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Corporate Governance and The Modification of Audit Opinion: A Study in The Jordanian Market

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ABSTRACT

The objective of this study is to examine the relationship between some Corporate Governance indicators and the probability of modifying the independent auditor opinion in the Jordanian market. The sample consists of 104 non-financial firms listed on Amman stock Exchange for the year 2015. The logistic regression via SPSS is used to analyze the data. The results show that firm's profitability (measured by ROA) and the number of institutional investors on the board of directors are significant negative predictors of the probability of receiving modified audit opinion by the firm. That is the higher the firm's ROA and the larger number institutional investor representatives on the board of directors the less likely the firm will receive a modified audit opinion. On the other hand, the results also show that the board of directors' size is significant positive predictor of receiving a modified audit opinion by the firm. That is the larger the size of the board of directors the more likely the firm will receive a modified audit opinion. Although, it is an unexpected result it agrees with some other studies results. Finally, board independence, board activity and the presence of audit committee have no significant impact on the type of audit opinion the firm receives.

1. Introduction

Generally, corporate governance (CG) is a system of controlling corporate management's actions and policies in order to protect the interest of stockholders and other financial statements users in general (stakeholders).

As the Organization of Economic Co-operation and Developments (OECD 2004, 12) describes it Corporate governance *"involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth".*

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The Cadbury Committee of UK (1992) has defined CG as: "The system by which companies are directed and controlled". The Cadbury Committee was appointed by the United Kingdom government in May 1991 with a broad mandate to address the financial aspects of corporate governance. In December 1992, the Committee issued its report recommending, among other things, that the boards of directors of publicly traded companies include at least three non-executive (i.e., outside) directors as members and that the positions of Chairman of the Board and Chief Executive Officer (CEO) of these companies
Be held by two different individuals. The apparent idea reflected in the Committee's recommendations is that greater independence of a corporate board directors will improve the quality of board oversight of company's affairs.
Described more broadly by Lamm (2010) CG: "Is the culture, policies, procedures and controls that help ensure a company will meet its business goals".
Corporate governance mitigates the conflict of interest between the different groups of stakeholders. Its roots started long time ago since 1932 (according to Ganescu and Gangone 2012) but it has attracted serious attention since the fall of big companies around the world at the start of the current century, such as Enron, WorldCom, Marconi and Tyco, and because of the recent financial crises of 2007/2008.
One of the immediate results of the multiple corporate failures is the passing of Sarbanes's-Oxley act of 2002 in the US and the strengthening of listing requirements by many national and international stock markets in order to improve transparency and financial reporting quality, and encourage enter- market listing and investments.
Recently, CG became a necessary tool to ensure the values required by different stakeholder groups. It helps aligns the corporate goals to the interest of investors and society by promoting fairness, (progress through conflict resolution and integration not through domination and compromise). Responsible CG sets the balance between economic and social growth (Zinkin, 2010).

1.1 Corporate Governance and Audit Function

Corporate governance calls for the independence of the Board of Directors (BofD) and the formation of several key board committees, such as the audit committee (AC), the nomination and compensation committee and, in some cases, the governance committee and risk management committee. The BofD independence is viewed as a first line of protection against firm mismanagement and unequal treatment of different stakeholder groups.
The purpose of AC is to oversee the internal and external audit functions, which supposed to enhance the independence and effectiveness of both audit functions. The AC has a role in selecting the external auditor and communicating with him/her. Therefore, it is expected if the company has an independent BofD and active AC committee, it should be able to obtain more accurate and reliable financial reports, with no or low probability of mistakes, irregularities or fraud (Jouri, 2016, 404). When the external auditor examines such corporate financial reports and find no problems, he/she will usually render an unmodified (standard or clean) audit opinion to the company. That is to say responsible corporate governance, as exhibited by independent and active BofD and AC should lead to a higher quality financial reports, which in turn leads to unmodified audit opinion and vice versa.
Audit opinions are now divided into five types: 1- Standard Unmodified (or clean) opinion, 2- Unmodified opinion with explanatory paragraph or non-standard wording, 3- qualified opinion, 4- Adverse opinion, and 5- A disclaimer (Arens et al, 2017, 75). Following Farinha and Viana (2009) and Ishak and Yusof (2015) the last four types of audit opinion are considered modified audit opinions for the purpose of this research. They both considered if the company receives a modified audit opinion it is a sign of failure or lower reporting quality.

Jordan has initially voluntarily adopted International Accounting Standards (IASs) since the nineties of the last century (saaydah, 2012). It is now obligatory to use International Financial Reporting Standards (IFRSs) by listed companies (Jordan corporate law No. 40 for 2002 and later updates). Jordan has also issued its disclosures requirements for listed companies since 1998 and updated it in 2004 (Jordan Securities Commission 1998). The Jordanian securities commission has issued Jordanian CG guidelines since 2008 and it kept updating these guidelines. The last update was in 2017 in which the commission required listed companies to provide rich amount of information about the company's administration and financial affairs, including the affiliation of the members of the BofD, their qualifications, expertise and whether they are independent, related party information, and all board committees membership expertise etc. A study by the European Bank for Reconstruction and Development (2017, 6) conclude that the ASE website provide comprehensive database of financial and general information.

