholder) that risks their independence. In fact, in the aforementioned report, it has been stipulated that at least two members of the three outside (non-executive) members of the Board of Directors must be independent.

Wen et al. (2002) investigated the relationship between the Board size and capital structure. The results showed that there is a significant positive relationship between the Board size and capital structure.

Dahya et al. (2002) studied the relationship between the Board composition and ownership structure with the agency costs of Australian companies. Based on the results, there is a significant positive relationship between management ownership and assets turnover ratio. However, no significant relationship was found between the number of major shareholders (ownership concentration), percentage of shares held by major shareholders and Board composition with the standards of agency costs.

In a comparative research, Farinha & Viana (2009) examined the relationship between Board characteristics and the type of independent auditors' report in the companies listed in Portugal Stock Exchange (except for investment companies and football clubs), using the information of 46 companies during the years 2002 to 2004. They demonstrated that out of different Board characteristics, only the ratio of non-executive board members, return on assets, proprietary ratio, natural logarithm of assets at the end of the year and operating profit in the current year have a significant positive relationship with the auditor's unqualified opinion. Moreover, an increase in the ratio of market value to the book value of shareholders‟ equity and the fact that audit of company is performed by big four international audit firms have a significant negative relationship with the type of independent auditors‟ unqualified report.

In a study entitled "Audit quality, corporate governance and earnings management", Lin & Hwang (2010) used three criteria of auditor size, auditor industry specialization and auditor tenure to measure the audit quality. The results suggested that these criteria have a negative relationship with the earnings management.

Inaam et al. (2012) carried out a study entitled "Audit quality and earnings management in Tunisia" and investigated the impact of audit quality (auditor size, auditor industry specialization and auditor tenure) on limiting the amount of real earnings management (real activities manipulation) and accrual-based earnings management. Their research results indicate that industry specialist auditors and the auditors of big four audit firms are associated with lower levels of accrual-based earnings management. Also, there is a significant positive relationship between the auditors of big four audit firms and the amount of real earnings management. Additionally, they found that increasing the auditor tenure has no relationship with greater real earnings management and accrual-based earnings management.

In a research entitled "Board of directors and ownership structure", Munisi et al. (2014) examined the relationship between these two issues in African companies. They came to the conclusion that ownership concentration, foreign ownership and management ownership have a negative relationship with the Board size. In addition, they found a positive relationship between State ownership and number of outside directors of a company but a negative relationship between ownership concentration and number of outside directors of a company. They also concluded that the Board characteristics and ownership structure as corporate governance mechanisms are highly effective in reducing the agency costs.

1.9 Domestic literature review

Ebrahimi and Seyyedi (2008), in their study in 71 companies listed in Tehran Stock Exchange, investigated the effect of audit firm type (Audit Organization and other firms) and the type of audit opinion in the audit report on discretionary accruals and observed that only audit firm type has a relationship with discretionary accruals.

Nikbakht et al. (2010) studied the impact of Board characteristics on corporate performance among 159 companies during the years 2004-2009. The results indicated that the Board of directors in Iran capital market does not perform its task to reduce agency problems and has no significant impact on corporate performance.

Moradi et al. (2012) conducted a research entitled "Application of fuzzy regression in explaining the relationship between the Board characteristics and performance of the companies listed in Tehran Stock Exchange". Based on the obtained results, the proportion of outside Board members, separation of duties, Board size, gender diversity and financial leverage have an inverse relationship with performance.

HassasYeganeh and Azinfar (2010) analyzed the relationship between audit firm size and audit quality in Iran. To this end, audit firms belonging to certified public accountant's association are considered among the small audit firms and Audit Organization is regarded as the large auditor due to its large number of employees and oldness. Statistical analyses in this research indicate a significant reverse relationship between audit quality and auditor size (audit firm).

Abbaszadeh and Manzarzadeh (2011) carried out a study among 187 stock exchange companies during the years 2005 to 2009, in which they examined the possibility of issuing the independent auditors‟ unqualified report using the Board characteristics of the companies listed in Tehran Stock Exchange. Their research findings suggest that there is a significant negative relationship between an increase in the "number of Board members" and the auditor's unqualified report. Also, a significant positive relationship exists between an increase in "proprietary ratio" and the auditor's unqualified report.

Karami et al. (2011) studied the relationship between duration of auditor tenure and amount of earnings management among 133 companies listed in Tehran Stock Exchange during the years 2000 to 2006. In this study, the relationship between auditor tenure and the absolute value of discretionary accruals as flexibility in earnings management was tested. The results show that with the increase in auditor tenure, management flexibility in the use of discretionary accruals also increases. Moreover, it was revealed that there is a significant negative relationship between tenure and level of discretionary accruals. This proves the claim that management uses the created flexibility in the negative direction. Therefore, given the findings of this research, it can be said that long-term relationship between the client and the auditor leads to increased management flexibility in the use of discretionary accruals; but this use is further towards earnings reduction (conservative).

