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The Impact of Audit Committee Effectiveness on Audit Quality: Evidence from the Middle East

Krayyem Al-Hajaya*

Department of Accounting, School of Business, Mutah University, Jordan. *Email: hajaya@mutah.edu.jo

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ABSTRACT

This study examines the effect of the characteristics of the audit committee, as a tool of corporate governance, on audit quality (as measured by audit fees and type of audit agent) among insurance companies listed on the Amman Stock Exchange, Jordan. The empirical study was conducted on data of all 23 listed insurance companies for the period 2013-2017, resulting in 115 observations. Findings of multivariate analyses indicate that companies with larger audit committees and containing a high proportion of non-executive and independent directors are more likely to incur higher audit fees and hire big four audit agents, signalling their prominent level of audit quality. In contrast, more diligent audit committees are more likely to select non-big four auditing firms requiring lower audit fees. The study contributes to the existing body of literature by focusing on the role of the audit committee in enhancing audit quality, especially where there is a lack of such study in emerging economies, especially in the Middle East. The findings of the current study could be useful for regulators and policy makers in the Middle East and Arab region, particularly when they are about to review and set guidelines for effective audit committee characteristics.

Keywords: Audit Committee, Corporate Governance, Audit Quality, Audit Fees, Jordan, Middle East
JEL Classifications: G3, M4

1. INTRODUCTION

The information gap resulting from the separation of corporate ownership and management necessitated forms of control and monitoring both internally and externally (Young, 2000; Weir et al., 2002): internally through the board of directors and its committees, and externally through the report of the external auditors as well as through market control (Safari, 2017; Ali et al., 2018). Recent well-known international corporate failures and collapses, following the global financial crisis of the last decade, have urged global professional bodies for inclusive regular restructuring and reform of the systems of internal control and governance, emphasising the role of auditors and stressing the importance of audit quality (Kilgore et al., 2014).

A cursory glance at international corporate governance guidelines produced in the wake of these corporate collapses suggests a significant anticipated role for the audit committee in ensuring the quality of auditing. According to the Cadbury Committee (1992) and OECD (1994), audit committees would be an internal control and important governance mechanism that would reduce the agency gap, protecting the interests of the shareholders from management's opportunism. This monitoring role played by the audit committee over management is expected to enhance the audit quality and, hence, improve integrity of financial reporting (Cohen et al., 2004; Beasley et al., 2009; Sulaiman, 2017), and firm's financial performance (Baxter and Cotter, 2009; Laux and Laux, 2009; Caskey et al., 2010).

One way that the audit committee ensures investors' protection and transparent financial reporting is through monitoring and managing the relationship with the external auditors (Safari, 2017; Ali et al., 2018), reducing the probability of providing an improper opinion (Abbott et al., 2003). Importantly, the audit committee is responsible for addressing the key risks inherent in the external audit process, including appointing and settling auditors' fees (Lin, 2018). An effective audit committee will demand a high-profile audit agent, additional audit tasks and missions, and therefore better audit quality (Lennox and Park, 2007; Lin, 2018). This will result in higher audit fees incurred (Goodwin-Stewart and Kent, 2006; Lennox and Park, 2007; Zaman et al., 2011; Lin, 2018).

In Jordan, responding to the global corporate governance reforms, and in the face of the capital market restructuring of the last decade, an essential mark is issuing many versions of corporate governance codes for the main types of company in Jordan (general listed shareholding, banking, and others including private shareholding, limited labiality and non-listed companies). In addition, emphasising the significance of the insurance sector in Jordan, Corporate Governance Instructions for insurance companies were enacted by the Insurance Commission Pursuant in 2006, and later amended in 2007 and 2009. In all these codes, maintaining the audit committee, its characteristics and roles are clearly stressed.

