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The Effect of Corporate Governance Mechanisms on Audit Quality

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ABSTRACT

This study aims at investigating the effect of ownership structure among Iranian listed firms based on their audit quality. The sample study consists of one 72 companies on the Iran Stock Exchange. The analysis of logistic regression was used to investigate the relationship between the audit quality measured based on the audit firms size as a dependent variable, and Corporate Governance Mechanisms as independent variables.

The results showed that there is a positive and meaningful relationship between auditing quality and firm size. Meanwhile, there were no relationships observed between Corporate Governance Mechanisms and auditing quality. We can conclude that the institutional investors and the board of directors are reluctant to employ highly qualified auditors.

KEYWORDS: Audit Quality, Ownership Concentration, Corporate Governance, Size of the Audit Firm.

INTRODUCTION

The role of big companies in economic structure of the countries is undeniable. The increasing development of economic entities, developments in information technology and the existence of the contradicting benefits have created the controlling needs. Besides benefits' contradiction, other issues such as the lack of users' direct access to information have created the demand for independent auditing services. In fact, users use auditors to assess the quality of information.

The quality auditing has been noticed by the partners and the regulations' providers and the academics considerably from long ago. The studies in auditing in the United States have shown that there are 4 great international auditing institutions which provide qualified auditing services and they increase the validity and informative aspects of the financial statements. These studies have shown that the effect of the auditing quality on the validity of financial statements reported all over the United States has been the same. Naturally this auditing quality guarantees the reliability of the statements for the creditors and investors and reduces their information risk.

The dissolution and break off of Arthur Anderson's auditing institution in the year 2002 which was one of the 5 biggest institutions in the whole world and bankrupted following the big financial scandals and great fraudulences of Enron and Worldcom showed that the owners of this company interfered into the auditing process and the main adjustments of the auditing reports of it.

It seems that the ownership structure creates several stimuli to supervise the financial reporting and affect the independent auditor. One stimulus is that the audited financial statements are an important resource for information about the company and the investors value it significantly in analyzing the accounting information and financial decision makings about auditing quality and the type of the auditors' reports. Thus, it is expected that the companies' ownership potentially affects auditing quality and there is a logical relationship between the amount of these ownerships and auditing quality.

Capital structure and ownership structure and the structure of the board of directors are considered as the effective parameters on the developments and economic growth of the companies and they have always been considered by scholars and the financial researchers in the field. Several compositions of ownership structure such as the existence of institutional stockholders and main stockholders can affect firms' financial and strategic policies.

Many factors affecting auditing quality have been investigated so far and a lot of researches have been carried out to identify the relationships between different financial variables and firms' accounting and their effects on the auditing quality. But the ownership structure as one of the effective variables in auditing quality has been ignored in Iran. In the present research we will try to study the effect of ownership structure as one of the corporation leadership mechanisms on auditing quality to determine whether ownership structure has had any effects on the type and amount of revealing by the independent auditors and auditing quality or not?

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2. Background and Hypothesis Development

Corporate governance mechanisms are generally not limited to internal control. In fact, external auditor represents the most important external control mechanism. So, in our study, we focus on the impact of corporate governance mechanisms on the demand for higher quality auditor by firms. 5 major variables are studied: ownership structure and the board composition, Per Out Dir, Out Directors' Size, Board Size. This study also controls for other variables such as firm size and leverage.

2.1. Audit Quality

The measure of audit quality still lacks consensus. Many previous researches use the dichotomy 'Big Four/Non-Big Four' as a proxy for audit quality. Such a variable seems to be not so convenient to correctly assess the audit quality because such a concept depends on many factors, such as the size of the audit firm (Hay and Davis, 2004; and Pong and Kita, 2006), auditor's reputation (Piot, 2001; Fan and Wong, 2005; Kane and Velury, 2005; Lennox, 2005; and Knechel *et al.*, 2008), auditor's experience (Wooten, 2003; and John stone and Bedard , 2004), auditor's specialization (Pong and Kita, 2006), and the extent to which ICT are used in audit mission (Jean, 2003). In order to assess the audit quality with more precision, we ran a PCA.

