

# An Empirical Association between Audit Quality and Risk Taking toward Value Creation in Iran

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## Abstract

In the financial literature, risk-taking and investment-related decisions are among the most important decisions for companies that make optimal decisions in these two areas, optimally allocating resources and directing financial resources to economic investments and profitable projects for value creation. The purpose of the research is to investigate the relationship between audit quality and risk taking on value creation in firms listed in Tehran Stock Exchange (TSE). The research used five components of auditor's specialist, tenure, audit size, ownership concentration, and board of director's independence to evaluate audit quality. The statistical population of the study includes the companies listed in TSE. Using a screening method, 610 firm-year data were selected for a 5-year period (2013-2017). This research is based on panel data and multivariate regression method. The research findings show that among these five components as well as the risk factor, only the variables of auditor tenure and ownership concentration have a significant effect on corporate value creation. The originality of the results of the research contributes to the auditing and capital market in TSE.

**Keywords:** Risk-taking, audit quality, value creation.

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## Introduction

Today investors in capital markets place a heavy emphasis on reliable financial information. The high quality of financial reporting has helped investors to better assess risk and value for the company, which leads to improved investment decisions. Recent financial scandals in US and European capital markets (such as Enron, WorldCom, and Parmalat) have confirmed the importance of financial reporting quality, especially audit quality. Since market information risk is not volatile, it can be considered as a factor affecting investors' expected return on investment asset pricing models, which is therefore considered to be a capital cost component of the firm (Brant et al., 2015).

Risk can be the result of a lack of complete information so that there is a risk if there is no complete certainty of success. Transparency is an essential issue in the economy as it improves resource allocation and directly deals with efficiency and economic growth. Lack of transparent information in market will increase transaction costs and market failure. For this reason, lack of transparency has been identified as one of the factors influencing many of the recent failures of the capital market (Zalata and Clare, 2017). Transparency reduces market uncertainty about legislators' future decisions. As a result, the predictability of monetary policy and the efficiency of financial markets will increase. The lack of transparent information in the financial markets is a decisive factor in the influx of large volumes of foreign investment and their rapid exit in the event of a crisis. The lack of transparency in decision-making as well as the lack of regular presentation of relevant information to meet reasonable expectations compels private firms to increase the value of assets and investments, thus imposing a higher risk on their investments (Mangesti and Solimun, 2019). With the increase in resources available to the management, the number of stakeholders in the company increases, that is the consequence of such a conflict of interest situation. As a result of conflicts of interest, stakeholders must incur agency costs to reconcile the interests of others or minimize the effects of conflicts of interest. At the heart of this conflict of interest, management tries to reduce agency costs by providing financial information to the company. However, due to the management authority and the need to monitor the management practice, the expert judgment of the independent auditor is raised (Gul et al., 2015). Therefore, if higher quality auditing is performed, it reduces the conflict of interest and increases the transparency of the decision making environment, thereby reducing the investment risk. However, if the quality of auditing is reduced, it decreases the quality of financial reporting as well as increases the agency cost due to the conflict of interest between the management and the investor. In other words, it is possible for management to gain control of the company by using weak control and use the interests of its shareholders to the detriment of the value of the company. As a result, it increases the investment risk (Bryce et al., 2015).

In general, risk and return on investment are the most important concepts of investment. The risk in this study refers to the range of uncertainty associated with the expected results and the associated cash flow due to new investments. Creating value and increasing shareholder wealth in the long run is also one of the major goals of companies and shareholders of the capital market, this can only be done through optimal performance. Understanding the impact of audit quality and risk on value creation in

underdeveloped countries with a traditional market structure and capital market will lead to more inappropriate returns.

In the light of the above, this study examines whether audit quality, board characteristics, and risk taking can influence the value creation of a business unit.

### **Theoretical issues**

Auditing of financial statements provides a value added because research results show the relevance and reliability of the content of audited financial statements (Mangesti and Solimun, 2019). In general, the purpose of auditors is to safeguard the interests of shareholders against significant distortions and errors in financial statements. Although higher quality auditing can increase corporate risk taking on the one hand, it can also create value for shareholders and owners.

