

THE EFFECT OF SPIRITUAL AND HUMAN CAPITAL ON INDEPENDENT
AUDITOR'S OPINION AMONG IRANIAN AUDITORS

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DEDICATION

This work is dedicated to my parents Mari and Mehdi who provided unconditional love and taught me how to soar on eagle's wings, to my lovely wife Hosna and to my siblings SeyedReza Naslmosavi, Seyedeh Hoda and Syedeh Fatemeh for their love, support and encouragement.

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ABSTRACT

An independent auditor's opinion would enhance the confidence of investors in a reporting system and lead to increased capital markets' efficiency. The influential factors on quality based on an auditor's opinion in financial statements are highly regarded because these factors will ensure that the statements are reliable, useful and relevant to investors and creditors. However, there are effective factors concerning independent auditors that need to be investigated. Correspondingly, the aim of this research was to investigate the effect of spiritual capital (SpC) and human capital (HC) as components of intellectual capital (IC) on independent auditor's opinion (IAO). By exploring moral development, ethical climate and human capital theories, a comprehensive investigation of moral, ethical climate, culture and personal values which represent SpC (individual and organizational aspects), work experience, education, employee competence and skills that characterize HC was carried out. In addition, the mediating effect of human capital on the relationship between audit firms size and IAO was also studied. Quantitative data were collected from questionnaires distributed to 321 practicing audit managers and partners in Iranian audit firms. Multiple regressions with the aid of SPSS were employed to measure the effect of combined SpC and HC on IAO. Besides that, the path analysis method in structural equation model by utilizing LISREL was engaged to measure the relationship among HC (mediator variable), audit firm size and IAO. The results show that SpC and HC have significant effects on IAO. Following that, HC has a mediating effect on the relationship between audit firm size and IAO. Based on the results, this study proposed the moral development and ethical climate theory as appropriate theories to support the SpC as a component of IC. Besides that, the findings have strengthened the understanding of human capital theory through the explanation of the effect of HC on IAO. Overall, the study has highlighted the importance of SpC and HC and it is recommended that auditing standard setting authorities must pave the way for more attention to be given to these capitals in peer reviews.

ABSTRAK

Pendapat juruaudit bebas akan meningkatkan keyakinan pelabur dalam sistem laporan dan membawa kepada peningkatan kecekapan pasaran modal. Faktor yang mempengaruhi kualiti berdasarkan pendapat juruaudit dalam penyata kewangan adalah sangat signifikan kerana faktor tersebut dianggap akan memastikan bahawa penyata yang dikeluarkan boleh dipercayai, berguna dan relevan kepada pelabur dan pemiutang. Walau bagaimanapun terdapat faktor yang berkesan yang berkaitan dengan juruaudit bebas yang perlu diselidiki dalam hal ini. Sehubungan dengan itu, tujuan kajian ini ialah untuk mengkaji kesan modal spiritual (SpC) dan modal insan (HC) sebagai komponen modal intelek (IC) terhadap pendapat juruaudit bebas (IAO). Melalui penelurusan pembangunan moral, teori iklim etika dan teori modal insan, kajian penyelidikan komprehensif tentang moral, iklim etika, budaya dan nilai peribadi yang mewakili SpC (individu dan aspek organisasi), dan pengalaman kerja, pendidikan, kompetensi dan kemahiran pekerja yang bercirikan modal insan telah dilakukan. Selain itu, kajian ini juga menyelidiki kesan perantara modal insan ke atas hubungan antara saiz firma audit dengan IAO. Data kuantitatif dikumpul daripada soal selidik yang diedarkan kepada 321 orang pengamal pengurusan audit dan rakan kongsi mereka dalam firma audit di Iran. Regresi berbilang dengan bantuan SPSS telah digunakan untuk mengukur kesan gabungan SpC dengan HC terhadap IAO. Di samping itu, kaedah analisis laluan dalam model persamaan struktur menggunakan LISREL telah digunakan untuk mengukur hubungan antara HC (perantara boleh ubah), saiz firma audit dengan IAO. Hasil analisis menunjukkan bahawa SpC dan HC mempunyai kesan signifikan terhadap IAO. Selanjutnya, HC mempunyai kesan perantara kepada hubungan antara saiz firma audit dengan IAO. Berdasarkan hasil analisis kajian ini mencadangkan pembangunan moral dan teori iklim etika sebagai teori yang sesuai untuk menyokong SpC sebagai komponen IC. Selain itu, hasil kajian ini memperkukuh pemahaman teori modal insan melalui penjelasan kesan HC terhadap IAO. Secara keseluruhannya, kajian ini telah menonjolkan kepentingan SpC dan HC dan mencadangkan supaya penguasa penetapan standard pengauditan membuka jalan dengan memberikan lebih perhatian kepada modal ini dalam komen rakan sejawat.

