Increased Competition in an Unfavourable Audit Market Following Audit Privatisation: The Iranian Experience

Fakhroddin MohammadRezaei*, Norman Mohd-Saleh and Muhammad Jahangir Ali

ABSTRACT

A sudden surge of competition following audit privatisation in the Iranian audit market may create some positive or negative consequences on audit quality. Such significant accounting reform occurred in the unfavourable audit market of Iran where the demand for high quality audit services as well as litigation risks are low. This study examines whether increased competition in the Iranian audit market has any impact on audit fees, audit quality and auditor switching. Findings from this study indicate that increased competition in an unfavourable audit market is more likely to result in unfavourable consequences encompassing price competition (decreasing audit fees) rather than quality competition (audit quality improvement), and increased opportunistic auditor switching. This study offers policymakers some suggestions to mitigate the potentially unfavourable consequences of increased competition in an unfavourable audit market.

Keywords: Audit Fees, Audit Market Competition, Audit Privatisation, Audit Quality, Auditor Switching, Iran, Unfavourable Audit Market

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*Corresponding author: Fakhroddin MohammadRezaei obtained his PhD in accounting from Universiti Kebangsaan Malaysia in early 2014. He is a senior lecturer at the University of Economic Sciences, Tehran, Iran. E-mail: fakhroddin.mr@gmail.com.
Norman Mohd-Saleh is a Professor at the Faculty of Economics and Management, Universiti Kebangsaan Malaysia, 43600 UKM Bangi, Selangor, Malaysia. E-mail: norman@ukm.edu.my.
Muhammad Jahangir Ali is an Associate Professor at the Department of Accounting, La Trobe University, Melbourne, Australia. E-mail: m.ali@latrobe.edu.au.

1. Introduction

The consequences of audit market competition[1] and concentration are among the most controversial topics being discussed among regulators, researchers, auditors and their clients. This issue has attracted the attention of both regulators (e.g., European Commission in October 2010) and researchers (e.g., Francis, Michas, & Seavey, 2013) after the merger of the Big N audit firms and the demise of Arthur Andersen. An investigation by the Government Accountability Office (GAO) (2003) reveals that dispersed, limited and mixed impacts prevail following an increased concentration in the audit market. In addition, prior research shows no conclusive result on the joint effects of increased competition on quality and price in relation to auditing practices (e.g., Pearson & Trompeter, 1994; Willekens & Achmadi, 2003; McMeeking, Peasnell, & Pope, 2007; Numan & Willekens, 2012; Ding & Jia, 2012). However, there are contradictory views in connection with the potential consequences of increased competition or concentration in audit markets. This implies that according to the traditional view of legislators and courts, competition in any area can increase quality and decrease prices (Federal Trade Commission, 2003). In contrast, the economics theory suggests that when suppliers compete for market share, competition can result in lower product quality (Kranton, 2003).

It has been observed that audit privatisation in Iran leads to increased competition among auditors. In this regard, audit privatisation refers to an event where audit services which used to be primarily provided by a state entity are now liberalised and offered by private audit firms (Roudaki, 2008). It appears that audit privatisation is one attempt by the Iranian government to obtain the confidence of potential investors in the Iranian capital market. This is done via the provision of high quality financial reports. Audit privatisation began in late 2001, with the establishment of the Iranian Association of Certified Public Accountants (IACPA) pursuant to the 'Using Services of Certified Public Accountants' Act (USCPA Act).

According to Mashayekhi and Mashayekh (2008) and Bagherpour, Monroe, and Shailer (2008), the Iranian Audit Organisation (IAO) dominated the Iranian audit market from 1993 to 2001. Despite a large number of private audit firms becoming members of the IACPA and

[1] The investigation in the present study reveals that there is no common definition of audit market competition. However, it can be defined as an increased capacity on the supply side of the audit market (see, Beattie & Fearnley, 1998).

even with an increased competition among private audit firms, the IAO maintains its monopolistic market share over state-owned enterprises. Extant research have examined the consequences of audit privatisation in developed countries but these seem to be documenting mixed results with little research done on emerging economies. This study thus aims to fill the gap.

Iran has been chosen due to two differing institutional factors, namely low demand for audit services and low litigation risk. Given that audit market structure can affect different areas, extant gaps concerning the effects of audit market structure on issues such as auditor switching exist. In addition, increased competition among auditors is also observed to be occurring in the "unfavourable audit market" of Iran. The term, "unfavourable environment" is applied by Karampinis and Hevas (2011) to explain the lack of readiness of Greece to comply with International Financial Reporting Standards. The authors define it as "its code-law tradition, bank orientation, concentrated corporate ownership, poor shareholders' protection, and low regulatory quality" (Karampinis & Hevas, 2011, p. 304). This study applies the term "unfavourable audit market" in a similar fashion to imply insufficient demand for high quality audit services as well as a lack of high litigation risk. It is postulated that the audit privatisation in the Iranian audit market will provide an interesting research setting for the purpose of examining the consequences of this unique phenomenon on three factors: audit fees, audit quality and auditor switching.

The remainder of this paper is structured as follows: Section 2 provides the institutional background of the audit environment in Iran. Section 3 reviews prior research while Section 4 discusses the audit market in Iran. The consequences of increased competition in an unfavourable audit market are outlined in Section 5. Finally, Section 6 concludes the paper.

2. Institutional Background

2.1 The History of Iranian Audit Profession

Tax and Trade laws have played a prominent role in the formation of the accounting profession in Iran. Auditing was mentioned for the first time in the Income Tax Law in 1955. The law "accept(s) the professional opinions of official auditors for income tax calculation" (Roudaki, 2008, p. 37). In 1963, the Certified Public Accountant Association was founded pursuant to the Direct Tax Law while the Centre of the Iranian Official Accountants was founded pursuant to the Direct Tax Law in 1966. Laws were enacted to enhance the role of corporate auditing including the Security Market Act of 1967 that necessitates auditing for firms listed on the Tehran Stock Exchange (TSE). The appointment of an inspector for a public firm was mandated by the Trade Law of 1953.[2] As a result of the aforementioned laws, large international audit firms began operating in Iran. These firms began establishing branches in Iran and only selected Iranian official accountants served as their partners.[3] The operation of large audit firms in Iran created a considerable progress for both the accounting and auditing professions in Iran, whether for professionals or the academic field (Mashayekhi & Mashayekh, 2008; Roudaki, 2008). More information about the Iranian audit profession before the Islamic Revolution may be found in Roudaki (2008).

Following the Islamic Revolution in 1979, all banks and insurance firms were nationalised and the state became the supervisor of these firms. Consequently, demand for the services of private audit firms decreased sharply. The Nationalised Industries and Plan Organization Audit Firm (1980), the Mostazafan Foundation Audit Firm (1981) (see Mashayekhi & Mashayekh, 2008, p. 74), and the Shahed Audit Firm (1983) were then established as state and semi-state audit firms for the purpose of auditing the newly nationalised firms (Roudaki, 2008). However, a lack of comparability between the financial statements of client firms and audit reports issued by the three aforementioned semi-state audit firms led to the establishment of the Iranian Audit Organization (IAO) in 1987, following the ratification of an Act by the Iranian Parliament mandating the merger of the three semi-state audit firms.

