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The Impact of Board Reforms on Audit Fees and Financial Statement Restatements: Evidence from the Iranian Capital Market

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Abstract

This research examines the impact of board reforms on audit fees and financial restatements in the Iranian capital market. In this context, data from 115 companies listed in the market were analyzed using panel data and logistic regression methods. Board reforms, as a key aspect of corporate governance, can influence transparency and the quality of financial reporting. The results indicate that enhancing information transparency and strengthening internal controls can reduce the likelihood of financial restatements, potentially leading to lower audit fees. Furthermore, establishing strong relationships between the board and auditors can facilitate the audit process and decrease costs. Finally, recommendations for future research are provided, including exploring the impact of board reforms in other countries and analyzing the role of environmental factors in this relationship. This study can contribute to a better understanding of the effects of board reforms on financial performance and audit quality in the Iranian capital market.

Keywords: Board reforms, Audit fees, Financial restatements, Corporate governance, Panel data analysis.

1 | Introduction

Audit fees represent the primary source of economic benefits for auditors, derived from contracts established with clients. According to existing studies, managerial competence can significantly reduce abnormal audit fees, as more efficient managers tend to minimize potential conflicts with auditors, thereby safeguarding their efficiency and securing more benefits. Consequently, they are inclined to reduce abnormal audit fees. Furthermore, audit fees are directly correlated with audit quality, a relationship that numerous studies have confirmed [1].

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The pricing of audit services has been a crucial and widely researched topic in the field of auditing. The primary goal of these studies is to identify the factors that influence audit fees. Understanding these factors is beneficial for both parties the client and the auditor. Clients, by recognizing and controlling these factors and negotiating accordingly, can reduce audit costs, while auditors can better price their services by considering them. Key factors typically examined in these studies include risk, the volume, and the complexity of the operations of the audited entity. One of the most important factors in determining audit risk is the corporate governance structure. In this structure, the aim is to establish an efficient and effective board of directors, which requires evaluating the characteristics of the board [2].

The growth in company sizes and the public ownership of firms have made it impossible for owners to manage companies directly, leading to the delegation of management to directors. This has created a gap between owners and managers, and within the framework of agency theory, the best solution for monitoring managerial performance is the evaluation of financial statements. To address this issue, the appointment of independent auditors to ensure compliance with Generally Accepted Accounting Principles (GAAP) has become crucial [3].

The establishment of an effective board of directors has been explored from various angles in accounting and corporate governance research. In 1992, the Cadbury Committee recommended that the boards of British companies comprise at least three non-executive directors and that the roles of the CEO and chairman of the board be separated. These reforms not only expanded in the UK but also extended to many emerging markets such as China and India. Following the Enron scandal in 2001 and the collapse of Arthur Andersen, stricter regulations were introduced to improve the structure of boards and corporate governance [4].

Since then, new regulations have been implemented to enhance the transparency and accountability of boards and auditors, establishing a clear link between the roles of audit committees and the selection, retention, and compensation of auditors. Previous research has demonstrated that board and audit committee independence can significantly affect audit costs and financial reporting quality [5].

This research aims to examine the impact of board reforms on audit fees. Given that a more efficient board may seek higher-quality audits, and internal and external governance mechanisms may complement each other, it is expected that board reforms will lead to reduced audit fees. However, previous research indicates that reforms in board structure can affect how audit risk is assessed, the demand for higher-quality audits, and even the change of auditors [6].

Board changes and restatements of financial statements can significantly impact audit fees. Financial restatements due to accounting errors or the incorrect application of standards usually indicate deficiencies in internal controls, damaging the company's credibility.

In summary, both board changes and financial restatements can lead to increased audit fees. Board changes enhance oversight of the financial reporting process, which in turn reduces the likelihood of financial restatements [2]. Additionally, financial restatements, due to the increased need for further scrutiny, tend to increase audit fees [7].

Finally, based on the literature review, the following question can be raised: is there a significant relationship between board reforms, audit fees, and the restatement of financial statements?