De Angelo (1981) argued that audit quality depends on the joint probability of an auditor discovering and disclosing a problem in an accounting system. Bradshaw et. al. (2001) defined audit quality as the willingness to report any material manipulation or misstatements that will increase the material uncertainties and/or going concern problems; Baotham (2009) addressed another definition as the probability that an auditor will not issue an unqualified report for statements containing material errors. Palmrose (1988) asserted that high audit quality is associated with the absence of material omissions or misstatements in the financial statements. Audit quality and the measurement of audit quality have been studied widely, Kilgore (2007) indicated that no single generally accepted definition of audit quality has emerged, nor has any single generally accepted measure been introduced. Reisch (2000) attributed the absence of a single measure of audit quality to the fact that it is a multidimensional latent construct and is therefore, somewhat difficult to measure. This was a reason that many researchers study this area and have used different proxies for measuring the level of audit quality. Manry, et. al. (2008) used estimated discretionary accruals to measure audit quality, Knechel & Vanstraelan (2007) used the likelihood of an auditor issuing a going concern opinion as an indicator of audit quality, Li and Lin (2005) examined audit quality using non-audit fees, Chen et. al. (2010) used the propensity to issue modified audit opinion as a proxy for audit quality(Zureigat,2011).

The results of Sud somboon and Ussahawanitchakit's (2009) study show that professional audit competencies have a positive influence on audit quality and reputation. Baotham & Ussahawanitchakit (2009) indicated that audit independence has a positive relationship with audit quality, and audit quality has a positive association with audit credibility. Casterella et. al. (2009) found that peer review findings are indeed useful in predicting audit failure and argued that self-regulated peer review as mandated by the AICPA does provide effective signals regarding the level of an audit firms quality. In Jordan, Hmedat (2002) aimed to investigate the relation between audit quality and some factors related to the audit firm and other factors related to the clients' firms like client size, client financial position, sales growth, and department ratio. The findings showed that audit quality is related to the audit firms size, clients size, and clients financial position, while the other factors did not have a significant relation to audit quality. Unlike Humedat (2002) who focused on financial factors related to the clients' firm, the main aim of this study is to investigate the effect of the ownership structure for audited firms, as a corporate governance characteristic, rather than to study financial indicators.

Considering the negotiations between auditors and clients and its impending effect on the auditing process, clients have the power that may push auditors to have a greater tendency to compromise their independence which in turn leads to a deterioration in the audit quality, many researchers tended to study factors that may affect auditor-client relationship(Dong and Zhang, 2008).

2.2 The relationship between ownership structure and auditing quality

Based on the literature in agency theory and along with the increase of agency contradictions, the tendency of the economic entities to choose independent auditing institutions, increases. The inappropriate and insufficient revealing of financial reports and the lack of information transparency in companies increase the problems resulted from ownership isolations from the management. The lack of presenting the related and reliable financial information, results in economic losses for stockholders and other external beneficiaries.

Meanwhile, the independent auditing supports the rights of all beneficiaries through crediting financial statements, guaranteeing reliability and approving financial information quality. Additionally, the investors, creditors and other beneficiaries rely on the results of auditing carried out by the independent auditing institutions to assess the financial performance of the different business entities regarding different investment opportunities. Thus, the more auditing quality will result in more value, credibility and acceptability of it by the users of financial statements. On the other hand, auditing quality which is directly related with corporate governance and controlling strategies has a hidden and multi-dimensional structure.

there isn't any concise definition of auditing quality which entails all types of auditing and auditors. So, criteria such as the size of auditing institutions, incumbency period of the auditor, the specialization of auditor's industry, oldness and trademark of the business entities are used as alternates for auditing quality. The results of some experimental researches have shown that big auditing institutions create more quality in auditing tasks. Dee Angelo (1981) claimed that the quality of auditing institutions has a direct relationship with the size of auditing institution and their share in auditing market. However, some evidences show that big auditing institutions do not necessarily create a higher auditing quality compared to the smaller auditing institutions always (Hassas-e-Yeghaneh & Azinfar, 2010).

