

## IMPACT OF OWNERSHIP STRUCTURE ON AUDIT FEE

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### Abstract

This study examines the impact of ownership structure including directors', individuals' and institutional ownerships, on audit fee. The requisite data were acquired from the audited financial statements of the firms listed on Pakistan stock exchange (PSX). A sample of 210 public limited companies was carefully chosen from 445 non-financial firms. Fixed effect regression model was applied to achieve the objectives of the study. The findings suggest a significant positive association between individual ownership and audit fee. Conversely, the findings do not propose any association of directors' ownership, and institutional ownership with the audit fee.

**JEL Classification:** M420, M490

**Keywords:** Directors, Individuals, Institutional, Ownership, Audit Fee.

### 1. INTRODUCTION

Owners (shareholders) of listed companies are usually not actively involved in running the affair of the business. Therefore, they hire managers to operate their businesses. However, this segregation between the ownership and management creates the agency problem amongst the shareholders and the management due to the asymmetric information between the two. This information asymmetry increases the significance of financial reports issued by the business firms (William et al., 2016). Nevertheless, the management is responsible to make the financial statements that need to present a "true and fair" picture of the company's financial resources, obligations, performance, and cash flows, etc., according to the requirements of the international financial reporting standards. Conversely, owners (shareholders) can monitor the managers through the board of directors (BoD) (Gillan & Starks, 2002). A carefully composed board with adequate amount of independence helps to avoid agency problems and improves the performance of the business (Jensen & Meckling, 1976). Similarly auditing the financial reports plays an important role in minimizing the mistrust between the management and shareholders. Auditors enjoy access to the financial books and source documents. Auditors correspond with the members of the company in the form of reports regarding accounts, books of accounts, financial statements and documents, etc. The auditors' reports disclose the fact that they are provided with the requisite information to state their views that the set of financial information present true and fair picture of the business firm according to company law (Section 252, Companies Ordinance, 1984). An effective BoD positively affect external auditor's fees. An effective BoD requires higher quality audit in order to

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ensure better quality of financial reporting that lead to higher audit fee. However, effective audit committee can play an effective role in finalizing reliable financial reporting that can reduce external auditor's efforts leading to lower audit fees (Farooq, et al., 2018). On the other hand, Alkilani, Hussin, and Salim (2019) anticipated ownership to play pivotal role in improving the quality of financial statements and reducing the possibilities of a "modified audit opinion".

Audit assumes more importance in organizations that are owned by individual or general public than organizations owned by very few owners particularly directors. Further, the key shareholders can control and examine the management either by direct representation on the BoD or via informal channels e.g. intermediaries (Chan et al., 1993). The control of ownership plays an important role in determining the audit fees. However, business firms may incur higher audit cost (fees) for hiring better quality audit services (Mitra et al., 2007). Conversely, the managerial ownership synchronizes the interest of managers and owners, thus leading to decreased opportunistic activities by the managers which decrease the audit risk and reduces the audit fee. The auditors need to make a keen investigation when the managers have higher control over the firm's resources. This higher control can lead to opportunistic reporting by the managers (Lin & Liu, 2013).

Conversely, the firm is more diffused in case of greater individual (public ownership). The individual owners are less interested to interfere in the administration of the business so financial reporting process may be more influenced by the management to hide their opportunistic behaviour. Such dispersed ownership needs greater audit effort leading to larger audit fees (Khan et al., 2011). Individual shareholders may not have the requisite skills to observe the performance of the management due to manipulation of information by the management. On the other hand, majority of individual shareholders buy stocks for speculative purposes. Such investing tendency diverts the interest of shareholders from pure performance of management towards the capital appreciation. Therefore, individual shareholders have very little concerns for quality audit (Xu & Wang, 1999). Greater individual ownership gives rise to agency problems and to mitigate such problems firm's reliance on quality audit increases which in return increases audit fee (Chan et al., 2007). Alternatively, the separation between the owners and the managers of the firm make it very important for the institutional owners to be more active in controlling and monitoring the management (Mohammadi & Zahra, 2014). Institutional investors become rather more active when they are not satisfied with the BoD role (Gillan & Starks, 2002). However, institutional investors are generally more informed and interested in quality audit information regarding earnings thus enhancing the engagement of auditors and audit fee (Khan et al., 2011).