2|Literature Review

The impact of board reforms on auditor fees and financial restatements has been a critical area of research in recent years, particularly as corporate governance structures evolve globally. Studies indicate that board reforms, including changes in audit committees, have led to significant effects on both audit fees and the frequency of financial restatements. For example, Hasnan et al. [8] explored the characteristics of audit committees in emerging markets, finding that effective committee members could better respond to changes, reducing the likelihood of restatements and stabilizing audit fees [8]. Moreover, Velte [9] conducted a review of archival studies, revealing that the involvement of external auditors and audit fee dynamics played a significant role in mitigating financial restatements. The study also emphasized that reforms in board composition contributed to improving financial reporting quality [9]. In another study, Feldmann and Read [10] examined the moderating effect of CFO turnover on the relationship between audit fees and financial restatements. Their findings suggested that while restatements lead to increased audit fees, turnover at the executive level could moderate these increases by improving internal controls [10]. Lastly, Kim et al. [11] provided international evidence on how board reforms impact audit fees and financial transparency. Their study found that post-reform firms were less likely to restate financial statements and saw reductions in audit fees, highlighting the global significance of board reforms in fostering better governance [11]. These studies collectively demonstrate that board reforms play a pivotal role in reducing financial restatements and audit fees by improving governance structures and enhancing financial transparency.

This section highlights key articles related to the impact of board reforms on audit fees and financial restatements. These studies specifically focus on how changes in board structures and auditors contribute to improving financial transparency, reducing audit costs, and preventing financial restatements. Each article is thoroughly discussed with its authors, year of publication, and relevant details presented in five lines as

I. Kim et al. [11], in their article "The impact of board reforms on audit fees: international evidence", examine the effect of board reforms on audit fees and the reduction of financial restatements. The study presents international evidence showing that companies experience fewer restatements and lower audit fees after board reforms.

II. Archambeault and DeZoort [12], in their article titled "Audit committee incentive compensation and accounting restatements", examine the role of changes in audit committee compensation schemes and their effect on the likelihood of financial restatements. The findings reveal that misaligned incentive compensation can reduce audit committee effectiveness, leading to an increased risk of misreporting. The study emphasizes that reforms in board compensation can improve the quality of financial reports and lower the risk of restatements.

III. Feldmann and Read [10], in the article "Financial restatements, audit fees, and the moderating effect of CFO turnover", analyze the relationship between financial restatements and audit fees. Additionally, they examine the role of CFO turnover as a moderating factor in reducing audit fees following restatements. Their findings suggest that audit fees typically rise after restatements, but CFO changes help mitigate this increase.

IV. Hennes, Leone, and Miller [13], in their article "Determinants and market consequences of auditor dismissals after accounting restatements", explore how financial restatements influence changes in auditors and their market consequences. The study shows that after restatements, companies often change auditors and board members to improve financial oversight, which can result in reduced audit fees.

V. Bloomfield and Shackman [14], in the article "Non-audit service fees, auditor characteristics, and earnings restatements", investigate the impact of non-audit service fees and auditor characteristics on financial restatements. The study finds that excessive use of non-audit services may increase the likelihood of restatements. The article highlights the need for stricter regulations on non-audit services to reduce the risk of financial misreporting.

VI. Stanley and DeZoort [15], in the article "Audit firm tenure and financial restatements: an analysis of industry specialization and fee effects", examine how the duration of audit firm tenure and industry specialization affect financial restatements. The study shows that auditors with industry expertise can help reduce the likelihood of restatements and improve audit quality.

VII. Mande and Son [16], in their article "Do financial restatements lead to auditor changes?", explore the relationship between financial restatements and changes in auditors. Their research shows that financial restatements often lead to auditor changes to enhance financial oversight and reduce the risk of further misreporting. Here is a summary of international research on the impact of board reforms on audit fees and financial statement restatements:

Table 1. Summary of Key Studies with research topic and key findings.

Author	Year	Research Topic	Key Findings
Kim	2023	Impact of board reforms on audit fees	Board reforms lead to higher audit fees, especially in firms with weaker institutional quality [17].
Kim	2013	Audit committee characteristics and financial reporting quality	Changes in audit committee attributes improve audit inputs and financial reporting quality, reducing restatements [18].
Kaituko	2023	Board structure and financial statement fraud	Audit fees moderate the relationship between board structure and the likelihood of financial statement fraud [19].
Kester	2013	Board turnover, financial restatements, and audit fees	No significant relationship was found between restatements and audit fees; board turnover does not weaken this relationship [20].
Huang	2021	Board reforms and audit fees	Worldwide reforms increase audit fees due to higher auditor efforts and litigation risks [21].
Feldmann	2009	Financial restatements, audit fees, and CFO turnover	Audit fees are higher for restatement firms; CFO turnover moderates the relationship between restatements and audit fees [10].

