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Corporate Governance Characteristics and External Audit Fees: A Study of Large Public Companies in Israel

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Abstract

The purpose of this study is to examine the association between corporate governance characteristics and external audit fees in large public companies in Israel. The results show that board independence (proportion of external directors on the board of directors) and audit committee diligence (number of meetings) are positively and significantly associated with audit fees. The results are consistent with the demand-based perspective of audit services, wherein firms with strong corporate governance characteristics demand additional assurance from the auditors and higher audit quality, resulting in higher external audit fees.

The findings of this initial study in Israel offer support for the new proposal of Amendment 10 to the Israeli Companies Law that calls for general adoption of strict principles of corporate governance, including increasing the number of independent directors on the board of directors and expanding the roles of the board's audit committee.

Keywords: Audit committee meetings, Audit fees, Board independence, Corporate governance, External auditor, Israel

1. Introduction

In 2004, the Israel Securities Authority (ISA) formed a Corporate Governance Committee ("Goshen Committee") in an attempt to strengthen the independent control mechanisms in companies. The committee was formed in light of corporate governance codes adopted by the OECD states and the enactment of the U.S. Sarbanes Oxley Act in response to the collapse of Enron and other corporate scandals.

The Goshen Committee focused on a large number of issues, including the composition and activity of the board of directors and audit committee. Following the Goshen Committee's recommendations, Proposal of Amendment 10 to the Israeli Companies Law was published. The proposal was based on the recommendations of the Goshen Committee as well as some of the recommendations of the committee on stimulating institutional investors' involvement in the capital market in Israel ("Hamdani Committee").

The objective of this study is to analyze the various factors in corporate governance that affect external auditing fees in Israel. As part of this study, we examine three groups of variables.

The first group includes variables related to the quality of corporate governance – independence of the board of directors (relative number of external directors) and independence of the audit committee, its accounting and financial expertise and the frequency of meetings. **The second group** includes variables related to implementation of the new international financial reporting standards (IFRS). We selected two key balance sheet items affected by the new standards – Property, Plant and Equipment and Investment Property, since the use of the fair value model has a material impact on these items (Schuv & Ovadia, 2007). **The third group** includes control variables related to the size of the company, external audit risk and the complexity of the company.

Previous research on the relationship between corporate governance and audit fees has focused primarily on strong and sophisticated capital markets (the USA, Britain and Australia). Little research has been conducted in countries with emerging markets that are usually characterized by concentrated stock ownership and significant government ownership in listed firms (Yatim et al., 2006). These differences between developing capital markets and other developed markets may influence how boards of directors govern their firms.

The study of this issue in an emerging market such as Israel is interesting for two reasons. Firstly, Israel is different from most capital markets worldwide in terms of the size of the companies and the centralized impact of the controlling shareholders on the capital market. According to the ISA Economic Department, only in 10.2% of the companies traded on the Tel-Aviv Stock Exchange, the public owns more than 50% of the voting shares. These figures demonstrate the hegemony of the controlling shareholder in the Israeli capital market. This concentrated ownership structure is different than the structure in developed markets and may influence the way boards control their firm. Secondly, corporate governance in Israel is still evolving. Under the Israeli Companies Law, companies are required to appoint two external directors to their board of directors, with at least one of them having accounting and financial expertise. All public companies in Israel must have an audit committee. In addition, Israel is currently in a transition period – after the submission of the Goshen Committee's recommendations and prior to approval of Amendment 10 to the Companies Law that calls for general adoption of strict principles of corporate governance, including increasing the number of independent directors on the board of directors and expanding the roles of the board's audit committee.

This article joins the growing body of literature on the relationship between corporate governance variables and audit fees. This initial research on Israeli companies adds to the country diversity of the audit fee modeling literature and extends this line of research into another emerging market such as Israel. The findings of the study and understanding of the factors that explain differences between companies in audit fees are important for the ISA and directors in public companies. The results of the study may help the ISA recommendation to strengthen the external auditing and corporate governance at public companies in Israel. Furthermore, new regulatory requirements in Israel in recent years have increased the legal responsibility of officers and directors. Therefore, for directors whose objective is to preserve their reputations and reduce their exposure to lawsuits, particularly during a financial crisis, it is important to understand the various factors that influence the cost and quality of the external audit.

The remainder of this paper is organized as follows. The next section provides a brief review of corporate governance in Israel. The third section describes the literature and develops the hypotheses. The fourth section describes the research method. The results of the study are reported in the fifth section with discussion of the implications. The last section concludes and describes limitations as well as recommendations for further research.

