The Relationship between Auditor Reputation and the Cost of Equity Capital (With an Emphasis on Client Size)

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ABSTRACT

Providing high quality and favorable audit services alongside providing a proper image of accuracy of management’s claims can be effective in determining the risk of investment in the firm. The cost of equity capital is the minimum rate of return that shareholders demand on the firm in proportion to the investment risk. This study examines the relationship between auditor reputation and the cost of equity capital (with an emphasis on client size) in Iran. Natural logarithm of the audit fee revenue of exchange firms is used to determine auditor reputation and Gordon model is used for calculating the cost of equity capital. In this study, 93 firms listed in Tehran Stock Exchange since 2006 to 2011 have been reviewed. Methods of research are correlational and causal post event and hypothesis testing methods are correlation and regression. Eviews 7 and SPSS 16 software were used to test the hypotheses. Our findings show that there is a negative relationship between auditor reputation and the cost of equity capital. By taking the client (firm) size into account, a positive relationship between auditor reputation and the cost of equity capital is observed.

INTRODUCTION

Audit quality is one of the important issues in the field of auditing and capital market. In order to understand the implications and different aspects of audit quality, various studies have been conducted by researchers to explore the relationship between audit quality and other variables. However, since the audit quality is hardly visible in action, research in this area has always been faced with many problems. Many factors affect the quality of audit services, however very little researches have been performed in order to develop a model to describe the quality of audit services [1]. On the other hand, the effect of the cost of equity capital on investment and financing decisions is one of the most remarkable and important issues in financial researches and is the main factor in creating the gap between accounting profit and economic profit. With the formation of the topic of the separation of management from ownership and creation of a huge conflict of interest between owners and managers, evaluating the performance of firms and their leaders and managers have been subjects of interest to various strata such as creditors, landlords, government and even managers. One of the ways that financial managers can affect the shareholders’ wealth and thus maximize their wealth is determining favorable (optimal) capital structure. Financing sources generally include debt, common stock, preferred stock and retained earnings. Financial managers should take advantage of one or a combination of these sources to provide required capital for new investments and each of these sources have different effects on returns (profit) of the current stakeholders. The cost of equity capital is critical in investment and management decisions that affect the allocation of resources in society [2]. So according to the above mentioned issues, the aim of this study is to identify the literature and theoretical framework regarding the relationship between auditor reputation and the cost of equity capital (With an Emphasis on Client Size) is connected or not?

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In applied literature, audit quality has often been defined through its compliance with auditing standards. In contrast, researchers in accounting and auditing have considered multiple dimensions of audit quality. The mentioned dimensions have often led to various definitions. One of the most common definitions about audit quality is the definition proposed by "Di Angelo". She defines audit quality as “the market assessed” with the probability that an auditor will (1) discover material misstatement in the financial statements and accounting system of the employer, and (2) report the material misstatement. The probability of material misstatement detection by the auditor depends on his/her merit, and the probability of material misstatement reporting by the auditor depends on his/her independence. “Di Angelo” has defined the actual quality of audit based on users’ perception or so-called market perception of audit quality. Using this definition in expressing the actual quality of audit will be conducted with the assumption that the perception of audit quality reflects the actual quality of audit [1].

**Auditor Reputation:**

Auditor reputation is so important that capital market and its participants may evaluate audit quality based on the auditor’s reputation and not his/her ability to discover and report material misstatements of financial statements.

Watts and Zimmerman argue that reputation and credibility are incentives to auditors to remain independent. Obtaining credit through reporting violations costs too much, but after realizing, the demand for audit services and audit fees were increased and auditor’s credit is considered as a guarantee of his independence[3].

Benson believes that the importance of reputation is a strong incentive to maintain the independence of the auditors. Any compromise over the auditor independence, leads to a loss of popularity, and thus weakens the market of audit services.

With regard to the above research records, auditor reputation can be defined as a criterion for evaluating the audit quality by capital market and the relationship between referred works to the auditor and his/her reputation can be examined [4].

