Corporate Governance and Audit Quality in Thailand

Suparak Janjarasjit[1], Thanida Uthayapong[2], Pichaya Adthajak[3]
[1,2,3] Department of Accounting, Faculty of Business Administration and Accountancy, Khon Kaen, Thailand, 40002
suparja@kku.ac.th[1]; thanut@kku.ac.th[2], misspitchayasr@kkumail.com[3]

ABSTRACT

Introduction – Corporate governance has increasingly received attention from regulators in many countries in order to hold higher performance standards. By using agency theory to understand the role of corporate governance function, the well-structured corporate governance system can alleviate agency costs and can elevate audit quality.
Purpose – To examine whether corporate governance has any effect on the audit quality in the Thai capital market, an emerging market.
Methodology/Approach – Multiple regression analysis is executed to test the hypotheses using R studio. A data is collected from 479 non-financial Thai listed companies between 2018 and 2019, resulting in 945 observations. The financial information for the sample is retrieved from the data stream of SETSMART and hand-collected from the website of the Securities and Exchange Commission of Thailand and the listed company's annual report.
Findings – The results indicate that larger board size, along with greater percentage of audit committee (AC) expertise, can lead to greater audit quality while other corporate governance mechanisms do not impact the audit quality.
Originality/ Value/ Implication – The results add to the literature documenting relations between financial expertise and the quality of audit, as well as to the further understanding of the perspective of audit fees in the Thai market. The solely board size is less likely to improve audit quality. However, the interaction of board size and AC financial expertise can promote the higher audit quality in the Thai capital market.

Keywords: Corporate governance, Audit quality, Thailand

INTRODUCTION

Sustainability is mainstream business practice (Milne et al., 2009, Setyahadi & Narsa, 2020). In the widest definitions, sustainability is related with the present actions that affect the options available in the future (Aras & Crowther, 2008) and it has become an essential achievement of corporate both environmental issues and in business practice (Escrig-Olmedo et al., 2017; Milne et al., 2009). In order to achieve long term success of the company, many prior studies emphasise the relationship between corporate sustainability and corporate governance as one of key influencing factors (Aras & Crowther, 2008; Ludwig & Sassen, 2022; Setyahadi & Narsa, 2020). This could imply that corporate governance is one of the most important factors for business sustainability.

The corporate governance is an importance mechanism to improve company performance and accounting control (E-Vahdati, Zulkifli & Zakaria, 2018), favour the desires of shareholders (Aras & Crowther, 2008), strengthen the quality of financial information (Abdullah et al., 2021) and enhance the audit quality (Abbott et al., 2003). The heart of corporate governance is generally referred to the board of directors as the ultimate governing body in the company (Saidu & Aifuwa, 2020). According to agency theory, the board of directors have to manage the company by aligning their interests with shareholders' interests. Directors are also expected to deliver higher performance in order to reduce information asymmetry which is agency costs to shareholders. In doing so, there are important board characteristics that are likely to mitigate these costs. There are many prior studies in different contexts focusing on the corporate governance as one of the company's control functions (Habib, Bhuiyan, Huang & Miah, 2019; Inaam & Khamussi, 2016; Zalata, Tauringana & Tingbani, 2017; Detthamrong, Chancharat & Vithessonthi, 2017). The company which has the greater corporate governance is more likely to have the higher financial statement quality that can refer to higher audit quality. This is because higher audit quality can enhance the companies' financial statements credibility (DeFond & Zhang, 2014; Venkataraman, Weber, & Willenborg, 2008) and is related to a lower cost of debt (Causholli & Knechel, 2012). Further, the study by Hay, Knechel, and Wong (2006) suggested a higher audit quality related to a higher audit fees because the larger audit fees paid to an auditor mean that an auditor is expected to increase his/her effort in providing their audit services, which results in superior audit quality.

Various measurements of audit quality (e.g., audit firm size, audit hours, and audit fees) have been proposed. Audit fees, one of a proxy, have been examined by prior studies. For example, Zerni (2012) found the positive relationship between audit fees and audit quality. Essentially, superior audit services are provided by audit partners who specialize in the audited industry. Similarly, DeFond and Zhang (2014) found the positive relationship between audit fee and audit effort, which in turn, yielding greater audit quality. Results from prior studies indicate strong relationship between audit fees and audit quality. Therefore, following prior studies in this area (e.g., Hay, Knechel, & Wong, 2006; Mnif Sellami & Cherif, 2020), audit quality is measured using audit fees in this study.

