Volume 13 Issue 34
Originally issued as D5

Global Journal of Management and Business Research
Accounting and Auditing
Volume 13 Issue 5 Version 1.0 Year 2013
Type: Double Blind Peer Reviewed International Research Journal
Publisher: Global Journals Inc. (USA)
Online ISSN: 2249-4588 & Print ISSN: 0975-5853

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Keywords: *substitution theory, signaling theory, internal governance, audit fees.*

GJMBR-D Classification : *JEL Code: M42*

CANSUBSTITUTIONANDSIGNALINGTHEORIESEXPLAINTHERELATIONSHIPBETWEENEXTERNAL AUDITFEESANDTHEEFFECTIVENESSOFINTERNAL CORPORATEGOVERNANCE

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Can Substitution and Signaling Theories Explain the Relationship between External Audit Fees and the Effectiveness of Internal Corporate Governance? †

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Abstract- **The aim of this study is to investigate the relationship between external audit fees and the effectiveness of internal corporate governance of non-financial companies listed on Abu Dhabi Securities Exchange (ADX) by testing substitution and signaling theories. To reachthis aim, data were collected from the annual reports of all non-financial companies listed on the exchange for the year 2012. The result of the analysis showed partial support to substitution theory. Effective internal audit employed by nonfinancial Emirati companies listed on ADX appeared to be negatively related to external audit fees. The relations was, however, marginally significant.**

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I. Introduction

The economies of the Gulf Cooperation Council (GCC) countries aremainly dependent on oil exports. This exposes their economies to fluctuations in oil prices. To minimize the effect of this problem, GCC countries adopted a new strategy leads to diversifying their economies. In this context, Abu Dhabi witnessed similarities with countries like Norway, where both are small in size and have huge oil reserves. Yet, the economy of Norway is more diversified. Abu Dhabi Economic vision 2030 focuses on economic diversification in line with the Norway model. Hence, Abu Dhabi Authorities are developing the infrastructure of the country and creating environment that laid down the basis to become the financial center of the region. To assure investors, the authorities introduced in the last few years important measures to promote best corporate governance practices across industries. In 2009, the Securities and Commodities Authorities (SCA) introduced new *Corporate Governance Code* applied to all publicly-owned non-financial companies listed on Abu Dhabi Securities Exchange (ADX) with effect from 30 April 2010. The code is in line with the international corporate governance standards. As a result of this, non-financial companies listed on ADX started to publish governance reports that contain, among other information, audit fees in their 2011 annual reports. Hence, investigating the relationship between external audit fees and the effectiveness of internal corporate governance ofnon-financial companies listed on ADX will be animportant study since the listed companies never published governance reports before and corporate governance regulations vary across countries.In addition, limited number of companies are listed on ADX coincides with a number of local, regional and large international audit firms created imbalance in the supply and demand for external audit services. Furthermore, audit fees in the Arab Gulf region are influenced by personal relations. More importantly, even though an intensive research has been undertaken in the area of audit fees, research in exploring the relationship between external audit fees and corporate governance is still limited (Hay et al. 2006) and available research provides inconsistent evidence about the direction of the relationship.Hence, this study is expected to add a new dimension to the literature of the relationship between external audit fees and internal corporate governance.

The remainder of this paper is organized as follows. Previous related studies and hypotheses development are offered in the following section. Section three explains data collection and study methodology. While the findings are presented in the fourth section, the conclusion is summarized in the last section.

II. Previous Related Studies and Hypotheses Development

Corporate governance is generally laws, rules and standards that define the relationship between company's management and stakeholders. The basic principle of corporate governance is to identify the responsibilities of corporate management and protect the rights of shareholders through transparency and full disclosure.

In thelight of globalizationand the openness ofthe economies, corporate governance is becoming an importantelement in enhancing thesuccess of economic reformand developing regulatory framework of any

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country. In addition, since corporate governance principles andrules are adopted bypublic and private sectorsalike, it boosts confidencein the economy and protectsinvestors anddealers. It further gives indication about thelevelof commitment reached by management toprofessionalrules ofgood governance, transparency and accountability, and about existing measures to curbcorruption. Hence, corporate governance assists in increasing theattractivenessofthe economyforlocal and foreigninvestmentsand inensuring competitiveness.

