



Corporate Governance and Auditor Quality Choice: Evidence from Palestinian Corporations

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ABSTRACT

The aim of this study is to examine the impact of corporate governance mechanisms on auditor quality choice in Palestine. The relationship between corporate governance and auditor quality choice depends on whether Palestinian firms see the quality of auditor as a substitute or a complement to governance practices. The sample included 46 firms listed on the Palestine stock exchange (PSE) for the period from 2013 to 2015. Relevant data were collected from the annual reports of the sampled companies published at the PSE website. Auditor's quality was assessed using audit firm size (Big 4 or non-Big 4). To achieve the objectives of this study, a binary logistic regression was used. The results revealed that companies with a high ownership concentration, larger board size and the existence of audit committee tend to hire a high quality auditor. In addition, results showed a significant positive tendency of higher total asset firms to hire a quality auditor while firms with higher leverage tend to choose less quality auditors. Furthermore, director ownership, board independence, Chief executive officer duality were found to have no effect on auditor's quality choice. The study recommends that regulators need to encourage companies for more compliance with corporate governance instructions.

Keywords: Corporate Governance, Auditor Choice, Palestine

JEL Classification: M420

1. INTRODUCTION

Financial scandals in the last two decades of Arthur Anderson, Enron and WorldCom and others have negatively affected the reputation of accounting profession and financial reporting (Griffin et al., 2009). These financial scandals had reduced investors' confidence of the quality of financial statement (Abdullah et al., 2008). These financial failures have emphasized the need for corporate governance mechanisms. Particularly, external auditors who are the providers of a reasonable assurance for the accuracy of financial reporting (Adeyemi and Fagbemi, 2010). However, whether external auditor quality is substituting or complementing the good governance practices of the firm is still an open question.

Effective corporate governance and audit quality are vital components for any firm to ensure the truthfulness of internal control and to monitor the financial reporting procedures. Effective corporate governance mechanisms assume the provision of high quality audit for the firm. High quality audit firms are constantly

attempting to improve the quality of corporate governance mechanisms of their client statement (Abdullah et al., 2008). However, there is a lot to be done to enhance the accuracy of financial reporting systems out of better responsibility, better restoration of the information presented to be audited and improved policies of corporate governance (Saudagaran, 2003).

Although some progress has been made in Palestine, however, the auditing profession and corporate governance require additional scrutiny and development from researchers, regulators and other relevant parties. Auditor quality choice has been extensively investigated by researchers in developing countries but rarely investigated in Palestinian context though some studies focus on the determination of audit quality and the link between corporate governance and internal auditing (Jarrar, 2016). The impact of corporate governance on audit quality is largely ignored. The current study is expected to fill this gap by providing empirical evidence on the impact of corporate governance mechanisms on audit quality in a less developed economy, i.e., Palestine.

Particularly, the purpose of this study is to investigate the impact of corporate governance mechanisms, on auditor's quality choice in the Palestinian firms listed on Palestine stock exchange (PSE). This study should assist policy makers in revising the general guidelines and requirements relate to the board composition, ownership structure and audit committee in the governance codes and instructions in Palestine.

The remaining of this paper is structured as follows. In Section 2 literature review and development of hypotheses. Section 3 presents the methodology and data. Section 4 presents and discusses the results and Section 5 concludes.

2. LITERATURE REVIEW AND DEVELOPMENT OF HYPOTHESES

Previous auditing studies highlighted the usefulness of external audit services using the agency theory framework (DeAngelo, 1981; Watts and Zimmerman, 1986). The segregation between owners and managers lead to opportunistic managerial actions and increase agency problems in companies (Fama and Jensen, 1983). However, agency conflict could be reduced by agency cost which is a combination of supervising and bonding costs. Monitoring costs are techniques that control manager's behavior and the engagement of appropriate external auditors, while bonding cost is linked with contracting to assure that managers always take decisions that are supportive to shareholder's wealth (Jensen and Meckling, 1976).