#### *Value creation*

Siddiqui and Uddin (2016) introduced two concepts of value at the level of organizational analysis in their research, namely use of values and exchange of values. This value relates to the specific quality of a job, task, product or service that users will consider about their needs, such as the speed or quality of performance in a new profession or the forms and performance characteristics of a new product or service or other. Ambrosini and Bowman (2009) attribute value to personal judgment and subjective characteristics. They see value as the currency that is created over a given period of time for the company (shareholder), when it comes to the exchange of duty, work, product, new services, or as the amount of money received from a customer for a particular task, job, product or service. According to Mangesti Sri and Solimun, (2019) value creation depends on the relative amount of the value achieved by the end user (buyer), which is concentrated on value creation—even an individual, organization or community and such willingness would lead to the currency exchange for the obtained value. They believe that when one is considered as a unit of analysis, therefore, the main process is initiated by individuals who share similar characteristics such as ability, motivation and information. And when it comes to creating value for an organization, innovation, knowledge, creativity and management come to mind. Tseng et al. (2014) assessed the impact of human capital, financial capital, and business unit credit on value creation across different business cycles for formulating strategic management. They showed that human and economic capital play a role in creating the value of a business unit and that macroeconomic conditions must be considered in strategic management and value creation. Their results show that business cycles can be a source of value for companies, investment in appropriate projects and an excellent opportunity for governments to implement their industrial policies.

Tantalo and Priem (2014) examined value creation through stakeholder interactions. Their approach to value creation creates new opportunities that are strategically effective. Because individual strategic operations lead to audit quality and risk taking. In fact, the view presented by them is a new approach to understanding value creation.

#### *Audit quality*

There are various definitions of audit quality. In the professional literature, the quality of auditing is defined by the extent to which the relevant auditing standards are met. In contrast, accounting scholars favour multiple dimensions of audit quality, and these dimensions often lead to different definitions. The most general definitions of audit quality include the following elements:

The likelihood of significant errors in the financial statements that the auditor can detect and report.

The probability that the auditor will not issue a financial statement that contains material misstatement of the contingent report.

A measure of the auditor's ability to reduce errors and bias as well as improve the quality of accounting data and the accuracy of the information the auditor reports Tantalo and Priem (2014).

Although the perceived quality of the audit may be related to the actual quality of the audit, it is not necessarily the same; therefore, good reputation and professional care are used to maintain the true characteristics of the audit quality and perceived quality. In addition, it should be borne in mind that the professional care of the auditor affects the quality of the financial statement information, while the auditor's good reputation affects how stakeholders understand the information (Linda et al., 2017).

Audit quality in most empirical research, some have been defined in relation to audit risk. Audit risk is the risk that the auditor may make an invalid opinion on financial statements containing material misstatement. For example, DeAngelo (1981) defines audit quality as the probability of market valuation of (a) significant material misstatements in financial statements not disclosed by the auditor; and (b) reporting such misstatements. Most other definitions of audit quality, despite the differences, reflect some of the features of DeAngelo (1981).

DeAngelo's (1981) definition illustrates the critical feature of understanding the impact of auditing on financial statement information. An important point in DeAngelo's (1981) definition is that it falls within the context of market-assessed possibilities. Therefore, the definition depends on the market's understanding of whether the auditor has performed the audit properly and the extent to which the auditor is independent. DeAngelo (1981) shifts the emphasis on the components of audit quality by introducing the notion of market understanding of auditor competence and independence (Mangesti and Solimun, 2019).

Wanda Wallace (2012) argues that professional care of the auditor affects the quality of information with appropriate improvement, reducing information bias. This indicates that the auditor's ability to provide information about the difference between the reported economic conditions of the client and the unobservable and correct economic conditions of the client is optimal (Mangesti and Solimun, 2019). Sidiny (2017) argued the good reputation of the auditor is related to the market's perception of the auditor's competence and objectivity (independence in appearance). This demonstrates the auditor's ability to increase the validity of financial statements (even in the absence of quality information). Therefore, good reputation is probably one of the size characteristics of an audit firm. In

fact, the ability to monitor the auditor can vary with the type of audit contract, so as recent scandals such as the Enron scandal have proven, the good reputation of the auditor in the short term leads to a credible understanding of poor quality information, so at the micro level, there is an ambiguity between the quality of information perceived and the ability to monitor the auditor.

