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Institutional Investors on Boards and Audit Committees and Their Effects on Financial Reporting Quality

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Institutional directors and the quality of information: the role of directors appointed by banks

ABSTRACT

Manuscript Type: Empirical

Research Question: The objective of this paper is to study the impact that directors who represent institutional investors have on the quality of financial reporting. We focus on those who maintain business relations with the firm on whose board they sit (pressure sensitive directors), and analyze their influence both on Boards and Audit Committees. Additionally, we examine the specific role of bank directors on Boards and Audit Committees and examine their effects on the quality of information when they act as shareholders and directors.

Research Findings/Insights: Our results suggest that institutional directors are an effective monitoring device that leads to higher quality of financial reporting and, therefore, to less likelihood of qualified audit reports. Consistent with the relevant role of business relations with the firm, we find that directors appointed by pressure sensitive investors, both in Boards and Audit Committees, have a higher impact on the unqualified audit opinion. Nevertheless, when analyzing separately, only savings banks representatives on the Board increase the pressure to issue a clean audit opinion.

Theoretical/Academic Implications: The results confirm that Board characteristics have an important influence on financial reporting quality, in line with the views that have been expressed by several international bodies (e.g., FRC, 2003; OECD, 2004). The findings also suggest that both researchers and policy makers should no longer consider institutional investors as a whole, since directors appointed by different types of institutional investors have various implications on the audit opinion.

Practitioner/Policy Implications: This study makes its core contribution by empirically showing that directors appointed by different types of institutional investors have diverse implications on the audit opinion. This evidence could be potentially helpful in providing a basis for regulatory actions, namely those aiming to influence the structure of the Board of directors. The results have significant implications for supervisors and regulators, whose role in safeguarding the financial system will benefit from an understanding of how the presence

of savings banks and commercial banks in non-financial firms Boards impacts audit opinion in a bank-based system.

Key words: Corporate Governance, Audit Committee, Board of Directors, Institutional Investors, Financial Reporting Quality

INTRODUCTION

Persistence of accounting scandals has led to profound reconsideration of the workings of boards and audit committees. Research has shown that board characteristics may affect the quality of the board's supervision of the financial reporting process (e.g. Beasley, 1996; Xie et al., 2003) and extant research on this issue has focused on board composition, specifically on the presence of independent directors (Klein, 2002; Peasnell et al., 2005). However, along with the presence of these directors, there are other board members that have hardly been studied in the literature: directors appointed by institutional investors.

Institutional investors are among the most important controlling shareholders in continental Europe, where the principal agency conflict focuses on the expropriation minority shareholders wealth by controlling shareholders. In civil-law countries the importance of institutional investors as supervisors compensates for the weaknesses of investor protection laws (Faccio and Lang, 2002; de Andrés et al., 2005).The specific agency problems in European Continental countries have led to large block-holders, especially the institutional ones becoming directors. Thus, directors appointed by institutional investors (from now on institutional directors) have a significant influence on European Continental boards, accounting for 40 per cent of directorship in Spain, compared to 2 per cent in British firms (Heidrick and Struggles, 2011).

Whereas recent studies have shown the prevalence of large institutional shareholdings around the world, research on the influence of institutional investors as directors is still scarce. Moreover, whether the role of non-independent non-executive directors (also known

as ‘grey directors’) is more like that of inside directors or outside directors remains ambiguous in the corporate governance literature (Hsu and Wu, 2010). Research has found that institutional directors have an important influence on leverage (Booth and Deli 1999; García-Meca et al., 2013), firm value (Kumar and Sighn, 2012), and earnings management (García and Gill, 2007). Given the importance of institutional investors in allocating capital to corporations, as well as their role in firm governance, an understanding of how their presence in boards affects the quality of financial information is undoubtedly needed. Our paper tries to fill this gap in the literature as, to the best of our knowledge, we are the first to study the influence of directors appointed by institutional investors on the likelihood that a firm receives a qualified audit opinion.

Our analysis follows three steps. First we study the impact directors who represent institutional investors, both on boards and audit committees, have on the quality of financial reporting. In a second step, according to recent literature, we assume that institutional investors cannot be considered as a homogeneous group due to their different incentives and ability to engage in the corporate governance (Almazán et al., 2005; Cornett et al., 2007; Chen et al., 2007). We propose that the type of business relations between firms and institutional investors is a key issue to describe the role of institutional directors and, thus, their effects on the quality of information. Accordingly, we make a distinction between those who maintain business relations with the firm on whose board they sit, and institutional investors whose business activity is not related to the company in which they hold a directorship. In a third step, we focus on the specific role of bank directors on boards and audit committees and analyze their effects on the quality of information when they act as shareholders and directors.

We use a sample of Spanish listed firms between 2004 and 2010. Spain is a good paradigm to study the effectiveness of institutional directors due to its being the European

country with the highest presence of institutional investors on the boards of large firms (Heidrick and Struggles, 2011). Differences both in the corporate governance systems of Spanish firms and the Spanish auditing system highlight the futility of extrapolating for Spain from studies of the Anglo-Saxon markets (Fernández and Arrondo, 2007). Unlike the Anglo-Saxon capital markets, the ownership concentration and the lack of liquid capital markets in Spain have resulted in the board of directors being the prevalent mechanism of control and in the presence of the large block-holders, especially institutional investors, as directors. Regarding auditing processes, incentives implemented in countries with more of a tradition of auditing to help maintain high auditing quality are fairly limited in Spain (Ruiz Barbadillo et al., 2004). Finally, Spain offers a unique opportunity to analyze the conflicts of interests that arise from banks being simultaneously shareholders, creditors, and directors.