Additionally, the independent auditing is considered to be an appropriate strategy in controlling the contraction relationships between managers and stockholders and in most researches carried out in the field of the reciprocal relationship between agency theories and auditing, the effects of the corporate leadership strategies on the probability of choosing auditing institutions with high qualities have been investigated. Thus, regarding the difference in leadership structures of Iranian companies in different time periods, this question arises that has the existence of different owners in the composition of firms' stockholders, ownership concentration, institutional ownership and the difference in other controlling strategies such as the board of directors in firms accepted in Tehran Stock Exchange been effective or not?

3. LITERATURE REVIEW

Baowdo & Yelkins (2004), two researchers from Belgium, tested the effects of the size of auditing institutions on auditing quality in Belgium's market and they considered some other minor factors in auditing size such as the share of auditor's market, the number of auditing institution beneficiaries and … . Finally the results of their researches showed that there isn't any meaningful relationship between the auditor's size and auditing quality. Fuerman (2006) found out in his research that bigger auditing companies have less faults in their auditing tasks. Chan Tao & et al (2007) studied the analysis of cognition about stock market regarding the auditing quality among a number of small auditing institutions in China's auditing market. These researchers found out that there is a positive relationship between the size of an auditing entity and the understanding of the investor of the profitability quality.

Hassas-e-yeghaneh (2010) studied the relationship between auditing quality and an auditing entity size. In this research the member auditing entities of the Official Accountants' Association were categorized as small auditors (small auditing entities) and the Auditing Organization was considered as the big auditing entity due to its staffs and history. It was found that there is a meaningful and adverse relationship between auditing quality and auditor's size (auditing entity size).

While the authorities in devising the accounting regulations persist that the quality of an auditor's job does not depend on the size of the auditing institution, it seems that auditing quality has a meaningful relationship with the auditing institutions' size regarding a lot of researches carried out previously (Days, Gear & Guess, 1992; Kobertomory, 1998; Palmeros, 1988; Linux, 1999; Krish Han Shoer, 2000; Delta Sodogar, 2004; Fuerman, 2006; Chan Tao & et al, 2007) and big auditing institutions do their job with more quality compared to the small ones. The more famous auditors present more effective auditing and this result in enhancing the qualitative features of the information.

4.Research Hypotheses

The concepts presented, the author proposes a relationship between Corporate Governance Mechanisms and audit quality, and the hypotheses for this study will be:

H_1: there is significant relationship between audit quality and ownership concentration.
H_2: There is significant relationship between institutional ownership and audit quality.
H_3: There is significant relationship between Board Size and audit quality.
H_4: There is significant relationship between Out Directors Size and audit quality.
H_5: There is significant relationship between Per Out Dir and audit quality.

5. Measurement of Variables

5.1 Dependent variables.

Auditing quality is the dependent variable in this research. To measure auditing quality we have used the index of auditing institution's size as follows:

If the auditor is an auditing institution, we will use artificial variable (1) and if not artificial variable (0) will be used.

5.2 Independent variables

Three main Independent variables of this study included Ownership Concentration , Institutional Ownership, Per Out Dir, Board Size, Out Directors Size.

5.2.1 Ownership Concentration:

The ratio of the sum of the stocks of three main stockholders to total stocks issued by a company is considered as the amount of ownership concentration.

5.2.2 Institutional Ownership:

the percentage of firm's stock which are held by main investing institutions (own more than %5 of firm's stock) to total stocks issued and accessible to stockholders.

5.2.3 Per Out Dir

$$\textbf{Per Out Dir} = \frac{\text{Out Directors Size}}{\text{Board Size}} \times 100$$

5.2.4 Board Size

members of board of directors**.**

5.2.5 Out Directors Size

they are the members of board of directors who do not have an administrative position in a company.

5.3 Control Variables

5.3.1 Size of the Audited Firm

The sum of assets of a firm is measured by logarithm.

5.3.2 Level of Indebtedness of the Audited Firm

It is calculated by dividing total debts to total assets of a firm.

6. Methodology

6. 1 Research method

Among the accounting researches this research is of capital market research and in terms of methodology as the study title causal، and from purpose point of view is application research. These types of researches are done to gain information about the relationship between variables. In other word researcher wants to know whether there is correlation between the two groups of information or not, and if there is any starts to evaluate the independent variable effect and the way it affects (positive or negative) the dependent variable.

