# OWNERSHIP STRUCTURE AND AUDIT QUALITY

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## ABSTRACT

*The aim of this paper is to investigate the influence of minority shareholders' rights on client's demand for audit quality. Specially, this paper investigates the impact of shareholders' with at least 10% holdings on clients' demand for audit quality. The sample consists of the top 100 listed firms on the Borsa Istanbul (BIST) for 2014 and 2015. The result is aligned with the suggestions of the agency theory that shareholders with at least 10% holdings increase clients' involvement with audit quality. The results propose direction for future studies on the role of shareholders to monitor management behavior. This paper calls for future studies in the area of accounting and finance to operationalize a new measurement of Type II agency cost in order to better understand the agency conflicts and the state of the shareholders on the BIST.*

**Keyword:** Ownership Structure, Audit Quality, Turkey.

## INTRODUCTION

The analysis of corporate governance systems has attracted increasing attention in recent years. Many studies have analyzed efficient monitoring that can reduce agency costs associated with the separation of ownership and control. Since the separation of ownership and control is achieved in various ways in different corporate governance systems, the emerging conflicts of interest vary in nature (Mohammed, 2018). Studies on corporate finance have focused on public firms with a large number of dispersed shareholders and entrenched managers who control the company. The agency problem exists because managers, who are not under shareholders' control, can pursue their own goals. Prominent among the examples of managerial discretion are the pursuit of growth (Fama & Jensen, 1983). A possible way to correct this is to have a less dispersed ownership. Shareholders with a large stake in the company have greater incentives to monitor and take corrective action, because they partially internalize the benefits from their monitoring effort. Chandren et al. (2015) report empirical evidence on the monitoring role of large shareholders. In most European countries, share ownership is much more concentrated than in the US. Most firms are not listed and even when they are, a single large shareholder retains a controlling share in the firm (Mustafa et al., 2018). Since the concentrated ownership structure makes firms impervious to takeovers, the controlling stake commonly stays with the founder of the company and his family, even when the company is large and publicly listed. The controlling shareholder generally takes active interest in running the firm, by appointing the management and directly taking executive positions. In this situation, the conflict of interest arises mainly between the controlling shareholders and the minority shareholders, instead of the salaried managers. In the terminology of Franks and Mayer (1997), these features are shared by an insider corporate governance system, which they characterize has having few listed firms, large number of substantial share stakes. While outside investors can and are encouraged to participate

in equity returns through the stock market, they cannot exert much control. Japan and Germany are prominent examples of this type of corporate governance system. Issues related to corporate governance in the US and Europe is relatively well documented. However, similar studies are very rare for developing countries. In 2012, Turkey made substantial amendments to corporate governance mechanisms in order to integrate the Turkish market with that of Europe (Mustafa et al., 2017). Therefore, it is interesting to analyses the effects of 2012 reforms on clients' demand for high quality audit. The study demonstrates that the Turkish system shows strong similarities to the insider system. Families, directly or indirectly, own more than 75% of all firms and have the majority control (Mustafa et al., 2017). The separation of ownership and control is mainly achieved through pyramidal. In addition, an active market for corporate control does not exist, given the limited openness and concentrated ownership of the typical traded firm. It is almost impossible to acquire a traded firm without the prior willingness of the controlling owner to sell. There are also no signs that a market for large stakes operates in a way that disciplines poor performance. The distinctive features of the Turkish case are its financial system and the presence of Business Groups (BGs). Almost every private bank is under the control of families who typically control a large number of other financial and industrial firms (Che-Ahmad & Mustafa, 2017). Hence, the monitoring function of banks works in a way that reinforces the interests of family owners. There are substantial inter-corporate shareholdings organized around holding firms, similar to those observed in Korea, Mexico and Singapore (Granovetter, 1995).

## LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Ownership structure is considered as a significant mechanism of corporate governance. Concentrated ownership refers to the degree of distribution of power between agent and principle. Large shareholders have the ability to directly monitor management actions (Desender et al., 2013; Jensen & Meckling, 1976). Previous studies documented that agency theory is an optimal theory to illustrate the relationship between audit quality and agency conflicts, which is in this study represented by Type II Agency Problem. In agency theory, external auditor enhance monitoring role on management activities and reduce the incident of minority shareholders expropriation. Claessens et al. (2000) reported that ownership patterns of firms listed in emerging markets have two countervail affects. Controlling shareholders' interests might entrench or align with minority shareholders' interests. In case of entrenchment effects, controlling shareholders get more benefits to jeopardies minority wealth than increasing shareholders value. Thus, they are less likely to engage with high quality auditor. In contrast, the align of interests between majority shareholders and minority shareholders, the majority shareholders are more likely to improve firm value and improve firm monitoring mechanism. This study uses minority control rights at 10% to measure minority shareholders rights to enhance client's ability to demand high audit quality in the environment of controlling shareholders entrenchment. When we connect between the arguments of extend the minority shareholders rights enhance clients demand for audit quality. We might conclude that minority shareholders rights are more likely to demand high audit quality in order to mitigate agency problem. Therefore, this study hypothesis is as follows:

*H1: There is a positive significant relationship between minority shareholders rights and audit quality.*

## SHAREHOLDERS RIGHTS

The rights attached to shares of a firm give investors the power to extract from managers the returns on their investment. These rights become critical as a protection against managers or majority owners who act in their own interests. Because shareholders exercise their power by voting for directors, La Porta et al. (1998) focus on voting procedures in evaluating shareholders' rights. A main finding of La Porta et al. (1998) is that, in a cross-country comparison, shareholder protection measures are associated with lower concentration of ownership. To explore this possibility, we begin by looking at voting rights attached to shares and rights that support the voting mechanism against interference by the insiders. The next set of rights is referred to as anti-director rights. They measure how strongly the legal system favors minority shareholders against managers or dominant shareholders in the corporate decision making process:

1. General meetings are mandatory for firms. A shareholder cannot attend and vote unless he has lodged his shares with the company one week before the time meeting.
2. Shareholders with at least 10% holdings can call an extraordinary shareholders' meeting to challenge the management.
3. Shareholders with at least 10% holdings are entitled to some legal mechanisms against perceived oppression by directors. These mechanisms allows minority shareholders to demand a special investigation of the firm records by the audit committee or go to the courts if the necessary investigation in not undertaken.

## RESEARCH DESIGN AND VARIABLE MEASUREMENT

We utilize panel data because it offers some useful benefit more than cross-sectional and time-series data analysis (Henderson & Kaplan, 2000). Following DeAngelo (1981), binary measurement of audit quality proxy by (1) if the firms hire international audit firms and otherwise (0). This study independent variable is shareholders control about 10% of voting rights. Shareholders own equal or more than 10% of voting rights is coded (1) otherwise (0).

$$INAU_{it}=\beta_0+\beta_1 MIRI_{it}+\beta_2 FSIZE_{it}+\beta_3 ROA_{it}+\beta_4 LEVE_{it}+\varepsilon_{it} \quad (1)$$

Where,
For each firm (i) and each year (t).
$INAU_{it}$=Audit quality measured by (international audit firms).
MIRI=Minority shareholders' rights.
FSIZE=Total assets.
ROA=Return on assets.
LEVE=Leverage (Total debt divided by total assets).
$\varepsilon_{it}$=Error term supposed to be normally scattered with constant differences.

## DISCUSSION

The $R^2$ using logistic regression is 0.24. This indicates that minority shareholders' rights explain about 24% of the variation in audit quality. The logistic regression results in Table 1 indicate that minority shareholders' rights positively influence audit quality (10% level of significance) with P-value 0.061 (t=1.87).

| Table 1<br>INAU REGRESSION MODEL | | | | |
|---|---|---|---|---|
| **Item** | **Coefficient** | **Standard Errors** | **t-value** | **p-value** |
| MIRI | 0.666 | 0.356 | 1.87 | 0.061* |
| FSIZE | -1.471 | 0.333 | -4.42 | 0.000*** |
| ROA | 1.593 | 0.593 | 2.68 | 0.007* |
| LEVE | -0.789 | 0.281 | -2.81 | 0.005** |
| Cons | 3.752 | 1.022 | 3.67 | 0.000*** |
| $R^2$ | 0.240 | | | |

Notes: *significant at 10%; ** significant at 5%; ***significant at 1%.

This is consistent with the agency theory's proposition that external auditors improve clients' monitoring function of management activities and reduce the incidence of minority shareholders' expropriation. This indicates that minority shareholders' rights can impact on clients' demand for high quality auditor. In other words, the Turkish legal system improves minority shareholders' rights and power to minimize management's expropriation with a strong monitoring mechanism. For example, minority shareholders might call an extraordinary shareholders' meeting to challenge management or request a special investigation of the firm's records by the audit committee or go to Court if the necessary investigation is not undertaken. Moreover, with regards to control variables, FSIZE and LEVE possess a significantly negative relationship with clients' demand for audit quality. The level of significance is at the 1% level for FSIZE (t= -4.42) and 5% level for LEVE (t= -2.81). Besides, the degree of impact on audit quality is -1.471 and -0.789, for FSIZE and LEVE, respectively. This finding displays that big firms with high level of leverage are more likely to be involved with low audit quality. Table 1 displays that profitability (ROA) has positive influence on clients' demand for high quality auditors at the 10% level of significance (t=2.68, p=0.007).

## CONCLUSION

The discussion above reveals that minority shareholders have a positive influence on clients' demand for high audit quality of Turkish top 100 listed firms. This indicates that minority control rights at 10% enhance clients' incentive to demand high audit quality in an environment of controlling shareholders' entrenchment. The research, therefore, recommends policymakers to issue new rules and regulations. These rules and regulations should enhance minority shareholders' power to mitigate agency conflicts by involving high quality auditors. The study also recommends future studies to include more data and other corporate governance mechanisms to compare client's demand before and after the regulatory changes in 2012.

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