There are numbers of prior study observing the relationship between corporate governance and audit quality in different jurisdictions though a small number of previous research investigated this correlation in an unsophisticated market where corporate governance requirements are weak. In doing so, this study observes in a developing market. Moreover, other possible influencing factors of corporate governance mechanism have not been focused on previous studies.

This study observes non-financial listed companies in Thailand stock market which is characterised by not being the high-standard capital market. There are greater challenges to regulatory bodies in introducing the corporate governance system to promote higher standards to increase the attention of prospective investors. Since corporate governance mainly engages the board of directors, this study focuses on board of directors' characteristics which are board of directors' size, board independence, audit committee (AC) size, AC financial expertise and CEO duality. Further, there is a limited number of studies that examine corporate governance from a board composition perspective. The results of this study add to the literature on the impact of control mechanisms and audit quality of an unsophisticated market, as well as the correlation between board size and AC attributes on quality of audit.

LITERATURE REVIEW

This section provides a theoretical explanation and a review of the studies that examined corporate governance and audit quality. Lastly, this study proposes testable hypotheses.

1. Agency theory

Various prior studies in the area of corporate governance largely equip agency theory in order to understand the corporate governance mechanism and its role in company (Detthamrong, Chancharat & Vithessonthi, 2017; Habib, Bhuiyan, Huang, & Miah, 2019; Inaam & Khamussi, 2016; Zalata, Tauringana & Tingbani, 2017). Agency theory has been used to explain the demand for control systems and the need of the corporate governance mechanism where the ownership and control are separated (Habib et al., 2019). Agency theory, developed by Jensen and Meckling (1976), assumes that the principal and the agent are driven by the need to maximise their self-interests. When these interests are incompatible and the agent is unable to monitor the behavior of the agent (Saidu & Aifuwa, 2020), the asymmetry information raises up and the agency problem occurs (Watts & Zimmerman, 1986). To mitigate this problem, Habib et al. (2019) suggested that the well-established corporate governance functions of the company, led by the board of directors, are likely to eliminate the agency costs. Furthermore, the control systems are likely to increase financial statement credibility (Cohen, Krishnamoorthy, & Wright, 2004) that means, improves the financial statement quality. In this sense, greater corporate governance can enhance higher audit quality. Similar result is found by Carcello et al. (2002) in that board attributes (e.g., expertise and independence) can promote audit quality. This is because the expert board is more likely to require greater quality to secure their reputation. Thus, there is a linkage between the board and audit quality.

2. Corporate governance and audit quality

Corporate governance is a framework to create an atmosphere of accountability and transparency in the company. This also limits the agency problem (Detthamrong et al., 2017). The study of Detthamrong et al. (2017) reported the relationship between corporate governance and firm leverage and firm performance. In Thailand, corporate governance has been encouraged by the Securities and Exchange Commission of Thailand since the 2000s due to the financial crisis, Tom Yum Kung crisis (Mitton, 2002). The regulators induced corporate governance systems to Thai listed companies in order to establish higher performance standards and boost the number of foreign investors. Moreover, Detthamrong et al. (2017) stated that there is an association between corporate governance and the financial reports quality and audit quality because of its control processes and systems.

Audit quality is a complex and multi-faceted concept. This study uses the definition of audit quality following the seminal study of DeAngelo (1981) that is "the quality of audit services is defined to be the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach" (p.186). The influence of corporate governance on audit quality is examined in many different contexts. For instance, AlQadasi & Abidin (2018) found the strong positive effect of corporate governance on audit quality when the company does not have a high ownership concentration in Malaysia because of the greater demand of control systems from shareholders. In the U.S., the AC attributes, i.e., independence and financial expertise, are associated with audit quality because of their actions of supervision (Abbott et al., 2003). Moreover, the attributes of board director are further explored in many countries. For example, in Sweden, female AC directorship, who has professional experience, significantly affects audit quality by using audit fees as a proxy (Mnif Sellami & Cherif, 2020). It is because the female AC with more management experience is more likely to acquire high-standard internal control systems. They also protect their reputation by demanding higher assurance from the external auditor through higher audit fees. This can assume that the greater audit quality measured by audit fees is related to AC characteristics. However, Saidu & Aifuwa (2020) argued that there is no evidence of the relationship between board of director characteristics, female board gender, and audit quality of listed manufacturing companies in Nigeria Stock Exchange because of the smaller number of females in board members.

