



Impact of Corporate Governance on Audit Fees and Audit Quality:

A STUDY IN THE INSURANCE INDUSTRY OF BANGLADESH

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Abstract

Corporate Governance, audit fee and Audit quality are very important components for any organization to ensure internal control and financial reporting procedures. This study is primarily done to measure the impact of corporate governance on audit fee and audit quality in the insurance sector of Bangladesh considering the growing importance of insurance industry for economic development. Though more than 63 insurance companies are working now in Bangladesh covering life and general insurance, for the analysis of the scenario, information was collected about 40 insurance companies out of 47 listed insurance companies in Dhaka Stock Exchange. Among them 8 are life insurance company and other 32 are general insurance company of Bangladesh. All the annual report of Insurance Company has been selected for 2017. It is evident that the audit fee of insurance companies of Bangladesh is too much lower than that is proposed in minimum audit fee schedule by the Institute of Chartered Accountants of Bangladesh (ICAB). Therefore, the contemporary study targets to assess the relationship between corporate governance, audit fee and audit quality in the insurance sector of Bangladesh. For this motive panel regression is used to analyze the relationship, and the results showed that Corporate Governance (CG), Firm Size (FS) and leverage have a positive relationship with audit fee and CG, FS and audit fee have a positive relationship with audit quality.

Introduction:

Insurance sector is now one of the largest contributory sectors in the total economy of Bangladesh. This sector generally signals the prospect and probability of other sectors too, as insurance sector assists other sectors to be safe from disasters. Insurance industry particularly has special social interest because of its various functions in society. The main aim of the modern insurance industry is to minimize the risk by association of the insured into the institutionalized risk communities, i.e., insurance companies and to ensure direct economic protection against negative effects of risk actuation through indemnity (Njegomir and Tepavac, 2014). In addition to the primary function, insurance companies are also involved in exchange and trade, credit improvement, mobilization of funds, effective capital allocation and other activities that contribute directly to the society. So the successful management of this industry is very crucial for all stakeholders and for entire community. And that is only possible through good corporate governance which confirm a better quality audit and also have an impact on the determination of appropriate audit fees. So Corporate Governance, audit fee and Audit quality are very important components for any organization to ensure internal control and financial reporting procedures. Governance in corporation and its effectiveness can lead to organizational success. Reputed audit firms are consistently trying to improve the corporate governance mechanism (Abdullah, 2008). On the other hand, failure or ineffectiveness of corporate governance can lead to financial distress. Corporate governance practices ensure that audit quality is properly maintained. Audit quality ensures the accountability of the firm. Empirical evidence also shows that poor corporate governance decreases the audit quality of financial reporting (Cercello et al., 2002). The purpose of this research is to observe the relationship between corporate governance, audit fee and audit quality; and measure the impacts of corporate governance on audit fee and audit quality.

Literature review

Audit and Audit fee

According to Iskak (1999) (cited in Suharli, Michell & Nurlaelah, 2008), audit fee is charged by a public accountant to the respective client for the financial audit services. This matches the opinion of Bangladesh

Securities and Exchange Commission (BSEC) that, the audit fee is the fees that must be paid for annual audits, assurance and review of financial statements for every fiscal year. The amount of audit fee is not fixed. Audit fee varies depending on these factors like assignment risk, the complexity of service, the level of expertise required, the cost structure of client's firm, and other professional considerations, terms and conditions. Members of Public Accounting Firm are not allowed to have clients by offering a fee that could spoil the image of the auditing profession. So, all the considerations must be concluded to provide certainty to public accounting members and clients that audit fee will reflect the responsibility and risk of public accounting.

Audit Fee and Corporate Governance

Several researches have been conducted to take a look at the relationship between the audit fee and CG. Study of Chow (1982), discovered the positive and significant relationship between audit fee & CG. Griffin, et al. (2010) mentioned that CG has both the positive (increasing) & bad (decreasing) affect over the audit fee. Arshad, et al., (2011), examined the positive impact of Audit committee over the profitability of firm. According to Hamza (2018), there is a significant impact of corporate governance principles on auditor's independence and audit fees.