### *Risk*

In financial literature, risk means to be exposed and probability of difference in actual return with expected return. Generally, the probability of a difference in return realized from expected or unpleasant changes in returns or downward returns is known as risk. In the definitions given there are three common factors: (a) an attempt or action that may have more than one result; (b) there is no end result; and (c) at least one of the possible outcomes has relatively undesirable consequences. According to agency theory, managers take their personal risk only when their decisions have an impact on the firm's risk. On the other hand, they cannot easily reduce risk by diversifying shareholders (Siddiqui and Uddin, 2016). Research suggests that because shareholders are at risk, investors prefer projects with positive net present value regardless of risk (John et al., 2008; Paligorova, 2010; Manos et al., 2014; and Furiady and Ratnawari, 2015).

### **Research Method**

The main purpose of this study is to investigate the relationship between audit quality, board characteristics and risk taking on value creation in listed companies in TSE. The statistical population of the research is the companies listed in Tehran Stock Exchange (TSE). Using a screening method, 610 firm-year data were selected for a 5-year period (2013-2017). Eviews software was used to perform the calculation and estimation of the research model and to test the hypotheses. The research is based on panel data and multivariate regression method. Both fixed and random effects were used to estimate the regression.

### *Research Hypotheses*

The research hypotheses were formulated as follows:

H<sub>1</sub>: The auditor's specialist has a significant impact on value creation.

H<sub>2</sub>: Auditor's specialist affects the effects of corporate risk taking on value creation.

H<sub>3</sub>: The auditor's tenure has a significant impact on value creation.

H<sub>4</sub>: Auditor's tenure affects the effects of corporate risk taking on value creation.

H<sub>5</sub>: Auditor size has a significant impact on value creation.

H<sub>6</sub>: Auditor size affects the effects of corporate risk taking on value creation.

H<sub>7</sub>: The non-executive directors have a significant impact on value creation.

H<sub>8</sub>: The percentages of non-executive directors contribute to the effect of corporate risk taking on value creation.

H<sub>9</sub>: Ownership concentration as a significant impact on value creation.

H<sub>10</sub>: Ownership concentration affects the effect of corporate risk taking on value creation.

H<sub>11</sub>: Corporate risk taking has a significant impact on value creation.

### Research Model and Definition of Variables

The following regression models have been used to evaluate the effect of audit quality and risk taking on business unit value creation and to test research hypotheses (Mangesti and Solimun, 2019).

The first model is used to evaluate the impact of audit quality and risk taking on value creation:

$$Vc = \beta_0 + \beta_1 Specialist_{it} + \beta_2 Tenure_{it} + \beta_3 Firm\ size_{it} + \beta_4 BM_{it} + \beta_5 Ownership\ concentration_{it} + \beta_6 Risk_{it} + \beta_7 DPR_{it} + \beta_8 RET_{it} + \beta_9 STD_{it} - OCF_{it} + \beta_{10} BTM_{it} + \beta_{11} ROA_{it} + \beta_{12} Leverage_{it} + \beta_{13} Size_{it} + \varepsilon_{it} \quad (1)$$

The second model was used to evaluate the impact of auditing quality measures on the impact of risk taking on value creation:

$$Vc = \beta_0 + \beta_1 Specialist_{it} + \beta_2 Tenure_{it} + \beta_3 Firm\ size_{it} + \beta_4 BM_{it} + \beta_5 Ownership\ concentration_{it} + \beta_6 Risk * Specialist_{it} + \beta_7 Risk * Tenure_{it} + \beta_8 Risk * Firm\ size_{it} + \beta_9 Risk * BM_{it} + \beta_{10} Risk * Ownership\ concentration_{it} + \beta_{11} DPR_{it} + \beta_{12} RET_{it} + \beta_{13} STD_{it} - OCF_{it} + \beta_{14} BTM_{it} + \beta_{15} ROA_{it} + \beta_{16} Leverage_{it} + \beta_{17} Size_{it} + \varepsilon_{it} \quad (2)$$

The table 1 shows the variables definition.