Auditor’s good reputation is related to the market’s perception of his/her merit and objectivity (independence in appearance). It displays the auditor’s ability to enhance the credibility of financial statements (even in the absence of high quality data). Good reputation is probably as an attribute of audit firm’s size. In fact, the ability of auditor to oversee can change with the type of audit contract. Thus, as the recent scandals such as Anderson scandal have proved, the auditor's good reputation, at least in short term, can lead to valid perception of poor quality information. <<The differentiation between “real” and “perceived” audit quality is important where users consider some parts of the financial collapse as a results of auditor’s work and do not accept his/her qualification in performing his/her duty. In this case, the primary loss is simply the cost of audit. However, if users simply accept the auditor's qualifications, while such trust is inapposite, the potential loss is much more serious (AAA, 1973). Recent audit collapses affirm that how serious losses can be fair (like Enron). The mentioned collapses also include concepts that assume audit quality the same as auditor’s size in economic issues[1]. The result of big audit firms’ reputation is that they have audit groups specialized in different industries, provide high quality services, use knowledgeable consultants in various sciences, consider independence standards, consider high standards of quality and finally they demand proper fees. Therefore, other audit firms must be able to provide high quality services with lower cost and better suited audit fees in order to compete with these institutions. Because big audit institutions have higher reputation that is considered as a credit for their audit report [5].

**Cost of Equity Capital:**

Making decisions and judging about the most appropriate way of investment with the aim of maximizing shareholders’ wealth is one of the most important issues in the field of financial management. To achieve the above aim, maximizing revenues from investments and minimizing the capital are considered two appropriate approaches. Accordingly, knowing the cost of capital has always had an important role in corporate decisions.

The most important application of the concept of cost of capital can be stated as follow, if a firm’s rate of return on investment is greater than its cost of capital and if this rate increase without the increase of degree of risk, shareholders wealth will increase. The reason is that if a firm’s rate of income is greater than its cost of capital, bond-holders and preferred stockholders will reach to the preferred rate of return and the remaining rate of return will be provided for common stakeholders that would be higher than their expected return rate [2].

**Client size (firm size):**

Firm size is one of the firm's internal factors. Firm size is one of the factors determining the volume and variety of activities that the firm is doing. In fact, the bigger the firm size, the volume and variety of activities done by the firm will be greater. Many researchers believe that bigger firms have more credibility in terms of capital market; therefore, these firms will have easier access to more resources with low interest. Hence,
whatever the size of firms may be smaller, Capital markets and credit institutions, will attach more loans and lower credits with higher interest to them [6].

So, the regulatory state and role of auditor apparently demands this “reasonable assurance” that financial statements be free and devoid of “false statements” rather than to guarantee against losses to the investor. In other words, it can be noted that instead of guaranteeing the investor against loss, it should be guaranteed that financial statements are correct. This guarantee can be achieved both reducing the negative effects of separation of ownership and control and reducing the imbalance of information between users of financial statements (such as investors) and their suppliers. Consequently, audit is a means of reducing information risk for users of financial statements. The reduction of risk should be adjusted and matched to the reduction of the cost of equity capital. Thus, while the assurance role of audit is important, it is argued that this role is not an original and primary role like control and information role [7].

Research Background:
Watts and Zimmerman have adduced to historical examples to defend the idea that auditors defend their professional reputation in capital market. Reputation is an incentive to maintain the independence of the auditors. However, the incentive to achieve mechanism reputation itself is a regulator for independence maintaining[3].

Clarkson and Simonich examined the strategies of employer’s risk and good reputation of auditor. Results of this study show that there is a positive relationship between auditor’s good reputation and the specific employer’s risk in the Initial stock markets of Canada but this does not apply to the initial supply market of America. The study concluded that audit quality (measured by audit firm revenues) is not used as a substitute mark for independence maintenance in the initial supply markets of America’s stock [3].

Betsson et al concluded that the cost of equity capital decreases and reduces for the firms by increasing the quality of information [3].

Zhin Chang et al examined the relationship between quality and reputation of auditors and the financial decisions in the firm. They provided a model and evidences that auditors’ reputation and quality affect the financial decision of the firm and they showed that high quality of auditing reduces the impact of market conditions on financial decisions of the firms and their capital structure [8].

