

**CORPORATE GOVERNANCE, AUDITOR QUALITY  
AND THE RELIABILITY OF AUDITED FINANCIAL  
STATEMENTS IN LIBYAN BANKING SECTOR**

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**DOCTOR OF PHILOSOPHY  
UNIVERSITI UTARA MALAYSIA  
September 2014**

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BANKING SECTOR**

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**Thesis Submitted to  
Othman Yeop Abdullah Graduate School of Business  
Universiti Utara Malaysia  
In Fulfillment of the Requirements for the Degree of Doctor of Philosophy**

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## ABSTRACT

This study attempts to provide evidence on the relationship between corporate governance mechanisms, auditor quality, and reliability of audited financial information in Libya. The objectives of the study are to extend the evidence linking external corporate governance mechanisms to auditor quality, examine the relationship between internal corporate governance practices and auditor quality, investigate the relationship between auditor quality and reliability of audited financial statements, and examine the mediating effect of auditor quality on the relationship between corporate governance mechanisms and the reliability of audited financial statements in the Libyan Banking Sector. The primary data for this study is gathered by using survey technique so the data used in this study is primary in nature. Convenient sampling is used to gather the data and the main respondent of this study are auditors and loan officers of banking sector of Libya. Then correlation and regression analysis are used to acquire empirical results from the data gathered, by using spss. The main findings indicate that there is a direct significant positive relationship between corporate governance mechanisms and the reliability of audited financial statements. It is also established that there is a direct positive relationship between corporate governance practices and auditor quality. The results also reveal a direct strong positive relationship between auditor quality and the reliability of audited financial statements. In terms of mediation, the findings of the study show that auditor quality partially mediates the relationship between corporate governance mechanisms and the reliability of audited financial statements. The main contribution of the study is its in-depth investigation of financial reporting and providing an understanding of the role played by external and internal corporate governance mechanisms in the external audit process in banking sector of Libya, albeit a form of investigation rarely found in prior studies, is also used to obtain the empirical results. Furthermore, the study highlights the role of audit committee in enhancing financial reporting quality. Finally, the study also improved the understanding of why and how auditor quality influences the reliability of audited financial statements.

**Keywords:** corporate governance mechanisms, auditor quality, reliability of audited financial statements, Libya, banking sector

## ABSTRAK

Kajian ini bertujuan untuk menyediakan bukti dalam hubungan antara mekanisme tadbir urus korporat, kualiti juruaudit, dan kebolehpercayaan maklumat kewangan yang telah diaudit di Libya. Objektif kajian ini adalah untuk melanjutkan bukti yang menghubungkan mekanisme tadbir urus korporat terhadap kualiti juruaudit luar; mengkaji hubungan antara amalan tadbir urus korporat dalaman dan kualiti juruaudit, mengkaji hubungan antara kualiti juruaudit dan kebolehpercayaan penyata kewangan yang telah diaudit, dan memeriksa kesan perantara kualiti juruaudit terhadap hubungan antara mekanisme tadbir urus korporat dan kebolehpercayaan penyata kewangan yang telah diaudit dalam Sektor Perbankan di Libya. Data utama bagi kajian ini dikumpul melalui kaedah tinjauan sampel dari responden secara rawak yang terdiri daripada para juruaudit dan pegawai pinjaman. Analisis data sekunder dari kajian sedia ada juga dijalankan. Analisis korelasi dan regresi digunakan untuk menguji hipotesis serta mentafsir keputusan. Penemuan utama menunjukkan bahawa terdapat hubungan langsung yang signifikan positif antara mekanisme tadbir urus korporat dan kebolehpercayaan penyata kewangan yang telah diaudit. Juga didapati terdapat hubungan positif yang langsung antara amalan tadbir urus korporat dan kualiti juruaudit. Keputusan juga menunjukkan hubungan positif langsung yang kuat antara kualiti juruaudit dan kebolehpercayaan penyata kewangan yang telah diaudit. Dari segi pengantaraan, hasil kajian menunjukkan bahawa kualiti juruaudit sebahagiannya menjadi pengantara dalam hubungan antara mekanisme tadbir urus korporat dan kebolehpercayaan penyata kewangan yang telah diaudit. Sumbangan utama kajian ini ialah penelitiannya yang mendalam ke atas laporan kewangan dan menyediakan pemahaman tentang peranan yang dimainkan oleh mekanisme tadbir urus korporat dalaman dan luaran dalam proses audit luaran di sesebuah negara membangun, memandangkan bentuk penyiasatan sebegini jarang ditemui dalam kajian-kajian sebelumnya. Tambahan pula, kajian itu menonjolkan peranan jawatankuasa audit dalam meningkatkan kualiti laporan kewangan. Akhir sekali, kajian ini juga meningkatkan pemahaman tentang mengapa dan bagaimana kualiti juruaudit mempengaruhi kebolehpercayaan penyata kewangan yang diaudit.

**Kata kunci:** mekanisme tadbir urus korporat, kualiti juruaudit, kebolehpercayaan penyata kewangan yang diaudit, Libya, sektor perbankan

## **ACKNOWLEDGMENTS**

First and most, I am grateful to Allah for providing me the power and inspirations needed in carrying out this study.

I would like to extend my appreciation to my supervisors, Associate Professor Dr. Faudziah Hanim Hj. Fadzil, and Associate Professor Dr. Syed Soffian Syed Ismail for her thorough supervision, encouragement, and willingness to support me throughout this study. I would also like to express my sincere gratitude for their enthusiasm and guidance. The completion of this study has been possible with their guidance.

Finally, I wish to dedicate this study to my family as they are always been my strongest supporters. I am indebted to all my family members for their love and appreciation throughout my study.

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## **LIST OF ABBREVIATIONS**

AAA	American Accounting Association
AC	Audit Committee
ACC	Audit Committee Characteristics
ACE	Audit Committee Effectiveness
AICPA	American Institute of Certified Public Accountants
APB	Auditing Practicing Board
AR	Auditor Rotation
ASCA	Arab Society of Certified Accountants
BCCI	Bank of Credit and Commerce International
BRC	Blue Ribbon Committee
BTS	Bartlett's Test of Sphericity
CBL	Central Bank of Libya
CFA	Confirmatory Factor Analysis
CG	Corporate Governance
FASB	Financial Accounting Standards Board
FCCG	Finance Committee on Corporate Governance
FRC	Financial Reporting Council
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GAO	General Accounting Office
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IASs	International Accounting Standards
ICAEW	Institute of Chartered Accountants in England and Wales

IESBA	International Ethics Standards Board
IFAC	International Federation of Accountants
IIA	Institute of Internal Auditors
IMF	International Monetary Fund
ISAs	International Standards on Auditing
KMO	Kaiser-Meyer-Olkin
LAAA	Libyan Auditors and Accountants Association
LBL	Libyan Banking Law
LCGC	Libyan Corporate Governance Code
LGPC	Libyan General People's Committee
LSM	Libyan Stock Market
NACD	National Association of Corporate Directors
NAS	Non-Audit Services
NASD	National Association of Securities Dealers
NYSE	New York Stock Exchange
OECD	Organisation for Economic Co-operation and Development
PCA	Principal Components Analysis
PCAOB	Public Company Accounting Oversight Board
POB	Public Oversight Board
RAFS	Reliability of Audited Financial Statement
SEC	Securities & Exchange Commission
SOX	Sarbanes-Oxley Act
SPSS	Statistical Package of Social Science
TI	Transparency International
UK	United Kingdom

## **CHAPTER ONE**

### **INTRODUCTION**

#### **1.0 Introduction**

This chapter lays out the background to the study by outlining the contexts that shape the research. It also captures the problem statement, the research questions as well as the research objectives. The importance of the study, the scope, limitations and the organisation of the study are also highlighted in this chapter.

#### **1.1 Background of the Study**

Corporate governance is currently one of the burning issues that are dominating the agenda of the business world and scholarly research. Recent corporate scandals such as BCCI, Enron Corporation, Lehman Brothers, WorldCom, HIH Insurance Group have played a critical part in attracting the increased attention and spotlight on corporate governance issues. Furthermore, these high-profile corporate and audit failures have also generated an unprecedented interest in the accounting profession, particularly auditing. Consequently, there are many more questions emerging than answers for the known lapses in the control systems that may have facilitated these corporate failures and crises. Unsurprisingly, a series of regulatory measures (corporate governance reforms) have been developed in the corporate environment to mitigate the impact of these high-profile audit scandals and failures.

Undoubtedly, one of the major imprints of the corporate governance reform regime has been the thrust to improve or enhance the reliability of reported financial information. It is imperative to note that corporate governance reforms in relation to

the efficacy of boards and audit committees are implemented to enhance financial reporting and audit quality (Cohen, Krishnamoorthy & Wright, 2004; Turley & Zaman, 2007; Beasley, Carcello, Hermanson & Neal, 2009; Krishnan & Visvanathan, 2009). The main assumption is that effective boards and audit committees yield more reliable financial statements as well as reducing the risk of the external auditor expressing an improper audit opinion (Young, 2000; Turley & Zaman, 2004). Moreover, boards and audit committees are anticipated to protect and enhance auditor independence by creating an enabling environment that provides a platform or forum for auditors to provide their opinions on clients' policies without fear or favour. It is evident from the foregoing that corporate governance reforms impact audit quality as well as audit policies such as auditor remuneration, (audit fees) and non-audit services fees (Turley & Zaman, 2004; Knechel & Willekens, 2006; Beasley *et al.*, 2009).

Despite these significant developments in corporate governance enhancement targeted at improving audit quality, significant differences in corporate governance requirements (such as board meeting requirements, shareholder roles and audit committee structure and responsibilities) still exist between countries and firms (see Doidge, Andrewkarolyi & Stulz, 2007). More specifically, there are also major variations in national requirements and recommendations in relation to audit committees. Put differently, although globalisation may have generated some common corporate governance standards, however, the implementation phase has yielded mixed results (Collier & Zaman, 2005; Khanna, Kogan & Palepu, 2006).

Clearly, the issue of corporate governance is now a common place and has dominated scholarly discourses in the past decade. Considerable academic focus has centred on various aspects of the issue including for example, corporate control (La Porta, Lopez-de-Silanes, Shleifer & Vishny, 2000) board structure, Institutional ownership (Mitra, Hossain & Deis, 2007), regulation (Keenan, 2004), among others. As is shown in the subsequent chapters, this study addresses the impact of corporate governance characteristics and auditor quality on the reliability of financial statements in Libya. The issues of corporate governance, auditor quality and financial statements have attracted serious interest from key stakeholders particularly government policy makers/regulators, the auditing profession and the public. As mentioned earlier, there is no doubt that recent high profile corporate collapses worldwide (such as BCCI, Enron Corporation, WorldCom, and Lehman Brothers in the United States; and HIH Insurance Group in Australia) have captured the attention of regulators, investors, and scholars across the globe. Consequently, more focus has been given to enhance corporate governance worldwide in order to put a stop to or at least minimise the episodes of corporate or financial failures. It is also anticipated that these corporate governance reforms will also restore confidence in capital markets that have been devastated by corporate scandals involving giant firms.

Unsurprisingly, as indicated earlier, concerns about recent high-profile accounting scandals have led most of the regulators to advocate for more effective audit committees as a means to enhance the quality of audited financial statements (see Blue Ribbon Committee of 1999 and Securities, & Exchange Commission of 2000). As a result, regulators have adopted regulations governing the functions of audit committees. In this respect, these regulations focus on a number of areas including

the independence of audit committee members, and their competence. An instructive example of such regulation in the US is the *Sarbanes-Oxley Act* of 2002 (hereafter SOX) which seek to strengthen a company's audit committee. Some of the SOX recommendations pertaining to the audit committee include: that at least one audit committee member should be a financial expert, that all the committee members be independent directors, and that the audit committee monitor the financial reporting and accounting processes including the auditing of financial statements". The findings of this study indicates that the corporate annual report is the most fundamental source of information relied upon to make informed decisions in Libya. However, the results also showed that the credibility and timeliness of the information sources are the most important qualitative characteristics that might affect the utility of financial information sources.

As indicated earlier, it is therefore not surprising that interest in corporate governance has received significant attention from scholars and public policy makers in both advanced and developing countries (see Reed, 2002; Solomon & Solomon, 2004; Sternberg, 2004; Mallin, 2010). Thus, an enhanced corporate governance system is now seen as a key feature or asset of firms. For instance, Levitt (1998) indicated that effective audit committees are the most dependable defenders of the public interest. In this regard, several studies, for example, Abbott, Parker & Peters (2002) established that firms with an audit committee, whose members were independent and diligent, were less likely to experience financial reporting errors or misstatements. These findings are consistent with corporate governance recommendations made by international commissions like the Blue Ribbon Committee (BRC) since they provide indicators for the efficacy of a number of

recommendations proposed to improve audit committee effectiveness. As noted by DeFond and Francis (2005), the consequence of the corporate scandals and crises has renewed the importance of independent audits and their linkage to the monitoring role of corporate governance. However, the mere existence of the audit committee does not automatically transform it into an effective oversight body. Consequently, the search for ways to enhance corporate governance and enhance the quality of financial statements is mostly engrossed in the formation of audit committees. In essence, it is important to consider precisely how the audit committee impacts upon external auditors and on their independence. Evidently, there are concerns about the independence of the auditor in the fallout from various corporate crises that occurred recently, particularly the role of auditors in these as was the case with Arthur Andersen in the Enron saga (Chen, Su & Wu, 2009). It has been stated that the existence of the audit committee (AC) would act as a buffer between the auditors and the executive directors, and thereby improve their independence (see Cadbury Report, 1992; Smith, 2003). This is more so in that their remuneration, appointment, and the type and scope of services that may be sourced from the external auditors, which had previously been decided by the management are now within the remit of the Audit Committee. After all, as stated by the BRC (1999, p. 7), “the audit committee is the ultimate monitor of the financial reporting process”.

The agency theory which provides an explanation of the agency relationship between a company’s management and its owners is very instructive in this study. More specifically, the role of agents in the firm reflects the accountability relationship between principals and agents, since they are responsible for protecting the interests and rights of principals and minimising managerial expropriation and acting in



favour of the principal. It is evident that agency theory assumes that principals and agents have conflicting interests which are likely to result in agency tensions that may yield financial malfeasances such as misstatements. To align these divergent interests, it is stated that agency theory recognises the monitoring tasks of a board of directors, an audit committee and external auditors play a crucial role in reducing agent-principal tensions. From the agency perspective, there are several characteristics of board and audit committee such as size, composition, expertise and levels of activities that contribute to an effective monitoring function.

Furthermore, the independent audit is acknowledged by the agency theory as a control device to minimise information asymmetry between the investors, shareholders, and management by promoting truthfulness and fairness in financial statements. Thus, from a theoretical perspective the agency theory provides an explanation of why independent audit is an important factor. More importantly, the independent audit helps to mitigate the agent-principal conflict by offering the assurance that financial statements are carefully prepared and free from material error (see Wallace, 1980). Similarly, it also reduces the likelihood of accounting fraud and illegal reporting practices (Wallace, 1980), so that the financial market participant or consumer can use the financial reports without any doubt. In addition, the auditor can improve or enhance the quality of financial reporting through their competency/expertise and willingness to report an accounting misstatement (DeAngelo, 1981b). It should also be pointed out that most regulators believe that good corporate governance practices enhance the ability of boards and their committees to execute their functions more effectively and in the best interest of

shareholders, whose confidence and trust is gained through higher quality auditing (see SOX, 2002; UK *Corporate Governance Code*, 2010).

An equally compelling theory used in this study is the stakeholder theory. In stakeholder theory, the concept of corporate governance refers to an organisation's relationship with its shareholders and all other stakeholders who are affected by or affect the firm's operations and decisions. Solomon and Solomon (2004) conceptualises corporate governance as "a system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity" (p. 14). The stakeholder theory challenges the shareholder perspective (see Keasey, Thompson & Wright, 1997; Mallin, 2010). Its main idea is that those responsible for the governance of the company or firm have responsibilities to other corporate stakeholders such as employees, suppliers, and customers, and that any fiduciary obligations owed to owners to maximise profits might be subject to the constraint of respecting obligations owed to such wider stakeholders (see Reed, 2002). In this way, it is evident that stakeholder theory sees corporate governance as an instrument to examine a wider set of stakeholders' relationships that consist of interactions between employees, customers, suppliers, creditors, society at large and other stakeholders. Therefore, stakeholder theory generally focuses on the interest of any group that may benefit from or be negatively impacted on by the firm, including those with a non-financial interest, who have a right to be treated fairly, and have access to disclosure of a wide range of information, including environmental information (Gibson & O'Donovan, 2007).

In most instances, shareholders rely on the capacity of a board of directors and its audit committee to monitor the independence of both auditors and management. For that reason, ultimate responsibility for financial reporting quality lays with the board and its audit committee. Interestingly, previous studies have tended to focus exclusively on the function of the audit committee as the main custodian of the integrity of financial information and as well as its facilitative role in the external audit process (see Abbott & Parker, 2000; Chen, Lin & Zhou, 2005). Nevertheless, given that the board of directors is overall responsible for appointing and dismissing members of the audit committee, its role is equally key in ensuring the high quality of financial statements. As aptly captured by the Blue Ribbon Committee:

*the performance of audit committees must be founded in the practices and attitudes of the entire board of directors ... If the board is dysfunctional, the audit committee likely will not be much better (BRC, 1999, p. 6-7).*

This is supported by a number of studies which have demonstrated that the effectiveness of the audit committee is linked with the composition of the entire board of directors (see Collier & Gregory, 1999; Cohen, Krishnamoorthy & Wright, 2002; Boo & Sharma, 2008). In this study, therefore, while the demand for a higher quality auditor is acknowledged, the oversight roles of the board and its audit committee are equally seen as important factors by which to promote a higher quality of financial reporting. In a way, the main purpose of this study is to investigate and offer an initial understanding of corporate governance practices within a developing country, and their impact on auditor quality and reliability of financial statements. More specifically, this study examines two interrelated empirical studies, namely, (1) the study of the relationships between the audit committee and audit quality and (2) the study of the relationships between the board of directors, the audit committee and auditor quality in respect of the reliability of audited financial statements.

### **1.1.1 Overview of the Libyan Auditing Sector**

Since this study focuses on the relationship between corporate governance practices and auditor quality and reliability of audited financial statements in Libya, it is instructive to have an overview of the country's auditing sector. The current practices and developments in the Libyan auditing profession can be traced back to the early 1950s when oil and natural gas were discovered in the country (Ritchie & Khorwatt, 2007; Shareia, 2010). According to Ritchie and Khorwatt (2007, p. 41), the Libyan auditing profession has been closely modelled along the US and the British systems because the initial exploration and production of the afore-mentioned resources in the country had been done by mainly British and American firms, which implemented their own business and accounting practices. Notably, this legacy has continued up to this day (Kilani, 1988). In a way, foreign investments in Libya's critical oil sector has inadvertently shaped the country's accounting practices and thus, encouraged the audit profession to operate within these frameworks.

It has been suggested that the auditing profession in Libya is also heavily influenced by three national factors, that is, "legal imperatives, quasi-legal professional requirements of the nationally recognised professional body and the socio-cultural imperatives of family, tribe and community" (Ritchie & Khorwatt, 2007, p. 41). The main sources of the legal imperatives are the legal statutes approved in 1973, in particular Law No. 116. This legal document contains provisions on the suspension, expulsion or imprisonment of auditors who fail to adhere to the required professional accounting standards. Other provisions focus on financial disclosure and professional ethics. More importantly, Article 53 of Law No. 16 outlines provisions governing the establishment of the Libyan Auditors and Accountants Association (LAAA),

including its functions and responsibilities. It is imperative to point out that besides its sole responsibility of implementing the legal statutes on behalf of the Government, the LAAA also coordinates every aspect of the Libyan auditing profession including delivering punitive action and sanctions against errant members. More importantly, the LAAA also provide many of the services expected of a professional body, that is, “promoting professional education and development, managing the entry to the profession, protecting members’ rights, establishing pension provisions and ensuring the communication of new developments throughout the profession” (Ritchie & Khorwatt, 2007, p. 41).

It should be pointed out that the LAAA has failed to achieve its key objectives as an administrative body for accounting in Libya (Alhsadi, 2007). Ideally, the LAAA is responsible for establishing and monitoring accounting standards and practices in Libya as stipulated under the Accounting Profession Law no 116 of 1973, however, in practice the body has failed to accomplish anything related to the organisation of the Libyan accounting profession such as issuing or embracing auditing standards or a code of ethics (Derwish & Elghli, 2006; Alhsadi, 2007). Despite being set up for almost four decades (since 1975), the LAAA has not developed an effective accounting profession (Almalhuf, 2009; Shareia, 2010) and general framework for accounting and auditing (Almalhuf, 2009). For instance, the LAAA has failed to establish a code of ethics for its members (Mahmud & Russel, 2003; Alhsadi, 2007) as well as to improve the status of the profession through such activities research, training and continuous education programmes. Furthermore, it has failed to self-regulate itself and instead it has merely followed government regulatory requirements pertaining to accounting practice. There is no doubt that the weakness

of the LAAA has led the State's being the sole accounting regulating entity. As noted by Kilani (1988) cited by Shareia (2010), the LAAA does not have stipulated uniform audit report requirements and professional examination requirements. In actual fact, the LAAA bases its practices mainly on members' accounting university education. In much the same way, Eldarragi (2008) observes that audit firms in Libya are currently not in full accordance with the professional standards and regulations obtaining in Libya, mainly due to weaknesses, and lack of enforcement of existing regulations and legal provisions. In view of the above factors, it is therefore not surprising that the current standing of the Libyan accounting profession is very weak.

From a socio-cultural perspective, the Libyan society is largely perceived as a highly collectivist society (see Hofstede, 1983; 1992; 2001) in which individuals are members of close-knit kinship groups such as families, villages, clans, and tribes. It is instructive to note that the ordinary Libyan 'family' comprise both immediate and distant relatives (those related via marriage and kinsmen) (Ritchie & Khorwatt, 2007). As a result, the "individual in such a society becomes a lifetime member of these groups, expected to provide unquestioning loyalty and support for the rules, traditions and beliefs in return for protection and support" (Ritchie & Khorwatt, 2007, p. 42). For example, Agnaia (1997) cited in Ritchie and Khorwatt, (2007) noted that this close relationship of the individual with the family unit entails that "their good or bad deeds may bring collective fame or shame to the whole family, the tribe and the local community" (p. 42). In view of this unique socio-cultural dynamic, these underlying behavioural traits pose complex problems to the auditor's professional obligation to maintain independence. As such, due to the nepotistic nature of the Libyan society, if the client is from the same socio-cultural group, the

pressure on the auditor may be to endorse financial statements which do not conform to the required professional standards (Ritchie & Khorwatt, 2007). Similarly, Kilani (1988) as cited in Almalhuf (2009) has questioned the independence of the Libyan auditors in practice, especially since the appointment of external auditors in Libya depended to a great extent on social and family ties. In a way, Libya is an interesting case study for investigating auditor quality in view of the complex cultural dynamics obtaining in the country as outlined by Ritchie and Khorwatt (2007).

Generally, the Libyan accounting and auditing environment is characterised by an ineffectual accounting profession including its auditing branch, limited accounting education opportunities as well as poorly regulated professional accounting standards (Shaeria, 2010). In essence, a number of studies have highlighted the failings of the LAAA which include its limited role in conducting effective research programmes, the failure to develop accounting and auditing standards, the failure to set up a code of conduct or ethics, and its weak professional control over accounting practices as well as its deficiencies in monitoring accounting education (Buzied, 1998; Ahmad & Gao, 2004; Almalhuf, 2009). In a way, only an effective professional accounting body that understands national conditions will be in the best position to institute the kinds of accounting systems that will best serve Libya's objectives.

### **1.1.2 Overview of Libyan Stock Market**

The Libyan Stock Market (LSM) was established in 2006 after the country issued Decision No.134/2006 of the Libyan General People's Committee (LGPC). The precursor of the LSM was a series of economic reforms which were implemented in the country, particularly the privatisation program which transferred the ownership of

government plants into private hands. The last stage of the privatisation process involved the privatisation of 54 companies between the beginning of the second half of 2007 and the end of 2008. Importantly, these privatised companies also took the form of corporate organisations, but were offered for investment to foreign investors. According to the LGPC Decision no. 134/ 2006, as cited in Magrus (2012), there are three main reasons why the Libyan government believed it was essential to establish a stock market. First, Libya had seen successive reforms and movement toward a free market. Second, the government viewed as crucial the role which stock markets play in developed and, as well as in emerging economies like Libya. Third, as indicated earlier, a new dispensation in the Libyan economy marked by various reforms such as the adoption of the privatisation policy and enlargement of the ownership base also contributed to the surge towards setting up the LSM. Interestingly, it is the creation of the LSM that generated pressure and demands for corporate governance in Libya, and those demands were realised in 2007 when the LSM introduced the Libyan Corporate Governance Code (LCGC).

### **1.1.3 Overview of the Libyan Commercial Banking Sector**

In order to operationalise the relationships between the main variables of this study, this research identified the Libyan Commercial Banking sector. Generally, the Libyan commercial banks are subordinate to the Central Bank of Libya (CBL) and they are controlled by Law No.(4) 1963 that was replaced by Law (1) 1993 which was then modified by Law (1) 2005, the Libyan Commercial Law and the Income Tax Law. The main reason which motivated this study to focus on the Libyan banking sector is that the country has experienced a massive economic and regulatory reform including the introduction and compliance to International



Accounting Standards (IASs) and International Standards on Auditing (ISAs) within the banking sector (see Faraj & Akbar, 2008, p. 4). Another motivating factor was the fact that the Libyan banking sector was a major beneficiary of the country's privatisation program. By 2006, the Gadaffi regime had already started to sell state-owned banks to private players in tandem with the framework of reforms recommended by the Bretton Woods Institution, the International Monetary Fund (IMF) and the Libyan Banking Law (LBL1/2005). As demonstrated earlier, the privatisation program is one key process that has triggered the whole corporate governance culture in Libya. Some of the Libyan commercial banks that have been privatised include Wahda Bank; Sahara bank, Gumhouria; Bank of Commerce & Development, and Assaray Bank. Of all the banks that have been commercialised, the Assaray bank is one that has been heavily privatised with individuals and the private sector owning 92 percent of the bank. More importantly, Libyan commercial banks have had a key role in the growth of the Libyan economy, where they provided the finance and facilities to the society's individuals and organisations by offering loans, opening documentary credits, selling and buying foreign currencies and discounting bills of exchange. Furthermore, since the banking sector is a critical element of the financial sector, Libya's economic success depends on a stronger and efficient banking system premised on market reforms (Faraj & Akbar, 2008, p. 15). In other words, a banking sector driven by corporate governance practices and mechanisms will spur both economic growth and stable financial sector.

On the same ground, the International Monetary Fund (IMF) also highlighted the importance of "enhancing banking supervision; restructuring the banking system; modernising the domestic payment system; and revising the legal and regulatory

frameworks” (IMF, 2006, p.10). It is therefore not surprising that the Libyan government took the advice and reformed its banking system as enshrined in LBL (1/2005), which among other things enhanced the autonomy of the CBL in line with international best practices; and encouraged the participation of foreign banks in the domestic banking sector. These reforms also encouraged the country’s adoption of the Basel Committee principles of effective banking supervision (Porter & Yegin, 2006; Faraj & Akbar, 2008). In view of the foregoing discussion, it is evident that the Libyan banking sector is one of the most developed areas that have incorporated the corporate governance value system. Although, the manual for corporate governance for the Libyan banking sector issued by the CBL in 2005 has had an influential role in the banking sector, its rules, however, are neither obligatory nor legally binding. To a certain extent the rules of the manual promote and regulate responsible transparent behavior in managing companies in accordance to the international best practices.

## **1.2 Problem Statement**

Libya as a transitional economy aims at benefiting from its rich resource endowment in order to develop its economy and build a strong and attractive environment for foreign investment. Therefore, adopting a new comprehensive policy framework in which corporate governance issues should be a major part is fundamental in order to enhance the country’s international competitiveness in the global economy. It is hardly surprising that the search for ways or measures to improve corporate governance and the quality of financial reports are issues that need urgent attention in Libya. Notably, as mentioned earlier, many foreign investors have entered the Libyan financial market especially after the country adopted an open market policy

in the 1990s. Consequently, the Libyan accounting system expanded at an incredible rate when foreign investors participated in the domestic capital market. Consequently, the credibility of the auditing process has become an issue of vital importance. Notably, Libya has been developing its corporate governance structures and systems especially after the country adopted capitalist economic reforms which were buttressed by the lifting of economic sanctions in 2003. Not surprisingly, when Libya launched its massive privatisation program, a logical consequence of this development was the establishment of the Libyan Stock Market (LSM) in 2006. As a result of these developments, pressure and demands for corporate governance emerged in the country, since good corporate governance was increasingly seen as a necessary tool to attract local and foreign investment as well as strengthening the growing private sector. Unsurprisingly, by 2005, the country's central bank had issued a manual of corporate governance for the banking sector which was generally regarded as an "essential guideline for boards of directors of commercial banks" (Faraj & Akbar, 2008, p. 35). The country's determination in developing corporate governance was further demonstrated when the government through the LSM issued the Libyan Corporate Governance Code (LCGC) in 2007. Like any corporate governance blueprint, the LCGC cover the major principles of good governance such as shareholders' rights, board of directors, conflict of interests, transparency and the setting up of board sub-committees.

Nonetheless, Libya has had its fair share of corporate governance challenges. The country has had a number of these challenges such as fraud cases involving Libyan officials in the Economic and Social Development Fund (Mahmoud, 2010). Other incidences of fraud and corruption involved huge amounts of money amounting to

billions of US dollars which were perpetrated by the Gadaffi regime (World Bank Report, 2006). Notable, among international organisations that provide evidence in support of the above assertions are reports of *Transparency International (TI)*. For example, the TI report of 2010 ranked Libya at 146 out of 178 countries in its *Corruption Perception Index* scale. The situation is also made worse by a weak legal environment, political interference, poor leadership, and lack of training of board of directors (Magrus, 2012). Studies by Magrus (2012) and Bribesh (2006) have already established that the corporate governance systems and mechanisms in Libya are weak and are in their early stages of development. In similar fashion, Larbsh (2010) indicates that the corporate governance framework in Libya is less developed, and thereby causing the country to lag behind neighbouring countries in matters of corporate governance. The study also revealed that the absence of strong corporate governance practices has led to weaknesses in areas of accountability and transparency. Furthermore, Larbsh (2010) study highlighted the influence of a number of the country's attributes such as opaque economic structure, the archaic legal system, socio-cultural influences, political interference, and accounting unprofessionalism in weakening the country's corporate governance structures. Other notable weaknesses are the country's education system and stakeholders' activism. More specifically, the manual of corporate governance for the country's banking sector has been dismissed as neither mandatory nor legally binding (Faraj & Akbar, 2008, p. 35).

Clearly, the above developments in Libya erode public confidence in corporate governance matters including the independence and quality of the accounting profession (especially the auditing profession) in the country. Consequently, in

Libya, the credibility of auditors are in doubt; firms' corporate governance systems are increasingly being questioned because of questionable auditor quality and oversight from firms' board of directors, and financial statements' reliability are also struggling to meet international standards. The quality of auditors is also compromised by Libya's strong cultural and family ties. For example, Kilani (1988) observes that the appointment of external auditors in Libya rely to a great degree on social and family ties.

Evidently, the increased concern for corporate governance in the international system has had an influence on Libya, particularly on its critical banking sector. In essence, the effectiveness of corporate governance structures is related to the adoption of good governance practices and mechanisms. After all, corporate governance reforms are designed to develop financial reporting and audit quality (Conyon, 2000; Peasnell, Pope & Young, 2005; Cohen *et al.*, 2004; Larcker & Richardson, 2004; Turley & Zaman, 2007; Beasley *et al.*, 2009; Krishnan & Visvanathan, 2009). The main assumption here is that effective boards and audit committees yield more credible and reliable financial statements (Young, 2000; McElveen, 2002; Turley & Zaman, 2004). Furthermore, these bodies are expected to protect auditor independence by providing an enabling environment that allows auditors to put across independent opinions on clients' policies. Unsurprisingly, effective boards and audit committees tend to select an external audit firm which provides good quality financial reporting because members are keen to protect shareholders interests as well their reputational capital by avoiding any situation that may attract litigation (Carcello, Hermanson, Neal & Riley, 2002). Thus, the independence of both the board of directors and the external auditor are two complementary corporate

governance mechanisms that lie at the heart of a growing body of literature analysing the link between corporate governance practices and audit quality.

As elucidated in earlier sections, the lack of auditor quality is a chief cause of many corporate crises and scandals that have shook the world in recent years. For that reason, audit quality is regarded as the key factor in auditing practice. Fundamentally, most of the existing body of knowledge on the relationship between corporate governance and auditor quality and the reliability of financial statements address this link from the perspective of the developed countries. Although the corporate governance system in Libya is in its infancy, it is growing as demonstrated by the LCGC. Thus, investigating corporate governance practices and their link to auditor quality and the quality of audited financial statements in a developing country like Libya will, therefore, contribute new knowledge to the growing academic area of corporate governance. To the researcher's knowledge, this study will be the first study that has focused on the relationship between these variables in the context of Libya. The researcher hopes to open the door for more research in this area. More importantly, it is hoped that the study findings will be of interest to Libyan policy-makers and academic community and contribute to improvements in the ongoing exercise of developing the country's corporate governance framework. In a way, this study is a comprehensive and consistent approach to quality from the board right up to the production of financial statement.

### **1.3 Research Questions**

The observed issues as stated in the research problem statement have led to the following questions that are designed primarily to analyse and determine the likely

relationships that exist between corporate governance practices and the reliability of audited financial statements. These set of questions are meant to get feedbacks from auditing practitioners that interact on daily basis with accounting and auditing activities that determines the reliability of audited financial statement. Hence, this study provides relevant answers to the following questions:

1. What is the relationship of external corporate governance (audit firm attributes – provision of NAS, auditor rotation, audit firm size, audit firm fees) and auditor quality of Banking Sector of Libya?
2. What is the relationship of internal corporate governance (audit committees' characteristics – independence, expertise, diligence/activity, size) and auditor quality of Banking Sector of Libya?
3. What is the relationship of auditor quality (perceived independence, perceived competence) and the reliability of audited financial statements of Banking Sector of Libya?
4. What is the mediating effect of auditor's quality (perceived independence, perceived competence) on the relationship of corporate governance mechanisms (external CG, internal CG) and the reliability of audited financial statements Banking Sector of Libya?

#### **1.4 Research Objectives**

The main aim of this study is to examine the relationship between corporate governance mechanisms, auditor quality and the reliability of audited financial

statements in the Libyan context. Other specific objectives of this study are captured below:

1. To examine the relationship between external corporate governance attributes (provision of NAS, auditor rotation, audit firm size, audit firm fees) and auditor quality in the Libyan Banking Sector.
2. To establish the relationship between the internal corporate governance (audit committees' characteristics – independence, expertise, diligence/activity, size) and auditor quality in the Libyan Banking Sector.
3. To investigate the relationship between auditor quality (perceived independence, perceived competence) and the reliability of audited financial statements in the Libyan Banking Sector.
4. To examine the mediating effect of auditor's quality (perceived independence, perceived competence) on the relationship between corporate governance mechanisms (external CG, internal CG) and the reliability of audited financial statements in the Libyan Banking Sector.

The above research objectives are expressed as hypotheses which are tested with the data collected and analysed appropriately.

### **1.5 Scope and Limitations of the Study**

The principal focus of this current study is to investigate the relationship between corporate governance mechanisms, auditor quality and reliability of audited financial statements in the Libyan banking sector. The research findings of this study are limited to Libya and as such it is not easy to generalise the research result to other



countries. Furthermore, this research only considers the variables in question and other variables which may have had an impact such as political, socio-economic and legal factors are ignored. Another limitation of the study pertains to its inherent research methodology that is exclusively based on the survey method. Since the manner of data collection is made via the questionnaire instrument, there is risk that this way will not always reflect the true responses of the respondents. For that reason, a more comprehensive picture would be obtained if triangulation is utilised in the data collection.

## **1.6 Significance of the Research**

This study is motivated by a number considerations, in particular the glaring absence of extensive and in depth studies on the link between corporate governance mechanisms, auditor quality and reliability of audited financial statements in the context of a developing country. In actual fact, there are a limited number of studies that have investigated the effect of corporate governance mechanisms on financial misstatements in Libya. To fill this gap, this study highlights the importance of the audit committee as a corporate governance instrument in the audit process. In this regard, the study documents important findings on the internal corporate governance, that is, audit committee characteristics such as independence, expertise, diligence/activity, and size in ensuring effective oversight on management and external auditors. There is no doubt that the study will assist policy makers and investors' understanding of the effect of the audit committee policies on auditing related activities on the external auditor in the Libyan context. To bolster its focus on corporate governance, this study also examines the impact of external corporate governance attributes, namely, audit firm characteristics such as the provision of

NAS, auditor rotation, audit firm size, and audit firm fees on auditor quality in the Libyan Banking Sector. In a nutshell, this study enhances our understanding of the concepts of corporate governance mechanisms, auditor quality and reliability of financial reports. After all, studies of corporate governance mechanisms, auditor quality, and financial reporting are relevant and important as they constitute a part of regulators' and policy makers' concerns.

### **1.6.1 Theoretical Perspective**

As mentioned earlier, this study highlights the importance of corporate governance theories such as agency and stakeholder theories. In essence, this study contributes to the existing debates and growing literature on the importance of corporate governance practices, auditor quality and reliability of financial statement. In particular, the current study is the only study (to the best knowledge of the author) that has investigated the relationship between CG mechanisms, auditor quality and reliability of audited financial statements. More importantly, the study also showcases the explanatory power of the agency theory which underpins principal-agent relationships as is the case in the auditing process. As is demonstrated in the next chapters, agency theory assumes that principals and agents have competing interests that may compromise the financial reporting process. To align these interests, agency theory recognises the monitoring roles of board of directors including that of sub-committees on auditing and external auditors in reducing agent-principal conflict. Specifically in terms of scholarly contributions of this study, a review of previous existing literature in Chapter Three of the thesis led to the identification of a number of gaps in the literature that this thesis seeks to fill. In the case of Libya, which is the focus of this study, academic concerns on corporate governance mechanisms, as well

as the relationship between audit committees and auditor's quality has been under researched.

### **1.6.2 Practical Perspective**

From a practical angle, studies of corporate governance mechanisms, auditor quality and financial statements are important because they constitute a part of regulators' and policy makers concerns. For example, lack of investors' confidence in auditor quality and reliability of audited financial statements can seriously undermine the financial market, since investors are the largest group of users that provide capital support to the economic system (see Levitt, 1998; 2000). Thus, it is hoped that the research findings of this study will assist Libyan regulators and policy makers such as the LAAA to come up with appropriate corporate governance and auditing mechanisms to combat corporate and audit failures in the country.

### **1.7 Definitions of Terms**

For the purposes of this study; the following terms are utilised:

*Corporate Governance:* As noted by Mallin (2010) corporate governance is an issue area that has grown quickly in recent years, especially in the aftermath of the demise of Enron in 2001 and the subsequent corporate and financial crises of other firms in several other countries. In essence, corporate governance is conceptualised by the mainstream accounting literature as the range of control practices that protect and enhance the interests of companies' shareholders (Fama & Jensen, 1983). According to the *Cadbury Report* of 1992, "corporate governance refers to a whole system of controls, financial and otherwise, which ensure that a firm is directed in the right way

and towards the right direction”. However, a comprehensive definition is provided by Yadong (2004) who views corporate governance “as the relationship between the corporation and the stakeholders that determines and controls the strategic direction and performance of the corporation” (p. 2). Put another way, it is the process by which firms are directed and controlled. Notably, this definition captures the roles of the key stakeholders in an organisation including that of shareholders, board of directors and the auditor. In this study, however, corporate governance is conceptualized as a set of relationships between a firm’s board, its shareholders and other key stakeholders (see Organisation for Economic Cooperation, 1998; Mallin, 2010).

*Corporate Governance Mechanism:* This refers to elements or practices of corporate governance such as setting up the audit committee or engaging an external auditor to enhance the effectiveness of a company’s board of directors and its management in determining and controlling the strategic direction and performance of the firm.

*Board of Directors or Board:* The board is the primary decision making body in an organisation and it is responsible for all aspects of a firm’s activities. The board appoints members of the management team and has the “responsibility for ensuring that financial reporting and control systems are operating properly” (Mallin, 2010, p. 162).

*External Audit:* This refers to “the examination by an independent external auditor to determine whether the annual report and accounts have been appropriately prepared and give a true and fair view” (Mallin, 2010, p. xx).

*Audit Committee:* It is a sub-committee of the main board comprising independent directors with a responsibility to exercise oversight on the auditing activities (see

Birkett, 1986; *Cadbury Report*, 1992; Collier, 1993; Mallin, 2010). Notably, the role of the audit committee is “to review the scope and outcome of the audit and to try to ensure that the objectivity of the auditors is maintained” (Mallin, 2010, p. xx).

*Audit Quality*: It refers to the degree or extent to which the audit conforms to requisite auditing standards (see Cook, 1987; Vanstraelen, 2000; Krishnan & Schaeur, 2001; Fearnley & Beattie, 2004).

*Auditor Independence*: This refers to the qualities of integrity, objectivity and impartiality as outlined by Abu Bakar, Rahman, and Rashid (2005) and Arens, Loebbecke, Iskandar, Susela, Isa and Boh (1999). Independent external auditors play a major role in corporate governance systems by reassuring investors and other key stakeholders by “reporting that the reports and financial accounts, produced by the directors, truly and fairly reflect the state of the company’s affairs” (Tricker, 2012, p. 480).

*Auditor Competence*: This refers to the likelihood that a given auditor will detect a breach or error in a client’s accounting system (DeAngelo, 1981). According to Fearnley and Beattie (2004) competence means that errors, omissions and misstatements will be identified.

*Reliability of Audited Financial Statement*: To be reliable, financial information must have representational faithfulness, and it must be verifiable and neutral (see FASB Conceptual Framework in SFAC No.2 para-33; Barua, 2006; Maines & Wahlen 2006).

*Audited Financial Statement*: This is a firm’s financial statement which has been prepared and certified by an auditor in accordance to auditing requirements and standards (Hodge, 2003; Johnson, 2005).

## **1.8 Organisation of the Study**

This study is organised into five chapters.

*Chapter One* introduces the background of the study. It also contains an overview of the Libyan auditing industry, statement of the problem, research questions, research objectives, scope of the study, significance of the research, definitions of terms and organisation of the study.

*Chapter Two* continues with the literature review by explicitly establishing the theoretical linkages between the constructs in the research model. It also contains the underlying theories upon which the model was conceptualised.

*Chapter Three* explains the research framework, the methodology to be used in the study, hypotheses, research design, sample size determination and data collection, research instrument, operational definition and measurement of the variables and method of data analysis.

*Chapter Four* analyses and interprets the results of the empirical findings in the research. It also analyses the unsolicited as well as requested responses to the survey questionnaire and any other statistical interpretations from the research findings.

Finally, *Chapter Five* organises and discusses the main findings, implications and limitations of the study as well as a statement leading to the conclusion. Above all, it also makes necessary recommendations for future research in this field of study.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.0 Introduction**

The primary aim of this chapter is to review extant literature on corporate governance mechanisms, auditor quality and financial reporting quality. Previous research has mainly focused on developed countries with established accounting practices and knowledge systems. Undeniably, these studies have broadened our understanding of the auditing processes and systems, but as aptly noted by Sidani and Olayan (2007), few researchers have examined auditing systems of Arab countries (including Libya). Basically, this chapter reviews the extant literature on three main topics: corporate governance mechanisms, auditor quality and reliability of audited financial statement. The first reviews focus on corporate governance mechanisms especially the audit firm attributes and audit committees characteristics. This is followed by the discussion and review of audit quality and how it is measured (the so-called audit quality indicators or proxies). Existing studies on the quality of financial reporting, particularly on audited financial statements are also reviewed. In essence, these reviews provide a general understanding of the areas of study that are being examined in this study. Towards the end of this chapter, the discussions and reviews focus on the relationships among corporate governance characteristics, auditor quality, corporate governance and auditor quality in relation to reliability of audited financial statements. Undoubtedly, these reviews help to identify similar empirical studies that have been conducted as well as providing possible evidence of research gaps that require further probing and examination. Finally, the summary of the chapter is captured in the last section.

## **2.1 Reliability of Audited Financial Statements**

Reliability of Audited Financial Statements is a concept derived from financial reporting and it is defined by the Financial Accounting Standards Board (FASB) *Concepts Statement No. 2* of 2005, as “the quality of information that assures that the information is reasonably free from error or bias and faithfully represents what it purports to represent”. After all, the main aim of financial reporting is to produce useful information. Thus, the outcome of financial reporting is to supply users with useful qualitative and quantitative information upon which informed decisions can be made. In a major way, this helps the users of financial reports to evaluate, compare, predict and ultimately utilise resources effectively to attain the primary goals of their organisations. As noted by Abu Bakar *et al.* (2005) an audit report is made up of two types, that is, the financial statement audit report and the special purpose audit report. The latter provides the auditor’s opinion on statements other than the normal financial statements. According to Bribesh (2006), corporate reports must have certain attributes or characteristics if there are to be effective, namely, relevance, comparability, reliability, timeliness, completeness, and understandability (pp. 57 to 62). However, the focus of this study is on reliability of audited financial statements. The fact is that reliable financial statements enable investors and other consumers of financial information to make rational financial decisions.

Following a series of corporate scandals and, more recently, the global financial crisis, the issue of quality audit is particularly important. More in several countries rely more on exogenous forms of control over the accounting profession in the interest of improving the quality of the audit work and reliability of audited financial statements. The purpose of the study is to investigate the question of how a



whistleblowing in the South African mandatory auditors. Using an interpretive approach, this study examines the association between the requirement for additional information and perceived audit quality, which recommends that the requirement for auditors to report certain violations to the attention of appropriate control may be responsible making decisions (Maroun, 2014).

As noted by Faraj and Akbar (2008) “reliability of accounting information, contained in the audited financial statements, forms a crucial part on which users and decision makers form their expectations and make their decisions” (p. 2). Moreso, reliability has been described together with relevance as the two primary qualities of accounting information (Johnson, 2005; FASB, *Conceptual Framework for Financial Reporting*, 2008). The importance of these two concepts is also highlighted by the fact that both relevance and reliability are used by the FASB and the International Accounting Standards Board (IASB) in setting standards for financial reporting. In a way, the reliability dimension implies that users of accounting information can rely on the information included in financial statements with a degree of confidence. This also implies that an accounting system output can be used with a degree of trust. However, it should be pointed out that reliability does not necessarily suggest that the financial information has to be factually correct, but it should be as credible, and believable as possible. If at all possible the information should be independently verified, for example, by an independent and competent auditor.

In much the same way, Bribesh (2006) seems to suggest that reliability of accounting information stems from three characteristics, namely, faithful representation, verifiability as well as neutrality. However, for Elliot (1994), reliable information is “

representational faithful, precise, complete and unbiased” (p. 78). According to FASB *Concepts Statement No. 2 of 2005* the main elements of reliability are representational faithfulness and verifiability. In much the same way, Obaidat (2007) views reliability as the quality of financial information that allows users to rely on it with confidence. Similarly, the FASB’s *Statement of Financial Accounting Concepts* (SFAC) No. 2 of 1980, outlines that reliable information is verifiable, has faithful representation, and is neutral (SFAC No. 2 of 1980). So what do we mean by representational faithfulness, verifiability and neutrality? A key element of reliability of financial information is faithful representation which is described as “the correspondence or agreement between a measure or description and the phenomenon that it purports to represent” (Obaidat, 2007, p. 28). In much the same way, the FASB’s *Conceptual Framework for Financial Reporting* of 2008, notes that useful financial information, must be a “faithful representation of the economic phenomena that it purports to represent” (p. 18). Put another way, faithful representation is achieved when the representation of an economic phenomenon is complete, and free from bias or material error. Meanwhile, verifiability is outlined “as a quality that may be demonstrated by securing a high degree of consensus among independent measurers using the same measurement methods” (*FASB Statement of Financial Concepts No. 2 of 1980*). Lastly, neutrality means that information is reasonably free of errors and bias towards a predetermined result (FASB, 1980, para-99). Nevertheless, reliability does not mean precision. In fact, the FASB’s *Statement of Financial Accounting Concepts Statement No. 2* clearly states in paragraph 72 that “reliability does not imply certainty or precision, and adds that any pretension to those qualities if they do not exist is a negation of reliability”. It is clear, then, that precision is not a component of reliability.

Razali and Arshad (2014) examined the relationship between the management structure and the likelihood of fraudulent financial reporting. The probability of fraudulent financial reporting is based on the integration of Beneish model M-score and Z-score model Altman. These relationships are studied based on the analysis of the content of annual reports of 227 listed companies in Malaysia for the year 2010-2011. The results of this study demonstrate that the effectiveness of the governance structure to reduce the likelihood of fraudulent financial reporting. These results indicate that effective governance structure is essential to enhance the credibility of financial reporting.

The reliability of financial statements and reporting has been argued as having its roots from the industrial revolutions and ancient trading (Taylor, DeZoort, Munn & Thomas, 2003; Yang, Rohrbach & Chen, 2005). This was because the goals of accounting record in the early times was keeping proper accounts of the business transactions so as to enable the business owners to effectively ensures stewardship on the business assets. However, this early procedure was practically challenged by the modern development of big corporations that required the separations of powers, specifically ownership from management control (Jurney, 2008). This was in response to emerging needs of relevant stakeholders of financial statements both within and outside the company for the purpose of accountability (Faraj & Akbar, 2008). These emerging needs of the stakeholders have led to the calls for harmonising accounting standards amongst countries so as to reasonably determine the global reliability of accounting standards. Although issues of global accounting harmonisation was considered a costly and time consuming project, but its initiation has proved very significant on the current accounting knowledge both in academics

and the industry for standard-setting purposes. A practical example is the statement No.4 that was issued by the American Institute of Certified Public Accountants (AICPA) in 1973 which clearly specified 7 financial statements objectives, among which includes “the provision of reliable financial information about the economic resources and obligations of a business enterprise”.

Notably, due to lack of single globally acceptable definition of financial statement reliability, its issues and practical implications have received little attention both in academic research and practice (Flaming, 2002; Lai, Li & Taylor, 2012). Notably, researchers like Ismail, Haron, Ibrahim & Isa (2006) demonstrate that reliability is the most important attribute of the service quality yet to be fulfilled by the audit firms. Notable among those scholarly works that have tried to define reliability of accounting statement and information is Maines and Wahlen (2006), who defines reliability of financial statement as the degree to which the statement objectively represents and measures those underlying constructs that it purports to have represents without any bias. Notably, this definition is lacking in its explanatory power of representational faithfulness as required by the Financial Accounting Standards Boards (FASB). Ismail *et al.* (2006) also defined reliability as the ability of the employees of the audit firm staff to execute their duties in a timely and accurate manner. Researchers like Schipper (2007) believed and argued that the extant literature do not generally agree on what constitute the term “reliability”. Schipper in his explanation pointed at some scholarly work that defines reliability as the ability of financial information to be objectively confirmed by an authorised external source; while others strongly believes that the reliability of an audited

financial statement can only be ascertained through high degree of consensus among the selected independent measures.

Although, the existing disagreement on what constitute reliability can be looked from different perspectives. Notable among them is investigating the impact of auditor independence on reliability of audited financial statement (Geiger, Lowe & Pany, 2002). In their empirical study, Geiger *et al.* suggested that reliability can be determined by asking financial users their confidence level of how free the audited financial statement is from misstatement and omissions. In a further examination of the aforementioned issue, researchers like Libby, Nelson & Hunton (2006) empirically found that most auditors allow more of misstatement in their accounting disclosures than in the recognised amounts. These was based on the auditors' believes that recognised amounts are more material than the actual amount that is disclosed amounts. Hence, the above theoretical linkages depicts that perceived information's reliability directly affects the degree of users and auditors' judgments of financial statements. In fact, Desira and Baldacchino (2005) stated that whilst users regarded that the degree of work performed by an auditor was clearly communicated, auditors themselves felt such disclosure as not adequate. This scenario could have been caused by inadequate disclosure within the auditor's report, and hence underscoring the need to determine the mediating impact of auditors independence on the association between non-audit services (NAS), audit fees and reliability of audited financial statement (Flaming, 2002). Although many scholars in the field of accounting and auditing have separately studied the determinants of auditors independence, very few have studied reliability (Flaming, 2002).

