

## Impact of Corporate Governance on Audit Fee: Empirical Evidence from Pakistan

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**Abstract:** The breakdown of world well known corporate giants such as *Adelphia*, *WorldCom*, *Enron* and *Parmalat* has resulted in an increasing attention to corporate governance mechanism. Even in Pakistan, some scandals have occurred, for example Pakistan *PTCL privatization & Mehran Bank* Frauds; an analogous could be drawn, denoting that these scandals have resulted in increased attention to audit and regulatory committees to ensure the soundness of publicly available financial information and to serve for the purpose of accountability over the firm activities. Therefore, the current study aims to examine the relationship between corporate governance and audit fee in Pakistan. For this purpose panel regression is used to analyze the relationship between corporate governance and audit fee of 37 publically traded firms listed at Karachi Stock Exchange (KSE), during 2009-2012. Results show that corporate governance, firm size and leverage have a positive relationship with audit fee. Moreover, results also demonstrate that audit firm size is insignificantly related to audit fee. The implications and limitations of the study have also been discussed.

**Key words:** Audit Fee • Corporate Governance • Firm Size • Leverage • Audit Firm Size • Pakistan

### INTRODUCTION

According to Larcker and Tayan [1] Corporate Governance is a set of control mechanism that an organization adopts to refrain its management from the activities that are detrimental to its welfare. This control mechanism becomes a centre of attention when world's well-known business i.e. *Adelphia*, *WorldCom*, *Enron* and *Parmalat* loses the trust of stakeholders. Countries all over the world are now very keen to encourage good corporate governance practices for assurance of fairness, transparency and accountability in the corporate sector and to safeguard the interest of all stakeholders [2]. Moreover, to ensure the soundness of publicly available financial information and to serve for the purpose of accountability over the firm activities, audit and regulatory committees have become a common mechanism of corporate governance [3]. The Sarbanes-Oxley Act of 2002 in the US, Australian Treasury (2002) and Higgs (2003) review in the UK are the examples of the regulatory committees [4]. Similarly, in Pakistan, Securities and Exchange Commission (SEC) established in 2002, acts as a regulatory body which issues the code of corporate governance for the companies listed on Pakistan's stock exchanges. The

purpose of these regulatory bodies and audit firms is to ensure the welfare of stakeholders of organizations through ensuring the correctness of publicly available financial information [5]. As the audit serves the purpose of accountability, therefore, its importance in corporate governance cannot be denied.

Much literature has been written on the importance of corporate governance. Ehikioya [6] found that sound corporate governance practices attract more capital for an organization. Similarly, the study of Lu & Sapra [7] found a significant association between effective corporate governance practices and the quality of the financial reporting process. Likewise, study of Cho & Kim [8] depicts that good corporate governance structure plays an important role in enhancing firm performance and sustainability in long term. Furthermore, a plethora of studies provided the evidence between corporate governance, corporate structure and firm performance. However, little research has been done on linking the corporate governance with external audit committees and audit fee especially in Pakistan. Therefore, the above literature leads to the following research questions:

- Is there any link between the corporate governance and audit fee?

- Is there any relation between company size and company leverage with audit fee?
- Is there any relation between the size of the audit firm and audit fee charged?

Therefore, the main purpose of the current study is to identify the corporate governance as one of the factors determining the auditing fee in Pakistan in the presence of various controlled factors i.e. firm size, leverage and audit firm size. Furthermore, rather than providing the theoretical consequences of the corporate governance, this study aims to provide empirical evidence from the manufacturing sector of Pakistan.

### Literature Review & Hypotheses Development

**Audit Fee:** Soltani [9] defined the audit fee as cost of conducting audit to express an opinion there on about the conformity of financial statements with generally accepted accounting principles (GAAP). In the similar context, Simunic [10] defined the audit fee as a cost associated with the audit services which are demanded by client. Study of Chow [11] explained that contractual or institutional requirements determine the demand for audit services to be provided by audit firm. Moreover, as a response of agency contract, DeAngelo [12] and Watts & Zimmerman [13] stated the audit of financial statement as a cost-effective contract between the management & shareholders.