The effectiveness of internal corporate governance is related to external audit since the latter is viewed as being an important element of corporate governance. Knechel and Willekens(2006) noticed that the demand for external audit is influenced by risks faced by corporate shareholders and mechanisms employed to minimize these risks.

Effective corporate governance aims at improving quality of corporate reporting and audit. It promotes transparency and reliability of corporate reporting and this would minimize external audit risk. Effective corporate governance is further expected to enhance external audit independence since the governance committee appoints external audit firm and negotiates its fees (Zaman et al., 2011). Effective internal governance reduces external auditor's risk. This requires less effort by external auditor and in turn lower fees. Consequently, corporate governance is expected to impact the quality of external audit as well as the paid fees.

Although numerous studies explored factors influencing external audit fees, attention has been recently paid to the relationship between audit fees and internal corporate governance[1]. As mentioned earlier, external audit is viewed as a sort of external governance and according to Fan and Wong (2005) it assists in mitigating agency conflict between shareholders and management and it reduces agency cost. Hence, management has incentive to appoint a well-established external auditor to assure shareholders, minimize agency cost and increase corporate value.

The relationship between internal corporate governance and audit fees can be explained by *substitution* and *signaling* theories (Wu, 2012). According to *substitution* theory, a significant part of external audit is substituted by the work of internal corporate governance that results in high transparency and produces reliable and high quality financial statements. This is expected to reduce external auditor's risk of providing inaccurate audit opinion (McElveen, 2002;Turley and Zaman, 2004, 2007; Beasley et al., 2009 and Krishnan and Visvanathan, 2009). Carcello et al. (2002)indicated that effective internal corporate governance is associated with low audit risk. This reduces external auditor's effort and cost. Thus, effective internal corporate governance is expected to reduce agency cost and minimizes external audit's risk. As a consequence, effective internal corporate governance results in less external audit fees. Hence, an inverse relationship exists between effective internal corporate governance and external audit fees.

Empirical evidence on the direction of the relationship between effective internal corporate governance and external audit fees is inconsistent. Gul et al. (1998) reported negative association between effective internal corporate governance represented by the number of independent board of directors and external audit fees. Carcello et al. (2002) found that effective internal corporate governance results in less external audit risk and less external audit fees.Li and Wang (2006) pointed to significant negative relationship between the board of director characteristics and audit fees. They found external audit fees to be related to the number of independent members of the board directors. They, however, found insignificant relationship between external audit fees and the effectiveness of internal corporate governance represented by frequent number of meeting of the board of directors and the existence of the audit committee. Researchers such as Gregory and Collier (1996) and O'Sullivan (1999) found no relation between the effectiveness of internal corporate governance and external audit fees. On the other hand, Stewart and Munro (2007) found in a sample of Australian companies that effective internal corporate governance, symbolized by audit committees with frequent meetings and more use of internal audit, tend to pay high external audit fees. It is therefore hypothesized that:

Hypothesis 1: External Audit Fees are Inversely Related to Effective Internal Corporate Governance

Under *signaling* theory, management of companies with agency problems have incentive to signal to the market that they have effective internal corporate governance and attempt to reduce agency costs and increase the value of the company by appointing a high profile external auditor who goes through strict and intensive external audit to assure the stakeholders that management works to their interest (Wang and Zhou, 2006; Wang, 2009).Empirical research showed that audit committees impact the scope of external auditor (Carcello et al., 2002; Hay et al., 2008;

