THE MODERATING EFFECT OF AUDIT QUALITY ON THE RELATIONSHIP BETWEEN OWNERSHIP STRUCTURE AND FIRM PERFORMANCE: A CONCEPTUAL STUDY

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ABSTRACT

This paper attempted to conceptually explore two main aims; firstly, to examine the direct effect of the concentration and managerial ownership on firm performance (ROA) among Omani non-financial companies. The second objective is to examine the moderating effect of the audit quality on the relationship between ownership concentration and managerial ownership, and firm performance of Omani companies. In addition, this study used control variable, namely leverage. Finally, this study provided the limitations and suggestions for future researchers at the end of the paper.

Keywords: Ownership Concentration, Managerial Ownership, Firm Performance, Audit Quality.

1. Introduction

Corporate governance is among the top researched topics as a tool to decrease conflicts-of-interests between managers and investors, with the primary aim of safeguarding the capital owners their rights. This notion has been advocated by Abdurrouf (2011), Jensen and Meckling (1976), Pandya (2011), Pfeffer (1972), Shleifer and Vishny (1986) who stated that corporate governance ensures that management works towards achieving interests of both shareholder and stakeholders groups. As a consequence, corporate governance mechanisms and regulations have been focused on by researchers and practitioners around the globe in terms of their role in enhancing overall economic capability to generate public advantages for all stakeholders, both individuals and organizations (Hsu & Petchsakulwong, 2010). Specifically, local and foreign investors are attracted to the firms who adopt corporate governance mechanisms. The correct use of corporate governance code can help steer clear of financial disputes and minimize corruption and in consequence, improves the overall growth of the firm that boosts the overall economic growth and development (Al-Matari et al., 2012).

Several researchers, firms and institutions advocate that the role of corporate governance lessens the conflict of interest, in that an effective corporate governance mechanism minimizes the right of
control and provides managers more autonomy to urge management to enhance shareholder’s wealth. Moreover, corporate governance furnishes directors the right to make correct decisions to serve shareholders while achieving the goals of shareholders and managers (Shleifer & Vishny, 1997). Irina and Nadezhda (2009) attributed this to need of firms to adjust on a corporate scale in order to enhance their performance. Accordingly, in the present study, a comprehensive model is developed and proposed to examine the factors improving the effectiveness of the corporate governance mechanisms and performance of Omani firms.

The primary aim of the external auditor is to ensure that the financial statements forwarded by the board of directors to the shareholders are reliable (Mautz & Sharaf, 1961). Coupled with this is the effort made by the external auditor in minimizing information asymmetry between management and shareholders (Fama, 1980). In addition, the external audit is deemed to be a controlling factor used by the firm to address agency issues and any manipulated changes in the accounting information (Jensen & Meckling, 1976; Watts & Zimmerman, 1983). Also, external audit helps in lessening the ownership gap and the control over the firm (Fama & Jensen, 1983).

The external shareholders-managers relationship is rife with moral hazard and opportunism that results from the information asymmetry and in this background; financial reporting is expected to contribute to the distribution between control and ownership (Wan, Shahnaz & Nurasyikin, 2008).

Although majority of researchers are of the consensus of the importance of the ownership structure-firm performance relationship, only few empirical studies have been dedicated to it. In this background, some authors revealed a positive relationship (e.g., Barontini & Caprio, 2006; Chen et al., 2006), whereas others (e.g., Brown & Caylor, 2004) revealed a negative one. Several other studies found no relation between the two variables like Masood (2011). These ambiguous findings urged other studies to conduct in-depth studies into the relationship – these studies include Abdurrouf (2011), Al-Matari et al. (2012), Kajola (2008), Liang et al. (2011) and Millet-Reyes & Zhao (2010). Added to this ownership structure’s importance is evident in matching the interests of owners and management. Thus, in the present study, some ownership structure characteristics are focused on namely concentration ownership and managerial ownership.

According to the above study findings, this study is an attempt to minimize the literature gap by looking into the characteristics of ownership structure namely ownership concentration and managerial ownership and their relationship with the performance of Omani firms. Moreover, the study also examines the moderating role of audit quality on the relationship between ownership structure and firm performance (ROA) relationship. In the coming sections, an in-depth explanation of the procedures employed in the study is provided.