Firm Size

A plethora of research supplies the evidence between firm size and audit fee and determines the positive relationship between them. Study of Francis and Wang (2005), located the positive relationship of Audit fee with firm size. They analyzed that audit fee is related to total property of company. Similarly, Hay, et al. (2006), relates the audit fee with audit quality and found the positive relationship between them. Moreover their study also concluded that audit fee determines the audit quality.

Firms Leverage

Highly leveraged corporations have more chances of becoming bankrupt, that will lead to positive relationship between the companies' leverage and audit fee because greater audit efforts are required for evaluation of leveraged company. Lu and Sapara (2009), mention that larger business risk association will increase customer's pressure for higher auditing quality, which in turn results in increase of audit fee. Similarly, Bedard and Johnstone (2004), observed the positive relationship between the company's leverage and audit fee.

Audit Firm's Size

Big 4 Audit firms in Bangladesh considered in this study are: 1. Rahman Rahman Huq, KPMG in Bangladesh; 2. A. Qasem & Co., Ernst & Young Global Limited; 3. Deloitte Bangladesh Limited, Nurul Faruk Hasan & Co. (Nufhas); 4. PWC Bangladesh Private Ltd.

There are several reasons for charging high fees by large audit firms; Such as:

- Large audit firms charge higher fee due to the fact of its monopoly or oligopoly in market.
- Large audit firms charge a premium due to the fact of their audit quality services as in contrast to the services provided through their competitors.

DeAngelo (1981) suggests that large audit firms have high level of reputational risk so provides a quality service to their customers & charges higher amount for that.

Audit Quality

According to American Accounting Association's (AAA) Financial Accounting Standard Committee (2001), audit quality is determined by the professional competence and sufficient independence. Widiastuty and Febrianto (2010) said that audit quality is an audit operated by a competent, expertise and independent person. All audit must meet the required auditing standards and quality control standards, because one of the most essential objectives of external financial reporting is to decrease company conflicts between the association and its various stakeholders (Healy and Palepu, 2001; Hope et al., 2008). However, in addition to the direct effects of audit quality on accounting trustworthiness, oblique consequences of audit excellency are additionally observed; these effects are mediated by way of the associations between audit excellency and different mechanisms of corporate governance (O'Sullivan, 2000; Carcello et al., 2002; Abbott et al., 2003; Knechel and Willekens, 2006). Broye and Weill (2008) through an empirical study examined an effect of audit quality on economic debt holders and document the existence of a fantastic affiliation between audit first-class and leverage. Numerous researches have reported that audit quality is generally applicable to the funding decisions that are made through investors and other participants in capital markets. Because Insurance Companies are regularly collecting funds from external shareholders, there is no reason to anticipate that audit quality possessing much less significance

in the insurance industry than in different industries that have been addressed by prior research. Audit fees (Lin and Hwang, 2010), auditor size (Boone et al., 2010), and auditor recognition (Hope et al., 2008) are the most commonly listed indications of audit quality. These indicators are all conveniently relevant to the Big 4 (or 5 or 6) auditors. These Big 4 auditors are not only the biggest auditors in the world, but are also generally the auditors with the best reputations and highest prices. According to Hay et al. (2006), a Big 4 binary variable is the most commonly used indicator of audit quality. Hope et al., (2008), propose that the capacity to detect material error in the financial statement is a function of auditor's competence, whilst the propensity to correct or reveal the material error is a function of audit committee independence from the Board. Based on the overwhelming proof that the use of Big 4 auditors is strongly associated to audit quality measures, this study uses Big 4 auditing as a proxy variable for audit quality.