Our results suggest that institutional directors are an effective monitoring device that leads to higher quality of financial reporting and, therefore, to less likelihood of qualified audit reports. Consistent with the relevant role of business relations with the firm, we find that directors appointed by pressure sensitive investors, both in boards and audit committees, have a higher impact on the unqualified audit opinion. Nevertheless, when analysing separately, commercial banks and savings bank representative directors show different attitudes. In this case, savings banks representatives on the board increase the pressure to issue a clean audit opinion. This could be justified by the specific composition of these entities, where the regional and local governing bodies exercise a decisive power in firm strategy[1]. Even though the Unified Code of Corporate Governance in Spain (2006) highly recommends forming audit committees of entirely independent and institutional directors, we fail to document a significant impact of the former, highlighting that it is the institutional (specifically pressure sensitive) and not the independent, the board and audit committee members, that influence the audit opinion. One explanation for this finding could be the "substitution effect hypothesis"

between institutional and independent directors. If this is the case, different levels of control provided by a single mechanism might be equally efficient, depending on the intensity of the control performed by other mechanisms available (Fernandez and Arrondo, 2005). To a certain extent, this lack of consistency could also lie in the lack of investor confidence in the role and true independence of "independent" directors in Spain (Crespí-Cladera et al, 2007; Lorca et al., 2011).

Overall, our results confirm that board characteristics have an important influence on the quality of financial reporting, in line with the views that have been expressed by several international bodies (e.g., FRC, 2003; OECD, 2004). Because the principal agency conflict in continental Europe and many other countries focuses on the expropriation of minority shareholders' wealth by controlling shareholders, the analysis of the institutional directors' influence on the quality of financial information highlight as a priority research question. The findings in this research partly support the importance of the monitoring function of non-executive directors on the main board and audit committee. This study makes its core contribution by empirically showing that directors appointed by different types of institutional investors have varied implications on the audit opinion. This evidence could be potentially helpful in providing a basis for regulatory actions, namely those aiming to influence the structure of the board of directors. An understanding of the factors associated with audit qualification could also act as an aid to the auditor's assessment of the engagement risk, including the planning process.

PREVIOUS LITERATURE AND HYPOTHESES DEVELOPMENT

Prior studies set in Anglo-Saxon environments suggest that the existence of an audit committee and the independence of such a committee and of the full board of directors are associated with the quality of an entity's financial reporting and auditing practices (Abbott

and Parker, 2000; Carcello and Neal, 2000; Raghunandan et al., 2001; Farihna and Viana, 2009). However, other studies (García-Osma and Gill, 2007; Sánchez-Ballesta and García-Meca, 2009) show that independent directors appear to be less effective in carrying out this theoretical role of monitoring management in Communitarian countries, noting that the effect of board independence depends on investor protection rights. Specifically, the majority of the results on the monitoring role of independent directors in Europe show inconclusive results (Sánchez and García, 2009; Lorca et al., 2011), and some highlight that the supervising role is not played by independent directors, as UK and US based research suggests, but by institutional directors, that is, those representing the controlling shareholders (García-Osma and Gill, 2007).

The assumed benefit of improved independence stems from the belief that independent directors are better monitors of management than are inside directors (DeFond and Francis, 2006). On the other hand, insiders and others close to the company might have firm- or industry-specific knowledge that would aid in director performance (Donaldson and Davis, 1991; Kiel and Nicholson, 2003). Thus, some research at the board level reports that the market values inside directors on the board (Rosenstein and Wyatt, 1997; Klein, 1998). Hence, although outside directors serve as monitors and help minimize agency conflicts between shareholders and management; inside and affiliated directors provide firm-specific expertise that is valuable for planning the firm's operations and development (Klein, 2002).

Institutional investor interests, which are mainly to create the maximum level of return for their beneficiaries, lead directors appointed by them to extend their influence to the decision-making board committees, given that increased share value resulting from direct supervision can compensate for any supervisory costs that may be directly incurred. This puts pressure on corporate managers to make the company look attractive to institutional investors and to create more shareholder value. Thus, monitoring by institutional investors is likely to

result in improved firm performance because, as large and sophisticated shareholders, institutional investors have the incentive and expertise to monitor the management and can do so at a lower cost than atomistic shareholders (Shleifer and Vishny, 1986). They are also able to exert enough influence to alter the governance structure and the firm's course of actions.

Institutional investors are known to influence various important corporate decisions. Agrawal and Mandelker (1990), Almazán et al. (2005), Borokhovich et al. (2006), Brickley et al. (1988), Bushee (1998), Ferreira and Matos (2008) and Hartzell and Starks (2003) show that institutional investors influence antitakeover amendments, R&D investment decisions, CEO compensation and profitability. Ramalingegowda and Yu (2012) also note that higher ownership by institutions that are likely to monitor managers is associated with more conservative financial reporting, and Ljungqvist et al. (2007) support the hypothesis that the presence of institutional investors provides incentives for analysts to publish unbiased or less biased research. In addition, institutional investors are often characterized as sophisticated investors who have advantages in acquiring and processing information compared with individual investors (e.g., Kim et al.1997; Bartov et al., 2000).

Given institutional shareholder incentives to supervise managerial actions, a positive influence of institutional directors on the quality of information would be expected. We believe that because earnings information is important for business valuation purposes, institutional directors demand high quality information and exert more influence than other board members. This is because institutional owners, as a group, command large amounts of capital that are professionally managed and employed in the equity markets. Using this capital, institutional owners can exert influence by buying and selling large blocks of a firm's securities, and by holding voting rights that can be directly employed to influence the decisions of management (Kane and Velury, 2004). The existence of sophisticated institutional investors could also induce managers to provide high quality audits (Felo et al.,

2003). According to these authors, by doing so, institutions can delegate the actual task of monitoring to auditors, and the cost of that monitoring is borne by all shareholders within the firm (the "delegation" hypothesis). Rajgopal et al. (2002), Chung et al. (2002), and Jiraporn and Gleason (2007) also suggest institutional investors serve as monitors, mitigating earnings management behavior. In this line, some authors find that the higher the proportion of non-executive board members, the lower the probability of accounting fraud (Beasley 1996; Xie et al., 2003; Peasnell et al., 2005).