The IAO was charged not only with the auditing of state and semi-state firms but also the development of a set of national accounting and audit standards. The National Audit Standards in Iran are principally based upon the standards of the International Audit and Assurance Standards Board (IAASB) (Roudaki, 2008). The IAO plays a considerable

[2] Now, listed firms appoint both inspectors and auditors. Under the present system, an audit firm is appointed as an independent auditor, while one of the partners of the audit firm is assigned as the inspector. The auditor issues audit reports regarding financial statements and the inspector issues a separate report in accordance with their responsibilities under the Trade Law. The report of the inspector primarily concerns the level of compliance of the Chief Executive Officer (CEO) and board members with the requirements of the Trade Law.

[3] International audit firms have been banned to operate and offer audit services in Iranian audit market since the Islamic Revolution in 1979 (Azizkhani, Shailer, & Monroe, 2012). However, currently there are about 10 private audit firms in Iran that are affiliated with international audit firms to carry out the audit works of the international audit firms in Iran.

role in the development of the accounting and audit professions in Iran. In light of the privatisation policies implemented in Iran for the purpose of developing the country's economy following the end of the war with Iraq in 1988 as well as the fact that state auditors were ill suited to conduct the auditing of firms in the newly emerging private sector, the USCPA Act was enacted in 1993 by the Islamic Parliament of Iran. Audit privatisation then officially began following the establishment of the IACPA in the late 2001 in accordance with the Act (Bagherpour et al., 2008). Following the establishment of the IACPA, many private audit firms were founded and became members of the organisation.[4]

2.2 *Audit Privatisation*

Although 'Using Services of Certified Public Accountants' Act (USCPA Act) was enacted in 1993, it did not come into operation until 2001, following the establishment of the IACPA. As a result, the IAO dominated the Iranian audit market for firms listed on the TSE between 1993 and 2001. After the establishment of the IACPA, a large number of private audit firms were established and began operating in the Iranian audit market as members of the IACPA. Thus, competition among auditors dramatically increased after 2001 (Bagherpour et al., 2008). Under the USCPA Act, the IACPA is responsible for the financial oversight of manufacturing, commercial and services firms. The IACPA also helps to ensure the reliability of the financial statements of firms as a way of protecting the interests of shareholders and other stakeholders. According to article 2 of the IACPA statute, the objective of the establishment of the IACPA is to promote the accounting and

[4] Audit privatisation is discussed in greater detail in the subsequent section of this paper. However, a brief discussion about the process of the sudden formation of private audit firms as the members of IACPA is beneficial for the reader. The Iranian Institute of Certified Accountants (IICA) was established in 1974, prior to the establishment of the IACPA, and continues to operate at present (Roudaki 2008). Prior to audit privatisation, the members of the IICA consisted of government officials and private auditors who performed auditing services for private firms and some listed firms. Following its establishment, the IACPA certified the audit managers of the IAO, some managers of the Tax Department and the partners of audit firms that were existing members of the IICA as members without requiring such persons to successfully pass the CPA examination. There is no credible source regarding the number of CPAs that were certified by the IACPA without passing the CPA examination. A considerable number of IAO managers who were CPAs left the IAO and established their own private audit firms after 2001. Additionally, every year accountants and auditors who pass the CPA examination and meet its requirements become members and recognised CPAs. At least three CPAs must be involved in the joint establishment of a private audit firm for that firm to be eligible to become a member of the IACPA (see, IACPA Website).

audit professions in Iran and to provide professional oversight on the work of certified public accountants.

The provisions and notes of the statute on the IACPA that were ratified or affirmed by the Ministers Council in 1999, delegated a considerable amount of authority of the IACPA to the Economics and Financial Ministry. According to Vadizadeh (2011), this delegation of power undermines the role and function of the IACPA as an independent professional body.

Even though the IACPA attempted to reduce its dependence on the state, the IACPA statute was amended in 2011 in order to delegate all initial authority granted to the IACPA to be given to the Economic and Financial Ministry. The result of this delegation is that the main role of the IACPA as a professional, self-disciplined and non-governmental monitoring body was abrogated. Following this, there were reports of economic corruptions in recent years which seem to indicate that these had occurred due to the lack of independence granted to the audit profession in Iran. In other words, the profession lacks the efficiency and effectiveness to actually perform audit works (Vadizadeh, 2011).[5]

Based on the IACPA statute which was ratified by the state in 2001, members of the association are categorised as 'active' and 'inactive' members. Active members can accept audit jobs, while inactive members may not. Table 1 shows that the IACPA had 2,057 members as of February 2012, the majority of whom are active. Hoshi (2012) argues that while there are 237 audit firms which are also members of IACPA with 7000 staff, only 30 per cent of the capacity of the IACPA is utilised.[6] In other words, its capacity is under-utilised as there are more auditors to service the limited number of auditees. Hence, a new demand should be created for audit services so as to utilise the 70 per

[5] Numerous and significant acts of financial corruption have been detected in Iran. For example, the scandal involving a state bank in Iran, Saderat Bank was detected in 2011 when Amir Mansur Arya withdrew USD3 billion from the Saderat Bank through collusion with the directors and top managers of the bank and even in connection with some powerful bureaucrats. First, such financial corruption reveals that the internal and external mechanisms of corporate governance in Iran cannot appropriately play their monitoring role. The large expropriation of assets was not detected by the auditor of the Saderat Bank, which indicates that the effectiveness of audit is very low in Iran. Second, the transparency of financial reporting is also very low. Although the expropriation of asset was occurring (Tavakoli, 2011; Azadnegar News, 2011), the firm's financial statements did not indicate embezzlement, possibly due to the manipulation and misclassification of accounting numbers in financial statements.

[6] A person with at least six years' experience in auditing after obtaining the relevant bachelor degree and passing CPA examination may become a member of IACPA. An audit firm may be established by at least three CPA members of IACPA. Some of the members of IACPA have other jobs (example, faculty members) and are categorised as "inactive" members.

cent surplus capacity of the IACPA.[7] The Regulator and the Securities and Exchange Organization (SEO) are expected to increase the demand for audit services by enforcing operational and internal audits which require a significant amount of time and effort to complete.

Table 1: Number and Percentage of IACPA Members by Type of Membership

Membership type	Number	Percentage
Audit firms	237	11.5
Individual independent auditor	179	8.7
Auditor, partner of audit firms	772	37.5
Auditor working at IAO	254	12.4
Auditor working in audit firms	146	7.1
Inactive members	469	22.8
Total	2,057	100

Source: IACPA members list, February 2012. (www.iacpa.ir)

2.3 The Contemporary Audit Market of Iran

The audit market in Iran appears to be a unique case comparatively because of the intense competition existing among private audit firms which are also co-existing alongside the IAO which currently, monopolises the auditing of state owned enterprises. Based on Note 5 of the USCPA Act, an auditor for any state owned enterprises has to be selected from the IACPA members. However, the implementation of this Note has been stopped by a circular of the State since 2002. This has resulted in higher competitiveness among private audit firms as the IAO continues to have its monopolistic market share on state owned entities (Hoshi, 2012).

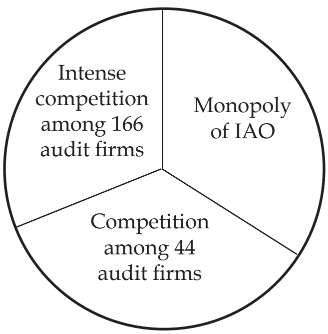
Esaee-Khosh (2011) notes that state owned enterprises and firms with more than 50 per cent of shares belonging to the state are to be audited by the IAO. In addition, the IAO has declared that the auditing of firms with more than 20 per cent of shares owned by the state must also be conducted by the IAO due to the need to prepare consolidated financial statements. Thus, in practice, a portion of the market share

[7] There is no data on the differentiation of private audit firms based on size. However, the argument of Hoshi (2012) reveals that each audit firm has 29 staff on average. This indicates that the firms are small.

of audit jobs in private firms has been assigned to the IAO. Instead of reducing its operation following the audit privatisation, the IAO has extended its operations.