External auditor plays a significant role in providing assurance to all the shareholders that the financial statements are free from misstatements and voluntarily mistakes. This assurance may be affected if the auditors are not performing independently. The dependency of auditors on its client financially may lead to violation of auditor's independence [14]. Regarding the independence of auditor, DeAngelo [12] and Watts & Zimmerman [13] provided that auditor must not only detect errors and frauds, but must be independent (report appropriate). This may cause the unwillingness of auditor to detect errors and frauds in financial statements even though he knows about it. Jensen & Meckling [15] considered non-audit service (or consulting) services by audit firm as a key issue towards the auditor's independence. In contrast, study of Antle *et al.* [16] provided that the availability of prior knowledge about the client company's system make it easy about provision of services.

In this study, characteristics of various companies as mentioned by Francis [17] are taken to propose that audit fee depends on company size, leverage, governance practices and auditor quality (audit firm size).

Audit Fee = f (Firm size, Leverage, Auditor Quality, Corporate Governance)

**Audit Fee and Corporate Governance:** Several studies have been conducted to test the relationship between the audit fee and corporate governance. Study of Ibrahim [18] provided that there is low significant relationship between corporate governance and audit fee. Similarly, study of Chow [11] found the positive and significant relationship between audit fee & corporate governance. Griffin *et al.* [19] stated that corporate governance has both the positive (increasing) & negative (decreasing) impact over the audit fee. Earlier research of Bell *et al.* [20] suggests that audit fee charged to the riskier companies is far greater than those companies whose risk is less because riskier companies perceived to have weak internal control. Moreover, study of Hay *et al.* [21] also highlighted the relationship of corporate governance & audit fee with reference to section 404 of SOX Act, which requires the listed companies to provide the disclosure of internal control information. In Pakistan during the past few years both corporate & financial world have showed a significant changes. In March 2002, SECP issued code of corporate governance for the purpose of establishing good governance for companies listed in Pakistani Stock Exchanges. Study of Shah and Butt [22] stated that family owned business and non-professional directors are dominant in Pakistani business sector. This feature leads towards the high agency cost. Study of Hay *et al.* [21] has pointed out the determinants of audit fee including company size, audit risk, complexity of client and degree of market competition. Likewise, Naser *et al.* [23] explained corporate size, audit firm status, industry type, degree and complexity of risk as major determinants of audit fee. In addition, Arshad *et al.* [24] analyzed the positive impact of Audit committee over the profitability of firm.

From the above discussion, this study proposes the first hypothesis:

**H<sub>1</sub>:** The auditing fee will be higher in case of better corporate governance.

**Firm Size:** Study of Francis [17] found the positive relationship of Audit fee with firm size. Similarly study of Hay *et al.* [21] relates the audit fee with audit quality and found the positive relationship between them. Moreover their study also concluded that audit fee determines the audit quality. Likewise, study of Field *et al.* [25] depicts that audit fee is a function of firm size and there exists positive relationship between company size and auditing

fee; hence the auditing firms demand higher fee from larger companies because of their complexity and more hours of work relative to small companies. While presenting the reason for positive relationship between audit fee & firm size, Palmorose [26] stated that it is a natural phenomenon that evaluation of large company will take more time and additional efforts. In addition, Francis [27] analyzed that audit fee is related to total assets of company.

A plethora of studies provide the evidence between firm size and audit fee and found the positive relationship between them [16, 28].

Thus, the literature exposed above leads us to formulate the second hypothesis:

**H<sub>2</sub>:** Larger the company size higher the audit fee will be.

**Firm's Leverage:** According to Arrunda [29] company's probability of facing future financial difficulties may result in more independent audits. Greater auditing efforts are required for the firm having financial difficulties. Highly leveraged companies have more chances of becoming insolvent that will lead to positive relationship between the firm leverage and audit fee because more audit efforts are required for evaluation of leveraged firm. Lu and Sapara [30] examined that higher business risk association increases customer's pressure towards the auditing quality, which in turn results in increase of audit fee. Similarly, Bedard and Jonstone [31] found the positive relationship between the firm leverage and audit fee. Chaney et al. [32] also examined the significant positive relationship between the audit fee & financial risk. Arshad et al., [24] experienced that the firms with more leverage have to spend more on their audit fee. Recent study of Zaman, Hudaiba and Haniffa [28] also found the positive relationship between Firm leverage and Auditing fee.