However, the level of commitment of companies under the recommendations of these codes is still vague and unknown. In addition, there is a lack of knowledge regarding the extent to which these recommendations contribute to boosting the performance of audit committees in Jordan, and hence to the external audit quality. Consequently, the level of effectiveness of the audit committees has not yet been explored, and doubts can be expressed about the ability of the audit committee to perform its anticipated roles. Therefore, a study into the effectiveness of audit committees in Jordan, especially the efficiency of the characteristics proposed in the Corporate Governance Instructions of 2006 for Insurance Companies, and its implications on audit quality, is overdue. In this vein, Alhababsah (2018) argues that effectiveness is not necessarily ensured by adhering to the recommendations of the codes, particularly where companies try either to show outward commitment to legal requirements or to imitate other companies, applying the form rather than the substance. Thus, this study investigates the implementation of the recommendations of the Corporate Governance Instructions of 2006 for Insurance Companies in Jordan regarding characteristics of audit committees, to ascertain whether they can contribute to audit quality as proxied by audit fees and type of audit agent.

In doing so, the study deploys a combination of proxies of audit committee effectiveness, which are listed in the Corporate Governance Instructions. The specific characteristics recommended include the presence of an audit committee of at least three members who are neither executive managers nor members of other committees of the board; and holding a meeting at least once every 3 months or whenever necessary.

The study contributes to the existing body of literature by focusing on the role of the audit committee, as an effective corporate governance mechanism, in enhancing audit quality especially where auditors play a crucial role in promoting confidence in the market system. The findings of this study extend this debate and provide further evidence pertaining to the role of an effective audit committee in enhancing audit quality. Despite the presence of many studies addressing this topic internationally, there is a lack of such studies in emerging economies, especially in the Middle East. Furthermore, following the failure of giant international companies, dramatic reforms of corporate governance have been undertaken over the last two decades, attempting to restore confidence in the capital markets. However, different regulators apply different approaches in their own countries (Ali et al., 2018). This study investigates the Jordanian context, particularly the insurance sector, where special instructions were issued in 2006 to organise originating audit committees and their criteria. These criteria are expected to enhance the effectiveness of the audit committee and its main role in exercising control over management. This raises the importance of the current study in assessing the extent to which each criterion would contribute to the efficiency of the audit committee, and hence to the level of audit quality. Therefore, as corporate governance codes are still in their infancy in Jordan (Alhababsah, 2018), insights into governance guidelines that best improve the efficiency of audit committees will be delivered to regulators in Jordan. This highlights the mediating effect of changing regulations and the business environment on the dynamics of the relationship between characteristics of audit committees and the quality of auditing functions. The findings of the current study could be useful for regulators and policy makers in the Middle East and Arab region, particularly in reviewing and setting guidelines for effective audit committee characteristics. Finally, the study extends international literature by examining the independence of members of audit committees, who are not members of other committees of the board, as an attribute of audit committee effectiveness and its impact on audit quality as measured by audit fees and audit type.

2. LITERATURE REVIEW AND DEVELOPMENT OF HYPOTHESES

Auditing seeks to ensure the integrity and credibility of financial statements (Chu and Hsu, 2018; Khasharmeh and Desoky, 2018). Therefore, high audit quality leads to more reliable financial reporting. Despite the availability of a wide range of literature on audit quality, a common or uniform definition or measure of audit quality is lacking (Kilgore et al., 2014). In fact, most of the relevant literature draws on the definition of audit quality introduced by DeAngelo (1981), which examines the probability of auditors of discovering and reporting a breach in the accounting system and fraud in financial statements. In fact, this is largely dependent on auditors' level of independence and their professional ability (Chu and Hsu, 2018).

Previous studies have linked the characteristics of the audit committee, as an axis of corporate governance, to several accounting and financial issues, including: accounting conservatism (Goodwin, 2003; Dhaliwal et al., 2010), earnings management (Badolato et al., 2014; Zgarni et al., 2016; Safari, 2017), timeliness of financial reporting (Ika and Ghazali, 2012; Sultana et al., 2015; Oussii and Taktak, 2018) and external audit opinion (Pucheta-Martinez and De Fuentes, 2007). Similarly, several studies have addressed the relationship between audit committee characteristics and audit quality (e.g. Carcello et al., 2002; Abbott et al., 2003; Zaman et al., 2011; Ali et al., 2018). In this respect, researchers have deployed a number of proxies in measuring audit quality, such as size of audit firm (Carver et al., 2011), type of audit agent, big four and non-big four (Khlif and Samaha, 2016), audit fees (Abbott et al., 2003; Goodwin-Stewart and Kent, 2006; Ali et al., 2018), auditor experience and specialisation (Lim and Tan, 2009; Randal et al., 2015) and provision of non-audit fees (Beattie and Fearnley, 2002; Lim and Tan 2008; Chu and Hsu, 2018). In the current study, audit fees and type of audit agent were selected as proxies for the level of audit quality prevailing in Jordanian insurance companies.