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LIST OF ABBREVIATIONS

AAA	-	American Accounting Association
ASB	-	Auditing Standards Board
AudSEC's	-	Auditing Standards Executive Committee
CDP	-	Continuing Professional Development
CICA	-	Canadian Institution of Chartered Accountant
CMD	-	Cognitive Moral Development
CPAQ	-	CPA's Characteristic Questionnaire
CPE	-	Continuing Professional Education
CWS	-	Cognitive Work Space
DIT	-	Defining Issues Test
ECQ	-	Ethical Climate Questionnaire
FRC	-	Financial Reporting Council
GAAS	-	Generally Accepted Auditing Standards
HC	-	Human Capital
IC		Intellectual Capital
ISQC1	-	International Standards on Quality Controls 1
IACPA	-	Iranian Association of Certified Public Accountants
IAS	-	International Accounting Standards
IBM	-	International Business Machines
IES	-	International Education Standards
IFAC	-	International Federation of Accountants
OCB	-	Organizational Citizenship Behaviors
PCAOB	-	Public Company Accounting Oversight Board
POB	-	Public Oversight Board (POB)
QRP	-	Quasi-Peer Review

RC	-	Relational Capital
RVS	-	Rokeach Value Survey
SAS	-	Statement on Audit Standards
SC	-	Structural Capital
SOX	-	Sarbanes-Oxley Act
SpC	-	Spiritual Capital
SpCi	-	Spiritual Capital (individual view)
SpCo	-	Spiritual Capital (organizational view)
SEM	-	Structural Equation Modelling
VIF	-	Variance Inflation Factor

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CHAPTER 1

INTRODUCTION

1.1 Introduction

Increase in the number of financial statement users was the driving factor behind the creation of auditing. Corporate scandals like Enron debacle and Arthur Andersen's collapse confirmed a requirement for high quality audit and considerable attention towards different factors that may have effect on opinions of independent auditors. High quality of auditor's opinion refers to the production of financial information without misstatements, omissions or biases (DeAngelo, 1981). In the agency theory perspective, Dang (2004) argues that audited financial statements are a monitoring mechanism to provide assurance for users of financial information. Gray and Manson (2005) agree with Dang (2004) and Flint (1988) when they stated that the role of an auditor is to monitor and secure accountability. Hasasyeganeh (2006) and Banimahd (2011) stated that Iranian shareholders' financial decisions are based on Iranian auditors' opinion. The auditing fee as a monitoring expense is acceptable in the financial statements. The authors also mentioned that the auditing fee is a part of agency cost.

The role of independent auditor has been investigated within a variety of perspectives in the literature like: independence, ethics, judgments and reduced audit quality (Windsor and Ashkanasy 1995, Cheng *et al.* 2009). In order to perform independent role of auditors with high quality, auditor's individual characteristics, audit firm climate and auditee environment such as ethics, values, culture, firm ethical climate, client pressure play instrumental roles for an auditor's decision making abilities (Gray and Manson, 2005; Karacaer *et al.*, 2009). Warming-Rasmussen and Windsor (2003) noted that managers of public companies play an important role for future generation through their influence on economy and social environment, making it critical for the auditors to go beyond investigation of manager's behavior in order to safeguard the public interests. For instance, Culp and Trussel (2005) commented on Enron's bankruptcy in 2001 and concluded that this bankruptcy was the result of an audit firm's involvement with Enron's leadership to hide delinquencies. Enron's auditors made unethical decisions that crushed Enron shareholders and other beneficiaries (Culp and Trussel, 2005). Unethical auditor behavior in the Enron scandal put a severe dent on the reputation on many auditing firms (Dewing and Russell, 2004; Carcello *et al.*, 2005).

After the bankruptcy of Enron and WorldCom, in 2002 the United States federal law, 2002 established Sarbanes-Oxley Act for the Public Company Accounting Oversight Board (PCAOB). PCAOB has the task of observing the quality control mechanisms of each firm, assess the value of audit jobs on particular audits and evaluate, either through peers or using processes to audit quality and policies (SAG, 2004). The PCAOB also focused on evaluating individual training programs, the assignment of responsibility, the professional competency of partners, compliance with independent standards, and assessing policies for client satisfaction. These actions on the part of the PCAOB show that human resource also has an important role to play in audit quality (SAG, 2004).

In addition to the perspective mentioned for investigation of related factors to auditor's opinion, this study accordingly recognized factors pertaining to Iranian auditors' opinion and their judgments because independent auditors' opinions affect

users' decisions. As the scholars in auditing area believed that auditors and their abilities in public accounting firms are a major part of their assets (Pennings *et al.*, 1998; Rezaee 2002; Cheng *et al.*, 2009), this study considered these assets as components of intellectual capital (IC). These components of IC can affect auditors' judgment behaviour and their companies' survival under Spiritual Capital (SpC) and Human Capital (HC). SpC in this study relates to moral reasoning, ethics, personal values, culture and ethical climate while HC relates to experience, skill, education and culture. This study finally tested a combined effect of SpC and HC under new terms of intangible assets on independent auditor's opinion.