Regarding the audit committee, the Unified Code of Corporate Governance (2006) in Spain, recommends forming audit committees entirely of external directors (i.e., independent and institutional directors) in a proportion similar to that of the board of directors. According to previous research, when audit committees are made up by a high proportion of institutional directors, they are more likely to be more effective in protecting the credibility of the firm's financial reporting since they are also external directors and independent of management (Pucheta-Martínez and de Fuentes, 2007). In this case, it will also be more difficult for management not to accept the adjustments proposed by auditors (McMullen and Raghunandan, 1996; Song and Windram, 2004).

In this line, Carcello and Neal (2003) report that when an affiliated director is able to dominate the audit committee, management can often pressure the auditor into issuing an unqualified report despite going concern issues and may even go so far as to dismiss its auditor for refusing to change an opinion with qualifications. Klein (2002) also found a significantly negative association between abnormal accruals and the percent of outside directors on the audit committee. Similarly, García-Osma and Gill (2007) found that the main role in constraining earnings management in Spain is played by institutional and not independent directors. Hsu and Wu (2010) note that that greater the number of grey directors on the board and audit committee of UK firms, the lower probability of corporate failure.

However, more independent outside directors on board and audit committee may not effectively contribute to decrease the likelihood of corporate failure.

In short we hypothesize that a higher number of institutional directors will increase the likelihood that the quality of financial statements will be better controlled and will increase the pressure to issue a clean audit opinion:

Hypothesis 1: The quality of financial information is affected by the presence of institutional directors on both boards and audit committees.

Theoretical work by Shleifer and Vishny (1986), Maug (1998) and Kahn and Winton (1998) highlights the choice institutions face between exerting monitoring effort for shared gain versus simply trading for private gain. Institutional investors vary in a number of dimensions, including the skill of their employees, their resources or incentives to gather information and the implicit or explicit pressure from firms in which they invest due to potential business relations (Brickley et al., 1988). In this line, different authors note that the presence or absence of business relationships can condition the institutional investor's levels of influence. Researchers such as Brickley et al. (1988), Agrawal and Mandelker (1990), Bushee (1998), Hartzell and Starks (2003), Almazan et al. (2005), Borokhovich et al. (2006), Ferreira and Mato (2008) and Ramalingegowda and Yu (2012) have shown that certain types of, but not all, institutional investors exert influence on antitakeover amendments, R&D investment decisions, CEO compensation, profitability, and earnings conservatism. García-Meca et al. (2013) also show that institutional directors have diverse incentives to engage in corporate governance, noting different effects on cost of debt depending on the type of institutional director.

In order to better understand institutional monitoring and the sometimes conflicting evidence, we study institutional investors within boards of directors and audit committees and focus on pressure sensitive investor directors, who are those that maintain business with the firm in which they invest - basically directors who represent banking and insurance companies. Pressure sensitive investor directors focus mainly on the firm's long-term viability, having more incentives to collect and process information. In this line, Brickley et al. (1998) find evidence supporting that firms with greater holdings by pressure-sensitive shareholders (banks and insurance companies) have more proxy votes cast in favor of management's recommendations.

Porter (1992) argues that "long-term" or "dedicated" owners alleviate pressures for myopic investment behavior because their holdings provide incentives to monitor managers. Similarly, Dobrzynski (1993) and Monks and Minow (1995) argue that institutions that invest in firms with the intention of holding substantial ownership blocks over a long horizon have stronger incentives to monitor the firm. Han et al. (2009) show that firms are more likely to hire a Big 4 auditor when long-term institutional ownership is high, suggesting that long-term institutional investors view high quality audits as a viable means of improving corporate governance, while reducing their direct monitoring costs. Their results suggest that dedicated long-term institutional investors demand higher quality audits to enhance corporate monitoring, and that short-term institutional ownership is positively associated with higher audit risk. Prior research (e.g., Shleifer and Vishny, 1986, Brickley et al., 1988, Gaspar et al., 2005 and Chen et al., 2007) also suggests that institutional investors' demand for conservatism is more likely to emanate from monitoring institutions with long term investment horizon.

In contrast, pressure-resistant investors are known to put pressure on management to meet short-term earnings targets, which can increase the likelihood of financial misreporting-

Coffee (1991) notes that short-term institutional investors may have incentives to sell their stock due to poor performance rather than initiate corrective action.

While this evidence is suggestive, these studies do not investigate directly the relationship between directors appointed by pressure sensitive investors and the quality of information. Thus, we pose the following hypothesis:

Hypothesis 2: The quality of financial information is affected by the presence of pressure-sensitive institutional directors on both boards and audit committees.

Nevertheless, even within pressure sensitive investors (insurance companies and banks) there are some differences. Banks are the most prevalent and identifiable representative of institutional investors, especially in Continental countries. On the other hand, in the US, earlier regulation has caused the corporate governance system to differ historically from that in other countries such as Spain, Germany and Japan where, by design, institutions (particularly banks) have played a large role in the ownership and monitoring of corporations (Gillan and Starks, 2006).

In Spain, banks are not only a major source of funding and financing for the country's business fabric but they also hold strong positions as company stockholders and members of boards. Bankers can play a certification role on the board since a banker joining the board of a firm can signal to the market that the firm is unlikely to experience financial distress. Hadlock and James (2002), Johnson (1997) and Lummer and McConnell (1989) document that long-term relations between banks and non-financial firms reduce the asymmetric information and allow banks to control firm's decisions. Thus, they diminish the adverse selection and moral hazard problems. Ljungqvist et al. (2007) also evidence that analysts issue more optimistic

recommendations when they are affiliated with banks that have an existing relationship with the firm covered and when they work for banks with larger businesses.

In addition, after recent regulation changes and press coverage following the accounting scandals, the need has been stressed for financial expertise on corporate boards. Thus, if a bank develops specialized knowledge through lending to many firms in a particular industry, bankers could provide valuable industry-specific financial expertise as board members of firms in that industry (Kroszner and Strahan, 2001). Moreover, a qualified report is costly for a bank director because free-rider problems and information asymmetries make it difficult for firms to renegotiate with creditors.