Table 1: variables definition

Dependent variable	Vc	Value creation	The difference between the market value of a company's common share and the book value of each share (Tseng et al., 2014).
Independent variables	specialist	Auditor specialist	Auditor specialist in the industry is defined as the sum of all the assets of a particular audit firm in a particular industry divided by the total assets of the clients in the industry (Mangesti and Solimun, 2019).
	tenure	Auditor tenure	An auditor's tenure is the number of years in which an auditor assumes the responsibility of auditing a firm. Corporate audit reports are used to collect audit tenure information (Linda et al., 2017).



	Audit size	Audit firm size	The size of an audit firm is an dummy variable that if the company is audited by the audit organization is 1 and otherwise is zero (Yeganeh and Azinfar, 2010).
	BM	Non-executive directors	Ratio of the number of non-executive members of the board of directors to the total number of members of the board of directors.
	Ownership concentration	Ownership concentration	Ownership concentration means the proportion of major shareholders (more than 50%).
	Risk	Risk taking	Standard deviation of expected return on stocks.
Control variables	DPR	Dividend pay-out ratio	The ratio of cash dividends to earnings per share.
	RET	Return	The ratio of the total return of an investor in a given period to the investment made in that period.
	STD_OCF	STD_Operational cash flows	Operational cash flows that are homogeneous by dividing them by total assets at the beginning of the period (Kothari et al., 2005).
	BTM	Book to Market Value	It is obtained by dividing the book value per share by its market value.
	ROA	Return on assets	Ratio of net profit to total assets.
	ROE	Return on equity	Ratio of net profit to shareholders' equity.
	Leverage	Financial leverage	The ratio of the book value of total debts to total assets.
	Size	Firm size	Natural logarithm of company equity market value.

### Research findings

In this study, in addition to descriptive statistics, correlation analysis, t-test and multivariate linear regression were used for data analysis. In descriptive statistics, data analysis was performed using central tendency such as mean and standard deviation indices, skewness and kurtosis. A summary of the descriptive statistics for the research variables is provided in the table below.

Table 2: Results of descriptive statistics of variables

Variable	Average	Max	Min	STD Dev.	Skewness	kurtosis
Vc	1.867	7.644	.385	.938	.1324	.714
Specialist	.228	12.0	3.0	.634	1.277	.174
Tenure	.132	.7512	.0621	.142	1.235	2.354
Firm size	13.293	19.066	10.031	1.381	3.2641	1.2364
BTM	.416	1.039	-1.22	.464	2.037	3.541
INSDOWN	.492	.949	.024	.192	1.284	2.642
RISK	.759	4.613	.002	.694	-1.405	1.930
DPR	6.5362	3.9236	4.0236	1.0235	2.126	6.709
RET	.4178	.85432	.3625	.213	4.247	1.0826
STD_OCF	2.641	3.217	.581	2.413	-2.845	5.045
BM	.6523	.8246	.326	.259	5.371	3.214
ROA	.8124	.6268	.0251	.4214	-.142	4.561
ROE	.549	4.6512	1.024	8.532	3.214	2.7461
Leverage	.326	.563	.023	1.021	1.463	7.311
Audit size	.2352	1	0	.456	2.314	.3125

As shown in the table above, the mean of the financial leverage variable is 0.326. This indicates that about 32.6% of the sample firms' assets were funded through debt during the research period. Also, the coefficient of kurtosis of the variables include ROA, STD\_OCF, DPR and RET is out of range of 3 and -3. This means that these variables are not normal, which is important in analysing their behaviour through regression models.