1.2 The Study problem

Internal and external auditing have evolved over time to accomplish efficiency in operation, accuracy in measurements and transparency in reporting in order to protect the interest of different stakeholders in the organization (Arens 2017, 36) . Nowadays an additional mechanism has joined the auditing profession in achieving almost the same goals above and protecting the general public interest in every listed company. Because the above mechanisms (CG and auditing) have similar end objectives it is expected that any improvements in one mechanism will reflects positively on the other one. That is effective CG practices will facilitate quality internal and external auditing and the results of this interaction will show up in the quality of financial reports and the type of audit opinion the company obtains. Since the relationship between CG and the type of audit opinion has not been studied enough in the Middle East region in general, and the Jordanian environment in particular, the main question in this study is: What is the relationship between CG indicators and the probability of modifying the external (independent) audit opinion in the Jordanian market?

1.3 Objective of the Study

The main purpose of this study is to examine the association between some CG indicators and the probability of modifying the audit opinion of non-financial companies listed on Amman stock exchange (ASE) for the year 2015.

The rest of this paper is organized as follows: The next paragraph describes the problem of the study, next a theoretical background, past studies and hypotheses development are given. After that the methodology and study model are presented and the paper concludes by results analysis and conclusion.

2. Theoretical Background and Past studies

2.1 Theoretical Background

Many parties, such as investors, creditors and employees, rely heavily on the company's financial reports to evaluate the management's success and effectiveness when making rational economic and other decisions.

Financial markets as well as securities commissions all over the world place heavy emphasis on the strength of accounting and auditing standards and procedures. They focus on corporate disclosures to control the quality of financial reports and enhance its transparency and informativeness in order to protect the interest of investors and the general public at large.

The recent multiple business scandals has raised criticism to the accounting and auditing functions and the financial reporting quality (Brown et al 2010). These scandals have also led

to a deterioration in the investment confidence regarding business management and financial reporting (Beeks and Brown 2004, and Petra 2007)

There are several end objectives that are common among auditing function, securities commissions, stock market regulations and CG principles or guidelines. Among these common objectives are: Enabling investors to make rational economic decisions, and minimize the conflict of interest between stockholders and management. This is why if one investigates the intent behind them, she/he will find that they all inspired by accounting standards disclosure requirements, stock market listing rules and CG principles.

Auditing, basically, intend to reduce investors risk, improve decision making and enhance efficiency. The general goal of it is to ensure that an acceptable level of certainty is reached that financial statements are free from material misstatement and errors. This requires auditor to certify that financial statements are prepared in accordance with approved set of accounting standards (whether IFRS, local or other regional standards).

Securities commission normally aim to maintain stability and efficiency by regulating and monitoring securities market to enhance its efficiency, transparency, and effectiveness. It helps streamline the operations among brokers, dealers and exchanges. It also help restore confidence to financial markets and the investing public by protecting them from manipulative and fraudulent practices.

Stock markets play an important role in the economic development of a country by facilitating the channeling of people savings to make it available for investments. They create safe, attractive and transparent investment environment and regular system for trading securities in order to serve the national economy.

Effective CG should protect the rights of stockholders to help achieve the firm objectives and hold business directors responsible for their stewardship duty (Calder2008). Corporate Governance influences the quality of financial reporting as well as the auditor's judgment in audit procedures. Accordingly, we can expect that accounting information provided by companies subject to effective CG will be of higher quality with reduced probability of fraud and misstatement, and thus the obtaining of unqualified audit opinion seems reasonable.

The association between CG, financial reports quality and auditor reputation has been the subject of strong discussion in developed as well as developing countries (Agrawal and Chadha 2005 and Dimitropouls and Astriev 2010). The idea here is that a good controls on the behavior of management and the existence of strong internal and external audits should enhance the accuracy and reliability of financial reports issued by the company. If this is the case then it is more likely that the firm will receive favorable external audit opinion (i. e., standard or unmodified audit opinion). This is because the major external audit objectives are already achieved through the actions of CG and internal audit procedures.

2.1.1. Effective Corporate Governance indicators

There are several indicators of effective CG discussed in the literature, among the most important of them are: The characteristics of the board of directors (BofD) and the function of the Audit Committee.

The BofD has an important role and responsibility in ensuring the reliability, accuracy and integrity of corporate accounts and financial statements. Its responsibility starts with selecting and training accountants and other employees, and availing a reliable accounting information system to ensure that reliable internal audit and control systems are in place among many activities required from it. For the BofD to be effective and practice its responsibilities appropriately, certain characteristics have to be present, among them, is the independence of the BofD, its activity, size and the non-duality of key management positions. An independent member of the board is a one who does not work for the company on a regular basis and receive salary from it. Such members are supposed to be free in evaluating and criticizing board

decisions and policies for the general good of the company, its shareholders and the economy in general. Several studies found that the higher the percentage of independence (nonexecutive) members the better the decision made by the board, the more effective their control over the company's affairs (Ishak and Yousof 2015, Habibzadah Bagaya 2012), and the less likely of issuing of a modified audit opinion to the company.