Corporate Governance and Audit quality

Board Size

According to Lipton and Lorsch (1992), the dimension of the board is associated with board's controlling and monitoring ability. However, the literature on the effectiveness of board measurement on its monitoring efficiency is mixed. Some argue that companies with smaller board are better governed. For example, Ozkan (2007) states that smaller boards are more effective in monitoring activities due to the fact they enjoy higher interaction and communication. However Lipton & Lorsch (1992) and Jensen (1993) argue that larger boards are related with the board monitoring capability because companies with larger board enjoy extra expertise and experience. In alignment with these arguments and findings, we assume that the board size provides toward the board high-quality and such board will demand high quality audit, leading to enlarge in audit fees.

Board Independence

It is the primary obligation of the independent directors to monitor the movements and decisions of top managers to guard the shareholders' interest from the managers' opportunistic behavior. Prior research found that the independent directors are thought about as sound governance mechanism due to their monitoring function, because they

are not under the any hierarchal authority and do not face the issue of retaliation. Moreover, Beatty and Zajac (1994) also stated that the independent directors are regarded to be really useful for the organization, because they are much less conciliatory for top management. In alignment with the above argument, preceding research suggested that board independence is positively related with audit fees, because the independent directors demand high-quality audit.

Audit Committee

The Blue Ribbon Committee's (BRC) (1999) gives a strong suggestion concerning the existence of an audit committee and its characteristics like audit committee size, independence and financial information of the audit committee which results in strong audit committee oversight of financial statement disclosures. According to McMullen and Roghurandan (1996), the internal audit committee of a company helps reliable financial reporting and reduces the incidence of errors, irregularities and every other such indicator of unreliable reporting. Their finding assists that the presence of an audit committee will lead to high corporate disclosures. Similarly, Bangladesh Code of Corporate Governance (2012) also ensures the existence of internal audit committee and expects a better financial reporting as an effect of a presence of audit committee.

Audit Committee Size

BRC report (1999) suggests that in order to be effective an audit committee must consist of adequate members with greater independence. According to Braiotta (2000), suggestions involving audit committee size are to improve its organizational status. Correspondingly, large sized audit committee is legitimized by way of a meaningful organizational guidance from the board and regarded as an authoritative body, not only by internal audit function, but also by way of an external auditor.

Audit Committee Independence

According to Abbott et al., (2003), the improved percentage of non-executive directors on audit committee strengthens oversight of financial reporting, which leads to lower probabilities of unreliable financial reporting. Therefore, non-executive directors dominated audit committee facilitate excessive high-quality of financial reporting and improves the objectivity of the audit committee.

They documented a high-quality relationship between audit committee independence and audit fee.

Based on the valid arguments and empirical studies shown by the literature we can develop the following hypothesis which will be tested by the research model:

Hypothesis formulation: -

H1: There is positive relationship between audit fee and audit quality.

H2: Audit quality is positively related with firm size.

H3: In case of better corporate governance audit quality will be better.

H4: More the leveraged company, higher will be their audit fee.

H5: In case of better corporate governance audit fee will be higher.

H6: Larger the firm size the audit fee will be higher.

H7: The larger the audit firm, the higher the audit fee will be charged.

Research Methodology

The research paper is carried out on the basis of secondary data found in the listed insurance companies of Dhaka Stock Exchange (DSE) in Bangladesh. There are 47 listed insurance companies in DSE of which 12 are life and 35 are non-life (general) insurance company. For the purpose of this study 40 listed insurance companies were taken out of which 8 are Life Insurance Company and 32 are general insurance companies. The Dhaka Stock Exchange (DSE) website and Lanka Bangla investment portal have been used to collect the necessary data.

An essential purpose of this study is to observe the relationship of CG and Audit Fee. And the analysis consists of total 5 variables: Audit Fee (dependent variable), G-score (Independent variable) and Firm size, Audit firm size and Leverage (three controlled variables).

The other essential purpose of the study is to observe the relationship of CG and Audit Quality for which 4 variables are selected: Audit Quality (dependent variable), G-Score (independent variable) and Firm Size and Audit Fee (controlled variables).

Tables 1, 2 and 3 provide the operational definitions of these variables.