In a related study, Faraj and Akbar (2008) highlight the link between reliability of financial information and auditor independence. In this respect, Faraj and Akbar state that the reliability of audited financial statements is premised on maintaining an independent audit. They further observe that lack of auditor independence would result in collaboration or collusion between agents and auditors who may mislead the principals and supply false accounting information. It is no wonder then that Wallman (1996) also proposes a new framework for assessing independence issues that focuses on auditor dependence. According to Wallman, there is always need to ascertain whether a relationship or activity has the potential to create a dependency that could bias auditing judgments. As such, the alternative approach is regarded as more comprehensive and easier to instill as a culture in an organisation. In sum, Wallman believes that in an era of rapid change in the business world, the alternative model should result in more reliable accounting information. In much the same way, Taylor *et al.* (2003) contend that the public interest will be best served by reprioritising ethical and professional goals to entrench reliability in fact and appearance as the foundation of the profession, rather than relationship-premised independence in fact and appearance. For Taylor *et al.* (2003), this model requires three foundational essentials to control subjectivity or bias in auditors' judgments and decision making, that is, integrity, independence, and expertise (competence). However, the authors point out that objectivity is not only a necessary but sufficient condition for entrenching reliability in fact and appearance. In a way, the foregoing studies develop a new standpoint on auditor independence that refocuses existing and future research on auditor reliability. In this regard, the reliability of auditors will ensure that key stakeholders and users of financial information regularly find the auditor's work and opinions dependable and credible.

In a related study, Vaassen, Meuwissen, and Schelleman (2009) mentioned that the quality of information is dependent on the effectiveness of information; and this effectiveness is dependent on the reliability of the information. To achieve such effectiveness, validity or transparency reporting is a necessary condition. Validity refers to whether claims made by the audit firm are based on facts and resemble the actual situation at the audit firm. Validity is the upper boundary of statements in which no situation is described more positive than reality (without misstatements). Hence, the accuracy of information is whether it is mathematical correct, no calculation or typing errors are displayed in the figures of the audit firm. The completeness of information also refers to its 'accordance with the represented part of reality', but forms a lower boundary (without omission/deletion). In the case of fraud and error, the International Standard on Auditing (ISA) 240 as cited in Desira and Baldacchino (2005) states that "an audit conducted in accordance with the International Standards on Auditing is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement" (p. 694). It should also be noted that though the audit may act as a deterrent, the auditor, however, is "not, and cannot, be held responsible for the prevention of fraud and error" (Desira & Baldacchino, 2005, p.694). In much the same way, the International Federation of Accountants (IFAC) *Code of Ethics* of 2003 adopts a similar position on auditor responsibilities. It states that the purpose of an audit should be to provide a high level of assurance that the audited financial statements are free from material misstatement or error. On the contrary members of the public still view the role of the auditor as being responsible for finding all material misstatements in financial statements. Thus, when defining the auditor's role, there seems to be a variation of

opinion or misunderstanding between what is possible for auditors to perform and what the public believe they should do.

However, the extant literature reviewed have also indicated that there is no identified existing empirical study that has determined the joint impact of NAS, audit fees and auditors independence on reliability of financial statement ( Geiger *et al.*, 2002; Al-Ajmi & Saudagaran, 2011). And this is despite the continuous call for an empirical study that will establish the joint impact of these factors on the reliability of financial information (Geiger *et al.*, 2002; Taylor, 2003; Obaidat, 2007). In addition to available studies that have been conducted on the effects of information reliability are some studies that have attempted to empirically examine how users of audited financial information measures reliability of the accounting estimates. Their arguments were premised on the fact that users of financial information must first assess the reliability of available accounting estimates so as to be able to evaluate those information risks that is associated with the audited financial reports (Hirst, Jackson & Koonce, 2003; Elliott, Hodge, Kennedy & Pronk, 2007).

In essence, auditing and financial reporting are linchpins to the success of capital formation process; and auditors are basically the gatekeepers of our financial markets. Although considered the two key attributes of auditor quality which are necessary to avoid audit failure are competence and independence (Fearnley & Beattie, 2004), it is clear that auditor independence is the main element affecting the credibility and reliability of an auditor's financial report (Watkins, Hillison & Morecroft, 2004). In summary, reliability is an important concept of accounting measurements, hence both the FASB and the IASB utilise it in developing standards



for financial reporting (IASB 2001; FASB 2008). After all, reliable information faithfully represents what it purports to depict or capture and is verifiable and neutral (free from bias). It is therefore not surprising that the traditional audit function focuses more on reliability than other qualitative attributes of financial statements. After all, the combination of reliability and auditor's independence and competence yields credibility (Elliott *et al.*, 2007).

Notably, one of the key issues of concern to the financial sector in Libyan has been the reliability of economic tools in controlling Libyan high levels of inflation and the financial disclosure processes (Ritchie & Khorwatt, 2007). Ever since the country embarked on a market based economy (including the adoption of a series of privatisation strategies), the country's financial market has encouraged the dominance of conventional banks (Shareia, 2010). To complement the activities of the financial market, the government of Libyan established the Libyan stock market in 2006. However, due to the lack of knowledge and required expertise in financial securities to deal in the stock market, the Libyan Stock Market has been in a state of dilemma due to some barriers such as distrust and culture of fear that permeates the country's environment especially during the Gadaffi era.

In a related study, Bribesh (2006) revealed that the corporate annual report is the most vital source of information relied upon to make informed decisions in Libya. Nonetheless, the findings of the study also indicated that the credibility and timeliness of the information source were the most important qualitative. Despite indications that Libyan companies strongly comply with International Accounting Standards, the study discovered some differences in the level of annual disclosure.

An instructive example is that of some Libyan manufacturing companies that have good sales figures yet government organisation or their agents tend to disclose less information than other firms. The results of the study also show that the level of voluntary disclosure in published corporate reports of Libyan firms is low compared with the level of mandatory disclosure. In another study, Faraj and Akbar (2008) examine the effect of economic, regulatory and cultural factors on auditor independence and ultimately on the reliability of audited financial statements. The findings of the study revealed that all the factors, namely, audit tenure, audit committee, audit competition, audit fee size, audit firm size, provision of non-audit services, legal incentives, social relationships have a significant effect on the perceived reliability of audited financial statements. In much the same way, Faraj (2009) indicates that economic, regulatory and country-specific-culture have an impact on the auditor's independence and the perceived reliability of audited financial statements in Libya. The study also reveals that financial reports users consider auditor independence as an important ground for reliable financial statements on which they base their decisions. More importantly, the findings highlight the fact that amongst other variables, the absence of auditing standards in Libya is one of the main factors undermining auditor independence in the country.

## **2.2 External Corporate Governance (Audit Firm Attributes)**

As indicated earlier, one of the main aims of corporate governance is to resolve agency conflicts which occur in the principal-agent relationship. On one hand, shareholders (principal) have an interest in maximising the value of their ownership, and on the other hand, managers (agent) tend to be more interested in the private consumption of firm resources and the growth of the firm (Vitols, 1995). Academic

accounting research indicates that some monitoring or oversight mechanisms may be developed to mitigate the impact of the agency problem and thus, reducing the financing costs of firms. One such method which could contribute to corporate governance efforts in attending to agency problems is to engage an external auditor to certify the accuracy of a firm's financial statements (Fan & Wong, 2002). The external auditor acts as an indirect corporate governance mechanism whose mandate is to check on the information aspects of an obtaining governance system in place. In essence, the primary role of the external auditor is to ascertain whether the financial information given to investors and other users is reliable and credible. In this regard, the auditor's role is to look for financial misstatements caused by either error or fraud. Various stakeholders particularly investors rely on financial statements to make economic decisions. In that sense, external audit provides confidence, reduces uncertainty and risk, and adds value. The external auditor helps to create an environment that encourages or compels managers to be held more accountable, particularly by checking for financial misstatements as well as imposing various penalties on members of management responsible for inflating or manipulating accounting figures and financial statements (Ojo, 2009).

There is no doubt that the financial audit is a key element of corporate governance that makes management accountable to owners (principal) for its stewardship of a firm. In this respect, attention is drawn to the important role of audit committees vis-à-vis the external auditor's responsibilities. Notably, audit committees do not only serve as internal monitoring devices which augment good corporate governance practices, they are also regarded as instruments that ensure that a proper relationship subsists between the auditor and the client's management. Prior to corporate

governance reforms in many countries, the pressures faced by external auditors from top management in many companies were intense and in some cases compromising the financial audit due to ‘creative accounting’ practices. More importantly, the audit committee and the auditors need to maintain an ongoing dialogue independent of management and the rest of the board. In a way, the external audit serves as a signaling device to principals of a firm that financial information provided by the management can be depended upon. It is therefore scarcely surprising that mainstream accounting research reveal that enhancing the independence of audit committees and auditors would increase the credibility and reliability of audited financial statements for the benefit of all key stakeholders (Cohen *et al.*, 2002).

In accounting literature, external auditors have been defined as those individual experts that act as an external governing mechanism to the internal controls of a company by reviewing and evaluating its internal activities and controls primarily to detect any material misstatements (IAIS, 2009; Ojo, 2009). The main objective of hiring an external auditor is to allow him or her to express expert opinion on a firm’s consolidated financial statements and available management controls of financial activities to the board of shareholders (IAIS, 2009). These and many other issues have led to the sponsorship of the Blue Ribbon Committee (BRC) by the National Association of Securities Dealers (NASD) and New York Stock Exchange (NYSE), mainly to address SEC’s concerns on the diminishing quality of financial reporting due to mismanagement of earnings and inability of audit committees to effectively address earnings management. Following the inauguration of the BRC, its committee issued a ten recommendations report in 1999 mainly to improve the existing roles of the corporate audit committees and to improve its impacts on the reliability of

audited financial statements (BRC, 1999). These ten recommendations practically suggest constant interactions between the external auditors and the audit committee. They believe of the BRC is that this interactions will assist in effectively ensuring that the desired integrity of the audited financial reporting is in line with the established processes and industry standards.

Sequel to BRC's recommendations, the SEC and other regulatory bodies came up with new approaches of scrutinising the elements of audit committee characteristics and its related activities (Bedard, Chtourou & Courteau, 2004). This is because the audit committee primarily oversees the firm's management, its internal and external auditors. Meanwhile, the discovery of frauds and several other financial scandals that involve MNCs such as Enron, Global Crossing, and WorldCom, informed the need for SEC to call for a greater level of external auditor's independence (Bedard *et al.*, 2004). One of the strongest arguments by the SEC on the increasing number of frauds due to audit failures is the lack of independence by the external auditor. The SEC and many other notable professional bodies have argued that the economic reliance of external auditors on their client is a main source of frauds due to the lack of auditor independence. Yet many members of the public expect auditors to dispense their responsibilities in the auditing of financial statements by detecting frauds and errors (Desira & Baldacchino, 2005). It should be pointed out, however, that external auditors possess certain attributes and characteristics that shape their effectiveness in the auditing process. Some of these characteristics include the auditors' provision of NAS to its suppose audit client; audit firm size; audit fees; and audit tenure or rotation. There are other non-audit or external firm characteristics

which also affect the effectiveness of auditors such as the level competition in the audit market and accounting standards.

### **2.2.1 Provision of Non-Audit Services**

Notwithstanding the fact that there are a number of factors, which could compromise auditor independence such as the provision of NAS, audit fees, audit tenure, employment relationship and audit firm size, this section focuses only on the impact of the provision of NAS on auditor independence. Generally, NAS refer to the non-core role of providing professional advisory or consultancy services undertaken by the engaged audit firm. The main purpose of such a move is to enhance the client's use of its resources and capabilities to attain organisational objectives. Since the demise of Enron, this whole area of the provision of NAS and auditor independence has become a burning issue in scholarly circles (Klein, 2003). The extant literature on auditing have revealed that auditors' provision of NAS to its audit clients has consistently been criticised by both researchers and regulatory bodies across many countries as posing a serious threat to the independence of the auditors (Firth, 2002; GAO, 2003; *Sarbanes-Oxley Act*, 2002; Chen *et al.*, 2009; Lee, Mande & Son, 2009; Beaulieu & Reinstein, 2010; Al-Ajmi & Saudagaran, 2011; Ebimobewe, 2011). Both the industry reports and academic literatures have established that the provision of some types of NAS by auditing firms to their clients will potentially threaten the independence of the auditors. Various types of non-audit services (NAS) impact on the probability that the adjustments of financial statements are made in Malaysia. Based on the observation of 953 companies for the period 2007-2009, the evidence is found of a negative relationship between the provision for NAS and reliability of audited financial statements (Wahab, Gist & Majid, 2014).

Undoubtedly, the concern about the threat that NAS could pose on auditor independence was acknowledged by professional bodies worldwide. Consistent with these views, are the popular SEC rules that ban the provision of certain non auditing services. By coming up with such rules that also include making it a must for external auditors to disclose the fees received from audit and NAS from a particular client, it is clear that the SEC believes that issues of NAS have undermined external auditors, due to the risk of losing the lucrative financial benefits that are inherent in non-audit services. There is no doubt that such banning was triggered by the need to prevent external auditors from providing certain NAS that could impair their independence (Sullivan, Zaccaro, Schneir, Janofsky & Walker, 2009). Subsumed within the set of these new rules aimed at enhancing auditor independence is the Sarbanes-Oxley Act (2002) which prohibit audit firms in the US from providing some NAS to their audit clients by identifying nine different types of NAS that are practically inconsistent with auditor independence. Some of the prohibited services include the following: designing and implementing financial information systems, bookkeeping or any other accounting records, services on actuaries, valuation or appraisal services, internal audit services, any management functions, human resource services, any legal services and broker-dealer related services (SOX, 2002). It is therefore not surprising that many financial regulators believes that these type of reforms will collectively assist in improving the required integrity in financial reporting processes, and thus help in reducing the likely economic consequences that are associated with such financial misstatements (Sullivan *et al.*, 2009).

As the scope of NAS carried out for the client broadens and deepens, the relationship between the two parties (auditor & management) becomes closer as well. It is

scarcely surprising that researchers and scholars have debated the impact of the provision of NAS on auditor independence. As evident in the extant literature on auditing, issues of NAS are fast becoming a major concern within the financial sectors given the continuous increase in the amount of non-audit fees in the last two decades (Levitt, 2000; SEC, 2000a, 2000b; Frankel, Johnson & Nelson, 2002; Abbot *et al.*, 2003; Gwilliam, 2003; Brandon *et al.*, 2004). One of the main studies that showed a positive relationship between NAS fees and discretionary accruals, and a propensity for reporting a small earnings surprise, was conducted by Frankel *et al.* (2002). These findings support the argument for the separation of audit and NAS in order to enhance auditor independence. It has also been accepted that when auditors act as consultants to audit clientele they are in reality scrutinising their own work. Furthermore, provision of consultancy services may develop mutual interests between the auditor and the client's management. As suggested by Gore *et al.* (2001), in such circumstances auditors are in essence serving the interests of management and not shareholders, which may result in the audit firm also suffering fiduciary conflicts of interests. Interestingly, however, inconsistencies are still found in the empirical evidence, as suggested in other studies (Beck, Frecka & Solomon, 1988; Gul, 1989; DeFond, Raghunandan & Subramanyam, 2002; Raghunandan, 2003; Whisenant, Sankaraguruswamy & Raghunandan, 2003; Francis, 2006; Mitra, 2007).

There is no doubt that there has been a growing realisation of the continuous rapid increase in the growth of NAS which has practically increased the economic dependence of audit firms on their clients, further subjecting the auditors to the risk of impartiality and misstatement. In a way, the main concerns within the extant



literature review is more on the ability of the external auditors to objectively and impartially examine the clients' financial records while simultaneously getting those lucrative fees emanating from the provision of NAS to the same client (Sharma & Sidhu, 2001; Firth, 2002; Awadallah, 2006; Hay, Knechel & Li, 2006). Unsurprisingly, there is controversy or heated debate surrounding auditors providing NAS to their clients which centres around the ability of such auditors to audit objectively their client's financial statements while concurrently providing advisory services to the same client. As noted by Zaman, Hudaib and Haniffa (2011), the joint provision of audit and NAS generates a perception that auditors might undermine their independence and be improperly driven by a craving to protect their clients in their quest to safeguard their audit and NAS fee income.

Some of the researchers generally assume that the provision of NAS to audit clients undermines the independence of external auditors. This is based on the notion of economic dependence and mutuality of interest which is articulated by a number of scholars (Mautz & Sharaf, 1961; Firth, 2002; Awadallah, 2006). For example, Firth (2002) argues that audit firms by providing NAS to their audit clients, impair their independence because giving advice and decision making cannot be separated and that the auditor who provides NAS cannot avoid participation in management decisions. In the same league, Awadallah (2006) believes that the provision of both audit and NAS to the same client would consciously or unconsciously create a kind of conflict of interest that might lead to compromising the auditor's independence. He went further to entrench their position by arguing that external auditors might subjectively become sympathetic to managerial attitudes and perspectives, primarily because of their economic bonding and other inter-personal relationships. Some

available evidence also shows that the provision of NAS by the same auditing firm will potentially lead to a serious economic bond or attachment between the audit firm and its clients due to significant high fees that are involved (Geiger *et al.*, 2002; Chen *et al.*, 2009; Zerni, 2009). Notably, Geiger *et al.* (2002) empirically showed that the presence of NAS practically threaten the independence of external auditors because the economic bonding that will evolve between the audit firm and its clients would have a major influence on auditor independence. The foregoing view is consistent with the findings of Zerni (2009) who observes that increases in economic bonding between the auditor and client may jeopardise the appearance of independence, and have potential adverse consequences such as the client firms' willingness to purchase NAS (p. 23).

Consistently, researchers like Quick and Ben-Rasmussen (2005) empirically established that the provision of NAS by audit firms increases the auditors' quasi-rent, thus impairing the independence of the auditors. Flaming (2002) reaches a similar conclusion as his study indicates that investors' perception of auditor independence is negatively affected by the provision of NAS. In the same vein, Firth (2002) observed that the provision of NAS to an audit client will increase auditor's economic dependence on that client. Consequently, a decrease in auditor independence or perceived lack of independence will obtain. Additionally, Firth argued that any auditor in such a situation will be unwilling to issue an adverse report on items that are the product of, or partly the product of, his or her consulting services.

The above discussion demonstrates that there is widespread debate on the advantages and demerits of audit firms providing NAS. As pointed out earlier, the chief concern is that NAS is usually associated with economic dependence and mutuality of interest. Consequently, if NAS becomes integral, either in total or in relation to a client, the economic reliance of the audit firm on these non-core services and clients may degrade auditor objectivity, impartiality, and ultimately auditor independence. For that reason, audit and NAS fees are generally used in studies focusing on auditor independence (Watts & Zimmerman, 1983; DeFond *et al.*, 2002; Ashbaugh, LaFond, & Mayhew, 2003; Gul, Chen & Tsui, 2003). Nonetheless, the evidence documented by Firth (2002) is also consistent with NAS being beneficial to the audit process. NAS provided to the client may have helped the client to resolve problems which existed prior to the audit, which in turn enables the auditor to issue a clean opinion.

Notably, there is a growing list of studies which challenge the proposition that the provision of NAS to audit clients undermines the independence of external auditors (Firth, 2002; Flaming, 2002; Chung & Kallapur, 2003). Challenging conventional wisdom, Flaming (2002) found that the perception reliability of financial statements was not affected by provision of NAS. In their study, Chung and Kallapur tested the economic theory of auditor independence that hypothesises the probable undermining of auditor independence where incentives such as fees from the provision of NAS are substantial. However, the study findings established that there was no relationship between abnormal accruals and the client importance ratios, thereby demonstrating proof that is incompatible with the postulations of the economic theory of auditor independence. The findings of this study are consistent with the contention of existing studies which proffer that the provision of NAS

enhances an auditor's value to the client, thereby placing the auditor in a stronger position to refuse to give in to client demands and pressures. In a related study conducted by Mitra (2007), it is also revealed that there was no association between abnormal accrual adjustments and fees paid for NAS. According to Mitra an audit firm's reputational capital and industry specialisation are sufficient incentives to ensure auditors remain independent from the client's management. Other research findings have established that the joint provisions of NAS and audit will increase the auditor's knowledge about the client's company and thus increase auditors' independence and objectivity (DeFond *et al.*, 2002; Raghunadan, 2003; Whisenant *et al.*, 2003; Francis, 2006; Mitra, 2007; Arrunada, 2010). These proponents of NAS list a number of other benefits that could be obtained by the external auditors and their clients from providing such services such as cost savings and competitive advantage. Other studies focusing on the link between the provision of NAS and the reliability of audited financial statements also found no evidence in support of the curtailment of auditor independence due to the provision of NAS (Ashbaugh *et al.*, 2003; Ruddock, Taylor & Taylor, 2006). Meanwhile, a study by Hay, Knechel and Li (2006) conducted in New Zealand discovered that there is a possibility for the impairment of auditor independence 'in appearance' when external auditors provide NAS. On the other hand, the study established that there is no proof of any impact of the provision of NAS on auditors' 'independence of mind'.

Interestingly, another set of studies found that the joint provision of NAS and audit has neither positive nor negative effect on auditors' independence (Pringle & Bushman, 1996; DeFond *et al.*, 2002; Ghosh & Kallapur & Moon, 2006; Church & Zhang, 2011). As revealed by Geiger *et al.* (2002), the conflicting evidence in

support of the proposition which states that joint provision of auditing and NAS by the same external auditors will threaten auditor independence is no longer a major concern. It is clear from the foregoing discussion that studies that attempted to examine the impact of NAS purchases on auditor independence have produced mixed results. As a result, the mixed findings established in the extant literature make it challenging to draw conclusions from these sources regarding the influence of the magnitude of NAS fees on auditor independence. Unsurprisingly, some scholars use this conflicting empirical evidence to reach the conclusion that the available empirical proof does not support the viewpoint that auditor independence is threatened or undermined by the provision of NAS (Arrunada, 2010). On the other hand, some researchers like Krishnan, Sami, and Zhang (2005) have pointed out that though the potential impairment of auditor independence exists, this does not necessarily suggest that it can, or will happen. For others the focus of attention should be given to the evidence that indicates the impairment of auditor independence due to the provision of NAS.

Generally, as pointed out in earlier sections, there is a common belief that auditors compromise their independence when they provide NAS. Nonetheless, conflicting empirical evidence from research studies demonstrates that debate on the effect of auditors' provision of NAS to clients is still far from over. On close reflection, however, impairment to auditor independence in appearance or perception, has been well documented (Flaming, 2002; Quick & Ben-Rasmussen, 2005; Gul, Tsui, & Dhaliwal, 2006; Zaman *et al.*, 2011). As the relationship between auditor and client is believed to change with the provision of NAS, so too it is expected to change as the association between auditor and client lengthens.

### **2.2.2 Auditor Rotation**

The relationship between audit independence and audit firm rotation is a burning issue in the accounting literature. The debate is ostensibly shaped by two opposing views. Advocates for compulsory audit firm rotation emphasise the necessity to have a fresh look at intermittent intervals to guarantee client-auditor independence and auditor efficacy, while those opposed to auditor rotation highlight the risk of lower audit quality and higher audit failures that can arise due to the loss in continuity and audit competence generated by mandatory audit firm rotation. Basically, supporters of auditor rotation argue for the need to sustain auditor independence to assure quality reporting (Vanstraelen, 2000; Knechel & Vanstraelen, 2007; Lee *et al.*, 2009; Lassila, Omer, Shelley & Smith, 2010) while opponents of this practice have little faith in its ability to promote auditor independence (Jackson, Moldrich & Roebuck, 2008; Davis, Soo & Trompeter, 2009). Salleh and Jasmani (2014) conducted a study to analyze the relationship of reliability of audited financial statements and audit the auditors' rotation. The association between reliability of audited financial statements and the rotation of mandatory audit partner seemed significant.

The extant literature reviews have shown that the practice of rotating the audit firms and/or its partners is practically different around the world (Sori, 2005; Kwon, Lim & Simnett, 2010). In other words, there are mixed results on the impact of audit tenure or rotating audit firms on audit quality. On one hand, some scholars view auditor tenure as influential in audit outcomes (Vanstraelen, 2000; Geiger & Raghunandan, 2002; Dopuch, King & Schwartz, 2003; Gates, Lowe & Reckers, 2007; Jackson *et al.*, 2008; Manry, Mock, & Turner, 2008), and on the other hand, some disagree by highlighting differences in the regulatory frameworks in different

countries. For example, in Greece and Italy, rotation rules are in force, whilst other legal systems have allowed a free choice of auditors in the private sector, for example, the US, UK, Germany, France, and others (Arrunada & Paz-Ares, 1997).

Generally, most studies have examined the impact of audit tenure (which refers to the length of the relationship between auditors and their clients) on audit quality (Myers, Myers & Omer, 2003; Bae, Rho & Ro, 2007; Chen, Lin & Lin, 2008; Jackson *et al.*, 2008; Turner, Mock, Coram & Gray, 2010). However, most of these scholars recognise that auditor engagement over a long period promotes an emotional relationship from which strong feelings of loyalty may develop. In the long run, the argument goes, such forms of personal bond may eventually impair auditors' objectivity, and as well as audit quality. On the contrary, some studies have demonstrated a link between audit quality and audit firm tenure (Chen *et al.*, 2008; Jackson *et al.*, 2008). In this regard, Jackson *et al.* (2008) argued that audit quality is not improved by the imposition of mandatory audit rotation since their findings showed that audit quality tended to increase with audit firm tenure, when substituted by the propensity to issue a going-concern opinion. Besides, they also found that the initial costs associated with the start of each rotation place unnecessary financial costs on both the auditor and the client, which can themselves cause much stress. Similarly, Chen *et al.* (2008), in a study conducted in Taiwan, discovered that audit quality improves with audit partner tenure, and that the weaknesses of compulsory rotation are partially 'managed' by firms rotating back and forth with just two audit firms that they maintain a good relationship with whether they are in negative impact on auditor independence.

In a related study, Johnson *et al.* (2002) offer empirical proof indicating that short audit-firm tenures of two to three years are linked with lower quality financial reports than those generated by medium audit-firm tenures of four to eight years. This phenomenon is attributed to the low likelihood of detecting misstatements due to insufficient client-specific knowledge in the early years of an audit engagement. In line with this argument, Gul, Jaggi & Krishnan, (2007) argued that auditors with short tenure are likely to lack adequate knowledge of their clients' accounting and control systems which might give their clients' management an opportunity to manage its reported earning or to indulge in creative earnings management. In a way, short relationships between auditors and their clients can be considered as having a negative effect on auditor independence.

In view of the above findings, it is clear that lengthy audit tenure may have a positive impact on the auditor's role. This is corroborated by a litany of studies which have dismissed calls for compulsory or mandatory auditor rotation as misplaced (Beattie & Fearnley, 2004; GAO, 2003; Cameran, Prencipe & Trombetta, 2009; Ghosh & Moon, 2005; Kwon *et al.*, 2010). From an economic perspective, it has been proved that suggested compulsory audit firm rotations have increased the incremental cost of audit production whilst at the same time decreasing the rate of competition within the audit industry (Arrunada & Paz-Ares, 1997; Cameran *et al.*, 2009). Furthermore, Cameran *et al.* (2009) empirically demonstrated that audit firms' rotation could potentially damage the two main determinants of audit quality, namely the degree of auditors' specialisation and their technical competence. This was also supported by findings from a survey that was conducted by the US *General Accounting Office* (GAO, 2003). In this survey, it was established that the majority of the *Fortune 1000*



firms and largest public accounting firms believed that the cost implications of the compulsory audit firm rotations practically exceeds the inherent benefits.

Several other studies have indicated that compulsory audit firm rotation was professionally perceived as an ineffective approach with huge financial costs as well as attendant loss of audit firms' institutional knowledge (Johnson *et al.*, 2002; Beattie & Fearnley, 2004; Ghosh & Moon, 2005; Davis *et al.*, 2009; Kwon *et al.*, 2010). For instance, Ghosh and Moon (2005) showed that mandatory audit rotation schemes introduce some unintended costs to participants in the capital market. In much the same way, Davis *et al.* (2009) established that mandatory or compulsory rotation increases the switching and start-up costs of both players, that is, auditors and their clients. It is generally agreed that "when an auditor is engaged with a new client, the first year start-up cost to that auditor is large as the audit process will be more time and effort consuming than with existing clients due to the creation of the learning curve or an experience curve" (Mostafa & Hussein, 2010, p. 3). Consequently, auditor fees charged by the auditor will rise, so as to absorb the high cost of audit.

Some of the opponents of audit firm rotation established that certain incentives such as the threat of litigation actually spur auditors to work hard to preserve their reputation, thereby invalidating the role of audit firm rotations as unnecessary (Davis *et al.*, 2009). Furthermore, those who are antagonistic to mandatory auditor rotation argue that transnational corporations (TNCs) that are evidently becoming key players in the modern day globalised economy have complex financial operations across many countries that require auditors who are well attuned in accounting principles and auditing rules enshrined in the laws and regulations of each country.

In view of that reason, those who are against mandatory audit firm rotation argue that it can cause even greater harm to audit quality by hampering continuity and degrading audit competence. In a related study, Ruiz- Barbadillo, Gomez-Aguilar and Carrera (2009) established that mandatory rotation may in fact damage auditor independence.

Despite the above cited benefits of long audit firm tenure, the overall long-term implications of audit tenure have been identified as posing potential threats to auditor independence (Vanstraelen, 2000). Notably, relationships between external auditors and their clients can cultivate familiarity and bonding with the client's management which may ultimately impair auditor independence and degrade the quality of the financial reports. It has been observed that such forms of close relationship have caused external auditors to examine transactions in an unprofessional manner and in the process contributing to recent remarkable audit failures and mishaps at several high profile firms such as Enron and World Com (Abu Bakar *et al.*, 2005; Gates *et al.*, 2007). It should be pointed out that several studies have concluded that long association or involvement between audit firms and their clients may lead to some form of collusion which may jeopardise truly independent decision making in the external auditing process (Abu Bakar *et al.*, 2005; Nasser *et al.*, 2006; Gates *et al.*, 2007). For example, Lee *et al.* (2009) observed that long-term audit tenure potentially result in the lack of innovation and complacency of audit procedures (Lee *et al.*, 2009). Several other studies on the impact of the external auditor's tenure, has provided additional evidence that longer tenure may in fact have a negative effect on audit quality (Son, 2005; Knechel & Vanstraelen, 2007). As noted by Son (2005), benefits are likely to be minimal for auditors working for firms with long tenure,

because these auditors are already familiar with the system and operations of the clients. Increasingly, calls for audit firm rotation grew larger as proponents for such measures argued that these may reduce the economic relationship between the auditor and the client and help curtail certain audit judgment bias.

In view of the preceeding findings, it is therefore scarcely surprising that some regulatory bodies and frameworks have also raised fears over the ‘unholy alliance’ between audit firms and their clients. As argued by many scholars and regulatory bodies across the globe, a continuously unchecked long-term relationship between the auditors and the clients could consciously or subconsciously undermine auditors’ sense of objectivity (Lee *et al.*, 2009; Lassila *et al.*, 2010). Understandably, in an effort to maintain public confidence in the audit function and to protect auditor independence, regulations that disallow auditors from developing close personal associations with their clients that may result in a potential conflict of interest have been implemented by some regulatory and professional bodies in advanced countries such as the US and the UK (Nasser *et al.*, 2006). In order to overcome this problem, several regulatory bodies and independent researchers have all suggested the need to adopt a compulsory auditor rotation programs by the auditing profession (ICAEW, 1997; IFAC, 2005; Lee *et al.*, 2009). Under this scheme, the selected auditors can only be allowed to serve any particular audit client for a fixed limited time. As pointed out by Gietzman and Sen (2002), such a fixed limited scheme would alleviate auditors’ worries in upsetting client’s management based on the limited engagement period. Majority of the supporters of this mandatory auditor rotation strongly believes that such a scheme would increase audit quality due to the fresh

look that will be conducted by new auditors on clients' financial statements (Vanstraelen, 2000).

On this aspect of compulsory auditor rotation, there are two major benefits which are evident, namely, its contribution to auditor objectivity by not allowing the situation of the auditor becoming too familiar with a client's system, and its contribution to control processes, and to the development of favourable impressions among users of audited financial statements (Brody & Moscovice, 1998). Furthermore, the physical process or act of rotation adds to the appearance of auditor independence (Abu Bakar *et al.*, 2005; Alleyne, Devonish, & Alleyne, 2006; Gates *et al.*, 2007) even if actual independence is not damaged by a lack of rotation. The foregoing is corroborated by the findings of Gates *et al.* (2007). In their study, Gates and others discovered that MBA and law students were more prepared to make personal investments in firms where audit firm rotation was in operation. They also established that whilst audit firm rotation appeared to enhance the perception of auditor independence, the rotation did not alter the level of confidence in reported earnings.

Nevertheless, several other studies have reached different conclusions (Geiger & Raghunandan, 2002; Ghosh & Moon, 2005). These studies have highlighted some of the drawbacks associated with the practice of mandatory rotation. It is indicated that short audit engagements are often inappropriate for large complex businesses since it takes time for the external auditor to become fully acquainted with the firms' audit needs. For that reason, it is not expected that the firm will see the best audit work in the first few years of engagement. In much the same way, Johnson *et al.* (2002) argued that audit effectiveness is shaped by audit firms' accumulated knowledge and

long-term experience of a client's business systems and unique reporting issues, and that mandatory rotation would undermine this opportunity. Furthermore, Geiger and Raghunandan (2002) indicated that there were considerably more audit reporting failures in the earlier years of auditor-client relationship than when auditor had been engaged by the clients for longer periods or times. In a related research, Ghosh and Moon (2005) conclude that in general, audited financial statements, and especially reported earnings, are perceived as more reliable for audit firms with longer audit tenure. Kilgore, Radich, and Harrison (2011) also observed that respondents to their study considered the attribute of auditor rotation to be relatively unimportant in their perceptions of audit quality.

There is no doubt that the role of audit firm rotation as an instrument of enhancing auditor independence has been a topic of serious debate for a number of years. On one hand, several studies have major benefits associated with compulsory auditor rotation, such as its contribution to auditor objectivity by not allowing the situation of the auditor becoming too familiar with a client's system, and its contribution to control processes, and to the development of favourable impressions among users of audited financial statements. However, as indicated earlier several other studies have reached different conclusions (Geiger & Raghunandan, 2002; Ghosh & Moon, 2005). Though opponents of mandatory audit firm rotation do recognise the likely challenges that can emerge out of long audit tenures, they also point out a number of negative aspects associated with compulsory audit firm rotations. Basically, these foes of mandatory audit firm rotation do not agree with the notion that audit firm rotation is the best way to solve some of the challenges given the likely cost that this approach might cause. They further contend that compulsory audit firm rotations

pose even greater harm to audit quality by affecting continuity and lowering audit expertise. Additionally, they point out that the increase in training costs acquired by the new audit firms which would ultimately pass on to audit clients. As an alternative they propose several measures that ensure auditor independence such as improving the regulatory framework, accounting and reporting standards, as well as making auditors responsible for their monitoring role.

Given the equally convincing arguments of both sides, it is scarcely surprising that policy makers including regulators in many countries have attempted to strike a balance between the need for a new pair of hands and concerns about the decline in audit quality as well as loss of continuity, due to the rotation of the audit firm itself. But on close inspection, there is no consensus within the extant literature on the practice of compulsory audit firm rotation. Available evidence shows that countries like the US, Brazil, Italy, Singapore and Austria requires their public listed firms to rotate their audit firms within a fixed period of five years (Sori, 2005). Notably, in the US, audit firm rotation rules were very sloppy until the SOX Act was enacted in 2002, which made far-reaching reforms. However, it is worth mentioning that Singapore only requires the auditors of locally registered banks to rotate within five years, leaving the multinational banks to their internally based policies. On the other hand, countries like Japan, Germany, UK, France, Malaysia and the Netherlands have all adopted this compulsory rotation of audit firms and its partners (Kwon *et al.*, 2010). Furthermore, the authorities in UK, Malaysia, and Netherlands require the rotation of audit partners in every five years, while countries like France and Germany fixed a period of six years, and Japan seven years respectively. Nonetheless, the Coordinating Group on Audit and Accounting Issues in the UK did

not support the notion of mandatory rotation of audit firms due to the likelihood of negative effects on audit quality and effectiveness in the first years after rotation. In the European Union, mandatory rotation of corporate auditors has been proposed in order to improve audit quality. However, some researchers like Arrunada and Paz-Ares (1997) continue to assert that such audit firm rotation increase the cost of audit, and consequently the cost of fees, which in turn would bring the depletion of specific assets and the distortion of competition in the audit market.

A major problem with the above studies is that they cannot test if rotating auditors will improve audit quality as very few companies have in practice rotated auditors since legislation on the issue is relatively recent and in most cases does not require them to do so, especially private listed companies (Sori, 2005). Consequently, most of the results mentioned above use length of audit tenure in their assessment and then extrapolate their findings to the case of auditor rotation. On closer inspection, this may be an inappropriate method as auditor rotation is a discrete event and may not be predictable from these models which treat tenure as continuous. Despite these results from empirical research, theoretical postures suggest that there ought to be fixed terms for auditors. However, as indicated in other studies, longer audit firm tenure may be superior in that the understanding of the client's business operations by the auditor increases with their length of tenure. On the other hand, some studies also show that the longer the tenure, the higher the risk of client influence on the external auditor. Nonetheless, there must be some point where rotating auditors would yield higher net benefits.

From the preceding discussion, it is evident that there is no consensus within the extant literature on the role of audit tenure in audit quality nor the impact of audit firm rotation. In other words, existing literature shows conflicting or competing evidence as to the impact of audit firm tenure on perceived auditor independence. Some theoretical approaches and empirical studies suggest that long audit firm tenure may result in the development of an ‘unholy alliance’ that could negatively affect auditor independence and degrade the reliability and quality of the audited financial statements. In order to remedy the situation, mandatory audit firm rotation was proposed. On the other hand, others believed that the costs of audit firm rotation outweigh or eclipse the benefits and the experience and knowledge that is acquired over time in enhancing auditor quality would be undermined by the selection of a new external auditor. Additionally, it was pointed out that problems pertaining to auditor independence and audit reporting may be more likely to happen in the infantile years of the auditor-client relationship. So far, however, academic studies have been unable to generate conclusive empirical evidence about the gains of rotating audit firms. Nonetheless, there is some empirical proof of the risks associated with mandatory audit firm rotation.

### **2.2.3 Size of Audit Firm**

Generally, accounting literature indicate that the large size of the audit firm is regarded as having a positive effect on perceived auditor independence as opposed to the small size firm (see Abu Bakar *et al.*, 2005; Lennox, 2005; Francis & Yu, 2009). In other words, large audit firms are typically seen as more capable of retaining or sustaining a satisfactory degree of independence than small audit firms. So what are the attributes or characteristics of audit firm size? Several studies have identified a



number of features that are used as proxies for audit firm size. Several researchers have defined large firm size in terms of the provision of multi-services to many clients (DeAngelo, 1981; Dopuch, 1984; Gul, 1991; Wilson & Grimlund, 1990), in respect of the proportion of fees charged for both non-auditing and audit services (Shockley, 1982), in terms of the audit firm's market share revenue (Gul, 1991; Porter, Hatherly & Simon, 2008), in terms of the number of clients and the number of members of audit firm (Riytano, 2007) and on the basis of internationality (Jang & Lin, 1993; Mutchler, Hopwood & McKeown, 1997; Krishnan, 2003) using variations between the Big Eight, Six, now Four, and non-Big Four. Other characteristics of large audit firm size include the size and number of audit clients, which are also seen as signals of quality. In view of the importance of audit firm size, it is scarcely surprising that this attribute is one of the most researched factors or attributes that has increasingly received attention in many countries.

A number of reasons exist that explain the significance of the large size of an audit firm. For instance, Naser and Al-Khatib (2000) have indicated that high quality corporate financial reporting is linked with the status of the audit firm since those that work in large international audit firms are known to publish high-quality information. To buttress this view, it is argued that these large firms have a reputation to protect, and this can only be done through consistent and credible audit quality. This may, of course, be reflected in audit fees. Several studies give credence to the foregoing notion of the association between audit firm size and audit quality. A study by Michael (2007) show that clients audited by large firms generally have lower abnormal accruals, and are more likely to meet the benchmark earnings targets of small profits and small earnings increases. Furthermore, Michael (2007)

established that large audit firms are more likely to issue going-concern financial reports. Similarly, Abu Bakar *et al.* (2005) indicate that audit firm size appears to be the most influential factor in securing audit quality and auditor independence. This viewpoint is also shared with DeAngelo (1981a). DeAngelo observes that the relationship between clients and serving auditors is a two-sided monopoly, in which both parties wish to retain their established relationship, because neither one has a perfect substitute available. Put differently, clients need auditors with good reputations, and in turn those auditors need clients who can afford to pay them. Clearly, an end to such relationship would be damaging on both parties. Evidently, as noted earlier, there is a significant difference in audit quality offered by audit firms of different sizes with larger ones producing higher audit quality.

Undoubtedly, a significant portion of extant literature suggest that larger audit firms produce higher quality audits. For instance, Francis and Yu (2009) state that the size of audit firms is an important characteristic upon which the influence of auditor independence perception can be determined (Francis & Yu, 2009). In much the same way, Hudaib (2003) argue that certain features or attributes inherent in small audit firms may increase the threat of auditor impairment. For instance, Hudaib states that larger audit firms are perceived by users of financial reports to be more independent than their smaller counterparts in resisting client's management pressure in the event of disputes or conflicts as they normally have more clients and can afford to give up some of their more problematic clients. Similarly, Abu Bakar *et al.* (2005) who investigated the effect of audit firm size on perceptions of auditor independence as held by bank loan officers in Malaysia; also found that participants perceived that the

larger the size of an audit firm, the more likely that auditor independence would be enhanced.

In a related study, Tahinakis and Nicolaou (2004) show that participants of this study considered small audit firms as more likely to lose their independence vis-à-vis larger audit firms. Awadallah (2006) also reached the same conclusions when results of his study showed that respondents perceived small audit firms as more likely to lose their independence in relation to large audit firms. Similar findings were recounted by Alleyne *et al.* (2006) which showed that small firm size and being a sole practitioner were more likely to generate negative perceptions of auditor independence in respondents from Barbados. On the other hand, the same study shows that large audit firms were found to be generating positive perceptions of auditor independence in the same respondents. Notably, the respondents of this study included auditors, credit managers, financial directors, fund managers, investment analysts, government officers and shareholders from Barbados. Some of the theoretical arguments in favor of the size of audit firms are that it is very crucial given the inability of small auditing firms in developing appropriate research facilities and providing skilled staff that can audit large clients. As a result, Big Four audit firms tend to audit most of the large firms while non-Big Four auditors audit small and medium-sized companies as is the case in Hong Kong (Shafer, Morris & Ketchand, 2001).

Other researchers argue that those audit firms that have large client portfolios will have stronger and better incentives in protecting the independence and reputation of their firms (Yuniarti, 2011). The aforementioned argument is consistent with the

hypothesised deep pockets relationships as discussed by researchers like Reynolds and Francis (2000). According to Reynolds and Francis (2000) large audit firms with greater wealth are more motivated to be diligent in examining clients' firms and are more susceptible to any lawsuits or adverse reputational effects in the cause of discharging their audit tasks. Thus, practice wise, large audit firms with deeper pockets or financial base would officially have more to lose both financially and public image in case there is any audit failure as was the case with Arthur Andersen which was disbanded in the aftermath of the Enron collapse. It is therefore not surprising that bigger clients have the greater litigation risk and as such auditors report more conservatively for the bigger clients for the following reasons: litigation avoidance and protecting their reputation capital (Reynolds & Francis, 2000). This is also supported by DeAngelo (1981b), who empirically stated that the big audit firms will lose more in the event of their failure to sincerely report client's financial condition; thus, the reports of large audit firms are deemed to be more reliable. Furthermore, due to legal implications, a number of other researchers have established that larger auditors are not prone to collaboration with their clients on issues of financial misstatements (Boone, Khurana, & Raman, 2008; Krishnan, Rama, & Zhang, 2008). In a nutshell, large auditing firms will have more to lose in any situation of their association with audited accounting scandals basing on their large client portfolio that they control compared to the ones controlled by small audit firms. Nonetheless, the small clients' portfolios of non-Big Four audit firms (due to large clients' preference of Big Four auditors) may expose small audit firms to the risk of potentially depending on one major client, which may ultimately compromise their independence (Sori, 2005).

Meanwhile, some studies such as Kilgore *et al.* (2011) show that audit firm size is rated as the most important element in perceptions of audit quality. In that study, the participants demonstrated a penchant for Big Four firms and mid-tier audit firms vis-a-vis local small audit firms. As indicated earlier in prior studies, this finding is unsurprising since audit firm size has been revealed to be a key attribute in determining perceived audit quality (Reynolds & Francis, 2000; Francis, 2004; Alleyne *et al.*, 2006). The main reason being that larger audit firms are comparatively more independent and capable than smaller firms, and therefore produce higher quality audits. Some scholars point out that large audit firms such as the Big-Four audit firms are more superior in terms of possessing modern technology and skilled employees than the Non-Big Four audit firms, hence have higher probability of having higher incentives and expertise to discover and correct errors and misstatements in financial reports as well making auditors behave more independently (McLennan & Park, 2003; Sori, 2005; Sawan, 2010). It is therefore scarcely surprising that extant literature shows that acceptable levels of audit quality are generally more apparent in large audit firms than in small ones, the major reason being that the larger the audit firm, the higher the number of clients, and the greater the likelihood that the range of services provided are better. In this respect, the audit firm minimises its dependency on particular clients. Furthermore, large audit firms are better resourced and as such are in a more advantageous position to develop a strong reputation and brand name. To put differently, audit or financial reports certified and produced by large firms are generally regarded as more reliable because large audit firms have a vast array of more accurate and powerful mechanisms to examine client firms (Sori, 2005). As a result of this, prestigious large audit firms are typically considered as providing a high quality service than small audit firms (Naser

& Al-Khatib, 2000; Francis, 2004; Abu Bakar *et al.*, 2005; Michael, 2007). For instance, Michael (2007) revealed that clients audited by large firms generally have lower abnormal accruals. Furthermore, Abu Bakar *et al.* (2005) reveal that the size of the audit firm comes out as the most influential factor in securing audit quality and auditor independence in the Malaysian context.

The viewpoint that large audit firms produce a higher level of audit quality vis-à-vis small firms is shared by Lennox (2005) who argues that large audit firms' opinions are more accurate compared with those of small audit firms due to the high quality audits that are associated with large audit firms in relation to small audit firms. It is therefore not surprising that the auditing paradigm has consistently depicted audit firm size as a major proxy for determining the quality of audited financial statement (Michael, 2007; Francis & Yu, 2009; Yuniarti, 2011). Put another way, audit firm size has been utilised as a surrogate or proxy measure of audit quality in numerous studies. Nonetheless, the debate about the impact of audit firm size on audit quality is unending and still persisting. In fact, large audit firms are more and more being castigated on the basis of their size, by both smaller audit firms and regulators within the auditing profession. Some researchers even argue that audit firm size has no influence on quality, since there is uniformity across different sized audit firms due to professional standards, and consequently, the size of an audit firm should be irrelevant in the appointment of an auditor. Arguing along similar lines, Sawan (2010) implies that audit quality is independent of firm size. Nonetheless, as noted by Arrunada (2010) audit firms do provide differing quality audits because different audit firms have different levels of agency costs. As mentioned earlier, audit quality usually increases with the audit firm size in response to varying demands for quality

amongst clients. On close inspection, it appears that it is unfair to differentiate audit quality between large and small audit firms if professional standards and qualifications are embedded in the profession or industry.

Based on the foregoing discussion and empirical results, it can be deduced that audit firm size has an effect on perceived auditor independence and perceived reliability of audited financial statements. Generally, large audit firms are perceived to be more independent and competent vis-à-vis smaller audit firms due to a number of reasons that affect the provision of high audit quality such as the level of economic dependence on the clients, the nature of relationships with clients, and the level of experience and qualifications of staff. It appears that there is a substantial difference in audit quality depending upon the audit firm size with larger ones producing higher quality audits. Nonetheless, as mentioned earlier, competing viewpoints suggest that audit quality is independent of the size of audit firm. Arguing along similar lines, Fearnley, Beattie and Brandt (2005), suggest that individuals are responsible for providing audit quality rather than audit firms as demonstrated in the Arthur Andersen debacle with Enron. The extent of the debate on this specific issue indicates a difficulty in reaching a consensus on it. Nevertheless, many of the variations between large and small firms can be minimised by maintaining professional auditing standards and, a more efficient regulatory framework governing accounting qualifications and practices. After all, the demise of Arthur Andersen as established by Fearnley *et al.* (2005) indicates that individuals are responsible for providing audit quality rather than audit firms. To sum up, extant audit literature yields several useful conclusions about the attribute of auditor size (see Notbohm, 2010). First, larger audit firms perform better quality audits. Second,

larger audit firms have better reputations and status. Third, larger auditor offices both do better quality audit work and charge higher audit fees.

#### **2.2.4 Audit Firm Fees**

A critical factor that has been examined in many studies focusing on influences of audit quality is the fees for audit services (Abbott, Parker, Peters & Raghunandan, 2003; Gul *et al.*, 2003; Jensen & Payne, 2005; Hope & Langli, 2010). In recent years, as demonstrated earlier, there has been increased scrutiny of the auditing profession because of the increasing levels of NAS fees received from audit clients and the potential unfavourable influence of these fees on auditor independence, and hence audit quality (Holland & Lane, 2012). Equally, concerns have been raised on the threats to auditor independence posed by audit fee dependence (Hope & Langli, 2010). There is no doubt that economic dependence is a recognisable threat to auditor independence. In fact, auditing professional bodies across the world are aware of the significant threat that arises when auditors become economically reliant or dependent on their audit clients (Barbadillo, Aguilar, & López, 2006; Hoitash, Markelevich & Barragato, 2007; Hope & Langli, 2010; Holland & Lane, 2012). As early as 1979, the Cohen Report focused its efforts on the significance of the size of audit fees as one of the major audit independence-related factors. It is noted that if one or a few large clients supply a substantial share of the total fees of an audit firm, the firm's independence will be compromised. Similarly, Al-Ajmi and Saudagaran (2011) established that economic dependence of auditors on their clients which arises when the fee from the audit client is a sizable share of the auditor's total revenues is one of the most important auditor independence-threatening factors.



Audit fees affect the decisions of audit planning and control decisions based clients. While there has been significant progress in regard to better understand the causes and consequences of litigation against auditors face major challenges in risk of litigation correct measurement (Habib, Jiang, Bhuiyan, & Islam, 2014).

So what constitute a substantial or significant audit fee share? According to the APB (2004) in its publication, *Ethical Standards for Auditors*, an audit firm is considered to be economically dependent or reliant on an audit client if the total fees for audit and NAS from that client (including subsidiaries audited by the audit firm) represent 10 percent of the total fees of the audit firm. This applies to both listed and non-listed audit clients. Arguing along a similar line, the IFAC (2005) stressed that a self-interest threat to audit firm independence could be created due to economic dependence which breeds the concern of the possibility of losing the client when the total fees generated by that client represent a significant share of an audit firm's total fees. Observably, the fact that the external auditors are receiving audit fees from their clients practically implies the potential for the impairment of auditor independence and reliability of financial information based on fees. The root to this line of research could be traced to Watts and Zimmerman (1986) and DeAngelo (1981), where they both suggests that the economic dependence on client fees is an incentive to compromise auditor's independence and thereby providing unreliable financial information. They both conclude that the economic bond between the duo could lead to a major concern for auditors with respect to possible loss of revenue from audit fees, hence the likelihood of falling to clients' wishes.

Yao, Percy, and Hu, (2014) the study provides evidence that an auditor or independent appraiser significantly alter the beneficial value of the property increases, and audit fees. In addition, companies with long-term assets are revalued upwards, and those who appreciate the long-term assets every year, the audit fee is significantly higher. Other studies provide empirical evidence that the strength of corporate governance has a moderating effect on the level of audit fees. This study contributes to the current debate on the role of auditor's fee in providing the reliable audited financial statements.