From the above discussion, this study further proposes the third hypothesis:

**H<sub>3</sub>:** More the leveraged company, higher will be their audit fee.

**Audit Firm Size:** Big Four Audit firms in Pakistan are Ernst & Young (Fordh Rodhes Sidat Haider & Co), KPMG (Taseer Hadi & Co.), Deloitte Touche Toumatsu (M. Yousaf Adil Saleem & Co.) and PWC (A.F. Ferguson & Co.). There are several reasons for charging high fee by large audit firms [33]:

- Big audit firms charge higher fee because of its monopoly or oligopoly in market.

- Big audit Firms charge a premium because of their audit quality services as compared to the services provided by their competitors.

Arshad *et al.* [24] examined that there exist a positive relationship between the audit firm size and fee charged by audit firm i.e. the big firm charge higher fee in exchange of services provided by them. DeAngelo (1981b) also experienced that large audit firms have high level of reputational risk so provide a quality service to their clients & charge higher amount for that. Zaman Hudaib & Haniffa [28] also found that the big audit firms charge a premium for quality audit services provided to their clients. Moreover, their study depicts that companies that hire any of big 4 audit firms have to pay higher audit fee. Thus, the literature exposed above leads us to formulate the final hypothesis of this study:

**H<sub>4</sub>:** The larger the Audit firm, higher the audit fee will be charged

## MATERIALS AND METHODS

The main purpose of the study was to examine the relationship of corporate governance and audit fee in the presence of control variables i.e. firm size, audit firm size & leverage. For this purpose data was collected from the companies listed at Karachi Stock Exchange. Convenience sampling technique was used to select sample from the whole population. Total 45 companies were selected out of which 8 companies were dropped out due to lack of data availability issue or for non-providing of disclosure about fee. Data was collected from year 2009 to 2012 because of availability of disclosure about the amount paid to external auditor. Panel data regression was used in this study because the data has cross sectional units over a numerous periods of time. Panel data covers the heterogeneity of cross sectional by analysing the individual firm and also reduces the risk of co linearity and biasness among variables. As "fixed effects estimates are always consistent" [34], thus, this study keeping in view the nature of data (balanced panel) used fixed effects method to estimate panel regression equation. This study consists of total five variables out of them, one i.e. audit fee is dependent variable, governance score is independent variable & three variables i.e. firm size, leverage and audit firm size are controlled variables. Tables 1&2 provide the operational definitions of these variables.

Table 1: Operational Definitions of Study Variables

Variable Name	Symbol	Operational Definition
<b>Dependent Variable</b>		
Audit Fee	AudF	Natural Log of Audit Fee
<b>Independent Variable</b>		
Governance Score	Gov-Score	Governance score is measured by summing up the five dichotomous variables i.e. Board Independence, Board Size, CEO Duality, Audit & Remuneration Committee and Audit Committee Independence. Governance score 5 indicates highest governance quality and 0 indicates worst governance quality [35].
<b>Control Variables</b>		
Firm Size	FS	Firm size measured by taking natural log of total assets of firm
Leverage	LEV	Measured as Total Debt/ Total Assets of firm
Auditor Firm Size	Big 4	Big 4 audit firm of Pakistan. Dummy variable takes value of 1 if the audit firm is related to one of the big four audit firms of Pakistan or 0 otherwise.

Note: Big-4 Audit firms in Pakistan considered in this research study are; (1) Ernst & Young (Fordh Rodhes Sidat Haider & Co), (2) KPMG (Taseer Hadi & Co.), (3) Deloitte Touche Toumatsu (M. Yousaf Adil Saleem & Co.) & (4) PWC (A.F. Ferguson & Co.).