[1]**Examples of recent studies looked into various factors influencing external audit fees**: Joshi and Al-Bastaki, 2000; Peel and Clatworthy, 2001; Haniffa and Cooke, 2002; Glaum and Street, 2003; Carson et al., 2004; Cameran, 2005; Clatworthy and Peel, 2006; Gonthier-Besacier and Schatt, 2007; Huang et al., 2007; Naser and Nuseibeh, 2008; Thinggaard and Kiertzner, 2008; Tagesson, et al, 2009; Vermeer et al., 2009; Choi et al., 2010; Ellis and Booker, 2011; Verbruggen et al., 2011; Wang et al.,2011; El-Gammal, 2012). **Examples of studies explored the relationship between external audit fees and corporate governance**: Peel and Clatworthy, 2001; Larcker and Richardson, 2004; Fan and Wong, 2005; Li and Wang, 2006; Liu and Hu, 2006; El'Fred andDivesh, 2008; Gao and Gao, 2008; Hay et al., 2008; Lifschutz, 2010; Zaman, et al., 2011; Abdul Wahab et al., 2011; Wu, 2012; Hassan and Naser, 2013.

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Turley and Zaman, 2007; and Beasley et al., 2009). They attempt to improve the quality of the external audit by extending the scope the external auditor's work and this in turn increase audit fees (Collier and Gregory, 1996; Abbott et al., 2003; and Turley and Zaman, 2004).In this respect, Zaman et al. (2011) contended that firms with effectiveinternal governance devote more time to monitor external audit more effectively than firms with low quality internal governance to minimize potential risk litigation and maintain their reputation. This would increase the scope of external audit to ensure its quality. As a consequence, external audit fees will be high. In other words, external audit fees are positively related to the level of internal corporate governance. This move by management results in more trust in the company andallows the company easy access to various sources of fund at a lower cost.

The results of the empirical testing of *signaling* theory is not clear. In this respect, Gul et al. (1998) investigated the relationship between agency costs and external audit fees and reported a positive association between the two variables. Carcello et al. (2002) investigate the association between board of director characteristics and external audit fees using Fortune 1000 data. Theyreported a significant positive relationship between audit fees and board independence, expertise and diligence.Similarly, Goodwin-Stewart and Kent (2006) examined the effect of the existence of audit committee and audit committee effectiveness on audit fees in a sample of Australian companies and found that the existence of an audit committee, more frequent committee meetings and increased use of internal audits to be associated with high audit fees. Knechel and Willekens (2006) found companies with audit committees and larger proportion of independent board members tend to pay high audit fees. On the other hand, O'Sullivan (1999) found no significant association between external audit fees and the board of directors and the characteristics of audit committee. It is therefore hypothesized that:

Hypothesis 2: External Audit Fees are Directly Related to Good Internal Corporate Governance

In addition to the main independent variable the effectiveness of internal corporate governance, three explanatory variables were used in the current study as a control factors: corporate size measured by natural logarithm of total assets (***LnAssets***), level of leverage measured by long-term liabilities to total assets (***Leverage***) and the percentage of shares owned by institutional investors (***PSOII***).

Quality and quantity of audit required by small companies are different than that demanded by large companies due to the degree of complexity of their operations and transactions. More audit services and time are needed to audit larger companies and they are expected to pay higher fees than small ones (Palmrose, 1986; Carson, et al., 2004).

The second control variable used in the current study is leverage as a proxy of corporate risk. Level of corporate risk is considered as one of the main determinants of audit fees. External auditors make extra efforts with risky companies since such companies are subjected to close monitoring from shareholders as well as lenders. External auditors also devote extra effort when auditing highly leveraged companies to avoid lawsuits against them. This reality will be reflected in external audit fees.

The third control variable adopted in the current study is the percentage of shares owned by institutional investors. Existence of institutional ownership enhances the monitoring mechanism employed to scrutinize management behavior since they usually acquire the required qualifications and expertise to assess and observe management decisions. Hence, in addition to effective corporate governance, ownership structure plays an important role reducing agency cost. Large institutional shareholders might have a strong incentive than small investors to benefit from monitoring management (Aljifri and Moustafa, 2007; Ping and Wing, 2011). Companies with high percentage of shares held by institutional shareholders are more likely to perform well to assure those investors and meet their expectations, and thus, reduce agency costs (Barako et al., 2006; Naser et al., 2006).They also have stronger incentive to monitor management behavior more than board members who may have little or no investment in the firm (Shleifer and Vishny, 1986).Hence, institutional ownership is expected to impact audit fees.