The BofD activity is demonstrated by the number of meetings by the board during the year, which expresses the degree of board diligence (Xie *et al*, 2003)

The board size is measured by number of the board members, which some authors consider big board size have higher monitoring capacity which is useful for firm financial reporting quality and performance (Saibaba, 2013), and the non-duality of management positions, which means the chairman of the BofD is not the Chief executive officer of the company at the same time, rather they are two different persons. Corporate Governance calls for the avoidance of duality which possibly lead to poor quality financial reporting (Byrad *et al*, 2006)

The idea of audit committee (AC) was first endorsed in 1939 by the New York Stock Exchange (NYSE) (Al-Baidhani, 2014) and later on by the SEC in 1972when it recommends that public companies should create audit committees comprised of directors from outside the company's management. In 1977, the NYSE required that all AC members be independent directors. In 1988 the AICPA, in its SAS 61, issued "Communication with Audit Committees" regarding the relationship between the AC, external auditors, and management of public -companies. Later after the major corporate collapse the US Congress passed the Sarbanes-Oxley Act in 2002 giving more authority and responsibility to ACs, regarding corporate control and disclosure requirements. The Sarbanes-Oxley Act increased the membership requirements and committee composition to include more independent directors. Furthermore, Companies were required to disclose whether or not a financial expert is on the AC membership.

Audit committees are viewed as effective means for corporate governance that reduce the risk of fraudulent financial reporting. They oversee the organization's management, internal and external audit functions to protect the shareholders' interests. To ensure effective corporate governance in the US, the audit committee report should be included annually in the organization's proxy statement, indicating whether the AC has reviewed and discussed the financial statements with the management and the internal auditors (Al-Baidhani, 2014). According to the Blue-Ribbon Committee (BRC) of 1999, the AC should provide the public with correct, accurate, complete, and reliable information, and it should not leave a gap for predictions or uninformed expectations. The BRC report provided guiding principles for improving the performance of audit committees that should eventually result in better corporate governance.

2.1.2 Corporate governance in Jordan

There are five key players in CG development in Jordan: Jordan Securities Commission, Jordan Central Bank, Amman Stock Exchange (ASE), Insurance Regulatory Commission and Company Control Department in the ministry of industry and trade. Jordan Securities Commission is the regulator of capital market. The main responsibilities of it are to develop legislation and regulations that emphasize transparency and disclosure, protection of investors, and enforcing the rule-of–law (Jordan Securities Law No. 8, 2002, Article 8). It issued CG guidelines for listed companies since 2008 and kept updating it. The last update was in 2017. The guidelines include mandatory requirements and voluntary provision on the basis of "comply or explain" that is the company has to comply with the CG guidelines or explain why it could not or why it is not applicable in its case.

According to article (46) of the Jordanian securities law, the Securities Commission issued the "Disclosure Instructions, Accounting and Auditing Standards and Qualifications of Auditors

of Organizations Subject to Commission's Control No. 53 for 2004". Article (15) of these instructions covers the formation, role, responsibilities and duties of the AC as follows:

A-The Board of Directors of the issuing Company shall form an Auditing Committee of three non-executive board members who are natural persons, and shall designate one of them as head of the Committee and notify the Commission thereof, and of any changes thereto and the cause of such.
B-Any member of the Board of Directors shall be considered as non-executive, if the member is neither an employee of the Company nor receiving a salary there from.
C-The Auditing Committee shall meet periodically and report to the board of directors, provided its meetings shall be at least four per annum and the minutes of such meetings shall be duly recorded.

Amman stock Exchange, as a second player in the development of CG, has issued the Listing Instructions for 2004 requiring (in Article 3, item 4) the formation of AC by listed companies. The Central Bank of Jordan, as the third main player in developing CG in Jordan administering the Jordanian Banking Law No. 28 for 2000. It issued first what is called "Bank Directors Handbook of Corporate Governance" in 2004 and "Corporate Governance Code for Banks" in 2007, and the "Corporate Governance Instructions for Banks" in 2014. This last instructions is mandatory for banks in Jordan.
Articles (32 and 33) of the banking law mentioned above detail the procedures for forming an AC in each bank operating in Jordan. According to article 32 of the law:
An "auditing committee" shall be formed in each bank by decision of its board of directors comprising a chairman and two members selected by the bank board of directors from among its members other than those entrusted with executive tasks within the bank. It shall continue to function throughout the tenure of the board of directors and shall assume specific duties and authorities:
The Insurance Commission, similarly, has also issued governance instructions for insurance companies. Finally, the Companies Control department, as a fifth player in CG development in Jordan, issued what is called "Jordan Corporate Governance for Private limited liability and non-listed Public shareholding Companies" which is basically voluntary.
Overall the European Bank for Reconstruction and Development (2017) evaluated CG in Jordan based on the five key areas, corresponding to the standards set forth in the best practices and international standards (like OECD principles for CG) using a questionnaire directed to law firms, audit firms, national regulators and ten largest listed companies. It arrived at the following results based on a 5-point scale rated as "strong to very Strong", "Moderately strong", "Fair", and "weak" and "Very Weak".

1- In the area of "Structure and Functioning of the Board, the rating is Weak
2- In the area of "Transparency and Disclosure" the rating is Fair overall (and strong in the sub area of financial information disclosure)
3- In the area of "Internal Control" the rating is Weak
4- In the area of "Rights of Shareholders" the rating is Fair, and filly
5- In the area of "Stakeholders and Institutions" the rating is Fair

2.2. Past studies
Jouri (2016), investigated the effect of the quality of the mechanism of CG on the independent auditor's opinion. The study used data from 90 listed companies in Tehran Stock Market over 8-year period (2001-2008). Based on the binomial test used in the study, the results indicated the presence of significant relationship between moderate and weak CG rate and the receiving

of unqualified audit opinion, however, the researcher could not find a significant relationship between strong CG and the unqualified audit opinion.

