The Impact of Audit Quality and Real Profit Management on Risk and Return with the Role of Internal Control Mechanisms

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Abstract

In investment decisions, risk and return are two major factors. To enter the market, investors need to ensure the safety of their capital and must identify the factors that affect risk and return (2). There are various factors that can affect return, risk and their changes. On the other hand, in order to enter the capital market and contribute to its growth with their continued presence, investors need to ensure that their capital is immune to losses and to predict investment returns based on reliable and trustworthy information. These goals will only be achieved in circumstances where the factors affecting return, risk and their changes, each of these factors in some way causes an increase or decrease in return and risk; have been identified and presented to shareholders for analysis. This research deals with audit quality, real profit management and internal control as factors affecting risk and return.

Introduction

Problem Statement:

Auditing can be one way to reduce and prevent earnings management, because it is believed that companies that provide audited financial statements and quality audit firms have more experience, resources and incentives to detect errors and fraud. Audit quality can help reduce earnings management and increase the accuracy of financial information. Internal control also helps ensure the quality of financial reporting. Weaknesses in these systems can lead to financial errors and earnings management errors. Internal control (IC) is an important mechanism through which the quality of financial reporting can be ensured by controlling the management of results. The IC process is designed to provide reasonable assurance about the achievement of organizational objectives. It means the efficiency and effectiveness of operations, the reliability of financial information, and compliance with laws and regulations (3). The quality of internal audit has been shown to be positively and significantly related to disclosure of risk management and internal control. Evidence suggests that the components of the internal audit quality index, which consists of several vital factors, support the role of internal audit in providing assurance of the effectiveness of risk management and internal control.

Given the combination of quality assurance techniques in internal audit activities, it helps internal audit prevent material deficiencies. Earnings management is defined as an activity in which managers use judgment to alter financial statements, mislead stakeholders, or influence the outcome of contracts. Managers of a company may have the incentive to manage earnings in order to maximize their benefits. On the other hand, disclosure and publication of the internal control report is an important means of communication between the company and investors, and investors and owners of the company can obtain and use important accounting and financial information of the company in this way. It is good to reduce the conflict of interest between managers and owners in their decisions. One of the motivations for earnings management is to meet or fail analysts' earnings forecasts. Usually, in the context of earnings management, it is determined that companies are involved in the abuse of powers permitted by accounting laws. The company and its stakeholders are trying to achieve their personal interests. Earnings management can also have an effective and positive nature. When a businessman seeks to increase the value of the company and does not only think about his own interests. In this case, by taking advantage of the options available to him, he presents the future cash flows of the company in a way that indicates good news in the future for shareholders and other stakeholders. Earnings management occurs when managers use their personal judgment to use financial reports and as a result, they bring about changes in the financial structure (4). Importance and necessity of research:

Earnings can be managed in several ways and affect cash flows and reported earnings. This research addresses the impact of audit quality and earnings management on risk and efficiency with the role of internal control.

Research Objectives:

The main objective is to study the impact of audit quality and real profit management on risk and return in relation to internal control. Sub-objectives include studying the effects of audit quality and real profit management on risk and return separately.

Research Questions:

Does audit quality and real profit management affect risk and return? The sub-questions address the impact of these two factors on risk and return in relation to internal control.

Research Hypotheses:

Audit quality and real profit management have an impact on risk and return. The hypotheses examine the effects of these factors separately and in relation to internal control.

This chapter deals with trends and models of audit quality, real profit management, risk, efficiency and internal control. The two main parts include the theoretical foundations and studies conducted in this field.

Chapter Two

Theoretical Foundations of the Research:

In light of this topic and in line with the current research objective, desk studies were conducted and various books and articles, trends and models in the field of audit quality, real profit management, risk, efficiency and internal control were reviewed in this chapter. Control is examined in two parts.

Audit Quality:

Independent Audit Position: Independent auditors are hired to ensure the accuracy of financial information and prevent conflicts of interest (15).

Audit Quality Concept: Audit quality is related to the ability of auditors to detect and report distortions and errors (20).

Real Earnings Management:

Earnings management refers to the actions taken by managers to achieve desired profits and can include manipulation of financial statements (33).

Risk and Return:

Risk Definitions: Risk means the possibility of deviation from expected results and can be divided into two types of systematic and unsystematic risks (24).

Share Return: Includes cash profit and profit from increase in share price (31).

Internal Control:

Internal Control System: Includes the processes used to ensure the efficiency of operations and the accuracy of financial information (12).

Internal Control Elements: Includes the control environment, risk assessment, control activities, information and communication, and monitoring (9).

Research Background:

Khoshkar et al. (1401) investigated real and partial profit management methods, board composition, and profit stability. The information needed for this research is taken from the financial statements of 142 companies in the period 2019-2019. In terms of the type of objective, it is part of applied research, and the research methodology is relational in terms of its nature and approach, and the panel analysis method was used to analyze and analyze the research hypothesis. The results of the hypothesis testing showed that there is a significant and negative relationship between earnings management and earnings stability. There is also a positive and significant relationship between board independence and earnings stability. However, the results showed that the relationship between real earnings management, board size and earnings stability is not statistically significant.

Hosseini et al. (1401) in a study titled Analysis of Earnings Management and its Sustainability in Leveraged and Non-Leveraged Companies Using Markov Chain, it is possible to manage earnings at any level of leverage. On the other hand, there is no regular forecast of earnings management in leveraged and non-leveraged companies. In addition to this profit, the current management situation in the current period to predict the stability of earnings management in leveraged and non-leveraged companies will decrease over time. In the final results, the results showed that there is no difference between the sustainability of earnings management in leveraged and non-leveraged companies.