Table 2: Operational Definitions of Dichotomous Variables used for Governance Score

Variable Name	Symbol	Operational Definition
Board Independence	BI	Takes value 1 if the firm %age of independent outside directors is greater than sample median value, otherwise 0
Board Size	BS	Takes value 1 if the firm board size is less than sample median value, otherwise 0
CEO Duality	Dual	Takes value 1 if there exists separation of Chairman and Chief Executive Officer (CEO), otherwise 0
Audit & Remuneration Committee	Aud_REM	Takes value 1 if the firm have both the audit and remuneration committees, otherwise 0
Audit Committee Independence	AudI	Takes value 1 if the firm %age of independent outside directors on the audit committee is greater than sample median value, otherwise 0

Note: Governance Score = BI + BS + Dual + Aud\_Nom + AudI

Thus keeping in view the operational definitions of the study variables and hypotheses of the study, the research model is produced as follows:

$$\text{AudF} = \beta_0 + \beta_1 \text{Gov-Score}_{it} + \beta_2 \text{FS}_{it} + \beta_3 \text{LEV}_{it} + \beta_4 \text{Big4}_{it} + \varepsilon_{it}$$

## RESULTS

**Descriptive Statistics of Dichotomous Variables:** Table 3 shows the descriptive statistics of five dichotomous variables. As shown in Table 3, the median value of board size is 8, for board independence, the median value is 71% independent directors in board structures. Moreover, median value of CEO duality & for companies having both audit & remuneration committee is 1. Finally, for independence committee, the median value is 80% independent directors in Audit committee.

**Descriptive Statistics of Study Variables:** Table 4 shows the results for descriptive statistics of all the variables. Results shows the log value of audit fee ranges from 5.01 to 9.35 having mean value of 6.95 & median value 6.91. Similarly, governance score of sample firms ranges from minimum value 1 to maximum value 5, mean value of governance score is 3.54 & median value 4.0. Moreover, log value total assets have been taken to represent the

firm size ranges from 13.12 to 20.46, having a mean value of 16.9 & median value of 16.98. However, Minimum leverage value is 0.08 and maximum value of leverage for sample firms is 1.38 with mean value of 0.62 & median value of 0.65. Big4 being a dummy variable have the minimum value of 0 and maximum value of 1.

**Correlation Analysis:** As the study aims to find the relationship between the corporate governance and audit fee in the presence of control variables i.e. size, audit firm size and leverage. Therefore, to test the relationship among these variables, correlation analysis was conducted. Table 5, depicts the correlation matrix between the variables of the study. Results show that there is a positive correlation between audit fee and corporate governance (Gov-Score) i.e.  $r=.653$ . Therefore, this particular findings support the hypothesis initially that there is a positive relationship between the audit fee and corporate governance. Similarly, the results also show that audit fee and firm size are positively correlated with each other ( $r=.713$ ). Moreover, results also demonstrate that audit fee is positively associated with audit firm size (BIG4) and firm leverage ( $r=.237$  &  $.367$  respectively). As shown in Table 5, the correlation matrix does not suggest any serious concern for multicollinearity problems.

Table 3: Descriptive Statistics of Dichotomous variables

	Obs	Mean	Median	Maximum	Minimum	Std Dev
BI	148	0.687	0.710	1.000	0.000	0.217
BS	148	8.594	8.000	13.000	5.000	1.979
Dual	148	0.865	1.000	1.000	0.000	0.343
Aud_REM	148	0.750	1.000	1.000	0.000	0.434
AudI	148	0.798	0.800	1.000	0.000	0.234

Table 4: Descriptive Statistics of Study Variables

	Obs	Mean	Median	Maximum	Minimum	Std Dev
AudF	148	6.956	6.910	9.350	5.010	0.856
Gov-Score	148	3.547	4.000	5.000	1.000	0.844
FS	148	16.903	16.980	20.460	13.120	1.666
LEV	148	0.620	0.650	1.380	0.080	0.249
Big-4	148	0.831	1.000	1.000	0.000	0.376

Table 5: Correlation Analysis

	AUDIT	Gov-Score	FS	LEV	BIG4
AudF	1	0.654***	0.713***	0.367***	0.237***
Gov-Score		1	0.614***	0.243***	0.293***
FS			1	0.348***	0.225***
LEV				1	0.062
BIG4					1