2. Literature Review and Hypotheses Development

2.1 Ownership Concentration and Firm Performance

Ownership concentration is an answer to the issue of safeguarding and providing legal protection of minority shareholders among firms in different countries (Azam et al., 2011). It refers to the proportion of the firm shares in the hands of specific number of majority shareholders (Sanda et al., 2005) and is measured through the fraction held by the five majority shareholders or through the significant number of shareholders (Karaca & Eksi, 2012; Obiyo & Lenee, 2011).

The first authors to indicate a positive relationship between ownership concentration and firm performance conceptually were Berle and Means (1932) while other others (i.e. Shleifer & Vishny, 1997) emphasized that ownership concentration and legal protection are two major determinants of corporate governance. Moreover, majority shareholders can assist their minority counterparts as they have the power to halt the expropriation of shares and asset stripping of management.
Concentrated ownership of firms may lessen management’s intention to conduct strategic decisions and obtain risks to their own advantage (Brickley et al., 1997; Bushee, 1998; Pound, 1988). In relation to this, a considerable total share of equity may result in enhancing the oversight power of majority shareholders (Clarke, 1998).

Based on the perspective of the resource dependent theory, company ownership invest a specific amount of resources and this is detrimental to assisting the partnership of the company with external investors and in turn, it reduces the supply of external resources from other relevant entities (government or financial institutions). The percentage of investment between foreign investors and owners should be similar so as to achieve the firm’s goals and in setting up wealth forms that minimizes firm’s risks. This may be helpful in providing experiences related to external environment as internal and external partnership that improves the performance of firms (Pfeffer, 1972).

In theory, the ownership concentration effects on firm performance are still inconclusive in both developed and developing nations. The next sections provide a preview of such mixed ambiguous findings in light of agency theory and resource dependence theory. Despite the extensively conducted empirical studies that investigated the relationship between ownership concentration and firm performance, the results are still divided; for instance, some authors around the globe that examined the relationship between concentration ownership and firm performance revealed a positive relationship between the two variables in developed nations (e.g., Siala et al., 2009; Wang & Oliver, 2009), and developing nations (e.g., Azam et al., 2011; Obiyo & Lenee, 2011).

Other authors evidenced a negative relationship between the two variables in both developed countries (e.g., Hu et al., 2010; Millet-Reyes & Zhao, 2010) and developing countries (e.g., Roszaini & Mohammad, 2006). Some other authors failed to find any relationship at all between ownership concentration and firm performance also in both categories of nations; developed (Shan & McIver, 2011) and developing countries (e.g., Fazlzadeh et al., 2011; Najjar, 2012; Wahla et al., 2012). Such ambiguous findings urge further studies to reinvestigate the relationship and accordingly, the present study attempts to contribute to literature by proposing the following hypothesis:

**H1: There is a relationship between the ownership concentration and firm performance.**

### 2.2 Managerial Ownership and Firm Performance

Managerial ownership is measured by using the proportion of firm shares that are held by insiders and board members (insider ownership) (Liang et al., 2011; Wahla et al., 2012). Such ownership type has been deemed as an effective corporate governance tool. In the study conducted by Jensen and Meckling (1976), the authors stated that a possible incentive exists to match management interests with those of shareholders. However, Khan et al. (2011) and Shleifer and Vishny (1986) explained that high managerial ownership may result in management entrenchment as they are not too controlled by the board and are not fully disciplined by it.

Moreover, the relationship between managerial ownership and firm performance has been focused on by several theoretical and empirical studies but their findings are mixed. Details to such findings are explained in this sub-section.

Based on the agency theory perspective (Jensen & Meckling, 1976), managerial ownership can help enhance agency conflicts between owners and management because if the latter owns a significant portion of the company shares, he is encouraged to maximize job performance to ensure greater firm performance. Contrastingly, entrenchment of management has been known to occur in firms having high managerial ownership and thus contributing to agency issues (Demsetz, 1983; Fama & Jensen, 1983).

From another theory’s point of view, specifically, the resource dependence theory, a partnership with external resources is promoted as they will enable the company to access multiple sources and
obtain different experiences to work towards increasing shareholder rights and the entire parties that are related with the company. It also concentrates on the entailment of confiscated resources and combines them to achieve fruition and achieve the company beneficiaries’ goals. Hence, managers and board members significant ownership prevent the improvement of companies’ performance (Pfeffer, 1972).