Ishak and Yusof (2015), examined whether the board of director formation of separate risk management committee beside the AC has an effect on the modified audit report of non-banking and financial companies listed on Bursa Malaysia. Their sample consists of 300 companies studied over the period 2004-2009, using multivariate analyses. Their results indicate that the risk management independence is negatively related to the acceptance of modified audit report, however, the study also find that the size of the firm influence positively the probability of issuing a modified audit report which is the opposite of the finding of other similar studies.

Brad *et al*., (2015), examined the correlation between financial audit and corporate governance variables for a sample of 41 Romanian companies for 2011. The data was modeled using a simultaneous equation model, assuming there is interdependency between financial audit variables and corporate governance indicators. They found a positive correlation between the type of auditor and the fees they receive for their audit process, and negative correlation between the value of auditor's fees and each of the existence of audit committee and the separation of CEO and the board chairman positions. Their explanation of this results is that the existence of audit committee as well as the separation of positions mitigate the risk associated with the auditing activities and enhance transparency.

Mahdi *et al*, (2015) examined the effect of audit quality and internal and CG on the quality of disclosures of financial statements quality using data from 146 Iranian firms for the period 2009-2014 (730 company-year). Using regression models, they found significant relationship between CG and the quality of disclosures of financial statements information, but they did not find significant relationship between the independent audit quality and the quality of disclosure of financial statements.

Al _Sufy *et al*, (2013) examined the impact of governance on the quality of accounting information using data from 50 industrial firms listed on Amman stock exchange for the year 2012 using a questionnaire. Thy found that CG affect the quality of financial reporting by making it more accurate.

Habibzadah Baygi (2012) examined the effect of some CG characteristics on the audit report in Iran. Their sample consist of 150 firms listed on Tehran stock exchange for the period 2005-2008. They used the fuzzy regression approach to evaluate research hypotheses. They found that the presence of non-executive board members and internal auditors have negative impact on the likelihood of receiving modified audit opinions., while the CEO duality is positively associated with likelihood of receiving modified audit opinions, and there is significant relationship between institutions ownership and the type of audit opinion.

Rainsbury *et al*, (2009) investigated the association between the quality of audit committee on financial reporting quality and external audit fees. They concluded that no significant association between the quality of an AC and the quality of financial reporting.

Farinha and Viana (2009) analyzed the effect of some dimensions of financial reporting quality on the probability of a firm receiving a modified audit opinion. They used a sample of companies listed on Euronext Lisbon Market when firm can publish financial statements not in accordance with GAAP. Their sample consisted of 171 firm-year observations for the period 2002-2005. There results indicate that the firms with more diligent and independent BofD are less likely to receive modified audit opinion. The board independence was measured by the portion of non-executive members of the total number and the board diligence was measured by the number of meetings during the year. They further conclude that the transition in 2005 to IFRS reporting in Europe is strongly associated with better financial reporting quality.

Abu-Mayyala (2008) investigated the impact of some factors on improving the effectiveness of AC as perceived by three Jordanian sample subgroups: Financial managers, internal auditors of the financial firms listed on Amman Stock Exchange, as well as external auditors.

A comprehensive survey was conducted to survey the firms of the financial sector listed on ASE, the number of which is (91) consisting of banks, insurance companies, financial service companies and real estate companies.

For the purpose of data collection, (302) questionnaires were administered to (91) financial managers and (91) internal auditors as well as (120) external auditors. The number of returned questionnaires from the financial managers was (83) or 91%, from the internal auditor (70) or 77%, and from the external auditors were (103) or 86%.

The data was then analyzed using the Statistical Package for Social Sciences (SPSS). One sample t-test, One-Way ANOVA and other descriptive statistics were used to analyze the collected data.

Abu-Mayyala examined 9 hypotheses, relate to the perceived effect of nine different positive characteristics of corporate ACs (qualification, experience, independence etc.) from the point of view of the three sample subgroups.

All of the nine hypotheses related to AC were rejected. Meaning that each characteristic has a significant positive impact on the effectiveness of AC. Another hypothesis in the study compares the difference in perceived effect of each characteristic on AC effectiveness among the three sample subgroups. The results of this hypothesis indicate, first, no significant differences in the perceived impact of the different nine characteristics of AC on its effectiveness between internal auditors and financial managers' subgroups or between external auditors and financial mangers' subgroups. Second, there are significant differences in the perceived impact of the different characteristics of AC on its effectiveness between the external auditors and the internal auditors' subgroups. Specifically, he finds that the average mean of perceived effect of each of the nine characteristics on the AC effectiveness is significantly higher for the internal auditors than the external auditors. He concludes, this result indicates a more believe by internal auditors of the role and function of AC as a corporate governance tool in the financial sector in Jordan.

Elfar (2006) studied the CG effect on Earnings Management and its relation to Firm's Market Value, in the Period of 2001-2004. The governance variables examined are the presence of independent internal audit committee, of sufficient experience, that attend to the process of setting the financial reports; and the presence of independent qualified board of directors, of suitable size and proper experience to the nature of company's activities. The researcher also examined the impact of the above variables on management's ability to exercise earnings management. The sample consists of 55 industrial companies listed on Amman Stock Exchange (ASE).