Basing on the above observations, it is unsurprising that concerns about the impact of audit firms' economic dependence on clients' fees on perceptions of auditor independence have attracted scholarly research. After all, economic dependence is largely seen as a threat to auditor independence. This viewpoint is shared by Barbadillo *et al.* (2006) who observed that auditors' independence may be impaired if the percentage or income that auditors receive from one or few clients is very high or significant. In much the same way, Markelevich, Baragato & Hoitash (2005) have argued that large audit fees could result in the auditor becoming unwilling to make proper investigations during the audit for fear of losing immensely rewarding fees. Similarly, Hoitash *et al.* (2007) also argue that huge fees paid to auditors make them economically reliant on their clients which may encourage an 'unholy' relationship whereby the auditor becomes disinclined to express appropriate audit opinions for fear losing massively lucrative fees. Clearly, existing studies show that the greater the probability of losing the client, the more likely the auditor will agree with management and issue an unreliable audit report.

A litany of studies has highlighted the impact of audit fees on auditors' independence. More specifically, several studies conducted across many countries indicate that economic dependence of auditors on their clients was perceived to represent the most serious threat to auditor independence (Geiger & Rama, 2003; Hudaib, 2003; Abu Bakar *et al.*, 2005; Alleyne *et al.*, 2006; Al-Ajmi & Saudagaran, 2011). For example, in a study of a sample of UK firms, Holland and Lane (2012), established that respondents (shareholders) perceived auditor independence impairment only at high total fee levels. Similar conclusions were also reached in a study conducted in Malaysia by Al-Ajmi & Saudagaran (2011). In their study, Al-Ajmi & Saudagaran, 2011 discovered that economic reliance of auditors on their clients' fees was perceived as representing one of the most serious threats to auditor independence. Similar results were achieved in Saudi Arabia when Hudaib (2003) showed that the economic dependence of auditors on the audit client was perceived by the majority of respondents as one of the most significant threats to auditor independence. In a related study undertaken in Barbados by Alleyne *et al.* (2006), it was also established that the economic dependence of auditors on their clients was discovered to have a negative effect on perceived auditor independence.

Although most of the above previous literature or studies revealed that auditor independence was perceived to be undermined due to the economic dependence of auditors on their audit clients, other studies have produced different results. In essence, prior studies display mixed results on the link between audit fees and modified audit opinions. For instance, DeFond *et al.* (2002) established no link between audit fees and impaired auditor independence. They attribute their findings to auditors' concerns over the loss of their reputational capital and potential litigation

costs. Thus, for DeFond and others, the loss of reputation and litigation avoidance dominate the expected benefits accruing from impaired auditor independence. In much the same way, Craswell, Stokes & Laughton (2002) demonstrate that the auditor's tendency or inclination to issue unqualified audit opinion is not affected by the level of auditor fees dependence in a study premised on a sample of Australian audit firms. On the contrary, Basioudis, Papakonstantinou, and Geiger (2008) reported findings consistent with auditor independence impairment using small samples in the UK. In a study using a sample of Norwegian private firms, Hope and Langli (2010) found no evidence linking high fee revenues to a lower tendency to issue going-concern or modified audit opinions. In other words, it appears that auditors of private firms in Norway do not seem to undermine their independence because of high fees or income from clients. A working paper by Willekens and Bruynseels (2009) based on a sample of private Belgian firms reach a similar conclusion. They reveal that an increase in abnormal fees decreases the amount of earnings management.

In another related study, Sundgren and Svanstrom (2013) establish that there is a quality variance in the Swedish audit market. Their findings reveal that audit fees are positively related with audit office size. In other words, the fees of Big Six auditors are significantly higher in relation to those of non-Big auditors. The study also establishes that the likelihood of a disciplinary action (due to substandard audit performance) is considerably higher for auditors from non-Big Six audit firms than for auditors from Big Six firms, suggesting that larger audit firms are positively related with audit quality. Clearly, these findings support the view that audit quality improves with audit office size. Thus, the increase in audit quality is likely to be

explained by larger in-house experience, the possibility of communicating with colleagues, as well as more formal and informal education, usually associated with the Big Six audit firms.

Interestingly, Holland and Lane (2012) observe that any relationship between total auditor fees and perceived auditor independence may not be linear as indicated in existing empirical studies have assumed a linear relationship. In a related study, Jensen and Payne (2005) discovered that well-developed audit-procurement practices have a negligible combined effect on audit fees, but that individual audit-procurement practices are associated with audit fees. There is also proof from the US, that the amount of audit fees is associated with the audit opinion (Geiger & Rama, 2003). Nonetheless, DeFond *et al.* (2002) also establish that there is no relationship between audit and NAS fees and audit opinions. Notably, given their large sample size, DeFond *et al.* (2002) do not take account default status, audit committee composition or management plans as control variables in their research. This is a crucial omission considering that these factors have been identified by previous researchers to be connected to audit opinions in the US.

Meanwhile, Basioudis *et al.* (2008) in a study conducted in the UK established a positive association between audit fees paid and receiving a going-concern modified audit opinion. It was noted that higher audit fees increase the chance of a going-concern modification. They further observe that higher profits from non-audit services are an incentive for the audit firm to 'appease' the client, and 'impairs auditor decision making'. Nonetheless, Huang, Liu, Raghunandan and Rama, (2007) suggest that there is insignificant evidence that impartial financial reporting by audit

clients is lower in clients with higher value of tax fee ratio or other non-audit fee ratio. The results also indicate that there is no relationship between different types of NAS fees and biased financial reporting. However, the findings of Kinney, Palmrose & Schoolz (2004) suggest that there is a strong positive relationship between audit fees, audit-related fees, and unspecified non-audit services fees and financial restatements. The unspecified non-audit services fees may develop economic dependence that results in more financial restatements. The study also notes that there are inadequate compensating financial reporting quality enhancements to counterbalance the audit firm reliance on clients' fees.

Notwithstanding the above arguments, it is observed that the extant relationships between audit fees and the likelihood of auditors sacrificing their independence are too theoretically ambiguous. A major reason for the above is that external auditors and their firms are not only considering the benefits that are inherent in higher fees when issues of compromising their professional objectivity arises, but they also consider the expected costs implications that is attached to audit failures. Importantly, many researchers have argued that the costs implications that is related to the inherent loss of firms' reputations and litigation have reduced the incentives for any external auditors to compromise their objectivity and independence (Chung & Kallapur, 2003). It thus confirms the fact that auditor's acquiesces to its client's pressures will potentially damage its firm's reputation, and will as a result loses audit fees from its current and future audit clients. Although the extant audit literatures have theoretically focused on issues of reputation effects and other expected lawsuits as key factors that will refrain auditors from compromising their professional ethics and independence. As mentioned above, auditors' economic reliance on clients is a

major threat to their independence. Unsurprisingly, this has also been globally recognised by many auditing professional bodies. Despite that, some studies concluded that auditor independence was not perceived to be affected by the economic reliance of auditors on their audit clients (Craswell *et al.*, 2002; DeFond *et al.*, 2002); the vast majority of existing studies take the opposite view (Geiger & Rama, 2003; Hudaib, 2003; Abu Bakar *et al.*, 2005; Al-Ajmi & Saudagaran, 2011; Holland & Lane, 2012).

Undoubtedly, the auditing profession is performing a vital role in societies through the credibility that the external auditor's report adds to the financial reports of firms which help several interested parties in their economic decision making process. It has been stated that this credibility depends mainly on the effect of certain factors (including auditor characteristics) on auditor independence. As noted by Sawan (2010), audit quality has attracted scholarly attention in developed countries due to the importance attached to the role of auditors' reports in the decision making process used by investors in these countries. Arguably, emerging economies, such as that in Libya, do not enjoy the same level of audit quality or sophistication as seen in advanced countries. As a result, such challenges continue to affect both investors, and those seeking to attract investors.

In his study on audit expectancy gap in Libya, Eldarragi (2008) reveals findings on the likely effects of certain factors on audit quality. Eldarragi notes that though a number of audit firms are perceived as highly competent and professional, some auditors, however, are generally seen as unqualified. The genesis of that problem was traced to the initial phase of the oil boom when there was an urgent need for auditors.

Consequently, the government was forced to issue auditors licenses to unqualified people (including almost anyone having any certificate in commerce or those with some working experience in accounting or any field that is related to finance). In some instances the social networking was the most influential factor in the issuing of such licences which were distributed like confetti (Saleh, 2001 as cited in Eldarragi, 2008, p. 204). There is no doubt that the existence of unqualified auditors who lack the requisite skills and competence, has negatively affected the audit quality and professional reputation of auditors in Libya.

On the matter of the provision of NAS, the majority of auditors who participated in Eldarragi's study indicated that they would like to provide NAS for their audit clients as it will be more beneficial. However, most of users of audit reports opposed the provision of additional services for the same audit clients, to dodge conflicts of interest and maintaining auditor independence. From the above finding, it can be deduced that there is auditor expectancy gap (AEG) in Libya between the auditor's belief and user's perception. Eldarragi's study also revealed four situations or factors that were perceived by most respondents as impairing auditor independence, namely, lengthy audit tenure, a trade and rent relationship, shareholdings or acting as a shares trustee, and frequency of interactions.

In a related study, Faraj and Akbar (2008) examine the impact of eight variables which may affect the independence of auditors and consequently decrease the reliability of financial statements in Libya. These variables included audit fee size, audit firm size, audit tenure, audit committee, nonaudit services, competition, legal incentives, and socio-culture relationships. Respondents in this survey study came



from both users and auditors (comprising owners, investors, managers, lenders, and auditors). The findings of the study indicated that all eight variables have a significant effect on the perceived reliability of audited financial statements. Basing on these findings one can deduce that the same variables also affect auditor quality which positively associated with the reliability of audited financial statement.

Another key study on the Libyan context was undertaken by Almalhuf (2009). In his study, Almalhuf (2009) investigated the impact of nine factors (audit firm size, audit firm tenure, competition, auditors' economic dependence on clients, audit committees, status and financial state of the audit client, financial and personal relationships and provision of NAS on perceptions of auditor independence held by participants from four sample group, that is, external auditors, auditors from the Institute of Financial Auditing, Taxation Board auditors and bank loan officers) in the Libya. The results of the study revealed that auditor independence was perceived to be undermined when an audit is performed by a sole practitioner or by a small audit firm, as well as when an audit firm audit the same client for a long period. Some of the factors that were identified by the study as having a negative impact on auditor independence included the existence of competition between audit firms, auditors who are economically dependent on their audit clients, and when NAS were delivered by the audit firm to its audit clients. Almalhuf also established that if the audit client is in the private sector or is in a strong financial condition, personal and financial relationships the likelihood of undermining auditor independence is increased. However, the findings of the study also revealed several factors that are perceived as enhancing auditor independence. For instance, audit independence was perceived to be enhanced when an audit is carried out by a big or medium audit firm.

Similarly, it was also established that auditor independence was enhanced by the presence of an audit committee in the audit client's firm, and when the audit client is in the state sector or is in a weak financial condition or when the audit firm did not provide any kind of NAS to its audit clients.

In addition to the above key results, Almalhuf showed that the regulatory and legal regime was very weak since it was not comprehensive enough to enhance and maintain auditor independence. Hence, the LAAA is generally regarded as lame duck that is known for not performing any integral role in either developing the accounting and auditing profession or in maintaining auditor independence. In much the same way, Eldarragi (2008) has no kind words for the LAAA. For Eldarragi, the Libyan accounting profession has not received any positive influence from the LAAA since it was set up in 1975. As noted by Alhsadi (2007), the LAAA has not accomplished anything related to the organisation of the Libyan accounting profession either by publishing or embracing auditing standards or a code of ethics (as cited in Eldarragi, 2008, p. 165). In view of such shortcomings, it is scarcely surprising that the Libyan accounting profession is visibly weak (Eldarragi, 2008; Almalhuf, 2009; Sawan, 2010). Notably, Eldarragi (2008) mentions that the Libyan auditors are acceptably well-qualified to accomplish audits, and a number of Libyan auditors are perceived as highly competent. However, Eldarragi also noted that some licensed auditors are not perceived as qualified auditors due to the impact of an earlier governmental policy intervention which was adapted to meet the urgent need of auditing at the beginning of the oil boom in the 1970's. As a result, the existence of unqualified practitioners has affected the reputation of the Libyan accounting profession in general, because they lack professional competence, which has a negative influence

on the profession (Eldarragi, 2008). The above findings corroborate earlier findings by Buzied (1998).

Meanwhile, Sawan (2010) examined the effect of five factors, namely, audit firm size, the provision of NAS, the length of auditor tenure, the level of competition in the Libyan audit market, and fees for audit services, on audit quality. This study's results which were based on responses elicited from both the demand and supply sides (Libyan oil firms and audit firms) revealed that respondents were not sufficiently satisfied with the current level of audit quality in Libya, and thus expressed disappointment with the role of the LAAA which was intended to boost the level of audit quality in the country. More specifically, the study establishes a positive relationship between the size of the audit firm and audit quality. Ipso facto, the Big Four audit firms are regarded superior in relation to other audit firms. Not surprisingly, such superiority is seen in relation to resourcefulness, technological advancement, and the consequent motivation to duties as professionally as possible. Interestingly, Sawan also finds that the provision of NAS to audit clients was perceived by respondents as providing auditors with greater experience of the client's business sector and greater access to the client's financial reporting system. Though the provision of NAS is seen as enhancing audit quality, Sawan also demonstrates that a split up of NAS from audit services is necessary since auditors were perceived to have greater credibility when the delineation is clear. A similar mixed result was also reached in that auditor tenure was found to be influential in as much as a long relationship was believed to impair the independence of the auditor, and as result impacting negatively on the level of audit quality. In the same vein, the study showed that mandatory rotation was seen to be positively related with audit quality, as it

diluted any relationship between the client and auditor. Sawan's study also revealed that competition within the Libyan audit market was found to be high but this was not perceived as having any significant negative impact on audit quality. Finally, the study established a positive relationship between audit fees and audit quality. It was generally perceived that an audit firm charging high fees spends more audit hours with its clients and, thus provide high audit quality. The results showed that both audit fees and audit hours were shaped by audit quality, and that audit hours and audit quality were higher among initial audits.

What is clear from the above discussion is that limited studies have been conducted to boost further understanding of the variables or factors that influence the external audit process in Libya. As indicated in extant literature, some of these key factors include the audit firm size; the audit fees size received by audit firms; the audit firm tenure; provision of NAS; and the presence of an audit committee.

### **2.3 Internal Corporate Governance - Audit Committee Characteristic**

What is clear from the preceding discussion is that corporate governance is an internationally debated concept with many different meanings. However, the concern of this study is whether in the context of corporate governance, audit committees and external auditors play an important role. Given that, the present study investigates the impact of the roles of the audit committee board members and the external audit on financial reporting quality (reliability of audited financial statements). For the purpose of the research, corporate governance is presented as a monitoring mechanism that ensures that the interests of shareholders are safeguarded. Such a position is consistent with agency theory. Furthermore, the focus of the current

research is centered on the quality of audited financial statements which impacts on the decisions and fortunes of other stakeholders, for example, potential investors and members of the public. For this reason, the stakeholder theory is also significantly expressed in this study. It is therefore scarcely surprising that there are growing calls to increase the role of auditing to encompass the control of firms for the benefits of all stakeholders including society in general (see Baker & Owsen, 2002).

According to Mallin (2010), the audit committee is “arguably the most important of the board sub-committees” (p.169). As a result, today, all codes of ethics in corporate governance and stock exchange listing conditions want listed firms to have audit committees in their governance structures. Although there is no ideal definition of the audit committee, the definition by Mautz and Neumann (1970) as cited in Köhler (2005) is very instructive. According to Mautz and Neumann, an audit committee refers to “a standing committee of board of directors established to work directly with the auditors, both independent and internal, as well as with the representatives of other accounting-related activities as seems appropriate” (Mautz & Neumann, 1970, as cited in Köhler, 2005, p. 231). For several researchers, the audit committee is simply a sub-committee of the main board (Cotter & Silvester, 2003; Porter, Simon & Hatherly, 2003), and for others, it is composed of a majority of non-executive independent directors (Fama & Jensen, 1983; Abbott & Parker, 2000; Raghunandan, Rama & Read, 2001). As a board sub-committee, the audit committee derives its formal authority from the board, and hence it is accountable or responsible to the board. Generally, the audit committee has widespread powers and authority to work with the external auditor, top management, and internal auditors (Tricker, 2012).

Although the existence of audit committees has been there for several decades, their increasing popularity in the business world only began in the 1980s and early 1990s in Western countries (Raghunandan *et al.*, 2001). There are several reasons behind the increasing popularity of audit committees in the world including their protection of shareholders' interests, and external auditors as well as their role in guiding management and enhancing corporate credibility as well as preventing corporate fraud (Beasley, Carcello, Hermanson & Lapides, 2000; Owen, 2004; Harrast & Mason-Olsen, 2007; Huang & Thiruvadi, 2010). For instance, Huang and Thiruvadi (2010) suggest that financial collapses and corporate failures were some of the most important reasons behind audit committee development. It is no wonder then that in recent years the role of audit committees have become more pronounced and include overseeing and reviewing all economic ties between management and the auditors. As such, audit committees are now in charge of the appointment, compensation and oversight of the auditor.

There is no doubt that the functions of the audit committee are to review the scope and output of the audit as well as ensuring that the impartiality of the auditors is upheld (Mallin, 2010, p. 169). For Sarkar and Sarkar (2010), the audit committee plays a major role in making sure that the independence of the audit process is guaranteed. Included in the primary responsibilities of the audit committee are the recommendations of potential external auditors to the company's board. Another key function of the audit committee is receiving, reviewing, and forwarding the annual audited financial report to the board of directors (Alleyne, Howard & Greenidge, 2006). Many other researchers have also highlighted the audit committee's main role in the verification and safeguarding of a company's financial statements and internal

control processes (Abbott, Parker & Peters, 2004). Similarly, Harrast & Mason-Olsen (2007) suggest that audit committees help prevent corporate fraud and boost the integrity of financial reporting. In a related study, Klein (2002), for instance, shows that impairment of audit committee independence is positively related with increases in abnormal accruals.

In related studies and literature, the audit committee is conceptualised as playing a significant part in the review of financial reporting processes including communicating with the auditors, and reviewing internal controls systems (Goddard and Masters, 2000; Johnstone, Sutton & Warfield, 2001; Walker, 2004). Similarly, Mansouri, Pirayesh & Salehi (2009) note that the degree of audit quality is hugely affected by the audit committee. More specifically, effective audit committees improve financial reporting quality by fulfilling a number of tasks including reviewing accounting policies and financial statements. Furthermore, audit committees also play a major part in enhancing the effectiveness of auditors over financial reporting quality through their function of determining the appointment and remuneration of external auditors (Dhaliwal, Naiker & Navissi, 2010). On close inspection, audit committee development in most countries has been triggered by worries about the quality of financial reporting in light of recent high profile corporate failures (Huang & Thiruvadi, 2010).

Meanwhile, Faraj and Akbar (2008) state that audit committees play a major role in monitoring auditors as well as safeguarding their independence on which reliability of audited financial statements is premised. Hence, a number of studies show that one of the main benefits of having an audit committee is that it could increase auditor

independence (Fearnley & Beattie, 2004; Alleyne *et al.*, 2006). Unsurprisingly, a major theoretical argument in support of the audit committee is its ability to positively impact the independence of the external auditors (Alleyne *et al.*, 2006). In the same vein, scholars like Arens, Elder, and Beasley (2013) view the audit committee as a good medium of opening direct communication links between the board and external auditors. Generally, the audit committee is viewed both as a channel of information provided by the client's management to the auditors, and as a protector of the auditors from the demands of the management. For these reasons, the audit committee is expected to be independent of the management since its responsibilities involve deciding the scope or work of the auditor including the determination of audit remuneration and the extent of the provision of NAS. The rationale is to prevent the auditor from becoming reliant on the client's management, both in terms of executing its duties as well as in terms of its own survival (Sarkar & Sarkar, 2010).

As indicated earlier, another major benefit of having audit committees is their critical functions which include selecting auditors, determining auditors remuneration or fees and dismissing or retaining auditors. A significant number of existing researches which have examined the role of audit committees in the auditor choice process, have tended to focus on the impact of the mere presence of an audit committee on auditor selection. As noted by Rezaee, (2009) some inherent benefits of audit committee include reducing the client's management power over the control of external auditors, specifically through proper audit firm selection, direct negotiation of audit fees, and finally contributing to issues of auditor's replacement. However, other findings of prior studies revealed relatively little impact of the mere presence of



such committees on the auditor selection process. Notably, such roles by the audit committee ultimately reduce management's influence over the auditor thereby enhancing corporate governance. In a way, the audit committee helps to ensure that companies have adequate internal control systems, proper accounting practices, and independent auditors that will prevent the occurrence of corporate failure and improve the quality of financial reporting.

Despite the increasing importance of the audit committee as an instrument of corporate governance, some studies show that actual or concrete audit committee operations are ineffectual even though a large share of firms have established these committees (Lin, Xiao, & Tang, 2008). In that study based on the perceptions of four groups of stakeholders (creditors, independent audit committee members, company officers and auditors) of the roles, tasks and basic attributes of audit committees (ACs) in China, Lin, Xiao, and Tang establish that the actual roles of audit committees remain unclear in China. Interestingly, the study acknowledges the titular roles and functions of ACs in terms of improving the image of good corporate governance, increasing communication between board members and auditors, and mediating conflict between auditors and management. Nevertheless, on the more important AC monitoring duties and responsibilities such as monitoring management financial performance, corporate financial reporting, and auditing processes, the study reveals that various stakeholders especially management and non-executive directors did not fully recognise the audit committee's important roles in those respective areas (Lin *et al.*, 2008, p. 744). The findings of this study indicate that though a substantial number of Chinese listed firms have set up audit committees, many of these committees did not operate at all, or held incredibly few meetings.

Furthermore, the study finds that most of the audit committees were not involved or entangled in auditor selection and audit fee determination and that there was virtual no communication or contact between audit committee members and auditors. These facts show that AC operations in practice are unsatisfactory in China. In fact the importance of audit committees roles and responsibilities are more in appearance rather than in substance. This may help to explain why most stakeholders in China view the audit committees are at best a ceremonial relic of corporate governance.

In recent years, however, the functions of the audit committee in corporate governance have attracted the attention of regulatory bodies. In other words, audit committee functions have become an issue of increasing regulatory interest. This is not surprising considering that these committees are responsible for the reduction of board liability, the reduction of illegal activity, establishing links between the external auditor and the main board, and the prevention of fraudulent financial reporting and so forth. For instance, the US's *Sarbanes-Oxley Act* of 2002 recommends extensive reforms to the corporate governance systems of firms. Some of these reforms include a prerequisite for at least one member to have financial expertise, limits on the provision of certain NAS, and a condition that the audit committee pre-approve any non-proscribed NAS provided by the external auditor. Interestingly, additional regulatory platforms such as the NYSE and NASDAQ/AMEX have suggested additional rules on AC membership as well as additional AC responsibilities, including mandated periodic meetings. The importance of audit committees is also highlighted by the SEC in the US, and other bodies like the Public Oversight Board (POB) of 1993 and the National Association of Corporate Directors (NACD) of 2000. which have "stressed the role of the audit

committee in providing active oversight of the financial reporting process and in monitoring the relationship between a firm's/company's management and its external auditor" (Abbott *et al.*, 2003, p. 17). Similarly, in the UK, the *Smith Report* (2003) and the *Corporate Governance Code* for periods after June 2010 have also paid attention to the composition and activities of the audit committee.

However, a number of concerns have been raised on the role being played by the audit committee (Tricker, 2012). One of the criticisms of the audit committee pertains to the concern that audit committee members can get too involved in management affairs and hence may interfere in management's area of responsibilities. Furthermore, other critics have viewed the audit committee as becoming "bureaucratic and process-driven rather than exercising sound commercial judgement" (Tricker, 2012, p. 374).

In a nutshell, audit committee literature examining the incentives of the audit committee formation has produced mixed and inclusive results as demonstrated by the long list of factors responsible for audit committee formation. However, there is no doubt that audit committees provide a focus and means for a fuller view and analysis of the matters relating to auditing, internal controls and financial reporting. Hence, most of the studies in this area consider providing credible financial reports as the primary purpose or responsibility of audit committees. Moreover, as indicated by Fama and Jensen (1983), AC members have incentives to protect their reputation by assuming the important task for engaging the audit firm as well as protecting its independence. Notably, most studies that attempted to investigate the impact of the mere presence of the audit committee on auditor choice have produced mixed results.

Such mixed results demonstrate that the sheer existence of the audit committee does not automatically transform it into an effectual monitoring entity (Sommer, 1991; Abbott & Parker, 2000). More importantly, this highlights the importance of different AC characteristics in evaluating AC effectiveness in executing its duties. Hence, the next section reviews the extant literature on audit committees' characteristics, which are a key focus area of this study.

Although the main board is the chief oversight body within a firm, the audit committee has specific oversight over the auditing process. Just like board of directors, the audit committee members constitute one of the highest levels of control mechanisms in an organisation because they possess the ultimate authority to review the decisions that are made by management. However, since audit committees comprises board of directors, existing studies on board members' characteristics are instructive in the analysis of audit committees' characteristics. An audit committee can affect audit coverage by exercising its ultimate power over decision making and corporate governance tasks. It is therefore scarcely surprising that in most jurisdictions, all public listed firms are mandated to set up an audit committee.

However, as demonstrated in previous studies, the mere existence of the audit committee does not necessarily transform the body into an effective monitoring entity (Abbott & Parker, 2000; Beasley, Carcello & Hermanson, 2000; Raghunandan *et al.*, 2001; Carcello & Neal, 2003; Al-Lehaidan, 2006; Rohaida, 2011). Consequently, the search for devices and mechanisms to improve corporate governance and enhance the quality of financial reporting has mostly focused on certain attributes of audit committees as is the case in this study. In a study

conducted by Lin *et al.* (2008), the most desirable audit committee characteristics that were identified by the respondents were the audit committee's composition (independence), size and member qualifications (expertise). Notably, these audit committee characteristics are also consistent with the applicable requirements in the UK, the US, and other parts of the Western world. In the US, for example, the SEC then chairman, Levitt in 2000 declared that, "qualified, committed, independent, and tough-minded audit committees represent the most reliable guardians of the public interest". In this study, however, the following audit committee characteristics, namely, audit committee independence, expertise, and activity are considered because they can reasonably be measured, and the findings of prior studies have demonstrated that they may affect audit quality.

### **2.3.1 Independence of the Audit Committee**

Of the various audit committee attributes, independence has the most persuasive theoretical and empirical support because it is regarded as one of the key variables associated with audit committee effectiveness (ACE). For that reason, the independence of the audit committee has attracted a lot of scholarly interest. According to Robinson and Owens-Jackson (2009, p. 121), an independent director is "one who is not a current employee of the firm, former officer or employee of the firm or related entity, a relative of management, professional advisor to the firm, officer of significant suppliers or customers of the firm, interlocking director, and/or one who has no significant transactions with the firm". Generally, it is assumed that audit committee members are likely to be less biased and more able to exercise oversight over the client's management if there are not economically dependent on the company or did not have strong personal ties with management. Hence, we

anticipate more independent audit committees to be a strong deterrent to auditor maneuverings than less independent audit committees (Carcello & Neal (2003). In a related study, DeZoort and Salterio (2001) established that independent audit committee members also have greater audit knowledge and tend to protect external auditors in accounting disputes. In view of the foregoing discussion, it is evident that to fulfill its oversight mandate and protect the interest of shareholders, the audit committee must be independent of the company's management. In other words, independent audit committee members are effective monitoring tools because they are free from the demands of the management.

The main purpose of SOX is to ensure auditor independence. To study the relationship between the quality of the Audit Committee, management and the audit committee's decision to change auditors allowed provided tax services. The study finds that firms with more independent boards, committees more financial accounting audit, more experience is the property of the actions of leaders and institutions that separate the positions of chairman and CEO, and a higher tax rate ratios (Albring, Robinson, & Robinson, 2014).

According to Bedard *et al.* (2004, p. 18), the independence of the audit committee, constitutes two aspects, namely, the number of non-executive outside directors and whether these directors participate in the company's stock option plans. Without question, stock option schemes may compromise the independence of audit committee members because "outside directors with options that can be exercised currently or in the short run are less effective in curtailing income-increasing earnings management, especially if the options are in-the money or at-the-money

(i.e., the current stock price is higher than or equal to the exercise price of the options)” (Bedard *et al.*, 2004, p. 19). Although scholars agree that audit committees are effective if members are highly independent (Carcello & Neal, 2000; Abbott, Parker & Peters, 2000; Klein, 2002), there is, however, no consensus on the degree or level of independence. On one hand, for some researchers, audit committee members should all be independent directors so that they can evade challenges pertaining to conflict of interest in the execution of their monitoring tasks (Cotter & Sylvester, 2003; Sharma, 2004). However, for others like Klein (2002), it is the presence of a preponderant number of non-executive directors on the audit committee, rather than having all board members to be independent that seems to have a major impact on the audit quality.

Clearly, the audit committee is an important asset in any organisation because it is linked with the responsibility for monitoring management and thereby reducing agency costs that arise from the separation of ownership and control in day-to-day managerial operations (Fama & Jensen, 1983; Brennan & McDermott, 2004). It is therefore not surprising that a major focus of recent corporate governance reforms, particularly in Western countries, is directed at the composition of the audit committee. For example, NYSE and SEC in the US now want all audit committee members be non-executive directors (NYSE, 2002; SEC, 2003). Similarly, the UK, Canada and Australia have also adopted the same requirements vis-à-vis audit committees. The UK’s *Corporate Governance Code* (2010) which evolved from the earlier *Combined Code* of 1998 and 2003 states that one of the main tasks of outside directors is to “satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible” (p. 11).

Basing on the above reasons, higher proportions of independent members on boards are anticipated to stimulate a more effectual monitoring entity which then yields more reliable financial reports or statements. This is largely due to the incentive for non-executive directors to protect their reputational capital as decision making experts (Fama & Jensen, 1983; Abbott & Parker, 2000; Abbott *et al.*, 2003; Hussain & Mallin, 2003) and to provide an unbiased assessment of a management' actions (Vance, 1983). In other words, the independence criteria or dimension of audit committees has a great effect on the appearance of the committee as well as its effectiveness. As noted by Lam (1976), the appearance of independence of the audit committee enhances auditor independence and make both auditors and management more transparent in the financial reporting process. Hence, independent board members have a greater motivation to avoid nefarious activities that may soil their reputation in relation to executive board members (Abbott & Parker, 2000; Abbott *et al.*, 2003; Hussain & Mallin, 2003). Even though audit committee service may enhance the reputational capital of members, it also may harm their reputations should a financial misdemeanour or breach occur. To put it differently, independent membership of directorates is a double-edged sword. Nonetheless, since audit quality refers to the joint likelihood of the auditor detecting and reporting a material financial error or misstatement as stated by DeAngelo (1981), it is sensible to anticipate that independent audit committees have a preference for a superior level of audit quality.

A stream of studies has examined the relationship between the independence of audit committee, financial reporting outcomes and the external auditor. Prior studies involving the role of the main board including the audit committee have focussed on



several areas including the effect of these bodies on earnings management and financial statement fraud (Beasley *et al.*, 2000; Klein, 2002; Sharma, 2004). In a study focusing on audit committees, Beasley *et al.* (2000) established that companies that indulge in fraud had less independent audit committees' vis-à-vis their counterparts that did not partake in fraud. Put another way, companies committing financial misdemeanours such as fraud had a considerably lower proportion of independent board members (non-executive directors) than similar companies not indulging in financial statement fraud. In much the same way, Abbott *et al.* (2002) also discovered that US firms with independent audit committees were less likely to be 'caught offside' by the SEC for fraudulent or nefarious financial reporting activities. Similarly, Klein (2002) revealed an inverse association between board independence and earnings management. In this regard, Klein established that audit committee independence was negatively associated with abnormal accruals and that impairment of audit committee independence was strongly related with large increases in abnormal accruals. Utilising data gleaned from a sample of Australian firms that experienced financial statement fraud, Sharma (2004) established that as the proportion of non-executive directors increased, the probability of fraud decreased. Furthermore, Bedard *et al.* (2004) discovered that aggressive earnings management is negatively related with the presence of an independent audit committee.

Taken together, the above studies show that less independent boards particularly, audit committees are likely to be connected with cases of lower quality financial reporting such as financial statement fraud. To put in another way, prior studies suggest that higher percentages of non-executive directors on boards tend to be

negatively associated with an extreme version of financial misstatement, that is, financial statement fraud. Some studies have explored the relationship between board of directors characteristics and earnings management, a less severe version of poor quality financial reporting (Klein, 2002; Xie, Davidson, & DaDalt, 2003; Bedard *et al.*, 2004; Choi *et al.*, 2004; Van der Zahn, & Tower, 2004; Davidson *et al.*, 2005; Peasnell *et al.*, 2005; Vafeas, 2005; Rahman & Ali, 2006; Francis & Yu, 2009). Basically, earnings management behaviour is associated with aggressive accounting strategies in which management modify financial statements to either mislead some stakeholders about the underlying economic dynamics of a firm or manipulate contractual outcomes that rely on reported financial information. As noted earlier, Klein (2002) discovered an inverse relationship between board independence and earnings management. In a related study, Abbott *et al.* (2003) also found that companies with independent audit committees that are diligent, and which have financial specialists in their midst are less likely to have earnings of a lower quality (for example, experiencing a restatement of earnings). Notably, these findings imply that audit committee independence, financial expertise, and diligence enhance the quality of the financial reporting process.

Meanwhile, findings from O'Sullivan (2000) and Carcello *et al.* (2002) showed a positive association between the proportion of non-executive board members on a board and audit quality. This implies that independent board members demand more in-depth audit efforts from the external auditor, leading to a higher quality audit (Rohaida, 2011). In a related study, Abbott and Parker (2000) discovered that independent and diligent audit committees that meet more frequently tend to hire expert or high-quality auditors. In another study, DeZoort and Salterio (2001)

established that independent audit committee members have greater audit knowledge and have a tendency to protect auditors in accounting disputes during the auditing process. Carcello and Neal (2000) demonstrated that financially distressed companies with independent audit committees are more likely to be given going-concern opinions. Several studies also found an association between the proportion of independent directors on the audit committee and some indicators of reporting quality such as the size of abnormal accruals (Klein, 2002). In a study conducted in Australia which investigated among other agency variables the relationship between audit committee independence and firm value, Cotter and Silvester (2003) found an inverse relationship between audit committee independence and leverage. The findings of this study indicated reduced levels of monitoring by debt-holders being compensated for by greater audit committee independence (Cotter & Silvester, 2003). Meanwhile, the results of Carcello and Neal (2003) suggest that the independence of the audit committee is linked to financial condition disclosures of firms in financial distress. In their study, a strong positive relationship was established between the proportion of affiliated audit committee members and the optimism of the going concern disclosures.

More importantly, the above results of Carcello and Neal (2000, 2003), Abbott *et al.* (2003) as well as others are consistent with the assertion that independent audit committees do not have strong personal and/or economic ties with management. In other words, independent audit committees are not economically dependent on the client's management. Hence, an independent audit committee may be keen to express different opinions in relation to management views on a number of issues. Furthermore, an independent audit committee may insist on a stretched out audit

scope in order to evade the risk of a financial error or misstatement and, therefore protect reputational capital. After all, as indicated in other studies, a higher level of audit coverage from a long tenured auditor may result in enhanced financial misstatement detection which is derived from increased audit scope (Abbott *et al.*, 2003). The audit committee may also complement the auditor's insistence on additional audit procedures beyond the original audit plan for transactions deemed contentious, uncertain, or risky. This demonstrates that non-executive audit committee members demand higher levels of audit assurance and possibly provide additional support for external auditors during audit scope negotiations with the client's management.

Although many studies have demonstrated that audit committee independence is one of the key attributes associated with audit committee effectiveness, there are some dissenting voices. One such voice is that of Wolnizer (1995) who has been unimpressed by the role of audit committees and the significance attached to their independence as indicated below:

*Unless the establishment of audit committees is accompanied by changes in accounting and auditing practices such that the elements of financial statements can be authenticated by recourse to reliable or public evidence, it is unlikely that audit committees will lead to more reliable financial reporting (Wolnizer, 1995, p. 45).*

Clearly, Wolnizer was not amused with the silo approach of regarding independence as a sufficient guarantee of the reliability of a professional person's judgement. As noted by Baxter (2007), Wolnizer believed that there was a strong need for change in accounting and auditing procedures to enable the goals of audit committees to be met. On the whole, the existing literature has established that several factors are associated with audit committee independence. These aspects include board size and

board independence among others. The next section reviews the existing literature on audit committee expertise, which is another widely investigated audit committee characteristic.

### **2.3.2 Expertise of Audit Committee**

Audit committee expertise is another attribute that has been associated with ACE. According to Sommer (1992), having an audit committee as a component of the corporate governance system and having an effective audit committee are essentially two different things. Put another way, it is not sufficient for firms to form audit committees. As discussed earlier, the mere presence of audit committees do not guarantee their monitoring effectiveness. In this regard, it is argued that such committees should be composed of directors that can enhance their monitoring abilities. It is for this reason that some regulators in Western countries have recently specified that members of the audit committee must be financially erudite and at least one member should be a financial specialist. To this end, Section 407 of the US's *Sarbanes-Oxley* (SOX) Act of 2002, states that "a financial expert is a person who has an understanding of generally accepted accounting principles, financial statements, and audit committee functions". Similarly, the UK *Corporate Governance Code* (2010) proposes that "the board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience" (p.19). Notably, in contemporary usage expertise refers to financial expertise as well as experience. There is no doubt that such requirements or specifications of audit committees' directors have been proved to be crucial in dealing with the intricacies and complexities of financial reporting and as well as for minimising incidents of financial restatement and its lesser evil, earnings management (DeZoort & Salterio,

2001; Carcello & Neal, 2003). It appears that the growing call in most accounting literature suggest that audit committees members should have a specific qualification and expertise to discharge their tasks. It is no wonder then that this characteristic of audit committee members has received considerable attention in the extant literature.

From the review of extant literature, a number of studies which focus on audit committee members' perceptions of their own capability or competence show that they believe that there is a lack of expertise in accounting, auditing and law in most audit committees. For example, Kalbers (1992a, 1992b) in studies targeting external auditors and internal auditors discovered that both groups had notably lower perceptions of audit committee members' proficiency than those of audit committee members. Despite the difficulty in accessing audit committee member expertise, a number of experimental studies regarding audit committee expertise were conducted (DeZoort, 1998; DeZoort & Salterio, 2001; McDaniel, Martin & Maines, 2002). In this respect, Robinson and Owens Jackson (2009) note that "relatively few studies explore the proposition that financial expertise enables members to better assess and monitor management actions relating to financial reporting" (p120). Nevertheless, empirical proof for this belief is insignificant. One likely explanation may be the lack of benchmarks or standards for members' financial literacy, which is often mixed with member's expertise in contemporary parlance. As a result, financial literacy has attracted less attention in the auditing and accounting research and literature vis-à-vis other characteristics such as independence and expertise.

In one of the few studies which examine the variable of member financial literacy, Song and Windram (2004) discovered that UK firms with an audit committee with an

advanced level of financial literacy or proficiency were less likely to have financial reporting challenges. In much the same way, Abbott *et al.* (2004) found a strong inverse relationship between an audit committee with at least one financially literate member and the incidence of financial restatements. Meanwhile, Carcello and Neal (2003) were not able to establish any association between financial expertise and auditor dismissals. Nonetheless, several studies show that the knowledge and experience of audit committee members are directly associated with ACE (Beasley & Salterio, 2001; DeZoort & Salterio, 2001; McDaniel *et al.*, 2002; Bedard *et al.*, 2004). Clearly, effectiveness of the audit committee is linked with the financial and accounting expertise of audit committees' members. As previously noted, since the main task of the audit committee is to monitor corporate financial reporting and internal control processes, its members should therefore have adequate skills and expertise to comprehend accounting and financial issues to be investigated or discussed by the committees. DeZoort (1998) argues that an audit committee member's experience in accounting and auditing is necessary for a sufficient understanding of oversight tasks as indicated below:

*audit and internal control evaluation experience makes a difference in audit committee members' performance on an internal control oversight task. Of primary importance, audit committee members with experience made internal control judgements more like those of experts (i.e. practising auditors) in the area than did members without experience (DeZoort, 1998, p.17).*

Thus, it is generally accepted that in order to exercise their oversight functions over internal control and financial reporting processes, audit committee members should have the required expertise.

Clearly, it is tough to imagine an effective audit committee functioning if its members do not possess the requisite accounting and financial reporting skills. In

practice, however, audit committee members come from diverse professional backgrounds and may not possess the necessary technical expertise required to conduct an effective auditing oversight (Kalbers & Fogarty, 1993). Nonetheless, the claim that effective audit committees must have some members with requisite financial experience and expertise is in line with findings of existing studies (Knapp, 1987; DeZoort, 1998; Archambeault & DeZoort, 2001; Chtourou, Bedard & Courteau, 2001; DeZoort & Salterio, 2001; Carcello *et al.*, 2002; McDaniel *et al.*, 2002; Davidson *et al.*, 2004; DeFond *et al.*, 2005). For example, DeZoort (1998) establishes that experienced audit committee members make more consistent or reliable judgments, have better self-insight, and reach agreement more often than inexperienced ones. Thus, for DeZoort (1998), experienced committee members are in a better position to anticipate and assist firms in evading problems associated with financial reporting. Furthermore, the findings of a study undertaken by McDaniel *et al.* (2002) indicated that the inclusion of financially adept members on audit committees was likely to enhance the overall financial reporting quality. Similarly, Carcello and Neal (2003) established that audit dismissals are rare when board of directors have some members with corporate governance expertise. In a related study, DeFond *et al.* (2005) discovered a positive market reaction to the selection of audit committee members with financial expertise. Meanwhile, Woidtke and Yeh (2013) indicated that independent audit committees improve earnings informativeness only if the committees have members with financial expertise. Their findings also show the added positive benefits of having an independent audit committee along with financial literate members in offsetting the detrimental effect associated with concentrated ownership.



A number of researches have applied an archival approach in their investigation of audit committee expertise. For instance, Davidson *et al.* (2004) examined stock returns around the time of appointment of audit committee members, and their findings revealed strong stock price reactions when new audit committee members had financial literacy. Similarly, Krishnan (2005) established that audit committee members who are financially proficient were less likely to be associated with the presence of internal control problems. A number of other studies have examined the relationship between the expertise of the audit committee members, earnings management and earnings quality (McMullen & Raghunandan, 1996; Xie *et al.*, 2003; Bedard *et al.*, 2004; Choi *et al.* 2004; Agrawal & Chadha, 2005; Vafeas, 2005; Dhaliwal *et al.*, 2006; Rahman & Ali, 2006). For example, there is some empirical proof that indicate that the presence of at least one audit committee member who is financially literate is effective for extreme incidences such as earnings restatement (McMullen & Raghunandan, 1996; Xie *et al.*, 2003; Agrawal & Chadha, 2005). Put differently, earnings management is less likely to happen in companies whose audit committee members are financial experts. In a related development, Bedard *et al.*, (2004) showed that aggressive earnings management is negatively related with financial and governance expertise of audit committee members.

Meanwhile, several authors have indicated that the managerial labor market for non-executive board directorships offers an incentive to monitor effectively by rewarding effective non-executive board members with additional appointments as well as disciplining those who are ineffective in executing their monitoring duties (see Fama & Jensen, 1983; Milgrom & Roberts, 1992; Gerety & Lehn, 1997). More specifically, Gerety and Lehn (1997) show that independent board members of US

companies charged with accounting and disclosure violations by the SEC are more likely than others to lose their positions in other boards. In that sense, additional directorships do not only indicate independent directors' effectiveness, but it also highlights their abilities to display their governance expertise and knowledge of international best board practices. However, if the number of other directorships is too numerous for one audit committee member, then it may reduce the time the member can focus on the specific company, thus degrading the committee's overall effectiveness (Morck, Shleifer & Vishny, 1988; Beasley, 1996). As a result, additional directorships may improve an audit committee member's efficacy up to a point, but beyond that point, the audit committee member may be negatively affected because of the time and effort absorbed by other board directorship commitments. In a way, additional directorships are to some extent a double-edged sword.

It appears that audit committee composition literature has focused on member expertise with less attention given to member financial literacy. However, this review has demonstrated that a members' expertise including financial literacy are perceived to be critical components of audit committee effectiveness. These components of audit committee composition are associated with factors including audit committees engaging higher quality auditors, defending the external auditor from management pressure and a reduced occurrence of financial reporting difficulties. In addition, some general inferences and conclusions can be drawn from the accounting literature on audit committee expertise and experience. The extant literature have acknowledged the significance of different types of experience and expertise on various activities of the audit committee. More importantly, these previous studies recognise that the members of audit committee committees who have certain

capabilities and experience are useful in exercising oversight over both management and auditors. Moreover, regulatory concerns and the evidence from existing studies indicate that having appropriate experience and expertise, particularly in accounting and auditing, will likely enhance an audit committee's effectiveness or performance. Without doubt, such experience and knowledge enable audit committee members to better comprehend complex auditing matters, risks, and procedures. In a nutshell, existing studies have demonstrated support for audit committee expertise which enhances audit quality, and stock returns as well as contributing to less internal control difficulties and less earnings management. Notably, it should be pointed out that the next section reviews extant literature on audit committee activity or frequency of meetings, which has also been widely investigated.

### **2.3.3 Diligence or Activity of Audit Committee**

It has been suggested that the criteria of expertise and independence will not necessarily lead to effectiveness unless the audit committee is diligent or active. According to the Treadway Commission (1987), an active audit committee enhances the committee's role to execute its duties and responsibilities. As noted by Robinson and Owens-Jackson (2009), diligent audit committees that meet often demonstrate "greater commitment and interest and are more likely to be effective monitors" (p. 122). In other words, the frequency of audit committee meetings indicates whether the entity is active or not. In essence, audit committee diligence, generally refers to the eagerness of audit committee members to pursue their terms of reference and goals. Since actual audit committee activity is difficult to measure directly, extant literature is dominated by the use of the number of audit committee meetings per annum as a substitute for such activity or diligence (DeZoort, Hermanson,

Archambeault & Reed, 2002). Nonetheless, a number of other studies have used alternative proxies for diligence of the audit committee such as its voluntary disclosures, the duties it has to perform and its size. However, the most common substitute used in many studies has been the number of audit committee meetings for each year.

It has been suggested that for an audit committee keen to perform its tasks and responsibilities, it must maintain a constant level of activity and best practices of three or four meetings per annum (Treadway Commission, 1987; Cadbury Report, 1992; Blue Ribbon Committee (BRC), 1999; Higgs Report, 2003; Smith Report, 2003; Tricker, 2012). The BRC (1999) stated that audit committees should meet at least four times per annum, whilst the Smith Report (2003) recommended no fewer than three meetings annually. The foregoing appears to bolster Conger, Finegold, & Lawler (1998) suggestion that more frequent board meetings enhance a board's effectiveness. Ronen and Yaari (2008) state that one of the main duties of a board member is attending meetings and by doing so they would have the opportunity to vote on key decisions. In a way, for Ronen and Yaari board meetings are an indicator of the effort put in by the board members. According to Vafeas (1999) meetings are a key element of board activities, and as such, active boards that meet more frequently are more likely to carry out their responsibilities judiciously by putting more effort into monitoring the integrity of financial reporting and thereby improving the audit quality. The importance of audit committee meeting frequency is consistent with results of recent research. Two key studies, namely, Abbott *et al.* (2000) and Beasley *et al.* (2000) investigated meeting frequency vis-a-vis fraudulent financial reporting. Several other studies have investigated the association between meeting frequency,

earnings management and earnings quality (Xie *et al.*, 2003; Bedard *et al.*, 2004; Choi *et al.*, 2004; Van der Zahn & Tower, 2004; Davidson *et al.*, 2005; Vafeas, 2005; Yang & Krishnan, 2005; Rahman & Ali, 2006). A review of some of the prior studies is captured in the following paragraphs.

Without a doubt, the effectiveness of audit committees also relies to a large degree, upon their actual actions, such as the frequency, length, and content of their meetings (McMullen & Raghunandan, 1996; Park (1998); Beasley *et al.*, 2000; Beasley & Salterio, 2001; Ng & Tan, 2003; Abbott *et al.*, 2004; Vafeas, 2005). Meanwhile, Park (1998), reports that audit committee commitment is negatively correlated with reduced prevalence of litigation against auditors. In a related study, Bedard *et al.* (2004) discovered that audit committees that are active, have members with financial literacy and consist solely of non-executive members who are associated with less income-increasing earnings management. Similarly, Raghunandan *et al.* (2001) also found that audit committees that comprise only independent non-executive members that have at least one member who is financially erudite tend to have longer meetings (more active). Meanwhile, Abbott and Parker (2000) established that diligent and independent audit committees have a tendency to select industry expert external auditors. In another related study, Abbott *et al.* (2004) revealed that greater audit committee commitment, measured in terms of a minimum number of meetings, reduces the probability of financial restatements.

Earlier studies show that companies with a greater number of audit committee meetings are less likely to face sanctions for nefarious activities such as fraud and aggressive accounting (Abbott *et al.*, 2000; Beasley *et al.*, 2000) and are linked with

a lower prevalence level of earnings management (Xie *et al.*, 2003). Notably, these studies indicate that active audit committee members are associated with effective monitoring of the financial reporting processes. In other words, the more diligent, the more efficiently they fulfill their oversight duties. The above findings lend support for the contention that diligent audit committees help preserve the integrity of the financial reporting process (DeFond & Jambalvo, 1991; Dechow, Sloan & Sweeney, 1996). It is therefore scarcely surprising that diligent audit committees are associated with audit committee effectiveness. Similarly, the NACD (2000) recognises meeting frequency as a key component of audit committee effectiveness that is often utilised as a surrogate or substitute for measuring audit committee activity or diligence.

Meanwhile, some studies reveal that audit committees of companies that are encountering enforcement measures or restating their financial statements are less expected to have regular meetings (McMullen & Raghunandan, 1996; Xie *et al.*, 2003; Abbott *et al.*, 2004). The findings of this study are also corroborated by Abbott *et al.* (2004) who show that companies that restate their financial statements are less likely to have active audit committees. In a related study, Xie *et al.* (2003) discovered that audit committee meeting frequency is connected with fewer discretionary accruals. Xie *et al.* (2003) also state that a board of directors that is virtually inactive will have inadequate time to concentrate on key matters such as earnings management and creative accounting. This result demonstrates that board activity influences performance and it is an integral aspect in constraining misdemeanours such as earnings management. In a related study, Farber (2005) established that companies whose audit committees meet less frequently (inactive) were more likely to indulge in financial statement fraud. The foregoing findings are

consistent with the results of Beasley *et al.* (2000) who established that audit committees' of fraud companies meet less regularly than audit committees of non-fraud firms. Similarly, Chen, Firth, Gao & Rui (2006) indicates that greater frequency of board meetings lessen the likelihood of fraud because frequent meetings enable members to detect and resolve potential challenges, especially those that are connected to the quality of financial reporting.

Several other studies show that an audit committee should conduct independent meetings with management, internal and external auditors in order to perform its oversight role over the financial reporting and auditing processes in a more effective manner (Rezaee & Lander, 1993; DeZoort, 1998; Scarbrough, Rama & Raghunandan, 1998; Beattie, Fearnley & Brandt, 2000; Song & Windram, 2004). A number of formal reports including the Treadway Commission of 1987, and the BRC Report of 1999 highlight the importance of direct communication channels between the audit committee and the external auditor to discuss and review specific issues appropriately. As such, it is suggested that regular meetings between these actors should be conducted to ensure that the audit committee remains informed and knowledgeable about pertinent auditing and accounting matters (BRC, 1999; Raghunandan *et al.*, 2001).

Notably, a number of studies demonstrate that audit committee meeting frequency is related with various other audit committee and firm variables (Turpin & DeZoort, 1998; Collier & Gregory, 1999; Carcello *et al.*, 2002). In their study which investigated the association between audit committee activity and a number variables, Menon and Williams (1994) found that audit committee meeting frequency

was positively related with the ratio of independent board directors and the size of the audit firm. In another related study which utilised both the number and duration of meetings as a surrogate for audit committee diligence, Collier and Gregory (1999) established that high quality auditors and leverage had a positive relationship with audit committee diligence, while the inclusion of executive members on the audit committee was negatively associated with audit committee activity. Taking a similar approach, Turpin and DeZoort (1998) used voluntary disclosure of audit committee information in annual reports as a substitute for audit committee diligence by analysing the attributes of a sample of US firms that voluntarily included a separate audit committee report in their annual report. The results of their study indicated that companies preparing an audit committee report were bigger than companies that did not and that management was generally responsible for the inclusion of the audit committee report in the annual report. In a similar study, Carcello *et al.* (2002) investigated the disclosures in audit committee reports as mandated by the US's SEC, and showed that voluntary disclosures in the audit committee reports were discovered to be more common for depository institutions, larger firms, firms listed on the NYSE and firms with more independent audit committees.