Yong Li et al studied the relationship between audit quality, accounting attributes and the cost of equity capital. Their results showed that evaluation of audit quality using two dimensions of specialization of auditor industry and audit fees is unpredictable. They also found that there is a meaningful relationship between higher audit quality with lower cost of equity capital, measuring audit quality based on unexpected audit fees, as well as adjusting the positive impact of accruals on the cost of equity capital [9].

Fernando et al in their study entitled “audit quality attributes, client size and the cost of equity capital” concluded that there is a negative relationship between audit quality attributes and client size of the cost of equity capital. Their results also showed that the negative correlation is limited only to the small clients and potentially reflects poor environment data related to such firms [7].

Karjalainen has addressed the relationship between audit quality and cost of debt capital for private firms in his study. Their findings showed that four big auditing firms, and auditing with more than one responsible auditor, is associated with reduction of cost of debt capital. Firms are also faced with change in auditing report, reduction of accruals quality and increase of cost of debt capital. They also found that two elements of audit quality and audit effects are concerned in pricing debt capital for private firms. Further analysis shows that, while the results of audit are important in pricing regardless of firm size, but understanding audit quality is more important for bigger private firms [10].

Embong et al have studied the relationship between firm size, disclosure and cost of equity capital. Their results showed a significant negative relationship between disclosure and cost of equity capital for big firms but there is no significant relationship for small firms [8].

Khanbeigi and Khaleghi Moghadam investigated the relationship between conservatism and timeliness of net income with firm size and audit firm size. Their results showed that while firms’ net income is generally conservative, but has not been more timeliness and conservative over time. Two factors of firm size and audit firm size have not affect two examined attributes of net income in this study, so that the net income of big firms in comparison with small firms, and net income of firms audited by audit organization in comparison with net income of firms audited by audit firms trusted by Stock Exchange, are more conservative and timeliness [11].

Ahmadpoor and others examined the impact of corporate governance and audit quality on the cost of debt financing (borrowing). They concluded that existence of institutional major investors in ownership structure and monitoring their work has a meaningful decreasing effect on cost of debt of member firms, whereas audit quality does not have such impact [12].

Shamizade studies the relationship between audit quality and income attributes with capital cost. His results show that controlling financial leverage variables, firm size and the ratio of market value to book value confirms that there is no relationship between audit quality and cost of capital and there is a relationship between
income’s quality attributes, income persistence, the predictive capability of income, profit-to-equity and timeliness of income-to-capital cost, but no relationship was observed between conservatism with cost of capital[13].

Research hypotheses:

This study sought to examine the association between auditor reputation and the cost of equity capital (with an emphasis on client size), so this study examined two main following hypotheses:

The first main hypothesis: There is a relationship between auditor reputation and the cost of equity capital.

The second main hypotheses: client size has impact on the relationship between auditor reputation and the cost of equity capital.

MATERIALS AND METHODS

Population and research sample:

The study population consisted of all listed firms in Tehran Stock Exchange since 2006 to 2011. Namely a six-year period is considered. These firms and this period were chosen as a population because access to their audit financial statements was partly easy.

Sampling is based on systematic elimination method, so firms included in the sample selection must meet the following conditions:

1. They must be accepted in Tehran Stock Exchange before 2003, because the data of last 36 months is required for calculating beta which is a part of control variables;
2. Their stocks must be traded in exchange and their activity must not be interrupted, thus firms that had at least 3 months trading intervals have been removed from sample selection;
3. Their financial terms must have not changed;
4. Their financial year should end at the end of March each year;
5. They should not be a financial and credit, investment and leasing institution because these firms are structurally different from other companies;

Due to the imposed restrictions, finally 93 firms have been selected from 11 different industries.

Methods:

This study is correlational and causal post event and hypothesis testing methods are correlation and regression.