He used the adjusted Jones model to calculate the average discretionary accruals for each company and compare these means with the overall industry mean in order to rate the company as practicing or not practicing earnings management. Among others, the study results show that the activity and adequate experience of AC, and the experience and independence of the board of directors can have a significant effect on controlling the company management's ability to manage earnings.

Carcello *et al,* (2006) studied the association between audit committee financial expertise, as CG mechanism, and Earnings Management. They used a sample of 283 non-financial domestic firms from Compact D/SEC with fiscal years end between July 15 and 31 Dec 2003 traded on NYSE and Nasdaq's markets. They found that accounting and certain type of non-accounting financial expertise reduce earnings management for firms with weak CG, however, independent audit committee with financial expertise are most effective in mitigating earnings management.

Ballesta and Garcia-Meca (2005) investigated the corporate governance role in external audit in the Spanish capital market context considering the conflict of interest between managers and shareholders
analyzed in the agency theory. They used a logistics regression with a matched pair design developed with the dependent variable indicating whether the firm receives a qualified audit opinion and the independent variables representing the ownership concentration, board ownership, board size and family members on the board. The sample consisted of listed Spanish firms during the period 1999-2002. The results indicated that the higher the insider ownership the better the corporate governance structure, which leads to higher quality financial reports and less likelihood of receiving qualified audit opinion, while, the presence of family members on the board increases the probability of receiving a qualified audit opinion.

2.3. Hypotheses Development

According to the theoretical framework of the study, past research and the expected relationships between CG indicators and the type of audit opinion, the following hypotheses are justified and developed:

2.3.1. Board independence

Independent (non-executive) board members have no interest in violating corporate bylaws, rules and regulations. They bring check-and- balance to the board activities, policies and decisions. They supposed to enhance the quality and strength of monitoring as they are not influenced by the company's management or key employees. Some studies found that independent board members lessen the occurrence of corporate wrong doing as well as discretionary accrual (Xie et al., 2003), improve financial reporting and disclosure (sahlan, 2011), or lower earnings management (peasnell et al., 2005). Therefore, the first hypothesis in this study

Ho1: There is a significant negative relationship between the board of directors' independence and the probability of issuing a modified (qualified) audit opinion by external auditors in the non-financial companies listed in Amman Stock Exchange

2.3.2. Board Diligence

Board diligence or activity, as indicated by the number of meetings during a year, often viewed as a sign of board active monitoring of company's affairs. A more active board will normally be more concerned with supervising company's affairs including internal control, decision making, accounting and financial statements preparation and disclosure. Xie *et al*, (2003, 370) found a negative relationship between BofD number of meetings and the level of current discretionary accruals, and Farinha and Viana (2009) found a negative relationship between Board activity (number of meetings) and the likelihood of receiving a modified audit opinion. The second hypothesis without expecting direction is as follows:

Ho2: There is a significant relationship between the number of meetings of the board of directors and the probability of issuing a modified audit opinion by external auditors to the non-financial companies listed in Amman Stock Exchange.

2.3.3. Board size

Some authors argue that increasing the size of the board of directors will increase the monitoring capacity and this should result in higher quality financial reporting or better financial performance (Saibaba 2013). On the other hand, some authors believe that the larger the board size the less the ability to coordinate and communicate among directors, thus leading to ineffective functioning and poor financial reporting quality (Jensen 1993, Ballesta and Garcia-Meca 2005). Mak and li (2001) found that small board size is associated with better

firm performance. Therefore, mixed results are found in the literature with regards to the effect of board size on the firm results and financial reporting quality, which is associated with the type of audit opinion, the third hypothesis is

Ho3: There is no significant relationship between the board of directors' size and the probability of issuing a modified audit opinion by external auditors to the non-financial companies listed in Amman Stock Exchange.

2.3.4. Audit Committee

Audit committee is a good CG tool to control and coordinate internal, and external auditing and increase the efficiency and effectiveness of board actions as concluded in a good number of studies. For example, Chtourou et al 2001 found that earnings management is significantly associated with some of the governance practices by audit committee. For AC income increasing earnings management is negatively associated with a committee composed of outside (independent) board member who meet more than twice a year. Carcello et al 2006 found similar results. Since the qualification and activity of AC are not yet properly disclosed by adequate number of Jordanian companies, this study, as many others, will examine the impact of the presence of AC on the type of audit opinion. Therefore, the fourth hypothesis is:

Ho4: There is a significant negative relationship between the Audit Committee presence and the probability of issuing modified audit opinion by external auditors in the non-financial companies listed in Amman Stock Exchange (ASE).

2.3.5. Duality

Many researchers emphasize the need to avoid duality in firm's management, in order to have responsible CG, which is necessary for the independence of the board and the transparency of the firm's information. That is the need to separate the position of the chairman of the board of directors from the position of the chief executive officer (CEO). Dechow et al, (1996) concluded that duality increases the likelihood of violating the accounting principles. Byard et al, (2006), showed that duality is associated with poor quality financial information. Therefore, the fifth hypothesis is

Ho5: There is a significant positive relationship between duality and the probability of issuing a modified audit opinion by external auditors to the non-financial companies listed in Amman Stock Exchange.