Several empirical studies have addressed the impact of different characteristics of audit committees on audit fees and type of audit agent. However, the vast majority were conducted in the context of developed countries; for instance: in the US (Abbott et al., 2003; Blankley et al., 2012; Bruynseels and Cardinaels, 2014; Hossain et al., 2016); in the UK (Zaman et al., 2011; Adelopo et al., 2012; Ghafran and O'Sullivan, 2017); in Australia (Goodwin-Stewart and Kent, 2006; Clout et al., 2013; Ali et al., 2018); and in New Zealand (Rainsbury et al., 2009).

For developing countries, however, only three studies have been found examining the relationship between audit committee characteristics and audit quality as proxied by audit fees and/or audit type. In the Arab context, Habbash (2015) found no evidence for the relationship between an effective audit committee and selection of a big-four auditing agent in Saudi Arabia. Most recently, Farooq et al. (2018) showed a negative impact of audit committee effectiveness on audit fees in Pakistan, supporting the notion of better internal control leading to lesser audit risks and consequently less external audit efforts. Conversely, Alqadasi and Abidin (2018), in the Malaysian context, provide evidence to support the findings prevailing in the audit literature, that firms with effective corporate governance mechanisms, including an effective audit committee, are more likely to stipulate extensive audit service, which in turn raises the level of audit fees.

A view of relevant empirical research, examining the role of the audit committee in improving audit quality, indicates that it is largely limited to developed rather than developing countries, where the two contexts are very different. The former are characterised by an established auditing infrastructure, higher stringent regulatory settings, and better quality of internal audit control and corporate governance (Oussii and Taktak, 2018; Khlif and Samaha, 2016). In this respect, Alzeban and Gwilliam (2014) argue that audit committees in developing countries are still emergent, working differently from those in developed countries due to hierarchy and cultural differences. This indicates that an investigation into the relationship between audit committee and audit quality is an open avenue of interest in developing countries, especially where several restructurings of corporate governance and internal control systems have recently been implemented (Afify, 2009, Khlif and Samaha, 2016).

2.1. Audit Committee Characteristics and Audit Quality

Whether the quality of internal control and corporate governance can be a substitute for or complement external auditing, and its consequences on audit fees, is a debatable issue in the literature, with mixed findings from previous studies (Hay et al., 2008; Wahab et al., 2011; Farooq et al., 2018). The substitution view suggests that corporate governance can replace external auditing and vice versa, reducing the need for high audit quality (Hay et al., 2008). Based on the level of inherent risks in the auditing process, the type of audit agent and the amount of audit fees can be determined. Thus, a sound internal corporate governance system will lead to less inherent risks from external auditors, short auditing time and scope, and hence a lesser amount of audit fees incurred (Hay et al., 2008; Ghafran and O'Sullivan, 2017; Farooq et al., 2018).

The alternative view is that corporate governance and external auditors can complement the work of each other. This demand-based view implies that agents with good corporate governance mechanisms, in order to ensure integrity and reliability of financial reporting, are more likely to demand paramount audit quality (Srinidhi et al., 2014; Alqadasi and Abidin, 2018). Consistent with this view, companies with effective audit committees are more likely to select and switch to brand-name auditors, especially big four audit agents (Abbot and Parker, 2000; Beasley and Salterio, 2001; Cassell et al., 2012; Srinidhi et al., 2014; Habbash, 2015), and to require additional audit scope and tasks, and therefore incur higher costs for external auditing (Carcello et al., 2002; Abbott et al., 2003; Goodwin-Stewart and Kent, 2006; Vafeas and Waegelein, 2007; Boo and Sharma, 2008; Zaman et al., 2011; Ali et al., 2018; Alqadasi and Abidin, 2018).

International corporate governance codes characterise the ideal composition of the audit committee, indicating that more independent, more diligent and larger size are better for audit committee effectiveness. This might be due to the fact that larger and independent audit committees are less likely to be dominated by management, and therefore their power, monitoring status and functionality will be enhanced within the organisation. Furthermore, the diligent audit committee, in terms of frequency of meetings, can actively and extensively achieve its duties, enhancing the quality of internal control. As a result, the audit quality and integrity of financial reporting will improve.