Independent variable:
Auditor Reputation:

To measure the auditor’s reputation, the natural logarithm of the audit fee revenue of exchange firms will be used:

\[ \text{LAF} = \ln(\text{Audit fees}) \]

Dependent Variable:
Cost of Equity Capital:

For calculating the cost of equity capital Gordon model is used as follows:

\[ K_s = \frac{D_1}{P_0} + g \]

\[ g = \text{ROE} \times (1-d) \]

\[ d = \frac{\text{DPS}}{\text{EPS}} \]

\[ \text{ROE} = \frac{\text{Net Income}}{\text{Average Equity Capital}} \]

\[ \text{EPS} = \frac{\text{Net Income}}{\text{Number of Common Stocks}} \]

\[ \text{DPS} = \frac{\text{Earnings per share}}{\text{Common shares outstanding}} \]

\[ \text{ROE} = \frac{\text{Net Income}}{\text{Average Equity Capital}} \]

\[ \beta = \text{Systematic risk (versus non-systematic risk that is the square root of standard deviation of return).} \]

\[ \text{EPS: Earnings per share, D1: earnings forecast for next year, ROE: return on common shareholders, P}_0: \text{Market value of common stock at the beginning of the period.} \]

Client (Firm) Size:

To control the effect of this variable on the cost of equity capital, the logarithm of the total assets of the selected firms are used.

Systematic risk (\(\beta\)):

Beta coefficient is a number for comparing alignment intensity of firm’s return with whole market index returns. Beta coefficient is also known as systematic risk (versus non-systematic risk that is the square root of standard deviation of return). The following formula is used for beta calculation:
Cov(Z_p, Z_m)

\[ \sigma_m \]

Cov (Z_p, Z_m): Covariance between portfolio return and return on the market.

\[ \sigma_m^2 \]: Variance of market returns.

**Financial Leverage:**

Financial leverage shows the funds that are financed by debt. In this study, we divided total liabilities over total assets i, in t year in order to calculate the leverage of the company (Levi, t):

\[ Lev_{i,t} = \frac{L_{i,t}}{A_{i,t}} \]

\[ Lev_{i,t} \]: level of i firm leverage in t year,

\[ L_{i,t} \]: total liabilities of i firm in t year,

\[ A_{i,t} \]: total assets of i firm in t year.

**The ratio of book value to market value of stock:**

Book value can be a criterion for stock value which represents net assets. Book value is calculated by dividing equity capital at the end of the financial year by the number of common stock. The value of stock market is important for shareholders as a measure of investments value, Market value of all the issued stocks represents the firm’s current value. Stock market value is calculated by the average of stock price at the beginning and the end of the year.

**Annual sales growth:**

Annual sales growth is as the difference between sales of the year in comparison with sales of last year, and is calculated as follows:

\[ GRW = (Eps_2 - Eps_1) / Eps_1 \]

**Standard deviation of monthly stock returns:**

Return can be defined as the change of stock value as well as its income during a specified time period. Stock return volatility is distribution of stock return relative to is average. To calculate stock return from stock price returns volatility for monthly periods during the year, we do as follows:

\[ r_i = \frac{P_{i,t} - P_{i,t-1}}{P_{i,t-1}} \]

\[ r_i \]: monthly return of i stock,

\[ P_{i,t} \]: the price of i stock at the end of month t,

\[ P_{i,t-1} \]: the price of i stock at the end of month t-1.

\[ SD = \sqrt{\frac{\sum (r_i - \bar{r})^2}{n - 1}} \]

**Results:**

**Descriptive statistics:**

The results of descriptive analysis of data are given in Table 1.