2. Corporate Governance in Israel

The Israeli Companies Law of 1999 provides for a number of corporate governance means to be enacted over listed corporations: obligatory appointment of two external directors (section 239), obligatory appointment of an audit committee (section 114) and obligatory appointment of an internal auditor (section 146). The Companies Law stipulates that an audit committee shall concentrate on oversight of internal controls and approval of related party transactions (section 117).

In August 2004, the Israel Securities Authority (ISA) appointed a committee (Goshen Committee) to examine corporate governance in public companies in Israel. Its final recommendations were submitted in December 2006. According to a press release issued by the ISA in February 2007, given the process of globalization and the growing competition between financial markets, and given that Israel is considered an emerging market, the Committee places great importance on setting proper corporate governance standards and rules that align themselves with standards adopted in leading western economies.

Two key recommendations of the Goshen Committee include: (1) the independence of the board of directors and (2) composition and role of the internal audit committee.

In the Committee's opinion, independence of the board of directors is one of the cardinal principles of good corporate governance. In different countries that have adopted similar codes, various arrangements have been devised conforming to the characteristics of the capital market and cost/benefit considerations. The Committee believes that the issue of board independence necessitates a balance between objectivity, professionalism and risk-taking in corporate

management. This balance is required because the board of directors serves a dual function which may collide at times: formulation of the company's business policy and supervision of corporate management. While the first task requires a deep understanding of business and a close fiduciary relationship with corporate management, which facilitates the directors' ability to advise and help mold corporate strategy, the second task requires objectivity and an arms-length relation with management. After examining accepted practices abroad and the characteristics of Israel's capital market, it recommended that every public company have external directors, who will constitute one third of all directors, and the number of which shall not fall below two.

To compliment board of director independence, the Committee recommends consolidating the independence of the internal audit committee of public companies. The Committee states that "in light of the audit committee's importance, and as a complimentary step ensuring directors' independence, great significance is attached to the independence of the audit committee's members and their financial qualifications." Hence, the Committee recommends that a majority of the audit committee be independent directors (including external directors) and the chairman of the committee also be an external director. The Committee stipulates the duties of the audit committee in the process of approving financial statements and recommends that audit committee hold preliminary discussions on the company's financial statements and that its recommendations be brought before the board of directors. The board of directors is obligated to discuss the Committee's recommendations prior to approving the financial statements.

Additional matters concerning the audit committee, as stated in the draft bill in Amendment No.10 to the Companies Law, are as follows:

- The legal number of votes required to pass resolutions by the audit committee is a majority of audit committee members and a majority of the external directors (independent directors), who were present at the time when the resolution was passed.
- The internal audit process and external audit performed by the external auditor, agenda for the internal audit, resources at the disposal of the internal auditor, scope of the external audit work and external auditor's fees, will be discussed by the audit committee.
- The audit committee determines procedures for dealing with risks identified in managing the business.
- To promote open discussion, the audit committee will consult with the internal auditor and the external auditor outside the presence of the chairman and members of the board of directors at least once each quarter, and discuss matters pertaining to their work and risks that may have been identified.

3. Hypotheses Development

3.1 Background and audit fee research

Two different perspectives exist in the audit fee literature: the demand-based perspective and the audit-risk perspective. The demand-based perspective (e.g. Goodwin-Stewart & Kent, 2006; Abbott et al., 2003; Carcello et al., 2002) suggests a positive association between corporate governance characteristics and audit fees. Firms with strong corporate governance structures demand additional assurance from their auditor to preserve their reputation and avoid potential litigation (Abbott et al., 2003; Carcello et al., 2002), resulting in a higher audit fee. Alternatively, the audit risk perspective (Muniandy, 2007; Tsui et al., 2001) suggests that auditors regard corporate governance as an internal control mechanism that influences the nature and extent of audit testing. In firms with strong corporate governance, auditors will reduce their audit risk assessment. They would consequently reduce their audit testing, leading to lower external audit fees.

Beasley et al. (2000) found that as opposed to the comparison group, fraud in financial statements was common in companies where the audit committee was less independent and did not meet frequently. Carcello and Neal (2000) found that the probability of receiving going-concern opinions for financially distressed firms increased along with the independence of the audit committee. This serves to emphasize the higher probability that an independent director would express an independent opinion and not automatically accept what management dictates.

Research conducted by DeZoort (1997) and by DeZoort and Salterio (2001) shows that skilled audit committee members apply the same considerations as the external auditor and have a better understanding of the risks the auditor faces.

Beasley (1996) found a negative relation between the rate of external directors on the board and financial statement fraud, while Dechow et al. (1996) found the same type of negative relation with respect to sanctions imposed by the SEC in response to overstating profits. Abbott et al. (2004) found that companies with independent and experienced audit committees that meet more frequently have a lower risk of restatement.