Taken together, the results of existing studies indicate that active audit committees are more likely to be knowledgeable of pertinent auditing issues and more diligent in the exercise of their oversight role. This suggests that active audit committees can proactively and positively affect the various phases of the audit process. More importantly, these results imply that closer attention to corporate issues by both the full board and the sub-committees such as the audit committee yields enhanced board/audit committee effectiveness. As is evident in a number of previous studies, a



set of different substitutes for audit committee activity have been used including the number of audit committee meetings and the voluntary annual report disclosure of audit committee information. Furthermore, a number of studies have also investigated the link between audit committee activity and issues such as fraudulent financial reporting, earnings management and various other auditing dynamics. In a nutshell, the findings of the above studies show that there are three aspects of the audit committee's diligence, namely, the duties it has to perform, the frequency of its meetings, and its size. The next section reviews the prior literature on the size of the audit committee, which has also been widely studied.

#### **2.3.4 Size of Audit Committee**

Generally, the board of directors' size including that of its sub-committees is believed to be a crucial aspect of effective decision making (*UK Corporate Governance Code*, 2010). However, Vafeas (2005) observes that the audit committee size and the performance of the directors have a non-linear relationship. For this reason, both too small and too large a size of board or its sub-committee is likely to make it ineffective. Although average board sizes are relatively large, prior studies have indicated that smaller boards are more effective as members can communicate better on them and they are easier to manage (Yermack, 1996; Eisenberg, Sundgren, & Wells, 1998; Abbott *et al.*, 2004). These studies show that smaller boards promote a more resourceful conversation are associated with higher market values, and experience a lower incidence of financial restatements as the smaller boards contribute to effective communication. In particular, Abbott *et al.* study indicates that when board members communicate competently, they dampen the incidence of

misunderstanding and consequent errors that may affect their key stakeholders' confidence, especially concerning financial reporting issues.

Drawing from the foregoing studies, it is clear that the size of the board and its sub-committees do matter. Rohaida (2011) also provide a similar conclusion on the relationship between the size of boards and their effectiveness. According to Rohaida, audit committee size is one of the key characteristics that contribute to ACE. Hence, the audit committee size is another influential factor in examining the effect of audit committee attributes on the financial reporting process. Consistent with the argument for an effective committee size, too small a committee size may mean that an insufficient number of directors are able to serve it as the committee's assignments are spread across a small number of members. By implication, this may degrade the committee's monitoring effectiveness (Vafeas, 2005). Similarly, when an audit committee is too large, the performance of its members is also negatively affected due to coordination problems and process and thereby weakening the committee's monitoring effectiveness (Jensen, 1993; Yermack, 1996; Kalbers & Fogarty, 1997; Scarbrough *et al.*, 1998; Vafeas, 2005). In actual fact a large audit committee may not necessarily lead to more effective functioning since more members may indulge in unnecessary deliberations and interrupt the implementation of key decisions.

A number studies suggest that the ideal average size of an effective audit committee is between 3 and 4 members (Xie *et al.*, 2003; Abbott *et al.*, 2004; Vafeas, 2005), while some studies established that the normal AC size in the US and the UK was about three to five (Carcello & Neal, 2000; Raghunandan *et al.*, 2001; Davidson *et*

*al.*, 2004; Spira, 2013). On a balance of scales, accounting literature indicate that companies with larger audit committees are more effective in carrying out their monitoring duties and responsibilities vis-a-vis their smaller counterparts. For instance, Yang and Krishnan (2005) establish that quarterly earnings management is lower for companies that have a larger audit committee size in the United States (US). These findings point out that having an adequate number of audit committee members increases the efficiency of an audit committee's oversight function in terms of monitoring the integrity of the financial reporting process. In much the same way, Chen and Zhou (2007) discover that the companies with bigger audit committees are more concerned about their auditors' reputational capital and have a tendency of preferring the more established Big Four audit firms.

In a nutshell, the larger the size of the audit committees, the more effective they are in monitoring financial reporting.

The debate on the need for better corporate governance in Libya took shape in the 1990s when the privatisation programme was implemented (see Magrus, 2012). Unsurprisingly, corporate governance is currently one of the main agendas in Libya, particularly in the aftermath of the introduction of the *Libyan Corporate Governance Code* (LCGC) in 2007. Fundamentally, the concern is how corporate governance tools such as audit committees and external auditors carry out their duties effectively in Libya. Equally pertinent is to determine whether the LCGC is sufficient and complete in making sure that auditors perform an effective oversight role over the auditing process of firms. This is especially important in the light of recent indignities and scandals involving Libyan auditors as well as those in other parts of

the globe. This is essential because there is increased dependence by investors, and other key stakeholders on auditors' information in the form of audited financial statements. Hence, there is a growing yearning for corporate governance globally.

One of the key studies on corporate governance practices in Libya was undertaken by Magrus (2012). The main findings of his study showed that corporate governance in Libya is in its infancy and is generally characterised by a weak legal environment, lack of training on corporate governance among corporate leadership, weak investment awareness among investors and a general poor appreciation of corporate governance issues. Notably, Magrus indicate that rules of the LCGC of 2007 which include formation of audit committees are not yet mandatory. In other words, the Code is not yet a legal instrument according to existing laws in Libya. Furthermore, Magrus notes that the LAAA which was set up in 1973 has so far failed to regularise and organise the Libyan accounting practices in terms of adopting accounting and auditing standards. On reflection, Magrus's study indicates that the LCGC framework which governs the duties and obligations of audit committees and auditors has not produced the wanted result pertaining to accountability. In much the same way, Larbsh (2010) concludes that the corporate governance framework in Libya is not well developed, and thus the country has lagged behind its neighbours in the context of corporate governance. Furthermore, the study showed that the absence of principles of corporate governance has led to the weakening of accountability and responsibility processes. According to Larbsh, the contributing factors included an opaque economic structure, political interference, an archaic legal system, strong cultural and social influences, and lack of an accounting professionalism. Other contributing factors to the prevailing weak corporate governance regime in Libya

cited were the country's weak education system as well as weak stakeholders' activism.

Be that as it may, certain provisions have been developed to usher in corporate governance in the country. For instance, in the banking sector, Article no. 83 of the *Libyan Banking Law* (1/2005) states that "each bank must assign the auditing of its accounts to two chartered accountants selected by the bank's general assembly". More importantly, the selected auditor must meet two conditions, namely, "(i) not to be a member of the bank's board of directors, a bank employee or agent, or the recipient of a loan or facility from the bank with or without guarantee (ii) not to be related to any member of the board of directors or to the bank's other chartered accountant by a kinship tie up to the fourth degree" (Magrus, 2012, p. 34). In a related study, Pratten and Mashat (2009) discovered that corporate social disclosure in Libya is different from that to be found in the western countries. Their findings indicated that accountability within the context of heavy state regulation as seen in Libya can be problematic, as economic and social decision-making would always be perceived to be in the national.

In this study, we utilise a broad sample of Libyan banks to investigate the relationship between corporate governance mechanisms, auditor quality and reliability of audited financial statements. Whether Libyan auditors perform the monitoring role or mandate to minimise agency costs has been a subject of intense debate. Nonetheless, compared to external auditors in the developed world, for instance, in the US and some European countries, Libyan auditors possibly have a stronger governance role to play because the traditional corporate control systems are

degraded and thus too weak to protect the interests of investors. However, several reasons help to explain why external auditors are ineffective in developing economies like Libya. First, the untransparent nature of business transactions in these countries makes auditing an extremely challenging exercise. Second, audit committees are either ineffective or weak thus compromising the interests of shareholders (Magrus, 2012). Third, due to the weak legal enforcement regime there are no incentives for external auditors to safeguard their reputational capital because the threat of litigation (due to audit failure) is almost non-existent in emerging markets such as Libya where legal enforcement is weak (Magrus, 2012). Finally, the lack of audit expertise and lack of knowledge about corporate governance in developing economies may undermine auditors' monitoring role. This problem is magnified by an absence of local accounting standards for the accounting and auditing profession as is the case in Libya (Magrus, 2012).

On close inspection, the above findings of various studies on corporate governance in Libya seem to suggest that a good corporate governance framework is dependent on both internal and external factors such as a viable legal system, a strong economy, an effective board of directors, supportive political and educational regimes, and cultural and social norms (Larsh, 2010). In a way, the vision of corporate governance can come to fruition only if all the key stakeholders in Libya (including government, academia, external auditors, non-governmental organisations and universities) combine their efforts to eliminate obstacles that hinder the development of an effective corporate governance framework.

## **2.4 Auditor Quality (Audit Team Attributes)**

At the outset, it should be pointed out that the terms ‘audit quality’ and ‘auditor quality’ are assumed to be synonymous, and this is in line with Clarkson and Simunic’s (1994, p. 208) suggestion. Although a precise definition of auditor quality is difficult to identify, the most common definition for audit quality is, however, derived from DeAngelo (1981, p. 186), who presents it as the co-existing probabilities that an auditor will detect and also report any infringement in a client’s accounting system. Put another way, this definition captures auditor quality as the ability of an auditor to discover accounting misstatements and then to express them in a suitable audit opinion (Vanstraelen, 2000). What is striking about this definition is that it captures attributes crucial to understanding the influence of the audit on financial statement information. DeAngelo (1981) further argues that auditors major in providing different levels of quality, and as such if a company wishes to change audit quality it must also change auditors. More specifically, the likelihood of reporting the errors relies on the auditor’s independence (DeAngelo, 1981; Moizer, 1997; Vanstraelen, 2000). This definition does not only reveal the auditor’s compliance with the prevailing reporting and fieldwork standards, but also the degree of the auditor’s independence in being able to confront the client’s management with his or her reporting errors without any fears of losing the current audit engagement or potential future engagements. This would actually demonstrate that auditor independence is also a component of the auditor quality.

From the regulator’s angle, the ICAEW (2002) defines auditor quality as the ability to deliver “an appropriate professional opinion supported by the necessary evidence and objective judgements.” (2002, p. 8). Put differently, as long as the auditors

provide an independent audit opinion that is supported by ample audit evidence, the regulator deems such auditors as having performed a quality auditing service. Meanwhile, another regulatory body the FRC (2008) proffers a number of key drivers for auditor quality, that is, the audit firm culture; the audit process; skills and personal attributes of audit partners and staff; and usefulness of the audit reporting. In addition, the FRC indicates that the roles of internal governance mechanisms such as the audit committee and regulatory requirements may also help to enhance audit quality. However, for Duff (2004,) auditor quality is made up of both technical quality (consisting capability, reputation capital, experience, expertise, and independence) and service quality (empathy, responsiveness, and the provision of NAS and client services). In short, service quality represents the levels of clients' satisfaction and expectations.

Although there is little consensus over the meaning of auditor quality in existing literature, most of the definitions reflect some aspect of the DeAngelo (1981) definition as pointed out earlier. In essence, auditor quality embraces to varying degrees the dimensions of auditor competence and independence in actuality as well as how they are perceived (Watkins *et al.*, 2004). For example, Salehi and Kangatlouei (2010) view auditor quality as “how well an audit detects and reports material misstatements of financial statements, reduces information asymmetry between management and stockholders and therefore helps protect the interests of stockholders “ (Salehi & Kangatlouei, 2010, p. 941). The assumption here is that high auditor quality linked or associated with rich information quality of financial statements. In other words, financial statements audited by high quality auditors should be of a high quality because they are less likely to contain material errors or



misstatements (Salehi & Kangatlouei, 2010). In a related way, Smith, Bedard and Johnstone (2009) explore the necessary competence or independence for delivering quality audits, by capturing the input, process and output audit quality indicators in a meta-analysis which is intended to describe the possible public disclosure of audit quality indicators. The input indicators include knowledge and independence of the audit engagement team. The process comprises the proper type and amount of audit tests. Finally, the output indicators include reliable financial reports of the audit process.

Perhaps the only odd definition of auditor quality is the one provided by the US's *Public Company Accounting Oversight Board* (PCAOB). According to the PCAOB auditor quality is conceptualised as “meeting investors’ needs for independent and reliable audits and robust audit communications on: (1) financial statements, including related disclosures; (2) assurance about internal control; and (3) going concern warnings” (PCAOB, 2013). Nonetheless, the concept of auditor quality as derived from DeAngelo is unobservable (Krishnan & Schauer, 2001). In other words, it is complex and difficult to measure directly and as a result most studies utilise proxies or substitutes for audit quality such as audit firm attributes and audit team characteristics. Some of these attributes used to denote auditor quality include audit firm size, firm reputation, premium fees and extent of litigation (Samelson, Lowensohn & Johnson, 2006).

More specifically, as noted by Kilgore *et al.* (2011), two approaches, that is, direct and indirect, have been used to measure audit quality. Basically, the direct approach is predicated on the supposition that the likelihood of discovering and reporting of

breaches and misstatements will be seen in audit outcomes, such as audit errors, abnormal accruals, valuation of earnings surprises, and other financial statement outcomes. Some of the existing studies that have utilised the direct approach include Balsam, Krishnan, & Yang (2003) and Krishnan (2003). On the other hand, studies utilising the indirect approach comprise two main types. The first form measures auditor quality by using substitutes or proxies for auditor quality, such as audit fees, provision of non-auditing services, audit firm size, audit tenure, and audit firm experience (Elstein 2001; Geiger & Raghunandan, 2002). A close inspection of this type shows that it examines characteristics of the audit firm instead of the audit team members. On the other hand, the second type or form assumes a behavioural approach and measures audit quality by examining the characteristics or attributes of the audit team which are deemed to be related with audit quality. A number of studies reflect this behavioural perspective (Chang & Monroe, 2001; Duff, 2004).

As indicated earlier, existing literature describe auditor quality as the joint probability that an auditor will both detect a misstatement in the client's financial statements and express that misstatement in an audit opinion. Put differently, an auditor's independence and competence are two key elements of auditor quality. Notably, most of the traditional accounting literature view both competence and independence as two separate attributes of an auditor (Richard, 2006). Generally, auditor independence is perceived as a necessary condition of competence. However, for others auditor independence is as a much needed attribute rather than competence (Boritz, 1992). In a similar way, Richard (2006) observed that an auditor should understand how to be independent within the context of business transactions and relations since increasingly personal relations may impair auditor independence.

There is no doubt that accounting literature shows that auditing has an influence on the integrity of financial information, since the greater the level of the audit, the greater it is likely that more accurate information will be presented (DeAngelo, 1981). Nonetheless, this idea is one that is usually taken for granted because it is difficult to obtain empirical measures of audit quality. Unfortunately, as mentioned earlier the challenge in measuring or assessing audit quality has led many scholars to use different variables as surrogates or substitutes for audit quality. Some of these substitutes include auditor independence as well as aspects such as size of the audit firm, auditor rotation or tenure; provision of NAS, competition, and fees for audit services (Samuelson *et al.*, 2006). As mentioned earlier, several factors may influence the quality of an audit. In these studies the auditor's behaviour (his level of independence and competence) is seen as being influenced by several factors, such as economic dependence on a client, length of audit tenure, competition in the audit market and the policy orientation of the audit firm to which he or she belongs.

It should be noted as well that factors such as audit tenure, audit fees and NAS not only directly impair auditor independence, but they also implicitly support auditor effectiveness. In a related study, Wooten (2003) claims that audit firms, audit teams and the professional judgement or auditor independence are the main contributors to audit quality. Furthermore, FRC (2008) identifies five key drivers for audit quality, namely, the audit firm culture, personal qualities and skills of audit partners and staff, the audit process, utility of the audit reporting and elements that are beyond the direct control of the auditors. The FRC also suggest that existence of internal governance mechanisms such audit committees and regulatory requirements may help to improve audit quality. The use of these substitute definitions may allow for

variations in legal systems and differences in the efficiency of capital markets that may exist between developed countries and developing countries since the legal system and capital markets in advanced countries are likely to be more efficient than those in developing countries. Proceeding from that position, it is clear that an effective audit committee is capable of enhancing audit quality through active involvement during the audit period and effective communication with the auditors.

Perhaps because it is acknowledged that audit quality is important and of great relevance to a much wider population than might be thought initially, the idea that audit quality should be tied to standards has gathered momentum. In this regard, Sutton (1987) argues that audit quality should be defined as the extent to which auditing conforms to a set of pre-determined standards related to the features determining marketplace value and the service's performance of the function for which it was designed. In much the same way, Reed, Trombley and Dhaliwal (2000) views audit as the extent to which the process follows the prescribed standards for auditing, the extent to which the client's expectations of the client are met, and the degree to which the social responsibilities of the profession are satisfied. Lest we forget, auditors' reports are used by investors, together with other financial statements to help investors to make informed decisions. Consequently, audit quality is important for the general public as well as other key stakeholders. Perhaps because it is recognised that audit quality is important and of great relevance to a much wider population than might be thought initially, the idea that audit quality should be tied to standards is popular. In this respect, Sutton (1987) has defined audit quality as the degree to which auditing conforms to a set of pre-determined standards related to the

characteristics determining marketplace value and the service's performance of the function for which it was designed.

As is evident in the above discussion, audit quality has multiple dimensions, resulting in varied definitions, the classic one perhaps being provided by DeAngelo (1981). Other studies demonstrate that audit quality is positively associated with earnings quality (Francis, 2004). More specifically, there is no consensus in measuring audit quality. Some scholars and researchers use different variables as surrogates or substitutes for audit quality, such as size of the audit firm, auditor tenure or rotation, the provision of NAS, competition, and fees for audit services. It is also evident that the accounting literature as well as international standards governing audit conduct did highlight a number of factors that can promote and strengthen audit quality, all of which can be classified as ability and professional conduct. As mentioned in earlier sections, auditor characteristics such as ability to scrutinise, technical competence, knowledge, experience, industry specialisation, technological proficiency, independence, objectivity, integrity, due professional care, and judgement are generally regarded as key attributes in the external auditing process. Some accounting literature highlights independence as the fundamental attribute from which other attributes such as integrity, objectivity, and professional scepticism follow. There is no doubt, however, that all the above mentioned characteristics represent the absolute requirements that should be possessed by effective external auditors. It is therefore not surprising that the generally accepted definition of audit quality is the probability that financial statement errors or omissions will be discovered (competence) and reported (independence) as indicated by DeAngelo (1981).

### **2.4.1 Perceived Independence**

For several decades, auditor independence has attracted a lot of scholarly interest. In essence, it has been one of the most researched subjects in the accounting and auditing literature. The concept of auditor independence has evolved over the years through several stages in the history of the development of the accounting and auditing profession. Put another way, auditor independence has evolved through the development of the auditing profession which in turn is closely related with that of accounting. As indicated by Pany and Reckers (1983) the notion of auditor independence is closely interwoven with the existence of the auditing profession itself. After all, the independence of the auditor is a crucial attribute of a credible audit process when reporting on the reliability of firms' financial statements or reports. Hence, skills and expertise to identify errors and fraud are expected to be possessed by most audit firms but the reporting of those errors is a function of the auditor independence (Firth, 2002). As noted by Sutton (1997), independence entails a freedom from bias, personal interest, or vulnerability to undue influence or demands from clients. It is no wonder then that auditor independence is the linchpin aspect of the auditing profession (Pike, 2003). After all, the main purpose of the auditor's work, that is, an independent audit, crops up from the need for reliable financial information.

In order to understand the nature of independence in auditing, this study addresses firstly the issue from what constitute the term 'independence'. As defined by the Cambridge International Dictionary of English (1995, p. 720), independence is the state where a person or people are not controlled or influenced in any form or way by other persons, people, things or events. Relating the above definition into the context

of the current study shows that it is more of professional integrity that practically embodies selected characteristics by committees or individuals within a discipline so as meet the established performance objectives. Hence, the US's Security and Exchange Commission (SEC) in 2002 conceptually defined independence as a characteristic that establish the virtue of any good practitioner, that must be individually or collectively independent of any type of interest that might directly or indirectly affects his or her judgment. Nevertheless, the SEC's definition of independence is more of a professional standard, which reflects individual's self reliance of not subordinating their objective judgment to their clients' views (Sullivan *et al.*, 2009). It thus established that it is the collective rights of all the beneficiaries and stakeholders to receive accurate information and advice from this independent professional.

Generally, the auditing profession acknowledges two forms of auditor independence, namely, 'independence in fact' and 'independence in appearance' (Mautz & Sharaf, 1961). Independence in fact, in the auditing profession refers to an auditor's honesty, objectivity and mental attitude. Notably, the International Ethics Standards Board (IESBA) of the International Federation of Accountants (IFAC, 2005) describes this notion of independence as the "state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism". Put differently, this idea of independence refers to an auditor's objectivity as well as to their quality of not being influenced by regard to personal advantage. As can be seen from the extant literature the concept of auditor independence as the auditors' state of mind, their ability to make objective and

balanced audit decisions has a major drawback because it relies on an auditor's personal attributes or characteristics that are unobservable and unmeasurable (Wines, 2006). It is therefore not surprising that scholars, practitioners as well as regulatory and professional bodies have attempted to define auditor independence in a more precise way. Consequently, another concept of auditor independence has been established, that is, 'independence in appearance' as indicated earlier.

The notion of 'independence in appearance' requires auditors to avoid any relationships with their clients that might lead financial statement users to doubt their independence or autonomy. In other words, it refers to an auditor's freedom from possible diverging interests which might affect public confidence in the auditor's independence. As mentioned earlier, the auditing profession has recognised this view of auditor independence and emphasis has been put on it by most auditing professional bodies worldwide. For instance, the Auditing Practicing Board (2004) defines 'independence in appearance' as:

*Freedom from situations and relationships which make it probable that a reasonable and informed third party would conclude that objectivity rather is impaired or be impaired. Independence is related to and underpins objectivity. However, whereas objectivity is a personal behaviour characteristic concerning the auditor's state of mind, independence relates to the circumstances surrounding the audit, including the financial, employment, business and personal relationships between the auditors and their client (Para. 12).*

In much the same way, the IFAC (2005) has defined the notion of 'independence in appearance' as, "the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional scepticism had been compromised".



From the context of auditing, Abu Bakar and Ahmad (2009) defined independence as an avoidance of any situations that may impair an auditors' objectivity or permit his personal bias to influencing corporate judgments. Thus, the definition of auditor independence practically requires the establishment of clearly stated agreed standards necessary for maintaining required objectives and also for avoiding auditor's personal bias. In much the same way, several other authors have conceptualised auditor independence as a situation of impartiality in the attitude of those auditors that are charged with the task of auditing (Awadallah, 2006). Hence, Lassila *et al.* (2010) argues that the concept of auditor independence is the ability of both the internal and external auditors to freely engage and decide on the scope of their auditing work without any interference or influence from the company's management. Meanwhile, Perry (1984) identifies the five most common factors contributing to audit failure, namely, scope restrictions; auditing by conversation; inability to critically evaluate transactions; incompetence; and lack of impartiality and skepticism. Interestingly, each of these five reasons can be directly linked to the notion of auditor independence which is one component of an auditing firm's quality control system. After all, if the auditors are independent then they can do the best job in their profession (Mansouri *et al.*, 2009). More importantly, many researchers have consistently argued that auditor independence is the concept that reflects the positive image of the auditing profession to the general public through the assurance of the existence of integrity and objectivity in the expected standards (Anandarajan, Kleinman & Palmon, 2008). This was the precise reason that made Abu Bakar and Ahmad (2009) to define auditor independence as an unbiased auditors' attitude that is characterised with objectivity and integrity. Contrary to the above opinions are some researchers that argued against auditor independence as having lesser

importance and that there is no way that the auditors can be independent of their clients (Dopuch & Sunder, 1980). Therefore, this current study will like to define auditor independence as the ability of internal and external auditors in effectively making unbiased and impartial audit policies and decisions.

Meanwhile, the extant literature review reveals that auditor independence is a key foundation of the auditing profession, given its essential value in judging the reliability of audited financial statements (Al-Ajmi & Saudagaran, 2011; Bedard *et al.*, 2004). Hence, the extent to which an audited financial statement can be accepted as being reliable significantly depend on auditor independence (Flaming, 2002; Faraj & Akbar, 2008). However, the encouragements of market competitions between the auditing firms have also come under scholarly criticism for its implicit ability to erode the independence of the auditors. Hence, the appearance and reality of auditors' independence must be preserved by refraining from all implications to support the interests of the firms that auditors are offering services for. Auditors should maintain fairness and equality to all involved parties whether they are the corporation's executives, investors, shareholders, or employees. The definition offered by Siegel and Shim (2005) clearly illustrates independence as the "condition of the accountant having no bias and being neutral regarding the client or another party in performing the audit function" (p. 206). A good practical example was the encouragement of competition among audit firm by the Federal Trade Commission in 1978. This issue has been argued as potentially harmful to the practice of auditing, mainly in the area of preserving required standards of soliciting audit clients. Although some researchers have emphasised on the inherent benefits of increased competitions, but such competitions could also increased pressures on the incumbent

audit firms and indirectly leading them into compromising their established standards so as to be able to retain the clients (Faraj & Akbar, 2008). Meanwhile, Geiger *et al.* (2002) argued that the provision of consulting services by the external auditors to its clients will strengthen the auditor knowledge of the client's operations and ultimately improving auditing quality.

DeAngelo (1981a) believes that one should talk in terms of the probability of disclosing a material misstatement if discovered, by an auditor who may have economic incentives not to do so. This theory implies that the attributes of both the auditor and the client, together with the existing relationship between them, are likely to be influential on auditor independence and audit quality. Therefore, the study of auditor independence involves economic modelling of its implications and this requires decisions on the factors that may affect auditors' judgement in economic terms. It is imperative to note that the majority of studies modelling auditor independence in economic terms are from the US and are positivist in orientation (Adelopo, 2010, p. 125). As mentioned in earlier sections several studies have highlighted the fact that the level of economic ties between the auditor and the auditee has a tendency to impact on auditors' independence. For that reason, previous concerns of the high increase in the percentages of revenue earned by audit firms as a result of providing NAS to clients led the US's SEC into adopting a new rule (Geiger *et al.*, 2002). This is because of the latter's argument of the negative impact that the provision of NAS has on the perceived independence of the auditor. Notable among the new rules is the prohibition of auditing firms from the provision of certain NAS to their respective audit clients. The SEC rules also require that the public companies must disclose fees paid to their external auditors in their proxy

statements for both the audit and the non-audit services. The primary aim of enacting this new rule was to practically mitigate the negative effect that the provision of NAS posed to auditors' independence (Lee *et al.*, 2009; Ebimobowei, 2011). A critical issue of concern is: Does SEC argument on the percentage of audit to non-audit fees has any negative implication on auditor independence? A good answer to this question is the argument provided by Palmrose and Saul (2001) which point to the lack of adequate published empirical evidence to establish that the provision of NAS will compromise auditor independence. Palmrose and Saul (2001) went further to argue that despite issues of concerns as noted in Enron, there was no available practical evidence to establish that the impaired audit of Enron was as a consequence of the provision of NAS.

As is evident in the existing literature, auditor independence is vitally crucial to the auditor as it is considered as one of the integral factors of the audit process. For that reason, auditor independence is regarded as the mainstay of the auditing profession as well as audit quality. Thus, if auditors are not truly independent, their opinions will add no value to their clients' financial statements. Basically, high levels of audit quality rely on the proper balance between the auditor's independence, competence, professional and personal relationships (Richard, 2006). It is no wonder then that Rusmanto (2001) views the auditing profession as based on the independence of the auditors. In much the same way, Higson (2003) stated that without auditor independence, the issue of whether the figures in the financial reports are correct is seriously called into question, meaning that in fact an audit carried out in such circumstances is actually a waste of time. For instance, Pike (2003) recognises the role played by auditor independence in resolving conflict between auditors and

owners, since the auditor must abide by standards set by the profession. This further highlights the importance of auditor independence as a variable that should always be considered in research activity. This would actually reflect the fact that auditor's independence is a component of audit quality (Mohamed, 2010; Mohamed & Habib, 2013).

To sum up, the review of the literature in this section reveals that the idea of auditor independence has developed over the years through several phases in the history of the accounting and auditing profession. Unsurprisingly, auditor independence has been perceived to be one of the most key attributes that auditors should possess when executing their duties. As aptly captured by Mautz and Sharaf (1961), more than 50 years ago, the "significance of independence in the work of the independent auditor is so well established that little justification is needed to establish this concept as one of the cornerstones in any structure of auditing theory" (1961, p. 246). As a result most countries worldwide now require that financial statements be audited by independent auditors. The next section discusses the other main element of auditor quality audit, that is, auditor competence.

#### **2.4.2 Perceived Competence**

Auditor competence is inextricably linked with auditor independence because if the attribute of competence does not exist, the extent to which the audit opinion can be trusted as an independent or unbiased statement is reduced (Mansouri *et al.*, 2009). Thus, if the auditor is not competent, independence is not guaranteed. In such a scenario, auditors lacking expertise and experience are compelled to depend on the client's management in terms of exercising their functions. According to Mansouri *et*

al competent auditors are expected to “have academic training in accounting, taxation, auditing, and other areas related to their profession” (2009, p. 18). Meanwhile, Daud (2007) indicated that auditors must have a strong educational background with adequate knowledge and expertise in order for them to be regarded as competent. These attributes can be obtained by acquiring the relevant qualification, proper training and experience. Additionally, relevant skills are also essential. Skills could mean the ability of auditors to apply the knowledge acquired into the field of auditing. In practice, for instance, greater skill may be required to immediately recognise the potential risks of the business transactions or accounts prepared using computers and subsequently to propose modifications such as improving the internal control measures. Auditors, who do not have the right attitude, such as in the case of fraud, may choose to avoid potential areas where errors or omissions might be found. There have been suggestions recently that auditors need to come from multidisciplinary academic backgrounds such as economics, information technology, law, and computing. The effect of the knowledge and skill of auditors on audit quality has been captured in past studies focusing on the financial audit process (Chen, Shome & Su, 2001; Samelson *et al.*, 2006; Merhout & Havelka, 2008; Havelka & Merhout, 2009; Stoel, Havelka & Merhout, 2012).

As a result of technological revolution, the expansion of accounting and auditing services and products have compelled auditors to expand their technical education in order to address dynamic changes in the auditing sector. According to SAS No. 94 of AICPA (2001) the use of information technology audit experts as a source of audit evidence is necessary in audit engagements of advanced electronic systems, due to their potential value in both, gaining an understanding of, and assessing, the internal

control systems of clients who utilise such technology. Unsurprisingly, a number of scholars have highlighted the importance for auditors to enhance their knowledge and experience in dealing with advanced electronic systems in order to assure the integrity and reliability of the accounting processes (Curtis & Viator, 2000; Bierstaker *et al.*, 2001; Kinney, 2001; Pathak, 2003; Abu-Musa, 2004; Brazel & Agoglia, 2007; Brazel, 2008; Safty, 2009). In the context of auditing, auditor competence has been described by Safty, (2009) as a form of audit knowledge and skill, which is the product of education, training and practical experiences.

In much the same way, a recent standard issued by the IFAC in 2007, entitled *The International Education Standard (IES 8) Competence Requirements for Audit Professional*, states that auditors must have the relevant formal knowledge of auditing together with professional skills as well as the ability to apply the professional ethics, values and attitudes to diverse organisations and different contexts. In a way, auditors are expected to receive both formal and informal training throughout their professional careers (Boynton, Johnson & Kell, 2001). According to Stoel *et al.* (2012), accounting knowledge and audit skills refer to the audit personnel's level of accounting and auditing knowledge in general, their specific appreciation of the accounting system being audited, and their capacity to carry out tasks and exercise professional judgment as auditing practitioners. In view of the foregoing, it is clear that auditor competence comprise a set of relevant traits in the form of skills, knowledge, and attitudes.

Much research has been done which investigated the association between auditor experience and audit quality (Chen *et al.*, 2001; Stoel *et al.*, 2012). Generally,

research has shown a positive relationship between auditor specialisation and audit quality (Lowensohn, Johnson, Elder & Davies, 2007; Stoel *et al.*, 2012). According to Stoel *et al.* (2012) financial respondents rate auditor experience as having a bigger effect on audit quality than information technology respondents. In the same vein, Daud (2007) stated that auditor competence has a direct implication on the auditor independence and audit judgement. Existing studies have shown that knowledge is a major determinant of expertise. Notably, although more experienced auditors outperform auditors with less experience, knowledge plays a more critical role than experience in explaining performance variations among participants in their experiment. As indicated earlier, expert knowledge gained through years of on-the-job experience including technical competence (knowledge of advanced electronic systems) increases the probability that auditors will discover errors in financial statements (Safty, 2009). It should be noted that research also present proof that expert auditors are generally connected with enhanced client disclosure quality (Dunn & Mayhew, 2004), reduced incidence of fraud (Carcello & Nagy, 2004), enhanced investor response to reported earnings (Balsam *et al.*, 2003), lower levels of discretionary accruals (Krishnan, 2003), and lower levels of restatements (Stanley & DeZoort, 2007).

In essence, all audit tasks require knowledge for the task at hand. Gains in knowledge improve audit performance as demonstrated by the ‘knowledge spillover’ facilitated by improved efficiencies related with the joint provision of audit services and NAS. Through helping an auditor to gain knowledge about a client, NAS raises the auditor’s expertise and competence in executing their professional duties judgment. In a way, these knowledge spillovers effects from NAS to auditors can



enhance audit quality as established by a number of studies (Owhoso, Messier & Lynch, 2002; Balsam *et al.*, 2003; Sawan, 2010). After all, auditor knowledge of the industry provides the auditor with the capacity to be more effective in exercising professional judgement. Furthermore, Schelker (2012) indicated that more capable auditors are more effective monitors, which checkmates the tendency of agents to misreport. Since other key stakeholders such as investors and ordinary citizens depend on financial information to make informed decisions, the quality of audited financial information is very crucial. If skilled auditors improve financial information quality, investors and other stakeholders will be able to make the appropriate decisions. Therefore more competent auditing is positively related with more reliable fiscal information. In a way, auditor competence is a crucial element that affects the credibility and reliability of a audited financial statements (Watkins *et al.*, 2004).

Auditors are also seen as the custodians of a specialist body of knowledge. If the knowledge is not applied properly in the course of stewardship of public resources, it could be construed as a breach of public trust and hence a compromise of ethical standards. Therefore, the issue of auditor competence also has an ethical dimension to it. A dishonest auditor may choose to act in such a way that errors or omissions are not discovered by studiously avoiding areas prone to such errors. In any subsequent examination, it would be difficult to prove whether the omission was deliberate or simply an oversight. Notably, competence is largely a matter of perception. There is no absolute yardstick for measuring competence. To maintain public confidence, effective monitoring is required by the regulatory body to constantly update auditors' knowledge and skills. It is therefore in everyone's interest to require the auditors to

perform at a reasonable level of competence and care. Without such competence, the audit function becomes an activity in which the expectations of its beneficiaries cannot be effectively met by the auditors. In summary, it can be concluded that auditor competence is an important aspect shaping users' perceptions about the effectiveness of the audit function. Competence is also needed to establish credibility and authority. If the audit report is to carry authority with those who receive it, they require being confident that the auditors have the capability or credibility to produce reliable audited financial statements.

A litany of studies have investigated the status of audit quality in Libya (Ritchie, & Khorwatt, 2007; Eldarragi, 2008; Almalhuf, 2009; Sawan, 2010; Ahmad, 2012). For instance, Almalhuf (2009), focuses on the key attribute of auditor independence which he regards as the essence and the cornerstone of the auditing profession. The main findings of Almahuf study show that auditor independence in Libya is undermined especially by the regulatory regime. In this regard, it is revealed that rules and regulations enshrined in the Libyan laws are not comprehensive enough to protect auditor enhance. As such, most provisions are not succeeding in enhancing and maintaining auditor independence. According to Almalhuf, the situation is worsened by the ineffectual Libyan Accountants and Auditors Association (LAAA) which has not performed its role of either developing the accounting and auditing profession or safeguarding auditor independence. As a result, the Libyan accounting and auditing environment is characterised by a number of factors which have undermined the professional status of both auditors and accountants. Some of these factors include "the deficiency of the LAAA in performing its supposed role in developing the accounting and auditing profession and in protecting the interests of

its members, the existence of unqualified practitioners, the complete absence of any kind of code of conduct for the accounting and auditing profession in the Libyan environment, the uncontrolled process of auditor recruitment and remuneration, and the ignorance and lack of knowledge among Libyan society about the accounting and auditing profession and its role” (2009, p. 260).

Similarly, Eldarragi (2008) revealed that Libyan audit firms were not operating in full accordance with professional standards and regulation, largely due to weaknesses, and lack of enforcement of existing regulations and laws. This study also showed that though a number of Libyan auditors are perceived as highly competent, some of the licensed auditors are not perceived as qualified auditors. It was pointed out that the presence of unqualified ‘licensed’ auditors was the result of early governmental policy, which had been adopted as stop-gap measure to meet the urgent need of auditing at the beginning of the oil boom in the 1970’s. Undoubtedly, as pointed out by Eldarragi (2008), the existence of unqualified auditing practitioners has deeply affected the reputation of the Libyan accounting profession in general, because they lack the requisite professional competence, which in turn, has a negative impact on the profession. In much the same way the findings of a study by Sawan (2010) show that most respondents were not sufficiently satisfied with the current level of audit quality in Libya, and also expressed dissatisfaction with the ineffectual role of the LAAA which is expected to enhance the level of audit quality. According to Sawan, a number of reasons are behind this low level of audit quality in Libya, namely, (i) the lack of the professionalism among auditors in Libya, the weaknesses in the current regulatory framework, (ii) the ineffectiveness of the LAAA, (iii) the ignorance of audit firms in Libya in respect of new services, and (iv)

the inability of Libya's education system to produce graduates of a good enough caliber. All combine to cause the low level of audit quality that the profession itself wishes to improve.

According to Ritchie and Khorwatt (2007), Libyan auditors have a strong attraction towards the accounting and auditing practices and standards of Western countries, particularly those found in the UK and the US. They also observe that the Libyan auditing profession is affected by three distinctive influences, namely, (1) the legal imperatives, (2) quasi-legal professional requirements of the LAAA and (3) the socio-cultural factors of family, tribe and community. It is noted that the legal imperatives are derived from the legal provisions approved in *Law No. 116 of 1973* which provides for the suspension, expulsion or incarceration of auditors who fail to adhere to the requirements of the best practices or professional standards. Notably, Article 53 (1973) of the same law established the LAAA, which is largely viewed as ineffectual. In this regard, Ritchie and Khorwatt point out that until very recently the LAAA had no documented or formal code of ethics. Nonetheless, the LAAA has since adopted the AICPA code in its totality, thus providing a framework for its own ethical standards and expectations. This is a particularly welcome development even though it further underlines the strong affinity of the Libyan auditing environment towards Western auditing standards and practices.

In much the same way, Shareia (2010) examines the impact of Libya's unique legal, economic, political, religious, social and cultural systems on the development of its accounting profession in this country, and, by extension, on the way accounting is practiced. According to Shareia, Libya does not have a well trained professional

accounting body that understands national conditions and that will best serve the country's economic development endeavours, because of "the presence of factors that restrict the effectiveness and potential of the accounting profession" (2010, p. 22). In a related study examining the extent to which statutory financial auditors are involved in encouraging environmental responsibility and auditing of their clients in Libya, Ahmad and Mohmes (2012) found that Libyan financial auditors faced a number of challenges including lack of competence; lack of professional standards and guidance; lack of research, weak laws; limited public demand for environmental financial reports; and low level of environmental disclosure by Libyan firms. Although this study focused on environmental financial auditing, it however unraveled the overall state of auditing practices in Libya.

From the above discussion; it can be observed that the review of relevant literature provides strong evidence indicating that audit quality in Libya is weak. The literature shows that the Libyan key regulators, namely, LAAA, policy-makers and political actors are failing to take strong measures to regulate the auditing profession and bring it more effectively into line with current international standards such as those of the International Accounting Standards (IASs) and the International Standards on Auditing (ISAs).

## **2.5 Underpinning Theories**

There are several different theories of auditing that may illustrate the demand for audit services. It should be indicated that some of these theories are well known in research such as agency theory and stakeholder theory. However, some of them are more based on perceptions such as inspired confidence theory. As evident in

existing literatures, the roles of theory in aligning the corporate phenomena and practical issues with related theoretical linkages cannot be overemphasised (Riahi-Belkaoui, 2000). This is because theories assist in shaping, analysing and interpreting any concepts in relation to the inherent practical implications (Alles, Kogan & Vasarhelyi, 2008). Studies on governance relationship have been conducted using different theoretical frameworks within the corporate environment. Under this section, relevant discussions on related theories that could assist in shaping the extant meanings of reliability of audited financial statement and its linkages to corporate governance are captured. In this current study, the agency theory is the underpinning theory upon which the proposed conceptual framework in this study was built and how the hypothesised relationship will be measured. The subsidiary theory is the stakeholder theory.

### **2.5.1 Agency Theory**

A considerable body of studies on agency theory have emerged in this area within the context of the principal-agent relationship. In this regard, the works of Jensen and Meckling (1976) and Fama and Jensen (1983) are very instructive. Available arguments show that agency theory is theoretically rooted in the empirical work of Berle and Means (1932), where they have theoretically established the impact of separating firm ownerships from the management positions (see Mallin, 2010, p. 15). In this regard, an agency relationship occurs when one or more principals engage another person as their agent to perform a service at their behest. Performing this service leads to the delegation of some decision-making powers to the agent as noted by early advocates of agency theory such as Jensen and Meckling (1976). According to the ICAEW (2005), this delegation of accountability by the principal necessitates

the placement of trust in an agent to act in the principal's best interest. However, whenever the principal or shareholder contracts with the agent to manage his or her affairs, the agency predicament arises (Tricker, 2012). In a way, how to ensure that the agent acts only in the interest of the shareholder (principal) remains a challenging proposition. As noted by some researchers the issues of conflict of interest are a major factor that has been affecting the contractual agreements between principals and agents. Some concerns also arise about the trust due to the differing motives of agents and the principals. Scholars who perceive an unavoidable existence of conflict of interest between the appointed managers (agents) and the business owners (principals) base their views on the flexible assumptions made by the agency theory, where managers are assumed to be self-serving individuals that explore opportunity to its own advantage at the expense of the business owners (Tricker, 2012).

Within the context of the agency theory, principals delegate resources to agents who are expected to maximise the interests (wealth) of the principal against remunerations and bonuses which are paid to these agents. Agents, however, due to inherent opportunistic behaviour, may maximise their own self-interest (wealth). Anecdotal evidence of such behavior has been established, for instance, a lot of shareholders' wealth has been siphoned from US firms over the years by management abusing their power (Monks, 2008). In some instances, management may also engage in unnecessary corporate risks such as hostile take over bids considering that it is not their money they are risking (Tricker, 2012, p. 61). For those reasons, some agency relationships represent a conflict of interests. On reflection, the agency theory was built on the basic assumption that conflict of interests will lead to divergence of business objectives between the original goals of the principals and the management.

It is therefore not surprising that there are several combinations of means that may be utilised to align the interests of agents (trustees) with principals and to permit the latter to measure and control the behaviour of the agents and reinforce trust in agents (ICAEW, 2005). These monitoring mechanisms include the appointment of an audit committee and external independent auditors. The reason behind the need for external auditing is that an external independent auditor is expected to monitor and verify financial statements which are prepared by managers (agents) on behalf of owners or shareholders (principals). In a way, agency theory intends to mitigate the agency problem and align the asymmetry information gap between the principals and agents by using corporate governance monitoring mechanisms such as external auditors and audit committees. Hence, most scholarly research into corporate governance has utilised agency theory to explore links between corporate governance mechanisms and corporate processes (Tricker, 2012).

The appointment of external auditors however, may create additional agency relationship challenges, which in turn affects trust and generate new issues pertaining to their independence. For instance, several studies have demonstrated that the provision of NAS may undermine auditor independence resulting in audited financial statements being perceived as unreliable. In some situations, external auditors are found to be a source of support and advice concerning these audited financial statements' Beattie, Fearnley and Brandt (2004, p. 3). This is contrary to their brief which includes providing information to owners and to other stakeholders (potential investors) that are critical to the company's public ownership. Nonetheless, an external auditor's failure to discover considerable misrepresentations in a firm's financial statements can result not only to losses by individual investors, but also to



an overall degrading of trust or stakeholder confidence in organisations. An instructive example of this form of collusion is the Enron scandal in which Arthur Andersen (the Enron auditors) colluded with Enron's management at the expense of its principals. Consequently, within the context of agency theory, there is an ongoing need to put in place additional mechanisms such as the independent audit committee to monitor the behaviour (independence) of the auditors (ICAEW, 2005). After all, agency theory suggests that the independence of non-executive board directors is an essential quality that contributes to a committee's effective monitoring duties (Fama & Jensen, 1983). Within this context of agency relationship, an independent auditor may play a key role in monitoring the other agents, that is, managers.

According to what has been mentioned above, it can be seen that auditor independence is vitally important especially where a separation of the management functions from the ownership is effected for business reasons. Although the most commonly cited agency relationship in the corporate governance context is between shareholders and managers, it is "useful to be aware that the agency relationship can also cover various other relationships including those of company and creditor, and of employer and employee" (Mallin, 2010, p. 15). Hence, other different interested parties in the financial statements of firms other than the shareholder or owner have emerged such as potential investors, creditors, employees, government agencies and the public in general. Not surprisingly, auditor independence as well as competence have become social requirements worldwide. As a result, most countries including Libya have followed the Western proposition in requiring that financial statements be audited by independent and competent auditors. More importantly, in the context of corporate control of firms, agency theory views corporate governance mechanisms,

particularly the audit committee, as being a critical monitoring tool in minimising the effect of any problems that may crop up from the principal-agent relationship.

In a nutshell, the inherent and philosophical assumption of agency theory is that people are self-interested and as such cannot be expected to look after the interests of others (principals). In this regard, it is not surprising that agency theory views corporate governance processes as key monitoring tools that may mitigate problems arising from principal-agent relationships (Mallin, 2010, p. 5).

### **2.5.2 Stakeholder Theory**

Despite the aforementioned benefits of agency theory, many researchers have criticised it as addressing issues of corporate governance from short term perspectives (Dillard & Yuthas, 2001; Phillips, 2003; Freeman, Wicks, & Parmar, 2004). It thus indicates that the agency theory is very narrow in scope given its inability to explain and project business activities beyond the scope of the shareholders (Freeman *et al.*, 2004; Tricker, 2012). Due to these observed lapses in agency theory, researchers have come up with an alternative proposition that is now known as stakeholder theory (Freeman *et al.*, 2004; Freeman, 2010). The stakeholder theory was conceptualised on the notion that the forecasting and planning of business activities should be based on longer perspective and from a broader perspectives of the relationships between the shareholders and all other interested parties (Freeman, 2010). Theoretically, the stakeholder theory empirically posits that the existence of any corporate entity and its sets of activities should not only be directed at the benefit of the company's shareholders, rather such existence should be enshrined to benefit all the interested stakeholders (Freeman, 2010; Mallin, 2010; Tricker, 2012).

Included among the interested parties in any business activities are its shareholders, customers, suppliers, employees, suppliers, government agencies, credit providers, local communities, the general public and so forth (Dillard & Yuthas, 2001; Mallin, 2010). In the increasingly more environmentally and socially concerned world of the 21st century, notions of corporate social responsibility and sustainability reporting have commanded a lot of attention. It is therefore not surprising that the stakeholder approach to corporate governance that calls for boards of directors to take into consideration the interests of a diverse range of stakeholders has also attracted a lot of scholarly and corporate interest.

Undoubtedly, a major argument by those that theorised the stakeholder theory is that corporate entities should be practically managed in a dynamic way that will serve the diverging interests of key stakeholders. Hence, the ability to effectively coordinate these diverse interests would positively impact the organisation's ability in formulating good corporate strategies that would generate the desired outcomes. Seemingly, the extant theoretical arguments for stakeholder's theory have been premised on issues of moral justifications and ethical considerations in business activities (Phillips, 2003). However, critics view stakeholder ideas as problematic because meeting the conflicting needs of stakeholders and shareholders is not feasible (Tricker, 2012). The so-called stakeholder versus shareholder dilemma demonstrates that management or agents can not serve two masters at the same time. Although the stakeholders theory is much related to the current study, still available evidence have shown that that it has limited empirical evidence of measurability to efficiently establish its applicability on issues of corporate governance (Hendry, 2001). Unlike the agency theory of controlling business interest, the stakeholders'

theory has not suggested any measurable variables that researchers can use as proxy for measuring the different stakeholders' interest in a company. Notably, for the purpose of this study, the researcher has used stakeholder theory to provide alternative explanations (Brenner & Cochran, 1991) for the nature of interactions between the business and its stakeholders.

A recent variant of stakeholder theory, the enlightened shareholder theory attempts to go beyond the stakeholder versus shareholder dilemma (Jensen, 2010). This new approach recognises the primacy of meeting shareholders' interests, but it also acknowledges the importance of satisfying stakeholders' interests as well (Jensen, 2010; Mallin, 2010; Tricker, 2012). This theory advocates for a win-win scenario. Conclusively, this study strongly believes the stakeholders' theory has a major impact in establishing the theoretical linkages that exist between the shareholders, company management, audit committee members, external auditors, government agencies and the general public. It thus means that this current study is theoretically lacking in its ability to establish the practical linkage between the aforementioned variables of interest without the stakeholders' theory.

## **2.6 Chapter Summary**

There has been a considerable debate in recent times concerning the need for strong corporate governance (McConomy & Bujaki, 2000), with countries around the world drawing up guidelines and codes of practice to strengthen governance (Cadbury, 1997, Corporate Governance Code of Nigeria, 2005). The rationale for this emphasis can be linked to increased concerns over the integrity of financial reporting in financial statements (Millstein, 1999; IFAC, 2009).

Good corporate governance by boards of directors is recognised to influence the quality of financial reporting, which in turn has an important impact on investor confidence (Levitt, 1998; 2000). Studies have shown that good governance reduces the adverse effects of earnings management as well as the likelihood of creative financial reporting arising from fraud or errors (Beasley, 1996; Dechow *et al.*, 1996; McMullen, 1996). Traditionally, the external auditor has also played an important role in improving the credibility of financial information (Mautz & Sharaf, 1961; Wallace, 1980; Spira, 2013).

In recent times, a series of well-publicised cases of accounting improprieties in Nigeria (for example, such as is reported in relation to Wema Bank, NAMPAC, Finbank, and Springbank in Nigeria) has captured the attention of investors and regulators alike. The search for mechanisms to ensure reliable, high quality financial reporting has largely focused on the structure of audit quality. The auditing profession has been proactive in attempting to improve audit quality by issuing standards focused on discovery and independence. As a result, there has been a concerted effort to devise ways of enhancing independence (Corporate Governance Code of Nigeria, 2005). The profession has also responded to denigrations on audit quality. It emphasised that, by its nature, the inherent limitations of an audit make it impossible to eliminate the risk of audit failure (Ricchiute, 1998; IFAC, 2009; Beasley, Carcello, Hermanson, & Neal, 2013). The effect of sound governance practices on the quality of financial reporting has received attention from researchers, particularly in the United States (McMullen, 1996; Beasley, 1996; Beasley, 2000; Abbott, 2000; Beasley *et al.*, 2013).

Based on the above review of the extant literature, there are several reasons for conducting this study. Firstly, the review of the relevant existing literature suggests that little effort is directed to the study of the relationship between corporate governance mechanisms, auditor quality and financial reporting quality in Libya. This implies that the bulk of the previous studies in the area of research were conducted in developed countries. Secondly, most of the previous empirical studies on the factors that affect audit quality reveal mixed results. In this respect, there are conflicting results with respect to the effect of certain factors on the perceptions of auditor independence and competence. The review of literature also indicated that most studies on auditing have primarily focused on generic factors (audit fees, non-audit services, audit tenure' competition in the audit market) that affect auditor independence and competence, rather than validating the reliability of these activities on audited financial statement. In addition to the foregoing reasons, to the best of the writer's knowledge, no similar study has been undertaken in Libya, which focuses on the association between, corporate governance mechanisms, auditor quality and the reliability of audited financial statements.