Table 1: Operational Definitions of Study Variables

Name of Variable	Symbol	Definitions
Dependent Variable:	Audit Fee	Natural log of audit fee
Independent Variable: Governance score	G-Score	It is measured by summing up the four variables, i.e., Board Size, Board Independence, Remuneration & Audit Committee and Audit Committee Independence. It indicates maximum governance quality 4 and minimum governance quality 0.
Control Variables : Firm size	F Size	Firm size is calculated by taking natural log of firm's total asset. Big 4 audit firms of Bangladesh. If it is related to one of the big 4 audit firms of Bangladesh, variable takes the value 1, or
Auditor firm size	Big 4	if it is not related to one of the big four audit firms of Bangladesh, variable takes the value 0.
Leverage	Leverage	Calculated as total debt/ total assets of the company.

Table 2: Operational Definitions of Study Variables

Name of Variable	Symbol	Definitions
Dependent Variable: Audit Quality	Audit Quality	It is measured by summing up the three variables, i.e., Big 4 audit firms, Audit Committee Independence and Presence of board-reporting internal Auditors
Independent Variable: Governance score	G-Score	It is measured by summing up the four variables, i.e., Board Size, Board Independence, Remuneration & Audit Committee and Audit Committee Independence. It indicates maximum governance quality 4 and minimum governance quality 0.
Control Variables : Firm Size	F Size	Firm size is calculated by taking natural log of firm's total asset.
Audit Fee	Audit Fee	Natural log of audit fee

Table 3: Definitions of four Dichotomous Variables used for G-Score

Name of Variable	Symbol	Definitions
Board Size	B Size	If the company board size less than the sample median value takes the value 1 or otherwise takes the value 0.
Board Independence	B Independence	If the company percentage of independent outside directors is greater than sample median value takes value 1 or otherwise takes the value 0.
Remuneration & audit committee	REM_Audit	If the company have both the remuneration and audit committees takes value 1 or If the company doesn't have both the remuneration and audit committees takes value 0
Audit committee Independence	Aud Independence	If the company percentage of independent outside directors on the audit committee is greater than sample median value takes value 1 or otherwise takes the value 0.

This research study is a quantitative analysis (using STATA software) to determine the impact of CG on audit fee and audit quality in the insurance sector of Bangladesh, thus retaining the operational definitions of the variables and hypotheses of the study, the research models are produced as follows:

Model 1: $\text{Audit Fee} = \beta_0 + \beta_1 \text{G-Score} + \beta_2 \text{FS} + \beta_3 \text{Big4} + \beta_4 \text{Lev} + \varepsilon$

Model 2: $\text{Audit Quality} = \beta_0 + \beta_1 \text{G-Score} + \beta_2 \text{FS} + \beta_3 \text{Audit Fee} + \varepsilon$

Findings

Descriptive Statistics of four Dichotomous Variables:

Table 4 shows the descriptive statistics of four dichotomous variables. The table shows that the median value of board size (BS) is 17 for board independence, the median value is 12% for independent directors in board structures. Moreover, median value of remuneration & audit committee is 1. Finally, for audit committee independence, the median value is 25% independent directors in Audit committee.

Table 4: Descriptive Statistics of Four Dichotomous Variables

	Obser.	Mean	Median	Maxi.	Mini	Std. Dev
Board Size	40	16.2	17	20	5	3.53
Board Independence	40	0.15	0.12	.40	.05	0.07
REM_Audit Committee	40	1	1	1	1	1
Audit Committee Independence	40	0.30	.25	.67	.11	0.15

Descriptive Statistics of Study Variables for Model 1:

Table 5 shows the results for descriptive statistics of all the 5 variables. Results shows the log value of audit fee ranges from 6.09 to 4.70 having mean value of 5.35, median value 5.38 & standard deviation 0.30. Similarly, governance score (G-Score) of sample firms ranges from maximum value 4 to minimum value 1, mean value of G-Score is 2.3,

median value 2 & standard deviation 1.07. Moreover, log value total assets of sample firms to represent the firm size ranges from maximum value 10.64 to minimum value 8.79, having a mean value of F. Size is 9.39, median value 9.16 & standard deviation 0.52. However, maximum leverage value is 0.16 and minimum value of leverage is 0 with mean value of 0.02 & median value of 0. Big 4 being a dummy variable have maximum value of 1 and the minimum value of 0.

