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The Influential Role of Independent Auditors in Mitigating Agency Conflicts between Managers and Shareholders

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Abstract

Objective: Independent auditors seek to enhance audit quality to maintain professional credibility, avoid litigation, and bolster the credibility of financial statements. Higher audit quality leads to a greater degree of conservatism in financial reporting. The current study aims to investigate the role of independent auditors in reducing agency conflicts between managers and shareholders.

Methodology: The statistical population comprises firms listed on the Tehran Stock Exchange (TSE) during the period 2015–2024. After systematic screening, 131 firms were selected as the final sample. The research hypothesis was tested using multiple linear regression analysis.

Findings: The results of the regression analysis indicate that auditor conservatism can mitigate agency conflicts between managers and shareholders. Agency conflicts between shareholders and managers arise from agency problems and managers' misuse of financial reports, which compromises the quality of this information. Auditor conservatism has the potential to mitigate this issue.

Conclusion: As expected, leveraging greater information transparency and higher auditor conservatism can reduce agency conflicts between managers and shareholders.

Keywords: Auditor Conservatism, Agency Conflicts between Managers and Shareholders, Financial Information Quality.

1. Introduction

The primary objective of financial reporting is to provide useful economic information to external users. Investors and participants in the capital market base their decisions on the information disclosed by companies through their financial statements. The full benefit of this information is realized only when it is timely, complete, accurate, and understandable (Yin et al., 2022). Conversely, if this information is distributed unfairly, unequally, or asymmetrically, it can lead to adverse outcomes, negatively affecting both the capital market and investors. Any lack of transparency can disrupt shareholders' and analysts' decision-making, resulting in divergence among investors (Silva & Serqueira, 2021).

This divergence, stemming from poor information quality and lack of transparency, can lead to variations in investors' forecasts of expected future returns, exacerbating agency conflicts and shareholder dissatisfaction (Peng et al., 2016). Managers may, consciously or unconsciously, intensify information asymmetry through actions such as earnings management or financial statement manipulation. Unconscious managerial actions, by increasing agency conflicts between managers and shareholders, may heighten investor dissatisfaction (Liu et al., 2023). Agency conflicts occur when managers pursue personal interests that compromise the quality of corporate information provided to shareholders and other stakeholders.

Under these circumstances, financial statements attract the attention of numerous stakeholders, highlighting the importance of the auditing profession and auditor reports (Vafadar & Dadbeh, 2016). Independent auditors aim to enhance audit quality to maintain professional credibility, avoid litigation, and validate financial statements. Beyond issuing an opinion on the fairness of financial statements and their notes, auditors evaluate operations and internal controls independently. Higher audit quality typically leads to more conservative financial reporting (Ghorbani et al., 2022).

The level of conservatism applied by auditors depends on the client's economic performance and the type of audit firm. Research by Basu et al. (2002) and Ball et al. (2000) suggests that clients using large auditing firms tend to exhibit greater conservatism compared to those using smaller firms (Ani & Cheng, 2021). Auditors may also adopt higher conservatism to reduce litigation risk and protect their reputation. Conservatism is defined as the accounting tendency to require greater verifiability for recognizing gains or good news than for recognizing losses or bad news (El-Shafi, 2022).

In the Iranian Conceptual Framework for Financial Reporting, conservatism is referred to as "Prudence," a component of the qualitative characteristic of reliability. Prudence entails exercising caution when making accounting estimates under uncertainty, ensuring that revenues or assets are not overstated and expenses or liabilities are not understated (Foroughi et al., 2020). Essentially, conservatism is a response to uncertainty; accountants apply it whenever ambiguity exists. While conservatism allows companies to anticipate positive outcomes and increase profits from acquisitions, prior research shows that conditional conservatism improves the firm's information environment and transparency. Professional standards have institutionalized conservatism through accounting rules and regulations, aiming to protect investors' and creditors' interests and enhance the qualitative characteristics of financial reports (Zalghi & Bayat, 2015).

High-quality financial reporting can mitigate agency conflicts between managers and shareholders. Based on this discussion, and given that auditor conservatism contributes to improved information quality, the central question of this study arises: Can auditor conservatism reduce agency conflicts between managers and shareholders? The significance of this research is reinforced by the lack of conclusive evidence on this relationship, highlighting a clear research gap.

The remainder of this study is structured as follows: first, the theoretical foundations, hypotheses,

and empirical background are presented; next, the methodology and operational definitions of research variables are discussed; and finally, the findings and conclusions are discussed.