The results of the F-Limer test or the Chaw test are given in the table below. The results of this test indicate that the proper structure of the data is a panel with fixed effects. The statistical rule of deciding the Limer test is as follows:

$$H_0: \beta_i = \beta_j$$

$$H_1: \exists_i \neq j \rightarrow \beta_i \neq \beta_j$$

Table 3: Results of F-Limer test

F statistic	df	P-value	Result
18.251	8 - 813	.000	The fitting of the first model of the research is appropriate to the panel method.
4.609	8 - 816	.000	The fitting of the first model of the research is appropriate to the panel method.

Based on the results shown in the table above, the F-statistic and its calculated significance level (P-value) for the research model is less than .05 (P-value <.05), so the panel data model is suitable for fitting the first and the second research model.

Then, Hausman test was used to select the models between fixed effects and random effects. The table (2) represents the results of the Hausman test.



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F statistic	d.f	P-value	Result
18.251	8 - 813	.000	The fitting of the first model of the research is appropriate to the panel method.
4.609	8 - 816	.000	The fitting of the first model of the research is appropriate to the panel method.

Based on the results shown in the table above, the F-statistic and its calculated significance level (P-value) for the research model is less than .05 (P-value <.05), so the panel data model is suitable for fitting the first and the second research model.

Then, Hausman test was used to select the models between fixed effects and random effects. The following table presents the results of the Hausman test.

Table 4: Results of Hausman test

x <sup>2</sup> statistic	d.f	P-value	Result
10.019	6	.124	The fitting of the first model of the research is appropriate to the random effects.
36.833	3	.000	The fitting of the first model of the research is appropriate to the fixed effects.

According to the results of the Hausman test, the chi-square and its corresponding significance level, which is less than .05 (P-value <.05) for the research model, the null hypothesis for this model is not supported. Therefore, the appropriate model for fitting the first model of the research will be a random effects and the fitting model for the second model will be fixed effects.

The following table results are used to detect the absence of autocorrelation of error sentences.

Table 5: Results of autocorrelation test of error sentences

F statistic	d.f	P-value	Result
.994	8 - 813	.528	No serial autocorrelation of error sentences in the first model.
.817	8 - 816	.214	No serial autocorrelation of error sentences in the second model.

According to the results presented in the table 5, the significance level of this test for research model is more than .05. Therefore, there is no serial autocorrelation for the research models.

Likelihood ratio test (LR) was used to detect the Heteroskedastic problem. The results of this test are as follows:

Table 6: LR test results to detect Heteroskedastic

x <sup>2</sup> statistic	d.f	P-value	Result
3.215	1	.073	There is no problem of variance heteroskedastic for the first model.
1.315	1	.092	There is no problem of variance heteroskedastic for the first model

Since the values are close to the 5% level, the White period weight coefficient covariance method is used to estimate the regression model of the first and second models

more reliable and to avoid the problem of variance heterogeneity in the final estimation of the model.

Q-Q Plot was also used to determine the data normality. The following are normalized quadratic graphs and histograms for error sentences in each of the research models.

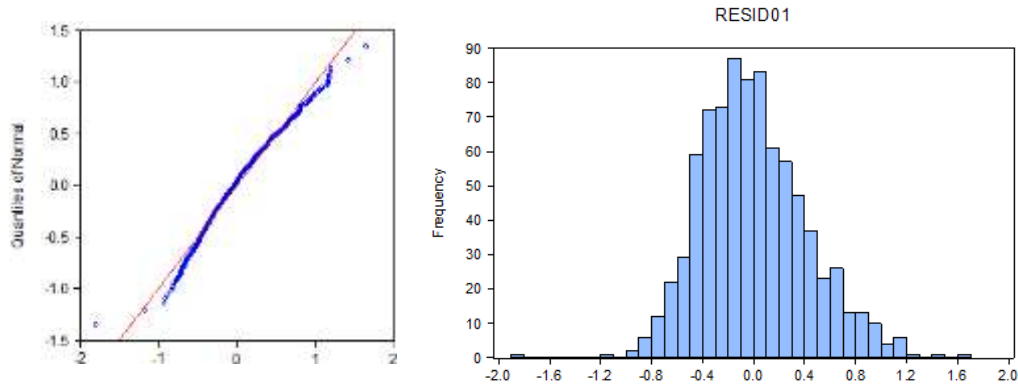


Figure 1. Normal probability graph and histogram for error sentences in the first model of research