6.2. Sample and Data

Statistical society is selected from companies in the Tehran Stock Exchange in industries and various groups. Study period is the financial information relating to the companies' performance of the years 2007-2011 listed in Tehran Stock Exchange in 5 years.

The sample systematic method has been selected. The conditions are:

1. Companies that lead to their financial year at the end of March each year.
2. Companies that are listed in Stoke Exchange before 2006.
3. Companies that during years 2007-2011 have not changed their financial period.
4. Companies that their stop symbol do not have more than six month abeyance in the research period.
5. Not to be among the Banks and credit and financial investment institutions.
6. Annual financial statements and temporary financial statements of firms should be audited during the research years.

With the application of above limitations, 72 companies listed in Tehran Stock Exchange from industries has been chosen.

6.3. Variables and Model:

In order to study the relationship between audit quality and ownership structure, this study used the following regression model:

$$\mathbf{AQ = \alpha + \beta_1\, OC + \beta_2\, BS + \beta_3 IO + \beta_4 POD + \beta_5 ODS + \beta_6 SI + \beta_7 LE + e}$$

Where:

AQ : Audit Quality (Size of the Audit Firm)

OC : Ownership Concentration
BS : Board Size
IO : Institutional Ownership
POD: Per Out Dir
ODS: Out Directors Size
SI : Company Size
LE : Leverage

7. Analysis and Rustles

7.1. Descriptive Analysis

Descriptive statistics and correlation coefficient tables of the variables are shown in Table 1.

Table(1) Descriptive Statistics Research Variables

Standard deviation	average	Max	Min	Number of observation	variable
0.14	0.55	0.98	0.10	360	OC
0.18	0.70	0.98	0.13	360	IO
0.77	3.49	5.00	2.00	360	ODS
15%	69%	100%	40%	360	POD
0.41	5.11	7.00	5.00	360	BS
1.32	13.02	17.64	9.23	360	SI
0.86	0.72	9.99	0.08	360	LE

7.2. Analysis of logistic regression:

Table(2):The hypothesis test results

$AQ = \alpha + \beta_1 OC + \beta_2 BS + \beta_3 IO + \beta_4 POD + \beta_5 ODS + \beta_6 SI + \beta_7 LE + e$				
Sig	**Statistic (Wald)**	**Stdev (β)**	β	**variable**
0.693	0.155	8.746	3.448	α
0.895	0.018	3.064	0.406	OC
0.875	0.025	2.470	-0.389	IO
0.383	0.762	2.742	2.394	ODS
0.335	0.930	13.961	-13.460	POD
0.208	1.588	1.753	-2.209	BS
0.000	27.386	0.110	0.575	SI
0.804	0.061	0.281	-0.070	Lev
(Pseudo r-square)	(Log-Likelihood)	P-Value	χ^2	Total Regression model
Cox&Snell =0.094 NagelKerke=0.141	357.533	0.000	35.448	

Regarding the results of model's test presented in table (2), the meaningfulness level of K2 statistics (0.000) is less than the acceptable error level (%5) and the total regression model is meaningful and it shows an appropriate adjustment of the model. Regarding the high amount of P-Value statistics, the generating independent variables of the error level acceptable for test results showed that there is not a meaningful relationship between the auditing institution's size and the firm's leadership structures. Also the test results show that the size of an auditing institution has a positive and meaningful relationship with the controlling variable of the firm which is the firm size but there was no relationship observed between the controlling variable of the leverage and the size of auditing institution.

8. Conclusion

After the recent scandals in big companies such as Enron and WorldCom, the need to pay attention to the quality of auditors became more apparent. Moreover, the nature of the emerging market in Iran, as a developing country, needs more work in the audit quality area to cover it with empirical evidences because of the limited number of studies that have examined the audit quality and the factors that influence it .The aim of the present research is to study the relationship between some mechanisms of corporate governance (ownership concentration, institutional ownership, the number of in-duty and those who are not in-duty in board of directors) and auditing quality in firms accepted in Tehran Stock Exchange. To study the amount of quality of auditing institutions, we have used the variable of auditing institutions' size. The results of testing the hypotheses do not approve the existence of a meaningful relationship between corporate governance mechanisms and auditing quality. On the contrary, the results approved a positive and meaningful relationship between the controlling variable (firm size) and auditing quality.

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