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The effects of agency conflicts on audit quality demand: Evidence from Tunisia

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Abstract

This study investigates whether agency conflicts affected the demand of audit quality by Tunisian listed firms. Our theoretical framework suggests that firms with high agency conflicts were more likely to demand audit quality. Focusing on owners, shareholders and lenders agency conflicts, we conduct an empirical study based on data from 253 firm-year observations. Our findings are consistent with the predictions of agency theory. We show that an increase in managerial ownership decreases the likelihood that the firm will engage a Big 4 auditor. An increase in ownership concentration and leverage in high investment opportunities set, on the other hand, increases the likelihood of a firm demanding higher audit quality. We document that size of audited client is also a significant determinant of audit quality demand.

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1. Introduction

Past financial scandals have resulted in an investors' confidence crisis and emergence of a set of laws all over the world. The Sarbanes Oxley Act (SOX) and the Financial Security Law (FSL) aim to protect investors, strengthen the corporate governance principals, ensure financial information quality and enhance the transparency. An important role is assigned to external auditor. Based on the fundamentals of agency theory, Watts and Zimmerman (1983) recognized external auditing as an effective mechanism to reduce the agents' opportunist behavior and ensure reliability of corporate disclosures. The resolution of conflicts of interest legitimizes the intervention of a statutory auditor, being an independent professional (Weik *et al.* 2018). Prior studies documented that the demand of a higher audit quality is associated to companies' contractual considerations such as ownership structure, financing policy and others (Dwekat *et al.* 2018, Fan and Wong 2005, Hope *et al.* 2012, Khan *et al.* 2015, Lennox 2005, Niskanen *et al.* 2011). The most previous studies focused on developed countries. Very few studies concerned emerging markets; despite that many of them were affected by the crisis, including Tunisia.

Our current study contributes to the range of previous studies by being conducted in a very special context, i.e. Tunisian one. Indeed, Tunisia suffered from many financial scandals such as BATAM. It was the largest home appliances trading company. Because of his inability to repay debts (about 200 million euros), it was placed under receivership in October 2002 and his external auditor was placed in detention. Since, multiple laws were succeeding in order to reinforce the security of financial relationships. Indeed, FSL was instituted in 2005 and aims to strengthen the transparency and ensure better corporate governance. Particularly, it emphasizes on the importance of audit quality as a crucial corporate governance mechanism. In fact, FSL redefines statutory auditor as a professional asked to assess the reliability of the financial statements under his own responsibility and in consideration of the regulation. The FSL reinforces also the auditor independence by constraining mandates indefinite renewals. Then, the auditor is appointed for a period of three years with a maximum of three mandates renewals (five renewals if he acts as an auditing firm). Several other reforms follow, mainly the adoption of the International Standards of Audit ISA since 2010. The specificity of Tunisian context appears also in fixing auditors fees. The regulator planned a scale to compute the fees perceived by the auditor, the last one dated from 2016. Recently, the Tunisian National Accounting Council decides to adopt the International Financial Reporting Standards (IFRS) from 2021 in order to prepare the consolidated financial statements. Despite all these laws, the Tunisian context is characterized by an emerging capital market, a weak implication of the financial market in companies' external financing, a high level of ownership concentration, a weak minority shareholders' right protection and a low level of corporate disclosure (Boubaker and Nguyen 2012). It relies on the auditor in order to perform a high quality of controlling corporate disclosures.

Thus, our study intends to contribute to the previous literature on audit quality demand by testing the predictions of agency theory in an emerging market. It examines particularly the relationship between different stakeholders and the demand of external audit quality. The empirical analysis is performed on a sample of 23 non financial Tunisian listed firms for the period between 2007 and 2017.

The remainder of this paper proceeds as follows: the next section explains our theoretical framework and develops research hypotheses. Section 3 describes the methodology aspects. The empirical results are depicted in section 4. Finally, section 5 concludes.

2. Literature review and hypotheses development

Following the prior literature on determinants of audit quality demand, we focus specifically on the impact of agency conflicts. So, we are interested to study the association between managers-owners, controlling-minority shareholders and debtholders-shareholders agency conflicts and the demand of a higher audit quality.