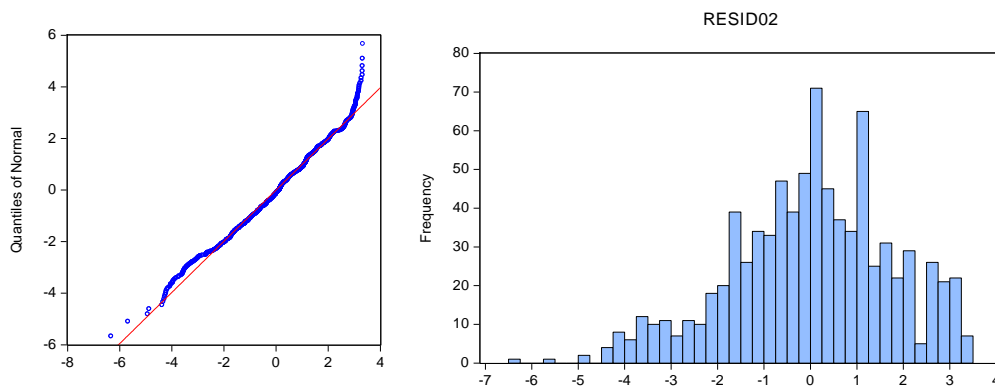


Figure 2. Normal probability graph and histogram for error sentences in the second model of research

As can be seen in the quadratic normal graph and the histogram of the research model error sentences, their distribution is approximately normal.

According to the results of previous tests, the first model of the research should be fitted with regression of least squares panel with random effects. The results of fitting the first model to the first, third, fifth, seventh, ninth and eleventh hypotheses are presented in the following table.

Table 7: Results of fitting the first regression model

Dependent variable: value creation				
Variable	Coefficient	Standard deviation	T statistics	P-value
Constant	250.8496	32.38543	7.745754	0.000
Specialist	0.789595	1.097432	0.719494	0.472
Tenure	1.658984	0.467281	3.550289	0.000
Ownership concentration	-15.07245	6.217297	-2.424276	0.016
Audit size	-0.001217	0.004868	-0.249967	0.802
BM	0.669020	1.688348	0.396257	0.692
Risk	1.113115	0.919518	1.210542	0.227
Leverage	0.998920	0.876931	1.139109	0.255
BTM	-0.000506	0.004688	-0.107847	0.914
STD_OCF	-29.16725	10.94036	-2.666022	0.008
DPR	-0.101727	0.048816	-2.083875	0.038
RET	1.115745	0.49393	2.25889	0.025
ROE	0.624500	0.187392	3.332580	0.001
Size	1.113115	0.919518	1.210542	0.227
ROA	-29.16725	10.94036	-2.666022	0.008
R <sup>2</sup>	0.568182	Adj. R <sup>2</sup>		0.4012539
F statistic	2.15265	Durbin-Watson stat		2.063142
P-value	0.000000			

The  $R^2$  is obtained as 0.568182, which indicates that the regression model interprets 56% of the dependent variable changes. The F statistic is obtained as 2.15265. Considering its significance level (Prob. = 0.000) it is significant at 5% level. The Durbin-Watson statistic is also equal to 2.063142 which, given the permissible value (1.5 - 2.5), it can be concluded that there is no autocorrelation detected between the error sentences.

The results of fitting the first model of the research are as follows:

Table 8: The results of fitting the first model

Variable	Coefficient	Standard deviation	t statistic	P-value
Specialist	0.789595	1.097432	0.719494	0.472
Tenure	1.658984	.467281	3.550289	.0004
BM	.669020	1.688348	.396257	.6922
Ownership concentration	-15.07245	6.217297	-2.424276	.0159
Risk	1.113115	.919518	1.210542	.2268

According to the results in the table above at 5% significance level, variables of tenure and ownership concentration have a significant effect on value creation. It is also clear from the obtained coefficients that tenure has a positive relationship and ownership concentration has a negative relationship with value creation.