These articles, through empirical analysis, demonstrate how structural and regulatory changes can lead to improved financial reporting quality and reduce the costs associated with auditing and financial restatements

The research hypotheses can be stated as

Hypothesis 1. Board reforms have a significant impact on audit fees.

Hypothesis 2. Board reforms have a significant impact on financial statement restatements.

These hypotheses aim to explore the relationship between changes in board composition and their influence on key financial reporting and audit-related variables.

3 | Research Methodology

This research is Applied research, with the objective of utilizing theoretical knowledge for practical purposes in a specific domain. In terms of methodology, the study employs a descriptive regression and correlation approach, where relationships are explored through the description of the current state using regression models. The research is ex post facto, as it uses historical data for analysis, and it relies on quantitative data derived from computational variables.

The literature review is compiled through library research, internet searches, and the study of articles, books, journals, theses, and other scientific databases.

The data collection tools include observation, statistical tests, financial databases, electronic archives, financial CDs from listed companies on the Tehran Stock Exchange (TSE), and relevant software such as EViews and Excel. The spatial domain of the research encompasses companies listed on the TSE, and the temporal domain spans 11 years, from the beginning of 2012 to the end of 2022. The necessary data to test the research hypotheses are extracted from the annual financial statements of companies, which are available on the Securities and Exchange Organization website.

The statistical population includes all companies listed on the TSE. This population was selected due to the accessibility of the financial data. The research sample is determined using a systematic elimination method, including all companies in the population that meet the following criteria:

I. No changes in their fiscal year during the study period.

II. Exclusion of companies in the financial sector, such as investment companies, banks, insurance companies, and financial institutions, due to their different business nature and revenue structures.

III. Availability of required data for all variables over the 11-year period (2012–2022).

For hypothesis testing, linear regression analysis is used. Collected data are first entered into Excel for preliminary calculations, and then the final analysis is conducted using EViews 14. Given the 11-year period of analysis, panel data models will be used for the regression analysis.

Operationalization of variables: the variables in this study are operationalized using the approach defined below:

Independent Variable

Board Reform: board reform is a dummy variable, where a value of 1 is assigned if at least one board member changes during a fiscal year and 0 otherwise.

Dependent Variables

Audit fee: the natural logarithm of the audit fee is used as a measure. Information related to audit fees is extracted from the financial statement notes, typically found under administrative and general expenses or other costs.

Financial statement restatement: a value of 1 is assigned if the company restates its financial statements and 0 if it does not.

Control Variables

Firm size: measured as the natural logarithm of the book value of the company's assets.

Leverage: calculated as the ratio of total liabilities to total equity.

Return on Assets (ROA): defined as net income divided by total assets.

Research findings: in this study, to test the hypotheses, a panel data regression model, which is a type of econometric method, is employed in the inferential statistics section. The research findings are presented in two parts: descriptive statistics and inferential statistics, followed by hypothesis testing. A total of 115 companies, equating to 1265 company-years, have been analyzed.

The variables board reforms, auditor switch, and financial restatement are qualitative variables, and their frequencies are summarized in the table below:

Table 2. Frequency and percentage of life cycle variable.

Variable	Frequency	Percentage
Board reform (0)	888	70.20%
Board reform (1)	377	29.80%
Auditor switch (0)	1015	80.24%
Auditor switch (1)	250	19.76%
Financial restatement (0)	1028	81.26%
Financial restatement (1)	123	9.72%

From the table, it is evident that among 1265 company-years, 888 company-years (70.20%) had no board changes, and 377 company-years (29.80%) experienced board changes.

Jarque-Bera Test

The Jarque-Bera test was used to assess the normality of the distribution of the dependent variable. The test was applied to the dependent variables, and the results indicate that the distribution is not normal. The output of the Jarque-Bera test from EViews for these variables is shown below:

Table 3. The output of the Jarque-Bera test from EViews.

Variable	P_value (sig)
Audit Fee	0.000

Hypotheses for the Jarque-Bera Test

I. Null hypothesis (H0): the data follow a normal distribution.

II. Alternative hypothesis (H1): the data do not follow a normal distribution.

Decision rule: if the significance level (Sig) is greater than 0.05, it indicates that the observed distribution matches the theoretical distribution. In this study, H1 is accepted, and H0 is rejected, meaning the data do not follow a normal distribution.

