

Research on the Impact of Entity's “Non-Professional Business” on Audit Quality

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Abstract

Driven by the excess return rate, the entity financial trends are becoming more and more intense, which the entity enterprise carrying out financial and real estate business are often advertised as “work outside”. In order to explore whether entity's “Non-professional Business” can influence the audit quality or not, this paper takes A shares in the two stock markets of Shanghai and Shenzhen between 2007 and 2016 as a sample to find out their relationship. Entity's “Non-professional Business” can be divided into direct and indirect entry way. Direct entry way means the entity carries out related financial and real estate businesses independently, while indirect entry means the entity buys existing financial assets through the secondary market and other channels. The results show that the direct entry of enterprises into the financial and real estate business will reduce the audit quality. And enterprises in the way of indirect entry into the financial and real estate business will improve the quality of the audit.

Keywords

Entity's Non-Professional Business, Direct Entry, Indirect Entry, Audit Quality

1. Introduction

Driven by the excess return rate, the entity financial trends are getting more and more intense since the beginning of 2005. This phenomenon is often billed as “work outside”. People have different opinions about the phenomenon. Some scholars believe that it will play a role in promoting the business of real enterprises. For example, Sean (1999) thinks that Entity's “Non-professional Business” can more effectively improve the utilization of idle funds and broaden the investment channels [1]; and there are also some scholars who believe that the job will have

inhibitory effect on the business. For example, Chen and Ma (2011) think that the work will produce a crowding out effect, causing the “economic hollowing” [2].

Entity’s “Non-professional Business” can be divided into direct and indirect entry way. Direct entry way means the entity carries out related financial and real estate businesses independently, while indirect entry means the entity buys existing financial assets through the two secondary market and other channels. These two ways are to make the business situation more complicated. The quality of audit has been greatly influenced by the practice environment. Therefore, Entity’s “Non-professional Business” has to bring a great challenge to the auditor’s work. Therefore, this article will take A shares in the two stock markets of Shanghai and Shenzhen between 2007 and 2016 as a sample to find out whether Entity’s “Non-professional Business” will affect audit quality.

2. Literature Review and Theoretical Analysis

Heand Zhang (2006) believed that the audit quality was greatly influenced by the practice environment [3]. Since Entity’s “Non-professional Business” is getting more and more popular, the auditor is under a more complicated environment which will bring grate challenges to them. In the case of the more complicated environment, the quality of audit will be affected to a certain extent.

Audit quality refers to the good and bad degree of the audit process and its results. DeAngelo (1981) believes that the audit quality can be expressed as the joint probability of the auditor’s discovery of the defaulting of the audited unit [4]. Audit quality is the joint product of auditor’s professional competence, practice ethics and auditor independence. Palmrose (1986) believes that audit quality is the extent to which the auditor is responsible for the truthful and reliable financial statements [5]. The Chinese scholar Xu (2002) believes that the audit quality can be expressed as the validity of the audit results to achieve the audit goal [6]. Therefore, the quality of audit is closely related to the personal attributes of the auditor, which is largely dependent on the auditor’s professional competence and independence. The increasingly complex practice environment that auditors are facing will require higher levels of professional competence for auditors.

Entity’s “Non-professional Business” has accelerated the process of financialization, which will change the business scope and profit mode of enterprises and make the environment more complex. Entity’s “Non-professional Business” can be divided into direct and indirect entry way. In a direct way, entities can expand their business scope through their own related financial and real estate businesses, which is essentially an unrelated diversification. Under such a type, the business operation mode of enterprises will be more diversified, which will make the auditor face the more complex and risky practice environment. There will be a higher requirement for the auditor’s professional competence. The auditor’s professional competence includes two parts, knowledge and experience, which requires a period of learning and accumulation. Therefore, this paper argues that entities directly involved in “Non-professional Business”, will reduce the audit

quality. Therefore, this article puts the first hypothesis:

H1: entities directly involved in “Non-professional Business”, will reduce the audit quality.

Entities indirectly involved in “Non-professional Business” means the entity buy existing financial assets through the secondary market and other channels. The purpose of buying those financial assets is to sell them when they add value. In this way, the business scope and type has not changed. But entities indirectly involved in “Non-professional Business” leads to “economic hollowing”, which will have a negative impact on the development of real estate enterprise. At the same time, the financial assets and real estate are greatly affected by the market risk, and the allocation of their transition resources will greatly strengthen the business risk of the enterprises. Therefore, business entities indirectly involved in “Non-professional Business” will cause the auditor to business pay more attention to the entity, which will make auditor work more carefully and hard. Therefore, this article puts the second hypothesis:

H2: entities indirectly involved in “Non-professional Business”, will improve the audit quality.

3. Study Design

3.1. Dependent Variable

At present, the domestic and foreign scholars' opinions on the selection of the substitute variables of audit quality are relatively consistent. In the empirical study, the main indicators are audit fees, non-standard audit opinions and earnings quality. Scholars have obtained some important research results through the above alternative variables. When using audit cost as an alternative variable, Palmrose (1986) finds that larger accounting firms are paying more audit time when they charge higher audit fees [5]. Chen and Zhou (2006) found that the audit fees would be reduced if the accounting firms were changed to small ones, indicating that the reason why the enterprises were hired before was that they could provide higher quality audit services [7]. When adopting non-standard audit opinion as an alternative variable, Liu and Mai (2006) found that the audit opinion was not significantly correlated with the top four accounting firms [8]. Shen and Ding (2011) found that when the largest shareholder held a relatively low share, the audit fees and audit quality were significantly positively related to the statistical level. On the contrary, audit fees and audit quality were significantly negatively related to the statistical level [9]. When using earnings quality as an alternative variable, Cai (2005) found that the manipulative accruals of non-dual audit companies were significantly higher than those of dual audit companies [10]. Chen and Lin (2011) found that there was no difference in the ability to identify earnings management attributes between the top four accounting firms and others [10].