III. Data Collection and Study Methodology

As mentioned earlier, non-financial companies listed on ADX are covered in this study. The number of Emirati companies listed on the exchange at the end of 2012 was 67. Out of this number, 32 companies were classified as being non-financial[2]. In line with previous studies in this area of research, the focus will be on non-financial companies since the nature of these companies together with their external audit fees structure are different than that of the financial companies (Simunic, 1980; Basioudis and Fifi, 2004; Cameran, 2005). Thus, the 2012 annual reports together with the governance reports for all non-financial companies listed on ADX are used in this study.

After deciding on the target group of companies to be covered in the current study, it is important to define the effectiveness of internal corporate governance. It is not easy to define effectiveness in terms of corporate governance. In the literature, different proxies have been employed to measure the

[2] 2 of these companies were non-Emirati companies and excluded from the sample employed in this study.

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effectiveness of corporate governance. Zaman et al. (2011) used four features of the audit committee to proxy effectiveness: audit committee size, audit committee independence, frequency of audit committee meetings and audit committee financial expertise. Dichotomous score was assigned for each of the four features of the audit committee as summarized below.

Audit committee size (*ACS*)	0 score if the number of audit committee members is≤ 3; 1 score if the number is > 3.
Audit committee independence (*ACI*)	0 score if at least one of the committee's members is not independent; 1 score if all members are independent.
Audit committee frequency of meetings (*ACFM*)	0 score if the audit committee held≤ 5 meeting; 1 score if the audit committee held >5 meetings
Audit committee financial expertise (*ACFE*)	0 score if one or more of the audit committee members does not have financial expertise; 1 score if > 1 of the audit committee have financial expertise.

Internal governance effectiveness index (*IGEI*) was then developed by adding the score of the four features of the audit committee for all nonfinancial companies listed on ADX and covered in the current study.

$$IGEI = ACS + ACI + ACFM + ACFE$$

The dependent and independent variables put together in two regression models. While, in the first model the four features of the audit committee that represent corporate effectiveness were entered individually, in the second model the four individual features of governance effectiveness were replaced by*IGEI*. The two regression models are presented below.

$$LnAF = \beta_0 + \beta_1 LnAssets + \beta_2 Leverage + \beta_3 PSOII + \beta_4 ACFM + \beta_5 ACFE + \beta_6 ACI + \beta_7 ACS + \varepsilon \ldots (1)$$

$$LnAF = \beta_0 + \beta_1 LnAssets + \beta_2 Leverage + \beta_3 PSOII + \beta_4 ACFM + \beta_5 IGEI + \varepsilon \ldots (2)$$

Where:

LnAF	=	*Natural Logarithm of Audit fees*
LnAssets	=	*Natural Logarithm of total assets.*
Leverage	=	*Leverage measured by long-term liabilities/ total assets*
PSOII	=	*Percentage of shares owned by institutional investors*
β_0	=	*Intercept*
β_1-β_5	=	*Parameters of the model*
E	=	*Standard error*

IV. Findings

a) Descriptive Statistics

Descriptive statistics concerning dependent and independent variables used in the regression models are summarized in table 1. It is evident from the table that Emirati nonfinancial companies listed on ADX vary in their characteristics. Audit fees paid by the companies range from 11.16 to 14.97in logarithms with a mean of 12.48. Companies' sizes measured by the natural logarithm of the company's total assets also varied from 18.62 to 25.11 in logarithm terms, with a mean of AED 21.29. Furthermore, the level of leverage measured by long-term total liabilities to total assets ranged from zero to 0.75 with a mean of 0.16. This indicates that the Emirati companies do not rely on long-term borrowings to finance their activities and reflects the Islamic culture of the country that prohibits dealing with *riba* (paying or receiving interest). Another important feature of the Emeritinonfinancial companies listed on ADX and appeared in table 1 is that significant proportion of companies shares are owned by institutional investors as reflected by the mean. The highly reported standard deviation of the percentage of shares owned by institutional investors points to a significant variations among the companies.