2.1- Managers-owners conflicts and audit quality demand

According to the previous literature on agency background, the managerial ownership affects managers-owners agency conflicts (Morck *et al.* 1988). That is, when managers possess a few percentage of the capital, they may not act in the interest of external shareholders. This led to an increase of the agency costs. Then it must be necessary to set up corporate governance mechanisms in order to constraint the opportunist behavior of managers. In this line, Lennox (2005) and Niskanen *et al.* (2011) document a negative relationship between the managerial ownership and the likelihood of audit quality demand. Other empirical studies don't find an association between managerial ownership and audit quality, such as Dwekat *et al.* (2018) and Hope *et al.* (2012). Besides, Nikkinen and Sahlstöm (2004) document a negative relationship between managerial ownership and the request of a higher audit quality in South Africa, in Hong-Kong, in Malaysia, and in United Kingdom but not in Singapore, nor in Denmark.

Tunisia offers a special context where the majority of firms are small to medium size and in general family owned. They are so managed either by a family member or by an external person. When the manager possesses a few part of capital, we expect that he will to be opportunistic towards the shareholders. To protect themselves, shareholders should appoint a higher quality auditor. Within the framework of the actual study, we try to test if there is an association between managers-owners agency conflicts (managerial ownership) and the probability to appoint a higher quality auditor. This led us to our first hypothesis:

H 1: The managerial ownership influences negatively the audit quality demand.

2.2- Controlling-minority shareholders conflicts and audit quality demand

According to agency theory, Shleifer and Vishny (1986) documented that the ownership concentration is an effective control mechanism. The capital dispersion prevents the minority shareholders from reaching easily required information. It deprives them of the decision-making power. However, the presence of controlling shareholders is useful for them in terms of controlling managers. In the audit quality demand's framework, the previous studies revealed that the audit quality demand is associated with the presence of blockholders (Fan and Wong 2005, Hope *et al.* 2012, Khan *et al.* 2015).

Khan *et al.* (2015) document a negative association between the ownership concentration and audit quality demand in Bangladesh. They explain this result by the fact that blockholders are able to practice a rigorous control of the companies, in particular when they belong to the same family. While, Darmadi (2016), Dwekat *et al.* (2018) and Fan and Wong (2005) establish a positive association between the ownership concentration and audit quality demand. They justify this by the important role assigned to external auditor in resolving agency conflicts between controlling shareholders and minority ones. This led us to the following hypothesis:

H 2: The ownership concentration influences positively the audit quality demand.

2.3- Debtholders-shareholders conflicts and audit quality demand

One of external funding sources, debt, led to establish a conflict of interest between lenders and shareholders (Pong and Kita 2006) because of its contractual nature. Independent auditor tends to ensure the reliability of financial information used to establish debt contracts, so to confirm the respect of contractual clauses. Basing on agency theory, Niskanen *et al.* (2011) show that a high level of debts increases the probability of appointing a higher auditor quality, in order to limit debts agency conflicts. Other researchers document that there isn't an association between debt and audit quality demand (Piot 2001). Collis *et al.* (2004) explain that the debt variable can't be influential on audit quality demand in a perspective of the agency theory. This can be explained by the fact that debt agency costs depend not only on the level of current debts of the firm but also on the possibilities of expropriation offered to the shareholders, in particular under the form of opportunist wealth transfers operated by means of the investment policy. Generally, if the value of the future option of investment is more important than the value of current assets, the debts agency costs will increase because of a lack of guarantee especially in case of bankruptcy. The demand of a high level of audit quality will be raised as the investment opportunities are important (Lennox 2005). Piot (2001) was the first researcher who combines the effect of debts and higher investment opportunities to capture debts agency conflicts in French listed firms. He shows that the audit quality demand increases with debt, only if the firm has strong investment opportunities. The author explains that in firms with a wide range of investment opportunities, there is a need to fairly evaluate the assets in place and the risk of insolvency, as well as the use of covenants in order to protect the interests of creditors against the risk of expropriation. Therefore, we propose the following hypothesis:

H 3: Debts in firms with strong investment opportunities set influence positively the audit quality demand.

3. Data and models

Our sample consists of 23 Tunisian listed firms. We exclude all financial firms from our analysis because of their particular regulatory environment. The period of the study begins in 2007 and ends in 2017. All data are collected from financial statements of listed companies available on the web site of the Tunisian Stock Market (TSM). Data about ownership structure are manually extracted from the stock guides of listed companies available on the web site of TSM. Table I defines all variables of our study.