2. Theoretical Foundations, Empirical Background, and Hypothesis Development

As repeatedly emphasized in the finance literature, investors and capital market participants base their decisions on the information published by companies through financial statements. The full benefit of this information is realized only when it is timely, complete, accurate, and understandable (Yin et al., 2022). Conversely, if information is distributed unfairly, unequally, or asymmetrically, it can lead to divergent outcomes, negatively impacting both the capital market and investors. Any lack of transparency can disrupt the decision-making of shareholders and analysts and create disagreements among investors (Silva & Serqueira, 2021).

Managers may, consciously or unconsciously, exacerbate information asymmetry. Khalifeh Soltani and Barzegar (2016) highlighted that the separation of ownership from management in expanding capital markets leads to agency conflicts, where managers may act in their own interest, breaching contractual obligations. Such conflicts are positively associated with earnings management. Abrishami et al. (2017) asserted that the availability of transparent and symmetric information is crucial for capital market efficiency, economic growth, and development. Information asymmetry allows the informed party to exploit the less-informed party, leading to suboptimal decisions and increased agency risk (Liu et al., 2023).

Agency conflict arises from delegated authority to managers, and earnings management occurs when managers manipulate financial reporting or transactions to alter reported financial figures (Abdi Golzar et al., 2023). Such managerial actions compromise the quality of financial information, the cornerstone of investor decision-making, ultimately leading to shareholder dissatisfaction. Khalifeh Soltani and Khajavi (2016) argued that agency conflict, as a form of information asymmetry, affects financing decisions, leading firms to rely on debt financing under the Pecking Order Theory. Kamyabi and Bourboury (2016) and Abdi-Golzar et al. (2021) further show that managerial agency risk increases stock price crash risk and reduces investment efficiency, emphasizing the importance of corporate governance mechanisms.

Auditing acts as a regulatory mechanism to enhance financial reporting quality and reduce agency costs between managers and shareholders. Independent auditors aim to improve audit quality, preserve professional credibility, avoid litigation, and provide assurance on financial statements. High audit quality generally leads to more conservative financial reporting (Ghorbani et al., 2022; Daneshvar et al., 2018). Conservatism is defined as the accounting practice of requiring greater verifiability for recognizing gains than for recognizing losses, restricting opportunistic managerial behavior, and mitigating information asymmetry (El-Shafi, 2022; Foroughi et al., 2020). Basu et al. (2002) and Ball et al. (2000) show that clients using large audit firms exhibit higher conservatism. Liao and Krishnan (2020) note that increased auditor legal liability compels more conservative auditing efforts, while Ghorbani et al. (2022) highlight that conservative auditing can limit income overstatement and opportunistic reporting.

Empirical evidence indicates mixed effects of auditor conservatism. Mirzamohammadi (2020) found no significant effect on accrual-based earnings management, while Daneshvar and Baradaran Hassan-Zadeh (2019) found no significant impact on firm value. Nevertheless, auditor conservatism improves information quality and transparency, thereby mitigating moral hazard risks and agency conflicts between managers and shareholders.

Based on the preceding discussion, the central conjecture of this research is that auditor conservatism can reduce agency conflicts between managers and shareholders by enhancing the quality of financial

information. Accordingly, the research hypothesis is formulated as follows:

Research Hypothesis

Auditor conservatism influences the reduction of moral hazard risks between managers and shareholders.

3. Research Methodology

The present study is applied in nature and, methodologically, follows a causal-ex post facto design, as it investigates events after their occurrence. The statistical population comprises companies listed on the Tehran Stock Exchange (TSE), covering the fiscal years from 2015 to 2024.

To ensure comparability and data consistency, the final sample of 131 companies was selected using systematic screening based on the following criteria: companies must have a fiscal year-end of Esfand 29th (March 20/21) and must not have changed their fiscal year-end during the 10-year observation period. Required financial information must be disclosed and accessible, and companies belonging to the banking, insurance, or investment sectors were excluded.

Data analysis was conducted using a pooled panel data approach in EViews 12, employing Heteroskedasticity Robust Standard Errors (Robust Standard Errors) for hypothesis testing. By combining cross-sectional and time-series dimensions, the pooled panel data method provides more comprehensive and reliable information, making regression with robust standard errors the optimal approach for examining the relationships in this study.

3.1. Operational Definitions of Research Variables

3.1.1. Dependent Variable of the Research: Ethical Hazards between Managers and Shareholders (Moral Hazard)

Following Fakhari and Peitehnoei (2017), the bid-ask spread of stock prices is used as a proxy for measuring information asymmetry. Higher levels of information asymmetry increase the risk for liquidity providers (market makers), meaning that greater information asymmetry is associated with a wider bid-ask spread (Bhattacharya et al., 2009).

$$SPREADit = \frac{1}{Dit}\sum_{1}^{Dit}\left(\frac{ASKt - BID}{(ASKt + BIDt)/2}\right)$$

In this regard:

SPREAD: The range of the bid price for buying and selling shares of Firm I in the year t

ASK: What is the latest bid price for the annual sale of firm I shares

BID: Latest bid for the annual purchase of shares of Firm I

DIT: The number of days in the year t in which the last bid price and the last bid price are available annually for the shares of the firm.