A review of empirical studies of the relationship between corporate governance variables and external auditing fees shows mixed results. Thus, for example, Carcello et al. (2002) found that the characteristics of the board of directors and not those of the audit committee are what influence the cost of the audit. In contrast, Abbott et al. (2003) found a

positive and significant correlation between the independence and experience of the audit committee and the cost of the audit. However, they did not find a significant relation between the frequency of audit committee meetings and the audit fee. Goodwin-Stewart and Kent (2006) found in Australia that the independence of the board of directors and the number of audit committee meetings had a positive and significant impact on audit fees. However, they did not find a significant correlation between the independence and financial expertise of audit committee members and the audit fee. Stewart and Munro (2007), using an experimental design, found that participants expect audit committees to increase audit fees, particularly when meetings are more frequent and the external auditor has to attend the meetings.

A recent study in an emerging market, Malaysia (Muniandy, 2007), found that the existence of CEO duality on the board, a proxy for board independence, is associated with higher audit fees and that this positive relationship is weakened in the presence of a strong independent audit committee. Another study on Malaysian companies (Yatim et al., 2006), found that audit fees are positively and significantly associated with board independence, audit committee expertise and the frequency of audit committee meetings.

3.2 The association between corporate governance variable and audit fees

The literature review usually shows that firms with strong corporate governance are likely to demand additional assurance from the external auditor, resulting in higher audit quality and fees (the demand-based perspective).

The independence of directors contributes to their demand for quality from the external auditor, their understanding of the risks the auditor faces and the tendency to agree with the auditor's demands with respect to the scope of the audit and the fee. Boards of directors are more effective and uncompromising as the number of external directors increases, and at times even when the members of their audit committees are independent, experienced and meet more often. The audit committee plays a key role in supervising and controlling the company's activity, explaining why the effectiveness of control increases with the number of meetings. This also has a positive impact on the quality and cost of the external audit.

The aforementioned literature provides us with a theoretical framework for composing hypotheses regarding the variables on which we will focus in the study:

H1. There is a positive association between the board's level of independence and audit fees.

H2. There is a positive association between all or part of the characteristics of the audit committee (independence, experience, number of meetings) and audit fees.

3.3 The association between IFRS variables and audit fee

In addition to our two main hypotheses, we develop a third hypothesis related to implementation of the IFRS in Israel. We selected two key balance sheet items that are influenced by the new accounting standards – Property, Plant and Equipment (PPE) and Investment Property. This is due to the intensive use of the fair value method, which has an especially strong impact on these two items with the shift to IFRS in Israel (Schuv & Ovadia, 2007). IFRS and the transition to fair value accounting increase the scope of the external auditor's work and responsibility. This is due to the fact that the IFRS are based on principles, are more subjective than in the past and therefore require more effort and expertise when auditing fair value of assets. The transition to IFRS and the increased scope of work and responsibility of the external auditors entails additional costs. Therefore, PPE and Investment Property are expected to have a positive effect on the external audit fees.

H3. There is a positive association between PPE and Investment Property and audit fees.

3.4 Control variables related to audit fees

In line with previous studies, our control variables include variables related to company size, external audit risk and company complexity. Among the variables, we examine the following: comprehensiveness of the company's balance sheet, proportion of items with a relatively high audit risk that demand additional audit procedures – these include Inventories and Receivables (Simunic, 1980) and a number of the Company's activity segments. In large companies, where the audit risk is greater as is the complexity of the audit, the external audit fees increase, and therefore these variables are expected to have a positive effect on audit cost, as was found in most studies on this subject. We did not test other control variables such as Big 4 auditor and audit opinion due to the extremely low variance in these variables among the companies in our sample.

4. Methodology

Following previous studies (e.g. Goodwin-Stewart & Kent, 2006; Abbott et al., 2003; Carcello et al., 2002), we use OLS multivariable linear regression to examine the association between the explanatory variables and the audit fees.

Due to data availability problems of small companies, in this preliminary research we used the data of the largest public companies in Israel. The sample we used includes the 100 largest public companies on the Tel-Aviv 100 Stock Exchange Index, with the exception of banks, insurance companies and dual-listed companies, which have a distinct set

of control and financial reporting rules. After eliminating companies with missing data, our final sample consisted of 60 large public companies.

The data was taken from the publicly issued 2007 financial statements through the MAYA service.