This has caused the income of the IAO to increase to more than USD50 million in 2010. In the same year, 210 private audit firms reported a combined total income of only USD92 million. In other words, the income of the IAO alone was more than half of the income of all the private audit firms put together. The IAO performed audit works for 200 firms which were listed on the TSE and more than 1,000 firms in the Iranian audit market (IAO's CEO, 2010).[8] Bozorg Asl (2012) posits that 57 per cent of the total income of private audit firms was earned by 21 per cent of the audit firms. This finding indicates that the bulk of the total income of private audit firms in 2010 was earned by a relatively small number of private audit firms (i.e. 44 audit firms) while the remaining 166 private audit firms did not have sufficient income. As a result, most private Iranian audit firms experience financial problems. Chart 1 depicts the audit market share of private Iranian audit firms and the IAO.

Chart. 1: Iran's Audit Market in 2010 Based on Audit Fees



Currently, among the most controversial issues in the Iranian audit profession is the issue of low audit fees of private auditors (Amani & Davani, 2010). Deilamipour (2012) conjectures that clients of the IAO do not have the right to select their auditors. In fact, most clients of the IAO are required by law to appoint the IAO to perform audit work. Hence, the IAO has more bargaining power in determining the audit

[8] There is no reliable information about the total population of client firms. However, the population of listed firms is between 500 and 600.

fees. In addition, the monopolistic audit market share of the IAO, even after audit privatisation, has led to an intense competition among private audit firms. In this scenario, private audit firms may attempt to be more flexible so as to retain current clients and to obtain new clients. Consistent with this argument, Deilamipour (2011) states that the IAO, due to its special privileges, does not encounter the problems of bargaining with clients for audit fees and attempting to find clients, as faced by private audit firms. The clients of the IAO do not bargain about the audit fees because they believe that when both the auditor and the auditee are state bodies, the fees paid simply go from one pocket of the state to another pocket of the state. As a result, the audit fees paid to the IAO are higher than those paid to private audit firms (Deilamipour, 2011).

Bozorg Asl (2010) mentions two fundamental problems in the private sector of audit firms: (i) the perceived weakness of auditor independence; and (ii) the low audit fees that had resulted from the high competition existing among private auditors. These factors in turn, cause private firms to have difficulty in expanding their existing pool of human resources by employing more professional employees.[9] Deilamipour (2012) argues that newly certified accountants who establish new audit firms are typically faced with audit work shortfall. Such audit firms may propose very low audit fees to handle the audit work of potential auditee firms. These actions can lead to a decreasing fees syndrome and thereby, damage the reputation of the audit profession.

Hovansian Far (2010b) points out that audit firms that charge low fees for auditing deal with the problem of low audit fees in the following manners: (i) they use the services of accounting students who are undergoing training at the firms; (ii) they are only present in the client's place for 3 or 4 days so as to obtain copies and prints to bulk up audit files rather than to perform audit tests; (iii) they repeat the audit reports of the previous year and only make changes to their style of writing; and (iv) they report common problems typically faced by most clients.

In addition, it can be argued that there may be heterogeneity not only between private auditors and the state auditor, but also within private auditors. A number of private audit firms in the IACPA have been accepted as Trustee Audit Firms by the Securities and Exchange Organization (SEO). Listed firms on the TSE which are not required to

[9] Bozorg Asl (2010) argues that most private audit firms do not have sufficient income to hire experienced auditors due to low audit fees and client shortfall. Hence, the audit firms often carry out audit work by audit teams that do not have adequate experience. As a result, they may not discover breaches.

be audited by the IAO have to choose their auditors from among these Trustee Audit Firms. Only 110 private audit firms are listed as Trustee Audit Firms in 2013, and this indicates that the SEO considers less than half of the private auditors as meeting its quality requirements.

2.4 Demand for Audit Services

In Iran, firms are less likely to have sufficient incentives to demand high quality audit services. Esaee-Khosh and Vadizadeh (2010) argue that the demand for audit services in Iran is primarily based on regulation enforcement and the audit market is limited to firms which are forced to undergo auditing by the law. Esaee-Khosh and Vadizadeh (2010) contend that the negative influence of increased competition in audit market on audit fees is exacerbated by the limited demand and low litigation risk currently existing in Iranian audit markets. Furthermore, they argue that when auditing is carried out just to fulfil the legal requirements, the price of services will undoubtedly be the basis for selecting an auditor rather than the benefits or effectiveness of the auditing process.

Hovansian Far (2010a) also observes that problems relating to the demand for audit services in the Iranian private sector also exist. He argues that most private firms and listed firms with concentrated ownership structure believe that when the majority shareholders have close relationships with the firm there is no information asymmetry and hence, the audit is useless. This claim is consistent with the findings of MohammadRezaei, Banimahd, and Mohd-Saleh (2013) who say that the financing system of Iran closely resembles the 'credit-insider' system. One of the main characteristics of this said system is that financial reporting is not the vital source for decision making because information asymmetry is reduced through close relationship and private channels (Nobes, 1998). Further, Hovansian Far (2010a) mentions that private firms assume that accounting expenses are additional and a waste of costs. Thus, they attempt to use the services of cheap or unqualified accountants in order to meet the requirements of the Tax Department. In other words, these firms appoint auditors in order to meet the requirements of the Tax Department, banks, SEO or other bodies, rather than appoint auditors because of the perceived need. Consequently, these firms attempt to comply with the regulations by incurring minimal expenses.

It is noted that the weak demand for high quality audit services by Privately Owned Listed Firms (POLFs) is also due to the concentrated ownership structure of such firms. In Iran, for example, there is no actual separation between owners and management in POLFs. Concentrated shareholders often become board members of such firms and in some instances, serve as chief executive officers (CEOs) of the firms. Sometimes, concentrated shareholders appoint other persons as board members and CEOs through their voting rights exercised in annual general meetings (AGMs). In this scenario, concentrated shareholders reduce information asymmetry by maintaining a close relationship with the firm, an aligned board and the CEO (see, MohammadRezaei, Mohd-Saleh, & Banimahd, 2012). As a result, information asymmetry is negligible between management and concentrated shareholders in most instances. This implies that concentrated shareholders have less incentive for external audits and high quality audits.

It appears that minority shareholders in Iran are also less likely to create incentives for firms to demand for high quality audit services from auditors. This is because minority shareholders do not have supervisory rights (Mashayekhi & Bazaz, 2008); they also do not have the appropriate incentives and resources to claim their rights. In fact, the main purpose of the minority shareholders is to obtain short-term gains through short-term investments. Minority shareholders typically behave like speculators and do not have any motivation to monitor the activities of the management and the firms (Hassas Yeganeh, 2006). Although information asymmetry exists between the minority shareholders and managers, and between the minority shareholders and concentrated shareholders, minority shareholders do not create sufficient incentives for firms to demand high quality audit services because of the lack of demand for high quality financial reporting and lower monitoring roles of the minority shareholders.