There is no doubt that this research is valuable to the Libyan accounting and auditing profession. This study addresses a number of pertinent questions that deal with emerging dynamics in the accounting and auditing profession, particularly in view of recent accounting failures such as Enron and Worldcom. The reviews undertaken in this chapter also show that all three broad variables are complementary and each can not flourish in isolation. Meanwhile, findings from the review of existing literature also show that agency theory and stakeholder theory are two major strategic concepts in modern day auditing theoretical discourse and practice. In a nutshell, this chapter

has discussed the major perspectives on the key variables of this study, that is, corporate governance mechanisms (audit committee and external audit attributes), auditor quality and reliability of audited financial statements. As a concluding remark, the researcher has conducted a detailed literature review to capture the extant theoretical gaps that can lead to a better knowledge of the reliability of audited financial statements in the Libyan context. (Refer to *Appendix H* for summary of the key literature review).

## **CHAPTER THREE**

### **RESEARCH FRAMEWORK AND METHODOLOGY**

#### **3.0 Introduction**

This chapter mainly discusses the research methods and techniques of inquiry that are utilised in the study. It starts by introducing the research framework and hypotheses. The overall research design, population and sampling, operational definitions of constructs, and survey type are also explained in this chapter. Information with regard to the data collection processes in the main explanatory study and data analysis strategies are also discussed in detail.

#### **3.1 Research Framework**

Based on the evidence gleaned from existing literature, the current study develops a research framework that shows the relationship between corporate governance mechanisms, auditor quality and reliability of audited financial statements. The relationship between these key factors is illustrated in a framework for this research as depicted in *Figure 3.1*. From existing studies, the researcher develops a linkage that an understanding and knowledge of corporate governance mechanisms and their application in organisations are likely to contribute positively to audit quality and by implication to the quality of audited financial statements. Hence, the conceptual framework in this study looks into the relationships that exist among the main conceptualised constructs including their proxies. Theoretically, these inter-relationships have been conceptualised into this research framework to find out the outcome and suggestion for improving the reliability of audited financial statement in Libya. Below is the conceptual framework of this study:



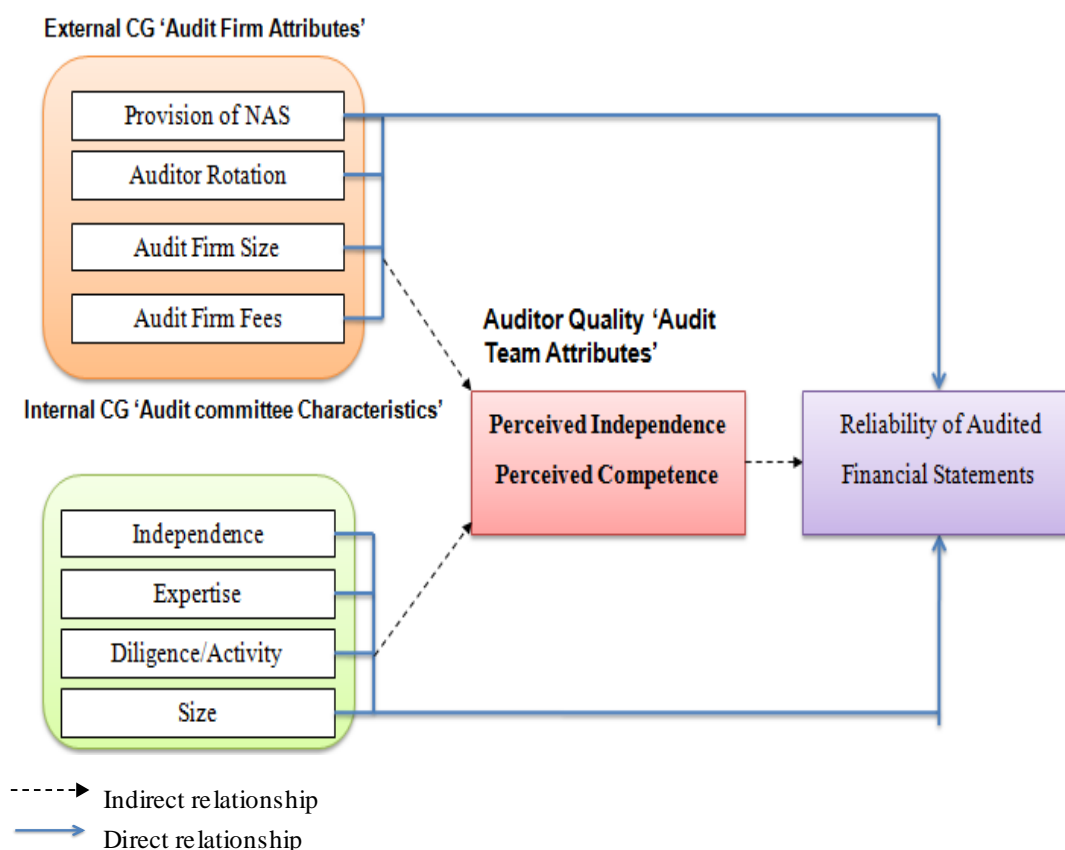


Figure 3.1  
*Research Framework*

Figure 3.1 offers a schema that reveals the relationships between the various dimensions of audit quality. It captures the association between corporate governance mechanisms (audit firm attributes and audit committee characteristics), components of auditor quality (auditor independence & auditor competence) and products of audit quality (reliability of audited financial statements). The foregoing dimensions are indirect and direct measures of audit quality. The corporate governance mechanisms which are derived from accounting literature influence the two components of auditor quality, namely, auditor independence and auditor competence. Meanwhile, auditor quality which is not observable and is predicated on users's beliefs about auditor monitoring strength (see Watkins *et al.*, 2004) influences the quality of information by detecting and reporting on errors and

misstatements. This dimension represents the auditor's ability to provide higher information quality and, thus reflecting the true economic circumstances of the client. As illustrated in Figure 3.1 the effectiveness of an auditor's quality as shaped by auditor independence and auditor competence yields reliable financial statements.

The above model proposed is premised on the agency theory where an agency relationship takes shape when one or more principals engage another person as their agent to do a service at their behest. Notably, such an arrangement may result in the delegation of accountability by the principal which necessitates the placement of trust in an agent to act in the principal's best interest (see ICAEW, 2005). Unavoidably, some concerns also arise about the trust as well as conflict of interests due to the differing motives of agents and the principals. For that reason, agency theory proposes several instruments of monitoring such as external auditors and audit committees to mitigate the agency problem and align the asymmetry information gap between the owners (principals) and managers (agents).

### **3.2 Hypotheses Development**

The variables of interest investigated in this study are discussed in this section. These main variables are (i) corporate governance mechanisms; (2) auditor quality; and (3) reliability of audited financial statements. Hence, hypotheses proposed for this study result from the reviews of extant literature on corporate government mechanisms (audit committee characteristic & external auditor attributes), auditor quality (auditor independence & auditor competence) and reliability of audited financial statements.

### **3.2.1 External Corporate Governance (Audit Firm Attributes)**

At the thrust of the functioning of the capital market is the role of the external audit as both owners (shareholders) and the professional managers would want to rely on the report of the external auditor in furthering their sometimes divergent interest arising from agency relationship that exists (Barbadillo & Aguilar, 2008) High-quality external audit has become an important policy issue.

Many researchers have raised some fundamental issues on the quality of audit and the independence of the external auditor amidst others. In particular, regulators have often expressed their concern that the length of the auditor-client relationship (or auditor tenure) and executives association with auditors could impair auditor independence and thus audit quality (Davis, Soo & Trompeter, 2003). The quality of an audit depends simultaneously on several audit firm features such as auditor specialty, auditor independence, auditor tenure, audit firm size, audit fee, auditor enterprise, and audit company type. (Al-Thuneibat, Al Issa, & Baker, 2010) Auditors express their audit opinions on a financial statement presented to them based on audit evidence. The objective of an audit, therefore, is to plan and perform the audit to obtain appropriate audit evidence that is sufficient to support the opinion expressed in the auditor's report.

Insufficient or inappropriate audit evidence may lead to wrong conclusions and this may affect the quality of the report. Hence, the issue of audit quality has received increased attention due to highly publicised audit failures culminating in corporate scandals, corporate fraud and corporate failure.

Audits have multiple standards, or characteristics, to which they must adhere. Typically, these standards are described in terms of actions the auditor must take while conducting the audit. By following these basic standards, auditors can ensure that the audits they perform are reliable and meet the needs of the client.

### **3.2.1.1 Provision of Non-Audit Services**

Basically, the concept of corporate governance employed in this study focuses on how firms are directed and controlled, as outlined by various studies (Denis, 2001; Cohen *et al.*, 2002; Mallin, 2010; Tricker, 2012). This conception is heavily shaped by agency theory and implies that corporate governance is associated with ownership and control and that it is designed to maximise shareholders interests. Within this view, it is assumed that managers act from a self-interest point and as such corporate governance is concerned primarily with developing contractual mechanisms aimed at controlling self-interested managerial posture (Baker & Owsen, 2002; Mallin, 2010; Tricker, 2012). Not surprisingly, integral to the agency theory perspective is the idea that board members including those of the audit committee should be free from those being monitored by management. Thus, the most valuable characteristics of board members as indicated by the agency theory are independence from the management and competence in executing their duties (Cohen *et al.*, 2002). For these reasons, existing studies on corporate governance have mainly focussed on firms' main boards (including sub-committees such as the audit committee) and external auditors. Certainly, one major concern about promoting good governance is whether there exist any effective governance mechanisms that can alleviate the conflicts of interest subsisting between shareholders and management.

In the extant literature weak corporate governance has been recognised as a key source of corporate failures. As a result, a number of countries in the Western world have produced reports geared at enhancing corporate governance practices. In the US, a number of these reports include the Commission on Public Trust and Private Enterprise of 2003; NYSE Corporate Governance Rules of 2003; and the Emergency Economic Stabilization Act of 2008. Meanwhile, in the the UK, some of these reports are the Higgs Report of 2003; the Smith Report of 2003; the Tyson Report of 2003 and the UK Corporate Governance Code of 2010. Basically, since the 1990s, there has been extensive discussion of corporate governance both in the academic and professional literature, partly due to the rising concerns on corporate governance failures. Some of these concerns include the spread of creative accounting practices, the stunning increases in unexpected corporate collapses; financial scandals; and the prevalence of fraudulent financial reporting. One reaction to corporate governance failures has been to focus on firm's internal control systems such as the audit committee (Riley, 2006). In the aftermath of the infamous corporate scandals in living memory, such as WorldCom, Enron, and Tyco, the stock of audit committees have since increased in the corporate world (see NACD, 2002; Cohen *et al.*, 2002; FRC, 2003; SEC, 2003; Spira, 2013). Unsurprisingly, in the last two decades, regulatory bodies in the US, UK, Canada, Australia and New Zealand have mandated listed firms to set up an audit committee as a tool to enhance the quality of corporate financial reporting and auditing processes and thereby avoiding corporate failures or accounting scandals (Carcello & Neal, 2000; Beecher-Monas, 2003; Smith Report, 2003; UK Combined Code, 2008).

There is no iota of doubt that a key component of an internal corporate governance mechanism is the audit committee which has been described as arguably the “most important of the board sub-committees” (Mallin, 2010, p. 169). For scholars like Sarkar and Sarkar (2010), the audit committee performs a key role in preserving the independence of the audit process. There is a growing belief that independent or non-executive board of directors are generally reputable members of the business community who view the directorate as an avenue of augmenting their reputational capital as specialists in decision making and control (Fama & Jensen 1983). Findings from existing studies show that non-executive directors have incentives to establish a diligent, viable and independent audit committee to reduce their liability concerns (Abbott *et al.*, 2003; Carcello & Neal, 2003; Hussain & Mallin, 2003).

In a related study, DeZoort and Salterio (2001) found that non-executive audit committee directors possess advanced audit knowledge and have a tendency to protect auditors in accounting disputes. In a fundamental way, the audit committee helps to ensure that firms have sufficient internal control systems, appropriate accounting policies, and independent auditors that will reduce the occurrence of corporate fraud as well as promoting high quality and timely audited financial statements. Meanwhile, results from O’Sullivan (2000) and Carcello *et al.* (2002) show a positive association between the proportion of outside independent directors on a board and audit quality. This implies that independent board members demand more in-depth audit efforts from the external auditor, leading to a higher quality audit (Rohaida, 2011).

Notably, audit committee expertise is another factor that has been associated with (ACE. Nonetheless, as indicated in earlier sections of this study, the mere presence of an audit committee as an element of the corporate governance system and having an effective audit committee are basically two different things. It is for this reason that some regulators in Western countries have recently specified that audit committee members must be financially adept and at least one member should be a financial specialist. Undoubtedly, such conditions for audit committees' directors have been proved to be crucial in dealing with the intricacies of corporate financial reporting and for minimising the incidence of financial restatements (DeZoort & Salterio, 2001; Carcello & Neal, 2003). Findings from DeZoort and Salterio (2001) indicate that experienced audit committee members are more likely to comprehend and sympathise with the risks the auditor encounters. In their study, DeZoort and Salterio also established that audit committee expertise was positively related to audit committee member support for an auditor in accounting conflicts. Put another way, informed audit committees are seen as better qualified to appreciate the gist of auditor judgments and recognise the substance of disagreements between the external auditor and management. Similarly, the findings of a study undertaken by McDaniel *et al.* (2002) suggested that the incorporation of financial experts on audit committees was likely to enhance the integrity of assessments of overall financial reporting quality (McDaniel *et al.*, 2002). This is supported by another study undertaken by Chtourou *et al.* (2001) which reveals that when board members are financially literate, they can understand and address matters pertaining to financial statements. In much the same way, Woidtke and Yeh (2013) established that independent audit committees improve earnings informativeness only if there are non-executive members in the sub-committee with the requisite financial skills.

It has been observed that the criteria of expertise and independence will not necessarily lead to effectiveness unless the audit committee is diligent. According to Abbott *et al.* (2004), an active audit committee enhances the committee's role to pursue its objectives such as reducing the likelihood of financial restatements. As suggested by Robinson and Owens-Jackson (2009, p. 122), audit committees that are active display greater zeal and are more likely to be effective and successful. There is no doubt that the effectiveness of audit committees also relies to a large degree, upon their actual undertakings, such as the frequency, duration, and content of their meetings (Abbott & Parker, 2000; Beasley *et al.*, 2000; Beasley & Salterio, 2001; Xie *et al.*, 2003; Ng & Tan, 2003; Abbott *et al.*, 2004). For instance, Abbott and Parker (2000) found that diligent and independent audit committees tend to select industry expert auditors. In another related study, Abbott *et al.* (2004) established that robust audit committee commitment, assessed in terms of a minimum number of meetings, reduces the probability of financial restatements.

A compelling finding from existing studies indicate that companies with a greater number of audit committee meetings are more unlikely to be sanctioned for nefarious activities such as fraud and aggressive accounting (Abbott *et al.*, 2000; Beasley *et al.*, 2000). Other studies show that firms with active audit committees are linked with a lower incidence of earnings management (Xie *et al.*, 2003). To put it succinctly, these studies show that audit committee members who meet regularly tend to be effective monitors in the audit process. Put differently, the more frequently they meet, the more efficiently they discharge their oversight duties and responsibilities. The above findings lend support for the contention that active audit committees will be effective in carrying out their functions or mandate including upholding the



integrity of the financial reporting process (Bedard *et al.*, 2004). From the foregoing findings, flows the argument that the activity of the audit committee in performing its tasks impact on the audit committee's effectiveness.

Although audit committees have been widely promoted as an effective corporate governance tool, there is continued concern about their efficacy and the realisation of their intended benefits (see Zaman, 2001). As illustrated in the above discussion, arguments in favour of the role of audit committees emphasise their probable contribution to, for instance, the relationships between board members, auditors and investors, the discharge of accountability and directors' performance of their duties and responsibilities. However, the overall conclusion from the evaluation of existing evidence on the corporate governance impact of audit committees show that while some beneficial effects have been noted, on many areas of expected benefits the results thus far are either inconclusive or unconvincing. As such, those vouching for the role of audit committees as a generalised solution to certain corporate challenges still need to find appropriate additional evidence.

In line with the agency theory, the audit function is viewed as a tool to reduce uncertainty on the levels of information asymmetry between owners and management. Undoubtedly, the existing studies have established the audit function as a practical mechanism of social control and valid mechanism for monitoring accounting activities. As mentioned earlier, one of the key aims of corporate governance is to resolve agency problems which come up between principals and agents, whereby shareholders have a keen interest in maximising the value of their shares and, whereas managers are more enthusiastic in the private consumption of

firm resources and its growth (Mallin, 2010; Tricker, 2012). Academic accounting research suggests that one such method which could contribute to corporate governance efforts in resolving agency problems or costs is to hire an independent external auditor to certify the accuracy of a firm's financial statements (Fan & Wong, 2005). The external auditor does not have a direct corporate governance responsibility but rather exercises oversight over the financial information aspects of an obtaining governance system in place. In essence, the principal role of the external auditor is to ensure that the financial information given to investors is reliable and credible. In this sense, the auditor's role is to look for financial misstatements caused by either error or fraud. Various stakeholders particularly investors depend on financial statements to make economic decisions. In that sense, external audit provides confidence, reduces uncertainty and risk, and adds value. The external auditor helps to create an environment that encourages or compels managers to be held more accountable, particularly by checking for financial misstatements as well as imposing various penalties on members of management responsible for inflating or manipulating accounting figures and financial statements (Ojo, 2009).

There is no doubt that the financial audit is a key facet of corporate governance that ensures management is accountable to owners for their stewardship of a firm. In this sense, attention is drawn to the important role of audit committees vis-à-vis the external auditor's responsibilities. As mentioned earlier audit committees do not only serve as internal monitoring mechanisms which aid good corporate governance practices, they are also seen as tools that ensure that a proper relationship occurs between the auditor and the client's management. Prior to corporate governance reforms in many countries, the demands encountered by external auditors from top

management in many companies were intense and in some cases comprising the financial audit due to ‘creative accounting’ practices. More importantly, the audit committee and the auditors need to maintain an ongoing dialogue independent of management and the rest of the board. In a way, the external audit serves as a signaling mechanism to owners of a firm that financial information availed by the firm’s management is reliable. Hence, mainstream accounting research indicates that enhancing the independence of auditors and audit committees would boost the credibility of audited financial statements for the benefit of shareholders and other key stakeholders (Cohen *et al.*, 2002). In accounting literature, external auditors have been defined as those individual experts that act as an external governing mechanism to the internal controls of a company by reviewing and evaluating its internal activities and controls primarily to detect any material misstatements (IAIS, 2009; Ojo, 2009). Thus, the main objective of hiring an external auditor is to express his/her expert opinion on a firm’s consolidated financial statements and available management controls of financial activities to the board of shareholders (IAIS, 2009).

One of the most contentious issues pertaining to the role of external auditor is the provision of NAS. Since the demise of Enron, this whole area of the provision of NAS and auditor independence has become a hot topic in accounting scholarly circles (Klein, 2003). The extant literature on auditing have established that auditors’ provision of NAS to its audit clients has consistently been attacked by both researchers and regulatory bodies across many countries as posing a serious threat to the independence of the auditors (Firth, 2002; Sarbanes-Oxley Act, 2002; GAO, 2003; Chen *et al.*, 2009; Lee *et al.*, 2009; Beaulieu & Reinstein, 2010; Al-Ajmi &

Saudagaran, 2011; Ebinobowei, 2011). Both the industry reports and academic literatures have established that the provision of some types of NAS by the auditing firms to its clients will potentially threaten the independence of the auditors. Consequently, most regulatory bodies have put in place measures that ban the provision of certain non-auditing services. As evident in the extant literature on auditing, issues of NAS is becoming a major concern within the financial sectors given the continuous increase in the amount of NAS fees in the last two decades (Levitt, 2000; SEC, 2000a, 2000b; Frankel *et al.*, 2002; Gwilliam, 2003; Abbot *et al.*, 2003; Brandon *et al.*, 2004). One of the main studies that showed a positive relationship between non-audit services' fees and discretionary accruals, and a propensity for reporting a small earnings surprise, was conducted by Frankel *et al.* (2002). Such findings support the argument for the separation of audit and NAS in order to enhance auditor independence.

Nonetheless, inconsistencies are still found in the empirical evidence, as suggested in other studies (Arrunada, 2000; 2010; Raghunadan, 2003; Whisenant *et al.*, 2003; Francis, 2006; Mitra, 2007). Contrary to conventional wisdom, some existing studies indicate that the joint provisions of audit and NAS will boost the auditor's knowledge about the client's company and thus increase auditors' independence and objectivity (Arrunada, 2000; 2010). These proponents of NAS list a number of benefits that could accrue to auditors and their clients from providing such services. Some of these studies state that the supply of NAS has little effect on auditor independence (Ryan, Herz, Iannaconi, Maines, Palepu, Schrand & Vincent, 2001) and a few indicate that NAS provide possible advantages (Arrunada, 2000; 2010; Lai & Krishnan, 2009). According to Arrunada (2000; 2010) the provision of NAS can

reduce total costs, increase the technical competence of the auditor and generates more intense competition in the audit market. For Arrunada the auditor's role in identifying the existence of the client's assets and their reliability is depended on the auditor's knowledge which can be significantly increased by the provision of non-audit services to the same client. Arrunada further argues that the supply of NAS does not necessarily undermine auditor independence or the quality of NAS.

On the contrary, a number of existing empirical studies have been unable to establish any significant association between the supply of NAS and auditor independence (DeFond *et al.*, 2002; Ashbaugh *et al.*, 2003; Chung & Kallapur, 2003). On that note, these studies provide evidence that the joint provision of audit and NAS undermine auditor independence. Hence, despite the heralded positive impact of NAS, their dual provision is largely a controversial issue. In actual fact the dual provision of NAS and auditing is still viewed by some with a lot of scepticism due to the potential that they may impair auditor independence by causing economic dependence on clients (SEC, 2001; Sharma & Sidhu, 2001; Beattie & Fearnley, 2002; Raghunandan, 2003; Larcker & Richardson, 2004). It is clear from the foregoing discussion that studies that attempted to examine the effect of NAS purchases on auditor independence have produced mixed results. On close inspection, in spite of the eventuality of a real impairment to independence in fact, harm to auditor independence in appearance or perception has been well acknowledged (Shockley, 1982; Wines, 1994; Gul *et al.*, 2006). In essence, a significant number of studies have established that the costs outweigh the positive effect of the dual provision of NAS and auditing, thus reflecting a declining in audit quality.

Quick and Rasmussen (2009) established that the type of NAS influences the degree to which auditor independence is perceived to be impaired. It was also found that perceived auditor independence does increase if NAS are provided by a separate department of the audit firm.

Lee *et al.*, (2009) With regard to the provision of NAS, it is established that there is a significant negative association between NAS and ARLS, which indicates that the provision of NAS increases auditor learning, thus reducing audit delays. The findings of the study suggest that both auditor tenure and non-audit services are significantly associated with audit report lags. So, the following hypotheses are derived:

H1a: Provision of non-audit service is negatively related to auditor independence.

H1b: Provision of non-audit service is positively related to auditor competence.

H1c: Provision of non-audit service is negatively related to reliability of audited financial statements.

### **3.2.1.2 Auditor Rotation**

Another burning issue in accounting literature is the relationship between audit independence and auditor rotation. Basically, the debate is two-pronged. On one hand, proponents for compulsory auditor rotation highlight the importance of having a fresh pair of hands at periodic intervals to guarantee auditor independence and quality financial reporting (Abu Bakar *et al.*, 2005; Abdul Nasser, Wahid, Nazris & Hudaib, 2006; Knechel & Vanstraelen, 2007). In essence, these supporters of auditor rotation acknowledge auditor tenure as influential in audit outcomes (Dopuch *et al.*,

2003; Geiger & Raghunandan, 2002; Gates *et al.*, 2007; Vanstraelen, 2000; Jackson *et al.*, 2008; Turner *et al.*, 2010). On the other hand, those opposed to audit firm rotation have little faith in its ability to promote auditor independence (Geiger & Raghunandan, 2002; Gates *et al.*, 2007; Jackson *et al.*, 2008; Davis *et al.*, 2009; Turner *et al.*, 2010). They emphasise the risk of lower audit quality and higher audit failures that can arise due to loss in continuity and audit competence which are typically associated with compulsory audit firm rotation. Generally, the extant literature reviews have shown that the practice of rotating the audit firms and/or its partners has generated mixed results.

Meanwhile, several studies have concluded that long associations between audit firms and their clients may lead to some form of collusion which may compromise independent decision making in the external auditing process (Abu Bakar *et al.*, 2005; Abdul Nasser *et al.*, 2006; Gates *et al.*, 2007). For instance, they argue that a lengthy tenure in office may cause the auditor to develop too close relationships (including emotional relationships) with their clients, which could undermine auditor independence. Similarly, it has been noted that in extreme cases, a long relationship between auditors and their clients could result in collusion between the two parties which would adversely affect the audit process. As is evident, the role of audit firm rotation as a device of safeguarding auditor independence has attracted serious debate in accounting research. Given the similarly convincing arguments of both sides in the debate, it is not surprising that regulators in some countries have attempted to strike a balance between the two competing perspectives. But on close inspection, there is no consensus within the extant literature on the practice of compulsory audit firm rotation.

Anis (2014) reveal that auditors' perceived mandatory rotation of auditors have a positive effect on audit quality, a negative effect on client-specific knowledge (competence), & a positive impact on auditors' independence.

Mohamed and Habib (2013) suggest the problem of auditor independence is mainly caused by the fact that most companies are closely held where the stockholders are the managers of the company. So, the following hypotheses are derived:

H2a: Auditor rotation is positively related to auditor independence.

H2b: Auditor rotation is negatively related to auditor competence.

H2c: Auditor rotation is positively related to reliability of audited financial statements.

### **3.2.1.3 Audit Firm Size**

Generally speaking, accounting literature indicate that the large size of the audit firm is regarded as having a positive effect on perceived auditor independence as opposed to the small size firm (see Abu Bakar *et al.*, 2005; Lennox, 2005; Francis & Yu, 2009). Several scholars identify large firm size in terms of the supply of multi-services to many clients (DeAngelo, 1981), in terms of the proportion of fees charged for both audit and NAS (Shockley, 1982), in terms of the audit firm's market share revenue (Porter *et al.*, 2008), and on the basis of internationality (Krishnan, 2003) by using variations between the Big Eight, Six, Big Four, and non-Big Four. A number of factors that explain the importance of the large size of an audit firm have been highlighted. In this regard, Francis and Yu (2009) contend that the size of audit firms



is an important attribute upon which the influence of auditor independence perception can be determined (Francis & Yu, 2009). Similarly, it has been noted that large audit firms would not be as economically dependent as small firms on any one client due to the associated fees that usually constitute a smaller fraction of the audit firm's total income. A similar view is shared by Gul (1989; 1991) whose study findings showed that bank loan officers perceived small audit firms as being less able to resist management pressures than large firms. Furthermore, Gul (1991) discovered that smaller audit firms were less unlikely to lose their independence due to their tendency towards a personalised mode of service and close relationships with their clients. Similarly, Abu Bakar *et al.* (2005) found that participants in Malaysia perceived that the bigger the size of an audit firm, the more likely that auditor independence would be enhanced. Basing on existing studies, it might be most accurate to say that satisfactory levels of audit quality are usually associated with large audit firms vis-a-vis small ones. Perhaps, the main reason for such a scenario is that the larger the firm, the greater the number of clients, and the greater the likelihood that the range of services provided is bigger. In this respect, the audit firm minimises its dependency on particular clients.

Hua, Georgakopoulos, Sotiropoulos & Galanou (2010) reveal, due to government protection, competition in the Chinese audit market is limited and the possibility that Libyan audit firms lower their fees to retain clients is much diminished. Hence, competition and audit firm size appear to be positive aspects for audit independence. Nonetheless, other national cultural and political-regulatory factors seem to have a moderating effect in the Libyan context. Firm size is also found positive with the reliability of audited financial statements. So, the following hypotheses are derived:

H3a: Size of audit firm is positively related to auditor independence.

H3b: Size of audit firm is positively related to auditor competence.

H3c: Size of audit firm size is positively related to reliability of audited financial statements.

#### **3.2.1.4 Audit Firm Fees**

A critical factor that has been examined in many studies focusing on influences of audit quality is the fees for audit services (Abbott *et al.*, 2003; Jensen & Payne, 2005). In particular, concerns have been raised on the link between audit fees and audit hours (Palmrose, 1986; Deis & Giroux, 1992; 1996). Part of the explanation for such concerns is the fact that economic dependence is a recognisable danger to auditor independence (Barbadillo *et al.*, 2006; Hoitash *et al.*, 2007). Observably, the fact that the external auditors are receiving audit fees from their clients practically suggests the potential for the impairment of auditor independence and reliability of financial information based on fees. The root to this line of research could be traced to Watts and Zimmerman (1986) and DeAngelo (1981), where they both suggests that the economic dependence on client fees is an incentive to compromise auditor's independence and thereby providing unreliable financial information. They both conclude that the economic bond between the two variables could lead to a major concern for auditors with respect to possible loss of revenue from audit fees, hence the likelihood of falling to clients' wishes. Although most of the existing studies show that auditor independence is undermined by the economic reliance of auditors on their audit clients, other studies have reached different conclusions (Craswell *et al.*, 2002; DeFond *et al.*, 2002; Huang *et al.*, 2007; Willekens & Bruynseels, 2009;

Hope & Langli, 2010). In essence, prior studies produce mixed results on the link between audit fees and modified audit opinions. For instance, Craswell *et al.* (2002) demonstrated that the auditor's penchant to issue unqualified audit opinion was not affected by the level of auditor fees dependence in a sample of Australian firms. Similarly, DeFond *et al.* (2002) found no association between fees and compromised auditor independence. Notably, DeFond and others attribute their findings to auditors' concerns over litigation costs and loss of reputation capital. In their view, these costs outweigh the expected benefits from compromising auditor independence.

Notwithstanding the above arguments, it is observed that the extant relationships between audit fees and the likelihood of auditors sacrificing their independence are too theoretically ambiguous. A major reason for the above is that external auditors and their firms are not only considering the benefits that are inherent in higher fees when issues of compromising their professional objectivity arises, but they also consider the expected costs implications that is attached to audit failures. Importantly, many researchers have argued that the costs implications that is related to the inherent loss of firms' reputations and litigation has reduced the incentives for any external auditors to compromise their objectivity and independence (Chung & Kallapur, 2003). It thus confirms the fact that auditor's acquiesces to its client's pressures will potentially damage its firm's reputation, and will as a result loses audit fees from its current and future audit clients. Although the extant auditing literature has theoretically focused on issues of reputation effects and other expected lawsuits as key factors that will make auditors refrain from compromising their professional ethics and independence. As mentioned above, the recognition that auditors' economic reliance on clients is a formidable threat to the independence of external

auditors has also been globally accepted by many auditing professional bodies. Although some studies conclude that auditor independence is not perceived as being affected by the economic reliance of auditors on their audit clients (Craswell *et al.*, 2002; DeFond *et al.*, 2002; Geiger & Rama, 2003), the vast majority of empirical studies suggest the opposite (Gul & Tsui, 1992; Bartlett, 1993; Teoh & Lim, 1996; Geiger & Rama, 2003; Hudaib, 2003; Abu Bakar *et al.*, 2005; Alleyne *et al.*, 2006).

Hoitash *et al.* (2007) establishes a statistically significant negative association between total fees and both audit quality proxies (the standard deviation of residuals from regressions relating current accruals to cash flows (FLOSAQ) and the absolute value of performance-adjusted discretionary accruals (ABSREDCA) across all years (2000-2003).

Huang, Mishra & Raghunandan (2007) establishes no association between high non-audit fee ratios and meeting or just beating earnings benchmarks. High audit firm fee has a positive relation with the auditor competence. So, the following hypotheses are derived:

H4a: Size of audit firm fees is negatively related to auditor independence.

H4b: Size of audit firm fees is positively related to auditor competence.

H4c: Size of audit firm fees is negatively related to reliability of audited financial statements.

### **3.2.2 Internal Corporate Governance**

Internal corporate governance is also important to ensure the proper take care of the interest of the stakeholders and to maximise the wealth of the stockholders at large scale to benefit them maximum.

#### **3.2.2.1 Audit Committee Characteristics**

A number of studies show that one of the main benefits of having an audit committee is that they could improve auditor independence (DeZoort *et al.*, 2002; Alleyne *et al.*, 2006; Turley & Zaman, 2007). As is evident in the foregoing, independent audit committees' members enhance the quality of monitoring because they are not directly linked to the firms. In a way, non-executive directors of audit committees act as the shareholders' watchdog. Thus, a major benefit of having audit committees is their ability to positively impact the independence of the auditors. Furthermore, the major role played by audit committees in appointing auditors, determining their compensation and their dismissal or retention, reduce management's power and influence over the auditor thereby enhancing auditor independence (Rezaee 2009; Braiotta, 2010). As noted by Rezaee (2009), some inherent benefits of the audit committee include reducing the client's management power over the control of external auditors, specifically through proper audit firm selection, direct negotiation of audit fees, and finally contributing to issues of auditor's replacement.

Furthermore, several studies demonstrate that the penchant to switch from less credible to more credible external auditors or industry specialist auditor happens more frequently in firms with audit committees than in those without these bodies

(Abbott & Parker, 2000; Raghunandan *et al.*, 2001; Mangena & Taurigana, 2008). Other studies have indicated that audit committees appear more likely to choose Big Eight (currently Big Four in Libya) auditors than non-Big Eight (currently Non-Big Four) auditors because the Big Four auditors are more likely to report any material misstatements discovered during their auditing work. As noted by Zaman (2002), an audit committee is an exceptional mechanism in that it provides a forum where board members, management and auditors can engage each other on issues relating to financial reporting processes. In much the same way, Arens *et al.* (2013) argues that the audit committee is a good medium of opening a direct link of communication between a company's board and the external auditors. This is also corroborated by Line, Xiao and Tang (2008) who argued that the position of the external auditor would be professionally strengthened by the provision of a forum and communication channel through which the board of directors can discuss issues of concerns with the external auditors.

Hoitash & Hoitash (2009) suggest that increased audit committee roles and independence after SOX contribute to auditor independence and audit quality. It was established that stronger audit committees demand a higher level of assurance and are less likely to dismiss their auditors. So it has a positive relation with auditor competence, independence and the reliability of audited financial statements. So, following hypotheses are made:

H5a: Audit committee characteristics (independence, expertise, diligence / Activity, size) are positively related to auditor independence.

H5b: Audit committee characteristics (independence, expertise, diligence / Activity, size) are positively related to auditor competence.

H5c: Audit committee characteristics (independence, expertise, diligence / Activity, size) are positively related to reliability of audited financial statements.

### **3.2.3 Auditor Quality (Perceived Independence and Competence) and Mediating Effects**

A number of studies have also examined the association between audit committee independence and financial reporting outcomes as well as with the external auditor. Prior studies involving the role of board members including members of the audit committee have focused on several areas including the effect of these bodies on financial statement fraud and earnings management (Beasley *et al.*, 2000; Klein, 2002; Sharma, 2004). Taken together, the above studies reveal that less independent boards of directors particularly in audit committees are likely to be related with incidences of financial statement fraud, which are severe versions of poor quality financial reporting. To put it differently, existing studies indicate that higher percentages of independent directors on boards tend to be negatively related to financial statement fraud. Some researches have examined the link between attributes of the board members and earnings management, which is a less severe version of poor quality financial reporting (Klein, 2002; Bedard *et al.*, 2004; Van der Zahn & Tower, 2004; Peasnell *et al.*, 2005; Yang & Krishnan, 2005; Rahman & Ali, 2006). Notably, these studies demonstrate that the companies with larger proportions of independent board members encounter a lower incidence of earnings management. Several other studies also revealed a link between the proportion of independent members on the audit committee and some indicators of reporting quality such as the size of abnormal accruals (Klein, 2002). These findings also show that the audit committee acts as a catalytic agent in boosting quality financial reporting and

defending external auditors. As such, the setting up of an audit committee enhances the reliability and credibility of audited financial statements' by guaranteeing the objectivity of such financial information (Finance Committee on Corporate Governance [FCCG], 1999).

Existing studies literatures have established the inherent benefits in auditor's report through the provision of reliable opinion on the fairness of the financial statements information and the conformity of the auditee with the going concern concepts (Robinson & Owens-Jackson, 2009; Sori, Ramadili & Karbhari, 2009). This is because information in the audit report is very crucial for decision making processes on investment and financing decisions. As a general rule, the degree of audit quality is hugely affected by the audit committee (Mansouri *et al.*, 2009). More specifically, effective audit committees are anticipated to improve financial reporting quality by assuming responsibilities especially reviewing the financial statements prepared by the client's management. Additionally, audit committees are also estimated to play a key role in ensuring the effectiveness of external auditors in the audit engagement process by, fulfilling a number of responsibilities including the selection and remuneration of external auditors, as well as reviewing the auditors work (Dhaliwal *et al.*, 2010). It is evident that prior and current research indicate that both the existence of the audit committee and the attributes of audit committee members affect the usefulness and reliability of financial reporting (Abbot & Parker, 2000; Carcello & Neal, 2003; Agrawal & Chadha, 2005).

Sori *et al.* (2009) mention the majority of respondents believe that auditor independence is preserved and safeguarded by the presence of an actively



functioning audit committee. The results also suggest that the audit committee could significantly safeguard auditor independence if members are truly independent, knowledgeable and are committed to enhance good governance without fear or favour.

The study revealed that the provision of NASs could have a negative influence on auditors' perceptions of independence. Auditors' perceptions that the influence of NASs on independence depends on an individual auditor's rank are supported. In this regard, it was established that senior managers have the highest mean rating on perceptions, while partners have the lowest mean rating Law (2008). Nieschwietz and Woolley (2009) indicate that the SOX may enhance confidence in the audit process by increasing perceptions of independence. So, the following hypotheses are made:

H6a: Auditor independence is positively related to reliability of audited financial statements.

H6b: Auditor independence positively mediated the relationship between provision of NAS and reliability of audited financial statements.

H6c: Auditor independence positively mediated the relationship between auditor rotation and reliability of audited financial statements.

H6d: Auditor independence positively mediated the relationship between size of audit firm and reliability of audited financial statements.

H6e: Auditor independence negatively mediated the relationship between audit firm fees and reliability of audited financial statements.

H6f: Auditor independence positively mediated the relationship between audit

committee characteristics (independence, expertise, diligence/ Activity, size) and reliability of audited financial statements.

Nieschwietz and Woolley (2009) mention that auditor's perceptions of the efficacy of SOX provisions differ from the perceptions of sophisticated users of financial statements (loan officers) and the general public. Additional evidence supporting the continuance of an expectations gap between certified public accountants (CPAs) and users of financial statements (general public) is also existent.

H7a: Auditor's competence is positively related to reliability of audited financial statements.

H7b: Auditor competence negatively mediated the relationship between NAS and reliability of audited financial statements.

H7c: Auditor competence positively mediated the relationship between auditor rotation and reliability of audited financial statements.

H7d: Auditor competence positively mediated the relationship between size of audit firm and reliability of audited financial statements.

H7e: Auditor competence negatively mediated the relationship between audit firm fees and reliability of audited financial statements.

H7f: Auditor competence positively mediated the relationship between of audit committee characteristics (independence, expertise, diligence / Activity, size) and reliability of audited financial statements.

Agency theory, as developed by Jensen and Meckling (1976), indicates that the bonding role of an audit can reduce agency costs arising from the self-interested behaviour of agents. The existence of differential agency costs across clients and over time therefore results in a heterogeneous demand for audit services, characterised by DeAngelo (1981) as different levels of audit quality.

Conceptually, DeAngelo (1981) defined audit quality as the market-assessed joint probability that the auditor discovers an anomaly in the financial statements, and reveals it. Agency theory recognizes auditing as one of the main monitoring mechanisms to regulate conflicts of interest and cut agency costs. Therefore, assuming a contracting equilibrium in the monitoring policy, a change in the intensity of agency conflicts should similarly involve a change in the acceptable quality of auditing.

Fama and Jensen (1983) have theorised that the corporate governance is the best control mechanism to monitor actions of management. The study explored that the efficient corporate governance based on the agency theory. Studies of O'Sullivan (2000) and Salleh, Stewart, & Manson (2006) found that the efficient corporate governance mechanism had a significant positive impact on audit quality. They suggested that corporate governance mechanism encouraged more intensive audits as a complement to their own monitoring role while the reduction in agency costs expected through significant managerial ownership resulted in a reduced need for intensive auditing.

Stakeholder theory looks at the relationships between an organisation and others in its internal and external environment. It also looks at how these relationships affect how the organisation conducts its activities. The stakeholder is a person or organisation that can affect or be affected by the organisation. Stakeholders can come from inside or outside of the organisation. Examples of stakeholders of a business include customers, employees, stockholders, suppliers, non-profit community organisations, government, and the local community among many others.

One of the most important contributors to stakeholder theory, Freeman (2010) mention that in his book the core idea of stakeholder theory is that organisations that manage their stakeholder relationships effectively will survive longer and perform better than those organisations that don't. Freeman suggests that organisations should develop certain stakeholder competencies. These include the following:

1. Making a commitment to monitoring stakeholder interests.
2. Developing strategies to effectively deal with stakeholders and their interests.
3. Dividing and categorising interests into manageable segments.

So, stakeholder theory actually identifies the core responsibility of a firm to take care of and to enhance the value of stockholders' wealth and to take care of the rights of stakeholders including stockholders. Audit is considered the most powerfull tool to protect the stakeholders' rights as audit depicts the true picture of the organisation. Especially in the reference of financial terms as all the stakeholders are even more conscious about the financial position and financial performance of the organisation. A fair audit can be done only in the presence of efficient corporate governance.

### **3.3 Methodology**

This section discusses the overall research approach including the research design, sampling and data collection, research instrument, operational definition and measurement of variables and data analysis methods.

#### **3.3.1 Research Design**

Basically, the main objective or purpose of this study is hypothesis testing. As stated by Sekeran and Bougie (2009), research that employ hypothesis testing “usually explain the nature of certain relationships, or establish the differences among groups, or the independence of two or more factors in a situation” (p. 108). In other words, hypothesis testing is conducted to explain the variance in the dependent variable or predict certain outcomes in organisations. In some cases, it may establish cause and effect associations or relationships. Hence, this form of investigation enhances the understanding of the link or relationship that exists among variables. More importantly, hypothesis testing can be done with both qualitative and quantitative data. Notably, the basic research design for this study is a survey design. In general, the survey method is popular because it allows the gathering of a large amount of data from sizeable population in a highly efficient and economic manner via the questionnaire instrument.

As indicated by Creswell (2012, p. 627), research design is a way for collecting, analysing, and reporting research in quantitative and qualitative research. This type of research design comprise techniques in quantitative research in which researchers administer a survey instrument (questionnaire) to a sample or to the entire population

to describe the opinions, attitudes, behaviours or features of the population. As indicated earlier, this study uses a survey design. In essence, there are two types of research surveys, namely, longitudinal and cross-sectional. Due to the potential difficulty inherent in gaining access to the targeted audit firms, this research utilises the cross-sectional survey design which is a type of design in which the researcher collects data at one point in time (see Hair *et al.*, 2006). The main advantage of this design is measuring or capturing current practices or attitudes. Furthermore, this research design supplies information in a short amount of time.

Unsurprisingly, surveys are the most common and popular method of generating primary data. Generally, survey research describes trends in the data rather than offering rigorous or laborious explanations. In this procedure, researcher collects quantitative data using survey instruments and statistically analyse the data to describe trends about responses to questions and to test research hypotheses. Since survey studies describe data rather than offer arduous explanations, they share much in common with correlational designs which are also in use in this study. Although survey researchers often correlate variables, their focus, however, is geared toward learning about a population and less on relating variables or predicting outcomes, as is the focus in correlational research (Creswell, 2012, p. 376). As mentioned earlier, the time dimension is as very important factor in this study as it helps to determine the impact of auditor independence on reliability of audited financial statement at a specific point in time. Importantly, respondents will be asked to supply information on their 2012 audited financial statements, in relationship to its auditor's independence, auditor's competence, non-auditor services, audit committee, audit market concentration, audit fees and so forth. It should be noted that survey scholars

engage in a number of processes including “sampling from a population, collecting data through questionnaires or interviews, designing instruments for data collection and obtaining a high response rate” (2012, pp. 380-1).

### **3.3.2 Population and Sampling**

A research population comprises of a collection of data and information whose properties are to be analysed in a given research (Hair, Black, Babin & Anderson, 2014; Cavana, Delahaya & Sekaran, 2001). Population could be defined as the complete collection of the subject of interest to be studied in a research (Cavana *et al.*, 2001). A sample could be defined as part of the target population of interest to be studied; it can be statistically referred to as a sub-collection that is selected from a population of interest. Meanwhile, population sampling can be defined as the process through which any group of representative elements or individuals are selected from a given population for the primary purpose of statistical analysis (Hair *et al.*, 2014). The target population for this study were members of the LAAA, academics (some were members of the LAAA) and loan officers (again some were members of the LAAA) across the breadth of Libya. The total number of the population is around 1000, and approximately 200 constitute the source of information, which amounts to 20 percent.

Crucially, Maines and Wahlen (2006) stated that the reliability of accounting information is assessed by auditors, users, and regulators. Importantly, the population for this current study include the officially registered members of LAAA as detailed in the directory of LAAA. Therefore, the main use of inferential statistics in this

study is to use the obtained information from the selected sample out of the registered members of LAAA to infer the impact of auditor independence, auditors competence, and its determinants on the reliability of audited financial statements in the Libyan financial industry. Furthermore, academics selected to participate in the study are members of the LAAA. An added advantage of including academics is the visible fact that they are not directly affected by audited financial statements, even though they have great interest in auditing and accounting issues. After all, their professional views regarding reliability of financial statements are not influenced by commercial interests (Al-Eissa, 2009). In other words, academics are more objective participants.

Secondly, the sample group includes loan officers from each of the fifteen locally-owned commercial banks operating in Libya. However, loan officers from the sole operating foreign-owned commercial bank were excluded from this study. Notably, these local banks used to select the sample of the bank loan officers of this study operate under the supervision of the Central Bank of Libya. Since there are 481 branches of the foregoing 15 commercial banks, the author distributed questionnaires to at least all the branches selected from every branch. These fifteen banks are captured from (CBL, 2012) (Refer to Appendix G).

Generally, respondents to the questionnaire were members of the LAAA (auditors, accountants and academics), with the exception of sophisticated consumers of audited financial statements (loan officers). It should be noted that although some loan officers were members of the LAAA, some were not. The respondents were



randomly selected from available mailing lists, with surveys being sent to each group during the spring of 2012. As noted by Creswell (2012), the aim of simple random sampling is to “choose individuals to be sampled who will be representative of the population”. Thus, any bias in the population will be equally distributed among the people selected.

### **3.3.3 Sampling Design**

For ease of generalisability, this study uses simple random sampling design. As mentioned earlier, simple random sampling design is a sampling method that involves giving every members of the population equal chance of being selected from a target population using a specified techniques such as excel software as the basis of sample selection (Cavana *et al.*, 2001; Van *et al.*, 2002; Hau & Marsh, 2004). As explained by Cavana *et al.* (2001), the best common way of selecting the members for a target sample population using the simple random sampling technique is by simply giving the total number of units in the total population equal chance of being selected. The outcome of this selection will serve as the standard marker for selecting the sample units from within the total population. For this current study, given the anticipated random group of between 350 and 450 from a target population of above 500 registered members of LAAA in Libya using the simple random sampling design as suggested by Roscoe (1975). Basing on Roscoe’s rules of thumb that a sample size that is larger than 30 but smaller than 500 is adequate for statistical analysis, this current study distributed 500 questionnaires and managed to get 213 respondents (42.6 percent). The response rate is above the threshold (usable rate) of 37.6 percent. It should also be pointed out that this study used Excel analysis

software in selecting the targeted sample size at random from the list of registered members of the LAAA in Libya.

#### **3.3.4 Unit of Analysis**

The unit of analysis denotes the unit (for example individual, family, or school) the researcher utilises to gather data. In other words, the unit of analysis is the group and individuals that a researcher will study. The unit of analysis for this study included registered members of the LAAA in Libya, as each of them have been established to have experience in the implementation and outcomes of audit applications in Libya (Ritchie & Khorwatt, 2007). These LAAA members are deemed the most suitable respondent for this research because they are the primary users of audit tools and processes, and also serve as the major decision makers in firms and the auditing firms (Shareia, 2010). Other units of analysis for this study are bank loan officers who are sophisticated users of audited financial statements, and hence understand the significance of the independent audit function (Abu Bakar *et al.*, 2005). Notably, loan officers also utilise accounting information in business decision situations (Abu Bakar *et al.*, 2005; Almalhuf, 2009).

#### **3.4. Data Collection**

This study utilises both primary and secondary data. Notably, in this study, primary data was generated via the survey method. Meanwhile, secondary data was sourced from reports, statistical bulletins, journal articles and other secondary sources of data.

### 3.5 Questionnaire Construct

The foundation of the questionnaire was premised on the opinions and views of the respondents comprising registered members of the LAAA as well as bank loan officers in Libya. Notably, the questionnaire was designed after an extensive literature review. Summary of the contents and their sequence is captured in Table 3.1 below:

Table 3.1  
*Research Instrument Construct*

Section	Title	Items
Part A	Demographic data	5 Questions
Part B (Dependent Variable) (I)	Reliability of Audited Financial Statement	7 Questions
Part C (External & Internal CG) (II)	Audit Firm Attributes	31 Questions
(III)	Audit Committee Characteristics	8 Questions
Part D (Auditor Quality) (IV)	Perceived Auditor Independence.	8 Questions
(V)	Perceived Auditor Competence.	9 Questions

#### Part A: Demographic Profile

##### *Section A: Background Information*

Part A is designed to obtain general information about the respondents. Using a likert seven point scale, the five questions in this section solicit data on the respondents' expertise and work experience.

#### Part B: Dependent Variable (Reliability of Audited Financial Statement)

##### *Section B: Reliability of Audited Financial Statement*

The extant literature have established reliability of audited financial statements as a key value upon which the confidence of investors of publicly traded companies are

based (Elliott *et al.*, 2007; Al-Ajmi & Saudagaran, 2011). As indicated in earlier sections, the main aim of financial reporting is to provide useful information. Although there is no single acceptable definition of financial statement reliability it is however believed to denote the degree to which a financial statement represents and measures those underlying constructs that it purports to represent without bias (Maines & Wahlen, 2006). Meanwhile, Ismail *et al.* (2006) defines reliability as the ability of audit team members to perform the promised service timely and accurately. In their study, Geiger *et al.* (2002) indicated that reliability can be determined by asking financial consumers their confidence level of how free the audited financial statement is from misstatement and omissions or errors. Not surprisingly, reliability has been regarded as one of the two primary qualities of accounting information (Johnson, 2005; FASB, 2008). It is no wonder then that reliability is a key instrument used by the FASB and the IASB to set standards for financial reporting. To reiterate Faraj and Akbar's (2008) observation the "reliability of accounting information, contained in the audited financial statements, forms a crucial part on which users and decision makers form their expectations and make their decisions" (2008, p. 2).

Notably, it has been empirically demonstrated that the reliability of any firm's audited financial statements is dependent on auditor's independence (Maines & Wahlen, 2006; Faraj & Akbar, 2008). Faraj and Akbar, for instance, observe that the lack of auditor independence may result in collusion between agents and auditors who may mislead principals and supply false accounting information to other key stakeholders. Ultimately, the quality of accounting information is dependent on the effectiveness of information and this effectiveness in turn is dependent on the reliability of the information (Vaassen *et al.*, 2009). In the final analysis, reliability of

any audited financial statements serves as good means through which users of financial statements make appropriate financial decisions. However, these series of financial decisions, whether it is for investment or lending purposes, can only be good when it is established as been reliable (Geiger *et al.*, 2002). For this reason, most researchers have argued that available accounting information that is contained in audited financial statements should be reliable and satisfy the expectations of its users. Table 3.2 illustrates the sources of the measurement items for the dependent variable (reliability of audited financial statements), that are used in the questionnaire. This new scale provides seven (7) items measurement instrument used in the structural equation model.

Table 3.2  
*Measures of Reliability of Audited Financial Statements Construct*

Items	
1	Perceived audited financial statements as an indication that the company as free from fraud.
2	The extent of audit work performed is clearly communicated.
3	The financial statements give a true and fair view.
4	The auditor does not agree with the accounting policies used in the financial statements.
5	The current standards of audit practice give a clear guidance to auditors.
6	The extent of assurance given by the auditor is clearly indicated.
7	Users can have absolute assurance that the financial statements contain no material misstatements.