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Table 1: Descriptive Statistics of Variables Employed in the Study

	Mean	Median	Std. Deviation	Minimum	Maximum
Lnaudit	12.4774	12.509	0.85972	11.16	14.97
Lnassets	21.2855	21.1444	1.38473	18.62	25.11
Leverage	.1592	.1038	.17751	.00	0.75
PSOII	43.1123	42.74	27.84393	0	97.78
IGEI	1.9667	2	0.80872	1	4
ACFM	0.4667	0	0.50742	0	1
ACFE	0.6333	1	0.49013	0	1
ACI	0.5667	1	0.50401	0	1
ACS	0.3	0	0.46609	0	1

b) Correlation

Pearson correlation has been utilized to identify the extent of association between the variables used in the regression model. The results are shown in Table 2. The Table pointsto a number of significant correlations among the variables. Significant and positive associations detected between external audit fees and each of corporate size and the frequency of audit committee meetings. Significant and positive association has been also detected between corporate size and the frequency of audit committee meetings, between the effectiveness of the internal governance index and each of the audit committee and frequency of the audit committee's meetings. On the other hand, table 2 showed negative and significant association between the size of the audit committee and financial experience of the audit committee members.

The largest reported correlation value among the variables as appeared in Table 2 was between the size of the audit committee and the financial expertise of the audit committee members (-0.709). This value is, however, lower than the critical valueof 0.80 (Judge et al., 1988; Bryman and Cramer, 2005). This gives indication that multicollinearity does not seems to be a serious problem. In addition, the Variance Inflation Factors (VIFs) reported in Tables 3 and 4 were all well below the critical value of 10 used to assess the strength of collinearity. Neter et al. (1989) believe that collineairty is considered a serious problem in regression only when the VIF $\geq$ 10.

Talbe 2 : Correlations Between Variables Employed in the Study

	Lnaudit	*Lnassets*	*Leverage*	*PSOII*	*IGEI*	*ACS*	*ACI*	*ACFM*	*ACS*
Lnaudit	1.000								
Lnassets	.703**	1.000							
	.000								
Leverage	.281	-.136	1.000						
	.132	.474							
PSOII	.163	-.171	.214	1.000					
	.389	.367	.256						
IGEI	.168	.206	.206	.103	1.000				
	.375	.275	.275	.588					
ACS	.339	.362*	.047	.001	.302	1.000			
	.067	.049	.805	.994	.105				
ACI	-.300	-.208	.044	.057	.556**	-.308	1.000		
	.107	.269	.817	.765	.001	.097			
ACFM	.575**	.486**	.422*	.113	.627**	0.554**	-.126	1.000	
	.001	.006	.020	.553	.000	.001	.508		
ACFE	-.332	-.294	.045	-.007	.142	-.709**	.312	-.397*	1.000
	.073	.115	.813	.973	.454	0.000	0.094	.030	

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

*. Correlation is significant at the 0.05 level (2-tailed).

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c) Regression Analysis

Two regression models areestimated. In the first one, the four features of audit committee that represent effectiveness entered separately as independent variables. In the second model, all four features were combined together in an effectiveness index(*IGEI*)as one independent variable. The results of the two regressions are summarized in tables 3 and 4.