<table>
<thead>
<tr>
<th>Variable</th>
<th>Mark</th>
<th>Number of observations</th>
<th>Average</th>
<th>Standard deviation</th>
<th>Minimum</th>
<th>Maximum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of equity capital</td>
<td>COEC</td>
<td>558</td>
<td>0/523</td>
<td>0/312</td>
<td>0/01</td>
<td>0/997</td>
</tr>
<tr>
<td>Auditor reputation</td>
<td>FEE</td>
<td>558</td>
<td>6/053</td>
<td>0/802</td>
<td>4/248</td>
<td>8/611</td>
</tr>
<tr>
<td>Interaction between auditor size and reputation</td>
<td>Fee*Size</td>
<td>558</td>
<td>82/15</td>
<td>17/37</td>
<td>50/29</td>
<td>149/3</td>
</tr>
<tr>
<td>Risk</td>
<td>B</td>
<td>558</td>
<td>0/862</td>
<td>0/633</td>
<td>-1/65</td>
<td>4/880</td>
</tr>
<tr>
<td>Leverage</td>
<td>LEV</td>
<td>558</td>
<td>0/615</td>
<td>0/173</td>
<td>0/135</td>
<td>0/953</td>
</tr>
<tr>
<td>Firm Size</td>
<td>SIZE</td>
<td>558</td>
<td>13/48</td>
<td>1/45</td>
<td>9/85</td>
<td>19/96</td>
</tr>
<tr>
<td>Book value-to-market</td>
<td>BM</td>
<td>558</td>
<td>0/637</td>
<td>0/209</td>
<td>0/108</td>
<td>0/985</td>
</tr>
<tr>
<td>Annual growth</td>
<td>GRW</td>
<td>558</td>
<td>0/308</td>
<td>1/97</td>
<td>-0/97</td>
<td>43/81</td>
</tr>
<tr>
<td>Monthly stock returns</td>
<td>STDEV</td>
<td>558</td>
<td>0/092</td>
<td>0/075</td>
<td>0/000</td>
<td>0/576</td>
</tr>
</tbody>
</table>
The results of descriptive analysis show that the average cost of equity capital in sample firms is equal to 0.523. However, due to the large distance between the minimum and maximum of the variable, it can be noted that this variable had a low stability and reliability during the study period. The auditor reputation on average is equal to 0.6053 and the average of auditor’s size and reputation is equal to 82.15.

The average of systematic risk ($\beta$) of sample firms is equal to 0.862, and the average of firm size is equal to 13.478. The average of leverage and the ratio of book value to market value of sample firms are respectively equal to 0.615 and 0.637. Finally, in the minimum values the variable with the lowest rate is systematic risk, and in the maximum values the variable with the highest rate is the calculated annual growth.

The First Hypothesis of the Study and the Model Used:

The first hypothesis stated: There is a relationship between the auditor reputation and the cost of equity capital.

The following multivariate model has been used to test the first research hypothesis:

$$\text{CoEC}_{i,t} = C + \beta_1(FEE_{i,t}) + \beta_2(BETA_{i,t}) + \beta_3(LEV_{i,t}) + \beta_4(SIZE_{i,t}) + \beta_5(BM_{i,t}) + \beta_6(GRW_{i,t}) + \beta_7(STDEV_{i,t})$$

The results of the first hypothesis Regression model test are presented in Table 2.

<table>
<thead>
<tr>
<th>Variable Name</th>
<th>Variable Symbol</th>
<th>Coefficient</th>
<th>t-statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant Value</td>
<td></td>
<td>0/176</td>
<td>2/371</td>
<td>0/018</td>
</tr>
<tr>
<td>Auditor Reputation</td>
<td>$\beta_1$ (FEE)</td>
<td>-0/029</td>
<td>-1/886</td>
<td>0/006</td>
</tr>
<tr>
<td>Risk</td>
<td>$\beta_2$ (BETA)</td>
<td>0/187</td>
<td>7/007</td>
<td>0/000</td>
</tr>
<tr>
<td>Leverage</td>
<td>$\beta_3$ (LEV)</td>
<td>0/213</td>
<td>3/293</td>
<td>0/001</td>
</tr>
<tr>
<td>Firm Size</td>
<td>$\beta_4$ (Size)</td>
<td>-0/004</td>
<td>-1/758</td>
<td>0/020</td>
</tr>
<tr>
<td>Book value-to-Market value</td>
<td>$\beta_5$ (BM)</td>
<td>0/207</td>
<td>3/494</td>
<td>0/000</td>
</tr>
<tr>
<td>Sale Growth</td>
<td>$\beta_6$ (GRW)</td>
<td>0/007</td>
<td>1/057</td>
<td>0/290</td>
</tr>
<tr>
<td>Monthly Stock Return</td>
<td>$\beta_7$ (STDEV)</td>
<td>0/186</td>
<td>1/129</td>
<td>0/259</td>
</tr>
</tbody>
</table>