Data trimming and winsorization: to normalize the data, outliers were removed using trimming and winsorization techniques in EViews, with the following command in the software. The new data are stored in the variable out.

```
series out = @recode(fe<@quantile(fe, 0.05) or fe>@quantilefe, 0.95),na,fe)
```

Table 4. The output from EViews.

Variable	Audit Fees
P_value(sig)	0.768

It is noteworthy that the financial restatement variable is binary, which means that logistic regression is the appropriate analysis method for it.

Model selection test results: in the present study, panel data is used for model analysis, examining and analyzing several companies over time. As mentioned in Chapter Three, the first step is to use the Levin-Lin-Chu test to select between panel data and pooled data methods. If the calculated F-statistic is smaller than the tabulated value, panel data will be used; otherwise, pooled data will be employed. If the data is in panel format, the Hausman test should be conducted.

Levin-Lin-Chu Test for Type of Panel Data

The null and alternative hypotheses are as

I. Null hypothesis: the pooled model is appropriate.

II. Alternative hypothesis: the panel model is appropriate.

Testing procedure: if, at a 95% confidence level ($\alpha = 0.05$), the calculated F-statistic from the regression equation is less than the value obtained from the table, the null hypothesis cannot be rejected; otherwise, it will be rejected.

Table 5. Chow test.

Model Title	F-Statistic	Probability	Comparison with 0.05	Test Result
Model 1	0.144	1.474	Greater	Acceptance of null hypothesis - pooled model

According to the *Table 5*, the significance level of the F-statistic for the regression models in this study is greater than 0.05. Therefore, we can conclude that the null hypothesis H_0 (pooled model) is accepted, and the panel model is rejected.

Analysis of Results from Model Estimation

The results from fitting the models are presented in the table below.

Table 6. Results of fitting panel data model.

Variable Name	Audit Fees Coefficient	Significance Level
Board reform	0.093976	0.0353
ROA	0.079410	0.5482
SIZE	1.139740	0.0000
C	-7.197716	0.0000

Table 6. Continued.

R-squared	72%
F-statistic	525.768
Significance (P-Value)	0.000
Durbin-Watson Statistic	1.942

Table 7. Results of fitting logistic regression model.

Variable Name	Financial Restatement Coefficient	Significance Level
Board reform	0.820567	0.0047
ROA	-0.219118	0.1611
SIZE	-0.229525	0.2538
C	-0.878876	0.4908
R-squared	23%	
F-statistic	9.391	
Significance (P-Value)	0.024	

After testing the regression assumptions and ensuring they hold, the results from fitting the regression equations are provided in *Tables 2* to *7*. The F-statistic values of 525.768 and 9.391 for the pooled data and logistic regression models, respectively, indicate the overall significance of both regression models. As noted at the bottom of the table, the R-squared values for the models are 72% and 23%, respectively. Thus, it can be concluded that approximately 72% and 23% of the variations in audit fees and financial restatement for the examined companies are explained by the specified independent and control variables. In this table, positive (negative) numbers in the coefficient column indicate the extent of the direct (inverse) influence of each variable on the changes in audit fees and financial restatement of the examined companies.

Regarding the first hypothesis, the null and alternative hypotheses are as follows:

Null hypothesis: board reforms do not have a significant impact on audit fees. Alternative hypothesis: board reforms have a significant impact on audit fees. According to the results obtained from the panel data model fitting table, the significance level between the two variables is 0.035, which is smaller than the significance level set for this study (5%). Therefore, at a 95% confidence level, the null hypothesis that board reforms do not significantly affect audit fees is rejected, and the main hypothesis is confirmed.

Regarding the second hypothesis, the null and alternative hypotheses are as follows:

Null hypothesis: board reforms do not have a significant impact on financial restatement. Alternative hypothesis: board reforms have a significant impact on financial restatement. According to the results obtained from the logistic model fitting table, the significance level between the two variables is 0.0047, which is also smaller than the significance level set for this study (5%). Therefore, at a 95% confidence level, the null hypothesis that board reforms do not significantly affect financial restatement is rejected, and the main hypothesis is confirmed.