Audit fee is the money paid to the auditors by the business firms for their services (Mohammadi & Zahra, 2014). Two types of factors determine the audit fee i.e. auditor specific and client specific. Auditor specific factors include reputation of auditor, affiliation with big audit groups and technological advancement. On the other hand, the client specific factors that influence audit fee include size of client, client business complexity, its risk of liquidation or inherited risk of audit related to the business of

client (Anwar & Leghari, 2015). Auditor acts in the capacity of agent to the owners protecting the benefits of all the important stakeholders like shareholders, creditors, retirees, and workers, etc. Auditor assures these stakeholders about the integrity of financial reporting, which is important for forecasting the future existence of the company (Gonzalo, 1997).

The current study primarily intends to investigate the influence of ownership structure on audit fees in companies listed in Pakistan Stock Exchange (PSX). Previously very limited research addressed the relationship between the ownership structure and audit fee, in Pakistan. This situation motivates this researcher to undertake the current study. This research takes into account directors/managerial, individual and institutional ownership as the types of ownership structure. Thus, precisely, this study is focused on the following objectives.

- 1) To observe the influence of director ownership on audit fee.
- 2) To observe the influence of individual ownership on audit fees.
- 3) To observe the influence of institutional ownership on audit fee.

Previous researches investigated the influence of one type of ownership structure on audit fee, at a time, whereas, the current study incorporates three types of ownership as variables simultaneously. This can help in identifying the collective power of the model. The findings of this study may prove worthwhile to the auditing profession as well as to the top management of business firms. Further, this research may prove a good addition to the body of knowledge utilizing data of Pakistani companies.

The rest of the paper consists of 4 sections. Section 2 gives detailed review of existing literature on the agency theory, different types of ownership structures and audit fee. At the end of the section 2, theoretical framework is prepared and statements of hypotheses are given. Section 3 explains the components of research methodology adopted during this study. Section 4 covers the data analysis and interpretation of findings. Section 5 sums up the current research.

## **2. SURVEY OF LITERATURE**

Agency problem occurs due to different goals and division of labours between the cooperating parties (Ross, 1973). Agency theory narrates the arrangement in which the principal hands over the responsibilities to the agent. Conversely, the agent commits to discharge the responsibilities for the benefits of the principal (Jensen & Meckling, 1976). Agency theory addresses the problem that arises due to the conflicting targets of the principal and agent. Further, the diverse attitudes of principal and agent towards risk also create problem (Eisenherdt, 1989). CEOs pursue to maximize their compensation through self-dealing and at the cost of firms by restraining efforts (Hendry, 2002). In case the owners are unaware about the CEO actions and behaviour, CEOs tend to concede selfish actions and in return firms have

to bear that cost (Bosse & Philips, 2016). Agency theory applies the corporate governance mechanism where the BoD act in the best interests of the firm and CEOs act as agents to operate the business (Jensen & Meckling, 1976). However, in order to amalgamate the interests of a firm and its CEO, the CEO is given option to retain shares of the firm (Fama & Jensen, 1983) so that they can focus on maximizing the worth of the business (Wowak & Hambrick, 2010). Agency theory elucidates the functions of the BoD and highlights the significance of its controlling (Zahra & Pearce, 1989) and monitoring role. On the other hand, the executives are responsible for playing a strategic role rather than monitoring role (Hung & Kaveh, 1988). The intensity of conflict and information asymmetry varies from one business to another and therefore can require various levels of audit intensity and quality (DeAngelo, 1981).