In the 'credit-insider' system (see, Nobes, 1998) of Iran (Moayedi & Aminfard, 2012), the incentive for a firm to demand high quality audit services from auditors is unlikely to be affected by creditors. In Iran, creditors (banks) attempt to decrease information asymmetry through close relationship with firms (see, MohammadRezaei et al., 2013). The financing interest rate obtained from banks is determined by the Central Bank of Iran and it does not vary between firms despite varying levels of risk. Hence, creditors also do not generate appropriate motivation in firms to demand for high quality audit services.

Iran's Security Market Act was enacted in 1967 and the Tehran Stock Exchange (TSE) was opened in 1968 (Mashayekhi & Mashayekh, 2008). Following the Islamic Revolution in 1979, the TSE experienced a period of standstill but this ended in 1989 following the end of the war between Iran and Iraq. In the last two decades, Iran has attempted to improve its economic prosperity and the role of the TSE through privatising state owned enterprises. In 2005, the Iranian Security Market Act (ISMA) was enacted and it repealed the Security Market Act of 1967. The ISMA of 2005 served as the basis for the establishment of the Securities and Exchange Organization (SEO) which not only established a department to monitor the audit reports of firms listed on the TSE but also issued several rules. These rules touched on the penalty imposed on auditors who breached their duties. The establishment of the SEO appears to create an environment of increased litigation risk. Nonetheless, the SEO is still evolving and is currently developing mechanisms which can help it to oversee listed firms. Until effective oversight mechanisms can be implemented, the TSE cannot play an effective role as a means for listed firms to obtain capital from the market. Additionally, controlling shareholders may have the intention to maintain their controlling roles for the long-term. Thus, the other role of a capital market, as a place that investors can easily buy and sell a firm's shares with low transaction costs, may not be important for the controlling shareholders. Therefore, the SEO and TSE, as external mechanisms, cannot create strong incentives for listed firms to comply with the regulations in the capital market and other requirements such as corporate governance laws.

Audits performed by external auditors are demanded as a monitoring mechanism due to possible conflicts of interest arising between principals and agents, as well as among different stakeholders (Watts & Zimmerman, 1981). Disparate demand for audit services is due to the different agency costs prevailing among firms (DeAngelo, 1981). Based on this perspective, it appears that there is little demand for high quality auditing services in Iran. The lack of demand may also be due to several other reasons including the lack of information asymmetry between concentrated shareholders and management, the lack of supervisory rights and motivation among minority shareholders who demand high quality audits, the lack of information asymmetry between firms and banks due to their close relationship, the lack of the influence of different levels of risks on the interest rate of financing, the weak role of the capital market in providing capital, and the intention of concentrated shareholders to maintain control rights for long-term. Jeong and Rho (2004) argue that auditors will not have strong incentives to mitigate the managers' misreporting activities but will be motivated to act opportunistically to keep current clients and attract new clients in the absence of a demand for high quality audit services. Thus, the consequences of such institutional elements in Iran on audit quality are likely to be negative.

2.5 Enforcement System

There are laws in Iran which determine the legal responsibilities of auditors. The laws can be reviewed in light of civic responsibilities and criminal responsibilities. Articles 1, 2, 8 and 12 of the Civic Responsibility Law[10] consider the public responsibilities of auditors. Articles 43 and 52 of the ISMA also mention the civic responsibilities of auditors. In addition, articles 154, 270 and 273 of the Trade Law, likewise, specify the civic responsibilities of auditors. For instance, article 154 of the Trade Law provides that the "auditor or auditors have to pay incurred losses of firms and individuals if the losses were due to the violations of the auditor or auditors" (Vafadar Zadeh, 2011). Furthermore, the criminal responsibilities of inspectors (auditors) are outlined in articles 266 and 267 of the Trade Law. Articles 588 and 648 of the Islamic Penal Code also stipulate the responsibilities of auditors while articles 46, 47, 49, 51 and 52 of the ISMA outline the criminal liabilities of auditors (Vafadar Zadeh, 2011).

The brief review of laws regarding the responsibilities and liabilities of auditors in Iran shows that there are laws in the country that could increase litigation risks. However, in practice, the litigation risks are negligible for auditors. Dehkordi and Makarem (2011) argue that litigation "risk is not so grave that it endangers audit firms" (p. 125). Indeed, litigation risk in Iran does not deter auditors from adopting opportunistic behaviours. In practice, the main risk faced by auditors in Iran is the possibility of their certificate being cancelled by the IACPA due to audit failures but such sanctions rarely occur. The chairman of the High Council of the IACPA announced the investigation verdicts of 81 cases related to violations committed by audit firms. The penalties invoked against the audit firms are as follows: 30 cases resulted in a one-year suspension of membership, 51 offending audit firms were prohibited from accepting new clients, and 20 cases were submitted to the High Judicial Council of the IACPA (Mahmudi, 2010). In Iran, lawsuits are rarely brought against auditors and the prosecutions of auditors are confidential (Dehkordi & Makarem, 2011). Thus, the existing mechanisms do not deter auditors from adopting opportunistic behaviours.

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[10] The Civic Responsibility Law was ratified on 27 April 1960 and contains 16 provisions. The law explains the general responsibility of citizens in society.

One of the main reasons causing the low litigation risk may be due to the lack of actual separation between ownership and management in firms. Additionally, it may also be due to the high level of concentrated ownership structure currently existing in Privately Owned Listed Firms in Iran. As argued earlier, low litigation risk could also be caused by the fact that minority shareholders do not have adequate rights, the resources and incentives to claim their own rights or to litigate against auditors. Further, the SEO is emerging and currently, it appears to be unlikely to serve as an effective mechanism that can protect the interests of all stakeholders.

The low litigation risk in Iran, as a matter of fact, does not deter auditors from opportunistic behaviours. Chaney, Jeter, and Shaw (2003) argue that a trade-off exists between the cost of reporting breaches committed by the client firm and the cost of the litigation due to not reporting the breach. If the cost of reporting a discovered breach is lower than the litigation cost, the auditor would be more inclined to provide quality audit reports. Seetharaman, Gul, and Lynn (2002) argue that audit fees are higher due to risk-premiums. When the legal system is strong, the litigation risk is high, and this gives the auditor greater incentives to perform higher quality audit.

In the context of the Iranian audit market, the low litigation risk leads to unfavourable outcomes due to the following reasons: (i) intense competition among firms; (ii) client shortfall; (iii) weak demand for high quality audit services; and (iv) lack of concern among private auditors in relation to reputation capital. Due to the environment of the Iranian audit market, auditors may accept audit work that pays low audit fees, and they may decrease their audit effort due to the low audit fees. Further, when they discover any breaches, they may become unwilling to make any report because of their need to retain clients. While weak litigation risk would be expected to lead to low audit quality, the negative effects are further increased when auditors are faced with client shortfalls or financial problems.

3. Prior Research

3.1 Audit Market Structure, Audit Fees and Audit Quality

Audit market structure, concentration and competition have attracted the attention of legislators and scholars following an increased concentration in audit markets due to the merger of Big N audit firms and the demise of Arthur Andersen. The Sarbanes Oxley Act in the US mandates that the Government Accountability Office (GAO) investigates the effects of audit market concentration on audit fees, auditor independence, audit quality, competition and client choice. The investigation by the GAO (2003) reveals that there are mixed and limited evidence. More recently, in October 2010, the European Commission considered some principal questions which relate to increased concentration in audit market including whether or not competition exists in the audit market, and whether or not concentration in the audit market is detrimental (Numan & Willekens, 2012). A summary of prior studies regarding the role of audit market structure (competition or concentration) on audit fees and audit quality is presented in Table 2.