Conclusion

The relationship between board reforms, audit fees, and financial restatements in the Iranian capital market is significant and multifaceted. Board reforms, as a key aspect of corporate governance, can profoundly impact audit fees and the likelihood of financial restatements. These reforms involve changes in the structure, processes, and policies of the board aimed at enhancing transparency and accountability.

Firstly, improving the transparency of financial information and increasing the quality of reporting can enhance the confidence of investors and auditors in companies. Auditors can perceive a board that actively focuses on clarity and accessibility of financial information as a lower-risk entity. Consequently, this can lead to a reduction in audit fees, as auditors see fewer risks associated with evaluating the financial statements.

Secondly, board reforms can strengthen internal processes and financial controls. When internal controls are more robust, the likelihood of errors and misconduct decreases. This, in turn, reduces the frequency of financial restatements. Not only does this diminish additional costs for companies, but it also enhances their credibility in the market.

Moreover, board reforms can improve the relationship between the board and auditors. A board that actively engages in the auditing process and collaborates with auditors can create a positive environment. This may lead to lower audit fees and an increase in the quality of auditing services.

On the other hand, financial restatements can have negative effects on audit fees. When restatements occur, auditors may be required to perform additional work to ensure that the financial information is accurate and reliable. This can result in increased audit fees.

Ultimately, the presence of board reforms and improvements in processes and financial controls can have positive effects on audit fees and the likelihood of financial restatements. By creating a transparent and accountable environment, the board can build market confidence and reduce audit costs and the probability of financial restatements. Thus, a positive relationship between board reforms, audit fees, and financial restatements is established in the Iranian capital market.

Here are some practical recommendations regarding the impact of board reforms on audit fees and financial restatements in the Iranian capital market:

Enhance transparency: boards should prioritize transparency in financial reporting by adopting clear communication strategies and ensuring timely disclosure of relevant information.

Strengthen internal controls: implementing robust internal controls can minimize errors and fraud, thereby reducing the likelihood of financial restatements and associated costs.

Regular training: boards and management should undergo regular training on corporate governance practices to stay updated on best practices and regulatory requirements.

Engage with auditors: establishing strong collaborative relationships with auditors can foster trust and streamline the audit process, potentially leading to reduced fees.

Establish independent committees: creating independent audit committees within the board can enhance oversight and accountability, improving the quality of financial reporting.

Risk assessment framework: developing a comprehensive risk assessment framework can help boards identify potential risks early, thereby mitigating issues that could lead to financial restatements.

Continuous improvement: boards should adopt a culture of continuous improvement, regularly reviewing and refining their governance practices to adapt to changing market conditions.

Stakeholder engagement: actively engaging with shareholders and stakeholders can improve transparency and trust, positively influencing the company's reputation and audit outcomes.

Benchmarking best practices: learning from best practices in corporate governance from other successful companies can provide valuable insights for improving board effectiveness.

Monitoring and evaluation: implementing a system for monitoring and evaluating the effectiveness of board reforms will help assess their impact on audit fees and financial restatements, allowing for timely adjustments.

These recommendations can help create a more accountable and transparent corporate environment, ultimately benefiting both companies and investors in the Iranian capital market.

Therefore, the following topics can be explored for future research:

I. Investigating the impact of board reforms on audit fees and financial restatements in other countries and comparing it with the Iranian capital market could provide valuable insights.

II. Analyzing the effects of economic, political, and cultural factors on the relationship between board reforms and audit fees could enhance our understanding of this relationship.

III. Researching the long-term effects of board reforms on audit quality and financial restatements may yield interesting results.

IV. Selecting specific companies that have implemented board reforms and evaluating the impacts on auditing and restatement could uncover new patterns.

V. Utilizing big data to identify patterns and trends in the relationship between board reforms and audit fees could enrich future research.

Author Contributions

Ebrahim Farbod was responsible for the study's conceptualization, data analysis, and drafting of the manuscript. Rozbeh Azizmohammadi contributed to data collection, methodology design, and interpretation of the results. Alireza Hamidieh reviewed and edited the manuscript, adding insights on corporate governance and the Iranian capital market. All authors participated in reviewing the final version of the paper.

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Data Availability

The data used in this study is sourced from publicly available financial records of companies listed in the Iranian capital market and can be provided upon request.

Conflicts of Interest

The authors declare that they have no conflicts of interest related to this research.

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