The Spanish banking system is an industry with two main institutions, commercial banks and savings banks, which compete with each other for loans and deposits. Spanish savings banks have a special governance structure, since they are controlled by politicians and public entities (Sapienza, 2004; Crespí et al., 2004). In recent last years the regional regulation have increased the presence of public administration in savings banks at the expense of depositors' representation, leading the regional and local governments to exercise a decisive power in the renewal of the governing bodies and the establishment of the savings banks' strategy (Fonseca and González, 2005)[2]. Thus, it is interesting to analyze separately how the governance of these banks affects the quality of financial reporting when they are members of other firms' boards and audit committees. This comparison is relevant since both commercial and savings banks operate under the same regulatory framework and market conditions. We therefore pose the following hypothesis:

Hypothesis 3: The quality of financial information is affected by the presence of commercial and saving bank directors on both boards and audit committees.

EMPIRICAL DESIGN

Sample

The sample is drawn from the population of Spanish non financial firms listed on the Spanish Stock Exchange during 2004–2010. We exclude financial companies both because they are under special scrutiny by financial authorities that constrain the role of their board of directors and because of their special accounting practices. We obtain our data from two databases. Audit opinion, financial information and firms' market value come from the **"Sistema de Análisis de Balances Ibéricos" (SABI)** database, while corporate governance information is collected from the annual corporate governance reports that all the listed companies have had to publish since 2003.

We build an unbalanced panel of 627 firm-year observations from 162 firms. Roughly, our sample accounts for more than 95 percent of the capitalization of Spanish non financial firms. The panel is unbalanced because during this time period some firms became public, and other firms delisted as a consequence of mergers and acquisitions. Nevertheless, the estimations based on unbalanced panels are as reliable as those based on balanced panels (Arellano, 2003).

Variables

The dependent variable (IA) is a dummy variable that equals 1 when the company receives a qualified audit opinion and 0 otherwise. Some other papers have used audit opinion as a proxy for the quality of information (Bartov et al., 2000; Chen et al., 2001; Butler et al., 2004; Pucheta and de Fuentes, 2007; Farihna and Viana, 2009).

As independent variables, we define INST as the proportion of institutional directors on the board. These are mainly directors appointed by institutional investors and they often represent banking and insurance companies or investment funds. INDEP variable represents

the independent members of the board. In line with García-Meca et al. (2013), we define SENSIT as the proportion of the board members who are representative of pressure-sensitive institutional investors (i.e., banks and insurance companies). Given our special attention to the roles played by the different institutional investors, we define the COM_BANK variable as the proportion of directors who are representative of commercial banks and SAV_BANK as the proportion of directors who are representative of saving banks.

We define analogous variables concerning the presence of these directors on the audit committee. Specifically, INSTAC and INDEPAC represent the existence of institutional and independent directors on the audit committee respectively. SENSITAC is a dummy variable that takes the value 1if there are pressure-sensitive representatives on the audit committee, COM_BANKAC and SAV_BANKAC are respectively dummy variables for directors appointed by commercial banks and saving banks on the audit committee.

We control for a number of factors that can potentially affect audit opinion and that make our research comparable to previous studies. SIZE is the log of total assets and is a measure of firm size. Carcello et al. (1995) and Mutchler et al. (1997) report a negative relationship between company size and the receipt of a qualified audit report. In line with deAngelo (1981) this is probably due to the fact that the issuance of qualified audit reports could cause a switch of the audit firm, and the initial auditor would lose the quasi-rents associated with future audits of the client.

Previous literature shows that big auditors provide higher quality services (Teoh and Wong, 1993) and they are also better able to express a qualified opinion (Lennox, 1999; Farinha and Viana, 2005). Thus, we propose BIGFOUR as a dummy control variable that takes the value 1 if the opinion is issued by a Big Four audit firm. Regarding the ownership structure, Sánchez and García-Meca (2005) reported that director ownership is an effective monitoring device that leads to higher quality of financial reporting and therefore, less

likelihood of receiving qualified audit reports. Then, we define DIREC_OWN as the percentage of stock owned by directors. In addition, we expect that the larger the audit committee, the harder it would be for managers to put pressure on a significant number of members, making it more difficult to resist the adjustments proposed by auditors. Thus, we include as control variable AC_SIZE, defined as the size of the audit committee and measured as the number of members.

Given that financial health has been identified as a factor that may increase the likelihood of the auditor's issuing a qualified audit report (Carcello et al., 1995; Mutchler et al., 1997), two variables have been included to control for the financial distress effect. These are LEV as a proxy for the agency cost of debt and measured by debt over total assets and losses in the previous year (LOSS). We also control for the return on assets (ROA), defined as operating income before interests and taxes over total assets. According to previous literature (e.g. Sloan, 1996; Bradshaw et al., 2001) we expect a negative relationship between audit qualifications and ROA because, from the auditor perspective, lower ratios mean a higher probability of corporate failure. ROA gives an idea as to how efficient the management is at using its assets to generate earnings. Previous evidence shows that ROA is a significant factor in explaining corporate failure. In this sense, Altman (1968), Altman et al. (1977), Izan (1984), Mcgurr and DeVaney (1998), Laitinen and Laitinen (2000), Zapranis and Ginoglou (2000), Ginoglou et al. (2002), Beaver et al. (2005) and Lakshan and Wijekoon, (2013), among others, found ROA as a significant variable. Table 1 provides a summary of all the variables.

Insert table 1 about here

RESULTS

Descriptive Statistics

Table 2 presents the mean value, the median, the standard error, and the percentiles 10 and 90 of the main variables. As can be seen, representatives of large shareholders account for around 44.39% of directorships on the board and 78% on the audit committees, with pressure sensitive institutional investors representing 7% on the board and 20.60% on the audit committee. In accordance with the international trend to increase the importance of institutional investors (Li et al., 2006 and Cuatrecasas, 2012), the proportion of directors appointed by institutional investors in our sample has grown from 42.97% in 2004 to 45.45% in 2010 on the board and from 77.78% in 2004 to 79.57% in 2010 on the audit committee. The presence of independent directors is 30.03% on the board and 84% on the audit committee. These data provide evidence that the percentage of institutional investors, pressure sensitive and independent directors is higher on the audit committee than on the board.