1.2 Research Background

Auditors are responsible for balancing the various stakeholders' interest by ensuring realistic dissemination of company's financial information in the public interest (International Federation of Accountants, 2005). Fair judgment is one of the important obligations of auditors to protect public interest (Warming-Rasmussen and Windsor 2003), the current study identified influential factors within components of intellectual capital (IC). Iranian audit standards described that attention to code of ethics, independency, accountability and technical trainings are property of Iranian auditors (IACPA, 2013) and they have to follow all professional standards to give fair opinion. In this perspective, the ability of auditors to overcome ethical dilemma conditions is most essential capital for audit firms. Spiritual capital and human capital dimensions were found in literature to be the most related capitals and embedded factors among all the IC components of independent auditor's opinion since they are directly related to human (Sweeney and Roberts, 1997; Windsor and Ashkanasy, 1995; Haniffa and Hudaib, 2007). Spiritual capital includes moral reasoning, ethics, culture, personal values, ethical climate and ethical culture while factors like education, training, work experience, skills are related to human capital.

Literature on accounting and auditing discusses the relationship of the components of spiritual and human capital and auditor's independence, but presents different findings. For instance, Windsor and Ashkanasy (1995) examined the effect of moral reasoning development on auditor's independence in Australia and New Zealand. The result of their study revealed that there is a positive relation between these two variables. Likewise, Sweeney and Roberts (1997) reported that the level of cognitive moral reasoning affects auditor's independent behavior, and the auditor's consideration of client's issues is influenced by moral atmosphere of an audit firm. Ponemon (1990) examined the effect of moral reasoning development on auditor decision-making and reported the alike three levels mentioned in Kohlberg theory. However, Cushing (1990) believed that moral development is separated and needs to be used in more comprehensive models on decision-making. He also proposed that Ponemon (1990) model could be extended by including the effect of economic variables (audit fees) in a materiality judgment situation.

Lampe (1992), on the other hand, examined the code of conduct on the auditors' ethical decision and reported that this code is not sufficient to be regarded as a motivation for auditors to follow ethical behavior. Correspondingly, Ponemon (1988, 1990, 1992, and 1995) and Ponemon and Glazer (1990) tested the effect of cognitive moral reasoning theory on an ethical perspective of auditor's judgment procedures. Ponemon and Glazer (1990) tested the effect of cognitive moral reasoning on an ethical perspective of auditor's judgment procedures. In general, Ponemon and Glazer presented that domain-experience and ethical culture in the firm along with ethical reasoning are related to ethical behavior. Whereas, in conjunction to ethical conduct, Satava (2006) believed that the foundation of financial accounting and auditing is based on the rule-based traditions.

American Institute of Certified Public Accountants (AICPA) on code of professional conduct (2003) defines the concept of a principle-based approach. It describes how the rule-based traditions of auditing translate to a suitable tool for persisting on unethical conduct. AICPA proposed 10 ethical dimensions of rule and principle-based ethical conduct for auditors and accountants. Haniffa and Hudaib

(2007) in their study revealed that code of ethical conduct and auditing standards could reduce the “expectation gap” in auditor’s opinion, which is the difference between auditor’s performance and the expectation of financial statements users.

Similarly, Falk (1999) investigated the effect of self-interest behavior and ethics on auditor’s independence. The result of his empirical study indicates that (i) the probability of client’s loss leads to the development of unqualified reports; and (ii) the level of moral reasoning does affect independent judgment.

In addition to moral reasoning and ethical behavior, some researchers examined the effect of culture on auditor’s independence. The variable exemplified by Tsui (1996) revealed that multi-national public accounting firms should consider the effect of culture on auditor’s behavior as it affects employees. The author reported that ethical behavior is an important element of auditor response in conflict situations.

Parallel to the above, auditing scholar’s findings revealed that personal values are related to auditors’ independence. For instance; Baker (1976) investigated the differences of values amid accounting and non-accounting major through Rokeach Value Survey (RVS) measuring tool. The author reported a significant difference among accounting student’s values and non-accounting student’s values. Wright *et al.* (1997) similarly examined the importance of values for auditors. They revealed that the value system and auditor’s ability for recognizing ethical issues are important in the success of accounting profession. Moreover, Karacaer *et al.* (2009) examined the effect of personal values on auditor’s ethical decisions and found that value affects ethical judgment.

Discussions in the literature demonstrates that ethical conduct, moral and culture are embedded in the heart of a company (Ander, 1995; Brooking, 1996; Ashmos and Duchon, 2000). Thus, new IC model suggested by Ismail (2005)

explains that the firm should pay attention to this intangible capital (Intellectual Capital). New IC model presented that all capitals in spiritual capital are devoted to both individuals and organization. Individual and organizational factors are two types of factors that influence ethical conduct in an organization and have become an area of investigation among the accounting and finance authors (Trevino *et al.*, 1998). Researchers like Trevino (1986), Ferrell *et al.* (1989) and Leo *et al.* (2000) also assert that moral reasoning and personal values as a part of individual characteristics and some terms such as rewards and rules in the company are as a subdivision as organizational factors influence the ethical conduct.