As a result of agency conflicts and financial scandals the demand for quality external audit services has increased to provide an effective monitoring function. DeAngelo (1981) has provided a definition for audit quality as "the market assessed joint probability that given auditor will both (a) discover a breach in the client's accounting system and (b) report the breach." This means the ability of the auditor to determine any material misstatement and to report it. Watts and Zimmerman (1986) clarify DeAngelo's definition, where the first part of the definition points to the auditor adequacy and the second part points to the auditor's independence. Therefore, according to Watts and Zimmerman, any factor related to a lack of auditor adequacy or independence is able to influence the quality of auditing. Bradshaw et al. (2001) clarified audit quality as the preparation to determine and record any manipulation and material misstatement that would increase the uncertainty or going concern. Duff (2004) suggests that audit quality combines both service and technical quality.

Despite all the previous definitions, there is no specific acceptable clarification for audit quality, neither has any general accepted measure been informed (Kilgore, 2007). Most of the previous research have highlighted the link between corporate governance and audit quality using audit firm size and audit fees proxies (Abdullah et al., 2008; Lin et al., 2009; Edrin et al., 2015; Nelson et al., 2015; Mitra et al., 2007; Brad et al., 2015). The relation between audit fees and audit quality is well-known (Linberg, 2001). According to Craswell et al. (1995) and Palmrose (1986) the higher audit fees is an indication of audit quality. In addition

DeAngelo (1981) claims that the larger audit companies obtain higher fees compared to small size audit firms.

Other research has provided evidence supporting the effect of the audit firm size on audit quality. Kilgore (2007) stated that audit firm size is the most commonly used criterion of audit quality. Moreover, DeAngelo (1981) considered that the larger the audit firm the better the audit quality, since the larger firms have more resources and employ better qualified, highly skilled and competent staff. In contrast, various researchers indicated that there are no real audit quality variations between large and small firms as it is only a matter of perception because large firms have gained a high quality reputation (Wooten, 2003).

Quality of external auditing is an efficient external technique to improve the quality of corporate governance in companies and the internal mechanisms of corporate governance. There are several studies that find important internal corporate governance mechanisms that have a significant relationship with audit quality proxied by audit size and audit fees, (Makani et al., 2012; Soliman and Abdelsalam, 2012, Lin et al., 2009; Brad et al., 2015; Zengin, 2013; Karim et al., 2012; Fan and Wong, 2005; Zureigat, 2011). This study will build on this literature to investigate the impact of corporate governance mechanisms on audit quality. Six major variables will be considered to measure corporate governance mechanisms namely: Ownership concentration, director ownership, board size, Chief executive officer (CEO) duality, board independence and audit committee.

3. OWNERSHIP CONCENTRATION

According to Shleifer and Vishny (1986) ownership concentration increases control over managers. In addition Heflin and Shaw (2000) claimed that monitoring with large shareholders helped in accessing private, valuable and important information. When large shareholders are also board members they can affect management especially in companies with concentrated ownership. Fan and Wong (2005) stated that the demand of higher audit quality is related positively to the presence of majority shareholders. Moreover various studies such as those by Abdullah et al. (2008) and Makani et al. (2012) found that there is a positive relationship between ownership concentration and audit quality. By contrast, both Zureigat (2011) and Zengin (2013) claimed that companies with large controlling shareholders are less probable to hire high quality auditors. Based on the previous discussion, the first hypothesis will be formulated as follow:

H₁: There is a significant positive relationship between ownership concentration and auditor quality choice.

3.1. Director Ownership

Both Niskanen et al. (2009) and Mahdavi et al. (2011) indicated that the higher the director ownership percentage, the lower information asymmetry and conflict of interest between managers and shareholders. In addition Niskanen et al. (2009) argued that an increase in managerial ownership decreases the probability of engaging a big-four auditor. Nevertheless, Abdullah et al. (2008), Makani et al. (2012) and Soliman and Abdelsalam (2012) found

that director ownership has no effect on the preference of a reputed auditor. On the other hand, Adeyemi and Fagbemi (2010) found that director ownership may increase the quality of audit. Indeed, when managerial ownership is higher, managers will have enough voting power to safeguard their positions regardless of their achievement performance. This can reduce the value of the firm and cause amplification of information asymmetry. In summary, most previous research suggested a negative relationship between the proportion of capital held by the director and hiring a better quality auditor. Thus, the second hypothesis will be formulated as follow:

H₂: There is a negative relationship between director ownership and auditor quality choice.