3.1.2. Independent Research Variable: Auditor Conservatism (AC)

To measure auditor conservatism, the study employs the model developed by Chung et al. (2003) as well as the research framework of Ghorbani, Pourtaher Edam, and Rahnama Roudposhti (2022). This sub-model represents a novel approach for measuring auditor conservatism in the local context, as it has not been previously applied in the country. The model assesses auditor conservatism by capturing the concept of "sub-conservatism," utilizing Basso's (1997) model and its subsequent extensions.

$$\begin{aligned} E/P = \beta_0 + \beta_1 D + \beta_2 R + \beta_3 R.RANK + \beta_4 R.D \\ + \beta_5 R.D.RANK + \beta_6 R.DPB \\ + \beta_7 R.DRHO + \beta_8 R.DSD \\ + \beta_9 R.DSIZE + \beta_{10} R.D.DBP \\ + \beta_{11} R.D.DHRO + \beta_{12} R.D.DSD \\ + \beta_{13} R.D.DSIZE + \varepsilon_{it} \end{aligned}$$

In the above pattern:

E/P: Earnings-per-share ratio.

D: It is a virtual variable that is equal to one or zero if the firm has a negative return.

R: Firm Stock Returns in Year T

RANK: A dummy variable is defined for audit firm quality. If the audit firm of the company is classified as Grade A, the variable takes the value of 1; otherwise, it takes the value of 0. According to Article 31 of the Statute of the Association of Certified Public Accountants of Iran, audit firms are annually evaluated based on the quality control of the institution and the audits performed. Firms are assigned scores that fall into four categories: Grade A (801–1000 points), Grade B (651–800 points), Grade C (501–650 points), and Grade D (0–500 points).

DPB: Virtual variable: if the ratio of market capitalization to book value of the firm is higher than the average value of the sample firms, the number 1 is given, and if not, the number zero is given.

DHRO: Virtual variable: if the autocorrelation coefficient of the firm's quarterly earnings (four periods) is higher than the average of the self-correlation coefficient of the profits of the sample companies, the number is one, and if not, the number zero is given.

DSD: Virtual variable. If the standard deviation of the firm's quarterly earnings (four periods) is higher than the average standard deviation of the profits of the sample companies, the number is 1, and if not, the number zero is assigned.

DSIZE: The virtual variable, if the size of the firm at the end of the year is larger than the average size of the sample companies, will be 1; and will be zero.

It should be noted that the coefficient in the above model indicates the auditor's conservatism.β_5

Control variables of the research

Firm Size (SIZE): The natural logarithm of total assets

Return on Assets (ROA): Net profit divided by total assets

Sales Growth: Sales minus the previous year's sales divided by the previous year's sales

Leverage (LEV): Total liabilities divided by total assets

Firm Age: Natural logarithm of the date of establishment of the firm

Firm Growth (MB): It is the ratio of market value to book value of shareholders and is a measure of the firm's growth.

3.2. Research Regression Model

Following previous empirical research, such as Ghorbani et al. (2022), the following mathematical model has been presented to test the research hypotheses:

$$\begin{aligned}\text{Moral hazard}_{it} = {} & \beta_0 + \beta_1 AC_{it} + \beta_2 SIZE_{it} \\ & + \beta_3 ROA_{it} + \beta_4 growth_{it} \\ & + \beta_5 LEV_{it} + \beta_6 Age_{it} \\ & + \beta_7 MB_{it} + \varepsilon_{it}\end{aligned}$$

4. Research Findings

Table 2 shows the descriptive statistics of the research variables. Descriptive statistics show the dispersion of data, and the mean and standard deviation are two important factors in descriptive statistics. In the above table, it can be seen that the mean of financial leverage is 0.55, which shows that most of the data is around this point. The highest standard deviation is related to the growth of the firm (3.58), and the lowest is related to the moral hazard (0.011). The highest and lowest are the highest and lowest in each variable between the research samples shown.

According to the results obtained in Table 3, it can be seen that the significance level of the variables in the durability test is less than 5% and indicating the reliability of the variables.