At times the board members or the managing directors own a portion of the company's shares, leading to a managerial or director ownership structure (Mahmoud et al., 2014). Such type of ownership structure is an important variable to address the agency conflict because the managers work more for their self-interest if a greater segregation of ownership and control exists (Jensen & Meckling, 1976). Therefore, managers and employees are encouraged to own the shares because it decreases the agency costs (Fleming et al., 2005). Nikkinen and Sahlstrom (2005) observed a significant inverse association between audit fee and managerial ownership. Conversely, Sun et al. (2014) observed a significant affirmative association between "CEO inside debt" and audit fee. The inside debt is equivalent to external debt in all respect but only with delayed executive compensation. However, Nelson and Rusdi (2015) found no significant relationship between greater managerial ownership and audit fee. Conversely, Yin (2011) found a significant negative relationship among independent NEDs and audit fees. It implies that BoD with people holding no managerial posts in the company leads to less audit risk. There is no conflict of interests between directors and managers and there exists a sound and objective decision-making mechanism due to segregation of authorities, hence resulting in lower audit fees. Desender et al. (2009) and Desender et al. (2011) observe greater influence of board independence on audit fees in case of disbursed ownership. Other researchers (Chiao, 2012; Peel & Clatworthy, 2001) found significant negative connection between concentrated board ownership and audit fees, indicating concentrated board ownership more effective in monitoring opportunistic managerial behaviour, resulting in lower audit fees. A concentrated BoD ownership weakens the association between CEO duality and audit fees (Chiao, 2012). Lin and Liu (2013) divide the managerial ownership in three types i.e. (1) low (no managerial ownership), (2) intermediate (where the interest of manager is allied with the interest of external shareholders) and (3) high regions (when managers has 100 percent ownership). Lin and Liu (2013) found a significant negative connection between audit fee and managerial ownership in low and high regions. They further observe that managers would not act deviously in managing the firms' operations and financial reporting when the ownership structure moves from low level to the next level of managerial shareholding. Thus, the audit risk is reduced. O'Keefe et al. (1994) states that lack of managerial shareholding results in weak integration of interests as

managers promote their personal interest at the cost of the firms. Resultantly, inherent risk magnifies requiring the auditors to apply rigorous examination, which lead to larger audit fee. Niemi (2005) found opposite impact of managerial and non-managerial ownership concentrations on audit fees observing a significant negative connection between managerial control of the firm and audit fees. Other researchers also found significant negative relation between managerial ownership and audit fees [Mitra et al. (2007) and Chiraz & Lesage (2010)].

After thorough review of literature regarding the association between the director ownership and audit fee, this hypothesis ( $H_1$ ) is developed.

$H_1$ : There is significant association between the director ownership and audit fee.

When substantial amount of shares are held by individuals (general public) then there exists individuals' ownership (Khan et al., 2011). The public firms exhibiting a wide spread ownership result in individual owners who are less interested in monitoring the management activities. This causes the auditors to perform an in depth examination of the firm to check for the concealment of the opportunistic behaviour of the management in the financial reporting. Conversely, individual shareholders with bulk of shares increase the shareholders' monitoring of financial reporting and hence reducing the audit risk and ultimately reducing the audit fee. So a dispersed or more widespread ownership requires for a higher audit fee whereas a concentrated or large ownership by individuals may lead to a lesser audit fee. Further, the public shareholdings have a negative but statistically insignificant relationship with audit fee (Khan et al., 2011). In the event that owner owns an organization through the pyramidal structure, the voting rights are more prominent than the cash flow rights of the same owner. This distinction could impact the company's audit related strategy and auditors conduct resulting in poor audit quality and low audit fee showing a negative connection between the two (Choi et al., 2007). However, Alkilani, Hussin and Salim (2019) did not find any association between the individual ownership and a "modified audit opinion".

The affiliation between the individual ownership and audit fee is proposed in the following hypothesis ( $H_2$ ).

$H_2$ : There is significant association between the individual ownership and audit fee.