The significance of organizational and social characteristics are linked to the practical perspective, as managers control the work environment, thus their enhanced ability should go beyond the mere moral and value individual factors (Northouse, 2010; Trevino *et al.*, 1998). Moreover, ethics in organization has two dimensions; the first dimension as referred by Victor and Cullen (1987) is related to ethical climate. It determines what members believe is right or wrong and shape their ethical decision-making and behavior. The Second dimension as referred by Trevino (1990) is concerned with ethical culture. The ethical culture of an organization comprises all those aspects and elements of an organization which influence the ethical conduct of its members (Kaptein, 2008).

In addition to individual and the organizational factors, this study employed the components of human capital (education, training, work experience, skills and employee competence) and measured its effects on independent auditor's opinion. Literature indicates the dearth of empirical studies using the dimension of human capital on independent auditor's opinion. Though, there have been a few studies on experience, skills, employee competence, training and educational effect on auditor's opinion (Bröcheler *et al.*, 2004). For instance, Morrise (1998) believed that the components of human capital are expected to play a key role in the description of success and failure of audit firms. Equally, Pennings *et al.* (1998) asserted that the firm survival chance increases with the experience of owners, founders and employees. While, Bröcheler *et al.* (2004) documented that higher levels of

experience during the lifetime of an audit firm, i.e., the aging of the firms' auditors, have a negative effect on firm performance though, experience at the stage of inception has a positive influence on audit firm's performance. The authors noted that higher level in education will increase the audit firm's performance at the time of inception as well as later stages.

However, Bonner's (1990) reported that prior studies have not considered the role of task-specific knowledge and established some problems that have significant correlation with experience such as the role of task-specific knowledge in cue selection and cue weighting in the analytical risk assessment and control risk assessment. Cue selection is included, as many psychology researchers agree that experience is important for superior performance in cue selection. Cue weighting is studied as there are mixed results and opinions in both psychology and accounting as to the importance of experience therein. The result of his study indicated that task-specific knowledge improves the auditor's performance in analytical risk assessment of both cue-selection and cue-weighting components only. Parallel to that, DeAngelo (1981) delineated that firm size as organizational characteristics which influence the auditor's opinion. The author noted that larger audit firms have high performance; therefore, auditors in larger firms are more independent than auditors in smaller firms. Further, Watts and Zimmerman (1986) argued that a larger firm provides good benefits to its auditors compared to smaller firms; hence, auditors in large firms have stronger incentive to maintain their independence.

Francis and Yu (2009) also tested the impact of the Big 4 firms on audit quality. The study was a comparison test of large firms and other small audit SEC registered organizations. The period of observation was from 2003 to 2005. They found that the big firms provided higher quality auditing. However; the findings also showed that there was a systemic difference between the performance results of small firms versus large firms.

Similarly, Sundgren and Svanström (2011) examined how audit quality and audit pricing varied between audit firms (big) and audit offices (small). The authors investigated the relationship between of audit quality and audit fees on audit firm size. They employed disciplinary sanctions as a measure of audit quality. The study investigated four large and four small firms. The result of the study showed that there was a negative association between the likelihood of sanction and the size of the audit office. The results showed that audit fees follow this pattern and indicates this that large audit firms attempt to maintain quality.

1.3 Statement of the Problem

Although, there are studies on the relationship between spiritual capital and the multifaceted level (organizational and individual levels) of development (Dent *et al.*, 2005; Middlebrooks and Noghiu, 2007), a little attention was paid to spiritual capital and independent auditors' opinion. In reaffirming its importance, Warming-Rasmussen and Windsor (2003, p.79) asserted that "the auditor's ability to provide a fair independent opinion is critical for good corporate governance and public". Therefore, this explains how to coordinate and integrate workplace spirituality to introduce and deploy required resources to curtail its consequences and enforce implementation. As the cost of strategy changes in the workplace, some potential disadvantages like inappropriate practice in spirituality will reduce the net income of organization in future (Polley *et al.*, 2005). Anecdotal evidence advocates that various control mechanism have been explored in literature but little investigation has been conducted on spirituality recognition in the work place (Polley *et al.*, 2005).

Similarly, study of reinforcement elements such as employee inner life, meaningful work and community are connected with spirituality in a workplace (Ashmos and Duchon, 2000). Adequate management of spiritual capital is beneficial to favourable ethical climate and potential future drawbacks (Polley *et al.*, 2005).

Spirituality should not be misused (Polley *et al.*, 2005) because it is a key to workers recognition of organizational intentions. Failure to adjust equitably to spiritual work environment exposes one to potential manipulative control (Brown, 2003). Moreover, managers of organizations have to hire practiced employees with high ability to understand and solve errors. In fact, the knowledge and abilities of employees are a part of human capital for all organizations especially audit firms. The ability of auditors to issue unbiased judgment and timely opinion on financial statements would improve the audit firm reputation and also audit firm performance.

Capital market interplay requires focused and careful psychiatry by the auditors; it is decisive on the account of the auditors to stay cautious like judges in the courts (Jenning *et al.*, 1991). Auditors' insight concerning the misstatement of financial statements based on their judgment must be independent; as the independent stature of the auditors enable them to proffer the true analysis of the financial happenings to the investors and the creditors by illustrating and reporting the fraudulent portfolio in the audited financial statements (Rezaee, 2002). This shows that valid and unbiased judgment traces back to ability of auditors to find errors and overcome ethical dilemma conditions.