Table 2: Descriptive Statistics of Research Variables

Variable	Mean	Max	Min	ST.D
Ac	-0.20	0.67	-0.95	0.32
Moral Hazard	0.032	0.054	0.010	0.011
Growth	0.347	1.653	-0.360	0.42
LEV	0.559	0.975	0.104	0.203
ROA	0.143	0.594	-0.289	0.155
SIZE	14.72	19.77	11.30	1.534
MB	4.22	14.29	1.01	3.58

Table 3: Durability Test of Research Variables

Variable	Test Statistics	Sig	Results
Ac	-13.2719	0.0000	Stationary
Moral Hazard	-24.8933	0.0000	Stationary
Growth	-20.8019	0.0000	Stationary
LEV	-16.9376	0.0000	Stationary
ROA	-15.6341	0.0000	Stationary
SIZE	-779.528	0.0000	Stationary
MB	-5.89369	0.0000	Stationary

Table (4).Tests of Classical Regression Assumptions

Test	Test Statistics	Significance
F-Limmer Test	0.39	0.95
White Test	90.015	0.42
Brush Godfrey Test	1077.6	0.0000

According to the results presented in Table 4, the significance level of the White test in the research model exceeds 5%, indicating the absence of heteroskedasticity in the model's residuals. Additionally, the significance level of the serial autocorrelation test is below 5%, suggesting the presence of autocorrelation in the model, which could affect the final estimation results. This issue was addressed by applying the Generalized Least Squares (GLS) method and using robust standard error techniques in Eviews 12 software (Aflatooni, 2018). Furthermore, the significance level of the Chow test for the research hypothesis testing model is greater than 5%, supporting the use of the pooled (integrated) data model, and thus rendering the Hausman test unnecessary.

The results presented in Table 5 indicate that auditor conservatism has a negative coefficient of -0.030 and a significance level below 5% (0.002), suggesting a significant inverse relationship with ethical risks between managers and shareholders. Therefore, the research hypothesis is supported at the 5% significance level. Additionally, control variables, including return on assets, firm growth, and firm size, also have significant effects on the dependent variable at the 5% error level.

The model's coefficient of determination (R^2) is 0.30, indicating that the independent and control variables explain 30% of the variation in the dependent variable, which is notable in the context of panel data analysis. The Durbin-Watson statistic is 2.28, falling within the 1.50–2.50 range, which indicates no serious autocorrelation in the residuals. The variance inflation factor (VIF) is below 5, confirming that multicollinearity is not a concern among the research variables. Finally, the F-test is significant at the 5% level, indicating that the overall model has a good fit.

Table (5), Test the Research Hypothesis

Variables	Coefficients	Standard Error	T Statistic	Sig	VIF
Ac	-0.030	0.0100	-3.06	0.002	1.15
Growth	0.009	0.009	0.98	0.32	1.16
LEV	-0.002	0.003	-0.78	0.43	1.20
ROA	0.41	0.040	10.04	0.0000	1.63
SIZE	0.067	0.019	3.43	0.0006	1.02
MB	-0.0009	0.0001	-5.78	0.0000	1.22
AR(1)	0.52	0.027	19.2	0.0000	-
C	0.60	0.054	11.13	0.0000	-
Determination Coefficient		0.30			
Watson Durbin		2.28			
Statistic F		3.615711			
Sig		0.0000			

5. Discussion and Conclusion

The primary objective of this study was to examine the effect of auditor conservatism in mitigating moral hazard risks between managers and shareholders. Due to the separation of ownership and management, accrual items reported in the income statement may be subject to manipulation, leading investors to question their reliability and, consequently, the quality of earnings. In this context, independent auditors assure investors regarding the accuracy and reliability of financial statements by systematically examining company records.

High-quality auditing significantly reduces information asymmetry between internal and external stakeholders, particularly when addressing conflicts of interest and potential fraudulent reporting. Expert auditors can also influence management to disclose information in financial statements that reflects best practices and aligns with higher-performing firms. In contemporary professional settings, financial information is generally considered reliable when an independent entity, such as an auditing firm, oversees the reporting process. Auditing is defined as a systematic, organized process of objectively collecting and evaluating evidence concerning economic activities to determine the degree of correspondence with established criteria and to communicate the findings to interested parties.

Auditors often adopt a higher level of conservatism to minimize exposure to legal liability and protect their professional reputation. Increased legal responsibility encourages auditors to exercise more rigorous and cautious judgment in their evaluations.

The results of this study indicate that higher auditor conservatism reduces management manipulation in financial statements by enhancing information quality, thereby decreasing moral hazards between managers and shareholders. This finding directly supports the role of auditors in assuring financial reporting. The results are consistent with prior studies by Ghorbani et al. (2022), El-Shafi (2022), and Liu & Krishnan (2020), all of whom reported that auditor conservatism improves information quality and the reliability of reported earnings.

It is recommended that auditors pay particular attention to conservatism in their work to maintain the quality of financial statements and mitigate moral hazard risks between managers and shareholders. Future research could explore the impact of auditor conservatism on shareholder trust and loyalty and compare those findings with the results of this study.

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