3.2. Board Size

According to Jensen (1993), the link between the number of board members and levels of conflict is positive. In this line, some studies have indicated that the smaller boards are more efficient due to better director-to-staff communication, as well as smaller firms being easier to manage (Basiruddin, 2011). According to Lipton and Lorsch (1992), the optimal size for a board should not be more than nine. In contrast Pearce and Zhara (1992) suggested that when number of board members is higher, the control capacity and performance would be enhanced. Relevant to this study, Makani et al. (2012) indicated that board size positively affects the demand for higher quality auditors. Thus, the third hypothesis will be formulated as follow:

H₃: There is a significant positive relationship between board size and auditor quality choice.

3.3. CEO Duality

CEO duality occurs when the chairman is the same person who occupies the position of CEO. CEO duality may increase conflict of interest between shareholders and managers and reduce control over managers which affect the agency cost; therefore the performance of the company is expected to decrease (Jensen and Meckling, 1976). CEO duality is not recommended by most of corporate governance codes (Makani et al., 2012). CEO duality has a negative relationship with audit quality (Brad et al., 2015; Lin et al., 2009; Abdullah et al., 2008; Soliman and AbdElsalam, 2008; Zengin 2013; Karim et al., 2013). In contrast, Makani et al. (2012) finds that CEO-Chairman duality positively affects the demand for higher audit quality. Therefore, the fourth hypothesis will be formulated as follow:

H₄: There is a significant negative relationship between CEO duality and auditor quality choice.

3.4. Board Independence

Independent directors are clarified as persons who have no apparent family ties with those holding power in the company and do not have any affiliation with the top executives of the firm (Makani et al., 2012). Fama and Jensen (1983) argue that the administrative board is the most efficient control mechanism to supervise management actions and focus on the necessity of board independence according to agency theory. Abdullah et al. (2008) and Mahdavi et al. (2011)

suggested that increasing the percentage of outside (independent) directors will increase the possibility of selecting a high-quality audit firm. Also, Soliman and AbdElsalam (2012), and Zengin (2013), indicate that board independence has a significant effect on Big-4 auditor choice. In contrast, Makani et al. (2012) argued that board independence has no effect on the choice of high quality auditor. Therefore the fifth hypothesis will be formulated as follow:

H₅: There is a significant positive relationship between the percentage of independent board of director and auditor quality choice.

3.5. Audit Committee

Soliman and AbdElsalam (2012) indicate that the existence of an audit committee has a significant positive relationship with audit quality. Mitchell et al. (2008) suggested that interaction between external auditors and the audit committee can potentially improve the quality of information provided to the stakeholders. Although, Adeyemi and Fagbemi (2010) argued that the audit committee has no effect on audit quality. Therefore the sixth hypothesis will be formulated as follow:

H₆: There is a significant positive relationship between the existence of audit committees and auditor quality choice.

4. METHODOLOGY

4.1. Data

The data of this study were collected from companies' annual reports for the years 2013–2015 and from PSE web site. The population of the study includes all firms listed on the PSE. A total of 48 companies were listed on the PSE at the end of 2015 (PSE, 2017). However, the sample of the study includes the companies that meet the following criteria:

- The firm should be traded on the PSE during the 2013 to 2015 period.
- The data needed for variable measurement is available.

Applying these criteria resulted in a sample of 46 firms with a total 137 firm-year observations.