A total of 7 items were derived from previous literature to operationalise this variable (e.g. Geiger *et al.*, 2002; Desira & Baldacchino, 2005).

### **Part C: Independent Variable (Audit Firm Attributes and Audit Committee Characteristics)**

Tables 3.3, 3.4, 3.5, 3.6, and 3.7 show the five independent variables that were used in this study: Provision of Non-Audit Services (NAS), Auditor Rotation (AR), Audit

Firm Size (AFS) and Audit Firm Fees (AFF), Audit Committee Characteristics (ACC).

### **Section C: Measures of Provision of Non-Audit Services (NAS)**

A strong argument against the supply of NAS by auditors is the resultant economic dependence on clients that several researchers and professional bodies have highlighted as a key factor contributing to the erosion of auditors' independence (Beeler & Hunton, 2002; Chen *et al.*, 2009; Salehi, 2009; Beaulieu & Reinstein, 2010). However, efforts at restoring the public confidence in the activities of auditors and reliability of audited financial statements have led regulatory bodies into designing policies like mandatory rotation of audit partners and prohibition and disclosures of certain type of NAS (SEC 2000; *Sarbanes Oxley Act*, 2002). Although there are limited and mixed opinions in the available empirical studies on the perceived threats that NAS poses to auditor independence, still these legislative measures were put in place (Ebimobowei, 2011; Lee *et al.*, 2009). This further demonstrates that there are still unresolved debates within the extant research, and thus this research wishes to address the impact of economic bonding or ties between auditors and the client's management on auditor's independence.

However, several studies do not find any link between the provision of NAS and auditors biased financial reporting (Chung & Kallapur, 2003; Kinney *et al.*, 2004; Ghosh *et al.*, 2006; Huang *et al.*, 2007). In other words, these studies indicate that NAS provision has no impact or effect on auditor practices and independence. For instance, Huang *et al.*, (2007) suggest that there is negligible evidence that biased

financial reporting by clients is lower in clients with higher value of tax fee ratio or other non-audit fee ratio. The results also indicate that there is no relationship between different types of NAS fees and biased financial reporting. On the contrary, some studies establish a positive impact of the supply of NAS on auditor independence and practice (Faraj & Akbar, 2008; Arrunada, 2010). In this regard, Faraj and Akbar (2008) observe that there is a dramatic increase in the perceived level of reliability of audited financial statements when NAS are provided by a separate division or unit within the audit firm and full disclosure is made in the client's financial statements to all clients. In much the same way, Kinney *et al.* (2004) point out that extensive knowledge of a client's information systems due to the provision of NAS may spillover to the audit process and in the process enhance the information richness available to auditor, and hence impacting positively on audit quality.

Nonetheless, given the inconclusive results on issues of NAS on perceived auditor independence, this current study wish to measure auditor independence by considering some basic factors that relate to size of the NAS fees in comparison to audit fees and other managerial positions. The focus of these measurement factors is to ascertain the extent to which perceived auditors' independence will be impaired based on the amount and size of NAS fees that are collected relative to the audit fees from one particular clients. Although there are mixed results on the impact of NAS on financial reporting quality as demonstrated above, however on a balance of scales there is overwhelming evidence supporting the negative impact of NAS on auditor independence, auditor competence and reliability of audited financial statement.

Table 3.3 aptly depicts the measurement items that are used in measuring the impact of NAS on auditor quality and the reliability of audited financial statements.

Table 3.3  
*Measures of Non- Audit Services (NAS) Construct*

Items	
1	Non-audit services from incumbent $\geq$ 100 percent audit fee.
2	Non-audit services from incumbent $\geq$ 50 percent audit fee.
3	Non-audit services from incumbent $\geq$ 25 percent fee.
4	The audit firms should not provide any kind of non –audit services to its audit clients.
5	The prohibition of the provision of NAS to an audit client is only to maintain the perception of independence.
6	Non-audit services is provided to audit clients by a separate department within the audit firm give the auditor more credibility.
7	Non-audit services is provided by the auditor to all clients but full disclosure is made in the client financial statements.
8	The provision of NAS to an audit client leads to economic dependency on that client and causes a conflict of interests for the auditor.

A total of 8 items were derived from previous literature to operationalise this variable (e.g. Sori and Karbhari, 2006; Al-Eissa, 2009; Almalhuf, 2009; Sawan, 2010; Al-Ajmi, and Saudagaran, 2011).

#### **Section D: Measures of Auditor Rotation (AR)**

Issues of mandatory auditor rotation is practically and theoretically divided into two school of thoughts, specifically those that are opponents of mandatory auditor rotation and those that are proponents of mandatory auditor rotation (GAO, 2003; Lee *et al.*, 2009). A strong argument by those opposed to mandatory auditor rotation is that its implementation does not practically pass the popular cost/benefit ratio (Gietzman & Sen, 2002; Johnson *et al.*, 2002; GAO, 2003; Beattie & Fearnley, 2004; Ghosh & Moon, 2005; Cameran *et al.*, 2009; Kwon *et al.*, 2010). In support of their arguments is that mandatory rotation will yield higher audit costs with little or



nothing to show for in the incremental benefits. They went further to argue that increase in auditor rotations will eventually lead into general increase of associated costs for audit startups, hence general increase in total audit costs (Davis *et al.*, 2009; Kwon *et al.*, 2010). Some argued that mandatory audit rotation schemes may introduce unintended costs to participants in the capital market (Ghosh & Moon, 2005). Furthermore, the study by Cameran *et al.*, (2009) demonstrated that audit firms' rotation could potentially harm two key determinants of audit quality, that is, the degree of auditors' specialisation and their technical competence. In much the same way, the findings of Ruiz-Barbadillo *et al.* (2009) suggested that mandatory rotation may actually undermine auditor independence. Meanwhile, a number of studies suggest that auditor engagement over a long period yields a positive impact on the audit process (Geiger & Raghunandan, 2002; Dopuch *et al.*, 2003; Myers *et al.*, 2003; Beattie & Fearnley, 2004; Abu Bakar *et al.*, 2005; ; Bae *et al.*, 2007; Jackson *et al.*, 2008; Manry *et al.*, 2008; Cameran *et al.*, 2009). In a related study, Johnson *et al.* (2002) demonstrated that short audit firm tenures of two to three years are linked with lower quality financial reports vis-à-vis those prepared by medium audit-firm tenures of four to eight years.

On the contrary, the advocates of the mandatory auditor rotation argue that its implementation would provide an opportunity for a fresh look at the financial activities of the company (Knetchel & Vanstraelen, 2007; Manry *et al.*, 2008). They went further to claim that any longer stay of an audit firm with the same client, will result in a lack of objectivity on the part of the auditors when examining client's assertions and hence leading to their inability to detect errors in the company's financial statements. This lack of impartiality or objectivity by the auditors is said to

have multiple sources, such as auditors identifying itself as an advocates for auditee, lack of professional skepticism and feelings of mutual contingency loss (Vanstraelen, 2000; Jackson *et al.*, 2008). Meanwhile, researchers from Arab countries such as Egypt have proposed mandatory auditor rotation, either through the rotations of the partners or auditing firms as a possible mechanism to address the problems of lack auditor independence (Mohamed, 2010; Mohamed & Habib, 2013). Their argument was premised on the fact that there are many qualified and reputable audit firms in Egypt that are comparable in standards to the Big Four audit firms. However, Faraj and Akbar (2008) conclude that there is an increase in the level of perceived reliability of audited financial statements when the audit partner tenure is short. As theoretically established in Chapter Two, a major inherent benefit is that rotation of audit partner tenure relationships will significantly enhance auditors' independence and audit quality.

Below is Table 3.4 that detailed out the list of theoretical measurement items for Auditor Rotation:

Table 3.4  
*Measures of Auditor Rotation (AR) Construct*

Items	
1	Risk of averse market reaction to frequent auditor change threatening auditor independence.
2	Long tenure with a client gives an auditor more experience and leads to low audit hours by an auditor.
3	Long tenure should only be allowed with large companies.
4	The longer the duration an audit firm serves an audit client, the more likelihood that auditors' independence will be impaired
5	Mandatory audit firm rotation in the interest of independence is valid.
6	Mandatory rotation creates a positive users' perspective concerning independency in regards of financial statements reliability.
7	mandatory rotation enhance the audit firm –client independency
8	Depending on audit partner rotation instead of audit firm rotation enhance independency.
9	Management time and costs incurred in changing auditors threatening auditor independence.

A total of 9 items were derived from previous literature to operationalise this variable (e.g. Sawan, 2010; Al-Ajmi & Saudagaran, 2011; Al-Khadash, Nassar & Sweidan, 2011).

### **Section E: Measures of Audit Firm Size**

Existing studies imply that the large size of the audit firm is considered as having a positive impact on audit quality especially on the perceptions of auditor independence as opposed to the small size firm (Abu Bakar *et al.*, 2005; Lennox, 2005; Francis & Yu, 2009). One of the major arguments in favor of large audit firms is that it is perceived as more capable of maintaining a sufficient degree of independence vis-à-vis small auditing firms. In much the same way, Yuniarti (2011) argues that those audit firms that have large client portfolios will have stronger and better incentives in protecting the independence and reputation of their firms. In a related study, Naser and Al-Khatib (2002) argues that good quality corporate reporting is related with the status of the audit firm since those that are affiliated to large audit firms are known to publish high quality financial information. Similarly, Abu Bakar *et al.* (2005) demonstrate that audit firm size appears to be the most influential attribute in securing audit quality and auditor independence.

The aforementioned arguments are consistent with findings suggesting that small audit firms are more likely to lose their independence than their larger counterparts (Tahinakis & Nicolaou, 2004; Awadallah, 2006; Alleyne *et al.*, 2006). It has also been suggested that large audit firms with greater wealth and reputation are more motivated to be diligent in executing their duties since they are more susceptible to

litigation. Thus, practice wise, large audit firms with deeper pockets would officially have more to lose both financially and public image in case there is any audit failure as was the case of Arthur Andersen in the aftermath of the Enron scandal. It is therefore not surprising that some studies have rated audit firm size as the most vital characteristic in perceptions of audit quality (Kilgore *et al.*, 2011). Undoubtedly, existing studies indicate that large audit firms are more competent and independent than small firms. Hence, this study concludes that the extant literature have established the fact that large audit firms are more associated with providing reliable and credible information than the smaller audit firms.

Table 3.5 contains measurement items for measuring audit firm size within the auditing and accounting firm:

Table 3.5  
*Measures of Audit Firm Size Construct*

Items	
1	Being a Small, local audit firm.
2	Being a sole practitioner.
3	Being a Big Four international firm.
4	The Big Four firms can report the real financial situation of the clients more readily than other firms.
5	The Big Four firms perform more powerful, effective tests and are more credible than others
6	The companies or banks audited by the Big Firms are more attractive to investors and creditors.

A total of 6 items were derived from previous literature to operationalise this variable (e.g. Sawan, 2010; Al-Ajmi & Saudagaran, 2011).

## Section F: Measures of Audit Firm Fees

Many researchers have studied the threats that audit and NAS fees pose to auditor independence are (Hudaib , 2003; Markelevich *et al.*, 2005; Alleyne *et al.*, 2006; Barbadillo *et al.*, 2006; Ye, Carson & Simnett, 2006; Hoitash *et al.*, 2007; Basioudis

*et al.*, 2008; Ebimobowei, 2011). Notable among them is Barbadillo *et al.* (2006) who established that auditors' independence may be compromised if the percentage of income that auditors receive from their clients is very high or substantial. Similarly, Hoitash *et al.* (2007) argued that large audit fees paid to auditors could result in the auditor becoming unwilling to make proper inquiries during the audit for dreading the loss of highly lucrative fees. These findings were also corroborated by those established by Markelevich *et al.* (2005). Furthermore, Faraj and Akbar (2008) concluded that the higher the audit fees, from one client, the lower the reliability of audited financial statements are perceived to be.

Although the extant audit literature show that auditor independence is undermined by the economic dependence of auditors on their audit clients, other studies have reached different conclusions however (Craswell *et al.*, 2002; DeFond *et al.*, 2002; Geiger & Rama, 2003; Hope & Langli, 2010). For example, DeFond *et al.* (2002) established no relationship between fees and compromised auditor independence. A similar conclusion was reached by Craswell *et al.* (2002) who found out that the auditor's predilection to issue unqualified audit opinions was not affected by the level of auditor fees dependence. In much the same way, a study conducted in Norway by Hope and Langli (2010) found no evidence linking high fee revenues to a lower propensity to issue modified audit opinions. Notwithstanding the above arguments, on a balance of scales the vast majority of existing studies conclude that auditor independence is perceived to be affected by the economic dependence of auditors on their audit clients. Table 3.6 contains these lists of most related measurement items for measuring audit firm fees within the auditing and accounting firms:

Table 3.6  
*Measures of Audit Firm Fees Construct*

Items	
1	The external audit fee reasonable given the scope of the external audit.
2	There are differences between actual and estimated fees handled.
3	An assessment made on the amounts and relationship of audit and non-audit fees and services.
4	Disclosing audit and non-audit fees strengthens auditor independence.
5	The annual financial statements should include a management report which discloses the nature of other services provided by its external auditor.
6	Greater than 10 % of total firm's audit fees revenues are from one client.
7	The Big audit firm usually charge higher audit fees and local firms usually charge lower audit fees.
8	A company that pays higher audit fees is more likely to receive a clean audit opinion.

A total of 8 items were derived from previous literature to operationalise this variable (e.g. Sori & Karbhari, 2005; Al-Eissa, 2009; Almalhuf, 2009; KPMG, 2009; Sawan, 2010).

#### **Section G: Measures of Audit Committee Characteristics (ACC)**

Audit committee as a body that is established amongst the firms' board members charged with the primary purpose of overseeing the audited financial statement of the issuer and any other accounting and financial reporting activities (SOX, sec. 205, 2002). Included in their primary duties are the recommendations of potential external auditors to the company's board. The audit committee also receives, review, and forward the annual audited financial report to the board of directors (Alleyne *et al.*, 2006). Many researchers have argued in favor of audit committee as playing a major role in the verification and safeguarding of firm's financial statements and internal control systems (Goddard & Masters, 2000; Johnstone *et al.*, 2001; Abbott *et al.*, 2004; Walker, 2004). It can be argued that audit committee existence is perceived to be an important factor in assessing the reliability of financial statements. Generally,

the development and popularity of the audit committee in many countries has been triggered by concerns about the credibility of financial reports due to high profile corporate scandals and failures.

Generally, the audit committee is largely seen as a vital cog that ensures the independence of the audit process (Beattie & Fearnley, 2004; Alleyne *et al.*, 2006; Faraj & Akbar, 2008; Sarkar & Sarkar, 2010). For some, it is a good medium of opening direct links of communication between the board members and the external auditors (Arens *et al.*, 2013). In a way, the audit committee is perceived as both as a conduit of critical information provided by the management to the auditors, and as a protector of the auditor from the pressures and machinations of management. Another major benefit of having audit committees is their key role in appointing auditors, determining auditor fees and retention or dismissal of auditors. In this role, audit committees reduce management power over the control of external auditors, specifically through proper audit firm selection, direct negotiation of audit remuneration as well as contributing to issues of auditor's retention or replacement (SOX, 2002; UK Combined Code, 2003, Dhaliwal *et al.*, 2010). The reason is to make the auditor not to be reliant on the client's management, both in terms of executing duties as well as in terms of its economic survival.

As noted by Mansouri *et al.* (2009), the degree of audit quality is massively affected by the audit committee. Generally, effective audit committees enhance financial reporting quality through their functions of commenting and approving accounting policies as well as the reviewing of financial statements (Dhaliwal *et al.*, 2010). Prior studies indicate that the audit committee composition, expertise and diligence are key

features that may affect its oversight or monitoring effectiveness (DeZoort *et al.*, 2002; Walker, 2004). A litany of studies have empirically demonstrated that key determinants of audit committee effectiveness such as its composition, expertise and meeting frequency have a substantial beneficial impact on the quality of financial reporting (Abbott & Parker, 2000; Archambeault & DeZoort, 2001; Carcello & Neal, 2000, 2003; Chen, Moroney & Houghton, 2005; Mangena & Taurangana, 2008; Robinson & Owens-Jackson, 2009).

Although some studies have established that actual or concrete audit committee operations in practice are ineffective (Lin *et al.*, 2008), the majority of existing studies confirm the unique roles that Audit Committee is playing in the process of enhancing quality financial reporting and maintaining market confidence. In essence, existing studies indicate that certain attributes of audit committee members positively contribute to the attainment of ACE (Abbott & Parker 2000; Carcello & Neal, 2003; Abbott *et al.*, 2004). These key attributes include the composition of independent non-executive members, financial expertise of audit committee members and their meeting frequency. Some other key attributes include informal processes around the audit committee as well as audit committee-related disclosures and reporting.

Table 3.7 contains the nine items that are used in measuring audit committee within the accounting and auditing firms:



Table 3.7  
*Measures of Audit Committee Characteristics (ACC) Construct*

Items	
1	The existence of an audit committee in a company/ bank ensures that auditor is likely to be independence.
2	There is an active Audit committee (meeting more than 3 times a year)
3	Existence of AC composed of nonexecutive directors, a majority of whom are independent.
4	AC is responsible for the selection of auditor.
5	AC is responsible for the determination of auditor's fees before the services are provided.
6	AC is responsible for the dismissal of auditor.
7	There is a compulsory audit committee report describing activities and actions taken during the year.
8	The average size of AC is 4 to 6 members.

A total of 9 items were derived from previous literature to operationalise this variable (e.g. Sori, 2005; Rohaida, 2011; Al-Ajmi & Saudagaran, 2011; Almalhuf, 2009).

#### **Part D: Mediating Variables (Auditor Quality)**

As a consequent of a series of corporate scandals and audit failures, perceptions of audit quality have been an issue in recent times (Kilgore *et al.*, 2011). Essentially, there is a huge body of scholarly work and literature pertaining to auditor quality and its measurement. Nonetheless there is no agreement or consensus on what constitute audit quality and each measurement. Consequently, there is no single generally established definition or measure of audit quality. In fact much of the existing audit quality literature is centred around DeAngelo's (1981) commonly cited definition of audit quality. As mentioned earlier, this definition proffered by DeAngelo regard audit quality as the likelihood of both detecting and reporting a breach or misstatement in financial statements or in the accounting system (Kilgore *et al.*, 2011, p. 254). Put another way, audit quality is the ability of an auditor to detect accounting misstatements or errors (competence) and then to express them in an appropriate audit opinion (independence). However, as pointed out by Krishnan and

Schauer (2001) the two elements of the DeAngelo (1981) definition, namely, auditor independence and auditor competence are unobservable. Accordingly, two approaches have since been embraced to measure audit quality, that is, a direct and an indirect approach.

The direct approach is premised on the supposition that the likelihood of discovery and reporting of errors and breaches will be revealed or highlighted in audit outcomes such as financial statement outcomes and audit errors. There are numerous studies that have used the direct approach including Colbert and Murray (1998) who focused on audit errors; Balsam *et al.* (2003) who utilised abnormal accruals; and finally Krishnan (2003) who based his measures on valuation of earnings surprises. Equally, there are a number of studies which have utilised the indirect approach. This type of approach uses surrogates or substitutes for audit quality such as audit firm size, audit tenure, supply of NAS, and industry experience (see Geiger & Raghunandan, 2002; Elstein, 2001). Another type of the indirect approach examines attributes of the audit team rather than of the audit firm. Notably, the second type of the indirect approach assumes a behavioural standpoint and measures audit quality by scrutinising the audit team attributes perceived to be related to audit quality. Some of these attributes include communication and quality of working relationships between the audit team and client management, the level of partner attention to the audit, and the expertise of the audit team. Furthermore, audit team attributes comprise the knowledge of the audit team and partner about client's industry, and the ethical standards of the audit team; and the technical competence of the audit team (see Kilgore *et al.*, 2011). A number of these studies highlighting audit team characteristics include Chang and Monroe (2001), Duff (2004), and Zerni (2008).

Generally, because the audit service is done by a fairly few number of an audit team, audit team attributes probably play a key role in perceptions of audit quality. Below are the sets of measurement items for auditor quality (auditor independence and auditor competence) as a mediating variable.

## **Section H: Measures of Auditor Independence Construct**

Clearly, to fulfil their roles objectively, auditors need to be independent of the company and its management. After all, the dilemma is that, in effect, auditors serve two masters, namely, the management and shareholders (Tricker, 2012). As identified in the extant audit literatures, several professional bodies such as the Institute of Internal Auditors (IIA), the American Accounting Association (AAA), the AICPA, and the SEC have all emphasised that the independence of the auditors is both a professional and an ethical issue that is very crucial to the auditors and users of financial information. Some of the arguments provided by these professional bodies and several researchers are that a major solution for solving the observed ethical issues and its inherent dilemmas that serves as potential threats to the independence of the auditors is by placing more emphasis on rules and regulations that guides professional ethics. Similar to the view of these professional bodies are several researchers and authors that have defined auditors' independence from the angle of behavioral, sociological and legal perspectives and how each of these perspectives can lead to impairment. Notable among them is Abu Bakar and Ahmad (2009) who emphasised on the significance of auditor's independence vis-à-vis its relationships with the auditee. Moreover, Faraj and Akbar (2008) mention that reliability of audited financial statements is based on maintaining an independent audit. Hence, Lassila *et al.* (2010) argued that the notion of auditor independence is

the ability of both the internal and external auditors to freely engage and decide on the scope of their auditing work without any interference or influence from the company's management.

Generally, the existing studies show auditor independence as a vital cog in the auditing profession, given its essential value in the assessment of the reliability of audited financial statements (Bedard *et al.*, 2004; Al-Ajmi & Saudagaran, 2011). Notably, many studies have established that the extent to which an audited financial statement can be accepted as being reliable is significantly depended on auditor independence (Rusmanto, 2001; Flaming, 2002; Higson, 2003; Hodge, 2003; Yang *et al.*, 2005; Faraj & Akbar, 2008). For Higson (2003) without auditor independence, the issue of whether the figures in financial statements are correct is seriously called into question. Undoubtedly, the extant literature has demonstrated that auditor independence is a major and significant factor in determining the reliability of audited financial statement. As noted by Tricker (2012) independent external auditors play a fundamental role of reassuring “investors and others by reporting that the reports and financial accounts, produced by their directors, truly and fairly reflect the state of the company's affairs” (pp. 479 & 480). Table 3.8 depicts the measurement items that are used in measuring the impact of auditors' independence on the reliability of audited financial statements:

Table 3.8  
*Measures of Auditor Independence Construct*

Items	
1	Auditor's ability to be objective in disclosing a financial reporting problem.
2	Auditor's ability to be unbiased in disclosing a financial reporting problem.
3	Freedom from managerial interference with the audit program.
4	Free access to all records, procedures, and personnel relevant to the audit.
5	Active co-operation from management personnel during the audit examination.
6	Freedom from personal interests on the part of the auditor leading to exclusions from or limitations on the audit examination.
7	The auditor maintains independence in fact.
8	The auditor maintains independence in appearance.

A total of 8 items were derived from previous literature to operationalise this variable (e.g. Flaming, 2002; Samelson *et al.*, 2006; Salehi, 2009; Stoel *et al.*, 2012).

## **Section I: Measures of Auditor Competence Construct**

As identified in the extant audit literatures, auditors are seen as the custodians of a specialist body of accounting knowledge. After all, as noted by Abrar, Tian, and Deng (2009) “sound knowledge and competence; commands a premium” (p. 18). It is therefore scarcely surprising that there is a huge demand and appetite for auditing and accounting competence, including sufficient training and experience in all elements of an auditor’s work. As a matter of fact, auditors must have a strong educational background with adequate knowledge and skills in order for them to be deemed as competent. According to Stoel *et al.* (2012), accounting knowledge and audit skills refer to the auditors’ knowledge of accounting and auditing in general, their comprehension of the accounting system being audited in particular, and their capacity to carry out duties and exercise professional judgment as auditors. Therefore, it is expected by all stakeholders that auditors should have the requisite academic training in accounting, auditing, and as well as additional training, both formal and informal, throughout their career experiences (Abrar *et al.*, 2009).

According to Abrar, Tian and Deng (2009) lack of competence due to lack of knowledge and experience, compels the auditor to depend on the client's management in terms of asking pertinent questions and evaluating responses. By implication, if the auditor is incompetent, independence which lies at the heart of auditing integrity is not an audit attribute to be expected. The effect of the knowledge and skill level of auditors on audit quality has been covered in existing studies especially in financial audit research (Chen *et al.*, 2001; Daud, 2007; Abrar *et al.*, 2009; Havelka & Merhout, 2009; Stoel *et al.*, 2012). For example, Daud (2007) indicated that auditor competence has a direct implication on both auditor independence and auditor judgement. In addition, prior research provides strong evidence indicating that specialised auditors are linked with enhanced disclosure quality (Dunn & Mayhew, 2004) and as well as with reduced instances of financial reporting fraud (Balsam *et al.*, 2003; Stanley & DeZoort, 2007). Furthermore, substantial research has been undertaken to investigate the relationship auditor experience and audit quality (e.g. Chen *et al.*, 2001; Stoel *et al.*, 2012).

In view of the above findings, all audit tasks require knowledge and experience for the task at hand. Beyond doubt knowledge spillovers accruing from the auditor's expertise and competence enhance audit quality as established by several studies (Owhoso *et al.*, 2002; Balsam *et al.*, 2003; Sawan, 2010). After all, auditor knowledge of the industry provides the auditor with the capacity to be more effective in exercising professional judgement. Furthermore, Schelker (2012) indicated that the more competent auditors are the more effective monitors, which in turn reduces the leeway of agents to misreport. Since key stakeholders such as investors and citizens rely on financial information to input into their decision

making processes, the quality of reported information is undoubtedly critical. To sum up, more competent auditing is associated with more reliable financial information. Thus, auditor competence is a critical element that affects the credibility and reliability of an auditor's report (Watkins *et al.*, 2004). It can be concluded, then, that auditor competence is an important aspect shaping users' perceptions about the effectiveness of the audit function and for getting reliable audited financial statements. Table 3.9 depicts the measurement items that are used in measuring the auditors' competence:

**Table 3.9**  
*Measures of Auditor Competence Construct*

Items	
1	Auditor is knowledgeable different background rather than accounting. the idea of hiring auditors from different background other than accounting.
2	The audit firm has employees who are technically competent to perform the service.
3	The auditor makes extensive use of statistical techniques in conducting the audit.
4	The auditor's understanding of the accounting system is adequate.
5	The majority of audit firm personnel have passed the CPA exam or any equivalent professional exams.
6	The audit firm members are competent in their knowledge/application of Generally Accepted Accounting Principles (GAAP) and Generally Accepted Auditing Standards (GAAS).
7	The auditor has an appropriate amount of prior experience in auditing your company.
8	The audit manager has worked in your industry for at least 2 years.
9	The audit personnel have been on your audit at least 2 years.

A total of 9 items were derived from previous literature to operationalise this variable (e.g. Ismail *et al.*, 2006; Stoel *et al.*, 2012).

### **3.6 Data Collection Process**

Although there are many procedures and techniques of collecting data via the survey method, in this study, the primary data for statistical analysis was randomly collected through the questionnaire instrument which was administered to officially registered members of LAAA as alphabetically listed by the association in Libya. The researcher adopted a second qualitative measurement to affirm the research findings and also to assist in interpreting the results. The study also utilised data from previous research (Ismail *et al.*, 2006; Stoel *et al.*, 2012).

#### **3.6.1 Questionnaire Design**

Questionnaire design is a unique and very important stage of any research, and sound questionnaires should focus on three aspects (Sekaran & Bourghie, 2009, p. 198). The first one relates to the wording of the questions whereas the second refers to the “planning of issues with regard to how the variables will be categorised, scaled, and coded after receipt of the respondents” (Sekaran & Bourghie, 2009, p. 198). Finally, the third one refers to the general appearance of the questionnaire. On close inspection, the foregoing three elements of questionnaire design are crucial because they can minimize bias in the study. Meanwhile, Sekaran and Bourghie (2009, p. 198) note that the principles of wording refer to such factors as follows: “(1) The appropriateness of the content of the questions; (2) How questions are worded and the level of sophistication of the language used; (3) The type and form of questions asked; (4) The sequencing of the questions; and (5) The personal data sought from the respondents”.



In much the same way, Creswell (2012) observe that designing a good survey tool (questionnaire) is a challenging and intricate process. As such, researchers when designing a survey instrument should write different types of questions, utilise strategies for good question construction and undertake a pilot test or pre-test of the questions. There is no doubt that questionnaires are an efficient data collection instrument when large numbers of people are to be get hold of in different geographical areas. Furthermore, the questionnaire is a popular data collection technique because researchers can elicit information somewhat easily. Moreover, the coding of responses can also be done fairly easily. They can also be administered personally, mailed to respondents, or electronically distributed (Sekeran & Boughie, 2009, p. 197). More importantly, questionnaires can be utilised to measure the seriousness of divergence in perceptions among the participants or to validate results of this study (Daud, 2007). In a nutshell, questionnaires are most useful when the researcher knows exactly what is required and how to measure the variables of interest.

#### **3.6.1.1 Types of Questionnaire**

Questionnaires could be defined as a set of questions itemised to provide information on certain variables based on the feelings of other people called the respondent. These questions may be open-ended, dichotomous and/or close ended. For this research, the questions are close ended because they restrict the respondents within the set of provided alternative answers in measuring their objective and subjective feelings on the impact of auditor independence, and its determinants on reliability of audited financial statement in their respective companies. To efficiently achieve this, the researcher embarks on adequate standardisation of questions through a well-

structured undisguised and self-administered questionnaire. This effort is very necessary because the expected responses are important to the achievement of a reliable statistical analysis in the final results (Hair *et al.*, 2014). Once the questionnaire responses were coded according to the respondent group category (i.e. external auditors, accountants of LAAA members, and loan officers as sophisticated users), SPSS was applied to them, and the various statistical procedures used are reviewed in the following section.

### **3.6.2 Rating scales for the Response**

The usual rating scales for measuring the latent construct in social science research (Churchill & Peter, 1984) is utilised in this study. The researcher structures all constructs in the measuring instrument by using a 7 point Likert scale, including the independent (predictor), mediating and the dependent (outcome) variables. This is regardless of the fact that some other studies have highlighted the benefits inherent a 5 point Likert scale. However, as noted by a number of scholars, a 7 point Likert scale offers detailed feedback and does not subject the respondents into any undue cognitive burden (Cavana *et al.*, 2001; Hair *et al.*, 2014). Thus, to achieve a better optimal result in information processing and scale reliability, a 7 point Likert scale appears to be more instructive.

### **3.6.3 Content Validity**

To establish efficiency in the data collection processes, the researcher conducted a pre-test with five accounting managers from Malaysia who are deemed audit experts, and five academicians from University Utara Malaysia. Authors like Cavana *et al.*

(2001) and Krejcie and Morgan (1970) have established ten experts as sufficient for instrument refinements and verification in any content validity of a research questionnaire. Following this understanding, the questionnaire for this research was thoroughly reviewed by each of the ten experts so as to ensure adequacy in its understanding, face validity, comprehensibility, and the reliability of measures that have been employed. While the academic respondents primarily focused on content validity, the audit experts focused on the face validity as it relates to their industry practices. Nonetheless, both approaches assist in checking the extent to which each item reflects the proposed constructs, and whether the questionnaire response format instructions are appropriate with the item statements and the chosen scale points.

#### **3.6.4 Follow-up Procedures**

For a study like this that entirely depends on the completed questionnaires as its means of data collection, there is need for a well structured follow-up procedure. Because of the sensitivity of auditing research, the researcher had to make strategic follow up procedures as indicated by Clark (1989). Part of the follow-up procedure that the researcher used included email and telephone contact to each of the participating members after two weeks of delivering the questionnaires. The researcher also continued to make telephone calls and email follow-up to participating members until they returned the completed survey, or showed interest in participating, or decline to participate.

### **3.7 Secondary data**

Unlike primary data which refers to data gathered first-hand by the researcher, secondary data is basically information obtained from existing sources such as data previously collected and assembled for some project or study. In other words, secondary data is “data that already exist and do not have to be collected by the researcher” (Sekeran & Boughie, 2009, p. 37). Some of the secondary data used in this study include data contained in statistical bulletins; online data, published or unpublished information, Libyan government publications, individual firms’ annual reports as well as data available from previous research (see Appendix H).

### **3.8 Data Analysis Strategy**

To attain reliability in data analyses and hypotheses testing, the researcher made use of several statistical tools from Version 18 of SPSS software. Among the various tests conducted are test of non-respondent bias, data screening and preliminary analyses for missing data, outliers and normality. Others are factor and reliability analyses to test for goodness of data, validity and reliability of measures, descriptive statistics to assist in describing the characteristics of the respondents, correlational analysis to assist in describing the relationship or association that exist between audit and audit firms variables and finally, regression analyses to test the theorised effect of determinants of auditor independence on auditor quality and reliability of audited financial statements relationships.

### **3.8.1 Research Instruments for Data Analysis and Hypothesis Testing**

After the collection of sufficient data that matches the minimum sample size requirements, the researcher code, summarise and analyse the data with SPSS, factor analysis and multiple regressions analysis. Below are detail explanations on the instruments that are employed in analysing and interpreting the data that are collected for the main study.

### **3.8.2 Factor Analysis**

As evident in existing literatures that factor analysis as a statistical modeling approach was first developed and used by an English psychologist called Charles Spearman in studying unobservable hypothetically existing variables (Raykov & Marcoulides, 2006). Like the path analysis, available literatures have shown that factor analysis also has relatively long history in business research (Hau & Marsh 2004; Hair *et al.*, 2014). As noted in Raykov and Marcoulides (2006) it was Spearman who actually proposed the known individual's ability scores which are the manifestations of the general ability now called the general intelligence, and several other similar abilities such as the verbal or numerical abilities. These general and specific factors were both combined to produce the currently known ability performance. An idea that was later labeled the two-factor theory in human abilities. Very important is that as more and more researchers became interested in this factor approach, the theory was later extended to accommodate many factors and its corresponding analytic approach resulted into what we now called "factor analysis".

In general terms, the use of factor analysis could be referred to as a modeling approach that is used in studying hypothetical constructs through various indicators or observable proxies that can be measured directly (Raykov & Marcoulides, 2006; Byrne, 2013; Hair *et al.*, 2014). Factor analysis is considered exploratory factor analysis (EFA), if the topic of interest is concerned with determining how many latent constructs or factors are required to efficiently explain the relationships that exist among a set of observed measures (Hair *et al.*, 2014; Hu & Bentler, 1995). Alternative to EFA is confirmatory factor analysis (CFA), this is where the preexisting structures of the relationships that exist among the measures are being quantified and tested. Unlike the EFA, CFA is primarily not concerned with researchers trying to discover a factor structure; rather researchers are more concerned with examining and confirming the available details of the assumed factor structures. Meanwhile, in order for researchers to confirm any specific factor structures, they need to have initial idea about the structure compositions.

Thus, CFA is generally considered to be a modeling approach that is designed to test any hypothesised relationships about a factor structures, more importantly when these factor numbers and its interpretations in terms of indicators were given in advance of the analyses. Hence, this research follows the three suggested stages in CFA, that is, (a) reviewing related theories first, (b) conceptualising the hypothesised relationships into a model, and, (c) testing the model for internal and external consistency with the observed explanatory data.

### **3.8.3. The Statistical Package of Social Science (SPSS)**

The SPSS Version 18 computer program was then utilised to analyse the data from the pilot study, to test the appropriateness of the scales which were used to measure the study variables. The choice of these statistical tests is related to firstly, the number of variables, secondly, to the type of question to be answered, and finally, to the scale of measurement (Zikmund, 2000; Sawan, 2010).

## **3.9 Chapter Summary**

Chapter Three has extensively discussed the research methods that are employed in collecting data for this current study. This research is purely a quantitative study where questionnaires are distributed to the respective respondents in order to determine their perceptions towards the constructs under study. Also presented in this chapter is the research framework as conceptualised from the literature reviews in relation to the research design and related measurement instruments. This chapter also contains relevant hypothesised relationships that are tested in order to determine the reliability of the arguments in the extant literature. Included under this section is the operationalisation of measurement instruments with their sources. This is because for all the constructs in the research framework, the researcher makes use of existing measurements scales as obtained from articles. The concluding part of this chapter discusses about the data analysis techniques and instruments.

## **CHAPTER FOUR**

### **DATA ANALYSIS AND FINDINGS**

#### **4.0 Introduction**

The main objective of this chapter is to present the results of data analysis on the relationship between corporate governance mechanisms, auditor quality and the reliability of audited financial statements. This chapter covers descriptive as well as inferential statistics relevant to the purpose of this study. In a way, the main function of this chapter is to provide information on the data analysis. Following the introduction, the response rates and the demographic profiles are first discussed. This is followed by the factor analysis for audit committees, non-audit services, auditor rotation, audit firm size, audit firm fees on auditor independence, auditor competence and a discussion of the impact on the reliability of audited financial statement. The tests of the research hypotheses using descriptive and inferential analysis are then explained. The final section provides the key findings and discussion as well the summary of the chapter.

#### **4.1 Descriptive Statistics of Respondents**

The primary data for this study was gathered via the survey method by using an instrument in the form of a questionnaire administered to members of LAAA and loan officers of commercial banks in Libya, randomly sampled from a population of 500 auditors and loan officers. Prior to responding to the questionnaires which were distributed by email, web survey and by hand delivery in some cases, the participants were briefed on the purpose of the study as well as the requirements of the survey instrument. A three stage process was implemented to enable data analysis, coding



and editing. In the initial stage, returned mail questionnaires were opened and recorded accordingly for purposes of identification (e.g. distinguishing the late and early respondents). In this respect, the survey instrument had an individual code to make it easy to trace and check when data was keyed into the SPSS version 18. Secondly, all data obtained from returned questionnaires was coded as per the items and numbers incorporated in the questionnaire design. The third phase of data screening was the editing of the data from the questionnaires. In this regard, questionnaires that were submitted by respondents with unanswered questions were automatically discarded and marked as 'blank'. In much the same way, questionnaires with a sizeable number of items (for instance 23.9 percent) which were left unanswered, also met a similar fate (discarded). Consequently, 67 questionnaires were discarded. This is because, data editing "deals with detecting and correcting illogical, inconsistent, or illegal data and omissions in the information returned by the participants of the study" (Sekaran & Bougie, 2009, p. 308).

#### **4.1.1 Analysis of Survey Response**

##### **4.1.1.1 Response Rate**

The subjects used in this study were members of LAAA and loan officers of commercial banks. Table 4.1a displays data on sampling and return rates of the questionnaires sent to the members of LAAA and loan officers in the commercial banks in Libya. The respondents were selected using simple random sampling. For compliance with data collection requirements, 500 questionnaires were distributed by email, web survey and hand delivered in other cases. This type of data collection technique is in line with the extant industry literature. From this number, 280 subjects were contacted but only 213 responses from both members of LAAA and

loan officers were received resulting in a response rate of 42.6 percent. 25 of the questionnaires were deemed unusable because most questions were not answered. According to Cavana *et al.* (2001), “if a substantial number of questions - say, 25 percent of the questionnaire - have been left unanswered, it may be advisable to throw out the questionnaire and not include it in the data set for analysis” (p. 316). Prior to responding to the questionnaire, the respondents (particularly those who received the questionnaire by hand) were given an explanation of the objectives of the study as well as the requirements of the survey instrument.

Table 4.1 a  
*Summary of Response Rate*

<b>Description</b>	<b>Results</b>
Questionnaires Distributed	500
Undelivered	287
Subjects contacted	280
No. of Responses	213
Unusable questionnaires	25
Returned and useable questionnaires	188
Response rates (213/500)	42.6 %
Useable response rate (188/500)	37.6%

In addition to the points noted above, several similar studies have used response rates less than 37.6 percent (which is the usable response rate of this study). For instance, in a study undertaken in Malaysia by Abu Bakar *et al.* (2005); out of 240 questionnaires mailed to the bank loan officer (respondents), the data was gathered only from 86 usable questionnaires, producing a usable response rate of 35.8 percent.

#### **4.1.1.2 Profiles of Respondents**

This section discusses the respondents of the study which represent the background information of the respondents to questionnaire survey. Certain demographic data

was gathered from each subject. Though the data was not gathered to address a particular research question, it offers an insight into the subjects and may help in interpreting findings. The demographic variables are: academic, specialisation, occupation, experience, and professional. Summaries of the demographic data collected from LAAA's members and the loan officers of commercial banks are shown in Table 4.1b below:

Table 4.1b

*Summary of Demographic Data on Respondents from LAAA's Members and the Commercial Loan Officers*

Demographic	Characteristics	Frequency	Percent
Occupation	Auditor	49	26.1
	Accountant	17	9.0
	Academic	17	9.0
	Loan officers	101	53.8
	Others	4	2.1
Academic Qualifications	Diploma	11	5.8
	Bachelor	123	65.4
	Master	49	26.1
	PhD	5	2.7
Study major	Accounting	147	78.2
	Management	15	8.0
	Economic	7	3.7
	Finance	12	6.4
	Others	7	3.7
Experience	Less than 5 years	21	11.2
	5 - 10 years	74	39.4
	11 - 20 years	68	36.2
	More than 20 years	25	13.3
Professional Qualifications	Member of LAAA	71	37.8
	Arab Society of Certified Accountants (ASCA)	15	8.0
	American Institute of Certified Public Accountants (AICPA)	1	0.5
	Institute of Chartered Accountants in England and Wales (ICAEW)	3	1.6
	None	98	52.1

Related to the demographic statistics for respondents from the LAAA's members and the loan officers, Table 4.1b shows about 26.1 percent (49) of respondents are auditors, while 9 percent (17) are accountants, 9 percent (17) are academics, 53.8 percent (101) are loan office and others (such as consultants) are 2.1 percent (4). It is observed that the majority of respondents are loan officer rather than auditor.

Meanwhile, most of the respondents 65.4 percent (123) are Bachelor holders, while 26.1 percent (49) are Master's degree holder, 2.7 percent (5) are PhD's degree and 11 respondents or 5.8 percent hold a diploma degree. In addition, about 78.2 percent (147) of the respondents hold a degree majoring in accounting, 8 percent (15) in management, 3.7 percent (7) in economics, 6.4 percent (12) are finance, and 3.7 percent are others. It can also be seen from the table that in relation to the experience, about 11.2 percent (21) of the respondents have less than 5 years' experience, 39.4 percent (74) have an experience between 5 to 10 years, 36.2 percent (68) have an experience between 11 to 20 years while 13.3 percent (25) have an experience of more than 20 years. This result shows that the respondents have enough experience in reporting accounting information.

Finally, about 37.8 percent (71) have professionally registered with LAAA, 8 percent (15) registered with ASCA, 0.5 percent (1) registered with AICPA, 1.6 percent (3) registered with ICAEW, while 52.1 percent (98) do not have any professional qualifications. Even though most of the respondents have more than 20 years of experience in reporting accounting information but only 47.9 percent have professional qualification.

#### 4.1.1.3 Test of Non-Response Bias

Table 4.2a presents descriptive statistics of respondents as categorised by academic qualification, specialisation, occupation, working experience and professional qualification of both members of LAAA and loan officers. Notably, another classification captured in Table 4.2a, is between early responses (88) and late responses (100). According to Table 4.2a a comparison of the means of the constructs found little difference between early and late respondents. In other words, these statistics suggest that there were no significant statistical differences in the demographic variables. The last column outlines the standard error of the mean for each of the two groups of responses.

Table 4.2a  
*Descriptive Statistics of Respondents*

Variable	Response	Number of Cases	Mean	Standard Deviation	Std. Error Mean
Academic	Early Response	88	2.26	.634	.068
	Late Response	100	2.25	.575	.058
Specialisation	Early Response	88	1.61	1.129	.120
	Late Response	100	1.39	1.024	.102
Occupation	Early Response	88	3.02	1.259	.134
	Late Response	100	2.92	1.390	.139
Experience	Early Response	88	2.47	.830	.088
	Late Response	100	2.56	.891	.089
Professional	Early Response	88	3.38	1.967	.210
	Late Response	100	3.01	2.038	.204

An independent sample test was conducted for the purpose of investigating the differences between the two groups (early and late respondents). A Levene's test which is an inferential statistic used to verify the assumption that variances are equal across groups was utilised for this exercise. It should be noted that equal variance of population samples is also known as homogeneity of variance or homoscedasticity. In a Levene's test, if p-value is equal or less than the typical significance level of 0.05 ( $p < 0.05$ ), the obtained differences or sample variances are unlikely to have

occurred based on random sampling from a population with equal variances. Put another way, there is a difference between the variances in the population and as such the null hypothesis of equal variance is rejected. However, if the p-value is larger than the significance level of 0.05 ( $p > 0.05$ ), then equal variance or homoscedasticity is assumed in a given population (see Pallant, 2010).

The results from the Levene's test reveal that there is no significant difference between all variables except specialisation and professional because the p-values range from 0.111 to 0.400 ( $p > 0.05$ ). Since the p-values are larger than the significance level, then homogeneity of variance or homoscedasticity is assumed in the given population. To put differently, the assumption of equal variance has not been violated. However, for specialisation and professional qualifications, the p-values of Levene's test are 0.04 ( $p = 0.05$ ) and 0.05 ( $p < 0.05$ ). In these scenario, the variances for the two groups are not the same, and thus violates the assumption of equal variance. For the continuous variables, a good example is the comparison between the final constructs of the variables which reveals that there is no significance difference i.e. auditor independence ( $t = 0.824$ ,  $p = 0.188$ ) and reliability of audited financial statements ( $t = 0.918$ ,  $p = 1.311$ ). It shows that the p-value (2-tailed), has no significant differences between the early and late respondents. For detail verifications of the descriptive test, please refer to Table 4.2b and Appendix D for independent samples test on equality of variance and means.

Table 4.2b  
*Independent Sample Test of Variables*

		Levene's Test for Equality of Variances		t-test for Equality of Means						
		F	Sig.	t	df	Sig.(2- tailed)	Mean Diff.	Std. Error Diff	95% Confidence Interval of the Difference	
									Lower	Upper
Academic	Equal variances assumed.	1.549	.215	.129	186	.898	.011	.088	-.163	.185
	Equal variances not assumed.			.128	177.02	.898	.011	.089	-.164	.187
Specialisation	Equal variances assumed.	4.187	.042	1.424	186	.156	.224	.157	-.086	.533
	Equal variances not assumed.			1.415	177.03	.159	.224	.158	-.088	.535
Occupation	Equal variances assumed.	2.566	.111	.528	186	.598	.103	.194	-.281	.486
	Equal variances not assumed.			.532	185.83	.596	.103	.193	-.279	.484
Experience	Equal variances assumed.	.713	.400	-.746	186	.457	-.094	.126	-.343	.155
	Equal variances not assumed.			-.749	185.39	.455	-.094	.126	-.342	.154
Professional	Equal variances assumed.	3.697	.056	1.246	186	.214	.365	.293	-.213	.943
	Equal variances not assumed.			1.248	184.39	.213	.365	.292	-.212	.942

Sequel to the above, this study tends to conclude that there is non-response bias that could significantly affect the study's ability to generalise its findings. The above result has therefore given this study the opportunity to utilise the entire 188 responses in the data analysis.

## 4.2 Data Screening and Preliminary Analysis

### 4.2.1 Overview

To establish the assumption of psychometric properties before applying the necessary data analysis techniques; this study employed a series of data screening techniques which includes detection and treatment of missing data, normality, outliers, and multicollinearity. This is because the data distribution and the selected

sample size have a direct effect on whatever choice of data analysis procedures and tests that are chosen (Byrne, 2013).

#### **4.2.2 Missing Data**

Several studies have established that missing data is an issue of great concern to many scholars and can negatively affect the findings of any empirical research (Cavana *et al.*, 2001). However, there was no missing data in the online questionnaires, this is because the online questionnaire was structured in a way that the respondent will not be able to submit it if it has any missing data.

For this study, the ten missing mailed questionnaires were replaced with the median of nearby values since they are all minor omissions. As observed in this study the most common item of missing data was the continuous variables such as level of income of provision of NAS. Based on the need to protect the identity of respondents this research concluded that the missing data is simply for administrative purposes.

#### **4.2.3 Checking for Outliers**

Statistical evidence has established outliers as “values that are substantially lower or higher than the values in the data set” (Pallant, 2010, p. 123). One effective way of checking for outliers is to use the scatterplot to look for values that are sitting out on their own. However, in this study, outliers were detected by inspecting the *Mahalanobis (MAH) distances* that generated by the multiple regression programme (Hau & Marsh, 2004; Pallant, 2010; Hair *et al.*, 2014). Clearly, a compelling reason for using this approach is that multivariate outliers can be easily identified using the



*MAH distance* in the regression sub menu. According to Pallant (2010, p. 286), *MAH distance* is “the distance of a particular case from the centroid of the remaining cases, where the centroid is the point created by the means of all the variables”. In essence, this technique will detect any cases that have a strange pattern of scores across the dependent variables. Nevertheless, to identify which cases are outliers, one needs to determine the critical chi-square value using the number of independent values as the degrees of freedom. As indicated by Coakes (2013, p. 151), *MAH distance* is “evaluated as chi-square with degrees of freedom equal to the number of dependent variables”. Notably, the critical chi-square values can be found in any critical values of chi-square table. Some scholars have recommended an alpha level of 0.001 (Tabachnick & Fidell, 2013). Put another way, to decide whether a case is an outlier, one needs to compare the *MAH distance* value against a critical value (usually the critical chi-square value). If a subject’s *MAH\_1* value exceeds the critical value, it is considered an outlier.

As indicated in the foregoing the *MAH distance* can simply be attained by running a simple linear regression through the selection of the newly created response number as the dependent variable and selecting all measurement items apart from the demographic variables as independent variables. After doing this, the data file will add another new variable or output *MAH\_1* to it. In this study, an examination of the *MAH distance* values suggested that there were 25 items out of the total 213 responses that were considered outliers because their *MAH\_1* values were greater than or equal to the critical chi-square value of 79.08 at an alpha level of 0.05 (see Appendix F). Since the outliers were a lot, they were subsequently deleted from the

data file to reduce their influence. As a result, the data analysis and final regressions in this study were done using the remaining 188 cases in the data file.

### **4.3 The Goodness of Data**

This section focuses on the properties that attempt to ensure that measurement error is kept to a minimum. The first property is validity, which is whether a tool measures what it sets out to measure (Field, 2009, p. 11). The second property is reliability, which is whether an instrument is free from random error. In other words, reliability is an indication of whether a scale or an instrument can be interpreted consistently across time and across the various items in the measuring instrument. We will now discuss the various types of validity, that is, content validity, construct validity, criterion validity, convergent validity and discriminant validity.

#### **4.3.1 Content Validity**

Content validity refers to the systematic assessment of scale to ensure that it is able to measure what is supposed to measure (Hair, Money, Samouel & Page, 2007). Face validity is a simple and basic type of content validity in which the researcher asks a few good people to check whether a measuring tool measure what it is designed to measure. However, this study utilises a more rigorous approach to assess content validity. In this respect, known experts were asked to give their opinion on the validity of the tool. To put it differently, data was considered to be contently validated if experts agreed that the instruments of the study included items that are able to cover all variables which are being measured (Sekaran, 2006; Bhattacharjee, 2012; Hair *et al.*, 2014). Notably, content validity alone is not enough to determine

the whole validity of the data; and therefore, other types of validity were checked. In sum, the goodness of measures is established through the various types of validity and reliability.

#### **4.3.2 Construct Validity**

This type of validity tests the link or connection between a measure or scale and the underlying theory. In other words, construct validity bears testimony to how well the findings obtained from the use of a measure fit theories around which the test is designed. Construct validity is assessed through convergent and discriminant validities (Sekaran & Bougie, 2009, p. 160; Pallant, 2010, p. 7). Basically, evidence of construct validity can be obtained by comparing the findings obtained using other tests, other related attributes of the individual or factors in the individual's environment which would be anticipated to affect test performance. Construct validity is typically measured using a correlation coefficient. In this regard, when the correlation is high, the instrument can be considered valid.

