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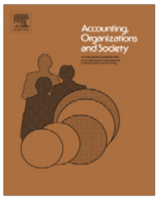

Agency conflicts and auditing in private firms

Ole-Kristian Hope [a,*], John Christian Langli [b], Wayne B. Thomas [c]

[a] Rotman School of Management, University of Toronto, Canada
[b] Department of Accounting, Auditing, and Law, BI Norwegian Business School, Norway
[c] Michael F. Price College of Business, University of Oklahoma, United States

A B S T R A C T

We are interested in understanding how agency conflicts in private firms arise through ownership structures and family relationships. Specifically, we analyze auditors' increase of effort and firms' choice of auditors in situations with higher level of agency conflicts. For a large sample of private firms, we use unique and confidential data (obtained through special permission by the government) to measure direct and ultimate ownership for each shareholder as well as extended family relationships (based on marriage and blood lines, going back four generations and extending out to fourth cousin) among all shareholders, board members, and CEOs. We first find that audit fees, our proxy for audit effort, vary as hypothesized with firm-level characteristics related to ownership structures and family relationships. Second, we find evidence that firms in higher agency cost settings respond by having their financial statements audited by a higher-quality auditor (i.e., a Big 4 firm). However, for CEO family-related settings (i.e., where the CEO is related to the major shareholder or as the number of board members related to the CEO increases), we find no evidence of a greater demand for a Big 4 auditor.

Introduction

In this study, we seek to understand how ownership structures and family relationships influence agency costs in private firms. We do this by observing two aspects related to auditing. First, in higher agency cost settings, auditors are more likely to *supply* greater effort to prevent misstatement associated with moral hazard and adverse selection problems. We examine how auditors adjust their level of effort when auditing financial accounting information. Second, a subset of firms in higher agency cost settings likely have a greater *demand* to choose a higher-quality auditor to provide a credible signal of their commitment to higher-quality reporting. To test this, we examine the extent to which firms with various characteristics hire a Big 4 auditor.

Our examinations draw on very detailed data on ultimate ownership and extended family relationships provided by the Norwegian government. We find that audit fees (i.e., our proxy for auditor effort) increase with expected agency costs.[1] Audit fees relate negatively to ownership concentration and to the extent of ownership by the second-largest shareholder. Concentrated ownership increases the likelihood that a large shareholder closely monitors managerial actions, and an influential second shareholder monitors potential expropriation by the largest shareholder. Audit fees also relate negatively to the portion of shares held by the CEO, consistent with ownership aligning the incentives of the CEO and other stakeholders. Audit fees are positively associated with family relationships between the CEO and the major shareholder (consistent with these family relationships indicating reduced monitoring).

* Corresponding author.
E-mail addresses: okhope@rotman.utoronto.ca (O.-K. Hope), john.c.langli@bi.no (J.C. Langli), wthomas@ou.edu (W.B. Thomas).

[1] The fee (or effort) regression includes controls for 24 client-firm characteristics, five audit-firm variables, as well as year and industry fixed effects.

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With respect to board independence, we find that audit fees decline as the number of board members related to the largest shareholder increases, consistent with fewer agency conflicts between owners and the board. In contrast, as the number of board members related to the CEO increases, audit fees increase, suggesting less board independence and more agency conflicts.

For our tests of demand for Big 4 auditor, we report two interesting sets of results. First, for agency settings that are *not* CEO family-related, we observe results consistent with those obtained for our auditor effort tests. Specifically, the propensity to hire a Big 4 auditor increases as ownership concentration decreases, ownership of the second largest owner decreases, and the major shareholder's family influence on the board decreases. These results are consistent with the demand for a Big 4 auditor being greater in higher agency cost settings. In these settings, a higher-quality auditor plays a stronger role in reducing agency costs by sending a more credible signal of managers' commitment to higher-quality reporting. We do not find significant evidence of a relation between hiring a Big 4 auditor and the fraction of shares owned by the CEO for our main tests, but we do in sensitivity tests.