Table 5: Descriptive Statistics of Study Variables for Model I

	Obser.	Mean	Median	Maxi.	Mini	Std. Dev.
AuditFee	40	5.35	5.38	6.09	4.70	0.30
GScore	40	2.3	2	4	1	1.07
FSize	40	9.39	9.16	10.64	8.79	0.52
Big 4	40	0.1	0	1	0	0.30
Lev	40	0.02	0	0.16	0	0.04

Descriptive Statistics of Study Variables for Model 2:

Table 6 shows the results for descriptive statistics of all the 4 variables. Results shows the log value of audit quality ranges from 2.4 to 1.11 having mean value of 1.34, median value 1.25 & standard deviation 0.26. Similarly, governance score (G-Score) of sample firms ranges from maximum value 4 to

minimum value 1, mean value of G-Score is 2.3, median value 2 & standard deviation 1.07. Moreover, log value total assets of sample firms to represent the firm size ranges from maximum value 10.64 to minimum value 8.79 , having a mean value of F. Size is 9.39, median value 9.16 & standard deviation 0.52. However, maximum audit fee value is 6.09 and minimum value of audit fee is 4.70 with mean value of 5.35 & median value of 5.39.

Table 6: Descriptive Statistics of Study Variables for Model 2

	Obser.	Mean	Median	Maxi.	Mini	Std. Dev.
Audit quality	40	1.34	1.25	2.4	1.11	0.26
G-Score	40	2.3	2	4	1	1.07
F. Size	40	9.39	9.16	10.64	8.79	0.52
Audit Fee	40	5.35	5.39	6.09	4.70	0.30

Regression Analysis for Model 1:

Regression analysis was performed to find out whether corporate governance (CG), firm size (FS), auditor firm size (Big 4) and leverage are the predictors of audit fee. Major findings of the regression analysis in form of estimated relationships are shown in the Table 7. Table 7 provides “beta” value for every variable as well as its standard error in parenthesis. In order to estimate the relationship, audit fee was regressed on the corporate governance (CG), firm size (FS), leverage and auditor firm size (Big 4). The results illustrate that there is a positive impact of corporate governance (CG) on audit fee (=0.0232464). This statistically significant result supports the hypothesis (H₅) that there is positive

relationship between the audit fee and corporate governance (CG). Again, the results show that there is a positive and significant impact of firm size (FS) on audit fee (= .2348427). This result additionally supports the hypothesis (H₆) of the study that there is positive relationship between the audit fee and firm size (FS). Similarly, there is a positive impact of Leverage on audit fee (=0.0025096) supported (H₄) and auditor firm size (Big 4) on audit fee (=0.3147481) (H₇). Moreover, outcomes of the regression analysis also show that independent variables, (Corporate governance(CG), firm size(FS), leverage & audit firm size(Big 4), account for 29.70% significant variance in

audit fee ($R = .2970$). Thus, hypotheses of the study are established and these outcomes are in consistent with preceding studies.

Table 7: Regression Results for Model I

*(5 variables, 40 observations pasted into data editor)						
Regressauditfeegscore fs bigfour lev						
Source	SS	df	MS	Number of obs = 40		
Model	1.07546081	4	.268865202	F(4, 35) = 3.70		
Residual	2.54550823	35	.072728807	Prob> F = 0.0130		
				R-squared = 0.2970		
				Adj R-squared = 0.2167		
				Root MSE = .26968		
Auditfee	Coef.	Std. Err.	T	P> t	[95% Conf. Interval]	
Gscore	.0232464	.0405698	0.57	0.570	-.0591147	.1056075
Fs	.2348427	.0837198	2.81	0.008	.0648824	.4048031
Bigfour	.3147481	.143463	2.19	0.035	.0235027	.6059934
Lev	.0025096	1.028139	0.00	0.998	-2.084724	2.089744
	3.064438	.7915812	3.87	0.000	1.457442	4.671433