2.1 Board size and audit fees

Board size refers to the number of boards of directors who is the most important part of corporate governance in overseeing, directing and operating the company. However, the certain number of board members has not been regulated. There is only a guideline from the regulators in various contexts. For example, in Nigeria Stock Exchange, the positive effect of board size on audit quality is observed (Saidu & Aifuwa, 2020). As the board size increases, it yields sufficient number of members to provide the effective function section. The large board size with various expertises provides the more competent management to the company that pronounce financial quality then, audit quality (Ahmed & Che-Ahmad, 2016). Similar to a study by Khudhaira, Khudhair, Al-Zubaidia, and Raja (2019), the positive impact of board size on audit quality is found in Iraq. The study explained that a large number of members can enhance the quality of company management from the various suggestions which results in a higher financial statements quality and then, audit quality. According to prior studies, this study expects board size to have a positive impact on audit quality in Thai capital market.

Hypothesis1. Board size is positively associated with audit fees.

2.2 Board Independence and audit fees

Board independence means an independent director who does not have any significant relationship to a company operation or holds shares. As the degree of board independence increase, board members are likely to seek greater audit quality to carry their responsibility and maintain their reputation of external parties (Carcello et al., 2002). In this way, this higher requirement may be reflected in the superior audit fees. Also, Setyahadi & Narsa (2020) described that an independent director provides independent oversight of company financial statements, encourages internal control systems which improves the quality of audit. Therefore, this study proposes a positive association between board independence and audit quality.

Hypothesis 2. Board independence is positively associated with audit fees.

2.3 AC size and audit fees

The number of ACs in the board of directors plays a crucial role in corporate governance. Abbott et al. (2003) highlighted that there is an association between AC and an increased audit quality according to their accountability. This requirement of AC to the external audit quality may reflect in extended audit scope and efforts that are likely related to audit fees. Agyei-Mensah (2019) found that AC is associated with audit quality because they have responsibility in monitoring and overseeing internal control systems of the company. Thus, this study expects a positive relationship between AC size and audit quality.

Hypothesis 3. AC size is positively associated with audit fees.

2.4 AC expertise and audit fees

Financial and accounting knowledge of board members is essential to the financial reporting process because members with financial and accounting background can understand the complexity of financial reporting and auditors' judgement. So, the members can act as a mediator between auditors and management (Mangena & Pike, 2005; Zhang, Zhou, & Zhou, 2007). Most companies assign the AC to be responsible for the financial reporting process. Any AC members with financial and accounting expertise can investigate the reasonableness of CEO explanations (Abbott et al., 2003). Subsequently, having AC members with financial and accounting background can lead to greater quality of financial reporting (Abbott et al., 2003; Hossain et al., 2011), which in turn, enhances the quality of audit. Therefore, this study expects a positive relationship between AC expertise and audit quality.

Hypothesis 4. AC expertise is positively associated with audit fees.

2.5 CEO duality and audit fees

CEO duality refers to a case where a CEO is also a chairman of the board of directors. When CEO duality occurs, it can cause conflict of interest as posited by agency theory. Specifically, stockholders need high quality of financial information for decision making, whereas the CEO, who can control information disclosed to other board members, may hinder some operational issues from the board (Cornett et al., 2007). Therefore, the quality of financial reporting may be damaged (Tsui et al., 2001). According to agency theory, this study posits that CEO duality may cause a CEO to pay limited attention to quality of financial reporting, which may infer limited attention to quality of audit. Therefore, this study hypothesizes a negative relationship between CEO duality and audit quality.

Hypothesis 5. CEO Duality is negatively associated with audit fees.

METHOD

This section discusses the methodology used to test hypotheses in this study. In order to evaluate the impact of corporate governance on audit fees, this study employed a quantitative methodology, both descriptive and inferential statistics, in order to examine the association between corporate governance mechanisms and audit quality of companies listed on the Stock Exchange in Thailand (SET).

1. Data and sample

This study observes a sample that contains all non-financial companies listed in Thailand from 2018 to 2019, the pre-pandemic period which provides regular business circumstances (Srisukha et al., 2022). The financial information for the sample is retrieved from the data stream of SETSMART. The data on audit fees and AC financial expertises are hand-collected from the website of the Securities and Exchange Commission of Thailand and the listed company's annual report and the annual general meeting. The observations with missing data are excluded from the study's sample. Outliers are also tested and find no statistical impact on the analysis. Therefore, outliers are not removed. The final sample for this study consists of 945 firm-year observations which are presented in industry groups as shown in Table 1.