On the other hand, livelihood of auditors relies on receiving auditing fee from clients (Ponemon and Gabhart, 1993; Eynon *et al.*, 1997). Although, Hasasyegane (2006) notes that the nature of independence is hidden in client–auditor's relation and auditors as a third party perceptions (Pany and Reckers, 1988; Bonner, 1990; Gul, 1991) should give their opinions based on moral reasoning and ethical behavior (Ponemon and Gabhart, 1994). The differences between the levels of expected presentation as predicted by independent accountants and users of financial statements create “expectation gap” (Jenning *et al.*, 1991; Haniffa and Hudaib, 2007). Hajizadeh (2009) documented that the Iranian auditors' opinion is one of the inflectional factors on Iranian investors to take a decision for trading stocks in the financial market. Hence, the auditors in Iran and also worldwide have to balance their opinions on financial statements based on the interest of some groups such as

clients, firm's management, lenders, creditors and the public (Johnstone *et al.*, 2001; Hajizadeh 2009).

Based on the above discussion, extant literature has identified and confirmed that Iranian auditors, like other auditors in the world, issue opinion on reliability of financial statements. However auditors' judgment is influenced by some factors. This study categorized these factors into four privileged issues in auditing area which described in below.

The first issue is the influence of psychological factors in spiritual capital on Iranian auditor's opinion such as the role of morality, ethics (Trevino and Youngblood, 1990; Ashkanasy *et al.*, 2006), culture and value as personal characteristics (Cowperthwaite, 2010). This study is therefore timely in addressing the impact of individual spiritual factors such as moral, ethics, culture and value on independent auditors' opinion. Alimadad (2010) also notes that Iranian auditors need the sum of the minimum standards of professional conduct and ethical standards that establish procedures for complaints and disciplinary action against any behavior that characterize conservative error. Adjibolosoo (2004, p. 24) construes that SpC "equips the individual to see beyond what the five senses are able to grasp and also furnishes him or her with deeper insights into the non-material world" (Adjibolosoo, 2004, p. 24). Thus, spiritually valued individuals emphasize more on work than personal success, money and power.

There is no specific study on psychological components of IC on Iranian independent auditor's opinion. However, scholars believed that they should explore moral reasoning, ethical behavior, culture and values as a cognitions and psychological aspects of independence (Bamber, 1993; Rest, 1994; Davani, 2009). Cowperthwaite (2010) noted that similar to the personal characteristics of the artists, individual character of the auditor can affect the auditor's judgment. Cowperthwaite (2010, p.180) stated that "The auditor's intelligence, education, approach to ethics,

and cultural values all come into play in conducting an audit engagement”. For instance, SAS (1972) in its statement mentions that “the profession has established, through the AICPA’s Code of Professional Conduct, precept to guard against the presumption of loss of independence”. It is implied that all members of profession should rely on code of ethical conduct as a psychological and practical standards like those used by the Canadian Institute of Chartered Accountants (CICA) and the American Institute of Certified Public (AICPA) (Shaub *et al.*, 1993; Falk *et al.*, 1999).

Additionally, today the atmosphere of workplace has changed. Some issues, such as race, gender and multiculturalism are in the foreground of many decisions, and there is a need to establish an organizational culture that is skilled in interpersonal process (Andre, 1995; Shore *et at.*, 2009; Chen *et al.*, 2012). Accordingly, moral reasoning, ethics, culture and values are the important factors, which can be viewed as the subdivision of IC because it consists of some intangible assets in the company. Hence, it seems that IC investigation of employee psychological effects is potential area of discussion. IC is divided into Spiritual capital (SpC) (Ismail, 2005), Human capital (HC) (Brooking, 1996; Stewart,1997; Edvinsson and Malone, 1997) Structural Capital (SC) (Roos *et al.*, 1997; Sullivan, 1998) and Relational Capital (RC) (Haanes and Lovendahl, 1997; Edvinsson and Malone, 1997; Saint Onge, 2002). Compelling evidences have revealed a significant expectation gap between social values and expectations of society at large and profession with respect to expected auditing standards (Zaid, 1997; Salehi *et al.*, 2009; Ebimobowei and Kereotu, 2011).

Prior studies have amplified the role of psychological aspects of auditor’s opinion, articulation was made on the need to critically re-examine the new model of IC developed by Ismail (2005). This examination and possibly a mix of all theories (Moral development theory and Ethical climate theory) can be used to measure the effect of SpC, which will contribute to the measurement of spiritual capital effects as a part of IC.