\*\*\*Correlation is significant at the 0.01 level (2-tailed)

Table 6: Regression Results

	AudF
C	-0.549 (1.064)
Gov-Score	0.279*** (0.051)
FS	0.355*** (0.065)
LEV	0.744*** (0.245)
Big4	0.057 (0.122)
R-squared	0.954
Adj. R-square	0.936
St. Error of Regression	0.215
F-statistic	55.239

Notes: \*\*\*=Significant at 1 percent level

**Regression Analysis:** Regression analysis was conducted to find out whether corporate governance, firm size, audit firm size and leverage are the predictors of audit fee. Major findings of the regression analysis in shape of estimated relationships are shown in the Table 6. Table 6 presents 'beta' value for each variable as well as its standard error in parenthesis. Level of significance was also expressed by using 'asterisk' symbol. In order to estimate the relationship, audit fee was regressed on the corporate governance, firm size, firm leverage and audit firm size. The results illustrate that there is a positive and significant impact of corporate governance on audit fee ( $\beta = .279$ ,  $p < .000$ ). This statistically significant result supports the hypothesis of the study that there is positive relationship between the audit fee and corporate governance. Similarly, there is a positive and significant

impact of firm size on audit fee ( $\beta = .355$ ,  $p < .05$ ) and Leverage on audit fee ( $\beta = .744$ ,  $p < .05$ ). However, the impact of audit firm size on audit fee is not statistically significant ( $\beta = .0567$ ,  $p > .05$  i.e. 0.64). Moreover, results of the regression analysis also illustrate that independent variables (Corporate governance, firm size, leverage & auditor firm size) account for 95.3% significant variance in audit fee ( $R^2 = .953$ ,  $F = 55.23$ ,  $p < .000$ ). These particular findings showed that corporate governance, firm size and firm leverage are the significant predators of the audit fee. However, audit firm size (Big4) is not a significant predictor of audit fee. Thus, most of hypotheses of the study are confirmed and these results are in consistent with previous studies [16, 28].

## CONCLUSIONS

The aim of the current study was to examine the impact of corporate governance on audit fee in the presence of some control variables i.e. firm size, leverage and audit firm size. For this purpose, 37 companies listed at Karachi Stock Exchange of Pakistan were analyzed. The results of the study demonstrate that there exists a positive relationship between the governance score and audit fee. Moreover, the results also showed that there exists a positive relationship between audit fee and firm size. Further, the findings showed that there is positive and significant relationship of audit fee with leverage.

Finally, although the relationship between audit fee and audit firm size is positive, however, the relationship is not significant. The main reason of this insignificant relationship might be that the majority of firms listed at KSE appoint big4 audit firms as their external auditor irrespective the quality of their governance score. Thus the results of the current study prove that audit fee is a function of corporate governance, firm size and leverage.

The organizations are now facing intense competition due to contemporary forces of globalization, technological changes and changing customer's demands for better quality. To survive in this turbulent environment, organizations not only have to improve their performance but also have to encourage good corporate governance practices for assurance of fairness and transparency of financial statements. In order to refrain management from the activities detrimental to the welfare of the organization, good corporate governance, audit independence and audit fee structure are of utmost importance. Moreover, coupled with an environment where corporate scandals like Adelphia, World Com, Enron, Parmalat and including Pakistan PTCL privatization & Mehran Bank Frauds are the results of bad governance. Consequently, the companies should be vigilant in crafting the good corporate governance system with due importance given to audit independence and audit fee structure.

Similar to all other research studies, the present study also has some limitations. Sample of 37 firms from the year 2009 to 2012 have been taken which can be improved in future. Therefore, in future studies, number of firms as well as time span may be increased so that results can be generalized more vigorously. Moreover, future studies can also evaluate the relationship of corporate governance with other factors by measuring the governance quality by incorporating Pakistani standards. Although, no such index is introduced in Pakistan by any legislative body, however, Pakistan Institute of Corporate Governance is currently working for the development of such index, so in future studies it will be helpful to measure the governance quality of Pakistani companies on national index.

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