2.2. Hypotheses

The current study draws on the complementary view of the relationship between characteristics of audit committee and audit quality it terms of audit fees and type of audit agent. It is suggested that insurance companies in Jordan with effective audit committees, in terms of size, diligence and independence, tend to minimise agency problems with stockholders through demanding higher quality of auditing, in order to signal their non-opportunistic behaviour. The following two hypotheses are proposed:

H1: There is an impact of audit committee effectiveness (in terms of size, diligence and independence) on the level of audit fees.

H2: There is an impact of audit committee effectiveness (in terms of size, diligence and independence) on selecting big four audit agent.

3. RESEARCH DESIGN

3.1. Sampling and Data

This study is restricted to the insurance sector in Jordan, and the sample is all insurance companies listed on the Amman Stock Exchange (ASE) for the period 2013-2017. This involves a total of 23 companies over the 5 years, resulting in 115 observations. Data were collected from annual reports of insurance companies published on the ASE website. In a few cases, where information is not available in the financial reports, direct contact was used to obtain the missing data from these companies.

3.2. Regression Models

Given the statistical nature of the dependent variables, which represent the audit quality, audit fees and audit type, the study used two distinct types of regression model. OLS regression is utilised for the audit fees equation as a continuous variable, while logistic regression is used for the categorical variable equation: Audit type. These typical equations are as follows:

OLS regression equation

$$\text{Audit fees} = \alpha 0 + \beta 1ACS_I + \beta 2NM_I + \beta 3CI_I + \beta 4ROA_I + \beta 5SIZE_I + e_I$$

Logistic regression equation

$$\text{Audit type} = \alpha 0 + \beta 1ACS_I + \beta 2NM_I + \beta 3CI_I + \beta 4ROA_I + \beta 5SIZE_I + e_I$$

Where,

Audit fees = Amount of statuary audit fees for the year;

Audit type = A dummy variable with the value 1 if the firm is audited by one of the big four firms and 0 otherwise;

α0 = The constant of the model;

ACS = Audit committee size as measured by number of audit committee members;

NM = Number of audit committee meetings during the years;

CI = Committee independence as measured by percentage of members on the committee who are non-executive members and/or not members of other company boards;

ROA = Return on assets ratio;

SIZE = Total assets at the end of the year;

B = Model's coefficients;

I = The company;

e = Error term.

4. EMPIRICAL ANALYSIS AND FINDINGS

This section presents the statistical testing of the hypotheses, indicating whether or not they are supported. The findings are discussed in the light of previous literature and theory.

4.1. Descriptive Statistics

Tables 1 and 2 below provide descriptive statistics regarding independent and dependent variables of the study. Figures shows that the book-value of the total assets of insurance companies, during the study period, is between some 7 million JD[1] and a 100 million JD, with mean scores totaling approximately thirty 2 million JD, indicating great variation in the size of these companies. Their mean return on assets ROA is around 1%, illustrating that Jordanian insurance companies are relatively small in size and generally less profitable.

Regarding their characteristics, the statistics demonstrate that the size of the audit committees ranges from two to six members, scoring above three members on average. According to international best practice, the minimum should be three members, a figure supported by the directions of regulatory bodies in Jordan. Further analysis indicates that only 34% of committees' members are non-executive or independent directors. Although the corporate governance directives require audit committees of insurance companies to meet at least 4 times a year, our figures range from 3 to 15 meetings a year, with five on average.

Table 2 indicates that a high proportion, 64%, of insurance companies are audited by non-big four auditing firms. This might be because audit price is the main factor in selecting the audit agent, especially, as illustrated earlier, where the profitability of the insurance industry in Jordan is at a minimal level. Details of the amounts of audit fees (Table 1) appear to support this view as they range from 7000 JD to 30,000JD for statuary external audit. The average of 15,000 JD annually as an audit fee is considered to be relatively low.

