Dividend is a substitute or an outcome of Auditor Monitoring? Another Evidence

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Introduction:

This study, examines the relationship between monitoring of auditor and dividend payout policies. The literature on dividend policy asserts that dividends payout policies can be used as a mean of monitoring the board of directors and mitigating agency concerns (Easterbrook 1984; Jensen 1986; Smith and Watts 1992). The most recent study of Skinner and Soltes (2011) shows that dividend-paying companies report more persistent earnings. Moreover, the managers of these companies have the higher tendency of issuing earnings guidance (Huang 2010). However, conceptually, the monitoring function performed by auditors also plays an essential role in mitigating agency conflicts (Jensen and Meckling 1976; Simunic and Stein 1987; Watts 1977; Watts and Zimmerman 1983), which seems to be supported by evidence

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from empirical studies of (Choi and Wong 2007; Fan and Wong 2005; Francis and Wilson 1988). The role of auditor in mitigating the conflict of interest originate from its independent assurance of financial information, as suggested by studies indicating that the quality of audits improve the quality of the company's financial reporting environment (Becker et al. 1998; De Angelo 1981; De Fond and Subramanyam 1998; Francis and Yu 2009; Reichelt and Wang 2010; Reynolds and Francis 2000; Teoh and Wong 1993). La Porta et al. (2000) suggested two agency models of dividends: the outcome model and the substitution model. The outcome model indicates that stronger auditor monitoring is allied with greater dividend payouts. The outcome model indicates that strong investor protection force the managers to disburse the excess cash in the form of dividends and thus protects shareholders. On the basis of this model we assert that stronger audits improve the quality of financial information, thus outsider shareholders can better monitor managers and, in turn, force them to disburse excess cash among shareholders. Hence, the outcome model predicts that stronger auditor monitoring is associated with greater dividend payouts. The empirical findings in La Porta et al. (2000) support this prediction. While contrary to it, the substitution model suggests that dividends can act as a legal protection for the minority shareholders. Porta et al. While the results of the study of John and Knyazeva (2006), which was based on a U.S. market sample where investor protections are strong, favors the substitution theory. This inconsistency in the results suggests further research is required to explore the relationship between audit monitoring and dividend policy.

To analyze the impact of auditor monitoring on dividend policy like the previous study of Anderson et al. (1993), Cohen et al (2010) and Engel et al. (2010), we used total audit fees paid by the firm as our proxy for auditor monitoring of the financial reporting process. The rationale of using audit fees as primary measure is that, previous studies show audit fee is positively related with auditor effort and better judgment of auditor concerning the properties of accruals, ceteris paribus (Davis et al. 1993; Srinidhi and Gul 2007).

The study used the large sample of data from 2005-2010 and observed auditor monitoring is positively and significantly associated with dividend payouts of the firm. Since in Pakistan the firms are recognized with concentrated ownership and have more likelihood to exploit the minority shareholders by paying less dividends thus auditor monitoring may have a positive impact on dividend payouts and thus exploitation of minority shareholder will be reduced.

This study is the contribution in the existing literature. Because, this paper is the first to document a relationship between auditors monitoring of the financial reporting process and a corporations dividend payout policy with more specific reference to Pakistan.

Collectively, the findings of this paper provide further insight to regulators and investors concerning the overall role of external auditors in corporations' governance environment of Pakistan.

The study further proceeds as follow. Section 2 describes the literature review, while section 3 provides the detailed methodology which is followed by the results and conclusions respectively.

2. Literature View:

According to, Miller and Modigliani (1961) in a perfect market the dividend policy of the firm do not matter. However, theories contrary to it assert that the dividend policy of the firm matter, because dividend policy is a helping tool in mitigating the agency cost between stakeholders and agents (Easterbrook 1984; Jensen 1986)

The empirical study of Smith and Watts (1992) provides convincing evidence of association between dividend policy and agency costs and suggested that agency theory can explain the dividend policy more convincingly than signaling or tax theories of dividend.

La Porta et al. (2000) examined the association between minority shareholder rights across multiple countries and dividend payout policies and observed that monitoring by external auditors does not provide the same investor protections imposed by a country's securities laws enforcement, thus the interests of minority shareholders could be protected by paying higher dividend payouts.