Regression Analysis for Model 2:

Regression analysis was performed to find out whether corporate governance (CG), firm size (FS) and audit fee are the predictors of audit quality. Major findings of the regression analysis in form of estimated relationships are shown in the Table 8. Table 8 provides "beta" value for every variable as well as its standard error in parenthesis. In order to estimate the relationship, audit quality was regressed on the corporate governance (CG), firm size (FS) and audit fee. The results illustrate that there is a positive impact of corporate governance (CG) on audit quality ($= .1107733$). This statistically significant result supports the hypothesis (H_3) that there is a positive relationship between the audit quality and

corporate governance (CG). Again, the results show that there is a positive and significant impact of firm size (FS) on audit quality ($= .0086045$). So the result supports the hypothesis (H_2) of the study that there is a positive relationship between the audit quality and firm size (FS). Similarly, there is a positive impact of audit fee on audit quality ($= .3059354$) which support hypothesis (H_1). Moreover, outcomes of the regression analysis also show that independent variables (Corporate governance (CG), firm size (FS), audit fee account for 38.18% and significant variance in audit fee ($R = .3818$). Thus, hypotheses of the study are established and these outcomes are in consistent with preceding studies.

Table 8: Regression Results for Model 2


*(4 variables, 40 observations pasted into data editor)						
regress audit quality g score fs auditfee						
Source	SS	Df	MS	Number of obs = 40		
Model	.99595376	3	.331984587	F(3, 36) = 7.41		
Residual	1.61250316	36	.044791755	Prob> F = 0.0005		
				R-squared = 0.3818		
				Adj R-squared = 0.3303		
				Root MSE = .21164		
Total	2.60845692	39	.066883511			
Auditquality	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
Gscore	.1107733	.0319726	3.46	0.001	.0459298	.1756167
Fs	.0086045	.0721966	0.12	0.906	-.137817	.155026
Auditfee	.3059354	.1243375	2.46	0.019	.0537673	.5581034
_cons	-.6337465	.7123869	-0.89	0.380	-2.078534	.8110411

Conclusion

Throughout this extensive study, it becomes clearly evident that corporate governance, audit fee and audit quality are not isolated from each other. The results of the study through Model I demonstrate

that there exists a positive relationship between the G-Score and Audit Fee. Moreover, the effects also showed that there exists a positive relationship between Audit Fee and Firm Size. Further, the results

showed that there is positive relationship of Audit Fee with Leverage. Finally, the relationship between Audit Fee and Audit Firm Size is positive. Thus, the outcomes of the present study prove that audit fee is a function of corporate governance (CG), firm size (FS), audit firm size (big 4) and leverage. Similarly Model 2 demonstrate that there exists a positive relationship between the G-Score and Audit Quality. Moreover, the results also showed that there exists a positive relationship between Audit Quality and Firm Size and also have a positive relationship of Audit Quality with Audit Fee. Thus the outcomes of the present study prove that audit quality is a function of corporate governance (CG), firm size (FS) and the size of the audit firm. Actually basic corporate governance ensures high audit quality and in that relationship audit fee plays its role. To ensure better and more applicable audit quality, corporate governance and its proper practices within and outside the organization needs to be addressed. Audit fee needs to be reasonably good so that it doesn't distract corporate governance. Other issues that might come into equation like Broad size, Leverage, Firm size needs to be reviewed to reduce the gap that ultimately be beneficial for corporations.

The insurance companies are now facing extreme competition due to contemporary forces of globalization, changing customer's demands and technological changes for better quality. To survive in this turbulent environment, organizations not only have to encourage good corporate governance practices, but also have to improve their performance for transparency of financial statements and assurance of fairness. In order to refrain management from the activities detrimental to the welfare of the company, audit fee structure, good corporate governance and audit independence should get the highest importance. 

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