4.2. Measurement of Variables

4.2.1. Dependent variable

The measurement of audit quality is problematic and still lacks consensus among researchers (Wooten, 2003). Some studies used audit fees to measure audit quality Collier and Gregory (1996). Several other studies used audit firm size (i.e., big4/non-big4) as a proxy for audit quality (Beasley and Petroni, 2001; Velury et al., 2003; Abdullah et al., 2008; Niskanen et al., 2009; Zureigat, 2011). In PSE most listed companies do not disclose information about audit fees making the use of audit firm size to proxy for audit quality irrevocable. This variable is expressed as a dummy variable which equal 1 if the company is audited by a big 4 audit firm and 0 otherwise.

4.2.2. Independent and control variables

Six independent variables are used in this study namely: Ownership concentration, director ownership, board size, CEO

Table 1: The definitions, proxies, for the dependent, independent and control variables

Variable	Label	Operational definition	References
Audit firm quality	Qual	A dummy variable which equal 1, if the company audited by big 4 audit firm and 0 otherwise	Beasley and Petroni 2001
Ownership concentration	Concentr	A percentage of shares owned by shareholders owned more than 1% of equity capital	Zureigat (2011)
Director ownership	DirectOwn	A total number of shares owned by board of directors divided by total number of shares	Soliman and AbdElsalam (2012)
Board size	Bsize	A number of directors on the board	Makani et al. (2012)
CEO duality	CEODual	A dummy variable which equal 1 if the CEO are the chairman of the board, or 0 otherwise	Makani et al. (2012)
Board independence	Bindependence	A percentage of non-executive directors in the firm's board	Suwaidan et al. (2013)
Audit committee	AuditCom	A dummy variable which equal, 1 if the company exist audit committee, or 0 otherwise	Soliman and AbdElsalam (2012)
Firm SIZE	LnTA	The natural log of total assets of the firm	Makani et al. (2012)
Financial leverage	Lev	The total debt to total assets	Makani et al. (2012)

duality, board independence and audit committee. In consistent with Makani et al. (2012), Zureigat (2011) and Salehi et al. (2015) the firm size and the firm leverage are used as control variables. Table 1 provides the operational definition if all dependent and independent variables of this study.

4.3. Logistic Model

The choice of the quality of auditor is modelled as a binary logistic model similar to equation (1).

$$\text{Qual} = \beta_0 + \beta_1 \text{Concentr} + \beta_2 \text{Directown} + \beta_3 \text{Bsize} + \beta_4 \text{CEODual} + \beta_5 \text{Bindependence} + \beta_6 \text{AuditCom} + \beta_7 \text{LnTA} + \beta_8 \text{Lev} + u \quad (1)$$

Where dependent and independent variables are defined in Table 1, u is the error term and β_k are the regression coefficients.

5. RESULTS

5.1. Descriptive Analysis

Table 2 provides summary descriptive statistics of the categorical variables. About three fourths of the sample companies are audited by big four auditing firms, while one fourth is audited by non-big four. As seen from the table, about 19% of the sample companies have duality which reflects an improvement since the duality was 36% in 2012 according to Awartani (2013). Similarly, almost 67% of the sampled companies have audit committees which reflects that the awareness of the importance of the existence of audit committee have increased compared with 47% in 2012 according to Awartani (2013). Table 2 also demonstrates that board size ranges from 5 to 15 with an average presented in Table 3 of approximately 9 members. Moreover, Table 3 reveals that nearly 92% of board members of firms listed in PSE are non-executive. It can be seen from Table 3 that there is a great deal of variations in the variables as indicated by the minimum and maximum values and by relatively high standard deviations.

Finally, Table 4 presents the mean and standard deviation for explanatory variables categorized by the levels of the dependent variable which is informative in understanding the explanatory variables that discriminate between the levels of the dependent variable in a binary model.