The following is the regression equation:

$LNFEE_i = \alpha_0 + \alpha_1 * BDPOUT_i + \alpha_2 * ACOUTP_i + \alpha_3 * ACEXPP_i + \alpha_4 * ACMEET_i + \alpha_5 * LNPPE_i + \alpha_6 * LNINVSTP_i + \alpha_7 * LNTA_i + \alpha_8 * RECINV_i + \alpha_9 * SEGMT_i + u_i$

Where:

LNFEE - natural log of the audit fees; **BDPOUT** - percentage of external directors on the board of directors; **ACOUTP** - percentage of external directors on the audit committee; **ACEXPP** - percentage of directors with accounting and financial expertise on the audit committee; **ACMEET**- dummy variable representing the number of meetings held by the audit committee in 2007 (1 - above average, 0 – below average); **LNPPE, LNINVSTP, LNTA** - natural log of plant, property and equipment (PPE), investment property and total assets, respectively; **RECINV** - ratio of receivables and inventories to total assets; **SEGMT** - number of activity segments.

In line with the hypotheses we presented, we expect the corporate governance variables (**BDPOUT, ACOUTP, ACEXPP, ACMEET**) to have a positive relation with audit fees (quality of the audit).

We expect the two items influenced by IFRS – Plant, Property and Equipment (**LNPPE**) and Investment Property (**LNINVSTP**) will have a positive association with audit fees.

Finally, we expect that the control variables representing company size – its total assets (**LNTA**), items that are audit intensive – Receivables and Inventories (**RECINV**) and company complexity – number of activity segments (**SEGMT**), will all have a positive relation with audit fees.

5. Results

Table 1 presents descriptive statistics of the sample. The table presents a number of interesting findings. On average, the external directors constitute about one third of the board of directors and approximately 60% of the audit committee (the median is 2/3 – in other words, two external directors are on the audit committee out of the average of three committee members in the sample). This suggests that companies do the minimum required under the Israeli Companies Law (appointment of two external directors who will also be members of the audit committee). The average number of audit committee meetings is about three a year. This is a low number of meetings given the audit committee's many areas of responsibility. However, there is still a big variance between companies. The audit committee of Bezeq The Israel Telecommunication Corp, Ltd., for example, held 24 meetings in 2007.

Table 2 presents the Pearson Correlation matrix of the variables in the model. **LNFEE** is positively correlated with size (**LNTA**), complexity (**SGMTS**), frequency of audit committee meetings (**ACMEET**) and Property, Plant and Equipment (**LNPPE**).

To test for potential multicollinearity, we calculated the variance inflation factor (VIF). The highest VIF for any of the variables reported in Table 2 was 2.45 for LNFA suggesting that multicollinearity is not a significant problem.

The OLS regression results are reported in Table 3. The explanatory power of the model is quite high (Adj. R^2= 0.77), and the overall model is significant (F=22.5). As expected, we found a positive correlation between the weight of external directors on the board and audits fees. The variable coefficient, **BDPOUT** was found to be positive (2.08) and significant (p=0.02). Furthermore, a positive and significant relation (p=0.03) was found between the number of audit committee meetings (**ACMEET**) and audit fees.

However, no correlation was found between additional corporate governance variables that represent the percentage of external directors on the audit committee (**ACOUTP**) and the percentage of audit committee members with financial expertise (**ACEXPP**) and the audit fees.

In addition, partial support was found for the hypothesis that the transition to fair value accounting, as reflected in the scope of the items influenced by the new fair value model, led to an increase in audit fees. Only Plant, Property and Equipment (**LNPPE**) was found to be positively and marginally significant (at 8% level) with audit fees.

Finally, all of the other control variables had a positive and significant relation with audit fees, as has been found in most other studies worldwide. The size of the company (**LNTA**), number of activity segments (**SEGMT**) and the relative weight of the Receivables and Inventories items (**RECINV**) were all positively and significantly associated with audit fees.

The findings of this study with respect to the independence of board members and the number of audit committee meetings as supporting the quality of the external audit are in line with the findings of Goodwin-Stewart and Kent in Australia (2006).

Our study provides empirical support for the recommendations in the proposal for Amendment 10 to the Israeli Companies Law with respect to increasing the percentage of independent directors and expanding the role of the audit committee and, accordingly, an increase in the number of meetings.

In brief, we find that two corporate governance variables – board independence and audit committee diligence – are positively related to the audit fees of large public companies in Israel.

6. Conclusion

This study examined the association between corporate governance variables of large public companies in Israel in 2007 and the external audit fees, prior to the approval of Amendment 10 to the Israeli Companies Law. It was found that the percentage of external directors on the board of directors and the number of audit committee meetings are positively and significantly associated with the external audit fees. The results are consistent with the demand-based perspective of audit services, wherein firms with strong corporate governance characteristics demand additional assurance from the auditors and higher audit quality, resulting in higher external audit fees.