Fan and Wong (2005) conducted their study on East Asian countries and suggested where the conflicts of interests are difficult to mitigate by using traditional means in such cases the firms are most likely to hire the services of Big 5 auditors, to act as a mechanism of reducing the conflict of interest among shareholders and managers.

Similarly the study of Choi and Wong (2007) also observed that Big 5 auditors play a very vital in reducing the agency conflict in such countries where protection mechanism for investor is weak.

To observe whether the auditor charge higher audit fee to the client with higher agency problem, Cohen et al. (2010) concluded there is a positive relationship between price of audit and free cash flow. Firm specific result of their study also indicate that positive association between audit price and free cash flow is weaker for the firms with more leverage and low growth.

According to Jensen and Meckling (1976) the monitoring function by an independent auditor is an example of bonding cost that a firm pays in order to increase the firm value and reduce agency cost. Moreover, Watts and Zimmerman (1983) reviewed the history of auditing and observed that the development of the auditing profession is the result of market demand for reducing the opportunistic behavior of the agent more than the govt efforts.In line with these theoretical predictions, Francis and Wilson (2008) find that firms with greater agency conflicts have more chances to switch to Big 8 auditors because, Big 8, auditors perform more effective monitoring functions than non-Big 8 auditors.

3. Methodology:

3.1 Data and Data Sources:

In order to assess the impact of auditor monitoring on dividend policy of the firm, study collected the data of 140 firms listed on Karachi Stock Exchange for the period 2005-2010. For homogeneity purpose study only considered the manufacturing sectors and thus ignored the service industry of Pakistan. Study used the annual reports of firms to collect the data on various variables used in the study. Annual reports of the firms were obtained from the Karachi Stock Exchange. Moreover, the data used in the study is panel data.

3.2 Variables and Their Explanation:

The study used the following model to observe the relationship between auditor monitoring and dividend policy

$$Div_{i,t} = \alpha\ \beta_1 AUDMO_{i,t} + \beta_2 PER_{i,t} + \beta_3 FSZ_{i,t} + \beta_4 LEV_{i,t}$$

Here in above model

Div_{it}= is used as dependent variable and captures the amount of cash paid as dividend to the shareholders.

$AUDTMO_{it}$= is Auditor monitoring. Study measured it by taking into account the audit fee. The measurement of audit fee is consistent with the previous studies of (Cohen et al.2010; Engel et al. 2010; Lawson, 2011).

PER_{it}= is Firm performance. Study measured it by taking into account the EBIT (Earnings before interest and Tax) of the firm.

FSZ_{it}= natural log of book value of assets.

LEV_{it}= Long term debt/ total equity.

4. Results

Among the fixed effect and random effect test which is to be used it is analyzed on the basis of F-statistics in panel data. Moreover, if the presence of fixed or random effect is determined in F test, Hausman test reflects the model to be used (Green, 1993). The results in table 1 indicate there is no fixed effect both in cross section and time section. However, the results obtained by Hausman test while selecting the fixed effect model or random effect model are shown in table 2. These results indicate that there is cross section random effect in model.

Table 1: F Test Result

Effects	Statistics	d.f	prob
Cross-section F	6.635451	(60,295)	0.0000
Cross-section Chi-square	308.379899	60	0.0000

Table 2: Hausman Test Results

Test Summary	Chi-Sq. Statistics	Chi-Sq. d.f.	Prob

Cross-section random	3.536646	5	0.6178

Table 3: Panel Data Analysis Estimation Results

Variables	Coefficient	t-value	p-value
AUMO **PER** **FSZ** **LEV**	**0.00063** **1.90E-07** **-3.06E-08** **2.688214**	**2.910467** **0.853463** **-1.634396** **0.789257**	**0.0038** **0.3940** **0.1031** **0.4305**
R-Squared **F-Statistics** **Probability F-Statistics** **Durbin Watson**	**0.027** **2.466538** **1.72**		 **0.044686**

5. Conclusions:

The results in table: 3 indicate that auditors monitoring is significantly and positively related with dividend payouts policy of firm. These results strongly favor the application of outcome model among the competing agency models of the dividends in Pakistan and thus imply that strong auditor monitoring improve audit quality due to which managers are forced to pay dividends. Moreover, among the control variables firm performance and firm size showed the positive relationship with dividend payouts while leverage showed negative relationship. The results of the study are in line with prior studies.

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