Table I- The definitions and measurements of dependent and independents variables

Variable	*Label*	*Operational definition*	*References*
Dependent Variable :			
Audit Quality	QUAL	A dummy variable which equal 1 if the firm is audited by at least one of the 'Big4', and 0 otherwise.	Dwekat *et al.* (2018), Khan *et al.* (2015), Niskanen *et al.* (2011)
Independent Variables :			
Managerial Ownership	PRMANG	A percentage of shares owned by the managers of the company in the year.	Lennox (2005), Niskanen *et al.* (2011)
Ownership Concentration	PLACT	A percentage of shares owned by three main shareholders.	Hope *et al.* (2012)
Leverage in a high investment opportunities standard	FOILDT	Equal LTDTA if the indication OI is upper or equal to the median value in the sample; and 0 otherwise. Where:	Piot (2001)

		LTDTA: The long-term debts divided by total assets OI: (market value of own capital + Book value of the debts) / Book value of Assets	
Control Variable :			
The firm size	LNACTF	The natural log of total assets of the firm	Dwekat *et al.* (2018), Niskanen *et al.* (2011),

To test our hypotheses, we use the following model[1]:

$$P(QUAL_{it}= 1) = ß_0 + ß_1 \, PRMANG_{it} + ß_2 \, PLACT_{it} + ß_3 \, FOILDT_{it} + ß_4 \, LNACTF_{it} + ε_{it}$$

4. Results and discussion

4.1- Descriptive Statistics

Table II reports descriptive statistics. It shows that the Big 4 held about 30% of statutory audit missions on the audit market of listed non financial firms from 2007 to 2017. The 'Big4' auditing firms seem to be dominant in the Tunisian audit market. Indeed, Big 4 represent around 1.5% of the total number of professionals acting to audit listed Tunisian firms. Given that the Tunisian economy is composed mainly of small and medium-sized firms generally with a family capital structure, it seems very interesting to explain their choice to appoint a Big 4 audit firm.

Table II. Descriptive Statistics

Dep.Variable	**Mean**	**Median**	**Std.dev.**	**Min**	**Max**
PRMANG	0.0619	0	0.1661	0	0.755
PLACT	0.6275	0.6574	0.1755	0.29	0.9975
FOILDT	0.0628	0	0.1136	0	0.7071
LNACTF	18.1242	17.95	0.9760	16.5594	21.5862
Ind.Variable	**Frequence of '0'**	**Frequence of '1'**	**Std.dev.**	**Min**	**Max**
QUAL	175	78	0,46	0	1
For variable definitions, see Table I.					

The descriptive analysis shows that the managerial ownership in the sample is about 6 % on average (against 60 % in Lennox 2005), ranging from 0 to 75 % (PRMANG). Lennox (2005) considers a non linear association between managerial ownership and audit quality demand taking simultaneously account of agency and entrenchment effects. In our study, we recognize that it isn't useful to take into account the entrenchment effect because of the fewer mean value of managerial ownership.

Also, descriptive statistics show that the capital of the firms included in the sample is strongly concentrated, as it indicates about 63 % as a mean value of the ownership concentration (PLACT), which is similar to the Palestinian context (65 % in Dwekat *et al.* 2018). Further, the statistics indicate that the firms included in the sample of our study are relatively weak long term indebted with an average about 6 %.

4.2 Correlations

According to Pearson correlation coefficients of all independent variables introduced in our model, there isn't a major overlap indicated in the independent variables multicollinearity[2] (Kervin, 1992).

[1] We choose to test the effect of long-term debts on the audit quality demand but not the total debts because of an econometric problem of multicolinearity in the model with total debts variable.

[2] All coefficients are less than 0.7 (Kervin 1992).

According to the variance inflation factor test (VIF), computed in order to diagnose a multicollinearity problem between predictors, no predictor is correlated with other variables[3] (Gana and Lajmi, 2012).

4.3- Logit Panel Regression

To test our model and giving that the dependent variable is a binary one, we use the logit panel regression. We perform a Hausman specification test to choose between fixed effects model and a random effects model. The Hausman test statistic indicates that a random effect was suitable to our data and there isn't a correlation between the unique errors and the regressors in the model. Table III summarizes the results of the logit panel regression and presents the marginal effects coefficients of explanatory variables.

Table III. Logit Panel Regression Results

Variable	*Variable Type*	*Expected sign*	*Coefficients (Standard errors)*	*Validation of hypotheses*	*Marginal effects coefficients (Standard errors)*
PRMANG	Independent	-	***-9.0163**** (5.3206)	*H1 is accepted*	***-0.3005*** (0.1748)
PLACT	Independent	+	***10.4015***** (4.8453)	*H2 is accepted*	***0.3467*** (0.1623)
FOILDT	Independent	+	***10.7259**** (6.1095)	*H3 is accepted*	***0.3575*** (0.1855)
LNACTF	Control	+	***2.1220****** (0.7678)		
Constant			-51.8126*** (15.0183)		
N			253		
Log likelihood			145.07***		
Pseudo R^2			0.967		

For variable definitions, see Table I.
Statistical significance (p-values) less than 0.01, 0.05 and 0.1 indicated by ***, **, and *.
Standard errors are reported between parentheses.