The second issue was the influence of firm's atmosphere on auditor's opinion in Iran. Most organizations are facing problems of dealing with emotions and ethics as they ignore the spiritual element in their organizational atmosphere (Tichy and Sherman, 1994). Alimadad (2009) believes that Iranian audit firms must have their own internal rules and they should pay attention toward the legitimate expectations of society. He also noted that if Iranian audit firms consider balancing ethical climate then the ethical dilemma will not affect auditors' functions. Similarly, this reaffirms the belief that audit firm's attributes and its moral atmosphere can affect auditors' independency in decision making (Sweeny and Roberts, 1997). Ponemon (1990; 1992) reported that the moral atmosphere and ethical climate in an audit firm have positive influence on auditor's consideration of client's issues. Other than that, litigation cost against auditors is a serious problem which requires on the part of the auditing firms to set some guidelines to foster ethical behavior in their firms. Ponemon (1992), Ashkanasy (1995), and Windsor (2009) strongly recommended ethical and moral training for auditors and accountants under the organizational atmosphere, as training is useful in coping with ethical dilemmas. This creates an issue to the auditors and firms at large, thus an investigation of the effect of organizational atmosphere as a dimension of spiritual capital on independent auditor's opinion is crucial. Therefore, it seems more appropriate to study intensely the influence of critical decisions on codes, ethics and professionalism, and its answers are significant to accountability of auditors (Collins *et al.*, 2007).

Parallel to the two prior issues, the third issue is the influence of the dimensions (education, training, work experience, skills and competence) of human capital (HC) on independent auditor's opinion. Iranian Association of Certified Public Accountants (IACPA) (2013) on Iranian audit standards states that auditor should all be consistent with their training and will always work hard to cope with their problems and give a full report to superiors. Carelessness, manipulation and secrecy are fundamentally wrong. Cheng *et al.* (2009, p. 523) believed that "following the high profile collapses of Enron and WorldCom together with the demise of Anderson, human capital has become a key driver of auditor's quality". In

accordance with Statement on Audit Standards (SAS), “the independent auditor’s formal education and professional experience complement one another”. Auditors’ ability has been construed by the leading accounting authors’ empirical findings to be the knowledge of accounting practices. Consistent with the perspective of these authors, this study recognized the effects of education, training, experience, skill and employee’s competence as a subdivision of HC on auditor’s opinion (Brooking, 1996; Ismail, 2005).

In addition, Bröcheler *et al.* (2004) indicated that the education and experience have an impact on efficiency, effectiveness and behavior of founders, owners, partners and employees. The positive influence of education level on career advancement is clear in the U.S environment and was empirically established (Alford and Strawser, 1990; Bhamornsiri and Guinn, 1991; Siegel *et al.*, 1992). Nevertheless, the effect of education as a part of HC in other places, such as Iran is unclear. Prior researches have examined the effects of specialty and experience on auditor tasks in auditing process (Libby and Ferderick, 1990), going-concern evaluations and audit planning (Christ, 1993). However, there is a lack of research on HC influencing independent auditor’s opinion; therefore the findings of this study fill the existing gap in the accounting literature.

Fourth issue in this study was concerned with the impact of human capital as a mediation role on audit firm size and independent auditor’s opinion. As human capital includes education, training, work experience and skills, it may increase the audit firms’ quality. In fact, the large audit firms attempt to hire high experienced auditors to enhance the quality and decrease the audit risk to find errors (Francis and Yu, 2009). DeAngelo (1981), Francis and Wilson (1988), DeFond (1992) and Francis and Yu (2009) revealed that the size of audit firm has a significant relationship with auditor quality. Hajizadeh (2009) also noted that auditor quality in Iran would be improved with high level of education, work experience and training. Small Iranian audit firms should find some ways to increase the abilities of their auditors to decrease cost of risk. Besides, Sweeney and Roberts (1997) and also Caramanis and Spathis (2006) advocated that the relationship between size of the

audit firm and independent auditor's opinion is unclear. Therefore, this ambiguity is required to elaborate the suitable alternative to solve this gap. On the basis of human capital definition and its dimensions and other scholars' work in auditing area, lastly this study suggested the mediation role of HC on the relationship between size of the audit firm and independent auditor's opinion.

Similar to the discussion in the problem statement, Iranian audit firms and their auditors faced the same problems. In addition, Iranian auditors' problems also are most important for Iranian audit standard setters to understand the weakness. The research questions of this study are related to Iranian audit firms. Then, this study revolved around the following research questions:

- I. What is the effect of spiritual capital (individual view) and its dimensions on independent auditor's opinion?
- II. What is the effect of spiritual capital (organizational view) and its dimensions on independent auditor's opinion?
- III. What is the effect of human capital and its dimensions on independent auditor's opinion?
- IV. What is the combined effect of spiritual capital and human capital on independent auditor's opinion?
- V. What is the effect of audit firm size on independent auditor's opinion?
- VI. Does human capital mediate the relationship between audit firm's size and independent auditor's opinion?
- VII. What is the effect of audit firm size on human capital?

1.4 Purpose of the Study

The purpose of this study was to investigate the effect of spiritual capital and human capital on independent auditor's opinion. This study aimed to comprehensively examine moral reasoning (pre conventional- conventional and post conventional levels), ethics, culture, value, experience, education, training, employee competence and skill under spiritual and human capital in the context of independent auditor's opinion. Moreover, human capital was utilized as a mediator to examine the relationship between audit firms size on independent auditor's opinion. This study also pursued to examine to the effect of human capital among different sizes of audit firms.