2.3.6. Control Variables

Similar studies have used variety of control variables, the most common ones, are corporate size and profitability. This study will use these two-control variables, and further it will use the number of institutional investor representatives on the BofD as another control variable.

2.3.6.1. Firm Size

Firm size may be an influencing factor to the nature of audit opinion as auditors are more cautious/conservative with larger clients due to a greater litigation risk by such clients (Reynolds & Francis 2001, Farinha & Viana 2009, and Bystrom 2016). Therefore, this study will use firm size as control variable, and measure it, similar to other researchers, by the natural logarithm of total assets.

2.3.6.2. Profitability

Profitability is another significant contributing factor to the company's financial health. It is an internal source of financing growth and paying liabilities. Consistent firm's profitability lowers the default risk which leads in turn to lower the probability of firm's receiving a modified audit opinion. Bradshaw et al (2001) and Farinha & Viana 2009 found empirical support to the

negative relationship between firm's performance (measured by return on assets: ROA), and the probability of getting modified audit report. This study measures profitability by ROA.

2.3.6.3. Institutional Investors Representatives

Institutional investor representatives are those board members who supposed to be independent because they are appointed by the voting power of the institutional investors in the company. They are assumed to be qualified to do their work in caring more about the company's success and progress to serve the objectives of the investor groups they represent. Therefore, It is assumed that the larger the number of the representatives on the board of director the stronger the CG and, therefore, the lower the probability of getting a modified audit opinion.

The number of representatives is identified from firms' annual reports as this information is made available based on the CG guidelines issued by the Jordanian Securities Commission since 2014.

3. Research Methodology

3.1. Study Model

The following figure presents the possible relationship between effective CG indicators (which consist mainly from BofD characteristics and the formation of AC), financial reporting quality and the cleanness of independent auditor opinion, in the presence of relevant control variables.

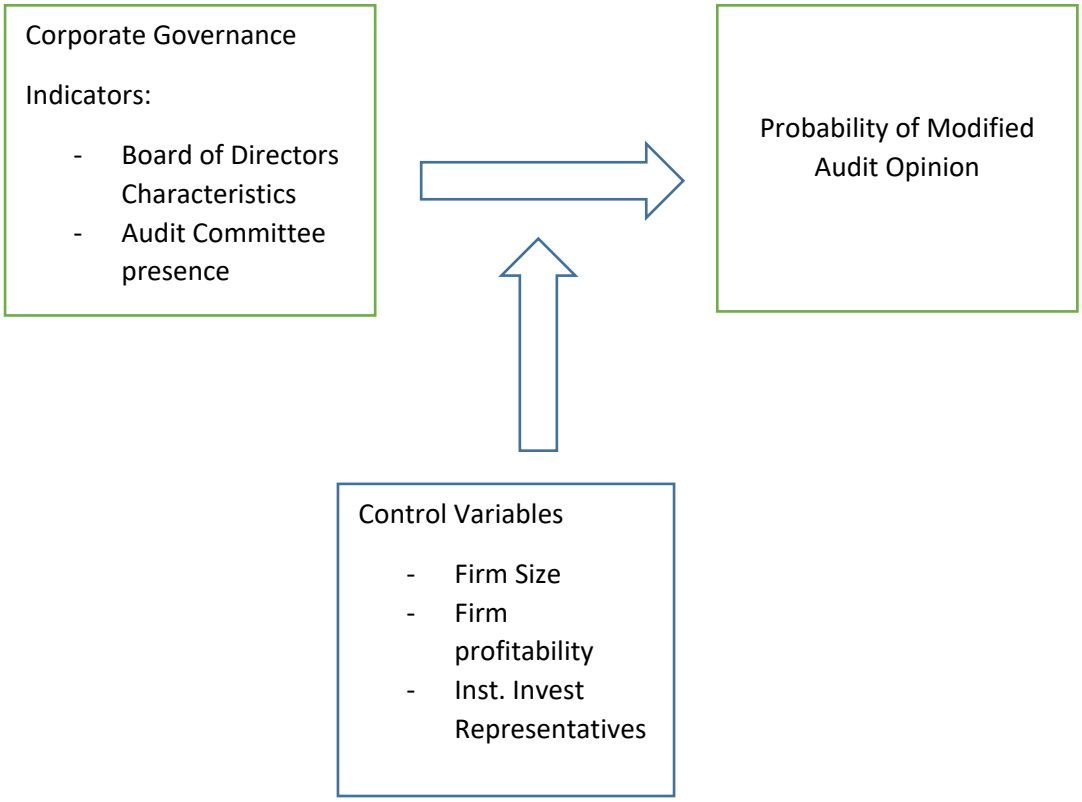

Figure 1. Study Model

3.2. Population and sample

The population of the study consists of all non-financial firms listed in ASE for the year 2015 which:

1-Have their annual reports posted on ASE website

2- Their financial year ends on Dec. 31

3- All required data to compute study variables is included in the annual reports

The above terms resulted in an initial sample of 106 firms out of 139 who supposed to be included in ASE website, for 2015. Two companies were deleted due to outliers' observations leaving 137 companies. Furthermore, thirty-three firms of those remaining in the initial sample either did not provide annual reports or their CG data is missing or severely incomplete were deleted, thus leaving 104 companies in the final sample distributed among the main sectors as shown in table (1) below:

Table 1.
Distribution of sample companies among main sectors

Sector	Number of listed non-financial companies in 2015	Number of non- financial companies in the final sample	Portion of population represented in the final sample
Industrial	54	47	87%
Commercial	10	6	60%
Service	73	51	69.86%
Total	137	104	75.91%

3.3. Statistical Procedures

This study uses the logistics regression as the main statistical approach to examine the relationships between the type of audit opinion and the predictor variables (CG indicators). The model takes the following form:

$$AOT_{it} = B_0 + B_1ndep_{it} + B_2Bsize_{it} + B_3Bmeeting_{it} + B_4Reps_{it} + B_5Duality_{it} + B_6\,ACpres_{it} + B_7\,Fsize_{it} + B_8Profit_{it} + E_{it}$$

Where:

AOT_{it}: Audit opinion type (Dummy variable taking 1 if the opinion is modified and 0 otherwise) for firm I in 2015.

$Bindep_{it}$: Board of director's independence (number of non-executive members over total number of directors) for firm I for 2015.

$Bmeeting_{it}$: Board activity (number of meetings of the board of directors during the year) for firm I for 2015.

$Bsizeit_{it}$: Number of the members of the board of directors for firm I for 2015.

$ACpres_{it}$: Audit committee presence (Dummy variable takes 1 if AC exist and 0 otherwise) for firm I for 2015 for firm I for 2015.

$Reps_{it}$: Number of institutional investors' representatives on the board of directors for firm I for 2015.

$Duality_{it}$: Dummy variable takes 1 if the chairman of the board of directors is also the Chief executive officer at the same and 0 otherwise for firm I for 2015.

$FSize_{it}$: Firm size (the natural logarithm of total assets) for firm I for 2015.

$Prof_{it}$: Firm profitability (return on assets: ROA) for firm I for 2015.

E_{it}: Error term

3.3. Descriptive and Correlation Analyses

Before discussing the results of the study let us provide information on the descriptions of study data and the correlations among variables.

Table 2 below shows the descriptive statistics of study data. It appears from the table that more than one third (36.5%) of sample companies have received modified audit opinions in 2015, which exactly equal to 38 companies out of 104. This indicates that receiving modified audit opinions is not unusual practice in the Jordanian market nowadays. However, this may be due, partially, to the difficult economic condition Jordan suffers over the past number of years due to the particular political environment and unrest in the Middle East region. The economic

growth remained around 2% in Jordan and the unemployment rate as high as 14%, decreasing export and the directing of good portion of the kingdom's budget to support the basic needs of refugees due to the shortage in world donations toward that end. This in turn led to too many companies suffering from losses and decreasing market values.

Table 2.
Descriptive statistics of study data

Variable	Number	Minimum	Maximum	Average	Std. deviation
AOT	104	0	1	.365	.484
Bindep	104	0	1	.581	.146
Bmeeting	104	5	17	8.58	1.859
Bsize	104	3	13	7.81	2.026
Reps	104	1	12	5.29	1.966
Duality	104	0	1	.401	.351
ACpres	104	0	1	.92	.197
FSize	104	13.21	20.97	16.954	1.425
Prof. (ROA)	104	-.94	.26	-.0165	.134

AOT: audit opinion type (1 modified; 0 unmodified or clean)
Bmeeting: number of board meeting in the year
Bsize: number of board members
Bindepen: independence (% of non-executive board member)
Reps: number of institutional investors representative on board
Duality: 1 if the chairman of board is also the CEO, 0 otherwise
ACpres: 1 if the company has an audit committee; 0 otherwise
Fsize (Ln assets): natural logarithm of total assets
Prof: profitability (return on assets: ROA)

The table also shows that the percentage of board independence is 58.1% which is not too high not too low. The average number of board meetings is 8.58 times a year. The average number of institutional investor representatives is 5.29, which relatively high, given the average number of board members (7.8 members). About 40% of sample companies still employ the same person as a CEO and chairman of the board of directors. The frequency tables (not shown here) indicate that 32 companies have duality in the positions of CEO and board chairman, and 12 companies have some sort of duality, meaning that the if the two positions are not held by the same person they are held by close persons like being brothers or of the same family members, which I considered partial or halfway dual. The majority of sample companies (103) have audit committees in place, representing 92%. Firm average size is 16.954. The average profitability (ROA) is negative (-01.65%) indicating the difficult time Jordanian companies have, which results in suffering losses.

Table 3.
Pearson Correlations of study variables

	Bmeeting	Bsize	Bindep	Reps	Duality	ACpres	Size	ROA
Bmeeting	1							
Bsize	0.092	1						
	(0.352)							
Bindep	-0.062	-0.017	1					
	(0.533)	(0.862)						
Reps	-0.059	0.548**	0.314**	1				
	(0.552)	(0.00)	(0.001)					
Duality	-0.008	-0.326**	-0.140	-0.367**	1			
	(0.935)	(0.001)	(0.156)	(0.00)				
ACpres	-0.001	-0.086	0.086	0.012	-0.002	1		
	(0.995)	(0.385)	(0.386)	(0.90)	(0.986)			
Fsize	0.253	0.190*	0.027	0.150	-0.072	-0.054	1	
	(0.010)**	(0.022)	(0.786)	(0.124)	(0.466)	(0.584)		
ROA	0.031	-0.029	-0.02	-0.073	0.146	-0.010	0.427**	1
	(0.751)	(0.773)	(0.837)	(0.46)	0.139	(0.917)	(0.00)	

Table 3 shows the Pearson correlations among study variables. It doesn't appear from the table there is any high correlation between any pair of independent variables. The highest correlation is between Board size and number of Representatives (0.548, sig. at 0.00), and the next highest correlation is between the firm size and ROA (0.427, sig. at 0.00). This indicates there should be no multicollinearity problem in the data.

