Accounting and Auditing

Impact of Cross-listed Directorship on Appointment and Independence of Auditors: Evidence from Republic of Macedonia

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Abstract: This study investigates the association between cross-listed directors at multiple boards of directors and the choice of audit firm in emerging market economy such as Republic of Macedonia. The study involved all listed companies and companies with special reporting obligations at Macedonian Stock Exchange owned domestically, since appointment of auditors for subsidiary companies is influenced dominantly by parent company decision making process. Determinants of auditor selection are important input for overall assessment of auditor independence and audit quality and provide valuable argument for revised regulations in order to improve credibility of audit of financial statements. There is limited research available regarding the close relationship and ties between management and auditors, especially in the case of small audit markets where the potential impact of cross-listed directorship on auditor independence and audit quality is considerable. The results of the study provide little evidence of significant relationship between cross-listed directorship and the choice of auditor in respect of Macedonian listed entities. The findings will be of interest for public accounting firms in developing their strategies for close inter-relationships with those charged with governance. It is intended to help regulators assess the impacts of interpersonal relations to auditor independence and quality of assurance services provided to the general public, as well as improvement of monitoring function on behalf of shareholders.

Keywords: cross-listed directors; auditor choice; audit quality; small audit market

JEL classification: M42

1. Introduction

This paper examines the connection between cases of cross-listed directors at multiple board of directors and audit firm links. Potential links of such nature are important as they can influence both auditors' independence and audit quality (Davison et al., 1984; Jubb 1999). The motivation for our study of cross-listed directorship and auditor links has been inspired by the importance of auditors' independence and little research available in relation to auditors' independence in South-East Europe. In addition, when it comes to the close ties and links between directors and auditors little evidence of research, if any, could be found in respect of small audit services markets, such as the audit market in Republic of Macedonia.

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It has been argued that inappropriate competitive strategies such as low-balling or decreased services quality could prevail on small professional services markets. Our motivation for the study was to identify whether close links and ties between board member and auditors exist and compare the results with previous research conducted on large audit markets.

Cross-listed directorship occurs when one or more directors of one company sit on the board of another company or companies. This paper provides analysis of instances of the same director being linked to the same auditor across more than one company, as an indication of close ties and relationship between board members and auditors impacting auditors' independence.

Cross-listed directorship or interlocking directorates are long-standing phenomena with many implications for all economies. Fama and Jensen (1983) argue that multiple directorships encourage greater monitoring of corporate decisions on behalf of all shareholders. This is because directors involved have significant investment in establishing reputation as decision experts. Since interlocked directors are most likely to be outside directors, it is argued here that systematic links by these directors with the same auditor present a potential conflict of interest. They have the potential to compromise audit independence and degrade the effectiveness of audit to serve as monitoring function for shareholders.

Flint (1988) provides evidence that long-term relationship between auditors and clients may cause the auditors to start expressing strong loyalty or emotional connection with their clients, which could result in decreased auditor independence. This means that the quality of audit work completed and overall auditors' competence to decline resulting in subjective, unjustified judgments made when evaluating audit evidence.

In order to maintain the credibility of the audit function and protect auditors from lengthy and costly litigations, the auditing profession and regulators in various jurisdictions prescribe special requirements designed to limit personal relationship between auditors and clients. In the case of the Republic of Macedonia, in accordance with the Auditing Law audit, engagement partners rotate every 7 years, for bank holding companies the statutory audit firm rotates every 5 years. Nevertheless, rotation of engagement partners can't be considered as proficient measure to break close auditor-client ties and secure auditors' independence. Therefore, we have included only non-financial entities in our sample companies and reviewed membership at their board of directors as well as appointed auditors.

The paper proceeds with previous literature on interlocking directorates and auditors' choice provided in section 2, section 3 and 4 present the research method applied and results obtained, while section 5 presents the conclusion and implications for future research.

2. Literature Review

Primary paper addressing the issue of cross-listed directors and selection of auditors is the work of Davison *et al.,* (1984) whose analysis have shown significant relationship between the number of director interlocks and the probability that these interlocked companies are audited by the same auditor. Seabright, *et al*., (1992) investigated the effect of attachment of individuals primarily responsible for the auditor-client exchange on the likelihood of auditor switching. The results of this study suggest that auditor-client relationship relies largely on personal knowledge and trust and these forbid clients to consider an audit firm change.

Jubb (2000) examines auditor choice from this people factor perspective. The study controls for alternative explanations for auditor choice and finds the existence of shared directors (multiple-board external directors) has a systematic and significant measurable effect on auditor choice. The analysis covered various locations in Australia, across different specialist levels and between big 5 and non-big five audit firms. An additional motivation behind selecting an auditor goes to what has been referred as the “insurance hypothesis” or the “deep pockets” syndrome. Internationally affiliated audit firms with substantial resources and insurance coverage are expected to be able to make significant payments in the event of audit failure.

Many explanations have been offered for the existence of interlocking directorates covering a range of theoretical prescriptions. These perspectives have included transaction costs (Williamson, 1991), agency theory (Eisenhardt, 1989) and class theories (Koenig and Gogel, 1981). However, the most relevant explanation for their existence, in terms of the context relevant to this study, is that they serve to reduce or control uncertainty in business environments (Allen, 1974; Schoorman *et al.,* 1981; Mizruchi, 1996). Allen (1974) specifies three main ways in which interlocking directorates attempt to reduce environmental uncertainty. These are (1) by the exchange of information and expertise between companies; (2) by providing a stable means of communication and liaison between companies; and (3) by advising management concerning the relationship of the company to its external environment.