Hajiha and Akhlaqi et al. (2013) performed a study with the title of "Investigating the impact of Board characteristics on corporate debt maturity structure" among 72 companies during the years 2002 to 2009. They concluded that there is a significant positive relationship between the Board size and debt maturity structure. Besides, a significant negative relationship was found between the percentage of outside Board members and debt maturity structure. The research results suggest the effectiveness of a strong Board in financing decisions.

Nonahal-nahr et al. (2013) carried out a research entitled "Assessing the effect of auditor quality on earnings management in the newly listed companies in Tehran Stock Exchange". In order to determine the auditor quality, two criteria of audit firm size and auditor tenure were used. Also, modified jones model was applied to measure earnings management as the dependent variable. Additionally, firm size, leverage and cash flow obtained from operations were used as control variables. In this study, 50 companies newly listed in Tehran Stock Exchange during the period 2003 to 2010 were examined. To test the hypotheses, multiple linear regression model was employed. The results obtained from the research regardless of the control variables indicate that larger audit firms and longer auditor tenure have a negative impact on earnings management in newly listed companies in Tehran Stock Exchange. But by adding control variables, the results show the non-effectiveness of larger audit firms in earnings management and also the negative impact of longer auditor tenure on earnings management in newly listed companies in Tehran Stock Exchange.

1.10 Research Hypotheses

Hypothesis 1: Board characteristics have a significant impact on selecting a particular type of auditor. Secondary hypothesis 1-1: Board size has a significant impact on the size of the audit organization.

Secondary hypothesis 1-2: The proportion of outside directors has a significant impact on the size of the audit organization.

Hypothesis 2: Board characteristics have a significant impact on auditor tenure.

Secondary hypothesis 2-1: Board size has a significant impact on auditor tenure.

Secondary hypothesis 2-2: The proportion of outside directors has a significant impact on auditor tenure.

2. Materials and methods

This study is classified as a type of applied research, based on the objectives and is conducted using the results of basic research in order to improve the behaviors, methods, tools, equipment, products, structures and models used by human societies. The purpose of applied research is to develop the applied knowledge in a particular area. Type of the research method regarding the nature of implementation is descriptive-correlational and since we do not make any changes in the values of independent and dependent variables, type of the research data is historical (post- event). After providing the research method and collecting the data required to test the hypotheses, we analyze this data using appropriate statistical methods so that finally we can find a proper answer for the research questions through confirming or rejecting the proposed hypotheses. Data analysis is a multi-step process during which the data that has been collected in different ways is summarized, classified and processed to pave the way for establishing relations between the data and conducting scientific analyses to test the hypotheses. In this process, data is refined both conceptually and empirically. Various statistical techniques play an important role in the generalization of findings. Analysis processes are different based on the type of research, the nature of hypotheses, type of theory-building and the tool used for data collection. In order to collect information on basic variables of the research, annual financial statements of the sample companies for a five-year period of 1388-1392 are used. This information has been extracted from the databases and website of Tehran Stock Exchange Organization and to calculate this data, SPSS, Eviews and Rahavardnovin software are applied.

2.1 Statistical population and sample

Statistical sample of the present study is built using the following criteria:

- Due to the need for information to cover the study period, the name of the companies should be listed among the companies accepted in the stock exchange before 2009.
- For the consistency of reporting date and elimination of seasonal effects, their fiscal period should be ending on 29 Esfand (20th of March).
- The company in question should not be a member of the intended industries in the research.
- The company in question should have continuous activity during the research period.
- Companies that have not incurred a loss throughout these years.
- The company should completely provide the required financial information to conduct this research during 2009/3/21 (1388/1/1) to 2013/3/20 (1392/12/29).
- The mentioned companies should not have any business combination during the years 2009 to 2013.

3. Discussion and results

3.1 Research model

In this research, regression analysis has been applied to test the relationship between variables and significance of the proposed model in order to explain the dependent variable. For this purpose, the research model has been designed as follows:

$$\begin{aligned} AudSIZE &= \beta0 + \beta1*BS + \beta2*OD + \beta3\ SIZE + \beta4\ LEV + \beta2*MTB + \varepsilon \\ TENURE &= \beta0 + \beta1*BS + \beta2*OD + \beta3\ SIZE + \beta4\ LEV + \beta2*MTB + \varepsilon \end{aligned} \quad (1)$$

3.2 Independent variables

Independent variable in this research includes the Board characteristics, which is analyzed from two dimensions of Board size and the proportion of outside directors. The Board size is measured by the natural logarithm of total number of directors (executive and non-executive Board members). The proportion of outside directors is also calculated through the number of outside directors divided by total number of directors (Munisi et al., 2014).

Board Size = Ln Total Number of Directors

$$\text{proportion of outside directors} = \frac{\text{Number of outside directors}}{\text{Total Number of Directors}} \quad (2)$$

3.3 Dependent variables Auditor size

We consider audit organizations of Iran as large firms and other audit organizations belonging to certified public accountants association as small firms. We assign score 1 to large firms and score 0 to other firms.