In this paper, earnings quality is used as an alternative variable of audit quality, and the accruals profit separation method is used. The modified Jones model

is used to derive manipulative accruals as an alternative to earnings management. The concrete derivation process is as follows:

The model parameters of each industry, a_1 , a_2 and a_3 , are estimated according to the following formula according to the following formula.

$$\frac{AC_t}{ASSET_{t-1}} = a_1 \frac{1}{ASSET_{t-1}} + a_2 \frac{\Delta REV_t}{ASSET_{t-1}} + a_3 \frac{PPE_t}{ASSET_{t-1}} \quad (1)$$

The AC_t expressed as t total accruals according to the end of year $t - 1$; The ΔREV_t expressed the change in sales revenue in the year t relative to the sales revenue of $t - 1$; The PPE_t expressed the change in the total fixed assets value in the year t relative to the value of year $t - 1$; The ΔREC_t expressed the change in net accounts receivable in the year t relative to the value of year $t - 1$. Then the non-manipulative accruals (NDA) is calculated by formula (2)

$$NDA_t = a_1 \frac{1}{ASSET_{t-1}} + a_2 \frac{\Delta REV_t - \Delta REC_t}{ASSET_{t-1}} + a_3 \frac{PPE_t}{ASSET_{t-1}} \quad (2)$$

Finally, the company's manipulative accruals (DA) is calculated according to the formula (3).

$$DA_t = AC_t - NDA_t \quad (3)$$

3.2. Independent Variable (Entity's "Non-Professional Business" Degree)

When entity's carry out "Non-professional Business" in direct way, we use the proportion of the income generated by the financial and real estate business accounts for the proportion of its main business income as an alternative variable, which is defined as DI; When entity's carry out "Non-professional Business" in indirect way, we use the ratio, financial assets and real estate assets accounted for the proportion of total assets, as an alternative variable, which is defined as SI.

3.3. Control Variable

The control variables used in this paper include the logarithm of the total assets, the debt ratio, the rate of return on common stockholders' equity, the total assets turnover, the year and the industry.

3.4. Sample Selection

This paper takes the listed companies of Shanghai and Shenzhen A shares for 2007-2016 years as the research object. The following parts are excluded from the sample selection; 1) according to the industry classification of the SFC, the listed companies in the financial industry and the real estate industry are excluded; 2) the samples with missing data are excluded. In order to avoid the impact of extreme values on the results, this paper carries out 1% Winsorize truncation processes for all continuous variables.

3.5. Model Design

In order to test the hypothesis 1, this article establishes the following model

$$DA_t = b_0 + b_1 DI_t + b_2 LTA + b_3 LEV + b_4 ROE + b_5 AT + \text{Industry} + \text{year} \quad (4)$$

In order to test the hypothesis 2, this article establishes the following model

$$DA_t = C_0 + C_1 DI_t + C_2 LTA + C_3 LEV + C_4 ROE + C_5 AT + \text{Industry} + \text{year} \quad (5)$$

The LTA expressed as entity's assets scale, which uses the natural logarithm of total assets at the end of the year; The LEV expressed as debt ratio; The ROE expressed as the rate of return on common stockholders' equity; the AT expressed as the enterprise's total asset turnover ratio; Industry and year respectively for the industry dummy variables and year dummy variables.

4. Empirical Results and Analysis

By putting the sample data into the SPSS, we get the regression results, as shown in the following **Table 1**.

From the results, when the enterprise in a direct way to carry out his "Non-professional Business", the P value is 0.014, significant at the significance level of 5%. What's more, the correlation coefficient is 0.019, which means the degree of enterprise "Non-professional Business" and audit quality is positively relative, which indicated that the entities directly involved in "Non-professional Business" will reduce the audit quality. This is because corporate diversification requires higher auditors' professional competency. Auditors' professional competency needs a period of learning to meet increasingly complex practice environment, which leads to the decline of audit quality.

From the results, when the enterprise in an indirect way to carry out his "Non-professional Business", the P value is 0.021, significant at the significance level of 5%. What's more, the correlation coefficient is -0.18, which means the degree of enterprise "Non-professional Business" and audit quality is negative relative. Which indicated that the entities directly involved in "Non-professional Business" will improve the audit quality. This is because the indirect entry of enterprises does not have a substantial impact on the way of operation of enterprises, but this way can lead to the phenomenon of economic hollowing in real

Table 1. Regression results for Hypothesis 1 and Hypothesis 2.

Independent variable	Directly enter way			Indirectly enter way		
	coefficient	T value	P value	coefficient	T value	P value
DI	0.019	2.447	0.014			
SI				-0.18	-2.309	0.021
Control variable						
LTA	-0.064	-7.378	0.000	-0.065	-7.477	0.000
LEV	0.001	0.062	0.950	0.002	0.238	0.812
ROE	0.003	0.338	0.736	0.003	0.345	0.730
AT	0.07	8.544	0.000	0.066	8.070	0.000

industries. Finance and real estate investment in the real economy investment crowding out effect will further increase the market risk, which caused the auditor's attention and alert to the risks, so that the auditors adopt more stringent close procedures, so as to improve the audit quality.

5. Conclusion

Through the above analysis, this paper found that the way entities involved in "Non-professional Business" will lead to different results. The enterprise in direct way to carry out his "Non-professional Business" is labeled as a kind of diversified behavior. This behavior requires the higher auditor's professional competence, which leads to lower quality audit results. But when the enterprise is in an indirect way job involvement, the auditor will think it would cause economic hollowing results and reduce industrial investment. Therefore, auditors will strengthen audit procedures to achieve higher audit quality.

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