Table 2: A Summary of Findings Regarding the Effect of Audit Market Structure on Audit Fees and Audit Quality

Panel A: Audit market structure and audit fees			
Author(s)	Independent variable(s)	Sample	Main finding(s)
Maher, Tiessen, Colson, and Broman (1992)	Competition in audit market	US	Significant decrease in audit fees occurs following increased competition in the audit market.
Pearson and Trompeter (1994)	Concentration in audit market	Wisconsin insurance companies	A negative relationship exists between audit market concentration and audit fees. The authors suggest that higher level of concentration is associated with higher level of price competition.
Iyer and Iyer (1996)	Audit firms mergers	UK	Increased concentration in the audit market does not resulted in a significant increase in audit fees.
Bandyopadhyay and Kao (2004)	Competition in audit market	Ontario municipal audit market	Generally, audit fees decrease as competition increases in the audit market. However, Big N audit firms earn fee premium even in the competitive audit market.

Jensen and Payne (2005)	Price competition in audit market	Florida municipal audit market	Increased competition in the audit market results in decreased audit fees.
McMeeking (2007)	Audit market concentration	UK	Increased concentration level results in an increase in audit fees while price competition is considerable at the initial tender stage.
Chen, Su, and Wu (2007)	Audit market structure	China	Big N audit firms gain significant fee premium in less competitive supplementary audit market, but not in the competitive statutory audit market.
McMeeking, Peasnell, and Pope (2007)	Audit firm mergers	UK	A direct link exists between concentration ratio and audit fees. However, the impacts of mergers between Big N audit firms on reputation fee premium and price competition depend on specific circumstances.
Behn, Lee, and Jin(2009)	Competition in audit market	South Korea	Audit fees per hours decrease as competition increases in the audit market.
Abidin, Beattie, and Goodacre (2010)	Audit market structure	UK	Increased concentration, in the UK audit market following the merger of PricewaterhouseCoopers (PwC) and the demise of Arthur Andersen, has not resulted in an anti-competitive pricing by auditors.
Carson, Simnet, Soo, and Wright (2012)	The mergers of Big N audit firms	Australia	Increase in premium audit fees paid to Big N audit firms after the mergers of audit firms.
Ding and Jia (2012)	PwC merger	UK	Following the merger of PwC, audit fees increase for both PwC and other Big N audit Firms.

Panel B: Audit market structure and audit quality				
Author(s)	Independent variable(s)	Dependent variable(s)	Sample	Main finding(s)
Kallapur, Sankaraguru swamy, and Zang (2010)	Audit market concentration at the city level	Audit quality	US	There is positive relation between audit market concentration and audit quality (measured by discretionary accruals and Dechow and Dichev (2002) accrual quality measure).
Ding and Jia (2012)	PwC merger	Audit quality	UK	Audit quality (measured by discretionary accruals) increases after mergers for PwC and other Big N audit firms.
Boone, Khurana, and Raman (2012)	Audit market concentration at the city level	Auditor tolerance for earnings management	US	Higher concentration is positively associated with earnings management.
Francis, Michas, and Seavey (2013)	Big N audit market concentration	The quality of audited earnings	42 countries	The clients of Big N auditors have higher earnings quality when the Big N auditors have been dominating the audit market. However, the earnings quality is lower for the clients of Big N auditors when unequal market share exists between the Big N auditors.

Panel A (Audit market structure and audit fees) and Panel B (Audit market structure and audit quality) of Table 2 reveal several extant gaps regarding the effect of audit market structure on audit fees and audit quality currently existing in literature. First, there is little evidence demonstrating the effect of audit market structure on audit quality. Second, there is conflicting evidence among prior studies to show the effect of audit market competition or concentration on audit fees and audit quality. While the majority of prior studies find that competition in audit market is negatively associated with audit fees, the findings of Pearson and Trompeter (1994), Iyer and Iyer (1996), and Abidin, Beattie, and Goodacre (2010) show otherwise. Further, contrary to Kallapur, Sankaraguruswamy, and Zang (2010) and Ding and Jia (2012), the study by Boone, Khurana, and Raman (2012) provides evidence that audit market concentration has a negative impact on audit quality (earnings quality).

Third, Table 2 also shows most of the prior studies (except Chen, Su, & Wu, 2007; Behn, Lee, & Jin, 2009) investigate the effect of audit market structure in Anglo-Saxon countries where client firms are more likely to have incentives to demand for high quality audit services and where litigation risk is also strong. Since prior studies focus mainly on the consequences of increased concentration in audit market, studies focusing on the consequences of increased competition in an audit market need to be expanded.

3.2 Auditor Switching, Fee Discounting and Opinion Shopping

Although auditor switching decision can be driven by a variety of underlying reasons, this study briefly reviews currently existing evidence about opportunistic auditor switching namely audit fee discounting and opinion shopping. Shockley (1981) and Beattie and Fearnley (1998) argue that when competition is high among auditors, client firms have more incentives to change auditors in an effort to achieve their opportunistic motivations such as audit fee discounting and opinion shopping. Likewise, Ettredge and Greenberg (1990) suggest that the increase in the number of auditors is more likely to result in the client firms choosing an auditor with the lowest fee and this can create high levels of fee cutting among auditors.

Simon and Francis (1988) find significant fee discounting (on average 24 per cent) in the initial engagement year. They also find that the fee reduction is, on average, 15 per cent for each of the next two years. Consistent with this finding is the evidence provided by Ettredge and Greenberg (1990) who show that the average fee discounting in the initial year of engagement is 25 per cent. Craswell and Francis (1999) find that fee discounting at the initial engagement stage is only for client firms that had switched from non-Big N to Big N audit firms. Nonetheless, Francis (1984) and Palmrose (1986) fail to find any evidence to indicate that such price discounting occurs in the initial engagement stage. It is worthy to note that Dye (1991) finds that when audit fees are disclosed to the public, discounting will not occur.

Although there is sufficient evidence on audit fees discounting following auditor switching, there is little evidence regarding the effect of auditor switching following increased competition in an audit market on audit fee discounting. Using Belgian data, Willekens and Achmadi (2003) observe that auditor switching has a positive relationship with audit fees in 1989 when the audit market is less competitive. However, the relationship is not significant in 1997 when audit market is competitive. Ghosh and Lustgarten (2006) examine audit fees in initial engagement in the US by taking into account the role of audit market structure. Their results show a 24 per cent fee discounting occurrence made by auditors (small auditors) in the initial engagement in an atomistic (competitive) sector but only 4 per cent in the oligopolistic sector (for large audit firms). Due to the few studies done, there is thus inconclusive evidence to show that auditor switching occurs because of fee discounting. Similarly, there is little and unclear evidence to show that the effect of audit market structure on auditor switching is due to fee discounting. This study thus examines the effect of increased competition in an audit market where clients emphasis less on audit quality but make decision regarding auditor choice mainly based upon audit fees.

Similar to the lack of evidence which shows that auditor switching is due to fee discounting, there is also limited and mixed findings which show that auditor switching is caused by opinion shopping incentives. Chow and Rice (1982), Krishnan and Stephens (1995), and Lennox (2000), in their findings, reveal that the likelihood of auditor changing is high when there is a high level of disagreement between the auditor and the client and when the auditor issues qualified audit report. This occurs when the manager of a firm, in desiring to receive a clean audit report, plays a role in auditor selection. Here, the manager attempts to engage in auditor switching (Jackson, Moldrich, & Roebuck, 2008). While most of the current empirical evidence (e.g., Smith, 1986), primarily from the US, fails to find a link between auditor switching and opinion shopping, theoretical evidence demonstrates that auditor switching is likely to result in the issuance of favourable audit reports. Additionally, Chan, Lin, and Mo (2006) find that in China, local government owned firms engage in opinion shopping by switching from non-local auditors to local auditors.