According to the first hypothesis test results presented in Table 2, Durbin-Watson statistic is between 1/5 and 2/5, which shows that there is not a correlation between the components of model error. Significance level of F-statistic (0/000) is lower than the accepted error level (5 percent) and the overall regression model is significant. The coefficient of determination and the adjusted coefficient of determination also indicate that the independent and control variables entered in the model, explain about 18 percent of the variations of the dependent variable. Given the lower probability (Prob.) of t-statistic than the level of acceptable error rate for $\beta_1$ coefficient, test results showed that auditor reputation and the cost of equity capital are negatively related. Thus, the first research hypothesis cannot be rejected at 99% confidence level. Firm size is also negatively related to the cost of equity capital in 95% confidence level. The results also show that the control variables entered the regression, systematic risk, leverage and the ratio of book value to market value have a positive relationship with the cost of equity capital at 99% confidence level, and a significant relationship was not observed between sales growth and monthly returns deviation with the cost of equity capital.

The second research hypothesis and the model used:

The second hypothesis states: Client size affects the relationship between auditor reputation and the cost of equity capital.

The following multivariate model is used to test the second hypothesis of the research:

$$\text{CoEC}_{i,t} = C + \beta_1(FEE_{i,t}) + \beta_2(SIZE_{i,t}) + \beta_3(SIZE \times FEE) + \beta_4(BETA_{i,t}) + \beta_5(LEV_{i,t}) + \beta_6(BM_{i,t}) + \beta_7(GRW_{i,t}) + \beta_8(STDEV_{i,t})$$

According to the first hypothesis test results presented in Table 2, Durbin-Watson statistic is between 1/5 and 2/5, which shows that there is not a correlation between the components of model error. Significance level of F-statistic (0/000) is lower than the accepted error level (5 percent) and the overall regression model is significant. The coefficient of determination and the adjusted coefficient of determination also indicate that the independent and control variables entered in the model, explain about 23 percent of the variations of the dependent variable. Given the lower probability (Prob.) of t-statistic than the level of acceptable error rate for $\beta_3$ coefficient, test results showed that firm size has a positive effect on the relationship between auditor
reputation and the cost of equity capital. Thus, the second research hypothesis cannot be rejected at 99% confidence level. Given the significant levels of $\beta_1$ and $\beta_2$ coefficients, the results show that firm size and auditor reputation negatively affect cost of equity capital. The results also show that from among the control variables entered the regression systematic risk; leverage and the ratio of book value to market value have a positive relationship with the cost of equity capital at 99% confidence level. A significant relationship was not observed among other control variables entered the model and cost of equity capital.

Table 3: Results of the second hypothesis Regression Test

<table>
<thead>
<tr>
<th>Variable Name</th>
<th>Variable Symbol</th>
<th>Coefficient</th>
<th>t-statistic</th>
<th>Prob.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant Value</td>
<td>C</td>
<td>2.444</td>
<td>2.996</td>
<td>0.002</td>
</tr>
<tr>
<td>Auditor Reputation</td>
<td>$\beta_1$ (FEE)</td>
<td>-0.348</td>
<td>-2.710</td>
<td>0.006</td>
</tr>
<tr>
<td>Firm Size</td>
<td>$\beta_2$ (Size)</td>
<td>-0.150</td>
<td>-2.505</td>
<td>0.012</td>
</tr>
<tr>
<td>Interaction between size and auditor reputation</td>
<td>$\beta_3$ (Size*Fee)</td>
<td>0.021</td>
<td>2.247</td>
<td>0.025</td>
</tr>
<tr>
<td>Leverage</td>
<td>$\beta_4$ (LEV)</td>
<td>0.241</td>
<td>3.804</td>
<td>0.000</td>
</tr>
<tr>
<td>Risk</td>
<td>$\beta_5$ (BETA)</td>
<td>0.133</td>
<td>7.460</td>
<td>0.000</td>
</tr>
<tr>
<td>Book value-to-Market value</td>
<td>$\beta_6$ (BM)</td>
<td>0.231</td>
<td>4.045</td>
<td>0.000</td>
</tr>
<tr>
<td>Annual Growth</td>
<td>$\beta_7$ (GRW)</td>
<td>0.004</td>
<td>0.629</td>
<td>0.529</td>
</tr>
<tr>
<td>Monthly Stock Return</td>
<td>$\beta_8$ (SIDEV)</td>
<td>0.137</td>
<td>0.835</td>
<td>0.404</td>
</tr>
<tr>
<td>Overall Regression Model</td>
<td>F-statistics and significance levels</td>
<td>Durbin-Watson Statistic</td>
<td>Coefficient of determination</td>
<td>Adjusted Coefficient of determination</td>
</tr>
<tr>
<td></td>
<td>11.653</td>
<td>1.664</td>
<td>0.231</td>
<td>0.211</td>
</tr>
</tbody>
</table>