Table 2: Frequency of the categorical variables

Variables	Not big 4	Big 4	Total
Qual			
2013	11	35	46
2014	12	34	46
2015	12	34	46
Total	35	103	138
	Non-duality	Duality	Total
CEODual			
2013	38	8	46
2014	38	8	46
2015	38	8	46
Total	114	24	138
	Not existed	Existed	Total
AuditCom			
2013	18	28	46
2014	15	31	46
2015	15	31	46
Total	48	90	138
Bsize	Frequency of firms		
Board members	2013	2014	2015
5	2	1	2
6	4	2	2
7	10	12	12
8	3	3	2
9	12	9	11
10	7	5	5
11	6	12	9
13	1	1	2
15	1	1	1
Total	46	46	46

5.2. Model Estimation

The correlation between variables is first estimated in Table 5 to grasp the univariate relationship between variables. A strong correlation between dependent and explanatory variables is good but a strong correlation between independent variables themselves may indicate multicollinearity problem if correlation is higher than 0.8 which is not the case of Table 5.

A binary logistic regression was used to predict the tendency to choose a quality auditor (binary variable) using a set of predictor variables. Model 1 in Table 6 provides the results of the binary logistic regression analysis.

Table 3: Descriptive statistics for all variables

Variables	Mean	Median	Maximum	Minimum	SD	Observations
Qual	0.752	1	1	0	0.434	137
AuditCom	0.657	1	1	0	0.476	137
BIndependence	0.919	1	1	0.01	0.162	137
Bsize	8.876	9	15	5	2.077	137
Ceodual	0.175	0	1	0	0.382	137
Concentr	0.650	0.693	0.977	0.125	0.222	137
Directown	0.466	0.517	0.968	0	0.281	137
LEV	0.422	0.370	0.947	0.009	0.267	137
LNTA	17.470	17.278	21.748	13.711	1.777	137

SD: Standard deviation

Table 4: Mean and standard deviation for explanatory variables categorized by the levels of the dependent variable

Variable	Mean		
	Dep=0	Dep=1	All
AuditCom	0.353	0.757	0.657
BIndependence	0.906	0.924	0.919
Bsize	7.324	9.388	8.876
Ceodual	0.176	0.175	0.175
Concentr	0.554	0.682	0.650
Directown	0.362	0.500	0.466
LEV	0.339	0.449	0.422
LNTA	16.005	17.953	17.470
Variable	SD		
	Dep=0	Dep=1	All
AuditCom	0.485	0.431	0.476
BIndependence	0.116	0.175	0.162
Bsize	1.870	1.885	2.077
Ceodual	0.387	0.382	0.382
Concentr	0.240	0.207	0.222
Directown	0.251	0.283	0.281
LEV	0.243	0.270	0.267
LNTA	1.035	1.707	1.777
Observations	34	103	137

The entire model was statistically significant (Chi-square = 78, $P = 0.00$), indicating that the predictors as a set reliably distinguished between companies audited by Big-4 and companies audited by non-Big 4. McFadden pseudo R-squared (McFadden, 1974) of about 0.5 indicated a very good fit of the model (McFadden, 1977).

The estimation results demonstrated that ownership concentration, board size, audit committee, firm size and financial leverage have a significant relationship with the probability to choose an audit quality. Ownership concentration made a significant contribution to predication (Sig. <0.01). This means that there is a significant positive relationship between the concentration of ownership and audit quality in Palestinian companies. Thus, H_1 is supported which is consistent with Fan and Wong (2005), Abdullah et al. (2008) and Makani et al. (2012). This can be interpreted as ownership concentration increases oversight over managers (Shleifer and Vishny, 1986). In addition Heflin and Shaw (2000) claimed that monitoring with large shareholders helped in accessing private, valuable and important information.

Board size made a significant contribution to predication (Sig. <0.01). This means that there is a significant positive relationship

between the board size and audit quality choice in Palestinian companies. Thus, H_3 is supported consistent with the results of Makani et al. (2012). Furthermore Pearce and Zhara (1992) suggested that when number of board's members is higher, the control capacity and performance would be enhanced.

Audit committee has a highly significant relationship with audit quality choice (Sig. <0.01). This means that there is a significant positive relationship between the existence of audit committees and audit quality in Palestinian companies and H_6 is supported. Soliman and Abdelsalam (2012) and Mitchell et al. (2008) have found similar results and suggested that interaction between external auditors and the audit committee can potentially improve the quality of information provided to the stakeholders.