Unlike other products or services, the quality of an audit is not readily discernible. It cannot be judged from the outside and must be experienced to be evaluated (Pennings *et al.*, 1998; Craswell and Francis, 1999). Interlocking directors holding multiple board positions are in one of the best positions to judge the relative quality of audits due to their experience with various service providers. Their experience gives them the ability to advise on and perhaps contribute to selection of the most appropriate auditor for companies on whose boards they sit. Sharing this knowledge with boards of other companies on which they sit reduces the costs of evaluating the strengths and weaknesses of potential auditors.

However, auditor independence is of primal interest in order to provide credibility to general purpose financial statements for various users and stakeholders, which is the main reason for existence and development of the auditing profession. Therefore, the significant impact of interlocking directorates to auditor's choice is important factor influencing relative independence of auditors and the objectivity in making professional judgments while completing audit assignments.

In respect of the approach and results of previous research, we formulate the Ho hypothesis as follows:

"Ho: The frequency of common director-auditor links is not associated directly with the frequency of interlocking directorates."

3. Methodology

The empirical study elaborated in this paper covers all firms listed on the official market of Macedonian Stock Exchange and publicly held companies with special reporting obligations, total of 101 companies as of July 2011. For 17 companies there were no exact or updated data on Board membership or appointed audit firm and were not taken into account. Also, another 26 companies were not included in the sample due to foreign ownership, since their audit decision can be affected by their foreign connection (Baydoun, 1999). The final sample consisted 58 companies audited by 15 different audit firms. Previous studies have classified accounting firms in three main groups: big-four, second tier and local accounting firms. The motive why this classification is made lies in the distinction in quality of performance that researchers make between big-four and international firms on one side and local accounting firms on the other (DeFond, 1992). Only 3 firms (5%) of the companies included in the sample were audited in 2010 by big-four audit firm, 19 (33%) by second-tier international firm and the rest by local firms. This result oppose the results of other research made in other countries were the majority of listed companies are audited by big-four auditor or second tier international firm. The reasons for such market conditions are not further explored and do not represent the interest of this paper.

Publicly available information with the Securities and Exchange Commission on composure of board of directors and appointed auditors at general shareholders meetings was used in order to prepare table 1 and 2.

4. Results

In order to examine the relationship between cross-directorship and auditor choice, two contingency tables were constructed. The contingency table 1 shows the distribution frequencies for selection made by companies with and without cross listed directors for each audit firm. All companies were audited by 15 audit firms, including international second tier and big four auditors. Since the expected frequencies for the table showing clients per each audit firms are very low Fisher exact test of independence and Chi Square-Yates corrected tests are used to test the Ho hypothesis.

In this case the results of both Fisher exact test and Chi Square-Yates test lead to the conclusion that Ho hypothesis can't be rejected at the 5% significance level. This means that there is no significant association between the cross-directorship and the choice of same auditors for companies whose shares are traded at the Macedonian Stock Exchange.

Table 1. Cross-listed directors and selection of each audit firm

Auditor	Companies with cross-listed director	**%**	Companies without cross-listed director	**%**	**Total**
PWC	1	**1,72%**	0	**0,00%**	1
B & Q	7	**12,07%**	5	**8,62%**	12
Bend	3	**5,17%**	0	**0,00%**	3
Grant Thornton	8	**13,79%**	2	**3,45%**	10
Deloitte	1	**1,72%**	0	**0,00%**	1
Dimitrov	1	**1,72%**	3	**5,17%**	4
E.R.C	2	**3,45%**	0	**0,00%**	2
Kojzakliev Pavleska	1	**1,72%**	0	**0,00%**	1
KPMG	1	**1,72%**	0	**0,00%**	1
MSR	1	**1,72%**	0	**0,00%**	1
Moore Stevens	4	**6,90%**	5	**8,62%**	9
Pelagoniska	4	**6,90%**	0	**0,00%**	4
Rafajlovski	0	**0,00%**	4	**6,90%**	4
Revizor Babamov	2	**3,45%**	0	**0,00%**	2
Trio Consulting	3	**5,17%**	0	**0,00%**	3
	39		**19**		**58**

Statistics: Chi-Square Yates; df=14, value=10.893, P=0.694
Fisher exact test; P-value=1, α=0.05

In order to be certain with the results another contingency table 2 has been prepared which shows frequency distribution for two groups of audit firms, international (containing second tier and big four) and local.

Table 2. Cross-listed directors and selection of international and domestic audit firms

Auditor	With cross-listed director	%	Without cross-listed director	%	Total
International Firms	15	**25,86%**	7	**12,07%**	22
Domestic	24	**41,38%**	12	**20,69%**	36
	39		**19**		**58**

Statistics: Chi-Square; df=1, value=0.014, P=0.905

5. Conclusion

From the results presented it can be concluded that the links between companies with same audit firm can't be sufficiently explained with cross listed directors present in their board of directors. The evidence provided in this paper support the conclusion that audit quality and auditor independence is not questioned by factors such as cross listed directors and ties with audit firm partners when Macedonian companies are in question. Although, there were cases in the sampled companies with cross listed directors where those companies were audited by the same auditor, such cases are incidence and couldn't support our assumption of significant association between analyzed variables.

The results of the study provide useful insight into corporate governance structures and practices in Republic of Macedonia, since auditors' independence and audit quality are important instance of good corporate governance. By being independent of board members auditors in Republic of Macedonia are able to effectively perform annual audit assignments and non-executive board members monitor organizational performance. However, this research paper does not provide conclusive evidence in respect of overall independence of auditors in Republic of Macedonia, since other factors such as audit fees, rotation practices, quality control and overall audit regulatory framework are not taken into consideration.

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