Such mixed empirical evidence shows that results are attributable to the different institutional factors. A comparison of these studies seem to show that studies conducted in developed countries (e.g., Smith, 1986; Craswell, 1988) have failed to provide any evidence regarding opinion shopping because there is a sufficient demand for high quality audit services and high litigation risk. In the context of China, for instance, the level of demand for high quality audit services and litigation risk are not comparable with developed countries. The limited and mixed evidence currently existing has highlighted that auditor switching and opinion shopping (Baskerville & Hay, 2006) and the effect of audit market structure on auditor switching are rarely examined (e.g., Beattie & Fearnley, 1998). The current study will thus address this limitation by investigating the effects of increased auditor switching that occurs following an increase in competition in an unfavourable audit market, on opinion shopping, in the context of Iran.

4. Audit Market Share, Auditor Switching and Audit Fees in Iran

Given the fact that most of the evidence regarding the circumstances within the Iranian audit market is merely anecdotal, data were hence collected in order to determine whether the existing anecdotal evidence can be used as a reliable basis for the analysis of the Iranian audit market. The data include auditor type (private and state), auditor change, audit opinions, and audit fees which were extracted from the annual reports of firms listed on the TSE between 1999 and 2010. These annual reports are available on the website of the Research, Development, and Islamic Studies (RDIS)7 of the SEO and the CD-ROM database of annual reports which are also produced by the RDIS. The period between 1999 and 2010 was chosen because audit privatisation had occurred in the late 2001. In addition, a large number of annual reports prior to 2001 is "incomplete and had pages removed" (Bagherpour et al., 2008, p.11). Nonetheless, in an effort to perform a descriptive analysis, a comparison approach highlighting the period before and after audit privatisation was applied hence, data for the period prior to 2001 were collected.[11] These data cover approximately one-third of the listed firms in Iran

[11] The years 1999, 2000 and 2001 are categorised as years before audit privatisation.

between 1999 and 2000. The final sample of data includes 2,717 firm-year observations between 1999 and 2010. The sample selection process is presented in Table 3.

Table 3: Sample Selection

Sample selection process	Total sample
Initial observations for the period following audit privatisation (2002 to 2010)	3,178
Less: Observations with insufficient audit report information	89
Less: Firms delisted	151
Less: Financial institutions	279
Less: Observations with missing value on financial information or other control variables to be adopted in the present study	384
Subtotal: Observation with available data from 2002 to 2010	2,275
Plus: Observations with available data for the period before audit privatisation (1999 to 2001)	442
Number of observations in final analysis	2,717

Table 4 provides descriptive information of audit market share of private and state auditors, the number of Trustee Audit Firms accepted by the SEO to perform audit on listed firms, audit opinion qualification by private auditors, auditor switching and audit fees. It shows that the market share of private auditors had increased from 35 per cent in 2001 to 82 per cent in 2010 and this is based on the number of clients. This increase can be attributed to the occurrence of auditor switching from state auditors (IAO) to private auditors during the period. Table 4 also shows an increase in the number of Trustee Audit Firms following audit privatisation. Although the market share of private auditors had increased continuously following audit privatisation (from 38 per cent in 1999 to 82 per cent in 2010), the number of private auditors that had increased is more than the increase in the market share of the private auditors (42 Trustee Audit Firms in 2002 to 92 in 2010). Prior to audit privatisation, only a small number (less than 30) of private auditors who were members of the IICA, were allowed to provide audit services for private firms. Following the establishment of the IACPA in late 2001, such private firms became members of the IACPA. The table indicates that auditor switching increases following privatisation (from almost 1 per cent in 2000 to 14 per cent on average between 2002 and 2010), that audit fees of private auditors (on average 0.1219) are lower than state auditors (on average 0.1665), and that the audit market share of private audit firms in the Iranian audit market increases over time.

Consistent with the evidence provided by Bagherpour et al. (2008), Shockley (1981) and Beattie and Fearnley (1998), this study finds that auditor switching increased dramatically following audit privatisation in Iran. Table 4 shows that during the initial years following audit privatisation, auditor switching principally involved switching from state auditors to private auditors. However, after 2005, auditor switching mainly involved switching from one private auditor to another private auditor.

Additionally, Table 4 shows that the issuance of modified audit opinions (MAOs) by private auditors had decreased (100 per cent in 1999 to 66 per cent in 2010) following audit privatisation. The high ratio of MAOs is consistent with prior studies done in the Iranian context (e.g., Anvarkhatibi, Safashur, & Mohammadi, 2012; Banimahd, Noorifard, & Davoudabadi, 2013) which is substantially larger than the findings of prior studies done of other countries. For example, Chen, Chen, and Su (2001, p. 12) provide evidence to show that only 10.96 per cent of listed firms in China had received MAOs between 1995 and 1997. In the Iranian context, however, there are five reasons for auditors to make audit opinion qualification in 2010 namely: (i) insufficient reserve for income tax; (ii) failure to receive a response to 'confirmation letters'; (iii) incorrect measurement of cost of goods sold; (iv) insufficient reserve for doubtful debts; and (v) non-realisation of expenses. These five reasons make up more than 65 per cent of the auditor's remarks for audit report qualification (Pourbahrami & Nameni, 2012). It is important to note that as mentioned in section 2.1 above, the auditing standards in Iran are based primarily upon International Auditing and Assurance Standards Board (IAASB) standards (Roudaki, 2008).

Table 4 reveals that the ratio of audit fees to total assets is lower among private auditors as compared to state auditors and the difference appears to be significant. Such findings are consistent with the arguments forwarded by some Iranian practitioners (e.g., Bozorg Asl, 2010; Amani & Davani, 2010; Deilamipour, 2012). For instance, Bozorg Asl (2010) notes that private auditors charge low audit fees due to high competition existing among themselves.

Table 4: Audit Market Share, Auditor Switching and Audit Fees by Auditors for the Respective Year in Iran

Audit market share						Auditor switch				Percentage of	Audit fees*	
Year	N	*Audst*	*Audpvt*	Per cent of *Audpvt*	Number of Trustee Audit Firms	N	From *Audst to Audpvt*	From *Audpvt to Audpvt*	From *Audpvt* to *Audst*	Modified audit opinions for Audpvt	*Audst*	*Audpvt*
1999	90	55	35	38.89		0	0	0	0	100.00	0.1542	0.1168
2000	99	61	38	38.38		8	2	5	1	100.00	0.1265	0.1164
2001	253	163	90	35.57		1	0	1	0	98.86	0.1419	0.1123
2002	262	136	126	48.09	42	34	30	4	0	91.06	0.1477	0.1168
2003	264	95	169	64.02	55	52	43	9	0	82.53	0.1471	0.1071
2004	267	75	193	72.28	69	41	22	19	0	78.01	0.1744	0.1093
2005	266	67	199	74.81	70	22	6	16	0	76.01	0.1732	0.1134
2006	268	61	206	76.87	72	40	7	33	0	72.68	0.1652	0.1454
2007	265	60	206	77.74	73	38	5	32	1	70.44	0.1824	0.1333
2008	234	51	183	78.21	77	33	0	30	3	71.35	0.1728	0.1258
2009	231	45	186	80.52	86	37	6	31	0	65.38	0.1982	0.1314
2010	218	39	179	82.13	92	25	4	19	2	66.54	0.2141	0.1358

Note: Audst = state auditor; Audpvt = private auditor; * The audit fees for client *i* divided by total assets of client *i* in year *t* ((audit fees/total assets)* 10000).