4.2. OLS Regression: Audit Fees

Before conducting OLS regression, the underlying assumptions were tested. Results show no violations of the assumption of multicollinearity among independent variables, where all tolerance values are >0.1 and all VIF values <10 (Tabachnick and Fidell, 2007). Furthermore, visual inspection of the normal P-P Plots and scatterplots generated for the model indicate that the data are normally distributed; the assumptions of homoscedasticity, linearity, independence of residuals and outliers were not breached. Thus, the subsequent analysis proceeded securely.

OLS regression was implemented to test whether audit committee effectiveness can significantly predict the level of audit fees as a surrogate of audit quality, controlling for firm size and profitability

Table 1: Descriptive statistics

Variable	Minimum	Maximum	Mean	Standard deviation
Audit committee size	2	6	3.50	0.959
Number of meetings	3	15	5.15	2.104
Committee independence	0.17	1.00	0.3355	0.316
ROA	-0.501	0.124	0.0118	0.066
Firm size	7,261,024	110,513,441	32,607,403	23,614,345
Audit fees	6960	30300	15213.90	5555.560

ROA: Return on assets

Table 2: Size of auditing firms

Variables	Non-big 4	Big 4	Total
#of firms	74	41	115
Percentage	64	36	100

1 JD: The average exchange rate for the Jordanian Dinar was 1.41 US Dollars during 2017.

(ROA). The main assumption of the study is that a larger, diligent and independent audit committee is more likely to demand more audit efforts and therefore entail higher audit fees. The results (Table 3) show that the model is statistically significant, F (5, 109) = 15.6, P < 0.0001, explaining around 39% (adjusted R^2) of the total variance in the audit fees.

The statistics in Table 4 show that two variables of audit committee characteristics positively significantly contribute to the power of the model. This indicates that higher audit fees can be predicted by larger audit committee size, and an increase in independent and non-executive members of the committee. Except for the number of meetings of audit committees, this result supports the first hypothesis. It is also in line with the complementary view of audit fees, where strong internal corporate governance, including an effective audit committee, is more likely to require higher audit quality and therefore greater audit fees. This result is consistent with the findings of a number of authors (Abbott et al., 2003; Goodwin-Stewart and Kent, 2006; Vafeas and Waegelein, 2007; Boo and Sharma, 2008; Zaman et al., 2011; Ali et al., 2018; and Alqadasi and Abidin, 2018).

4.3. Logistic Regression: Audit Type

Direct logistic regression was implemented to assess the impact of audit committee characteristics (size, independence and number of meetings) on the likelihood that insurance companies would select big four or non-big four as audit agent, signalling their audit quality. As before, issues of outliers and multicollinearity, which are potential sources of bias in logistic regression, were checked to ensure that independent variables are not highly inter-correlated and that outliers of residuals were fully remedied.

Table 5 exhibits models' goodness of fit and power to evaluate the effect of predictors on the probability of choosing one type of audit agent. Figures from the omnibus test indicate that the model's overall fit is statistically significant, P < 0.0001, demonstrating the efficiency of the model in differentiating between firms hiring big four as audit agents from those do not. The model is able to explain a substantial amount of the variance of the auditor selection status, which ranges from 0.505 (Cox and Snell R square) to 0.693 (Nagelkerke R square). Overall, the model was found to correctly classify around 88% of the cases, as shown in Table 6 below.

Except for firms' level of profitability, all variables in the model were found to make a uniquely significant contribution to the predictive power of the model. Three of them (audit committee size and independence, and firm size) were positive, while audit committee meetings, surprisingly, were found to have a negative impact in selecting big four auditing firms. With an odds ratio of 0.44, diligent and active audit committees, in terms of number of meetings a year, are less likely by 0.44 times to select big four companies for statutory auditing than are less active audit committees, controlling for other variables in the model. This might be explained by the substitution view of auditing, where a sound internal control system can reduce the need for high-quality external auditing. Furthermore, diligence of the audit committee might make it more able to control the work of an external auditor, preferring lower fees of non-big four firms. This is especially as, although it was not significant, this variable appeared negatively associated with audit fees. Consistent with the complementary view of external auditing, firms characterised by a larger audit committee are approximately 9 times more likely to hire a big four audit agent than a non-big four agent. The strongest predictor of auditor selection was audit committee independence, recording an odds ratio of 16,800. This indicates that audit committees composed of higher independent and non-executive directors are over 16,800 times more likely to select big four audit agents, controlling other variables in the model. This result demonstrates that the second hypothesis is supported. This contradicts the findings of Habbash (2015), who found no evidence of the relationship between an effective audit committee and selection of a big four auditing agent in Saudi Arabia. It is, however, consistent others' findings (Abbot and Parker, 2000; Cassell et al., 2012; Srinidhi et al., 2014), indicating that companies with effective audit committees are more likely to select or switch to brand-name auditors, especially big four audit agents.