In addition, it can be appreciated that the size of the company is 13.56 (log of the total assets), 86% of the companies are audited by one of the big auditing firms, 27.03% of the directors of the board held shares and the size of the audit committee, on average, is 3.5 members. Finally, we would like to highlight that the level of leverage of the companies is 58.64%, on average, 12% of the companies reported losses the previous year and the companies report a return on assets, on average, of 3.43%.

Insert table 2 about here

In table 3 we present the Pearson correlation matrix in order to test for multicollinearity. The correlation between most of the pairs is not significant and is low, generally below 0.3. None of the correlation coefficients is high enough (> .80) to cause multicollinearity problems (see Archambeault and DeZoort, 2001; Carcello and Neal, 2000), except the pair SENSITAC-

SAV_BANKAC, which is correlated by construction. According to these results, we can, therefore, conclude that the models are free of multicollinearity problems.

Insert table 3 about here

Table 4 shows the mean difference of INST, INDEP, SENSIT, COM_BANK, SAV_BANK, INSTAC, INDEPAC, SENSITAC, COM_BANKAC, and SAV_BANKAC variables between firms with unqualified and qualified audit reports to test for the presence of differences in means between both groups of companies. The analysis of the results reveals that the presence of institutional investors, pressure-sensitive institutional investors and saving banks on the board (INST, SENSIT and SAV_BANK) and on the audit committee (INSTAC, SENSITAC and SAV_BANKAC) is higher in companies receiving unqualified audit reports. This implies that institutional investors, pressure-sensitive institutional investor and saving banks directors on the board and on the audit committee enhance the quality of the financial information. On the other hand, the results report that the mean difference for independent and commercial banks directors on the board and on the audit committee between unqualified and qualified audit reports is negative and positive, respectively, but none of them is statistically significant. Therefore, it seems that institutional investors, pressure-sensitive institutional investors and saving banks directors exert much more control on the board and audit committee than independent and commercial banks directors, in order to enhance the quality of the financial information.

Regression Results

In table 5 we show the results of the logistic regression for the board. As can be observed, we have built three models. Model 1 analyses the proportion of institutional directors (INST) and independent directors (INDEP) on the board. In model 2, only the variable proportion of the board directors who are representative of pressure-sensitive

institutional investors (SENSIT) is examined, while model 3 studies the proportion of the board that represents commercial banks (COM_BANK) and saving banks (SAV_BANKS). The Chi-squared test shows that the three models are statistically significant at 1%.

Insert table 5 about here

According to our predictions, and as can be appreciated in model 1 of table 5, the variable institutional investors sitting on the board (INST) presents the expected sign and is statistically significant at 5%. Thus, we can accept Hypothesis 1 and it can be concluded that the proportion of institutional investors sitting on the board enhances the quality of financial information since their presence reduces the likelihood of receiving qualified audit reports. The variable proportion of independent directors sitting on the board offers the expected sign, but it is not statistically significant. This shows that institutional investors on the board exert much more influence than other board members regarding the demand for high quality of the financial information. Authors such as Almazán et al. (2005), Borokhovich et al. (2006), Brickley et al., (1988), Bushee (1998), Ferreira and Matos (2008), Ljungqvist et al. (2007) and Ramalingegowda and Yu (2012) also provide evidence of the positive impact of this class of directors on firms.

In model 2, the influence of the pressure-sensitive institutional investors on the quality of financial information is analyzed. The results reveal that the variable SENSIT, which represents this category of directors, presents the expected sign and is statistically significant at 5%. As a result, the second hypothesis can be accepted, and therefore, we can reach the conclusion that pressure-sensitive institutional investors (banks and insurance companies) sitting on the board decreases the likelihood of receiving qualified audit reports. This implies a high quality of financial information. This evidence is in line with prior research which reports that not all institutional investors, but only some types, exert influence on corporate

decisions (Brickley et al., 1988; Hartzell and Starks, 2003; Almazan et al., 2005; Ferreira and Mato, 2008; Ramalingegowda and Yu, 2012 and García-Meca et al., 2013).

In Spain, the presence of institutional investors representing banks is more prevalent than institutional investors representing insurance. In addition, banks on the board will exert more control in the company, demanding a high quality of the financial information, since bad quality financial information can make it more difficult for firms to renegotiate with creditors. For this reason, in model 3 we analyze the impact of this type of directors sitting on the board (COM_BANK and SAV_BANK) on the quality of the financial information. According to the results in table 5, it can be seen that, contrary to our predictions, the variable COM_BANK is not statistically significant. On the other hand, the variable SAV_BANK presents the expected sign and is significant at 5%. Consequently, Hypothesis 3 is partially accepted since only the presence of saving banks sits on the board increases the quality of the financial information because the likelihood of receiving qualified audit reports is reduced. Hadlock and James (2002), Johnson (1997), Lummer and McConnell (1989) and Ljungqvist et al. (2007) document the relevant role that bank directors sitting on the board play in the companies.

As regards the control variables, in the three models all of them show the expected sign, but only the size of the company (SIZE) and the return on assets (ROA) are statistically significant at 1% or 5%. Therefore, these results provide evidence that large companies with high levels of return on assets are likely to receive less qualified audit reports. Consequently, these firms offer higher quality financial information.

To sum up, the analysis of the structure of the board shows that the proportion of institutional investors, pressure-sensitive institutional investors and saving banks directors enhances the quality of financial information, as the presence of these directors reduces the likelihood of receiving a qualified audit report. Similar results have been reported by

Ramalingegowda and Yu (2012). Thus, this result reveals the important role that institutional investors on the Spanish boards play as a mechanism of Good Corporate Governance.

In table 6 we provide the results of the logistic regression for the audit committee. As with the board, three models also have been built in the same way. According to the Chi-squared tests, the three models are statistically significant at 1%.