5. The Consequences of Increased Competition in an Unfavourable Audit Market

It is worthy to note that quality differentiation is not a strategy that is applied by private auditors in Iran to overcome competitive pressure. Shaked and Sutton (1982) show that quality differentiation can relax price competition. When the quality of products is almost the same, "price competition between the increasingly similar products" decreases the profit of sellers (p. 12). Quality-based price discrimination exists because there is heterogeneity among consumers who demand for quality. In other words, competing firms that differentiate their goods or services are likely to set prices higher than marginal costs without fear of losing their market share (Shaked & Sutton, 1982). However, in Iran, it can be argued that private auditors are less likely to use quality-based price discrimination as a strategy because there is a weak demand for high quality audit services.

5.1 The Joint Effects of Audit Market Structure on Audit Fees and Audit Quality

Based on the traditional perspective of regulators and courts, competition in any sphere is seen to create a decrease in prices whilst increasing quality at the same time (Federal Trade Commission, 2003). However, based on an economic perspective, the effects of increased competition on price and quality should be investigated in light of the relative elasticity of price and quality (Dranove & Satterthwaite, 1992; Kranton, 2003). Doa, Raghunandan, and Rama (2012) postulate that "if price and quality are jointly determined, then the effect of increased competition on price and quality is not clear-cut" (p. 152). Such theoretical evidence highlights that the effects of increased competition should be analysed in relation to price and quality because "price and quality are jointly determined" (Kranton, 2003).

In light of the theoretical findings of Dranove and Satterthwaite (1992) and Kranton (2003), this study analyses the possible joint effects of increased competition in an unfavourable audit market on audit fees and audit quality. First, according to Francis (2004), Big N audit firms, being high quality auditors, charge premium fees. This is consistent with the assumption that high quality auditors charge high audit fees and low quality auditors charge low audit fees.

The joint effects of increased competition in audit market on audit fees and audit quality seem to be relatively simple in an unfavourable audit market. Increased competition in an unfavourable audit market, where there is neither sufficient demand for high quality audit services nor high litigation risks, is more likely to result in price competition rather than quality competition. In fact, in such an audit market, auditors mainly focus on reducing their fees to attract clients (see, Li & Wu, 2004; Chen et al., 2007).[12] On the other side of the audit market, given that the quality of audit services is seemingly unimportant for clients, increased competition can result in a situation where clients can easily switch from high fees and high quality auditor to low fees and low quality auditor. In other words, following increased competition, high fees and high quality auditors gradually lose their market share because clients have the option to choose from low fees and low quality auditors to fulfil the same job. Hence, the high fees and high quality auditors

[12] Price competition among auditors has been investigated in prior studies examining China. DeFond, Wong, and Li (2000) argue that firms in China that are required by law to undergo statutory audits do not demand for high quality audit services. In the emerging market of China, competition is primarily focused on fees, instead of quality or specialisation (Li & Wu, 2004). Chen et al. (2007) provide evidence that premium fees for Big N audit firms in China are only in the less competitive supplementary market, but not in the competitive statutory market. The authors demonstrate that Big N audit firms principally compete on the basis of audit fees with local audit firms in the Chinese statutory audit market, where no sufficient demand exists for high quality audit services and the audit market is competitive.

that exist in such an audit market would engage in price competition to the extent of decreasing their professional fees which could result in compromising the audit quality. Only strong litigation risk can deter auditors from such opportunistic behaviour and price competition (see, Simunic & Stein, 1996; Craswell & Francis, 1999). Therefore, increased competition in an audit market that is characterised by a weak demand for high quality audit services and low litigation risk is more likely to result in low audit fees and low audit quality.

Consistent with the above argument, increased competition in the unfavourable audit market of Iran is more likely to result in unfavourable outcomes. Following increased competition as a result of audit privatisation in late 2001, clients can easily switch (see, Table 4) from auditors with high audit fees to auditors with low audit fees, irrespective of audit quality. In such a scenario, auditors, especially new entrants, would engage in audit fees competition thereby, decreasing their audit fees in order to attract clients. It is argued that low audit fees (fee pressure) results in premature sign-off or performance of insufficient audit tests (Killough & Ho, 1985; Cook & Kelley, 1988; Raghunathan, 1991), and acceptance of doubtful audit evidence and greater risks (Margheim & Kelley, 1992).

5.2 Audit Market Competition and Auditor Switching

5.2.1 Audit Fee Discounting and Auditor Switching

It would appear that clients would have more choices following increased competition in the audit market and this allows them to easily switch from an incumbent auditor who had imposed high fees on their services to a successor auditor who charges lower audit fees. Many tend to switch without much consideration for the audit quality because this audit quality is not an important factor in their decision of selecting an auditor. Other factors such as the transaction costs of the client and the choosing costs of the client are more likely to affect client's decisions to switch auditors (Chaney et al., 2003).

Client's costs include the repetition of start-up costs that is related to the training of a new auditor and invitation costs to entrant auditors to offer their services especially, in an audit market that bans direct uninvited solicitation. In such a scenario, the decision of the client to invite auditors to offer their services and to switch from the incumbent auditor seems to be a little difficult. If the client's evaluation of audit costs shows that the client can reduce costs by switching, the client is more likely to invite auditors to offer their services (Chaney et al., 2003). It is also important to note that when a client does not have a demand for high quality audit services, the client is less likely to spend significant resources in training new auditors in an effort to lower transaction costs. In such a scenario, a client will switch its auditor when the audit fees of the entrant auditor plus the transaction costs of the client and choosing costs of the client over *t* period (an expected period by the client) are lower than the audit fees of the incumbent auditor over *t* period. Hence, the fees charged by the entrant auditor must be significantly lower than the fees of the incumbent auditor so as to encourage the client to switch its auditor.

As discussed in preceding sections, the IAO, as the state audit firm, dominated about three-fourths of the Iranian audit market prior to audit privatisation in late 2001. Following audit privatisation, a large number of private audit firms have since been established. Obviously, in such a scenario, private audit firms desire to enter the audit market and to maximise their market share. To achieve this objective, private audit firms which noticed the lack of demand for high quality audit services are more likely to engage in a price competition game with the IAO. In fact, private audit firms know that to attract clients in such an audit market, they must offer services for fees lower than the IAO (see Table 4).

5.2.2 Opinion Shopping and Auditor Switching

Beams and Killough (1970) suggest that increased competition has a negative effect on auditor's independence because auditors are aware that if they do not accept the audit work, many other auditors will accept the engagement. In other words, following increased competition, clients have more options while auditors are more concerned with retaining clients. As a result, auditors are more likely to perceive that opportunity costs are significantly low in a competitive audit market because the loss of a client is less likely to equate with the engagement of a new client.