Table 3: Results of Regression Analysis by Employing Four Internal Effectiveness Variables Separately

Variables	R^2 = 0.665	Adj. R^2= 0.559	F = 6.249	Sig. F = 0.000
	Beta	*T*	*Sig.*	*VIF*
(Constant)		1.844	.079	
Lnassets	.629	4.117	.000	1.532
Leverage	.161	.852	.403	2.357
PSOII	.247	1.917	.068	1.091
ACS	-.117-	-.578-	.569	2.685
ACI	-.121-	-.838-	.411	1.380
ACFM	.394	.144	.617	1.380
ACFE	-.169-	-.874-	.392	2.460

Table 4 : Results of Regression Analysis by Employing Internal Governance Effectiveness Index

Variables	R^2 = 0.708	Adj. R^2= 0.661	F = 15.153	Sig. F = 0.000
	Beta	*T*	*Sig.*	*VIF*
(Constant)		.797	.433	
Lnassets	.832	7.242	.000	1.130
Leverage	.402	3.355	.003	1.227
PSOII	.237	2.110	.045	1.077
IGEI	-.167-	-1.392-	.176	1.235

It is obvious from tables3 and 4 that the two regression models are powerful as reflected by the reported*F-values*. However, in the second model, where the effectiveness index replaced individual features of the effectiveness of the audit committee, *F-value* came higher than the first model. This indicates that the second model is more significant than the first model. An additional important point to notice in Tables 3 and 4 is that adjusted $R^2$for the second model (0.661) is higher than that related to the first model (0.559). This means that the explanatory variables used in the second model explain 66% of the variations in the dependent variable, whereas explanatory variables employed in the first model only explain 56% of the variations in dependent variable. In the two regression models corporate size measured by the total assets and the percentage of shares owned institutional investors appeared to be positively and significantly associated with external audit fees of the nonfinancial companies listed on ADX. While positive relationship appeared in the two tables between external audit fees and level of corporate leverage, the relationship was statistically significant only in the second model. As for the four effectiveness features of the audit committee reported in table 3, negative association reported between all of them with the external audit fees except for the frequency of the meetings of the audit committee where the sign of the relation was positive. On the other hand, table 4 pointed to a negative association between external audit fees and governance effectiveness measured by the index. The relationship is, however, marginally significant.

Negative relationship between the effectiveness of internal governance measured by four features of the audit committee individually and external audit fees except for the frequency of audit committee's meeting is in line with previous research (Gul et al., 1998; Carcello et al., 2002; Li and Wang, 2006). Positive association between

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the effectiveness of corporate internal governance represented by the frequency of the audit committee meetings and external audit fees is also found by (Goodwin-Stewart and Kent, 2006; Stewart and Munro, 2007). This result may reflect the nature of the Arab culture. It's very likely that the members of the committees in the Arab Gulf region are paid for attending the meetings. In addition, expenses incurred by committee members are covered by the company. Auditing committee members' remunerations together with their expenses may require extra work by the external auditor. On the other hand, when the internal governance effectiveness index (*IGEI*) was used to explain variations in audit fees, negative relation emerged between it and external audit fees. The fact that the resulted negative relation was marginally significant is due to the fact that corporate governance is recently adopted by Emirati nonfinancial companies listed on ADX and companies have limited experience in this field. The effectiveness of internal corporate governance is expected to improve by time. It is, therefore, worthwhile to conduct the same study in 3 years times to identify possible improvement in the level of internal corporate governance in the UAE and relate the resulted level with external audit fees.

V. Conclusion

This study is set out to investigate the relationship between external audit fees and the effectiveness of internal corporate governance of non-financial companies listed on Abu Dhabi Securities Exchange (ADX) by testing substitution and signaling theories. According to substitution theory, effective internal corporate governance, represented by the audit committee, substitutes external auditor's work. This reduces external auditor's risk and hence reduces its fees. On the other hand, signaling theory is related to agency theory in suggesting that management would use internal audit effectiveness to recruit external auditor who subjects corporate management to rigorous and intensive audit to signal to the stakeholders that management works to their interest. To reach this aim, data were collected from the annual reports of all non-financial companies listed on the exchange for the year 2012. The result of the analysis showed partial support to substitution theory. Effective internal audit employed by nonfinancial Emirati companies listed on ADX appeared to be negatively related to external audit fees. The relations is, however, marginally significant.

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