1.5 Objectives of the Study

Based on the problem statement and the questions of this study, the objectives of this research were:

- i. To examine the effect of spiritual capital (moral, ethics, culture and value) as an individual perspective of spiritual capital on independent auditor's opinion.
- ii. To examine the effect of organizational atmosphere as organizational perspective of spiritual capital on independent auditor's opinion.
- iii. To determine the effect of human capital (experience, education, employee competence and skills) on independent auditor's opinion.

- iv. To examine the combined effect of spiritual capital and human capital on independent auditor's opinion.
- v. To examine the effect of audit firm size on independent auditor's opinion.
- vi. To examine the mediator role of human capital on the relationship between audit firm size and independent auditor's opinion.
- vii. To determine the effect of audit firm size on human capital.

1.6 Significance of the Study

Auditing has become a method of assessing the business growth and success of a company (Public Oversight Board, 2000). Managers as users of the financial statement together with government should know about the factors that influence auditor's opinion and audit quality (DeAngelo, 1981; Liu, 1997; Cheng, *et al.*, 2009; Modarres and Rafiee, 2011). Unfortunately, auditing firms have lack of knowledge on the significance of IC and its effects on independent auditor's opinion; both among auditing firms and financial statements users. This study focused on psychological aspects of independent auditor's opinion by applying supporting theories like moral development theory, ethical climate theory and human capital theory under the new model of IC developed by Ismail (2005). This study has theoretical and practical significance.

Theoretically, this study explored the effect of spiritual capital of individual (SpCi) and spiritual capital of organization (SpCo) on audit managers and partners (independent auditors in audit firms) for audit firms to find the significance of ethical climate on their employees. Moreover contributing to the body of knowledge by applying spiritual capital as a new component of IC in auditing area, furthermore,

examining the human capital effects on independent auditor's opinion would improve the knowledge of audit firms to investment in human capital. This study also explained the mechanism for the financial statement users to improve their judgment on auditors' opinion.

Practically, the results of this study would increase the knowledge of audit firm's partners about the effect of spiritual capital and human capital on their employees. Further, Iranian Association of Certified Public Accountants (IACPA) is a new institution, and it needs some exploration in various areas to determine the strengths and weaknesses of the auditing profession and consequently, articulate the existing rules and policies to improve the weaknesses of the area. It is hoped that the findings of this study would be useful for Iranian government to frame the rules and policies to intensify the auditing practice in Iranian auditing firms.

Finally, this study has contributed to the knowledge in auditing by paving an avenue to understand the various factors that influence the auditor's opinion. The findings of the study may guide external auditors to understand their characteristics in ethical dilemma conditions. Indeed, they can be able to issue a clear opinion on financial statements.

1.7 Scope of the Study

This study was conducted in Iran and it was an empirical research which sought to evaluate the effects of two components of IC (SpC, HC) on independent auditor's opinion. The measurement tool was questionnaire and the respondents of the study included managers, partners and auditors who had the authority to sign audit report. These respondents were selected from Iranian private audit firms (members of IACPA) because this study released some questions on the base of

ethical dilemma which were related to auditor's benefits, while, the salary of Audit Organization's auditors as a governmental firm was from government and they were not concerned on their future incomes.

1.8 Definitions of Terms

The definition of intellectual capital, spiritual capital, human capital and different types of auditor's opinion are as follows;

1.8.1 Intellectual Capital (IC)

In the simplest terms, IC is the difference between market value and intangibles assets in a company and is composed of things such as customer loyalty, trademarks, professional skills, experience, goodwill, technology, process and other intangible resources (Roos *et al.* 1997, Bontis, 1998)

1.8.2 Spiritual Capital (SpC)

SpC is intangible knowledge, faith, belief and emotion embedded in the minds and hearts of individuals and in the heart of organization, which includes vision and direction, principles, values and culture. The individuals and in the heart of organization behave and act with honor, integrity, sincerity, honesty, trust, love,

moral and ethics (Ismail, 2005). Based on the literature review, the following dimensions of spiritual capital are related to auditors.

1.8.2.1 Moral Reasoning and Ethics

Morals are concerned with the principles of right and wrong behavior while “Ethics are basic philosophical conclusions about whether conduct and behavior is right or wrong” (Russell, 1999, p. 31). Universal values determine what is morally right or wrong, whereas set of rules of conduct which is created by a certain society determine what is ethical or unethical behavior (Haron *et al.*, 2006).

1.8.2.2 Culture

The definition presented by Hofstede for culture gives the idea that culture is a “collective mind programming which differentiates the associates of one social group from the other” (Hofstede, 1980, p. 10).

1.8.2.3 Personal Values

Values are a powerful force behind the behavioral responses of individuals (Rokeach, 1973). “Values are thought to be the minimally identified social

psychological notions that have been engaged effectively around all the social disciplines” (Rokeach, 1989, p.776).

1.8.2.4 Ethical Climate

Victor and Cullen (1988, p. 101) stated that “the prevalent views of typical business methods and practices that have moral content” or “those factors of working environment that define what constitutes moral conduct at work.” Denison (1996) believed that, climate as embedded in the organizational system of values and it denotes the organizational social structure.