The overall results of logistic regression are shown in Table 7.

Table 3: Model of goodness statistics

R	R square	Adjusted R square	Standard error of the estimate	F	Significant
0.646	0.418	0.391	4336.180	15.626	0.000

Table 4: Results of OLS regression

Variables	Standardized coefficients	t	P-value	95.0% Confidence interval for B		Collinearity statistics	
	Beta			Lower bound	Upper bound	Tolerance	VIF
(Constant)		3.696	0.000	4323.881	14321.231		
Audit committee size	0.227	2.566	0.012	299.490	2331.760	0.683	1.464
Number of meetings	−0.009	−0.118	0.907	−417.153	370.409	0.944	1.059
Committee independence	0.166	1.859	0.046	6040.762	193.398	0.667	1.500
ROA	−0.015	−0.199	0.843	−14038.922	11482.454	0.904	1.106
Firm size	0.438	5.451	0.000	0.000	0.000	0.828	1.207

ROA: Return on assets

Table 5: Goodness of fit of the model

Omnibus test			Variance explained		
Chi-square	df	Significant	Cox and Snell R square	Nagelkerke R square	−2 Log likelihood
80.797	5	0.000	0.505	0.693	69.023

Table 6: Model of accuracy of classification

Observed	Predicted		Percentage correct (%)
	Non-big 4	Big 4	
Non-big 4	68	6	91.9
Big 4	8	33	80.5
Overall percentage			87.8

Table 7: Results of logistic regression

Variables	B	Standard error	Wald	P-value	Odds ratio	95% Confidence interval for EXP (B)	
						Lower	Upper
Audit committee size	2.198	0.557	15.542	0.000	9.004	3.019	26.850
Number of meetings	−0.818	0.308	7.084	0.008	0.441	0.241	0.806
Committee independence	9.729	2.422	16.134	0.000	16800.608	145.735	1936810.543
ROA	6.810	6.264	1.182	0.277	906.863	0.004	194828620.939
Firm size	0.000	0.000	9.948	0.002	1.000	1.000	1.000
Constant	−14.937	4.373	11.669	0.001	0.000		

ROA: Return on assets

5. CONCLUSION

The aim of this study was to examine the effectiveness of the audit committee on audit quality, as proxied by audit fees and audit type. This is in an emergent and less regulated context in terms of corporate governance. Within this context, the study aimed to establish whether larger, independent and diligent audit committees leads to boosting audit quality in Jordan as a Middle East country. This is especially relevant as Jordan has made great steps regarding corporate governance and internal control reforms intended to rectify the financial market and attract foreign investment.

In the wake of international corporate failures, there has been growing interest in the role played by the audit committee as an essential tool of internal control and corporate governance, which might contribute significantly to the quality of auditing and the integrity of financial reporting. In Jordan, adhering to corporate governance best practices is not mandatory, and different levels of application might occur in practice. This is what makes Jordan a uniquely interesting context in which to investigate the characteristics of audit committees as determinants of audit quality. Specifically, the study focuses on the insurance sector in Jordan, to which special corporate governance instructions have been applied.

The study sample includes all 23 listed insurance companies in the period 2013 to 2017, resulting in 115 observations. The findings generally indicate that companies with larger audit committees which contain a large proportion of non-executives and independent directors are more likely to incur higher audit fees and hire a big four audit agent, signalling the importance they give to audit quality. In contrast, in terms of the number of meetings a year, the findings show that more diligent audit committees, are more likely to select non-big four auditing firms requiring lower audit fees.

Generally speaking, corporate governance codes are still in their infancy in Jordan and the Middle East as a whole. Thus, the findings of the current study provide insights into the governance guidelines that best improve the efficiency of audit committees. They will be useful for regulators and policy makers in the Middle East and Arab region, particularly, in reviewing and setting guidelines for effective audit committee characteristics.

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