SESSION 1: BOARD OF DIRECTORS’ PRACTICES

BOARD FEATURES AND AUDIT QUALITY. DO BOARD FEATURES UPHOLD AUDIT QUALITY? A PERSPECTIVE FROM THE UK MARKET

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Abstract

The corporate governance framework acts in parallel with external audit, aiming to safeguard shareholders’ interests against self-serving managerial motives. Audit provides the necessary assurance that corporate financial statements are presenting a true and fair value of the firm’s financial stance. Reliable financial reporting supports investor confidence and leads to efficient market functioning.

Agency theory elaborates on the separate roles of ownership and control structures within a firm (Jensen & Meckling, 1976; Fama & Jensen, 1983). Contradicting interests between principals and agents may cause agency costs. Principals and regulators imposed several structures to control these costs. Corporate governance mechanisms evolved radically aiming to address issues of management shortfalls and self-serving actions. The board of directors, a crucial corporate structure, is empowered by shareholders to mitigate such costs and ensure the alignment of interests between managers and shareholders (Lin & Hwang, 2010). Strategic goal setting, decision-making on critical issues that set the agenda for future growth, as well as the appointment and re-appointment of external auditors are only some of the responsibilities of a firm’s board (Terjesen et al., 2016).
Firm performance is reflected in the financial statements. Consequently, proper implementation of the applicable accounting standards is a prerequisite for enhanced financial reporting quality, the latter being rather important for all interested parties (shareholders, investors, regulators) (Sarhan et al., 2019). Boards demand high-quality financial reporting in a dual manner; directly by monitoring internal structures to empower the duty and indirectly by appointing qualified auditors and requesting effective and intense audit efforts (Carcello et al., 2002). Mounting research suggests that increased participation of independent board members is associated with fewer instances of financial reporting fraud (Dechow et al., 1996; Davidson et al., 2005). Independent board members demand high-quality audits driven by self-driven motives related to their reputation and employment prospects (Gilson, 1990), but also because they are considered to be rather vigilant when shareholders’ interests are at stake (Carcello et al, 2002; Khalil & Ozkan, 2016). Another feature of the board of directors is its size. In this case, the evidence is unequivocal. Board size is reported to be positively related to audit quality (Lin & Hwang, 2010; Sarhan et al., 2019).

Lastly, empirical research examines the role of the chief executive officer (CEO). A dominant CEO who chairs the board of directors could easily impose a personal agenda with adverse consequences on financial reporting quality (Hudaib & Cooke, 2005). The CEO duality style of leadership compromises the board’s impartiality (La Porta et al., 1999; Gelb & Zarowin, 2002). However, research is inconclusive on the role of the CEO and its implication on audit quality. When the Big 4 auditor serves as a proxy for audit quality, there is evidence suggesting a positive relationship between the CEO dual role and audit quality (Asthana et al., 2010; Ben-Hassoun et al., 2018; Lin & Liu, 2009). On the other hand, other researchers document the absence of a significant relationship (Farinha & Viana, 2009).

This study assesses certain board characteristics and their implications on audit quality. We opted for the UK market, where regulators urgently shaped a framework to address audit quality imparted in the “Audit Quality Framework” (The Financial Reporting Council [FRC], 2008). We suggest that board features have a significant impact on audit quality after controlling for widely accepted influential factors. Our results are robust even when alternative audit quality proxies are employed. Board size is, unquestionably, positively related to audit quality. Board independence upholds audit quality when the Big 4 proxy for audit quality is applied. Conversely, the role of the CEO is disputable. When we approximate audit quality by discretionary accruals terms, CEO duality seems to improve quality contrary to many other findings. However, this conclusion does not seem to be statistically significant when audit quality is approximated in terms of auditor size.

Our conclusions justify the focus on corporate governance structures as prerequisites for an increased level of audit quality. The latter
contributes to the well-functioning of the financial markets and supports investor confidence. Our work adds to the extant literature on the subject and can act as an evaluation tool for the regulatory intervention applied in the competitive UK market.

REFERENCES


