



Article

## External audit quality and ownership structure: interaction and impact on earnings management of industrial and commercial Tunisian sectors



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### ABSTRACT

This article emphasizes the significance of researching the cross effect of using jointly external audit quality and ownership structure over managerial discretion in a largely unexplored, non-Western and emerging context. The analysis is based on a sample of 61 Tunisian firms listed and unlisted on the Tunis Stock Exchange and operating in the industrial and commercial sectors during the period 2007–2011. To provide evidence on this topic, we conduct an empirical examination. First, we examine the effect of external audit quality and ownership structure on the discretionary accruals for the whole sample. We find that only auditor reputation has a negative and significant effect on earnings management. Second, this article provides empirical evidence on the cross effect of external audit quality variables and capital concentration on earnings management. This test suggests that this combination has a negative and significant effect on earnings management in industrial firms but it has a positive and non significant effect in commercial firms. Finally, the third empirical test concerns the combined effect of external audit quality and institutional property on earnings management. We find that the cross effect of this combined relation is negatively and significantly associated with earnings management of industrial firms but it has no significant effect on the earnings management of commercial firms. As for the cross effect of the auditor seniority and the institutional property, it has a positive and a significant effect in the commercial sectors, while, it is positively and non-significantly associated with earnings management of industrial firms.

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## Calidad de la auditoría externa y la estructura propietaria: interacción e impacto sobre la gestión de los ingresos en los sectores industriales y comerciales tunecinos

### RESUMEN

Este artículo enfatiza la importancia de investigar el efecto cruzado del uso conjunto de la calidad de la auditoría externa y la estructura propietaria sobre el criterio gerencial, en un contexto emergente no occidental y ampliamente inexplorado. El análisis se basa en una muestra de 61 empresas tunecinas y no cotizadas en la bolsa de Túnez, que operan en sectores industriales y comerciales durante el período 2007–2011. Para aportar evidencia sobre esta cuestión, realizamos un examen empírico. Primeramente, examinamos el efecto de la calidad de la auditoría externa y la estructura propietaria sobre el acumulado discrecional de la muestra en su totalidad. Encontramos que únicamente la reputación del auditor tiene un efecto negativo e importante sobre la gestión de los ingresos. En segundo lugar, este artículo aporta evidencia empírica sobre el efecto cruzado de las variables de calidad de la auditoría externa y la concentración del capital sobre la gestión de los ingresos. Este test sugiere que esta combinación tiene un efecto

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negativo sobre la gestión de los ingresos en las empresas industriales, aunque presenta un efecto positivo y no significativo en las empresas comerciales. Por último, el tercer test empírico se refiere al efecto combinado de la calidad de la auditoría externa y la propiedad institucional sobre la gestión de los ingresos. Encontramos que el efecto cruzado de esta relación combinada es negativo y está asociado de manera importante a la gestión de los ingresos de las empresas industriales, pero no tiene un efecto significativo sobre la gestión de los ingresos de las empresas comerciales. En cuanto al efecto cruzado de la antigüedad del auditor y la propiedad institucional, tienen un efecto considerable sobre las empresas comerciales, mientras que están asociados a la gestión de los ingresos en las empresas industriales, de modo positivo y no significativo.

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## 1. Introduction

Under the agency theory, the relationship between managers and shareholders is such a conflictive relation. The separation of the property functions and control engenders agency conflicts that materialize in a context of asymmetric information by an opportunistic manager's behavior. Indeed, the need for shareholders to control the managers is positively related to the organization complexity. This can be explained by a more and more important number of hierarchical levels which establishes a limit for shareholders to monitor managers' activities (Bonazzi & Islam, 2007; Kesten, 2013; Massimo, Annalisa, & Samuele, 2014). In front of this organization complexity and the decision function diffusion, we can assist an increase in agency problems and the associated costs, the firm owners are in front of the difficulty of controlling and observing the efforts of their agents. Taking advantage of this asymmetric information, managers can adopt opportunistic behavior against proprietary interests while trying to maximize their own utilities (Jensen, 1993).