3.4 Auditor tenure

It refers to the year in which the auditor has been hired by the business unit.

3.5 Control variables

Since in a research, the effects of all the variables on each other cannot be studied simultaneously, the researcher controls the effect of some variables and neutralizes them. In the present study, to assess the effect of confounding variables on the Board characteristics of the sample companies, the variables of firm size, financial leverage, firm growth and free cash flow of the company are used as follows.

3.6 LOGSIZE

Firm size is defined as the natural logarithm of total assets at end of the period.

$$LOGSIZE_{it} = \log(A_{i,t}) \quad (3)$$

3.7 LEV

It is the ratio of debt to total assets at the beginning of the current year and earnings management is expected to reach a level higher than this value.

$$LEV_{i,t} = DEBT_{i,t} / A_{i,t} \quad (4)$$

3.8 MTB

It is the ratio of stock market value to stock book value

3.9 Research findings

Table 1. Descriptive statistics of the research variables

	Proportion of outside directors	Board size	Auditor tenure	Auditor size	Financial leverage	Firm size
Mean	0.561408	0.765830	2.127027	0.189189	0.568999	5.866655
Median	0.500000	0.778151	2.000000	0.000000	0.584750	5.832777
Maximum	0.833333	0.903090	5.000000	1.000000	0.904297	7.352191
Minimum	0.166667	0.301030	1.000000	0.000000	0.020845	4.732988
Standard deviation	0.148803	0.055096	1.190556	0.392189	0.163831	0.439250
Skewness	-0.400101	-4.378863	0.834480	1.587151	-0.551260	0.433096
Elongation	3.155669	38.28970	2.724815	3.519048	3.102846	3.786385

Table 2. Results of studying the research models

Dependent variable: auditor size Model: Multiple linear regression of panel data with fixed time effects			
Research model / Variable	Model No. 1-1	Model No. 1-2	Overall research model
Constant coefficient	-612.2742[*] (0.2037)[†]	-0.879103 (0.0066)	-0.792088 (0.1379)
Board size	-0.203052 (0.4324)		-0.106884 (0.8320)
Proportion of outside directors		0.247687 (0.0893)	0.239097 (0.1116)
Firm size	0.103390 (0.0057)	0.134639 (0.0089)	0.134514 (0.0090)
Financial leverage	-0.082846 (0.3516)	0.023170 (0.8523)	0.023024 (0.8530)
Coefficient of determination	0.738681	0.663590	0.666360
Durbin-Watson statistic	1.887560	1.853054	1.845853
F-statistic significance level	٠.٠٠٠	٠.٠٠٠	٠.٠٠٠
Dependent variable: auditor tenure Model: Multiple linear regression of panel data with fixed time effects			
Research model / Variable	Model No. 2-1	Model No. 2-2	Overall research model
Constant coefficient	2.169476[‡] (0.1169)[§]	1.402804 (0.3976)	6.744656 (0.0178)
Board size	-1.864495 (0.1269)		-6.297597 (0.0228)
Proportion of outside directors		-0.362353 (0.6266)	-0.809719 (0.2892)
Firm size	0.098486 (0.5739)	-0.035241 (0.8931)	-0.064318 (0.8041)
Financial leverage	0.066467 (0.8755)	0.499870 (0.4417)	0.472601 (0.4616)
Coefficient of determination	0.236867	0.214986	0.240969
Durbin-Watson statistic	1.958133	1.905075	1.918442
F-statistic significance level	٠.٠٠٠	٠.٠٠٠	٠.٠٠٠

[*]Variable coefficient associated with the dependent variable
[†]T-statistic significance level
[‡]Variable coefficient associated with the dependent variable [§]T-statistic significance level

4. Conclusion

Proponents of auditor change believe that in case of mandatory change, auditors are placed in a position in which they can resist the pressures and demands of managers and apply more detached judgment. Long-term presence of the auditor beside the client creates tendencies to maintain client management; a situation that undermines his independence and impartiality (Rajabi, 2006). Also, they introduce auditors‟ desire to maintain the client through supporting him as another reason for passing restrictive laws since the auditor incurs initial costs in the early years of activity for the new client and is therefore inclined to maintain his client in order to compensate them.The results of studying the research variables among 74 companies in 6 industries using multiple linear regression and panel data demonstrated that the Board size has a significant inverse relationship with auditor tenure. But this variable has no significant relationship with the auditor size. Therefore, it is recommended that to improve audit procedures, acceptable standards should be considered for auditor selection so that auditor tenure would be less affected by the Board size and personal judgments. Additionally, the proportion of outside directors has no significant relationship with auditor tenure and auditor size. According to the obtained results, firm size has a significant positive relationship with auditor size. So, the larger the company, the larger the firms employed for auditor selection will be. Thus, it is suggested that to enhance audit quality, larger audit firms should be used in larger organizations.

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