1.8.2.5 Ethical Culture

Ethical culture is "a subset of organizational culture, representing a multidimensional interplay among various formal and informal systems of behavior control that are capable of promoting ethical or unethical behavior" (Trevino *et al.*, 1995, p. 12).

1.8.3 Human Capital (HC)

Human capital includes all individual characteristics such as experience, value, capacities, behavior and knowledge. In fact human capital is composed of

competence; economic based relationship with colleagues, customers and the value creation (Jelčić, 2007). Based on literature in auditing area, work experience, education, employee competence and skills are concerned with independent auditor's opinion.

1.8.4 Audit Firms Size

Size of audit firm can be categorized by the number of staff, the number of clients (Yuniarti, 2011) and the quasi-rent (DeAngelo, 1981; Watts and Zimmerman, 1981). In this study, the number of staff was applied for measuring size.

1.8.5 Independent Auditor's Opinion

AICPA (2006) in its revision on the reports of financial statements (SAS, 1989) explained that, whether an auditor should convey an opinion about the financial statements, or convey that the expression about the opinion cannot be made in the report by an auditor. If an auditor is unable to express an opinion, at least he is supposed to mention the reason in an auditor's report. In such cases, where auditor and financial statements are connected to each other, an auditor is supposed to clearly mention the character of the work done by an auditor. There are few types of independent auditors' opinion, which are mentioned below:

This study included scenarios in the questionnaire to allow auditors show their disagreement with the auditee company on unrecorded tax liabilities in the

financial statements. The aim of this part of questionnaire was to measure the independence of auditors in ethical dilemma conditions. The different types of independent auditor's opinion are described below:

1.8.5.1 Unqualified Opinion

AICPA (2006, Au.508) discussed that "An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles".

1.8.5.2 Qualified Opinion

"A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles" (AICPA, 2006, Au. 508).

1.8.5.3 Adverse Opinion

AICPA (2006, Au.508) pointed that "An adverse opinion states that the financial statements do not present fairly the financial position, or results of operations, or cash flows of the entity in conformity with generally accepted".

1.8.5.4 Disclaimer Opinion

A disclaimer of opinion states that the auditor does not express an opinion on the financial statement” because circumstances indicate substantial problem of going concern in client or there are significant uncertainties in the business of client (AICPA, 2006, Au. 508).

1.8.5.5 Dual Opinion

In special condition which the results of investigating on financial statements are different, auditors can issue dual opinion. For example they can issue qualified opinion for balance sheet and unqualified opinion for income statements (Azad, 2013).

1.9 Outline of the Study

This thesis comprises five chapters;

Chapter 1 introduces the study, background of study, discusses the problem statement, objectives, scope, significance of the study and definitions.

Chapter 2 presents the comprehensive review of the literature concerning IC and its components, the history of auditing and opinion of auditors. The effects of SpC and HC on independent auditor’s opinion have been discussed in other sections of this Chapter.

Chapter 3 describes the theoretical framework, development of hypotheses, research methodology, data collection and the instruments for analyzing the data. The chapter also consists of two components of intellectual capital (SpC and HC) as independent variables and independent auditor's opinion as a dependent variable in the research framework.

Chapter 4 describes the accuracy and reliability of the measurement model for SpCi, SpCo and HC. The hypotheses were tested using SPSS to exclude the mediator hypotheses. In the mediator section, LISREL tested the mediator multivariate regression.

Chapter 5 discusses the findings and the conclusions of the study and provide recommendations for Iranian auditor opinion and also future research. The chapter also discusses the contribution and limitation of study.

Future research also could fruitfully be built by extending this study in several ways. First, the spiritual capital still needs to be examined among auditors in the world to understand its role on auditors' judgments; second, the culture is integrated to auditors' interpretation of accounting and auditing standards. Therefore, by discovering the differences among cultures will help IACPA and other institutes to improve standards. As human capital is part of audit firms' assets, further research for finding some ways to invest on this capital is vital for audit firms which HC is one of most important assets.

This study applied three controlling conditions which are (1) tendering, (2) size of fees; and (3) client financial condition in eight short audit scenarios to measure auditors' reaction in ethical dilemma conditions. It seems that other scholars in future should find a comprehensive instrument as new styles to measure auditors' opinion against ethical dilemma conditions.

For measuring moral reasoning, this study used the DIT test. Although, this instrument was a useful tool to understand moral reasoning, it seems that its scoring by researcher was costly, and time consuming to understand and analyze. Therefore, it is recommended to the future researchers to find a more effective way to measure moral reasoning. Furthermore, a researcher who is interested in using DIT, is suggested to simulate some stories related to auditor issues in practice.

This study explored the effect of two components of IC (SpC and HC) on judgment of independent auditors. Further research is suggested to examine of the effects of all components of IC including relational capital (RC) and structural capital (SC) on internal auditors. This is because internal auditors have to advertise their services and good reputation. RC will be useful for them. In addition, the internal auditors can negotiate with their clients on the fee of services and also they can show their flexibility whenever they face ethical dilemma. These flexibilities are a part of SC in IC.

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