

## Chapter 2

# Corporate Governance Characteristics and Audit Fees: Evidence From Portugal and Spain

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### ABSTRACT

*The purpose of this chapter is to analyze the effect that corporate governance measures have in external audit fees in two countries where this matter is not much developed: Portugal and Spain. The analysis includes a sample of 39 listed companies on the Portuguese Stock Exchange and 104 listed companies on the Spanish Stock Exchanges for the years 2013 to 2015 using an OLS regression model. For the Spanish sample, the results show that the capital hold by the Board of Directors influence negatively external audit fees. The results are in accordance with the supplier perspective which states that better corporate governance practices decrease the control risk and, consequently, audit fees. On the other hand, the Board of Directors' diligence also affected external audit fees but positively, that is, the greater the number of meetings the greater the demand for an audit with quality which result in higher fees charged (demand perspective). For the Portuguese sample it can be observed that corporate governance characteristics do not affect external audit fees.*

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## **INTRODUCTION**

The profession of auditing as an activity whose main function is to contribute to the reliability of information is experiencing a strong pressure on its ethical position, independence and quality. Audit fees can jeopardize the auditor's independence to the extent that if they are set high they can lead to evidence of corruption between client and auditor, but if too low it can also be indicative that the auditor did not take the necessary efforts to issue a proper opinion.

In general, external audit fees are defined considering three important aspects: client characteristics, auditor characteristics and corporate governance characteristics (Kikha, 2014). With the various financial scandals that resulted in a global economic instability, the importance of corporate governance in the business world has substantially increased.

The implementation of the Sarbanes-Oxley Act (SOX), considered as the most extreme change in securities market laws in the U.S.A (Calder, 2008) has promoted the importance of corporate governance with the creation of a set of practices and measures of auditing, supervision and control. This study aims, therefore, to focus on the relationship between characteristics of corporate governance and external audit fees, given the relevance and interest that these two themes have in the current world, in Portugal and Spain. These two countries that form the Iberian Peninsula have a strongly related economic and cultural history, having also joined the European Union on the same date. In addition, Portugal and Spain have particular corporate governance' characteristics and the subject audit fees have not been much studied in these countries which makes important to understand its behavior by comparing results. Besides that in Portugal the liberalization of audit services was made with the elimination in 2005 of the table setting the minimum fees based on the size standards of the audited company. So the perception about this matter is very limited for Portugal which makes this study more interesting.

In fact, most of the studies that have focused on the relationship between corporate governance mechanisms and audit fees present an Anglo-Saxon corporate governance model, such as the US, UK and Australia, which are characterized by strong legal protection and transparency in the dissemination of information.

Unlike the Anglo-Saxon countries, listed companies in Portugal and Spain are characterized by a concentrated shareholder structure. In Spain, this concentrated structure creates conflicts of interest between majority and minority shareholders (Castells, Sanz, & Chiner, 2013). The reduction of agency costs caused by the separation of ownership and management is due to the high presence of controlling shareholders (majority) in the Board of Directors (Cristobal, Uceda, & Navallas, 2011). Also "the ownership in Portuguese listed firms is highly concentrated. This feature can influence the earnings management activity, because it is highly concentrated in determining the nature of the agency problem in Portuguese firms "(Alves, 2012, p.59).

The importance of the Audit Committee has also stood out as the codes of good governance have undergone updates, reinforcing their role as supervisory body. It is important, however, to point out that this code is voluntary and not mandatory "unlike in countries such as the UK, where these recommendations constitute, in effect, 'strong guidance' (Sánchez, Frias-Aceituno, & Garcia, 2012).

In Portugal, the structure of administration and supervision is more complex than in Spain since the Commercial Companies Code (CSC) allows companies to opt for the Latin, Anglo-Saxon or Germanic (dualist) model considering what is best for them. Thus, according to CSC: the management and supervision of the company may be structured in one of three ways: a) Board of Directors and Supervisory

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