This study utilised confirmatory factor analysis which is one of the most commonly used tests to determine the construct validity of the data (Sekaran, 2006; Sekaran & Bougie, 2009; Pallant, 2010; Bhattacharjee, 2012). In this sense, factor analysis, is a multivariate technique that confirms the dimensions of the operationalised concept, as well as indicating which of the items are most appropriate for each dimension, and thus establishing construct validity (Sekaran & Bougie, 2009). In essence, factor analysis is a data reduction technique used to reduce or summarise a large set of variables to a smaller set of underlying factors or components that summarise the key information contained in the variables (Pallant, 2010, p. 181; Coakes, 2013, p. 128).

This reduction makes the data more visible, straightforward and manageable (Lattin, Carroll, & Green, 2003). In other words, it establishes the construct validity of data by indicating which of the items are most suitable for each dimension (Sekaran & Bougie, 2009). In a way, factor analysis represents the group of factors resulting from the observed relationships among the variables in addition to the correlation between each variable and each factor, which is termed factor loading (Babbie, 2013). It is premised on the key assumption that some underlying factors, which are smaller in number than the actual number of observed variables, are liable for the covariation among the observed variables (Dunn, Seaker & Waller, 1994). Indeed, factor analysis coalesces the variables that have similar characteristics together, depending on the fact that small numbers of dimensions are easier to control and manage (Lattin *et al.*, 2003).

There are two sets of different but related techniques of factor analysis, that is, principle component analysis (PCA) and factor analysis (FA). However, this study uses PCA and varimax rotation with Kaiser's criterion. Accordingly to Hair *et al.* (2014), PCA is the most appropriate method to use when data reduction is the main concern, and when existing information indicates that specific and error variance represent a relatively small proportion of the total variance. Furthermore, it is suggested that PCA is mathematically simpler, psychometrically sound, and it circumvents some of the potential challenges such as factor indeterminacy which is associated with other forms of factor analysis (Pallant, 2010). The varimax technique tries to minimise the number of variables that have high loadings on each factor. The Kaiser's criterion or eigenvalue rule states that we should use only factors with an eigenvalue of 1.0 or more. The Kaiser's criterion is premised on the idea that the

eigenvalue of a factor represents the amount of the total variance explained by the factor (Field, 2009; Pallant, 2010). It has been suggested that the Kaiser's criterion is restrictive and it may be proper to retain all factors with eigenvalues of more than 0.7 (Field, 2009, p. 641).

It should be noted that conducting factor analysis requires the data to be adequate and appropriate to be factored. Pallant (2010) have noted that two issues have to be considered when conducting factor analysis; namely, the sample size and the inter-correlations among the items. With regard to the sample size, it has been argued the samples more than 150 can be considered as adequate samples for conducting factor analysis (Stevens, 2009; Pallant, 2010). According to Gorsuch (1983) as cited in MacCallum, Widaman, Zhang & Hong (1999), for the purpose of factor analysis, a sample should be at least 100. Therefore, the representative sample in this study of 188 should be considered as an adequate sample for conducting factor analysis as indicated by Gorsuch (1983), Stevens (2009), and Pallant (2010). The second issue which was raised by Pallant (2010) is the strength of inter-correlations among the items. Such an issue can be dealt with by using both Bartlett's Test of Sphericity (BTS) and Kaiser-Meyer-Olkin (KMO) measure of sampling adequacy (Pallant, 2010). Basically, the first stage in conducting a PCA is to perform the KMO measure of sampling adequacy. According to Kaiser (1970) as (cited in Hair *et al.*, 2014), KMO Value in the 0.90s are marvelous; in the 0.80s are meritorious; in the 0.70s are middling; in the 0.60s mediocre; in the 0.50s are acceptable but miserable; and below 0.50s are unacceptable. We can deduce that the KMO value should be at least 0.6 and above to be considered suitable for factor analysis (Pallant, 2010). Meanwhile,

BTS has to be significant ( $p < 0.5$ ) for the factor analysis to be acknowledged as suitable (Pallant, 2010).

#### **4.3.2.1 Factor Analysis on Independent Variables**

Factor analysis was undertaken on independent variables namely, provision of NAS (8 questions), auditor rotation (9 questions), audit firm size (6 questions), audit firm fees (8 questions), and audit committee characteristics (8 questions). The findings of factor analysis on independent variables are captured in Tables: 4.3a, 4.3b, 4.3c respectively.

Table 4.3a presented results on whether factor analysis is appropriate for the variables of the study with both KMO and BTS being utilised to assess the factorability of the data. The findings in the table show that the KMO depict a measure of 0.89. A KMO value of 0.89 indicates ‘meritorious’ adequacy (see Hair *et al.*, 2006; Tabachnick & Fidell, 2007), and thus appropriate for using factor analysis. Basing on the KMO measure it is reasonable to go ahead with principle component analysis (PCA) as the approach to conduct factor analysis in our study. Furthermore, the value of BTS is also large (6091.113) and its associated significance level is very low (.000). The BTS is significant because  $p = 0.00$ , therefore factorability is assumed. In this study, the KMO value was 0.89, exceeding the recommended value and BTS reached statistical significance, supporting the factorability of the correlation matrix. In other words, both the KMO value and BTS results show that the items used in the instrument are clearly suitable for factor analysis.

Table 4.3a  
*KMO and Bartlett's Test*

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.	0.89
Bartlett's Test of Sphericity Approx. Chi-Square	6091.113
Df	595
Sig.	0.000

Table 4.3b below illustrates the results of the factor analysis using principal components with varimax rotation methods. The criteria used to identify the factors are that eigenvalues must be greater than one and that they each have at least one item to ensure stability. According to the rule of thumb of Hair *et al.* (2014), for practical significance, the factor loadings should have values greater than 0.40 (which explain around 16 percent of the variance in the variable). However, they recommended that the sample size can be a determinant of the accepted value of factor loading. Following the previous criteria, factor loading values should be higher than 0.40 (Stevens, 2009; Field, 2009; Hair *et al.*, 2014). This is because of the sample size of this study is 188. The eigenvalues for each component are listed in Table 4.3b. In this case, all the five components or factors recorded eigenvalues above 1 (10.68, 6.53, 3.06, 2.89, 2.25). These five components explain a total of 72.671 percent of the variance (refer to Table 4.3b).

Table 4.3b  
*Principal-Components Analysis*

Factors	Eigenvalue	Percentage of Variance	Cumulative Percentage
Non-Audit Services	6.53	18.67	49.20
Audit Rotation	10.68	30.53	30.53
Audit Firm Size	2.89	8.28	66.23
Audit Firm Fees	2.25	6.43	72.67
Audit committee	3.06	8.75	57.95

To help in the interpretation of the components, varimax rotation was performed. As shown in Table 4.3c, the loading values of the items are ranged between .555 and 0.915. All items have a factor loading of more than 0.40, indicating that the items correlate significantly to the factor itself, which can be interpreted that one set of items measured one variable (refer to Table 4.3c). All the five factors described in Table 4.3c are named accordingly where the first factor or component consists of eight items that describe information about the provision of NAS which account for 18.67 percent of the total variance. The second component or factor consists of nine items that capture information about auditor rotation, accounting for 30.53 percent of the total variance. The third factor is audit firm size and it contains six items, accounting for 8.28 percent of the total variance. The fourth factor consists of five items that describe information about audit firm fees and accounts for 6.43 percent of the total variance. And the last factor consists of seven items regarding the audit committee characteristics which account for 8.75 percent of the total variance.



Table 4.3c  
Factor loadings of the items of variables

Factor / Code	Title and items	Loading greater than 0.40	Loading	Percentage of variance
1	Non-Audit Services			18.67
Non-Audit Services1	a. when Fees from non-audit services are 100 %.		.864	
Non-Audit Services2	b. when Fees from non-audit services are 50 %.		.911	
Non-Audit Services3	C. when Fees from non-audit services are 25%.		.884	
Non-Audit Services4	d. The audit firms should not provide any kind of non –audit services to its audit clients.		.829	
Non-Audit Services5	e. Prohibition of NAS to an audit client is only to maintain the perception of independence.		.915	
Non-Audit Services6	f. Non-audit services are provided to audit clients by a separate department.		.897	
Non-Audit Services7	g. Non-audit services is provided by the auditor to all clients but full disclosure is made.		.914	
Non-Audit Services8	h. The provision of NAS to an audit client leads to economic dependency on that client and causes a conflict of interests for the auditor.		.783	
2	Auditor Rotation			30.53
Audit Rotation1	a. Risk of adverse market reaction to frequent auditor change threatening auditor independence.		.866	
Audit Rotation2	b. Long tenure with a client gives an auditor more experience and leads to low audit hours by an auditor.		.840	
Audit Rotation3	c. Long tenure should only be allowed with large companies.		.777	
Audit Rotation4	d. longer the duration an audit firm serves an audit client, the more likelihood that will be impaired auditors' independence.		.874	
Audit Rotation5	e. Mandatory audit firm rotation in the interest of independence is valid.		.897	
Audit Rotation6	f. Mandatory rotation create a positive users' perspective concerning independency in regards of financial statements reliability.		.864	
Audit Rotation7	g. mandatory rotation enhance the audit firm –client independency.		.854	
Audit Rotation8	h. Depending on audit partner rotation instead of audit firm rotation enhance independency.		.734	
Audit Rotation9	i. Management time and costs incurred in changing auditors threatening auditor independence.		.567	
3	Audit Firm Size			
Audit Firm Size 1	a. The auditor being a local audit firm seriously undermined independence.		.581	8.28
Audit Firm Size 2	b. Auditor being a sole practitioner undermined independence.		.823	
Audit Firm Size 3	c. Big Four international audit firms are more independent and more likely to issue qualified reports.		.837	
Audit Firm Size 4	d. Big Four audit firms can report the real financial situation of the clients more readily than other firms.		.822	
Audit Firm Size 5	e. Big Four audit firms perform more powerful, effective tests and are more credible than others.		.810	
Audit Firm Size 6	f. The companies/banks audited by the Big audit firms are more attractive to investors and creditors.		.779	

Table 4.3c (Continued)

4	Audit Firm Fees	Loading	Percentage of variance
Audit Firm Fees2	b. There are differences between actual and estimated fees handled.	.657	6.43
Audit Firm Fees3	c. assessment made on the amounts and relationship of audit and non-audit fees and services.	.609	
Audit Firm Fees6	f. Greater than 10 % of total firm's audit fees revenues are from one client.	.914	
Audit Firm Fees7	g. The Big audit firm usually charge higher audit fees and local firms usually charge lower audit fees.	.715	
Audit Firm Fees8	h. A company or bank that pays higher audit fees is more likely to receive a clean audit opinion.	.909	
5	Audit Committee	Loading	Percentage of variance
Audit Committee 2	b. There is an active Audit committee.	.680	8.75
Audit Committee 3	c. AC composed of nonexecutive directors, a majority of whom are independent.	.777	
Audit Committee 4	d. AC is responsible for the selection of auditor.	.826	
Audit Committee 5	e. AC is responsible for the determination of auditor's fees before the services are provided.	.864	
Audit Committee 6	f. AC is responsible for the dismissal of auditor.	.832	
Audit Committee 7	g. There is a compulsory audit committee report describing activities and actions taken during the year.	.648	
Audit Committee 8	h. The average size of audit committee is 4 to 6 members.	.808	

#### 4.3.2.2 Factor Analysis on Auditor Quality (Perceived Independence and Perceived Competence)

The 16 items of auditor independence (8 items) and auditor competence (8 items) were subjected to PCA using SPSS version 18. Prior to performing PCA, the appropriateness of data for factor analysis was conducted. The KMO value of Sampling Adequacy was 0.873, exceeding the recommended value of 0.6 as indicated by Kaiser (1970). Furthermore, the BTS was significant with a p-value = 0.000 (refer to Table 4.4a). These results show that factor analysis is appropriate. PCA revealed the presence of eigenvalues exceeding 1, explaining 40.6 percent and 17.9 percent of the variance respectively (refer to Table 4.4b). The factors cumulatively captured 58.484 of the variance in the data. The factor loading for all items were above 0.57, exceeding the recommended 0.40, and thus implying that the items correlate significantly to the factor itself, which can be interpreted that one set

of items measured one variable. The following Tables (4.4a, 4.4b, & 4.4c) present the details of factor analysis as presented in the foregoing.

Table 4.4a

*KMO and Bartlett's Test*

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.	0.873
Bartlett's Test of Sphericity Approx. Chi-Square	2104.866
Df	136
Sig.	0.000

Table 4.4b

*Principal-Components Analysis*

Factor	Eigenvalue	Percentage of Variance	Cumulative Percentage
Auditor independence	6.897	40.569	40.569
Auditor competence	3.046	17.915	58.484

Table 4.4c

*Factor loadings of the items of variables*

Factor/Code	Title and items	Loading greater than 0.40	Loading	Percentage of variance
1	Auditor Independence			40.569
Independence 1	Auditor's ability to be objective in disclosing a financial reporting problem		0.738	
Independence 2	Auditor's ability to be unbiased in disclosing a financial reporting problem.		0.795	
Independence 3	Auditor is independent when he is free from managerial interference.		0.838	
Independence 4	Auditor is independent when he is free to access all records, procedures, and personnel relevant to the audit.		0.847	
Independence 5	Auditor is independent when he received active co-operation from management personnel		0.824	
Independence 6	Auditor is independent when he is free freedom from personal interests		0.833	
Independence 7	External auditor maintains independence in fact.		0.863	
Independence 8	External auditor maintains independence in appearance.		0.869	
2	Auditor Competence			17.915
Competence 1	Auditor has different background rather than accounting.		0.804	
Competence 2	The audit firm has employees who are technically competent to perform the service.		0.846	

Table 4.4c (Continued)

Competence3	The auditor makes extensive use of statistical techniques in conducting the audit.	0.814
Competence4	The auditor understands the accounting system and internal controls.	0.724
Competence6	The audit firm members are competent in their Knowledge/application of GAAP and GAAS.	0.677
Competence7	The auditor has an appropriate amount of prior experience in auditing your company.	0.622
Competence 8	The audit manager in your audit firm has at least more than 2 years' experience with the auditing.	0.579

#### 4.3.2.3 Factor Analysis on Reliability of Audited Financial Statements (RAFS)

The 5 items of reliability of audited financial statements (RAFS) were subjected to principal components analysis (PCA) using SPSS version 18. Prior to performing PCA, the appropriateness of data for factor analysis was conducted. The KMO value of Sampling Adequacy was 0.71 (middling range), exceeding the recommended value of 0.6 as suggested by Kaiser (1970), and the BTS reached statistical significance, with a p-value = 0.000 (refer to Table 4.5a). In this case, the KMO value and BTS support the factorability of the correlation matrix. PCA revealed the presence of an eigenvalue exceeding 1, explaining 54.21 percent of the variance (refer to Table 4.5b). The factor loading for all items were above 0.58, exceeding the recommended 0.40, and thus indicating that the items correlate significantly to the factor itself, which can be interpreted that one set of items measured one variable. Below, are Tables (4.5a, 4.5b, and 4.5c) which capture the details of factor analysis on RAFS.

Table 4.5a  
*KMO and Bartlett's Test*

Kaiser-Meyer-Olkin Measure of Sampling Adequacy.	0.71
Bartlett's Test of Sphericity Approx. Chi-Square	329.205
Df	10
Sig.	0.000

**Table 4.5b**  
*Principal-Components Analysis*

Factor	Eigenvalue	Percentage of Variance	Cumulative Percentage
reliability of audited financial statements	2.71	54.21	54.21

**Table 4.5c**  
*Factor loadings of the items of variable*

Factor/Code	Reliability of Audited Financial Statements	Loading	Percentage of variance
Reliability1	a. The audited financial statement is perceived to indicate that the company is free from fraud and misstatement.	.824	54.21
Reliability3	b. The financial statements give a true and fair view.	.673	
Reliability4	c. The auditor does not agree with the accounting policies used in the financial statements.	.796	
Reliability6	d. The extent of assurance given by the auditor is clearly indicated.	.769	
Reliability7	e. Users can have absolute assurance that the financial statements contain no material misstatements and biased.	.594	

### 4.3.3 Convergent and Discriminant Validities

In essence, according to Pallant (2010) construct validity is explored by examining its relationship with other constructs, both related (convergent validity) and unrelated (discriminant validity). Basically, convergent validity is established when scores obtained with two different tools measuring the same construct are highly correlated (Sekaran & Bougie, 2009). In other words, this form of validity denotes the degree to which there is agreement between two or more attempts to measure the same construct through dissimilar methods. On the other hand, discriminant validity is “established when, based on theory, two variables are predicted to be uncorrelated, and the scores obtained by measuring them are indeed empirically found to be so” (Sekaran & Bougie, 2009, p. 160). More importantly, when convergent validity and

discriminant validity are established, construct validity is supported. As noted by Hair *et al.* (2014), to achieve convergent validity by PCA, factor loading for each item should be at least 0.40 for posited construct. Notably, for achieving discriminant validity, they should not be any cross-loadings higher than 0.40. In other words, the loading of the item on its factor should be at least 0.40 or above, and the loading of the item on other factors should be less than 0.40. With regard to this study, the table in Appendix E display the results for both convergent and discriminant validities. In the first case, it is demonstrated that each loading value is greater than 0.40), and in the second case it is established that cross-loading less is than 0.40. Basing on these results, we can accept that the first case assures the convergent validity, while the second case assures the discriminant validity.

#### **4.3.4 Criterion Validity**

Criterion validity aims to assess whether a given measure relate well with a current or future criterion (Bhattacharjee, 2012). Such validity can be established by assuring both the concurrent and predictive validities (Bhattacharjee, 2012; Sekaran, 2006; Sekaran & Bougie, 2009). To put it differently, both concurrent and predictive validity are measures of criterion validity. Basically, concurrent validity uses an already existing and well-known measure against which the new measure can be compared. On the other hand, predictive validity refers to the ability of an instrument to differentiate among individuals with reference to future criterion. To put it differently, this form of validity measures the degree to which a tool can predict a future event of interest. In practice, there are many different methods that can be used to assess criterion validity. There are also many degrees of the collinearity between the independent variables. This study utilises the most commonly used

methods of measurement, namely, Pearson Correlations, Variance Inflation Factors (VIF), and Tolerance Value. As stated by Hair *et al.* (2014), when the correlation between two independent variables is higher than 0.8, it can be an indicator of existence of multicollinearity, which can affect how one can interpret any relationships between the independent and dependent variables.

The correlation assessment of the variables of this study resulted in the correlations observed in Table 4.6. It is clear that the correlations between all independent variables seem to be significant at given levels. Furthermore, Table 4.6 shows that there is no multicollinearity (high correlations among the independent variables) between the given variables. This is so because Pearson correlation of all variables is lower than 0.8, which indicates that there is no multicollinearity problems between the variables (Hair *et al.*, 2007).

Table 4.6  
*Pearson Correlations*

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Non-Audit Services (1)	1							
Auditor Rotation (2)	.210**	1						
Size of Audit Firm (3)	.062	.486**	1					
Audit Firm Fees (4)	.222**	.080	.201**	1				
Audit Committee (5)	-.007	.437**	.436**	.014	1			
Auditor Independence (6)	.135	.180*	.291**	.279**	.193**	1		
Auditor competence (7)	-.024	-.093	.046	.104	.049	.365**	1	
Reliability of Financial Statements (8)	.210**	.378**	.446**	.247**	.323**	.336**	.247**	1

\*\* . Correlation is significant at the 0.01 level (2-tailed).

\* . Correlation is significant at the 0.05 level (2-tailed).

Furthermore, we extend our analysis to detect multicollinearity using the Collinearity Diagnostic Test by giving Tolerance Value, and Variance Inflation Factors (VIF). This was done to ensure that there are no serious collinearity problems among the independent variables that might lead to impair the accuracy and stability of the next steps of the analysis. Using this approach, the acceptable level of collinearity should be more than 0.10 for Tolerance Value, and less than 10 for VIF (Hair *et al.*, 2014). In this study, Table 4.7 displays the result of the Collinearity Diagnostic Test for the variables involved in testing the hypotheses. The results show that the Tolerance Value of each independent variable is greater than 0.1, which can lead us to conclude that all the variables in the model are free from multicollinearity problems. Therefore, Table 4.7 suggests that multicollinearity should not be a severe problem for this model. In much the same way, the VIF values are within the acceptable level of multicollinearity because all the scores are less than 10 for VIF. Below is Table 4.7 which captures the details of the Collinearity Diagnostic Test.

Table 4.7  
*Testing of Multicollinearity*

Variables Model	Collinearity Statistics Tolerance value	VIFs value
Non-Audit Services	.658	1.520
Auditor Rotation	.726	1.378
Size of Audit Firm	.858	1.165
Audit Firm Fees	.894	1.119
Audit Committees	.905	1.105

a. Dependent Variable: Reliability of Audited Financial Statements

#### 4.3.5 Reliability Analysis

If one uses factor analysis to validate a questionnaire as is the case in this study, it is useful to check the reliability of the scale (see Field, 2009, p. 673). The term reliability means that a measurement tool should consistently reflect the measure the



construct that it is measuring. In this study, reliability is premised on the idea that sets of items should produce results consistent with the overall questionnaire. To put it differently, reliability analysis is used to measure the consistency of the survey instrument (questionnaire).

One of the simplest methods for assessing reliability is test-retest reliability. In this type of reliability, the researcher administers the same measurement instrument multiple times. In this case, the reliability coefficient is obtained by repeating the same measure on a second occasion. To put it another way, the correlation between the scores obtained at the two different occasions from one and the same set of participants is the test-retest coefficient. The higher it is, the better the test-retest reliability and, as a result, the stability of the measure across time (Sekeran & Bougie, 2009, p. 162). Thus, high test-retest correlations are indicative of a more reliable a scale.

In this study, the coefficient alphas for different constructs were computed through the reliability test in SPSS and presented in Table 4.8. The Cronbach's Alpha of all the measures was comfortably above the limit of acceptability which is 0.70 (Cronbach's Alpha > 0.70). Hence, we can conclude that all the measures were highly reliable. Below is Table 4.8 which displays the details about the reliability test before and after factor analysis.

Table 4.8  
*Reliability Test before and after Factor Analysis*

Constructs	Pre-factor analysis		Post-factor analysis	
	Number of the Items	Coefficient Cronbach's Alpha	Number of the Items	Coefficient Cronbach's Alpha
Non-Audit Services	8	0.89	8	0.89
Auditor Rotation	9	0.90	9	0.90
Size of Audit Firm	6	0.75	6	0.75
Audit Firm Fees	8	0.78	5	0.74
Audit Committees	8	0.87	7	0.85
Auditor Independence	8	0.78	8	0.78
Auditor competence	9	0.84	7	0.86
Reliability of Audited Financial Statements	7	0.78	5	0.71

#### 4.4 Methods of Multiple Regression

Multiple regression analysis is basically an extension of simple regression analysis. Multiple regression analysis is used when the researcher assumes that there are several independent variables contributing to the variation of the dependent variables (Hair *et al.*, 2007; Sekeran & Bougie, 2009; Bluman, 2011).

According to several scholars there are three major multiple regression models, that is, standard or simultaneous, hierarchical or sequential, and stepwise (Coakes, 2013; Pallant, 2010). Standard or simultaneous multiple regression is the most common type which is characterised by the entering of all the independent variables into the equation at the same time because the researcher wants to assess the relationship between the whole set of independent variables and the dependent variable. Meanwhile, in hierarchical or sequential multiple regression, the independent variables are entered into the equation in order predetermined by the researcher's theoretical knowledge. Finally, stepwise multiple regression is premised on a set of

criteria which assist the researcher to select a list of independent variables which are then manipulated by the SPSS program accordingly. It should be noted that the choice of regression model is largely shaped by the researcher's goals.

#### **4.4.1 Normality, Linearity and Homoscedasticity**

Many of the modern statistical tests have been relying upon some specified assumptions about the actual variable to be used in the data analysis. Arguably, researchers and statisticians have confirmed the need to meet these basic assumptions in order for the research results to be trustworthy (Leslie, 2010; Byrne, 2013; Hair *et al.*, 2014). According to Pallant (2010), normality refers to the normal distribution of the residuals about the predicted dependent variable, while homoscedasticity assumes that the variance of the residuals about dependent variable scores should be the same for all predicted scores. Linearity refers to the relationship between two variables which is linear (represented by a straight line).

##### **4.4.1.1 Normality**

For every regression analysis, academics always assume that the variables are normally distributed. This is because a non-normally distributed variable will be highly skewed and could potentially distort the relationships between the variables of interest and the significance of the tests results (Hulland, 1999). To prevent the occurrence of this abnormality in this current study, the researcher has conducted necessary data cleansing such as determining the z-score of each items and transforming them through `cdnorm` in SPSS version 18. Sequel to the transformation the of data, this study has conducted visual inspections of the data through using two

types of normality tests; histogram with normal curve, and skewness and kurtosis. In the first stage, the researcher conducted the histogram test for both independent variables and mediator, and independent variables and dependent variables. Figures 4.1, 4.2 and 4.3 depict the histograms and normal curves of the three tests. We can see that in these cases, the curve is symmetrical and bell shaped and the majority of values are located within plus/minus three standard deviations from the mean. Therefore, that the normality assumption is met.

In a related development, Hair *et al.* (2014) suggested the use of both graphical plots and any statistical tests such as skewness and kurtosis ratio test to assess the actual degree of departure from normality. In this study, Figures 4.1, 4.2 and 4.3 show results from the histogram that test the normality of the distribution. A close inspection of the graphs suggests that the data could be a sample from a normal population, therefore indicating no violation of the normality assumption.

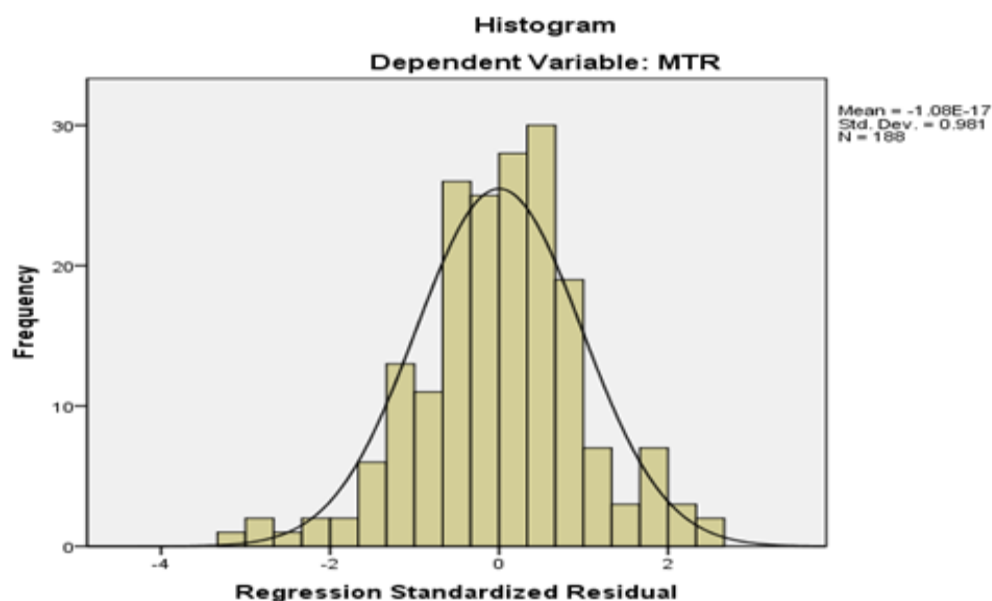


Figure 4.1  
*Normality test for Reliability of Audited Financial Statements*

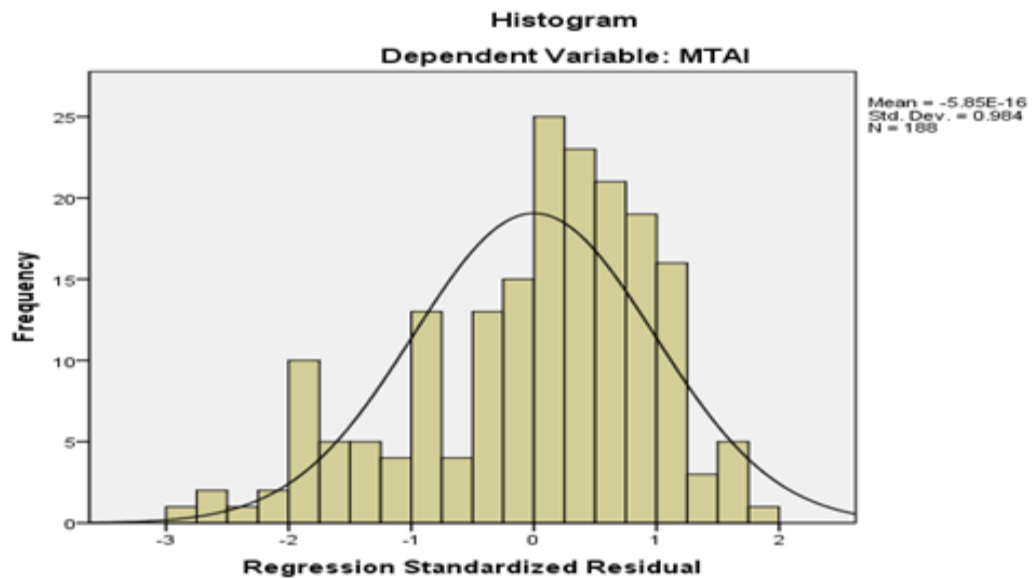


Figure 4.2  
*Normality Test for Auditor Independence.*

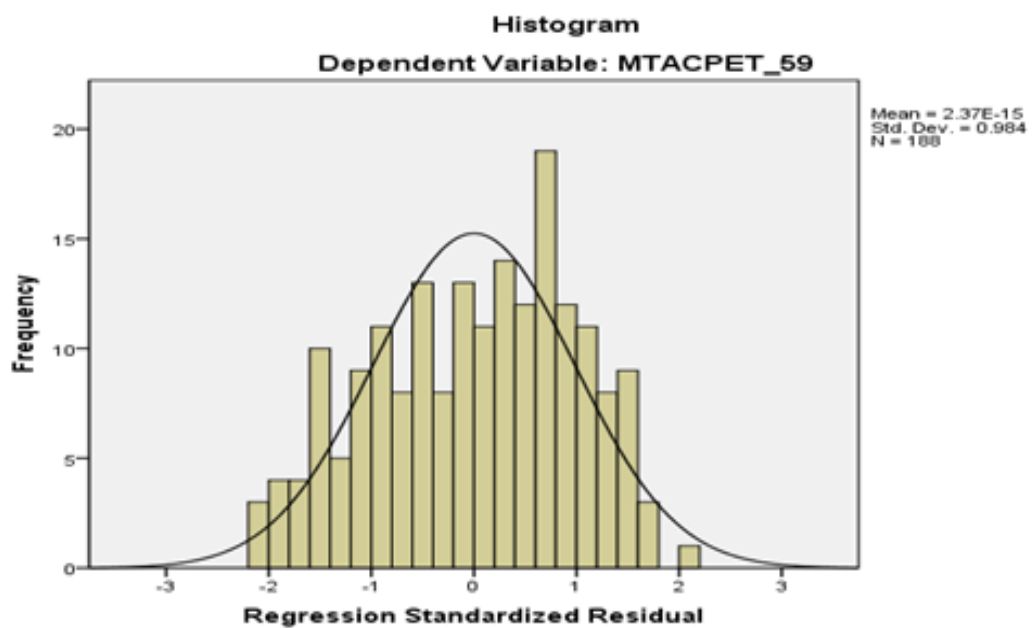


Figure 4.3  
*Normality Test for Auditor competence.*

#### 4.4.1.2 Linearity

It has been argued that for any standard multiple regression analysis to be accurate in its estimates of the relationships that exist between the dependent and the

independent variables, the relationships must be linear in nature. This is because there are several instances in some social sciences studies where non-linear relationships have occurred between the variables of study (Hau & Marsh, 2004).

Similarly, linearity can be checked by inspecting the Normal Probability Plot (P-P) of the regression standardised residual as suggested by several authors (Lattin *et al.*, 2003; Pallant, 2010). In the Normal Probability Plot, normality is indicated by points which lie in a reasonably straight line from bottom left to top right (Pallant, 2010). The linearity test for each of auditor independence (mediator), auditor competence (mediator), and reliability of audited financial statements (RAFS) (DV) was conducted. The following illustrations (Figures 4.4, 4.5 and 4.6) show that all the points lie in a reasonably straight line, therefore the assumption of normality happened and there are no major deviations from normality.

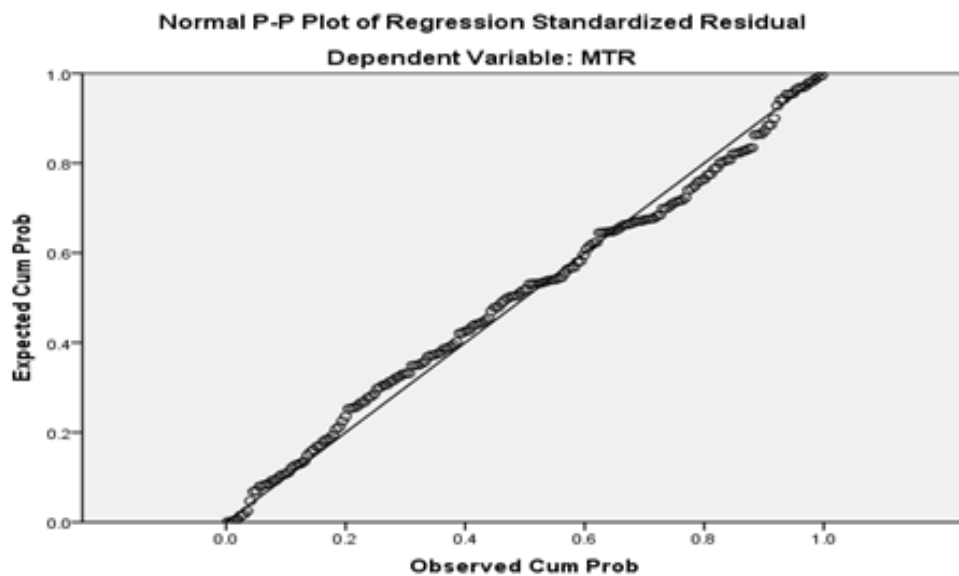


Figure 4.4  
*Test of Linearity of Reliability of Audited Financial Statements*

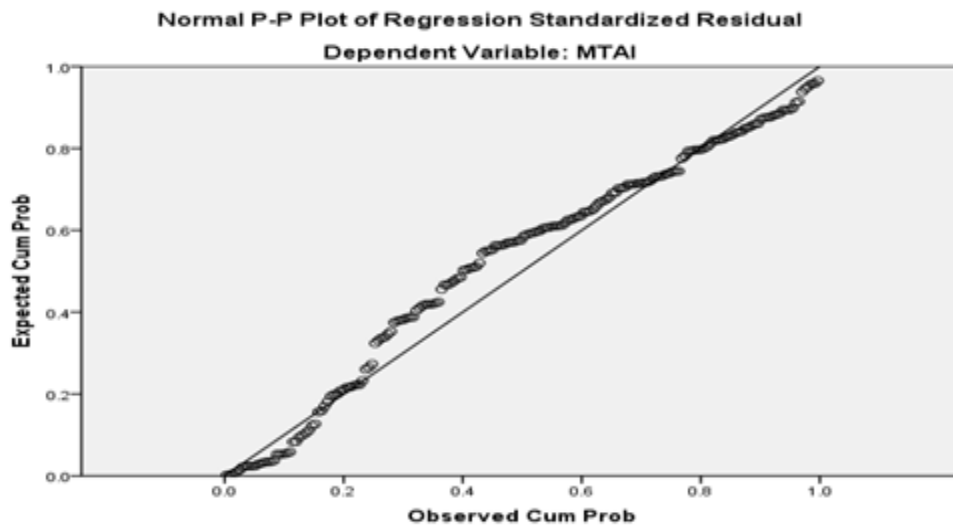


Figure 4.5  
*Test of Linearity of Auditor Independence*

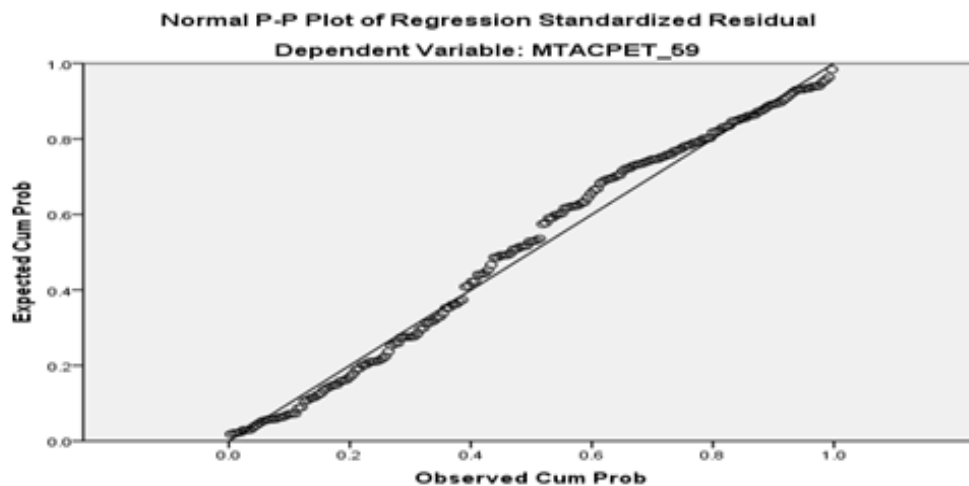


Figure 4.6  
*Test of Linearity of Auditor Competence*

#### 4.4.1.3 Homoscedasticity

Homoscedasticity occurs when the “variability in scores for one variable is roughly the same same at all values of the other variable” (Coakes, 2013, p. 64). Scatterplot diagrams are used to test homoscedasticity for both auditor independence and RAFS as well as auditor competence and RAFS. The scatterplot diagrams are depicted by Figure 4.7 and Figure 4.8. An inspection of the two scatterplots show that the

majority of scores or data points are concentrated in the center near to the zero point. In other words, there is no existing systematic pattern such as curvilinear, or the existence of the residuals in one side. Therefore, the assumption of homoscedasticity is met.

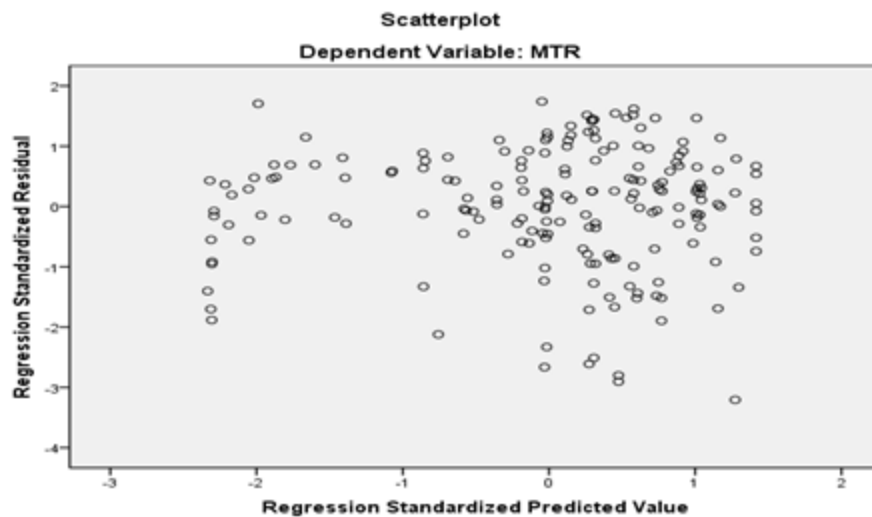


Figure 4.7  
*Test of Homoscedasticity between Reliability of Audited Financial Statements and Auditor Independence*

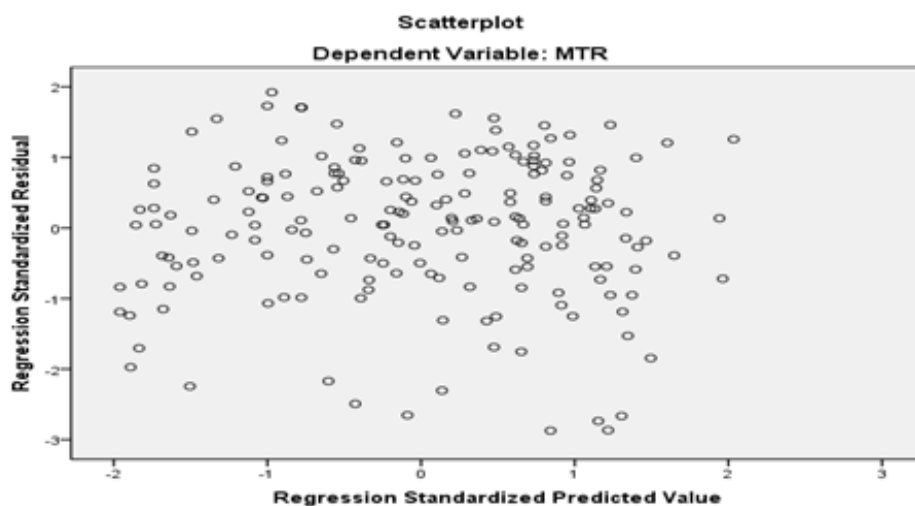


Figure 4.8  
*Test of Homoscedasticity between Reliability of Audited Financial Statements and Auditor Competence*



#### 4.5 Correlation Analysis

Correlation is a statistical technique used to investigate the existence of a linear relationship between the variables of a study (Bluman, 2011). Bluman added that this relationship can be simple between one independent variable and one dependent variable, or complex involving more dependent variables. A correlation coefficient is a numerical index that is usually utilised to determine the strength and direction of the linear relationship between two variables. The value of this correlation coefficient ranges between -1 and +1. Hence, the linear relationship can be either positive or negative. One of the most commonly used methods for identifying the correlation coefficients between two variables is the Pearson Product Moment Correlation Coefficient ( $r$ ). As indicated earlier, a correlation can range in value from -1 to +1. As outlined by Pallant (2010), the sign out the front reflects whether there is a positive correlation or a negative correlation. Notably, the absolute value of the coefficient is indicative of the strength of the correlation. For example, a correlation of -0.7 is stronger than a correlation of +0.5. Put another way, the assumption that a direct or positive relationship is always stronger than an indirect or negative correlation because of the sign is wrong. Generally, if the value of  $r$  is close to +1, then there is a strong positive relationship between the two variables. Meanwhile, if the value of  $r$  value is close to -1, then there is a strong indication that there is no association between the variables. However, if the value of  $r$  is 0 it suggests that there is no relationship or association between two variables.

Since all assumptions of linearity and normality are met in the study's data, the use of the Pearson Product Moment Correlation Coefficient to examine the relationship between variables is appropriate (see Hair *et al.*, 2007). To determine and interpret

the strengths of the correlations between two variables, Cohen (1988) provides a guideline that can be used by the researcher for the purpose of interpreting the relationships between different variables (refer to Table 4.9a).

Table 4.9a  
*Cohen's Guideline of Correlation Strength*

<i>r</i> values	Strength of relationship
$r = +.10$ to $.29$ or $r = -.10$ to $-.29$	Small
$r = +.30$ to $.49$ or $r = -.30$ to $-.49$	Medium
$r = +.50$ to $1.0$ or $r = -.50$ to $-1.0$	Large

Below is Table 4.9b which shows another guideline of interpreting a correlation coefficient.

Table 4.9b  
*Interpreting a Correlation Relationship*

Size of Correlation	Coefficient General Interpretation
0.8 to 0.1	Very strong relationship
0.6 to 0.8	Strong relationship
0.4 to 0.6	Moderate relationship
0.2 to 0.4	Weak relationship
0.0 to 0.2	Weak or no relationship

Base on the above two guidelines, the following interpretations are made to determine the strength and direction of the linear relationships between variables as captured in Table 4.9c.

From the Table 4.9c, it is observed that auditor independence has a weak positive relationship (small correlation) with the following attributes: provision of NAS, auditor rotation, and audit committees, size of audit firm, and audit firm fees. These relationships seem to be significant at the 0.05 significance level for provision of NAS, and auditor rotation. In much the same way, at the 0.01 significance level, these relationships seem to be significant for audit committees, audit firm size, and audit firm fees.

With regard to the RAFS, Table 4.9c shows that this variable correlates with all independent variables. The correlations between RAFS and provision of non-audit services, as well as with audit firm fees seem to be small (weak relationship). While the correlations between RAFS and auditor rotation, audit committees, and size of audit firm seem to be of medium range (moderate relationship). In addition, the correlations between RAFS and each of non-audit services, auditor rotation, size of audit firm, and audit committees seem to be positive but weak to moderate in terms of strength at the 0.01 significance level. Finally, Table 4.9c shows a positive but weak relationship between auditor independence and RAFS, and this weak relationship seems to be significant at the 0.01 level.

Table 4.9c which captures the correlations between independent variables, auditor competence and dependent variable. It is established that auditor competence has a negative but weak or no relationship with the provision of NAS and auditor rotation. It is also established that auditor competence has a positive but weak or no relationship with size of audit firm, audit firm fees, and audit committee. Meanwhile, the correlation between auditor competence and RAFS at the 0.01 significance level

is weak (refer to Table 4.9c). Finally, Table 4.9c shows a positive but moderate relationship between auditor independence and auditor competence at the 0.01 level of significance.

Table 4.9c

*The Correlation Analysis- All Variables*

		R	NAS	AR	AFS	AFF	AC	AI	ACP
Reliability	Pearson Correlation	1							
	Sig. (2-tailed)								
Non-Audit Services	Pearson Correlation	.210**	1						
	Sig. (2-tailed)	.004							
Auditor Rotation	Pearson Correlation	.378**	.210**	1					
	Sig. (2-tailed)	.000	.004						
Audit Firm Size	Pearson Correlation	.446**	.062	.486**	1				
	Sig. (2-tailed)	.000	.398	.000					
Audit Firm Fees	Pearson Correlation	.247**	.222**	.080	.201**	1			
	Sig. (2-tailed)	.001	.002	.274	.006				
Audit Committee	Pearson Correlation	.323**	-.007	.437**	.436**	.014	1		
	Sig. (2-tailed)	.000	.919	.000	.000	.853			
Auditor Independence	Pearson Correlation	.336**	.135	.180*	.291**	.279**	.193**	1	
	Sig. (2-tailed)	.000	.064	.014	.000	.000	.008		
Auditor Competence	Pearson Correlation	.247**	-.024	-.093	.046	.104	.049	.365**	1
	Sig. (2-tailed)	.001	.741	.206	.535	.157	.500	.000	

\*\*. Correlation is significant at the 0.01 level (2-tailed). N=188

\*. Correlation is significant at the 0.05 level (2-tailed). N=188

#### **4.6 Testing the Model Using Multiple Regression Analysis**

Basically, multiple regression analysis is a multivariate technique that is used to “predict scores on a dependent variable from scores of a number of independent variables” (Pallant, 2010, p. 122).

As indicated earlier, there are three major types of regression models, that is, standard or simultaneous, hierarchical and stepwise regression (Coakers, 2013; Pallant, 2010; Haier *et al.*, 2014). In this study, we utilise the standard or simultaneous model in which independent variables are entered in the regression equation at the same time to examine the relationship between the whole set of independent variables and the dependent variable (see Coakes, 2013). Notably, there are a variety of ways of presenting the output or results of multiple regression analysis. As a minimum, one should show what type of analysis was performed, standardised Beta coefficients if the study was theoretical, or unstandardised values if the study was applied (Pallant, 2010). As indicated by Hair *et al.* (2014), evaluating the multiple regression model requires the following steps: (1) examining the F value to determine the statistical significance of the model; (2) checking the square of multiple  $r$  ( $R^2$ ) to determine if it is large enough; (3) examining the regression coefficients and their t statistics (beta coefficients) to determine the independent variables that have statistically significant coefficients, and lastly; (4) conducting the regression with the independent variables resulting from step 3 to identify the influence of each independent variable. The above approaches of presenting the output of multiple regression analysis were applied in this study as demonstrated in the next sections.

#### 4.6.1 Multiple Regression Analysis between Independent Variables and dependent Variable

The output of the multiple regression analysis concerns the relationship between one continuous dependent variable (RAFS) and a number of independent variables or predictors (provision of NAS, auditor rotation, audit firm size, audit firm fees, and audit committees characteristics). The results of this multiple regression analysis are captured in Table 4.10.

From Table 4.10, we can observe the first three steps of the multiple regression of this model. First, F value can be considered to be statistically significant when its value does not exceed 0.05. Therefore, since the F value in this model is 0.000, we can accept the assumption that the model is statistically significant and the sample is unlikely to produce a large  $R^2$  when the population  $R^2$  is actually zero.

Table 4.10

*Multiple Regression between Independent Variables and RAFS*

Variable	Relevant Hypotheses	Expected Sign	Coeff	Std. Error	t-value	p-value
Constant				.055	4.760	.000
Non-Audit Services	H1c	-	.136	.047	2.113	.036
Auditor Rotation	H2c	+	.121	.059	1.603	.100
Size of Audit Firm	H3c	+	.236	.060	3.113	.002
Audit Firm Fees	H4c	-	.167	.067	2.591	.010
Audit Committees	H5c	+	.135	.057	1.883	.061

DV= Reliability of Audited Financial Statements,  
 $R^2 = 0.322$  Adj  $R^2 = 0.299$  F-Ratio= 14.313 Sig F=0.000\* N=188.

The other potential useful piece of information in Table 4.10 is the total  $R^2$  value for the model. As indicated in the coefficients table, all independent variables together

explain 32 percent of the variance ( $R^2$ ) in RAFS, which is statistically significant, as indicated by the F value of 14.31 (refer to Table 4.10). This result is premised on the recommendations made by Hair *et al.* (2014). According to Hair *et al.* (2014), the square of multiple r or  $R^2=0.20$  can be found to be statistically significant with the power of 0.80 when the sample size is 100 and the number of the independent variables is 10 at the 0.05 significance level. They also note that  $R^2=0.15$  can be found to be statistically significant with the power of 0.80 when the sample size is 100 and the number of the independent variable is 10 at the 0.01 significance level. Since the sample size of this study is 188, and the number of independent variables is 5,  $R^2=0.32$  can be considered statistically significant value and as a result demonstrate the goodness of the model.

Third, as indicated by Hair *et al.* (2007), a t-test can be used to determine which independent variables have statistically significant coefficients. An examination of the t-values indicates that several independent variables namely, provision of NAS, audit firm size and audit firm fees contributes to RAFS. Table 4.10 which is the coefficients table shows these significant independent variables, that is, the provision of NAS with a Beta value of 0.136 and significant level of 0.036 (p-value), audit firm size with a Beta value of 0.236, and significant level of 0.002, and finally audit firm fees with a Beta value of 0.167 and significant level of 0.010. In other words, these three variables have significant contributions in explaining RAFS at the 0.05 level. A close inspection of the Beta column shows that audit firm size has the largest Beta coefficient of 0.236 which means that this variable makes the strongest unique contribution to explaining the dependent variable. The Beta value for auditor rotation was the lowest (0.121), suggesting that it made the least contribution to explaining



RAFS. Since the Sig. values of the provision of NAS (0.036), audit firm size (0.002), and audit firm fees (0.167) are less than 0.05, these three variables make significant unique contributions to the prediction of the dependent variable. However, since the Sig. values of auditor rotation (0.10) and audit committees characteristics (0.06) are greater than 0.05, we can conclude that these variables do not make a significant unique contribution to the prediction of the dependent variable (RAFS). Such a scenario may be due to an overlap with other independent variables in the model.

#### 4.6.2 Multiple Regressions between Independent Variables and Auditor Quality

##### 4.6.2.1 Multiple Regression Analysis between Independent Variables and Auditor Independence

The output generated from this multiple regression analysis is basically similar to the previous output, but with a new dependent variable. In this regard, the same five independent variables were retained vis-à-vis the new dependent variable, that is, auditor independence. It should be noted that auditor independence is a proxy of auditor quality. The output of this analysis is captured in Table 4.11a below.

Table 4.11a

*Multiple Regression between Independent Variables and Auditor Independence*

Variable	Relevant Hypotheses	Expected Sign	Coeff	Std. Error	t-value	p-value
Constant				.071	2.442	.016
Non-Audit Services	H1a	-	.070	.060	.978	.329
Auditor Rotation	H2a	+	.019	.075	.221	.825
Size of Audit Firm	H3a	+	.214	.077	2.526	.012
Audit Firm Fees	H4a	-	.213	.085	2.962	.003
Audit Committees	H5a	+	.104	.073	1.308	.193

DV= Auditor Independence,  
 $R^2 = .158$  Adj  $R^2 = 0.130$  F-Ratio= 5.656 Sig F= 0.000 N=188.