On the basis of the prior discussion, it is evident that the findings concerning the relationship between managerial ownership and firm performance are mixed, where some studies in the context of the developed countries (e.g., Juras & Hinson, 2008; Leung & Horwitz, 2010) and developed countries (e.g., Chung et al., 2008; Ehikioya, 2009; Hasnah, 2009; Sing & Sirmans, 2008; Uwuigbe & Olusanmi, 2012) revealing a positive relationship between the two. Contrastingly, other researchers evidenced a negative relationship between managerial ownership and firm performance in both developed countries (e.g., Irina & Nadezhda, 2009; Juras & Hinson, 2008) and developing countries (e.g., Liang et al., 2011; Mandac & Gumus, 2010; Tsegba & Ezi-Herbert, 2011; Wahla et al., 2012). In other studies, no relationship was found between the two both in developed countries and developing ones (e.g., Juras & Hinson, 2008; Siala et al., 2009; Nazli Anum, 2010; Nuryanah & Islam, 2011; Mohd, 2011 respectively). Therefore, for further confirmation, this study proposes the following hypothesis for testing;

**H2: There is a relationship between the managerial ownership and firm performance.**

2.3 The Moderating Effect of the Audit Quality on the Relationship between Ownership Structure and Firm Performance

The external auditor is generally associated with ensuring that the reliability of the financial statements drawn up by the BOD for the shareholders is confirmed (Mautz & Sharaf, 1961). Added to this, the efforts exerted by the external auditor can mitigate the information symmetry that exists between managers and shareholders (Fama, 1980) and an external audit is deemed to be a controlling tool employed by the company to resolve agency problems and the manipulation of accounting information (Jensen & Meckling, 1976; Watts & Zimmerman, 1983). Stated clearly, the external audit is invaluable in minimizing the separation gap between ownership and firm control (Fama & Jensen, 1983).

The external shareholders-management relationship is associated with moral hazard and opportunism stemming from asymmetry of information. In this background, the social role of financial reporting heightens with the separation of control and ownership (Wan et al., 2008). Along a similar line of study, Kane and Velury (2004) stated that higher degrees of institutional ownership leads to the firms’ higher potential to purchase audit services from major audit firms to ensure audit quality. Moreover, while a positive relationship was found between professional audit and audit quality by Chanawongs et al. (2010), no effect was found between audit size and audit quality by Dehkordi and Makarem (2011). It is therefore expected that audit quality improves the ability of corporate governance elements to generate enhanced performance and thus, the following hypothesis is proposed to be tested;

**H3: The audit quality moderates the relationship between ownership concentration and firm performance.**

**H4: The audit quality moderates the relationship between managerial ownership and firm performance.**
3. Proposed Research Framework

Based on the limited literature regarding the moderating effect of audit quality on the relationship between ownership structure and firm performance, this study proposed the following framework that is expected to explain a considerable amount of the variance in the firm performance (figure 1).

![Research Framework]

4. Conclusion, Limitations and Suggestions for Future Research

As we spotlighted earlier, this study tried to achieve two main objectives, the first objective is to conceptually examine the direct relationship between ownership structure namely ownership concentration and managerial ownership, and firm performance among non-financial companies in a period of three years (2012-2014). The second objective is to conceptually explore the moderating effect of audit quality on the relationship between ownership structures namely ownership concentration and managerial ownership, and firm performance.

This study is similar to any previous studies in that it has its limitations. This study was focused to conceptually examine the relationship between ownership structures, audit quality and firm performance so that we suggest future researchers to consider in studying this relation empirically. In addition, the study examined two variables of ownership structures namely ownership concentration and managerial ownership and therefore, this study advice future researchers to take into account other variables like government ownership, institutional ownership, foreign ownership and others. Finally, as we mentioned above, this study examined the relationship of ownership structures to firm performance and thus, we suggest future researchers consider other variables of internal corporate governance variables such as, board of directors characteristics, audit committee characteristics, risk committee characteristics, purchase committee characteristics, board diversity, internal audit characteristics and so on that have the potential to improve the level of performance of companies.
References