Insert table 6 about here

In model 1, the variables which represent the presence of institutional investors and independent directors sit on the audit committee present the expected sign, but only the presence of institutional investors (INSTAC) is statistically significant at 10%. In line with Felo et al. (2003) and García-Osma and Gill (2007), independent directors on audit committees (INDEPAC) do not affect the quality of information. Thus, Hypothesis 1 can be also accepted. In model 2, the variable SENSITAC representing the presence of pressure-sensitive institutional investors is negative, as predicted, and statistically significant. Therefore, the second hypothesis for audit committees is also accepted. In model 3, neither COM_BANKAC nor SAV_BANKAC are statistically significant, although both offer the expected sign. This last result can be explained because on the audit committee, on average, there are fewer members than on the board and, as a result, the presence of commercial and saving banks is likely to be smaller. In this case, the third hypothesis cannot be accepted. These conclusions reveal that the presence of institutional and pressure-sensitive institutional investors sitting on the audit committee increases the quality of the financial information as the companies where they are appointed are less likely to receive a qualified audit report. Thus, this evidence strengthens the role of institutional investors on the audit committee too, and within this type of directors, pressure-sensitive directors gain notable relevance.

As with the board models, all the control variables report the expected sign, but only the size of the company and the return on assets are statistically significant, and in models 2 and 3 the variable proportion of shares held by the directors is also significant.

In conclusion, big and profitable companies whose directors held shares and where institutional investors and pressure-sensitive institutional investors sit on the audit committees are less likely to receive qualified audit reports, and therefore, the quality of the financial information is higher.

CONCLUDING REMARKS

The specific agency problems in European Continental countries have led to an increasing presence of the large block-holders as directors, especially directors appointed by institutional investors. Although considerable research has been conducted on institutional ownership, the literature to date has failed to reach a consensus on whether institutional investors perform a specific role in boardrooms. Thus, given the importance of institutional investors in allocating capital to corporations and their role in firm governance, an understanding of how their presence on boards affects the quality of financial information is undoubtedly needed. Our study contributes to the literature by providing evidence of the effect of directors appointed by institutional investors on audit opinion. We study the effectiveness of institutional directors in Spain, the European country with the highest presence of institutional investors on boards of large listed firms.

We propose that the type of business relations between firms and institutional investors is a key issue in describing the role of institutional directors and, thus, their effects on the quality of information. Accordingly, we focus on those who maintain business relations with the firm on whose board they sit (pressure sensitive directors), and analyze their influence both on boards and audit committees. In a third step, we examine the specific role of

bank directors on boards and audit committees and analyze their effects on the quality of information when they act as shareholders and directors.

Our results suggest that institutional directors are an effective monitoring device that leads to higher quality of financial reporting and therefore, less likelihood of receiving qualified audit reports. Thus, when boards are made up by a high proportion of institutional directors, they are more likely to be more effective in protecting the credibility of the firm's financial reporting since they are also external directors and independent of management. The results suggest that, compared to independent outsiders, institutional directors may be more effective in overseeing management since they may have more firm-specific knowledge. Moreover, institutional directors have a relatively close relationship with top management, so they may also reduce the conflict between board and top management. These results support the relevant role of institutional directors on boards and the lack of influence of independent directors in European countries, already suggested in the literature.

In addition, despite the fact that in the Spanish context the Unified Corporate Governance Code (2006) holds that the audit committee should be made up exclusively by independent and institutional directors, our results also show that only institutional, non independent directors on audit committees influence the quality of information, suggesting that independent and institutional directors may play distinguishable governance roles both on boards and audit committees. The lack of significance of independent directors on both boards and audit committees, could be related to the measure of independence, in Communitarian studies in general, where there are many concerns that board members are not independent of those who nominate them. Another explanation could be the substitution effect between independent and institutional directors.

Consistent with the significant role of business relations with the firm, we find that directors appointed by pressure sensitive investors, on boards and audit committees, have a

higher impact on the unqualified audit opinion. This confirms that institutions that invest in firms with the intention of holding substantial ownership blocks over a long horizon have stronger incentives to monitor the firm. Nevertheless, when analyzing separately, only saving banks representatives on the board increase the pressure to issue a clean audit opinion. This could be justified by the specific composition of these entities, where the regional and local governing bodies exercise a decisive power in the firm strategy. Moreover, the high politicization of the savings banks could increase the pressure on auditors to issue a clean opinion. Thus, our results suggest that auditors are less likely to modify the reports when firms have board directors appointed by saving banks. The lack of influence of saving banks directors in audit committees could be related to their low representation on this committee.

This study contributes to the literature by showing that one of the ways in which institutional investors play a monitoring role is through influencing audit opinion when they are both board and audit committee members. The findings also suggest that both researchers and policy makers should no longer consider institutional investors as a whole, since directors appointed by different types of institutional investors have varied implications on the audit opinion. The findings are pertinent given the concerns about the regulation and quality of auditing services. Finally, the results have significant implications for supervisors and regulators, whose role in safeguarding the financial system will benefit from an understanding of how the presence of savings banks and commercial banks in non-financial firms boards impacts audit opinion in a bank-based system. Thus, the results have some implications for policy makers who are trying to find a suitable board model for companies and they define the role of independent directors. A greater discussion and analysis is required so that independent directors remain independent of the large shareholders and are able to safeguard minority shareholder rights.

NOTES

[1]In the context of the global financial crisis, criticism of the politicization of the savings banks has shifted to the centre of the political debate after some scandals in the management of some savings banks that have led to their being taken into administration by the Bank of Spain (Caja Castilla la Mancha, CAM, Cajasur). As a consequence, the reform of the savings bank law in 2010 addressed this issue by reducing the political power of public authorities and claiming for the privatization and the professionalization of governing bodies with the aim of depoliticizing the government of savings banks and capitalizing them.