4. Study Results

Table 4 reports the logistic regression results based on 2-log likelihood estimation procedures with a correct classification of 83.3% of observations. The model chi square is 58.821 which is significant at 0.00 level. The Cox & Snell R^2 is 42% and the Negelkerke R^2 is 57.3%.

Table 4.
Logistic Regression Analysis Results

Variable	B	S.E.	Wald	DF	Sig.	Exp. (B)
Bindep	1.829	2.194	0.695	1	0.405	6.226
Bmeeting	0.223	0.162	1.886	1	0.17	1.25
Bsize	0.44	0.185	5.68	1	0.017	1.553
Reps	-0.367	0.187	3.862	1	0.049	0.693
Duality	1.096	0.898	1.492	1	0.222	2.992
ACpres	5.336	3.535	2.278	1	0.1`31	207.749
Fsize	0.221	0.234	0.886	1	0.347	1.247
ROA	-24.449	5.512	19.676	1	0.000	0.000
Constant	-14.617	5.887	6.166	1	0.013	0.000
Chi-square	58.821	Sig. at 0.000				
Cox & snell R^2 =	0.42					
Nagelkerke R^2	0.573					
classification	83.3%					

The results show that Board size is a significant positive predictor of the probability of issuing a modified audit opinion by the company's auditor (sig= 0.017). This somewhat unexpected results indicate that the larger the number of the board members the higher the probability of issuing a modified audit opinion. These results, although unexpected, agrees with that of Ballesta & Garcia-Meca (2005), and to some extent with Farinah and Viana (2009) who did not that find board size to have significant impact on the probability of issuing a modified audit opinion.

The board activity (number of meetings during the year) is not a significant predictor of the type of audit opinion (sig=0.17). This result agrees somewhat with that of Farinha and Viana (2009), who did not find board activity to be significant determinant of the type of audit opinion.

Board independence is not also significant predictor of the type of the audit opinion (sig= 0.405). This result, although not expected, agrees with that of Ishak and Yusof (2015) who did not find that board independence lowers the probability of issuing modified audit opinion, but disagrees with that of Ishak and Yusof (2013), who found the independence of the board members (on the separate risk management committee) significantly lower the probability of modified audit opinion.

Duality, audit committee presence and company size are not significant predictors of the type of audit opinion (sig= 0.222 and 0.131 and 0.347 respectively).

On the other hand, the following two variables are significant negative predictors of issuing modified audit opinion. The first one is the number of the institutional investors' representatives on the board of directors which is significant at the 0.049 level. This result is expected as institutional investors' representatives are supposed to be more independent board members who practice stronger control over the company's affairs and care more about the interest of the investment groups they represent, and the company's overall good financial health. The other variable is profitability (ROA) as it is significant at 0.00 level, indicating that the higher the firm's profitability the lower the probability it gets modified audit opinion. This result is also expected as profitable firms are not subject to any pressure to manipulate their financial information and results, or misstate company's assets or liabilities.

5. Summary and Conclusion

Corporate governance (CG) is a system of controlling corporate management's actions and policies in order to protect the interest of stockholders and other financial statements users in general (stakeholders).

The OECD describes it as "a set of relationships between a company's management, its board, its shareholders and other stakeholders. It provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy.

This study aimed at exploring the relationship between some CG indicators and the probability of issuing a modified audit opinion by the independent auditor. The CG indicators valued in this study are those most currently dealt with in the CG literature. They include, first, the board of directors' independence, which is a basic condition for the proper functioning of corporate management. Second the board activity as indicated by the number of meetings in the year. It initially seems that the more active the board of directors the more productive it is which is good for the company. However, the results of research in this are mixed. Some support the presence of negative impact on the probability of issuing modified audit opinion, some support the presence of positive impact and still some did not find any significant impact as this study did. The board size, as it is known up to certain limit, the larger the board the more varied and rich the experience it has which is useful for rational decision making. Again, the research results in this area is also mixed. Some support, some refute and some did not find relationship. This study finds that the larger the board of directors the greater the probability of issuing a modified audit opinion, which is unexpected result but agrees to some extent with some other previous studies. Duality, audit committee presence and company size were not found to be significant predictors of the type of audit opinion.

On the other hand, the following two variables are significant negative predictors of issuing a modified audit opinion. The first one is the number of the institutional investors' representatives on the board of directors. This result is expected as institutional investors' representatives are supposed to be more independent board members who practice stronger control over the company's affairs and care more about the interest of the investment groups they represent, and the company's overall good financial health. The other variable is profitability (ROA), which indicate that the higher the firm's profitability the lower the probability getting a modified audit opinion. This result is also expected as profitable firms are not subject to any pressure to manipulate their financial information and results or misstate company's assets or liabilities.

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