Similar to the aim of avoiding the loss of clients, the aim of deterring clients from switching due to the significant 'start-up costs' with new clients that are incurred by the auditor particularly, when long-term engagements are not expected by the auditor, can also motivate the auditor to behave opportunistically in an unfavourable competitive audit market. According to DeAngelo (1981), "when audit technology is characterised by significant client specific start-up costs, incumbent auditors possess cost advantages of potential competitors in future audits of given client" (pp. 187-188). Following increased competition, auditors know that the likelihood of auditor switching is high (Chaney et al., 2003). As a result, if an auditor is dropped by one client and is engaged by a new client, the auditor will typically bear significant start-up costs. Additionally, the auditor knows that no long-term horizon of engagement with a client exists to cover the significant start-up costs of the new client. Consequently, the auditor perceives that deterring auditor switching among existing clients is the best way to avoid the significant start-up costs with new clients. In such a scenario, auditors may issue favourable audit reports for clients in an effort to retain existing clients.

Bagherpour et al. (2008) investigate factors affecting auditor switching in Iran following audit privatisation. Their findings reveal that these factors include increased competition, changes in CEOs, auditor-client alignment, qualified audit reports, and earnings management. They thus suggest that clients with qualified audit opinions are more likely to switch from the state auditors (IAO) to private auditors. Such findings may signal instances of opportunistic auditor switching following increased competition in the Iranian context.

In light of the above discussion which highlights the efforts of auditors deterring clients from auditor switching in an unfavourable competitive audit market, private auditors, as successor auditors, are more likely to perceive that opportunity costs are low in the intensely competitive Iranian audit market. The loss of a client is less likely to lead to an engagement of a new client due to client shortfalls. Due to the pressure exerted by such an environment, private auditors, as successor auditors, are more likely to cope with client shortfalls by behaving opportunistically in an effort to retain clients. Additionally, the potential for auditors to behave opportunistically, in their effort to prevent auditor switching and from bearing significant start-up costs with new clients, is more likely to be generalisable to the unfavourable competitive audit market of Iran.

6. Conclusion

While competition has dramatically increased in the Iranian audit market following audit privatisation in late 2001, there is still a lack of sufficient evidence highlighting the consequences of the phenomenon. This study addresses that gap by examining certain possible consequences of increased competition in the unfavourable audit market of Iran which leads to insufficient demand for high quality audit services and low litigation risks. This study finds that increased competition in the unfavourable audit market of Iran is more likely to result in price competition (decreasing audit fees) instead of quality competition (audit quality improvement). In particular, private audit firms, as entrant auditors, offer low audit fees in an effort to enter an audit market that is dominated by the state audit firm in order to maximise their market share. Private auditors view such an approach as the best way to attract clients who desire to incur minimum costs in complying with the legal requirements for external auditing (Hovansian Far, 2010a). Low audit fees, as a consequence of increased competition, are more likely to result in low audit effort such as premature sign-off which, in turn, is more likely to lead to low audit quality.

Further, this study finds that clients are more likely to switch their auditors due to the availability of more options following increased competition in the Iranian audit market. This is done in their effort to achieve opportunistic objectives including fee discounting and opinion shopping. In such an unfavourable competitive audit market, private audit firms that are faced with client shortfalls attempt to deter clients from auditor switching activities by behaving opportunistically such as issuing favourable audit reports for clients.

This study provides significant suggestions to both policymakers and researchers at the national and international levels. The findings suggest that increased competition in an unfavourable audit market is more likely to result in unfavourable consequences. Consequently, policymakers in audit markets that are characterised by a lack of demand for high quality audit services and lack of litigation risk should be cautious in making decisions that may further increase competition in the audit markets. In Iran, the IACPA and the SEO must increase their monitoring of audit firms so as to deter audit firms from possible opportunistic behaviours. Further, removing the monopoly of the IAO over the auditing of state owned enterprises can mitigate the problem of client shortfalls for private audit firms.

When a market fails to maintain an equilibrium between supply and demand, policymakers must enter the market. Since low audit fees in the Iranian audit market are attributed (e.g., Bozorg Asl, 2010) to increased competition and negative effects on audit quality, policymakers should establish a proper mechanism to determine a minimum rate for audit fees. Further, given that competition in the Iranian audit market has increased continuously over the years following audit privatisation, the IACPA must be cautious when consenting to the establishment of new audit firms.

In addition, both the IACPA and the SEO should encourage audit firms to merge in order to form medium and large audit firms. The SEO should not only monitor listed firms that frequently switch their auditors, but should also insist that the listed firms disclose, in their annual reports, the reasons for auditor switching. Further, the Iranian Parliament should approve the modern code of corporate governance and impose pressure on the state to accelerate the privatisation of state owned enterprises in order for it to shift to a capital market with a dispersed shareholders structure. This can improve the demand for high quality audit services, which is one of the fundamental problems currently faced by Iran.

While the present study is subjected to the common limitations faced by similar studies, certain significant caveats are worth noting. The present study is descriptive in nature. It employs prior research and collect descriptive data to examine the consequences of increased competition in the Iranian audit market. Hence, as suggested above, the consequences of increased competition in the Iranian audit market should also be empirically investigated. Due to the lack of sufficient evidence showing audit privatisation, relevant literature from Iran which are published in Persian was utilised in the present study. The findings of the present study can be generalised for countries with almost similar institutional environment but not otherwise.

The present study also opens a rich avenue for future studies in this area. Given that there is mixed evidence to show the effect of audit market concentration on audit fees and audit quality, meta-analysis research is suggested for the purpose of achieving a clear standpoint regarding these issues. For instance, researchers can analyse the mixed findings of prior studies looking at the impact of audit market concentration on audit fees and audit quality based on different institutional factors. The lack of sufficient evidence showing the impact of audit market structure, competition and concentration on auditor switching is obvious. Thus, this situation calls for further analysis to investigate the consequences of increased auditor switching following increased competition in an audit market. Given that there is virtually no empirical evidence to show the effects of audit market structure on audit report lag (ARL), researchers should examine the issue to fill the current gap in the literature. In regards to the fact that audit market structure has a wide range of potential consequences, this domain continues to be a rich research domain.

Researchers may conduct empirical studies showing the effects of increased competition in the Iranian audit market following audit privatisation on audit fees, audit quality, auditor switching and ARL. Researchers can examine whether or not differences exist between the audit fees of the state audit firm and private audit firms. Given that there is lack of litigation risk (as highlighted in the present study), researchers can also investigate whether or not audit risk is included by auditors in determining audit fees. Researchers can study the influence of low audit fees on the experience and quality levels of audit teams. Additionally, the relationship between audit fees and audit quality in the Iranian audit market can be further explored. The lack of sufficient evidence showing the audit quality of two types of auditors in Iran, private auditors and state auditors, is also evident, thus a necessity for future exploration.

Since the Iranian audit market is intensely competitive, especially for private audit firms, and there is a lack of demand for high quality audit services, researchers can investigate whether some private audit firms have market power or quality differentiated in the unfavorable audit market of Iran. Researchers can also investigate the aims of auditor switching after audit privatisation. For instance the aims of auditor switching may include fee discounting, shorter ARL and opinion shopping. Researchers can also examine the perceptions of audit partners in relation to clients with short-term horizon of engagement. For instance, studies can examine the pressure placed on audit teams by firm partners to decrease audit hours or to reduce the number of reports on breaches during the last year of engagement before auditor switching. In light of the lack of demand for high quality audit services and low litigation risk, the role of the personality of partners of private audit firms can be examined in relation to audit quality. Studies can also examine if ARL decreases following audit privatisation and, if so, whether the decreased ARL is driven by a decrease in audit workload or audit effort. Researchers can also examine the relationship between ARL and audit quality following increased competition. Finally, the relationship between ARL and audit fees following increased competition in the Iranian audit markets can also be investigated.

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