[2]As a consequence, the reform of the savings bank law in 2010 addressed this issue by reducing the political power of public authorities with the aim of depoliticizing the government of savings banks and capitalizing them

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TABLE 1
Variable Definition

Variables	Description
IA	Dummy variable that equals 1 when the company receives a qualified audit opinion, and 0 otherwise
INST	Proportion of institutional directors on the Board
INDEP	Proportion of independent directors on the Board
SENSIT	Proportion of the board directors who are representative of pressure-sensitive institutional investors
COM_BANK	Proportion of the board directors who represent commercial banks
SAV_BANK	Proportion of the board directors who represent saving banks
INSTAC	Dummy variable that equals 1 if institutional directors sit on the audit committee, and 0 otherwise
INDEPAC	Dummy variable that equals 1 if independent directors sit in the audit committee, and 0 otherwise
SENSITAC	Dummy variable that equals 1 if pressure-sensitive institutional investors sit on the audit committee, and 0 otherwise
COM_BANKAC	Dummy variable that equals 1 if commercial banks institutional investors sit on the audit committee
SAV_BANKAC	Dummy variable that equals 1 if saving banks institutional investors sit on the audit committee
SIZE	Total assets (log)
BIGFOUR	Dummy variable that equals 1 when the company is audited by one of the Big Auditing Firm, and 0 otherwise
DIREC_OWN	Proportion of stocks held by directors
AC_SIZE	Total number of members on the audit committee

LEV	Ratio of book debt to total assets
LOSS	Dummy variable that equals 1 if the firm reports losses the previous year, and 0 otherwise
ROA	Operate income before interests and taxes over total assets

TABLE 2
Main Descriptive Statistics

Mean, standard deviation and quartiles of the main variables. IA is equal to 1 if the company receives a qualified audit report; INST is the proportion of institutional investors on the Board; INDEP is the proportion of independent directors on the Board; SENSIT, COM_BANK, SAV_BANK is the proportion of the directors who represent pressure sensitive institutional investors, commercial banks or saving banks on the Board; INSTAC is equal to 1 if institutional directors sit on the audit committee; INDEPAC is equal to 1 if independent directors sit in the audit committee; SENSITAC, COM_BANKAC, SAV_BANKAC is equal to 1 if pressure-sensitive institutional investors, commercial banks directors and saving banks directors sit on the audit committee; SIZE is the log of total assets; BIGFOUR is equal to 1 if the company is audited by one of the big auditing firm; DIREC_OWN is the proportion of shares held by directors; AC_SIZE is the number of members of the audit committee; LEV is the book value of debt over total assets; LOSS is equals to 1 if the company reports losses the previous year; ROA is operate income before interests and taxes over total assets.

a) Continuous variables

Variables	N	Mean	Median	Std. Dev.	Perc. 10	Perc. 90
INST	627	44.39%	44.44%	23.26%	13.33%	75.00%
INDEP	627	30.03%	30.00%	18.74%	0%	55.87%
SENSIT	627	7.03%	0%	10.91%	0%	21.43%
COM_BANK	627	1.14%	0%	4.70%	0%	0%
SAV_BANK	627	5.03%	0%	8.52%	0%	16.66%
SIZE	627	13.56	13.16	2.01	11.10	16.44
DIREC_OWN	627	27.03%	18.52%	26.40%	.04%	65.00%
AC_SIZE	627	3.52	3.00	.85	3.00	5.00
LEV	627	58.64%	60.89%	19.77%	30.09%	81.16%
ROA	627	3.43%	3.83%	9.70%	-3.31%	10.12%

b) Dummies variables

	0	% (0)	1	% (1)
INSTAC	141	22%	486	78%
INDEPAC	103	16%	524	84%
SENSITAC	498	79.40%	129	20.60%
COM_BANKAC	602	96%	25	4%
SAV_BANKAC	532	84.90%	95	15.15%
BIGFOUR	87	14%	540	86%
LOSS	552	88%	75	12%

TABLE 3
Correlation Matrix

Pearson's correlation matrix. IA is equal to 1 if the company receives a qualified audit report; INST is the proportion of institutional investors on the Board; INDEP is the proportion of independent directors on the Board; SENSIT, COM_BANK, SAV_BANK is the proportion of the directors who represent pressure sensitive institutional investors, commercial banks or saving banks on the Board; INSTAC is equal to 1 if institutional investors sit on the audit committee; INDEPAC is equal to 1 if independent directors sit on the audit committee; SENSITAC, COM_BANKAC, SAV_BANKAC is equal to 1 if pressure-sensitive institutional investors, commercial banks directors and saving banks directors sit on the audit committee; SIZE is the log of total assets; BIGFOUR is equals to 1 if the company is audited by one of the big auditing firm; DIREC_OWN is the proportion of shares held by directors; AC_SIZE is the number of members of the audit committee; LEV is the book value of debt over total assets; LOSS is equal to 1 if the company reports losses the previous year; ROA is operate income before interests and taxes over total. *** for 99 percent confidence level, ** for 95 percent and * for 90 percent.

	IA	INST	INDEP	SENSIT	COM_ BANK	SAV_ BANK	INSTAC	INDEPAC	SENSITAC	COM_ BANKAC	SAV_ BANKAC	SIZE	BIGFOUR	DIREC_ OWN	AC_ SIZE	LEV	LOSS
INST	-.11***																
INDEP	.03	-.66***															
SENSIT	-.11***	.14***	-.05														
COM_BANK	-.02	.06	-.04	.47***													
SAV_BANK	-.12***	.10***	-.01	.78***	.08**												
INSTAC	-.09**	.58***	-.35***	.17***	.09**	.11***											
INDEPAC	.01	-.37***	.62***	.03	-.03	.05	-.10***										
SENSITAC	-.11***	.09**	-.02	.71***	.35***	.57***	.27***	.05									
COM_BANKAC	-.04	.054	-.014	.32***	.66***	.07	.12***	.00	.40***								
SAV_BANKAC	-.09**	.04	.01	.55***	.07	.70***	.23***	.03	.83***	.10**							
SIZE	-.16***	.036	.24***	.21***	.16***	.29***	.01	.19***	.19***	.17***	.25***						
BIGFOUR	-.02	-.01	.25***	-.04	.03	.03	-.01	.25***	.07	.08**	.07	.33***					
DIREC_OWN	-.03	.15***	-.33***	-.02	-.10**	-.06	.11***	-.17***	-.07	-.12***	-.10**	-.33***	-.23***				
AC_SIZE	-.09**	.11***	.08**	-.01	.01	-.03	.19***	.15***	.17***	.01	.13***	.27***	.22***	-.10**			
LEV	.00	.14	.05	.01	.14***	.09**	.10**	.06	-.02	.09**	.02	.41***	.13***	-.10**	.04		
LOSS	.12***	-.00	.03	-.05	.06	-.06	.01	.11***	-.04	.05	-.06	-.16***	-.01	.02	-.10***	.14***	
ROA	-.18***	-.02	.04	-.01	.01	-.01	-.01	-.05	.04	.03	.02	.17***	.11***	-.06	.19***	-.21***	-.42***