Table 1. Industry group distribution

Industries	Frequency	Percentage
Agro and Food	104	11%
Resources	91	10%
Technology	72	8%
Services	217	23%
Industrial	187	20%
Consumer Product	79	8%
Property and Construction	195	21%
Total	945	100%

2. Dependent variable

Audit fees (AF) is widely used as a measurement of audit quality (Abbott et al., 2003; Carcello et al., 2002; Mnif Sellami & Cherif, 2020; Srisukha et al., 2022) because the companies expect an auditor to provide the superior audit service as they pay higher audit fees (Hay et al., 2006). Following prior studies (e.g., Aldamen et al., 2018; Farooq et al., 2018; Lai et al., 2017; Nekhili et al., 2020), this study uses the natural log of AF that is paid to external auditors for audit services (in thousand Thai Baht) as the dependent variable.

3. Independent variables

Board size, board independence, AC size, AC expertise and CEO duality are independent variables of this study. Following prior studies (e.g., Bhagat & Bolton, 2008; Boone et al., 2007; Khanchel, 2007), board size (BD_SIZE) is measured by the total number of directors; board independence (BD_IND) is measured using the, ratio of the number of independent directors to the number of all directors; AC size (BD_AC) is measured by the number of AC members on the board; AC expertise (AC_EXP) is measured using the ratio of the number of AC with finance or accounting background to the number of all ACs; CEO duality (CEO_DUAL) is measured using a dummy variable, which takes a value of one if the CEO is also the chairperson of the board, and zero otherwise.

4. Control variables

Company size (SIZE). Small companies have poorer information systems, compared to large companies (Llorenteetal., 2002), causing greater difficulty to audit small companies. Furthermore, large companies have stronger bargaining power over their auditors than smaller companies (Casterella et al., 2004). Company size might play a role in audit quality, therefore this study includes company size as a control variable. Following prior studies (e.g., Chen et al., 2005; Detthamrong et al., 2017), company size is measured using a natural log of total assets (in thousand Thai Baht).

Subsidiary companies (SUB). According to Thailand Federation of Accounting Professions, a number of subsidiary companies can be one factor to consider by audit firms to determine an audit fees. To control for the effect of subsidiary companies, this study uses a number of subsidiary companies as a control variable.

Audit reputation (BIG4). Although prior studies (e.g., Abid et al., 2018; Aronmwan et al., 2013; Blum et al., 2022; Skinner & Srinivasan, 2012) reveal mixed results whether audit reputation has an effect on audit quality, this study includes audit reputation as a control variable to mitigate the potential effect of audit reputation on audit quality. Consistent with Detthamrong et al. (2017), a binary variable is used to measure audit reputation. A value of one is assigned if a firm's auditor is one of the Big 4 firms (i.e., KPMG, Deloitte, PwC, and EY), and zero otherwise.

5. Methods

The following regression models are adopted to test the hypotheses:

$$\begin{aligned} AFit = \beta 0 + \beta 1BD\_SIZE + \beta 2BD\_IND + \beta 3BD\_AC \\ + \beta 4AC\_EXP + \beta 5CEO\_DUAL + \beta 62SIZE \\ + \beta 7SUB + \beta 8BIG4 + \mathcal{E}it \end{aligned}$$

where

AF	natural log of audit fees;
BD_SIZE	the number of all board directors, including a chairperson and independent directors;
BD_IND	the ratio of the number of independent directors to the number of all directors;
BD_AC	the number of AC members on the board;
AC_EXP	the ratio of the number of AC with finance or accounting background to the number of all ACs;
CEO_DUAL	a dummy variable, which value of one is used if the CEO is also the chairperson of the board, and zero otherwise.
SIZE	natural log of total assets;
SUB	the number of subsidiary companies;
BIG4	a binary variable, which takes a value of 1 where an audit firm is one of the big four auditing firms, and zero otherwise.

Multiple regression analysis is executed to test the hypotheses using R studio version 2023.03.0 in this study.

RESULT AND DISCUSSION

1. Descriptive statistics

Table 2 illustrates the descriptive statistics of the variables used in this study. From the 945 firm-year observations, the companies have about 9 persons on a board of directors, with approximately 3 persons serving as the AC. Among the ACs, only 33.33% have a background in finance or accounting. Forty percent of directors are independent, and most companies do not have a CEO serving as the chairperson of the board of directors.