Institutional investors are considered the key "players of the financial markets" (Al-Najjar & Taylor, 2008). Institutional ownership implies that institutions (e.g. insurance companies, financial institutions, banks, associated companies and governmental firms) own a portion of the company's shares (Mahmoud et al., 2014). Mohammadi and Zahra (2014) consider the audit fee as an important issue both for the managers and independent auditors. However, they do not observe any meaningful connection between institutional ownership and audit fees. Similarly, O'Sullivan (2000) found no association between the two variables. Nevertheless, Chiraz and Lesage (2012) observe a significant affirmative relationship between institutional ownership and audit fees. Similarly, Niemi (2005) discovered a positive

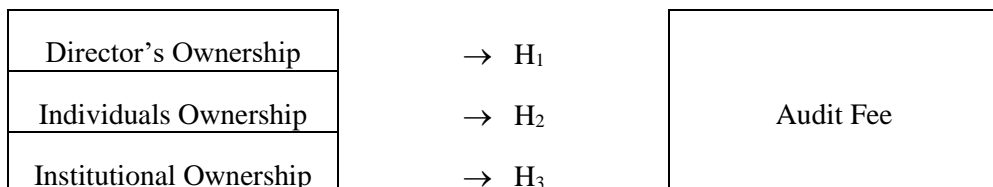
connection of state ownership and foreign holding control with audit fee. Mitra et al. (2007) observed a significant positive association between diffused institutional stock ownership and audit fee while significant negative association between institutional block holder ownership and audit fee as well as between managerial ownership and audit fee. Managers having substantial ownership interests would not like to misrepresent the financial results for their own interest which in turn mitigates the agency problem related to financial reporting. According to Khan et al. (2011) institutional investors, based on their large interests, tend to have an effective mechanism of monitoring. They closely monitor their investment portfolios thus reducing the audit risk leading to a reduced audit fee.

According to Han et al. (2009) audit quality is dependent upon the nature of ownership. Higher long-term institutional ownership requires high quality audits for better corporate governance and decreasing the direct monitoring costs for the institutional owners, which increases the audit fee. Auditors charge higher fees when short term institutional ownership is higher. Alzeaideen and Al-Rawash (2018) also observed statistically significant and positive relationship between the audit quality and foreign and institutional ownership holding companies. Hu et al. (2012) argue that the firms that are controlled by the central government pay lower audit fees than the firms that remain under the control of local government. Nelson and Rusdi (2015) found a significant positive connection between firms with large government ownership and audit fee. Yahyazadehfar et al. (2015) indicate ownership composition as the primary component determining the audit fee. They further observe negative association between institutional ownership and audit fee. Khan et al. (2011) also observe the same type of relationship between the two variables. This whole discussion can be concluded in the form of the following hypothesis (H<sub>3</sub>).

H<sub>3</sub>: There is significant association between the institutional ownership and audit fee.

The relationship between the ownership structure and audit fee is shown in the following theoretical framework representing the three hypotheses formulated for the purpose of this research. The ownership structure including directors' ownership, individuals ownership and institutional ownership is the dependent variable and audit fee is dependent variable.

**Figure 1: Theoretical Framework**



### 3. RESEARCH METHODOLOGY

During the period covered by this research, 577 companies from 35 sectors were found listed on PSX, including 132 financial companies (Jasir, 2008). However, the financial firms were omitted for the purpose of this study due to their special features. So a total of 445 non-financial companies listed on PSX constituted the population for this study.

Initially all the listed firms were included in our analysis for the period 2011-2015. All the financial firms were omitted due to their unique characteristics as their capital structure was quite different from the firms in non-financial sector which might affect the results (Tahir & Attaullah, 2004; Jasir, 2008; Khan et al., 2011; Desender et al., 2011). The sample was finalized by deleting 71 firms due to missing information in their annual reports and 164 firms due to unavailability of their annual reports, from the total of 445 non-financial firms. After eliminating such companies, a sample of 210 firms was finally selected. The data were obtained for 5 years from each firm i.e. for the period 2011-2015, making a total number of 1050 of observations for final analysis. The requisite data were obtained from the respective financial statements of the targeted firms.