The managerial ownership variable (PRMANG) receives a negative and statically significant coefficient ($p < 0.1$). This suggests that a low part of managerial ownership seems to increase the probability that a firm demand a higher audit quality. Indeed, according to agency theory, when the manager held a low part of the capital, he behaves opportunistically. This encourages shareholders to hire a better quality auditor in order to control his behavior. Our result supports the predictions of agency theory and it is in line with the result obtained by Gana and Lajmi (2012) in the Belgian context. Our first hypothesis is then accepted, i.e. H1: *The managerial ownership influences negatively the audit quality demand.* Interpreting to marginal effects of the regression coefficients, Tunisian firms are 30% less likely to appoint a Big 4 audit firm when managerial ownership increases by a unit.

However, Piot (2001) argues that the inexistence of an association between the managerial ownership and audit quality demand in the French context is due to the use of an inappropriate measure of the managerial ownership including shares held by managers, directors and others. Lennox (2005) dials with a non linear construction of the variable managerial ownership, taking into account a possible effect of managers' entrenchment in unlisted firms. In this study, we consider only shares held by executive manager to measure management ownership and we don't need to consider the entrenchment effect regarding to a

[3] All VIF coefficients are below 3 (Gana and Lajmi 2012).

weak average of managerial ownership in our sample firms (the mean of PRMANG is about 6 % while Lennox (2005) shows that the managers possess on average 46 %). It seems that the agency theory can be considered as an appropriate framework to explain the audit quality demand by firms' contractual characteristics.

As expected, PLACT receives a positive and significant coefficient ($p < 0.05$). This result is in line with our second hypothesis H2: *The ownership concentration influences positively the audit quality demand.* Indeed, the ownership concentration may increase the need for a higher audit quality in order to protect the interests of minority shareholders. The Tunisian context is recognized by offering a weak legal system that protects the interests of minority shareholders. This is why we can attribute to the auditor quality an important role in solving conflicts of interests between the majority and minority shareholders. Our result is in range of those obtained by Darmadi (2016) and Gana and Lajmi (2012). Interpreting to marginal effects of the regression coefficients, Tunisian firms are 35% more likely to hire a Big 4 audit firm when ownership concentration increases by a unit.

FOILDT has a statistically significant and positive coefficient ($p < 0.1$) supporting our third hypothesis H3: *Debts in firms with strong investment opportunities set influence positively the audit quality demand.* This indicates that long term debts in a highly investment opportunities set increases the probability of audit quality demand. Our result is in range with Fan and Wong (2005), Khan *et al.* (2015) and Piot (2005). Previous research concluded that the long term debts have more explanatory power rather than the total debts in the context of external auditor's choice. Firms with strong investment opportunities set which turning to the debts as an external way of financing, should so increase the quality of their statutory auditor in order to minimize their agency costs. Interpreting to marginal effects of the regression coefficients, Tunisian firms are 36% more likely to appoint a Big 4 audit firm when long term debts, in a high set of investment opportunities, increase by a unit.

In addition, our model includes the size of the audited firm as a control variable. As expected, LNACTF receives a positive and statistically significant coefficient ($p < 0.01$) suggesting that the largest firms demand a high level of audit quality. The result is in line with the prior literature (Dwekat *et al.* 2018, Hope *et al.* 2012, Niskanen *et al.* 2011).

4.4- Robustness check

In order to assess the robustness of our results, we re-estimate our model by integrating separately the long term debt variable and the investment opportunities one. This aims to confirm the usefulness of introducing jointly the two variables assessing the impact of debt agency costs on audit quality demand. It aims also to compare our results with those of previous studies. Two models are so defined:

- **Model 1: Long term debts as a measure of debt agency costs :**

$$P(QUAL_{it}= 1) = ß_0 + ß_1\ PRMANG_{it} + ß_2\ PLACT_{it} + ß_3\ LTDTA_{it} + ß_4\ LNACTF_{it} + \varepsilon_{it}$$

- **Model 2: Investment opportunities as a measure of debt agency costs :**

$$P(QUAL_{it}= 1) = ß_0 + ß_1\ PRMANG_{it} + ß_2\ PLACT_{it} + ß_3\ OI_{it} + ß_4\ LNACTF_{it} + \varepsilon_{it}$$

Where $LTDTA_{it}$= long-term debts divided by total assets $_{it}$, OI_{it}= (market value of own capital $_{it}$ + Book value of the debts $_{it}$) / Book value of Assets $_{it}$.