TABLE 4
Test of Means Comparison

INST is the proportion of institutional investors on the Board; INDEP is the proportion of independent directors on the Board; SENSIT, COM_BANK, SAV_BANK is the proportion of the directors who represent pressure sensitive institutional investors, commercial banks or saving banks on the Board; INSTAC is equal to 1 if institutional investors sit on the audit committee; INDEPAC is equal to 1 if independent directors sit on the audit committee; SENSITAC, COM_BANKAC, SAV_BANKAC is equal to 1 if pressure-sensitive institutional investors, commercial banks directors and saving banks directors sit on the audit committee; p-value is the significance level to accept the null hypothesis of equality of means between groups.

Variable	Unqualified audit reports (N=569) Mean	Qualified audit reports (N=58) Mean	Mean difference	p-value
INST	45.20	36.20	9.00	.01
INDEP	29.80	32.00	-2.20	.44
SENSIT	7.40	3.00	4.40	.00
COM_BANK	1.20	.70	.50	.63
SAV_BANK	5.40	1.70	3.70	.00
INSTAC	.79	.66	.13	.02
INDEPAC	.83	.84	-.01	.84
SENSITAC	.22	.07	.15	.01
COM_BANKAC	.04	.08	-.04	.36
SAV_BANKAC	.16	.05	.11	.03

TABLE 5
Results of the Logistic Regression for the Board of Directors

Estimated coefficients (p-value) through the ordinary least square method. The dependent variable is IA is a dummy variable equals to 1 if the company receives a qualified audit report; INST, INDEP, SENSIT, COM_BANK and SAV_BANK is the proportion of members of the board who represent institutional investors, independent, pressure sensitive institutional investors, commercial banks and saving banks directors; SIZE is the log of total assets, BIGFOUR is a dummy variable equals to 1 if the company is audited by one of the auditing big firms; DIREC_OWN is the proportion of shares held by directors; AC_SIZE is the number of directors on the audit committee; LEV is the book value of debt over total assets; LOSS is equal to 1 if the company reports losses the previous year; ROA is operate income before interests and taxes over total assets. *** for 99 percent confidence level, ** for 95 percent and * for 90 percent.

	Expected sign	Model 1 Estimated coefficient (p-value)	Model 2 Estimated coefficient (p-value)	Model 3 Estimated coefficient (p-value)
INST	−	-.02** (.02)		
INDEP	−	-.01 (.60)		
SENSIT	−		-.04** (.05)	
COM_BANK	−			.01 (.85)
SAV_BANK	−			-.07** (.02)
SIZE	−	-.28*** (.01)	-.27** (.02)	-.25** (.02)
BIGFOUR	+	.68 (.15)	.50 (.30)	.53 (.24)
DIREC_OWN	−	-.01 (.21)	-.01 (.13)	-.01 (.12)
AC_SIZE	−	-.14 (.50)	-.22 (.29)	-.24 (.25)
LEV	+	.54 (.51)	.17 (.84)	.20 (.80)
LOSS	+	.4 (.76)	.14 (.75)	.18 (.69)
ROA	−	-.05*** (.01)	-.04** (.02)	-.04** (.02)
Firm fix effects		Included	Included	Included
Observations		627	627	627
Classification		90.60%	90.70%	90.70%
χ^2		49.10 ***	46.96***	49.45***

TABLE 6
Results of the Logistic Regression for the Audit Committee

Estimated coefficients (p-value) through the ordinary least square method. The dependent variable is IA is a dummy variable equals to 1 if the company receives a qualified audit report; INSTAC, INDEPAC, SENSITAC, COM_BANKAC and SAV_BANKAC is equal to 1 if institutional investors, independent, pressure sensitive institutional investors, commercial banks and saving banks directors sit on the audit committee; SIZE is the log of total assets, BIGFOUR is a dummy variable equals to 1 if the company is audited by one of the auditing big firms; DIREC_OWN is the proportion of shares held by directors; AC_SIZE is the number of directors on the audit committee; LEV is the book value of debt over total assets; LOSS is equal to 1 if the company reports losses the previous year; ROA is operate income before interests and taxes over total assets. *** for 99 percent confidence level, ** for 95 percent and * for 90 percent.

	Expected sign	Model 1 Estimated coefficient (p-value)	Model 2 Estimated coefficient (p-value)	Model 3 Estimated coefficient (p-value)
INSTAC	−	-.55* (.09)		
INDEPAC	−	.19 (.66)		
SENSITAC	−		-.97* (.08)	
COM_BANKAC	−			-.56 (.60)
SAV_BANKAC	−			-.83 (.18)
SIZE	−	-.33*** (.00)	-.30*** (.01)	-.30*** (.01)
BIGFOUR	+	.51 (.27)	.53 (.24)	.55 (.23)
DIREC_OWN	−	-.01 (.14)	-.01* (.08)	-.01* (.07)
AC_SIZE	−	-.16 (.44)	-.17 (.42)	-.20 (.33)
LEV	+	.50 (.55)	.16 (.84)	.27 (.74)
LOSS	+	.16 (.71)	.18 (.68)	.18 (.68)
ROA	−	-.04*** (.02)	-.04*** (.02)	-.04*** (.02)
Firm fix effects		Included	Included	Included
Observations		627	627	627
Classification		90.70%	90.60%	90.60%
χ^2		45.12 ***	45.90***	44.46***