As governance mechanisms, the fundamental role of audit as well as ownership structure is to reduce asymmetric information between managers and shareholders (Jones, 2011; Usman, 2013). We expect that an effective control exercised by these two governance mechanisms is associated with lower levels of earnings management (Johnson & Waidi, 2013; Anis, 2014). The mechanisms of control are interrelated and the relationship between these variables is based on agency theory (Jensen & Meckling, 1976). In order not to be limited to assessing the effectiveness of a mechanism in isolation, it becomes favorable to study the effect of their interactions on the accounting manipulations and check the sense of different mechanisms, used in conjunction, on the earnings management (Kathleen, Emre, & Jin, 2014; Domenico & Ray, 2014). In this framework, the failure of a potential mechanism may possibly be offset by the action of an alternative mechanism (Brav & Mathews, 2011; Kee-Hong, Jae-Seung, Jun-Koo, & Wei-Lin, 2012; Paul et al., 2014).

We think that it would be of great interest to conduct this article for many reasons. First, most research about governance mechanisms are conducted in the context of developed countries. Even if there are few studies focused on exploring the impact of governance mechanisms on earnings management, conducted in the context of a developing country such as Tunisia (Zgarni, Hlioui, & Zehri, 2012), they are interested in studying the influence of these mechanisms one by one (separately and not jointly). This paper, to the authors' best knowledge, is the first to investigate the specificities and uniqueness of the combination's effect of external audit quality (particularly auditor reputation and auditor-audited relationship seniority) and ownership structure (specifically capital concentration and institutional property) on earnings reported by listed and unlisted Tunisian firms. So, this article contributes to extent existing empirical work on emerging markets by examining a new database given by the case of the Tunisian industrial and commercial sectors. This led us to identify if the empirical results

concerning other market hold for the Tunisian Stock Exchange. Second, the context of a developing country is novel. It would be interesting to provide a contribution to the literature by releasing new ultimate ownership data for firms' sample listed and unlisted on pure agency market such as the Tunisian Stock Exchange (TSE). The value of the findings may, however, be extended to other similar countries. This is important given the role that can generate the functioning in joint title of governance mechanisms in limiting managerial discretion. Finally, the findings may be helpful for managers to understand the influence of the governance mechanisms' interaction and for market participants, especially for institutional investors, to adopt optimal regulatory policies and choose efficient mechanisms' combinations.

According to the aforementioned, the questions that are necessary to highlight are: what is the impact of audit quality on accounting manipulation level in a context of concentrated ownership within Tunisian companies? What is the impact of sector affiliation on the relevance of the results found between the set of audit and ownership structure variables and earnings management?

In this particular framework, our aim is to empirically examine within a Tunisian perspective, the impact of synergy, between some variables related to the external audit quality and the ownership structure, on discretionary managerial discretion exercised through earnings management. The results suggest that institutional investors have no influence on earnings management. Therefore, they do not influence the leaders of the selected companies.

Specifically, it comes to examine the interaction between the following variables: the belonging of the external auditor to a "Big 4"<sup>1</sup>, the external auditor seniority, the capital concentration and the presence of institutional investors out in the presence of other factors affecting this phenomenon, which are the firm size and the debt ratio.

The remainder of this paper is organized as follows: section 2 provides theoretical background, section 3 carries about literature review and hypotheses for the study, section 4 describes the methodology used, section 5 reports the results of the empirical study and section 6 concludes.

## 2. Theoretical framework

The inability of traditional research to explain the phenomenon of earnings management was behind the formulation of a positive theory based primarily on the paradigm of accounting information's contractual utility (Watts & Zimmerman, 1978). This theory seeks to explain and predict the behavior of both producers and users of accounting information with the ultimate aim to clarify the genesis of the financial statements. To do this, it borrows its

<sup>1</sup> The Big 4 are: Deloitte, PwC, Ernst & Young and KPMG.

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