The director/managerial ownership structure was defined as substantial amount of shareholdings by the BoD or managers in the firm [Nikkinen & Sahlstrom (2005) and Mahmoud et al. (2014)]. This ownership structure was computed through dividing the number of shares in position of managers by the total number of shares outstanding (Mahmoud et al., 2014).

$$\text{Director Ownership} = \frac{\text{The Number of Share Held by Managers \& Directors}}{\text{Total Number of Shares of the Company}}$$

Individual ownership was computed on the basis of the following formula (Khan et al., 2011).

$$\text{Individual Ownership} = \frac{\text{The Number of Share Held by the General Public}}{\text{Total Number of Shares of the Company}}$$

Institutional ownership refers to the holding of substantial amount of shares by government, insurance companies, associated companies, banks or investment companies [Mohammadi & Zahra (2014), Mahmoud et al. (2014)]. It was calculated using the following formula (Mahmoud et al., 2014).

$$\text{Institutional Ownership} = \frac{\text{The Number of Share Held by Institutions}}{\text{Total Number of Shares of the Company}}$$

Audit fee is the amount paid to the auditors for the audit services (Mohammadi & Zahra, 2014). Audit fee was measured by taking natural log of audit fee for achieving normality of data and preventing the large companies from influencing the findings [Aswadi et al. (2011), Chiao (2012) and Mahmoud et al. (2014)].

The following model was applied for the purpose of this study.

$$LN_{AUDF} = \alpha_1 + \alpha_2(BRDOWN)i + \alpha_3(INDOWN)i + \alpha_4(INSTOWN)i + \alpha_5(LNTA)i + \alpha_6(LNINV)i + \alpha_7(LNROE)i + \epsilon_i \quad (1)$$

Where,  $LN_{AUDF}$  is the natural log of total audit fee,  $BRDOWN$  is the % of shares held by directors,  $INDOWN$  is the % of shares held by individuals (general public),  $INSTOWN$  stands for the % of shares held by Institutions,  $LNTA$  is the natural log of total assets,  $LNINV$  is the natural log of inventory and  $LNROE$  stands for the natural log of ratio of pre-tax profit to total equity

It is pertinent to mention that total assets, inventory and return on equity (ROE) were taken as control variables in the model.

#### 4. DATA ANALYSIS AND RESULTS

E view version 8 was used for the data analysis applying the fixed effect regression model. The results are discussed below.

Descriptive statistics is given in Table 1. There is huge variability in the data of ROE and that is why mean value is not appropriate measure of central tendency rather one should look at the median (Anderson et al., 1996, p.92). The median of ROE for the firms is 0.14. Similarly, the median value for institutional ownership is 0.48 and so on. It can be inferred from table 1 that data for all the variables is dispersed around the mean except for ROE which has the highest standard deviation showing dispersion of data quite away from the mean.

**Table 1: Descriptive Statistics**

	Minimum	Maximum	Mean	Median	Std. Dev.
ROE	-69.984	1733.867	6.118	0.146	88.298
ROA	-1.048	1.676	0.049	0.043	0.124
INSTOWN	0.000	1.000	0.496	0.485	0.334
BRDOWN	0.000	97.480	0.360	0.156	3.158
INDOWN	0.000	0.994	0.244	0.203	0.188
LNTA	11.435	20.132	15.617	15.489	1.461
LNREC	2.708	21.474	12.664	12.663	2.106
LNINV	5.533	18.480	13.402	13.457	1.724
LNAUDF	3.689	8.876	6.717	6.685	0.662

Correlation among the respective variables is presented in Table 2. It is checked for identifying the presence of multicollinearity. The maximum value is around 63 percent which is not that high a number. If the correlations are high, for instance, above 0.8, then there is fear of serious collinearity (Gujarati & Porter, 2010, p.254).



**Table 2: Correlation of Independent Variables**

	ROE	ROA	LNTA	LNREC	LNINV	INDOWN	INSTOWN	BRDOWN
ROE	1.000							
ROA	0.058	1.000						
LNTA	0.061	0.132	1.000					
LNREC	0.059	0.142	0.634	1.000				
LNINV	0.004	0.175	0.620	0.420	1.000			
INDOWN	-0.041	-0.132	-0.332	-0.185	-0.236	1.000		
INSTOWN	0.077	0.140	0.437	0.317	0.241	-0.548	1.000	
BRDOWN	-0.008	-0.019	-0.068	-0.082	-0.083	-0.039	-0.120	1.000

Hausman test was applied to test the following hypothesis.