Conclusions:

According to the results of the first hypothesis test, it can be stated that auditor reputation and the cost of equity capital are negatively related. Thus, the first research hypothesis cannot be rejected at 99% confidence level. According to the results of the first hypothesis test, if the firm owners use the most famous professional auditors for firms auditing, their cost of equity capital will be reduced.

The results of this theory corresponds to the results of other researches done in this field, such as foreign researches done by di Angelo, Watts and Zimmerman, New and Davidson, Clarkson and Simonich, Fernando et al and Smith and internal researches done by Mojtahedzade and Aghayi, Saghafi et al; The results of this hypothesis also does not correspond to the results of foreign researches done by Zhing Chang et al, Lee Jung et al and the results of internal researches such as Sajjadi and others, Ahmadoor and others and Shamizade.

According to the results of the second hypothesis test, it can be stated that client (firm) size has always been one of the factors that investors take into consideration when making decision to invest. So by entering firm size on the relationship between auditor reputation and the cost of equity capital, it can be seen that this variable affects the relationship between these two criteria and leads to a positive relationship between these two indices. Therefore, as investors consider the firm size, it is better to have a look at the intended firm’s audit institution. On the other hand, in order to reduce the audit costs and the cost of equity capital, the firm managers should select famous audit firms to audit their financial statement given the firm size they are in.

The results of this theory correspond to the results of other researches done in this field, such as foreign researches done by di Angelo, Watts and Zimmerman, New and Davidson, Clarkson and Simonich, Fernando et al and Smith and internal researches done by Mojtahedzade and Aghayi, Saghafi et al; The results of this hypothesis also does not correspond to the results of foreign researches done by Zhing Chang et al, Lee Jung et al and the results of internal researches such as Sajjadi and others, Ahmadoor and others and Shamizade.

So, the relationship between auditor reputation and the cost of equity capital (with an emphasis on client size) is investigated in this study. The results showed a negative relationship between auditor reputation and the cost of equity capital. And a positive relationship is observed entering firm size on the relationship between auditor reputation and the cost of equity capital. So it can be stated that the auditor's reputation as one of the audit qualitative attributes can affect cost of equity capital.

Practical Suggestions:

1. To select the audit firm should not be confined only to the audit firm’s famous name. But also audit service quality Institute should also be considered. So an institution should be chosen that is renowned for providing quality services. Increasing training of specialized personnel, using highly educated and experienced auditors in a particular industry of employer are factors that affect the quality of audit services and the audit report.

2. It is better for investors to assess the audit indices in financial statements in order to make a right decision on investment. And Firm managers should carefully select expert and famous auditors in order to reduce firm costs and increase investors’ confidence.

3. Audit organization as the establisher of auditing standards should consider the results of this study and other related studies and remind audit quality as the most important parameter in predicting future decisions.
Scientific recommendations for future research:

By conducting any research, a new path will be opened up and its continuous requires conducting further researches. Thus, the researcher believes that each of the following cases can be considered as proposed topics for study in future researches:

1. Impact of audit quality attributes on comparability of financial statements;
2. Relationship between auditor reputation and conservatism with the cost of equity capital;
3. Impact of auditor reputation and disclosure on the cost of equity capital; and
4. Relationship between audit quality attributes and environmental uncertainty.

REFERENCES