Furthermore, it was found that one of the items impacted by the transition to IFRS and fair value (Property, Plant and Equipment) is positively and significantly related to audit fees. It is possible that the transition to IFRS and the increased scope of work and responsibility of the external auditors in auditing fair value models entails additional costs.

And finally, all control variables exhibit the hypothesized results. Company size, complexity as reflected by the number of activity segments and the weight of audit-intensive items (Inventories and Receivables) had the expected positive and significant relationship with audit fees.

However, there are two main limitations in this preliminary research of Israeli companies. Firstly, the small sample covers one year of Israeli data, and the results may not be generalized over different time periods and countries. Secondly, only a few corporate governance variables were tested. Other variables such as managerial ownership and internal control can be considered in future research. Such a study could enhance our understanding of the association between corporate governance characteristics and audit monitoring in emerging markets.

The results of this initial study on Israeli companies support the proposal of Amendment 10 to the Israeli Companies Law, including: (1) Increasing the number of the independent directors on the board accordingly, (2) Expanding the role and responsibility of the audit committee – and thus dictating more meetings.

The results of this research may support the Israel Securities Authority (ISA) recommendations to strengthen the external auditing and corporate governance mechanisms at public companies in Israel. In addition, the findings of this study have implications for directors interested in reducing potential litigation by demanding a high-quality audit. This is especially important during the current financial crisis that requires the gatekeepers to be more effective than in the past.

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Table 1. Descriptive statistics of the variables

Variable	***Average***	***Standard deviation***	***Median***	***Minimum***	***Maximum***
LNFEE	13.88	1.51	14.03	5.94	16.44
BDPOUT	0.33	0.55	0.25	0.00	1.00
ACOUTP	0.61	0.19	0.67	0.00	1.00
ACEXPP	0.72	0.30	0.67	0.25	1.00
ACMEET	2.98	3.45	3.00	0.00	24.00
LNPPE	19.04	2.88	19.91	9.74	23.87
LNINVSTP	12.15	10.69	18.53	0.00	24.45
LNTA	22.55	1.30	22.47	19.63	25.41
RECIVV	0.18	0.19	0.14	0.00	0.77
SEGMT	2.90	2.25	3.00	0.00	7.00

Where:

LNFEE - natural log of the audit fees; **BDPOUT** - percentage of external directors on the board of directors; **ACOUTP** - percentage of external directors on the audit committee; **ACEXPP** - percentage of directors with accounting and financial expertise on the audit committee; **ACMEET**- dummy variable representing the number of meetings held by the audit committee in 2007 (1 - above average, 0 – below average); **LNPPE, LNINVSTP, LNTA** - natural log of plant, property and equipment (PPE), investment property and total assets, respectively; **RECINV** - ratio of receivables and inventories to total assets; **SEGMT** - number of activity segments.

Table 2. Correlation Matrix of the variables

	LNFEE	BDPOUT	ACOUTP	ACEXPP	ACMEET	LNPPE	LNINVSTP	LNTA	RECIVV	SEGMT
LNFEE	1.000									
BDPOUT	-0.031	1.000								
ACOUTP	-0.319*	0.097	1.000							
ACEXPP	-0.010	0.013	0.001	1.000						
ACMEET	0.267*	-0.431**	-0.172	0.178	1.000					
LNPPE	0.619**	-0.287*	-0.285*	0.075	0.285*	1.000				
LNINVSTP	0.105	0.028	0.017	-0.046	-0.057	-0.262*	1.000			
LNTA	0.827**	-0.033	-0.306*	-0.050	0.185	0.517**	0.211	1.000		
RECIVV	-0.007	-0.217	-0.088	0.321*	-0.026	0.356**	-0.447**	-0.227	1.000	
SEGMT	0.492**	-0.095	-0.127	-0.001	0.143	0.304*	0.026	** 0.382	-0.107	1.000

* significant at 5%.

** significant at 1%.

Table 3. The association between audit fees (LNFEE) and the explanatory variables

Variable	*Coefficient*	*t- statistic*	*p-value*
Intercept	-3.945	-1.934	0.058
BDPOUT	2.080	2.386	0.020
ACOUTP	-0.148	-0.241	0.809
ACEXPP	-0.545	-1.234	0.222
ACMEET	0.473	2.194	0.032
LNPPE	0.087	1.819	0.074
LNINVSTP	0.014	1.418	0.162
LNTA	0.716	6.943	0.000
RECINV	1.638	2.376	0.021
SEGMT	0.126	2.888	0.005
Adj. *R^2*	0.767		
F	22.5		
Significance	0.000		
Number of companies	60		