The models are estimated using a random effect logit estimation with panel data set[4]. Table IV summarizes the results. The long term debts and the investment opportunities variables hadn't a significant effect on audit quality demand in the Tunisian context. These results are in line with those of Piot (2001). Nor debts variable neither investment

[4] According to hausman test results.

opportunities variable can be assessing as a factor influencing the audit quality demand from an agency perspective. The use of an interactive term between debts and investment opportunities is then established.

Table IV. Robustness check results

Variable	*Variable Type*	*Expected sign*	*Coefficients in Model 1*	*Coefficients in Model 2*
PRMANG	Independent	-	***-9.0927****	-8.0618
			(5.0008)	(4.9861)
PLACT	Independent	+	***8.4799****	***8.6141****
			(4.8618)	(5.0091)
LTDTA	Independent	+	3.4406	------
			(5.8705)	------
OI	Independent	+	------	3.9188
			------	(3.2337)
LNACTF	Control	+	***1.9693*****	***2.0084*****
			(0.9699)	(0.8528)
Constant			-47.0497***	-49.0955***
			(17.9245)	(16.0825)
N			253	253
Log likelihood			140.13***	142.25***
Pseudo R^2			0.961	0.957

For variables definition, see Table I.
Statistical significance (p-values) better than 0.01, 0.05 and 0.1 indicated by ***, **, and *.
Standard errors are reported between parentheses.

Indeed, debts are a source of agency costs between shareholders and creditors when the opportunism of the owners is likely to occur, i.e. where there are strong investment opportunities. We show also that our model and our results are robust.

5. Conclusion

This study examines whether agency conflicts may impact audit quality demand in a Tunisian context. Tunisia provides a different institutional setting from the Anglo-Saxon one. It offers a strict framework for the auditor by fixing his status, his fees, and his area of responsibility. The majority of Tunisian firms have a concentrated ownership and a relatively high level of debts. All those particularities led us to interrogate about the prediction power of the agency theory in the Tunisian context, so if we can explain the differential audit quality demand by firms contractual characteristics.

To do this, we used a binary logistic model where the audit quality was approximated by auditor reputation, i.e hiring a Big 4 auditor. We gathered all necessary information about our sample from the financial statements and the stock guides for the listed Tunisian firms. Our sample consists of 253 year-firm observations from the period of 2007 to 2017.

We find that all agency conflicts tested in our research impact on audit quality demand. Accordingly, owners-managers agency conflicts, as measured by managerial ownership influence negatively the audit quality demand (which confirms our first hypothesis). We explain this by the fact that if the manager possesses a big part of shares in the firm, he will be able to have sufficient control of his firm. The manager-owner agency conflicts will not be remaining and the firm will not be in need of a reputed auditor to constraint the possible opportunistic behavior of a manager. Furthermore, we conclude that the ownership

concentration led to an audit quality demand. This result confirms our second hypothesis and is consistent with the conclusions of Darmadi (2016) and Gana and Lajmi (2012). We recognize that the Tunisian firms' ownership is heavily concentrated in comparison to the ownership structure of anglo-saxon companies. Strong agency conflicts between blockholders and minority shareholders can be balanced by a higher audit quality.

One of the contributions of this study is the use of a special measure of owners-debtholders agency conflicts which combines both investment opportunities of the firm and debt level. We argue this choice by the inappropriate use of only debts as a proxy of those agency conflicts in the context of demanding a higher audit quality as documented in prior literature (Piot 2005, Weik *et al.* 2018). We also show that considering long term debt is appropriate in the context of auditor choice (Khan *et al.* 2015). We document also that the size of the firm is an important factor which influence the audit quality demand.

Our study has also other contributions. First, our study validates prior research findings related to a very different institutional setting and stated that audit quality demand can be explained by the agency conflicts. Secondly, our study is conducted in an important period of audit regulations in Tunisia. Our period of study began in the year 2007 and ended in the year 2017, taking into account the effect of all new audit regulations (about the redefinition of statutory auditor, his status, his independence, his fees, etc). Taking into account the variability of the agency conflicts in such long periods and its effect on the change of auditors and on the direction of the change seems to be interesting (i.e change to higher or a lower audit quality). We recommend also that further research integrates other factors that may influence the audit quality demand.

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