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Audit fees, auditor choice and stakeholder influence: Evidence from a family-firm dominated economy

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ABSTRACT

Despite the dominance of family-owned publicly listed companies in developing economies, prior research has paid relatively little attention to this area and the socio-economic context of these countries has been mostly ignored. This study contributes to the accounting literature by providing empirical evidence of the effects of family control and ownership on audit pricing and auditor choice in a developing economy context. Using 1058 firm-year observations of publicly listed companies in Bangladesh, where family firms are the most dominant form of public companies, we find that in comparison with non-family firms, our sample family firms pay significantly lower audit fees and choose lower quality auditors. However, for export-oriented industries, family firms seem to pay significantly higher audit fees and recruit better quality auditors compared to non-family firms. Collectively, our findings have important implications for audit markets in emerging economies in which the sustainability of family firms is crucial for overall economic development.

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1. Introduction

We explore audit fees and auditor choice in a family-firm dominated economy. The current decade has seen a phenomenal growth in family businesses, especially in emerging economies in Asia. Credit Suisse (2011) reports that family businesses are now the backbone of many Asian economies, accounting for 32 percent of total market capitalisation. In Southeast Asia, where important emerging economies such as India and Malaysia are located, family businesses make up 65 percent of listed companies, and 49 percent of market capitalisation. However, despite this remarkable contribution of family businesses, especially in emerging economies, the topic of family business has remained relatively under researched in accounting literature. Likewise, family firms have received little attention from audit researchers (Burkart, Panunzi, & Shleifer, 2003; Faccio & Lang, 2002; La Porta, Lopez-de-Silanes, & Shleifer, 1999; Wang, 2006). Although the traditional agency problem, characterised by a conflict of interest between owners and managers (referred to as the 'type I' agency problem) is less of an issue for family firms, a growing body of literature (for example, Faccio & Lang, 2002; Villalonga & Amit, 2006) suggest that families have powerful incentives to expropriate wealth from minority shareholders, and pursue their own interests at the expense of non-controlling shareholders (referred to as the 'type II' agency problem). Prior research on auditor choice and audit fees in family firms presents two possible scenarios. Due to lower type I agency problems, it is expected that family firms

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will have lower demand for audit quality and eventually pay lower audit fees (Ho & Kang, 2013). On the other hand, the presence of strong incentives in family firms to engage in fraudulent activities may increase audit risk. To mitigate such risks, auditors may be required to perform audits that are more extensive and will charge higher audit fees. The presence of such conflicting arguments makes auditor choice and audit fees in family firms an interesting research area. In an important review paper summarising the large body of audit fee research, Hay, Knechel, and Wong (2006) identified the need for further research examining how different forms of ownership, including family ownership, have an impact on audit fees. In his follow-up paper, Hay (2013) reported no significant further developments in this area. This presents the context for our study.

In this paper, we respond to Hay et al.'s (2006) call to explore a potential gap in the audit literature by investigating audit fees and auditor choice in family firms in a developing economy, using the case of Bangladesh. Bangladesh has made significant economic progress in recent years.[1] However, like many other developing economies, the Bangladesh corporate sector is characterised by relatively unsophisticated legal and regulatory framework (Farooque, Zijl, Dunstan, & Karim, 2007), high ownership concentration, weak capital markets, lack of shareholder activism, and poor enforcement and monitoring of regulations (Siddiqui, 2010). On average, the top five shareholders, usually belonging to the same family, hold more than 50 percent of shares in listed public limited companies (Imam & Malik, 2007). As of December 31, 2011, more than 70 percent of the top performing companies on the Dhaka Stock Exchange (DSE) were family-owned firms, making this the dominant form of listed companies in Bangladesh.[2]