Table 9: Results of fitting the second regression model

Dependent variable: value creation				
Variable	Coefficient	Standard deviation	T statistics	P-value
Constant	250.80	32.385	7.745	.000
Specialist	12.212	3.799	3.214	.001
Tenure	1.256	1.326	3.265	.125
Ownership concentration	2.659	.023	2.365	.235
Audit size	.254	.123	1.654	.263
BM	-.1017	.0488	-2.083	.038
Risk* Specialist	.0925	.323	.286	.774
Risk* Tenure	-14.447	6.278	-2.300	.022
Risk* Ownership conc.	.0741	.1491	.4981	.618
Risk* Audit size	-10.127	12.0944	-.837	.403
Risk* BM	-.1481	.1324	-1.124	.263
Leverage	.191	.125	1.256	.125
BTM	1.256	-1.256	.654	.145
STD_OCF	1.254	.1450	1.341	.009
DPR	.125	.012	.312	.000
RET	.339	.058	5.882	.000
ROE	.108	.235	2.365	.012
Size	2.654	1.235	2.365	.256
ROA	.023	.025	6.356	.000
R <sup>2</sup>	.491582	Adj. R <sup>2</sup>		.304539
F statistic	2.628175	Durbin-Watson stat		1.969342
P-value	.0000			

The  $R^2$  is obtained as 0.491582, which indicates that the regression model interprets 49% of the dependent variable changes. The F statistic is obtained as 2.628175. Considering its significance level (Prob. = 0.000) it is significant at 5% level. The Durbin-Watson statistic is also equal to 1.969342 which, given the permissible value (1.5 - 2.5), it can be concluded that there is no autocorrelation detected between the error sentences.

Due to the results of the above table, the following can be deduced:

The hypothesis of “Auditor's specialist affects the effects of corporate risk taking on value creation” is confirmed.

The hypothesis of “Auditor's tenure affects the effects of corporate risk taking on value creation” is rejected.

Due to the value of the interaction between the firm's risk and the tenure is .022 therefore the hypothesis of “Auditor's tenure affects the effects of corporate risk taking on value creation” is confirmed.

Since the value of the interaction between the firm's risk and the audit size is .403 so the hypothesis of “Auditor size affects the effects of corporate risk taking on value creation” is rejected.

In addition, percentage of non-executive directors has no effect on the impact of corporate risk on value creation, so the hypothesis of “The percentage of non-executive directors contribute to the effect of corporate risk taking on value creation” is rejected.

The sig. level of the interaction between the firm's risk and ownership concentration is .618. It indicates the hypothesis of “Ownership concentration affect the effect of corporate risk taking on value creation” is rejected.

## Conclusions

The results of the first hypothesis showed that the quality of auditing and even the high level of auditor's specialist cannot influence the value creation of companies listed in TSE. Therefore, the auditor's specialist does not create any value for the owners. Therefore, it can be deduced that the auditor's specialist via professional judgment can influence the difference between management and ownership (agency difference). Therefore, the auditor's specialist will reduce the gap between management and ownership. The results also show that the auditor's specialist has a negative effect on the auditor's adjustments as well as the time asymmetry of earnings. According to previous studies, increasing the tenure of an auditor will reduce the risk of company information as well as the expected risk of shareholder returns. Decreasing returns reduces the cost of capital and thus increases economic value added. Profit prediction power is higher in firms with a higher tenure. The auditor's tenure has a significant effect on the type of audit opinion. The results of the fourth hypothesis are in line with Mangesti and Solimun (2019).

Ownership concentration also has a significant impact on value creation which is in line with research by Mangesti and Solimun (2019). This is because institutional shareholders as a component of corporate governance play an important role in reducing agency costs, and these costs have an adverse effect on company value.

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