We find no association between the choice to hire a Big 4 auditor and CEO family-related agency variables. Specifically, we find no significant evidence that the demand for a Big 4 auditor is affected when a family relationship exists between the CEO and the major shareholder or as the number of board members related to the CEO increases. One explanation for the lack of significance could be that while some CEOs in family-related agency settings may wish to signal more credible reporting by hiring a Big 4 auditor, other CEOs in these settings may feel a Big 4 auditor is either unnecessary given close family ties or unwanted because of the gains from extracting private benefits which could be reduced by a Big 4 audit.[2]

Our research is motivated by the need to understand agency conflicts facing private firms. Private firms make up a significant portion of the economic activity in Norway and nearly all other countries, yet prior research focuses primarily on public firms. Given the sometimes vast differences between public and private firms (e.g., Ball & Shivakumar, 2005; Beatty, Ke, & Petroni, 2002; Chaney, Jeter, & Shivakumar, 2004), it is not apparent without testing that results for public firms will generalize to private firms. Thus, private firms offer an economically important sample worth testing. While the benefits to understanding agency conflicts accrue directly to the firm's investors, they will also be important to many other stakeholders (e.g., creditors, employees, suppliers, and customers), regulatory bodies supervising auditors and firms' financial reporting, and society in general.

A sample of private (as opposed to public) firms may also offer a stronger test of agency conflicts related to ownership structure and family relationships. As we discuss in more detail in Hypotheses, prior research sometimes provides conflicting evidence or conflicting predictions for the impact of ownership structures and family relationships on agency conflicts. Our study provides a potentially strong setting for testing agency conflicts because private firms exhibit heterogeneous ownership characteristics and family relationships. Public firms are more homogeneous, including wide-spread ownership, relatively low CEO ownership, and fewer family ties between managers and shareholders and between managers and board members. Private firms offer interesting ownership structures that potentially increase our understanding of the relation between agency conflicts and the supply of auditor effort. For example, private firms show considerable variation in ownership percentages by second largest shareholders. This allows us to provide a meaningful test of the impact of agency conflicts among shareholders (i.e., monitoring of largest shareholders by second largest shareholders). Private firms also show greater variation in their choice of auditor (only 18.1% choose a Big 4 auditor). Nearly all public firms opt for a Big 4 auditor, limiting the ability to empirically test signaling through *demand* for a high-quality auditor.

Related to tests of the *supply* of auditor effort, a single-country setting (Norway) controls for cross-country variation in audit practices and fees and the strength of legal institutions. Cross-country differences could easily confound inferences. Norway also offers an environment where the impact of litigation on audit fees is relatively limited (Hope & Langli, 2010). This increases our ability to make more reliable inferences from using audit fees to measure auditor effort, and adds to calls for research to better understand the role of firm governance in explaining audit fees (Hay, Knechel, & Wong, 2006).

Finally, given the unique data we use in this study, we are able to measure attributes of ownership structure and family relationships that have been difficult to measure in the past. Specifically, for all private limited liability firms we have detailed information available to compute both direct and *ultimate* ownership for each owner, board member, and CEO.[3] In addition, we have detailed data on family relationships among *all* owners, board members, board chairs, and CEOs (based on both marriage and blood lines, going back four generations and extending out to fourth cousin). To our knowledge, no prior study has been able to test the effects of family relationship using such detailed data. These data, based on merging databases using social security numbers, are obtained through special

[2] As per Norway's Companies Act (§ 7-1), the annual meeting (or General Assembly) of the shareholders elects the auditor. While the selection of the auditor is technically the responsibility of the General Assembly (or in practice the board), it is almost certainly the case that the CEO plays a significant role in our setting. There is a large literature on how CEOs influence the selection of board members and more generally exercise "power" over the board (see, e.g., Bebchuk & Fried 2003). Even for large public firms in the US and UK the CEO has an impact on which auditor is selected (e.g., Beattie & Fearnley 1995; Carcello, Neal, Palmrose, & Scholz 2011; Firth 1999). For our sample of smaller private firms, the CEO is expected to have a greater influence on auditor selection because the boards are typically smaller, CEO ownership is common (the CEO owns shares in 78% of our sample firms), and the largest owner often is related to the CEO.

[3] For example, suppose an investor owns 30% of firm A and 30% of firm B, and firm A in turn owns 30% of firm B. The investor's direct ownership in firm B is 30%, while her ultimate ownership is 39%. Note that our data also account for cross-holdings.