The audit market in Bangladesh is characterised by poor demand for audited financial statements (Ahmed & Goyal, 2005) and poor perceptions regarding audit quality (Sobhan & Werner, 2003). At present, three categories of audit firms operate in the Bangladeshi audit market: the Big 4 firm – KPMG, Big 4 affiliate (B4A) firms, and local audit firms. It seems unusual that KPMG is the only Big 4 firm with a direct presence in Bangladesh. The rest of the Big 4 firms operate through their associates or cooperating firms; they do not have to adhere to Big 4 quality control standards. Siddiqui, Zaman, and Khan (2013) report that unlike Big 4 firms, B4A firms do not earn a significant audit fee premium in Bangladesh. This indicates that the quality of B4A firms is not perceived to be the same as a Big 4 firm. The presence of such quality differentiation in the audit market adds an interesting dimension to this study.

Another major feature of the Bangladeshi corporate sector is the presence of important stakeholder groups in the form of foreign buyers. Bangladesh is the second largest exporter of garment products in the world, and many family-owned firms operating in the garments sector act as supply chains to renowned international brands. Recent research (see Islam & Deegan, 2008; Khan, Muttakin, & Siddiqui, 2013) has identified these foreign stakeholders to be important pressure groups asking for greater financial disclosures, particularly in the form of corporate social responsibility. It might be reasonable to assume that these important stakeholders would also be concerned about the quality of audited financial statements in Bangladesh, and influence the choice of audit firms. Ashbaugh and Warfield (2003) document the influence of foreign stakeholders in the German context. The study found that foreign stakeholders had a general preference for 'dominant' auditors for their capacity to offer a wide range of services. In the context of Bangladesh, we argue that the decision to recruit a better quality audit firm may stem from the audit firm's reputation regarding the quality of audit services, which mitigate some concerns regarding the quality of financial statements.

The presence of such attributes makes developing economies such as Bangladesh an interesting research site. Prior research (see, e.g., Wang, 2006) provides two competing theories on the effect of family ownership on earnings quality: the entrenchment effect and the alignment effect. The alignment effect implies that concentrated ownership creates greater monitoring by controlling owners (Demsetz & Lehn, 1985; Shleifer & Vishny, 1997), suggesting that controlling families might monitor firms more effectively. According to this approach, founding families are more likely to forgo short-term benefits from managing earnings because of the incentives to pass on their business to future generations and to protect the family's reputation. Hence, family firms are motivated to report earnings of higher quality than non-family firms. However, the presence of such incentives to report earnings in good faith, may, in turn, reduce the demand for audit quality, if the stakeholders are convinced that family ownership enhances corporate governance (Wang, 2006). The entrenchment effect, on the other hand, is consistent with the view that controlling shareholders in family firms have incentives to expropriate wealth from other shareholders (Morck, Shleifer, & Vishny, 1988; Shleifer & Vishny, 1997). The impact of entrenchment effect on earnings quality is not as straightforward as the alignment effect. The presence of more severe type 2 agency problem would suggest that family ownership would be associated with the supply of lower earnings quality as family members have the incentive and ability to manipulate accounting numbers in order to engage in self-beneficial activities. In contrast, the entrenchment effect of family ownership may motivate users of financial statements and external shareholders to demand high-quality earnings from family firms to better safeguard their assets and interests (Wang, 2006). Young, Peng, Ahlstrom, Bruton, and Jiang (2008) points out that in developed countries, because minority shareholders are protected there is less scope for expropriation. Therefore, the lower demand for audit quality in family firms (see Ho & Kang, 2013) may be due to the alignment effect. In developing countries like Bangladesh, such institutional protection is absent (Young et al., 2008), making these countries more susceptible to the expropriation effect. Also, whereas the market for corporate control deemed to be the

[1] Bangladesh has maintained more than 6 percent GDP growth over the last ten years, mainly fuelled by a booming textile sector (World Bank, 2012). The country is now regarded as one of the 'next eleven' emerging economies (Goldman Sachs, 2011).

[2] For this research, we use company data until 2010. As of December 31, 2011, more than 70 percent of the top performing companies in the Dhaka Stock Exchange were family-owned firms (www.dsebd.org).

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