H<sub>0</sub>: Random effect model is appropriate

H<sub>1</sub>: Fixed effect model is appropriate

**Table 3: Test Cross-Section Random Effects - Hausman Test**

Test Summary	Chi-Sq. Statistic	Chi-Square d.f.	Prob.
Cross-section random	27.489560	6	0.0001

The result of Hausman test is significant, therefore null hypothesis of random effect model is rejected. Hence, the fixed effect model is applied and the results are reported below.

In the model the Prob (F statistic) endorses the general significance of the regression model and in the independent variable individual ownership is significant. Durbin-Watson statistic presents no problem of autocorrelation [Gujarati & Porter (2010) and Ayyangar (2007)]. All other variables are insignificant and hence they do not explain the variation in the audit fee. Thus, it is found that individual ownership has a significant positive relation with audit fee at 5% level of significance. However, this is in contradiction with Khan et al. (2011). Conversely, this study found no meaningful relation of director ownership and institutional ownership with audit fee. The result for directors' ownership is consistent with Nelson and Rusdi (2015). However, this result is in contradiction with other researchers [Mitra et al. (2007), Chiraz & Lesage (2010) and Lin & Liu (2013)] who found significant positive

connection between director ownership and audit fee. The findings for institutional ownership also show no meaningful relationship which is supported by O’Sullivan (2000) and Mohammadi and Zahra (2014). Nevertheless, it is in contradiction with the findings of some other researchers [Neimi (2005), Chiraz & Lesage (2012)] who found significant affirmative connection between institutional ownership and audit fee.

**Table 4: Fixed Effect Model**

Dependent Variable: LNAUDF

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	3.494258	0.456026	7.662408	0.0000
ROE	0.000133	0.000118	1.127043	0.2601
LNTA	0.184548	0.029452	6.266004	0.0000
LNINV	0.020359	0.014377	1.416040	0.1572
INDOWN	0.299208	0.131892	2.268579	0.0236
INSTOWN	-0.024110	0.122897	-0.196185	0.8445
BRDOWN	0.000186	0.002479	0.074941	0.9403
Effects Specification				
Cross-section fixed (dummy variables)				
R-squared	0.918370	Mean dependent var	6.710005	
Adjusted R-squared	0.896983	S.D. dependent var	0.661900	
S.E. of regression	0.212445	Akaike info criterion	-0.077153	
Sum squared residuals	34.79741	Schwarz criterion	0.940225	
Log likelihood	240.5737	Hannan-Quinn criteria	0.310015	
F-statistic	42.94091	Durbin-Watson stat	1.974414	
Prob(F-statistic)	0.000000			

## 5. CONCLUSION AND RECOMMENDATION

The results show significantly positive relationship between individual ownership and audit fee. However, no meaningful relationship was found between directors ownership and audit fee, and between institutional ownership and the audit fee. The results are some how in line with the literature that suggest directors or managerial

ownership have no meaningful relationship with audit fee (Nelson & Rusdi, 2015). Similarly, the results for institutional ownership with audit fee is in line with O'Sullivan (2000) and Mohammadi and Zahra (2014).

At the end it is imperative to mention that the current research examined only the types of ownership structure as the factors affecting audit fee. However, there are other important factors that may affect determining the audit fee including auditors' reputation/rating, size of firm, age of firm, riskiness of firm, industry nature, etc. Future research may better equip any combination of such factors to determine their effect on audit fee and audit quality. Nevertheless, this study may prove helpful to regulators and investors to have insight into the nature of ownership structure as an important factor to determine the quality of financial reporting and cost of audit. Conversely, the findings may educate auditors about the role of ownership structure in determining the audit efforts and cost.

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