Table 2. Descriptive statistics

Variables	Mean	Median	S.D.	Min.	Max.
BD_Size	10.01	9.00	2.41	5.00	21.00
BD_IND	41.61	40.00	9.52	13.33	85.71
BD_AC	3.14	3.00	0.37	3.00	5.00
AC_EXP	51.50	33.33	22.31	20.00	100.00
CEO_DUAL	0.23	0.00	0.42	0.00	1.00

SIZE	15.71	15.51	1.51	11.54	20.27
SUB	8.94	4.00	13.46	0.00	91.00
BIG4	0.64	1.00	0.48	0.00	1.00
AF	1.803	1.779	0.191	1.356	2.705

This study has conducted Pearson correlation coefficients. The relationship between audit fees and corporate governance mechanism is in the expected direction. Board size, board independence, AC size, and AC expertise are positively related to audit fees; whereas CEO duality is negatively correlated to audit quality. Correlation coefficients are generally below 0.70; therefore, multicollinearity is not a concern of this study.

2. Empirical results

Table 3 presents the results of OLS regression. Model 0 is the baseline OLS regression which includes only control variables. The results confirm the positive relationship between AF and three control variables: SIZE, SUB and BIG4.

Model 1 is to test the relationship between corporate governance mechanisms and audit fees. The results reveal a non-significant relationship between audit fees and four governance mechanisms (1) BD_IND, (2) BD_AC, (3) AC_EXP, and (4) CEO_DUAL. The only mechanism that has a significant negative relationship with audit fees is BD_SIZE, which suggests that larger board size leads to lower audit fees. The results therefore supported H1, and rejected H2-H5.

Table 3. Regression results.

Variable	Model 0	Model 1
Constant	0.768***	0.715***
SIZE	0.062***	0.064***
SUB	0.004***	0.003***
BIG4	0.051***	0.053***
BD_SIZE		-0.005**
BD_IND		0.000
BD_AC		0.02
AC_EXP		0.000
CEO_DUAL		0.008
Adjusted R^2	0.498	0.500
F	313.3***	118.7***

***, **, and * indicate statistical significance at p<0.01, p<0.05 and p<0.10, respectively

As a sensitivity test, this study defines the dependent variable as AF deflated by SIZE. Following Carcello et al. (2002), 0.57, is used to scale SIZE in computing a new dependent variable measure. Then, deflated AF regresses on BD_SIZE, AC_EXP and AC_EXP*BD_SIZE. The significant negative relationships between audit fees and BD_SIZE ($p < 0.01$) and AC_EXP ($p < 0.01$) are observed. Interestingly, the interaction effect between BD_SIZE and AC_EXP leads to a positive relationship with audit fees ($p < 0.01$). The sensitivity analysis highlights an important role of board size and AC expertise on audit fees.

CONCLUSION AND RECOMMENDATION

Corporate governance is an essential mechanism to govern companies to ensure long-term benefits to stakeholders (Aras & Crowther, 2008). Although corporate governance literature is quite developed, the effect of corporate governance on audit quality is unsettled. This study explores the relationship between corporate governance mechanisms and audit quality. From various mechanisms, this study focuses on board characteristics, which includes board size, board independence, AC size, AC expertise, and CEO duality. Audit quality and board composition of non-financial listed companies in Thailand are analysed using multiple regression analysis. The finding implies that larger board size, along with greater percentage of AC expertise, can lead to greater audit quality. Yet, other corporate governance mechanisms do not have a significant effect on audit quality. Board independence, AC size, and CEO duality reflect independence and diligence (i.e., a control environment). When auditors perform auditing services, they may consider macro-level factors such as corporate governance strength (Cohen & Hanno, 2000). However, a single influencing factor of corporate governance is less likely to strengthen audit quality in a weak environment such the Thai market. A strong control environment can reduce the auditor's assessment of control risk and audit procedures, which leads to low audit fees (Carcello et al., 2002). In other words, strong corporate governance mechanisms can result in little to no effect on audit fees determination.

This study is subject to a number of limitations. First, a number of 945 observations can be considered as small. A panel OLS regression cannot be executed. Therefore, the firm-effect and time-variant effect are not controlled in this study. Second, the sample is limited to non-financial listed companies in Thailand. The extent to which the results apply in other settings is uncertain. Third, this study attempts to control for determinants of audit quality documented in literature; yet, there may be other possible governance mechanisms that correlate with tested variables such as amount of related-party transactions.

Future research may re-examine the impact of corporate governance mechanisms on audit quality by extending a number of observations and the observation period. Additionally, the inclusion of mediating and moderating variables may be necessary to identify any previously overlooked effects.

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