Bonabi Jad and Faiz (1400) investigated the effect of information risk on the relationship between abnormal delay of audit report and abnormal stock returns. For this purpose, data from 123 companies in Tehran Stock Exchange were selected and analyzed using multiple regression models. The results showed that as the abnormal delay in the audit report increases, the abnormal return of stocks and information risk increase, with a positive effect on the abnormal return of stocks, the effect of the abnormal delay of the auditor's report increases. Ma and colleagues (2022) study the effect of investor preferences on audit quality. The research results indicate that when audit quality decreases, investors' willingness to invest increases. The results of further analysis also show that when investors have high feelings about the company's growth in the market, auditors are less likely to issue modified audit opinions.

Khong et al. (2022) in a study titled Board composition for earnings management and earnings stability in emerging markets by examining data from 228 companies in 2014 and 2017 in Vietnam showed that accumulated earnings management has a negative relationship with earnings stability, but real earnings management has a mixed relationship. Relationship with earnings sustainability In addition, the data indicate that board characteristics play an important role in earnings sustainability.

Agustina et al. (2021) explained that the positive role of corporate governance in earnings stability is monitored by the audit committee.

Chapter Three

Research Method:

This chapter is devoted to the research methodology and includes identifying and selecting appropriate methods for data collection. First, the research method, hypotheses, region, population, statistical sample, and data collection method are defined.

Research Method:

This research is applied and descriptive and has correlation and regression analysis. The measurement scale is relative and this research cannot deal with the independent variable.

Population and statistical sample:

The statistical population includes companies admitted to the Tehran Stock Exchange in the period from 2014 to 2015. The statistical sample was selected using the purposive sample method and includes 122 companies. The statistical sample is selected using the purposive sample method and by applying the following conditions. This means that companies that meet the following conditions are selected as statistical samples:

- The companies' fiscal year must end at the end of March.

- Companies operating in the sectors (investment, banking, insurance, brokerage, service and contracting companies, and agriculture) will be canceled.

- Their shares are regularly traded in the stock market.

- They do not have a trading break of more than three months.

- They have not been removed from the list of accepted companies and their fiscal year has not been changed during the research period.

- All data necessary to calculate the research variables must be available.

Table (1) How to select companies to be studied in the research

No.	a description	
642	Members of the statistical population at the end of 2016	Total Amount
45	The company's financial information and data are incomplete or unavailable.	Limit 1
129	The company's financial year does not end at the end of March of each year.	Limit 2
132	There were financial brokerage companies (investment, holding, leasing, banks and insurance).	Limit 3
79	Number of companies that were delisted from the stock market during the research period (2001-2014).	Limit 4
135	The company had stopped trading for more than six months.	Limit 5
520	Total number of companies removed from the statistical population	Total Restrictions
122	Number of selected companies	

Operational definition of research variables:

Dependent variables:

Risk: Change in total return per share.

Efficiency: Calculation based on a specific formula. Return: In this research, the following formula was used to calculate stock return based on the studies of Seyed Motahari and Pourian (2013):

$$R_i = \frac{P_1(1+\alpha+\beta)+D-(\alpha*1000)-P_0}{P_0+(\alpha*1000)}$$

Independent variables:

Audit quality: According to the type of audit firm. If the company under study is audited by an audit organization or a useful auditing firm, the number 1 is assigned, otherwise the number 0 is assigned.

Real earnings management: The residuals of the model are calculated. In this research, according to the research of Cohen and Zarevin (2010), the following model was used to estimate the real earnings management criterion. The remainder of this model is considered as a measure of real earnings management:

$$\frac{CFO_{it}}{TA_{it-1}} = \alpha_0 \frac{1}{TA_{it-1}} + \alpha_2 \frac{Sales_{it}}{TA_{it-1}} + \alpha_3 \frac{\Delta Sales_{it}}{TA_{it-1}} + \varepsilon_{it}$$

Moderator variable:

Internal control mechanisms: Based on weaknesses in internal control. : In this research, in order to measure internal control mechanisms, the report of significant weaknesses in internal controls (ICW) was used. This means that if the company has significant internal control weaknesses in the audit report, the number will be 1, otherwise it will be zero. Significant internal control weaknesses are obtained from the independent auditors' report.

The control variables include company size, return on assets and growth opportunities. Company size (Size): is the logarithm of the company's total assets

Return on assets (ROA): Return on assets is the ratio of net profit to total assets

Growth opportunity (GRO): Considering that in the research of Itrides (2008) the growth in earnings per share is used to measure the growth of the company. In this research, the growth in earnings per share is used as an indicator to measure growth opportunities:

$$GRO_{i.t} = \frac{EPS_{i.t} - EPS_{i.t-1}}{EPS_{i.t-1}}$$

Selecting an Estimation Model:

Study the classical assumptions of regression:

Including the normality of the dependent variable, equality of variance in the residuals, checking for collinearity, and testing for autocorrelation between the residuals.

How to draw conclusions about the hypotheses

The overall significance test of the model and coefficients is performed using F and t statistics.

This chapter generally describes the research methods and data analysis and provides a framework for testing the hypotheses.

Chapter Four

Results:

This chapter presents the results of the analyses conducted based on the research plan. The data are analyzed using Eviews10 software and the research hypotheses are tested.

Descriptive Statistics:

Descriptive statistics include calculating the population parameters and general characteristics of the variables. The results of these calculations are presented , which includes the mean, median, standard deviation, and other indicators for the variables of risk, efficiency, audit quality, real earnings management, internal control, company size, return on assets, and growth opportunity.

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