Table 6 demonstrate also that company size (lnTA) have a significant positive relationship with audit quality with ($\beta = 0.968$, Sig <0.01). This means that larger companies are more likely to hire high-quality auditor. In addition, there is a statistically significant negative relationship at 0.05 level between financial leverage and audit quality choice. Similar results with leverage for Belgium, Finland and Norway was found by Broeye and Weill (2008). They explain this result by the supply side effect of auditor market. As the firm risk increases, the cost of hiring high quality auditor may overcome the benefits of reducing agency costs. In this case, higher risk firms (i.e., firms with high leverage) will choose lower quality auditors.

With regard to the other independent variables, Model 1 in Table 6 found no statistical relationship between director ownership, CEO duality and board independence from one side, and audit quality choice from the other. Thus, H_2 , H_4 and H_5 are rejected.

As a robustness check, Models 2 and 3 in Table 6 re-estimate the model with some variations. Model 2 used robust standard errors to account for the possible heteroskedasticity and autocorrelation in the error term. Model 3 used lagged independent variables to account for the possibility that the effect of governance in 1 year affect the choice of auditor in the subsequent year not the same year. The results are qualitatively similar to Model 1 except that leverage loses some significance in Models 2 and 3.

6. CONCLUSIONS

This study examined the impact of corporate governance mechanisms on auditor quality choice to investigate if a substitute

Table 5: Correlation between variables

	Qual	AuditCom	Bindependence	Bsize	Ceodual	Concentr	Directown	LEV	LNTA
Qual	1.00	0.37	0.05	0.43	0.00	0.25	0.21	0.18	0.48
AuditCom		1.00	0.32	-0.01	-0.19	0.07	0.27	0.25	0.39
Bindependence			1.00	0.01	-0.29	0.03	0.29	0.06	0.19
Bsize				1.00	-0.02	-0.08	0.08	0.23	0.42
Ceodual					1.00	-0.37	-0.18	0.14	0.16
Concentr						1.00	0.37	-0.19	-0.23
Directown							1.00	-0.13	0.04
LEV								1.00	0.50
LNTA									1.00

Table 6: Models summary

Variable	Model 1	Model 2	Model 3
	First estimation	QML (Huber/white) standard errors	Lagged independent variables
AuditCom	2.197 (2.597)***	2.197 (2.678)***	1.999 (2.009)**
Bindependence	-1.533 (-0.975)	-1.533 (-1.209)	-2.008 (-1.499)
Bsize	0.744 (3.194)***	0.744 (3.163)***	0.552 (1.983)**
Ceodual	0.917 (0.897)	0.917 (1.342)	0.755 (1.102)
Concentr	6.331 (3.271)***	6.331 (4.377)***	6.044 (3.506)***
Directown	-0.021 (-0.016)	-0.021 (-0.020)	0.045 (0.043)
LEV	-2.899 (-1.957)**	-2.899 (-1.869)*	-3.182 (-1.896)*
LNTA	0.968 (3.005)***	0.968 (3.079)***	1.200 (3.211)***
C	-24.717 (-4.232)***	-24.717 (-5.279)***	-26.182 (-4.644)***
McFadden R ²	0.508	0.508	0.495
LR statistic (Chi-square)	(78.0)***	(78.0)***	(52.31)***
Total obs	137	137	92

***, **, * indicate significance at 1%, 5%, and 10% respectively

or complementary relationship exists between them. Results of the study revealed that a significant positive relationship between ownership concentration, board size and Audit committee on auditor quality choice. The study has revealed that these factors are important to help companies listed at PSE to improve the decision making process to be more independent, transparent and objective especially in selecting an external auditor. The results support the view that Palestinian firms see the selection of a high quality auditor as a complement not a substitute to good governance practices. Therefore, regulators need to encourage companies listed on PSE for more compliance with corporate governance guidelines. Future research, on auditor quality choice may use other proxies to measure audit quality such as, audit fees and industry specialist auditor.

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