Standard Multiple Regression was utilised to assess the ability of five independent variables to predict auditor independence. The first step was to check the sig. F value in this model. The value is 0.000 and thus we can accept the assumption that the model is statistically significant and that the sample is unlikely to produce a large  $R^2$  when the population  $R^2$  is actually zero. As depicted in Table 4.11a, all independent variables together explain 16 percent of the variance ( $R^2$ ) in the dependent variable (auditor independence), which is statistically significant, as indicated by Hair *et al.* (2014). The significance of the value is also supported by the F value of 5.66 (refer to Table 4.11a). Such results demonstrate the goodness of the model.

A close look at the Beta column shows that both audit firm size and audit firm fees have the largest Beta coefficient of 0.21 which means that these two variables make the strongest unique contribution to explaining the dependent variable. The Beta value for auditor rotation was the lowest (0.12), indicating that it made the least contribution to explaining auditor independence. In much the same way, a close inspection of the Sig. column (p-value) indicate that the Sig. values of the audit firm size (0.01), and audit firm fees (0.03) are less than 0.05, these two variables make significant unique contributions to the prediction of the dependent variable. However, since the Sig. values of provision of NAS (0.33), auditor rotation (0.83) and audit committees characteristics (0.2) are greater than 0.05, we can conclude that these variables do not make a significant unique contribution to the prediction of the dependent variable (auditor independence). As mentioned earlier, such a situation may be due to an overlap with other independent variables in the model.

#### 4.6.2.2 Bivariate Regression between Auditor Independent and Reliability of Audited Financial Statements (RAFS)

In essence, bivariate regression is a technique of predicting scores on one variable from scores on another variable (Pallant, 2010). In this section, we explore the relationship between auditor independence, and RAFS. The output of the regression analysis is presented in Table 4.11b below.

Table 4.11b  
*Regression between Auditor Independent and RAFS*

Variable	Relevant Hypotheses	Expected Sign	Coeff	Std. Error	t-value	p-value
Constant				.035	10.684	.000
Auditor independence	H6a	+	.336	.060	4.862	.001

DV= Reliability of Audited Financial Statements,  
R<sup>2</sup>= .113 Adj R<sup>2</sup>= 0.108 F-Ratio= 23.637 Sig F= 0.000 N=188.

Linear regression analysis was utilised to assess the ability of auditor independence to predict the dependent variable (RAFS). The results show that that auditor independence explains 11 percent of the variance (R<sup>2</sup>) in the dependent variable, which is regarded as statistically significant by Hair *et al.* (2014). The significance of the R<sup>2</sup> value is also supported by the F value of 23.64 (refer to Table 4.11b). Such results demonstrate the goodness of the model. Furthermore, the results in Table 4.11b show that auditor independence has a Beta coefficient of 0.336 and a significant value of 0.001, confirming that there is a positive significant relationship between the variable and the RAFS.

#### 4.6.2.3 Multiple Regressions between Independent Variables and Auditor Competence

The output generated from this multiple regression analysis examines the best prediction of a dependent variable (auditor competence) from several independent variables (Provision of NAS, auditor rotation, audit firm size, audit firm fees, and audit committees characteristics). It should be noted that auditor competence is a proxy of auditor quality. The output of this analysis is depicted in Table 4.12a below.

Table 4.12a

##### *Multiple Regressions between Independent Variables and Auditor Competence*

Variable	Relevant Hypotheses	Expected Sign	Coeff "Beta"	Std. Error	t-value	p-value
Constant				.072	7.507	.000
Non-Audit Services	H1b	+	-.010	.061	-.137	.891
Auditor Rotation	H2b	-	-.191	.076	-2.151	.033
Size of Audit Firm	H3b	+	.032	.078	.361	.719
Audit Firm Fees	H4b	+	.122	.086	1.611	.109
Audit Committees	H5b	+	.090	.074	1.068	.287

DV= Auditor Competence,  
 $R^2 = .061$ , Adj  $R^2 = 0.030$ , F-Ratio= 1.967 Sig F= 0.073 N=188.

Standard Multiple Regression was utilised to assess the ability of five independent variables to predict auditor competence. The first step was to check the sig. F value in this model. The value is 0.000 and thus we can accept the assumption that the model is statistically significant and that the sample is unlikely to produce a large  $R^2$  when the population  $R^2$  is actually zero. As shown in Table 4.12a, all independent variables together explain 6 percent of the variance ( $R^2$ ) in the dependent variable (auditor competence), which is marginally statistically significant, as indicated by Hair *et al.* (2014).

A close look at the Beta column shows that both auditor's rotation has the largest Beta coefficient of 0.2 which means that it makes the strongest unique contribution to explaining the dependent variable. The Beta value for provision of NAS is the lowest (0.01), indicating that it made the least contribution to explaining auditor competence. Similarly, a close check of the Sig. column (p-value) indicates that only the Sig. value of the auditor rotation is less than 0.05 suggesting that it is the only variable that makes a significant unique contribution to the prediction of the dependent variable. Notably, the other independent variables have the following Sig. values: provision of NAS (0.89), auditor firm size (0.72), auditor firm fees (0.11) and audit committees characteristics (0.29). Since these values are greater than 0.05, we can conclude that these four independent variables do not make significant unique contributions to the prediction of the dependent variable (auditor competence). As indicated earlier, such a situation may be due to an overlap with other independent variables in the model.

#### **4.6.2.4 Bivariate Regression between Auditor Competence and Reliability of Audited Financial Statements (RAFS)**

Basically, bivariate regression is a technique of predicting scores on one variable from scores on another variable (Pallant, 2010). In this section, we examine the relationship between auditor competence, and RAFS. The output of the regression analysis is presented in Table 4.12b below.

Table 4.12b

*Multiple Regressions between Auditor Competence on the Reliability of Audited Financial Statements*

Variable	Relevant Hypotheses	Expected Sign	Coeff "Beta"	Std. Error	t-value	p-value
Constant				.036	11.706	.000
Auditor Competence	H7a	+	.247	.064	3.471	.001

DV= Reliability of Audited Financial Statements,  
R<sup>2</sup>= .061 Adj R<sup>2</sup>= -0.056 F-Ratio= 12.047 Sig F= 0.001 N=188.

Linear regression analysis was used to assess the ability of auditor competence to predict the dependent variable (RAFS). The results of the output as indicated by Table 4.12b reveal that auditor competence explains 6 percent of the variance ( $R^2$ ) in the dependent variable, which is regarded as marginally statistical significant by Hair *et al.* (2014). Furthermore, the results in Table 4.12b show that auditor competence has a Beta coefficient of 0.25 and a significant value of 0.001, confirming that there is a positive significant relationship between the auditor competence and the RAFS.

#### 4.6.3 Measuring Mediating Effects Using Regression Analysis

This section discusses the mediating effects of the proxies of auditor quality, namely, auditor independence and auditor competence in the relationship between the independent variables and the dependent variable (RAFS). Basically, a mediator is an intervening variable which explains how and why a relationship exists between the independent variable and dependent variable (Baron & Kenny, 1986; Peyrot, 1996; Kim, Kaye & Wright, 2001). To put it differently, a mediator is a “mechanism through which an independent variable is able to influence a dependent variable” (Kim *et al.*, 2001, p. 69). In essence, a mediator may not have a direct impact on the dependent variable, but only a mediating effect by facilitating other things that do directly affect the independent variable. Generally, a mediator is often an intrinsic

characteristic or attribute of individuals as is the case in this study. Notably, there must be a significant relationship between the independent variable and the outcome variable before testing or assessing for a mediating effect (Baron & Kenny, 1986; Kim *et al.*, 2001). Notably, mediating effects can be investigated through structural equation modeling and path analysis methods (Kim *et al.*, 2001). However, this study utilises path analytic regression techniques. Prior to using path analysis, Pearson correlations among variables in the model are examined. After establishing significant correlations, three multiple regression analyses are conducted. In the first regression, the significance of the path from the independent variables to the mediator variable is examined. In the second regression analysis, the significance of the path between independent variables and the outcome variable is examined. In the third regression, the significance of the path from the mediator to outcome variable is examined by using independent variables and mediator as predictors of the dependent variable. If the path from independent variable to dependent variable in the third regression is reduced to zero, it provides strong evidence for a single, dominant mediator. If the path is not zero, it suggests that multiple mediating factors may be in force.

As indicated in the foregoing discussion, a mediator is a third variable that falls in the causal pathway between the independent variable and the outcome variable. Basing on the recommendations of Baron and Kenny (1986) as well as the above assumptions, to test the mediating impact of auditor independence in this study three regressions should be established as follows: (1) Regression analysis between provision of NAS, auditor rotation, audit firm size, audit firm fees, audit committee characteristics, and RAFS. (2) Regressions between provision of NAS, auditor

rotation, audit firm size, audit firm fees, audit committee characteristics, and auditor independence. (3) Regressing auditor independence on all independent variables (provision of NAS, auditor rotation, audit firm size, audit firm fees, audit committee characteristics) and RAFS. The output of the regression analysis is summarised in Table 4.13a.

Table 4.13a  
*Measuring Mediating Effects of Auditor Independence on the Reliability of Audited Financial Statements*

Variable	Relevant Hypotheses	Expected Sign	Coeff	Std. Error	t-value	p-value
Constant				.055	4.259	.000
Non-Audit Services	H6b	-	.123	.046	1.939	.054
Auditor Rotation	H6c	+	.117	.058	1.587	.114
Size of Audit Firm	H6d	+	.196	.060	2.584	.011
Audit Firm Fees	H6e	-	.127	.067	1.955	.054
Audit Committees	H6f	+	.115	.056	1.631	.100

DV=Reliability of Audited Financial Statements,  
R<sup>2</sup>= 0.352, Adj R<sup>2</sup>= 0.327, F-Ratio= 13.995 Sig F=0.000 N=188.

As shown in Table 4.13a, all the independent variables together account for 35 percent of the variance (R<sup>2</sup>) in RAFS due to the mediating impact of auditor independence. This result is quite respectable or significant, as indicated by the F value of 14.0 which is significant with a probability less than 0.001 (p< 0.001).

The Beta values tell us about the relationship between the dependent variable and each independent variable. If the value is positive, we can tell there is a positive relationship between the variables, whereas a negative coefficient reflects a negative relationship. Table 4.13a shows that three predictors (auditor rotation, audit firm size, and audit committee characteristics) have positive Beta coefficients suggesting



positive relationships. Likewise, the other two predictors (provision of NAS, and audit firm fees) have negative Beta values indicating negative relationships. However, the Beta values tell us more than this as indicated by Field (2009). According to Field (2009, p. 238) Beta coefficients tell us to what extent each independent variable affects the dependent variable if the effects of all other independent variables are held constant. In this regard, a perusal of the Beta column shows that audit firm size has the largest Beta value of 0.2 when rounded. This means that audit firm size makes the strongest unique contribution to explaining the dependent variable (RAFS), when the variance explained by all other variables in the model is controlled for. The outputs data also show that the Beta values for the other predictors were slightly lower, indicating that they made less of a unique contribution. Furthermore, since the standardised Beta values for provision of NAS (0.123), auditor rotation (0.117), audit firm fees (0.127) and audit committees (0.115) are virtually the same indicating that these variables have a comparable degree of importance in the model. These results concur with what the magnitude of the  $t$  values told us as indicated in the next paragraph.

An examination of the  $t$  values and Sig. values in Table 4.13a indicates whether the independent values are making a significant contribution to the model. In this instance, if the  $t$  value associated with Beta value is significant (if the value in the Sig. column is less than 0.05), then the independent variable is making a significant contribution to the prediction of the dependent variable. In other words, the smaller the value of Sig. value (and the larger the coefficient of  $t$ ) the greater the contribution of the independent variable. For this model, audit firm size ( $t = 2.58$ ,  $p < 0.001$ ) is a significant predictor of RAFS. Since, the Sig. values of the other variables are either

equal or greater than 0.05, we can conclude that the variables (provision of NAS with a Sig. value of 0.05; auditor rotation with a Sig. value of 0.11, audit firm fees with a Sig. value of 0.05, and audit committees characteristics with a Sig. value of 0.10) do not make a significant unique contribution to the prediction of the dependable variable.

As indicated earlier, to test the mediating effect there should be a significant relationship between each construct of independent variables and the dependent variable (Baron & Kenny, 1986). As a result, several variables were subsequently excluded for not meeting this condition with the exception of audit firm size and audit firm fees. Hence, the following regression analysis is limited to variables that met the foregoing condition (audit firm size and audit firm fees). The following section discusses the testing of the mediating effects of auditor independence on the relationship between each of these two constructs, audit firm size and audit firm fees and the RAFS. Table 4.13b displays the results of the output. A check of the values in the third column show that audit firm size is significantly related to the RAFS ( $B = 0.236$ ,  $P < 0.05$ ). However, when included the variable of auditor independence in the equation, the Beta value is reduced and the relationship is still significant as shown in the fourth column ( $B = 0.196$ ,  $P < 0.05$ ). Therefore, this result indicates that the relationship between audit firm size and the RAFS is partially mediated.

Second, Table 4.13b shows that audit firm fees are also significantly related to the RAFS ( $B = 0.167$ ,  $P < 0.05$ ). However, when included the construct of auditor independence in the equation the Beta value is reduced and the relationship became insignificant as shown in the fourth column ( $B = 0.127$ ,  $P > 0.05$ ), and thus,

technically, we would not reject the null hypothesis of no mediation. However, it should be remembered that .05 is an arbitrary cut-off value, and 0.054 is very close to it when rounded, and therefore we have some evidence for partial mediation. Consequently, it can be accepted that auditor independence mediated the relationship between audit firm fees and RAFS. Below is Table 4.13b with the output of the multiple regression analysis.

Table 4.13b  
*Summary of the Result of Regression Analyses for Mediation*

Predictors variables	Criterion variables		
	size of audit firm and audit firm fees with auditor independence Std. B	size of audit firm and audit firm fees without auditor independence Std.B	Auditor independence with size of audit firm , audit firm fees and reliability of audited financial statements Std.B
Size of Audit Firm	0.214**	0.236**	0.196*
Audit Firm Fees	0.213**	0.167**	0.127*
R <sup>2</sup>	0.158	0.322	0.352
Adj.R <sup>2</sup>	0.130	0.299	0.327
R <sup>2</sup>	0.158	0.322	0.352
F change	5.656	14.313	13.995

\*\*\*significant at the 0.001 level.

\*\*significant at the 0.01 level;

\* significant at the 0.05 level;

Meanwhile, Table 4.14a captures the output of the regression analysis to test the mediating effects of Auditor Competence in the relationship between five independent variables (provision of NAS, auditor rotation, audit firm size, audit firm fees, audit committee characteristics), and the dependent variable (RAFS). As in the previous case, the regression model assumes a three variable system. First, a direct and significant relationship between each of the independent variables and RAFS is

established. After introducing the mediator variable (auditor competence) the path between independent variable and dependent variable becomes non-significant. In this situation, the independent variable now influences the mediator, and mediator now influences dependent variable.

As shown in Table 4.14a, all the independent variables together explain for 36 percent of the variance ( $R^2$ ) in RAFS due to the mediating impact of auditor independence. This result is quiet respectable, as indicated by the F value of 14.69 which is significant with a probability less than 0.001 ( $p < 0.001$ ).

Table 4.14a  
*Measuring Mediating Effects of Auditor Competence on the Reliability of Audited Financial Statements*

Variable	Relevant Hypotheses	Expected Sign	Coeff	Std. Error	t-value	p-value
Constant				.062	2.606	.000
Non-Audit Services	H7b	-	.139	.046	2.210	.028
Auditor Rotation	H7c	+	.161	.058	2.171	.031
Size of Audit Firm	H7d	+	.230	.059	3.111	.002
Audit Firm Fees	H7e	-	.141	.065	2.240	.026
Audit Committees	H7f	+	.116	.056	1.661	.098

DV= Reliability of Audited Financial Statements,  
 $R^2 = 0.363$ , Adj  $R^2 = 0.339$ , F-Ratio= 14.685 Sig F= 0.000 N=188.

The output of the Beta values in explaining the relationship between the independent variables and the dependent variable are similar to those as depicted in Table 4.13a in the preceding regression analysis. In much the same way, Table 4.14a shows that three predictors (auditor rotation, audit firm size, and audit committee characteristics) have positive Beta values indicating positive relationships. On the other hand, the other two predictors (provision of NAS, and audit firm fees) have negative Beta values indicating negative relationships. However, the Beta values tell

us more than this as indicated by Field (2009). As stated by Field (2009, p. 238), Beta coefficients tell us to what degree each independent variable affects the dependent variable if the effects of all other independent variables are held constant. In this regard, a perusal of the Beta column shows that audit firm size has the largest Beta value of 0.23. This means that audit firm size makes the strongest unique contribution to explaining the dependent variable (RAFS), when the variance explained by all other variables in the model is controlled for. The output data also show that the Beta values for the other predictors were slightly lower, indicating that they made less of a unique contribution. Furthermore, the standardised Beta values for provision of NAS (0.139), and audit firm fees (0.141) are virtually similar indicating that these variables have a comparable degree of importance in the model. These results concur with what the magnitude of the *t* values told us as indicated in the next paragraph.

An examination of the *t* values and Sig. values in Table 4.14a indicates whether the independent values are making a significant contribution to the model. In this instance, if the *t* value associated with Beta value is significant (if the value in the Sig. column is less than 0.05), then the independent variable is making a significant contribution to the prediction of the dependent variable. Put another way, the smaller the value of Sig. value (and the larger the coefficient of *t*), the greater the contribution of that independent variable. For this model, audit firm size ( $t = 3.11$ ,  $p < 0.001$ ) is a significant predictor of RAFS because its Sig. value (0.002) is less than 0.05. Since, the Sig. values of three other variables are less than 0.05, we can also conclude that the variables (provision of NAS with a Sig. value of 0.028; auditor rotation with a Sig. value of 0.031, and audit firm fees make significant contribution

to the prediction of the dependent variable. Since the Sig value of audit committee characteristics (0.098) is greater than 0.005 we can conclude that this variable does not make a significant unique contribution to the prediction of the dependable variable (RAFS). This may be due to an overlap with other predictors in the model.

As mentioned earlier, to assess the mediating effects there should be a significant relationship between each construct of independent variable and the dependent variable (auditor competence). As such several variables were subsequently excluded for not meeting this condition with the exception of two variables, namely, auditor rotation and audit firm fees. Hence, the following regression analysis is limited to the output of these two variables that met the underlined condition. As is evident the following section discusses the testing of the mediating effects of auditor competence on the relationship between each of these two constructs, auditor rotation and audit firm fees and the RAFS. Table 4.14b displays the results of the output. An inspection of the values in the third column show that auditor rotation is significantly related to the RAFS ( $B = 121$ ,  $P < 0.10$ ). However, when included the variable of auditor competence in the equation, the Beta value is enhanced and the relationship is still significant as shown in the fourth column ( $B = 0.161$ ,  $P < 0.05$ ). Therefore, this result indicates that the relationship between audit rotation and the RAFS is not mediated. Hence the null hypothesis is accepted.

Second, Table 4.14b shows that audit firm fees are also significantly related to the RAFS ( $B = 0.167$ ,  $P < 0.01$ ). However, when included the construct of auditor competence in the equation, the Beta value is reduced and the relationship became insignificant as shown in the fourth column ( $B = 0.141$ ,  $P > 0.05$ ). Technically, we

could not reject the null hypothesis suggesting no mediation. As a result, it can be accepted that auditor competence mediated the relationship between audit firm fees and RAFS. Below is Table 4.14b with the output of the multiple regression analysis.

Table 4.14b  
*Summary of the result of Regression Analyses for Mediation*

Predictors variables	Criterion variables		
	Auditor Rotation and audit firm fees with auditor competence Std. B	Auditor Rotation and audit firm fees without auditor competence Std.B	Auditor competence with Auditor Rotation, audit firm fees and reliability of audited financial statements Std.B
Auditor Rotation	-0.191*	0.121+	0.161*
Audit Firm Fees	0.122+	0.167**	0.141*
R <sup>2</sup>	0.061	0.322	0.363
Adj.R <sup>2</sup>	0.030	0.299	0.339
R <sup>2</sup>	0.061	0.322	0.363
F change	1.967	14.313	14.685

\*\*\*significant at the 0.001 level;

\*\*significant at the 0.01 level;

\*significant at the 0.05 level;

+significant at the 0.10 level.

#### 4.6.4 The Sobel Test

##### 4.6.4.1 The Sobel Test for Mediator (Auditor Independence)

The Sobel Test, as stated by Baron and Kenny (1986), provides a test of whether the mediator is related to the outcome variable as well as an estimate of the relationship between the predictor variable and the outcome variable; which control the mediator. If the relationship between the independent variable and the dependent variable controlling for the mediator is zero, the data is consistent with a complete mediator model i.e. the mediator completely accounts for the relation between the independent and dependent variable. If the relationship between the independent variable and the dependent variable is significantly smaller than when the mediator is in the equation;

than when the mediator is not in the equation, but still greater than zero, the data suggests partial mediation.

The Sobel test equation is as follows:

$$Z\text{-value} = a*b/\text{SQRT}(b^2*s_a^2 + a^2*s_b^2)$$

Where:

$a$  = raw (unstandardised) regression coefficient for the association between predictor and mediator.

$S_a$  = standard error of  $a$ .

$b$  = raw (unstandardised) regression value for the association between the mediator and the dependent variable (when the independent variable is also a predictor of the outcome variable).

$S_b$  = standard error of  $b$ .

The first regression of independent variable (audit firm size) and auditor independence, gives a value of  $a$  and  $S_a$  (Model 1). Then, the third regression of independent variable (audit firm size) and auditor independence on the RAFS gives a value of  $b$  and  $S_b$ , and subbing the figures from Table 4.15a into the formula gives the following answer.

The results for this analysis are shown in the Table 4.15a. As indicated in the previous section, prior to testing the mediating effects, the independent variable must be significantly associated with the outcome variable and with the mediator. In this



regard, it is established that audit firm size has a significant relationship with the mediator i.e. auditor independence (Model 1) and the dependent variable i.e. RAFS (Model 2). Thus, it met the requirements of 1 and 2 for testing the mediating effect. In the third equation, when the auditor independence was added in the equation, it has a significant relationship with RAFS. This indicates that auditor independence is a mediator is a mediation variable. When auditor independence is controlled, the relation between the independent variable i.e. audit firm size and the dependent variable is zero, the Beta coefficient for audit firm size decreases from  $b = 0.446$  to  $b = 0.380$  which was slightly lower, indicating that it make less of a unique contribution to the prediction of the dependable variable (RAFS). This may have been caused by an overlap with other predictors in the model. Each dimension of audit firm size explains 19.9 percent of variance in the RAFS. When auditor independence is added, the variance increases to 24.5 percent.

Table 4.15a  
*Regression Analyses for Mediation by SOBEL TEST (Size of Audit Firm)*

Model	1			2			3		
DV	Auditor independent			Reliability of Audited FSs			Reliability of Audited FSs		
IV	Coeff (B)	Std. Error	Beta	Coeff. (B)	Std. Error	Beta	Coeff. (B)	Std. Error	Beta
Intercept	0.398	0.036		0.348	0.030		0.270	0.037	
Audit Firm Size	0.266	0.064	0.291***	0.355	0.052	0.446***	0.303	0.053	0.380***
Auditor independe nt							0.196	0.058	0.225***
R <sup>2</sup>	0.085			0.199			0.245		

\*\*\*significant at the 0.001 level;

\*\*significant at the 0.01 level;

\*significant at the 0.05 level.

The Sobel Test performs a statistical test to see if the indirect path from the predictor to the dependent variable is statistically significantly different from zero. This provides support for partial mediation. The Sobel Test is equal to 3.3617441, with a standard error of 0.02397506, while the p-value is equal to 0.00077452. Assuming we had set our alpha at 0.05, the researcher would conclude that the relationship between Audit Firm Size and RAFS is mediated by Auditor Independence after having statistically controlled for the Provision of NAS, Auditor Rotation, Audit Firm Fees, and Audit Committee Characteristics. Therefore, the statistical conclusion is as follows:

$$Z\text{-value} = 0.266 * 0.303 / \text{SQRT} (0.303^2 * 0.064^2 + 0.266^2 * 0.053^2) = 0.080598 / \text{SQRT} (0.000574803268) = 0.080598 / 0.023975055 = 3.36$$

The test shows that Auditor Independence has a significant mediating effect (since  $3.36 > 1.96$ ; significant at  $p = 0.05$ ) on the relationship of Audit Firm Size and RAFS.

The second regression test for indirect relationship is to test Audit Firm Fees in the relationship between Auditor Independence and RAFS. The results for this analysis are shown in Table 4.15b. Audit firm fees has a significant relationship with the mediator i.e. Auditor Independence (Model 1) and dependent variable i.e. RAFS (Model 2). Thus, it met the requirements of 1 and 2 for testing the mediating effect. In the third equation, when the auditor independence was added in the equation, it is established that it has a significant relationship with RAFS; indicating that independence is mediation variable. When Auditor Independence is controlled, the relationship between the independent variable i.e. Audit Firm Fees and the dependent

variable is zero, the Beta coefficient for Audit Firm Fees decreases from  $b = 0.247$  to  $b = 0.166$  which was slightly lower, indicating that it made less of a unique contribution to the prediction of the outcome variable (RAFS). This may be due to an overlap with other predictors in the model. Each dimension of Audit Firm Fees explains 6.1 percent of variance in RAFS. However, when auditor independence is added, the variance increases to 13.8 percent.

Table 4.15.b

*Regression Analyses for Mediation by SOBEL TEST (Audit Firm Fees)*

Model	1			2			3		
DV	Auditor independent			Reliability of Audited FSs			Reliability of Audited FSs		
IV	Coeff. (B)	Std. Error	Beta	Coeff. (B)	Std. Error	Beta	Coeff. (B)	Std. Error	Beta
Intercept	0.362	0.046		0.397	0.040		0.306	0.045	
Audit Firm Fees	0.331	0.083	0.279***	0.254	0.073	0.247***	0.171	0.073	0.166*
Auditor independent							0.252	0.062	0.289***
R <sup>2</sup>	0.078			0.061			0.138		

\*\*\*significant at the 0.001 level;

\*\*significant at the 0.01 level;

\*significant at the 0.05 level.

Therefore:

$$Z\text{-value} = 0.331 * 0.171 / \text{SQRT} (0.171^2 * 0.083^2 + 0.331^2 * 0.073^2) = 0.056601 / \text{SQRT} (0.000785291818) = 0.056601 / 0.028023058 = 2.01$$

The Z-value calculated above gives a mediation effect; if the z-score is greater than +/- 1.96; the effect is significant at the 0.05 level (Frazier *et al.*, 2004). Thus, the test shows that Auditor Independence has a significant mediating effect (since  $2.01 > 1.96$ ; significant at  $p = 0.05$ ) with Audit Firm Fees and RAFS.

#### 4.6.4.2 The Sobel Test for Mediation (Auditor Competence)

Table 4.16  
*Regression Analyses for Mediation by SOBEL TEST (Audit Firm Fees)*

Model	1			2			3		
DV	Auditor competence			Reliability of Audited FSs			Reliability of Audited FSs		
IV	Coeff. (B)	Std. Error	Beta	Coeff. (B)	Std. Error	Beta	Coeff. (B)	Std. Error	Beta
Intercept	0.445	0.046		0.397	0.04		0.307	0.049	
Audit Firm Fees	0.118	0.083	0.104 <sup>^</sup>	0.254	0.073	0.247***	0.230	0.072	0.223**
Auditor competence							0.202	0.063	0.223***
R <sup>2</sup>	0.011			0.061			0.110		

\*\*\*significant at the 0.001 level;

\*\*significant at the 0.01 level;

\*significant at the 0.05 level;

<sup>^</sup> not significant.

The Sobel Test performs a statistical test to see if the indirect path from the predictor to the dependent variable is statistically significantly different from zero. This notion provides support for partial mediation. Table 4.16 show that the test statistic is equal to 1.29886181, with standard error 0.02089522 and a statistical significance equal to 0.19399136. Assuming we had set our alpha at 0.05, we can conclude that the relationship between Audit Firm Fees and RAFS is not mediated by Auditor Competence after having statistically controlled for Provision of NAS, Auditor Rotation, Audit Firm Size, and Audit Committee Characteristics. Since the p-value in the Sobel Test bigger than 0.05 (p-value = 0.19), the statistical conclusion is as follows:

$$Z\text{-value} = 0.118 \times 0.230 / \text{SQRT} (0.230^2 \times 0.083^2 + 0.118^2 \times 0.072^2) = 0.02714 / \text{SQRT} (0.000436610116) = 0.02714 / 0.020895217 = 1.29$$

The Z value calculated above gives a mediation effect, if the Z score is greater than +/- 1.96; the effect is significant at the 0.05 level (Frazier *et al.*, 2004). Thus, the test shows that Auditor Competence has an insignificant mediating effect (since  $1.29 < 1.96$ ; significant at  $p = 0.05$ ) on the relationship between Audit Firm Fees and RAFS.

#### 4.7 Testing the Hypotheses of the Study

This section presents the findings of the statistical tests of the hypotheses. The following table (Table 4.17) summarises the results of hypotheses testing which are based on correlation and regression analyses.

Table 4.17  
*Summary of the Hypothesis Testing Results*

Hypothesis Number	Statement of Hypothesis	Remarks	Coeff	P-value
H1a	Non-audit service is negatively related to auditor independence.	Not Supported	0.070	0.329
H1b	Non-audit service is positively Related to auditor competence.	Not Supported	-0.010	0.891
H1c	Non-audit service is negatively related to reliability of audited financial statement.	Not Supported	0.136	0.036
H2a	Auditor rotation is positively related to auditor independence.	Not Supported	0.019	0.825
H2b	Auditor rotation is negatively related to auditor competence.	Supported	-0.191	0.033
H2c	Auditor rotation is positively related to reliability of audited financial statement.	Supported	0.121	0.10
H3a	Size of audit firms is positively related to Auditor Independence.	Supported	0.21	0.012
H3b	Size of audit firms is positively related to auditor competence.	Not Supported	0.032	0.719
H3c	Size of audit firms is positively related to Reliability of Audited Financial Statement.	Supported	0.236	0.002
H4a	Size of audit firms fees is negatively related to Auditor Independence.	Not Supported	0.213	0.003
H4b	Size of audit firms fees is positively related to auditor competence.	Supported	0.122	0.10
H4c	Size of audit firms fees is negativelyrelated to reliability of audited financial statement.	Not Supported	0.167	0.010
H5a	Audit committee characteristics are positively related to auditor independence.	Not Supported	0.104	0.193

Table 4-17 (Continued)

H5b	Audit committee characteristics are positively related to auditor competence.	Not Supported	0.090	0.287
H5c	Audit committee characteristics are positively related to reliability of audited financial statement.	Supported	0.135	0.061
H6a:	Auditor independence is positively related to reliability of audited financial statement.	Supported	0.336	0.001
H6b	Auditor independence negatively mediated the relationship between NAS and reliability of audited financial statement.	Supported	0.123	0.054
H6c	Auditor independence positively mediated the relationship between auditor rotation and reliability of audited financial statement.	Not Supported	0.117	0.114
H6d	Auditor independence positively mediated the relationship between size of audit firms and reliability of audited financial statement.	Supported	0.196	0.011
H6e	Auditor independence negatively mediated the relationship between audit firm fees and reliability of audited financial statement.	Not Supported	0.127	0.054
H6f	Auditor independence positively mediated the relationship between audit committee characteristics and reliability of audited financial statement.	Supported	0.115	0.10
H7a	Auditors' competence is positively related to reliability of audited financial statement.	Supported	0.247	0.001
H7b	Auditor competence negatively mediated the relationship between NAS and reliability of audited financial statement.	Not Supported	0.139	0.028
H7c	Auditor competence positively mediated the relationship between auditor rotation and reliability of audited financial statement.	Not Supported	0.161	0.031
H7d	Auditor competence positively mediated the relationship between size of audit firms and reliability of audited financial statement.	Not Supported	0.230	0.002
H7e	Auditor competence negatively mediated the relationship between audit firm fees and reliability of audited financial statement.	Supported	0.141	0.026
H7f	Auditor competence positively mediated the relationship between audit committee characteristics and reliability of audited financial statement.	Not Supported	0.116	0.09

## 4.8 Discussion

The previous section presented a summary of the key results of the study. In this section, we seek to establish whether the main findings of this study were able to address the key objectives of the research. In this regard, the hypotheses investigated in this study found some proof with respect to the objectives of this study and also confirmed the findings of some existing studies. Generally, there is a belief that corporate governance triggers processes that could eventually lead to financial reporting quality (see Norwani, Mohammad & Chek, 2011). Drawing inspiration

from the foregoing, the main purpose of this study is to investigate the relationship between corporate governance mechanisms, auditor quality and the RAFS in the context of Libya. It would be also interesting to extend debate on the role of corporate governance mechanisms in enhancing financial reporting quality to peripheral countries such as Libya. Notably, the purpose of this study is fourfold:

- to extend the evidence linking external corporate governance mechanisms to auditor quality.
- to examine the relationship between internal corporate governance practices and auditor quality.
- to support the auditor quality – reliability of audited financial statements (RAFS) relationship in the Libyan context.
- to improve the understanding of why and how auditor quality influence the RAFS.

Based on the significant results of this study, the impact or effect of corporate governance mechanisms on auditor quality and RAFS has yielded mixed results. The following sections discuss the major findings of this study in line with the research objectives as well as the empirical findings highlighted in the previous studies.

#### **4.8.1 External Corporate Governance Mechanisms and Auditor Quality**

One of the key objectives of this study is to investigate the relationship between external corporate governance mechanisms (represented by provision of NAS, auditor rotation, audit firm size & audit firm fees) and auditor quality (measured by auditor independence & auditor competence). In view of the foregoing, the impact on auditor independence of the joint provision of audit and NAS by auditors has

attracted scholarly attention and hence, it has been extensively debated. Undoubtedly, the issue of the provision of NAS and how it affects auditor quality is an issue of major concern to regulators and policymakers alike. As a result, a number of studies have investigated whether the joint supply of audit services and NAS impair auditor independence as discussed in the next section.

#### **4.8.1.1 Provision of Non-Audit Services and Auditor Quality**

Generally, regulators have voiced their concerns about auditor independence both ‘in fact’ and ‘appearance’, because of the incredible growth in the provision of NAS fees vis-à-vis audit fees. Available evidence from prior works shows that the provision of NAS by the same auditing firm providing auditing services will potentially lead to close economic ties between the audit firm and its client’s management due to significant high fees that are involved (Frankel *et al.*, 2002; Geiger *et al.*, 2002; Chen *et al.*, 2009; Zerni, 2009). Notably, Geiger *et al.*, (2002) empirically showed that the presence of NAS practically threaten the independence of external auditors because the economic bonding that will evolve between the audit firm and its clients would have a major influence on auditor independence. The rationale is that as the magnitude of provision of NAS fees increases, the auditor’s economic reliance on the client increases which in turn increases the auditor’s vulnerability to give in to client demands and pressure, resulting in biased and manipulated financial reporting. This thinking is captured in other studies (Abu Bakar *et al.*, 2005; Alleyne *et al.*, 2006; Higgs & Skantz, 2006; Al-Ajmi, 2009) which establish that the provision of NAS (including managerial advisory services) compromise auditor independence, and hence undermine audit quality. The foregoing finding is corroborated by Zerni (2009) who notes that increases in economic ties between the auditor and the client’s



management may jeopardise the appearance of auditor independence. Similarly, Adebayo (2011) establishes that auditor independence as well as credibility of financial statements are significantly impaired when NAS are provided by audit firms. In a related study, Al-Ajmi and Saudagaran (2011) find that some of the most auditor independence-threatening factors include economic reliance of auditors on their clients and the provision of NAS. Likewise, Law (2008) reveals that the provision of NAS could have a negative influence on perceived auditor independence.

Nevertheless, the findings of this study do not support the contention that the provision of NAS by contracted auditors is negatively related to auditor independence. The p-value (0.329) shows that there is no statistically significant relationship between auditor independence and the extent of purchases of NAS. In other words, the joint provision of NAS by auditors has no significant effect on their independence. In a way, this finding provides limited or no support for the proposition that perceived auditor independence is weakened by high NAS fees. More importantly, this result challenges conventional wisdom which indicates that the joint provision of NAS and audit services creates an economic attachment or bond that can actually undermine auditor independence. As indicated by Krishnan *et al.* (2005), there are countervailing factors that may offset the inducements arising from the economic bond such as auditors' incentives to remain independent as well as concerns about safeguarding their reputation and avoiding litigation or suits. It should be pointed out that the results of this study indirectly confirm the findings of other prior researches which indicate that the provision of NAS has no effect on auditor practices and auditor independence (Chen *et al.*, 2001; Jenkins & Krawczyk,

2001; Ashbaugh *et al.*, 2003; Kinney *et al.*, 2004; Sori, 2005; Hua *et al.*, 2010). Generally, these studies do not establish empirical proof indicating that auditors violate their independence due to clients purchasing relatively more of their non-auditing services. Chen *et al.* (2002) identify the provision of NAS as one of the least influential factors in determining audit quality.

In much the same way, other studies have established that the joint provision of NAS and audit has neither positive nor negative effect on auditor independence (DeFond *et al.*, 2002; Geiger *et al.*, 2002; Francis, 2006; Ghosh & Kallapur, 2006; Mitra, 2007; Church & Zhang, 2011). As stated by Geiger *et al.* (2002), the conflicting evidence in support of the proposition which states that joint provision of NAS and auditing services by the same external auditors threatens auditor independence is no longer a major concern. For instance, Chung and Kallapur (2003) tested the economic theory of auditor independence that hypothesises the likelihood of auditor independence impairment due to incentives such as high audit fees. On the contrary, their study revealed that there is no relationship between abnormal accruals and the client importance ratios, thereby providing proof that is not consistent with conventional wisdom as represented by the economic theory of auditor independence. Similarly, Francis (2006) argues that there is no direct proof that show that audit quality is impaired or undermined by the supply of NAS to audit clients. Likewise, Mitra (2007), in a related research, also shows no evidence in favour of the proposition that the provision of NAS undermines audit quality and auditor independence. Mitra establishes that abnormal accrual adjustments are not associated with the fees paid for NAS. According to Mitra, industry specialisation and safeguarding or protecting reputation are adequate incentives to make sure auditors

remain independent. In addition to the foregoing are other studies which also found no evidence in support of the impairedness of NAS on auditor independence (Ashbaugh *et al.*, 2003; Raghunandan, 2003; Whisenant *et al.*, 2003; Ruddock *et al.*, 2006).

Some existing studies have established that the joint provision of NAS and audit services will boost the auditor's knowledge about the client's company and thus increase auditors' independence and objectivity (Dopuch *et al.*, 2003; Arrunada, 2010; Lassila, Omer, Shelley, & Smith, 2010). In much the same way, Lassila *et al.* (2010) reveals that companies or firms with strong corporate governance systems projected benefits from knowledge spillover to outweigh costs from perceived auditor independence impairment. Some of these advocates of NAS list several benefits that could be gained by the external auditors and their clients from providing such services. Dopuch *et al.*, (2003) demonstrate that the provision of NAS to high-level clients may increase the auditors' reputation, causing them to be more independent. Nonetheless, scholars and practitioners keep raising the key question of what impact will the joint provision of audit services and NAS have on the impartiality of external auditors. Basing on the above findings, one can suggest that there is no significant threat posed by the supply of NAS on auditor independence. On the contrary, one can also conclude that the joint provision of audit and NAS can undermine auditor independence. As indicated earlier, the contradictory evidence on the effect of the joint provision of auditing and NAS by the same external auditors on auditor independence is no longer a major concern (Geiger *et al.*, 2002). Rather, establishing the joint impact of NAS and auditor independence on RAFS remains a subject of intense debate (Al-Ajmi & Saudagaran, 2011). Hence, there has been a

growing realisation of the continuous rapid increase in the growth of NAS which has practically increased the economic reliance of audit firms on their clients, further subjecting the auditors to the risk of impartiality and misstatement. Flaming (2002) reaches a similar conclusion as his study indicates that investors' perception of auditor independence is negatively affected by the provision of NAS and added that the auditor will be unwilling to adversely report on items that are the product of, or partly the result of, his or her consultancy advice.

In much the same way, Kinney *et al.* (2004) utilise financial restatements as the measure of auditor independence, and discover some positive relationship between certain unspecified NAS fees and financial restatements, especially for large companies. Some of the supportive studies reveal that the joint provision of NAS and audit services will increase the auditor's knowledge about the client's industry and accounting system, and thereby increasing auditors' independence and objectivity (Dopuch *et al.*, 2003; Arrunada, 2010). For these reasons, the main concerns within the auditing profession is more on the ability of the auditors to objectively and impartially examine the clients' financial records while at the same time getting those lucrative fees that are coming from the provision of NAS to the same client (Sharma & Sidhu, 2001; Firth, 2002; Kinney *et al.*, 2004; Awadallah, 2006; Hay, Knechel & Li, 2006). Not surprisingly, there is controversy or heated debate surrounding auditors ability to assess objectively the client's financial statements while at the same time providing advisory services or NAS to the same client. As indicated by Zaman *et al.* (2011), the joint provision of audit and NAS builds a perception that auditors might impair their independence and be improperly driven by a longing to maintain their clients in order to protect their audit and NAS fee

income. Similarly, Quick and Rasmussen (2009) reveal that Germany shareholders, generally, perceive a negative impact on auditor independence if non-audit services are delivered. Interestingly, as mentioned earlier, some studies have indicated no relationship between the degree of NAS and abnormal returns or accruals (Ashbaugh *et al.*, 2003; Chung & Kallapur, 2003).

Furthermore, this study also established that there is no PROOF indicating that the provision of NAS is positively related to auditor competence. However, this result is not in sync with most of the prevailing studies. In fact, existing studies show that the provision of NAS has the potential of increasing auditors' competence through knowledge gained from such an exercise (Firth, 2002; Raghunadan, 2003; Whisenant *et al.*, 2003; Son, 2005; Francis, 2006; Mitra, 2007; Arrunada, 2010). Some studies have demonstrated the knowledge spillover effect accruing from the provision of NAS (Owhoso *et al.*, 2002; Balsam *et al.*, 2003; Kinney *et al.*, 2004; Sawan, 2010). For instance, Kinney *et al.* (2004) suggested that understanding a client's information system including tax accounting could spillover to the audit process and bolster the available information to the auditor and thus improving audit quality. Though helping an auditor to gain knowledge about a client, provision of NAS raises the auditor's skills and competence in performing their professional duties. After all, auditor knowledge of the industry provides the auditor with the capacity to be more effective in exercising professional judgement. To sum up, all audit tasks require knowledge for the task at hand and as such gains in knowledge improve audit performance as demonstrated by the 'knowledge spillover effect' which is associated with the joint provision of audit services and NAS.

In the reference of Libya some studies have also shown the same results that the provision of NAS is not positively related to auditor competence (Faraj, 2009). Some studies show that the auditor's knowledge about a specific industry and the prevailing accounting system in that industry can be increased by a provision of NAS. Which eventually increases the overall objectivity and independence of an auditor (Abdulsaleh, 2014).

#### **4.8.1.2 Auditor Rotation and Auditor Quality**

A key result of this study is that it rejects the hypothesis that auditor rotation (Switching) is positively related to auditor independence. To put it differently, the study did not establish a statistically significant association between auditor rotation and auditor independence as depicted by the p-value of 0.891 (see Table 4.17). In a way, this study supports the notion that there is a negative relationship between auditor rotation and auditor independence. Put another way, the greater the auditor rotation the lower the auditor independence. More importantly, this finding give credence to the prevailing situation in auditing literature which is characterised by a lack of consensus on effect of audit rotation or its nemesis audit tenure on audit quality. In essence, existing literature shows conflicting evidence and lively debate in relation to the impact of the two competing processes.

Generally, in the accounting literature, the relationship between audit independence and audit firm rotation is hotly contested. The debate is ostensibly shaped by two opposing perspectives. On one hand, supporters of compulsory audit firm rotation highlight the necessity of having a 'fresh insight' at periodic intervals to guarantee auditor independence and auditor efficacy (Dopuch *et al.*, 2003; Hamilton, Ruddock,

Stokes, & Taylor, 2005; Alleyne *et al.*, 2006; Chi, Huang, Liao, Xie, 2009; Mohammed, 2010; Daniels & Booker, 2011; Firth, Rui & Wu, 2012; Mohammed & Habib, 2013). For example, Mohammed & Habib (2013), recommend mandatory auditor rotation as a solution to overcome the problems of lack of auditor independence. On the other hand, those against mandatory auditor rotation stress the risk of lower audit quality, switching and start-up costs to both the auditors and the clients, and higher audit failures that can arise as a result of loss in continuity and audit competence when obligatory audit firm rotation is effected (Johnson *et al.*, 2002; Jackson *et al.*, 2008). Basically, supporters of auditor rotation argue for the need to nurture auditor independence which is a critical ingredient in quality financial reporting (Vanstraelen, 2000; Ghosh & Moon, 2004; Knechel & Vanstraelen, 2007; Lee *et al.*, 2009; Lassila *et al.*, 2010; Schelker, 2013) while critics of this practice have little faith in its ability to promote auditor independence (Johnson *et al.*, 2002; Chen *et al.*, 2008; Davis *et al.*, 2009).

Generally, several countries have adopted mandatory auditor rotation including the US where Section 203 of the *SOX Act* of 2002 requires the lead audit partner (partner with main responsibility for the audit) and audit reviewing partner to be rotated every five years on all public firms' audits. On the other hand, the AICPA strenuously opposed mandatory rotation. In its study that examined 400 cases of audit failure between 1979 and 1991, the AICPA established that audit failures were about three times more likely to happen when the auditor was conducting the first or second audit of the client. In other words, this study implies that auditor rotation increases the probability or risk of audit failure mainly due to lack of information or knowledge of the client's financial and accounting systems. On the same footing,

some studies (Chen *et al.*, 2001) report that auditor rotation is one of those attributes rated as least important in determining audit quality. Interestingly, some studies have established no positive and significant relationship between auditor rotation and audit quality (Al-Khadash, Nassar, & Sweidan, 2011). According to Al-Khadash, Nassar & Sweidan (2011), though mandatory auditor rotation enhanced auditor independence, the rotation function is not the main factor responsible for strengthening the auditor's capacity to detect material errors and misstatements. Daniels and Booker (2011) also reached a similar conclusion when they found that neither the presence of an auditor rotation policy nor the length of the auditor tenure within rotation meaningfully influenced the respondents' (loan officers) perceptions of audit quality. The foregoing competing perspectives only serve to highlight the lack of consensus on the impact of both auditor rotation and auditor tenure on the auditing process.

As a general rule, mandatory auditor rotation is anticipated to produce better audit quality by deepening competition among audit firms, thereby minimising their reliance on a single client. Such developments yield increased audit effort as incumbent audit firms are likely to work harder when they are aware that their work will be reviewed by other auditors. In a related study, Anis (2014) reveals that auditors perceive mandatory rotation of auditors as having a positive impact on audit quality (in particular auditor independence). However, Anis (2014) also found that mandatory rotation of auditors had a negative effect on auditors' client-specific knowledge. Daniels and Booker (2011) also established that loan officers in the US regarded the presence of an auditor rotation policy as increasing their perceptions of auditor independence. Nonetheless, as mentioned earlier, regulators in numerous



countries have attempted to strike a balance between the need for a new insight (auditor rotation) with concerns about possible loss of continuity (auditor tenure). Undoubtedly, there are fears of a decline in audit quality and competence, in the aftermath of audit firm rotation. From this line of argument, it is understandable why Faraj and Akbar (2008) argued that audit tenure or rotating auditors more often may be perceived as a mechanism that increases reliability of financial statements. Indubitably, there are benefits associated with mandatory audit firm rotations. In essence, the implementation of compulsory rotation of auditors is often introduced as a means of averting actual or perceived weaknesses in auditor independence. Several other studies have pointed out that audit quality is enhanced by the periodic change of auditors since such rotation enables a fresh approach to be introduced to the audit process and prevents the auditor from becoming too relaxed in the process (Vanstraelen, 2000; Abu Bakar., 2005; Gates, 2007).

Overall, there are mixed results on the impact of either audit tenure or its nemesis, auditor rotation, on audit quality. Some scholars view auditor tenure as influential in audit outcomes (Vanstraelen, 2000; Dopuch *et al.*, 2003; Gates *et al.*, 2007; Jackson *et al.*, 2008; Manry *et al.*, 2008), while others disagree by noting that differences exist in the regulatory framework in different countries (Abu Bakar *et al.*, 2006; Gates *et al.*, 2007; Nasser *et al.*, 2007; Knechel & Vanstraelen, 2007; Lee *et al.*, 2009; Lassila *et al.*, 2010). Furthermore, existing studies also indicate that the practice of rotating the audit firms and/or its partners is practically different around the world (Sori, 2005; Kwon *et al.*, 2010). In a way, the inconclusive nature on the impact of auditor rotation on actual auditor independence in some way supports the finding of this

study which does not show a strong relationship between auditor rotation and auditor independence.

Another finding of this study is that auditor rotation (switching) is negatively related with auditor competence. This result is supported by existing studies which have highlighted some of the drawbacks associated with the practice of mandatory auditor rotation (Shu, 2000; Geiger & Raghunandan, 2002; Ghosh & Moon, 2004; 2005; Mohammed, 2010). These prior studies have noted that short audit engagements are often inappropriate for large complex businesses since it takes time for the external auditor to become fully acquainted with the firms' audit needs. For that reason, it is not expected that the firm will see the best audit work in the initial few years of audit engagement. For instance, a mandatory rotation may cause a sudden loss of previously accumulated client-specific knowledge, thus degrading auditor competence. In a related study undertaken in Egypt, Mohammed (2010) establishes that long auditor-client relationship enhances the audit quality through increasing the auditor's understanding and experience of the client's financial reporting and business processes. Put differently, a smaller amount of client-specific knowledge in the initial years of an audit work may yield a lower probability of detecting material breaches, thereby providing non-rotating auditors with a comparative advantage in discovering errors and breaches in the long run as they acquire a deeper understanding of the client's operations. Likewise, Ghosh & Moon (2005) find that audited financial statements and especially reported earnings, are perceived as more reliable for audit firms with longer auditor tenure. In the same vein, it would seem undeniable that audit effectiveness is precipitated by audit firms' accumulated knowledge and long-term experience of a client's business system and complicated

reporting issues, and that mandatory rotation would deny this opportunity (Johnson *et al.*, 2002).

Overall the existing body of literature shows the mixed result regarding the auditor rotation and the auditor independence. The current study is showing the results which actually reject the hypothesis that auditor independence can be positively affected by the auditor rotation. In the case of Libya there is also a mixed literature is available in this reference. Faraj, (2009) showed a positive relation of audit rotation and auditor independence and overall audit quality. He mentioned that shorter the time an auditor spends on the site and then being switched the higher the reliable reports will be. Another study conducted by (Ritchie & Khorwatt, 2007) showed a no relation between auditor rotation and audit quality and auditor independence.

#### **4.8.1.3 Audit Firm Size and Auditor Quality**

Another striking finding of this study is that evidence supports the notion that the audit firm size is positively associated with auditor independence. In other words, the bigger the audit firm the greater the auditor independence. This finding is to a large extent supported by existing studies. As a general rule, accounting literature indicate that the large size of the audit firm is regarded as having a positive effect on perceived auditor independence as opposed to the small size firm (see Abu Bakar *et al.*, 2005; Lennox, 2005; Francis & Yu, 2009). To put it differently, large audit firms are typically perceived as more adept at maintaining an acceptable degree of independence than their smaller counterparts. For example, Alleyne *et al.* (2006) identify small firm size as one of the factors that undermine perceptions of auditor independence. This viewpoint is also shared by Tahinakis and Nicolaou (2004)

whose research participants considered small audit firms as more likely to lose their independence when compared to larger audit firms. Similar findings were also reported by Awadallah (2006) and Abu Bakar *et al.* (2005).

According to Abu Bakar *et al.* (2005), small audit firms operating in a competitive market are perceived as having a higher risk of losing independence. Other researchers argue that those audit firms that have large client portfolios will have stronger and better inducements in protecting the independence and reputation of their firms (Yuniarti, 2011). Part of the explanation for this position is the existence of a number of reasons that explain the importance of the large size of an audit firm. In the same league, Francis and Yu (2009) suggest that the size of audit firms is an important characteristic upon which the influence of auditor independence perception can be determined. A similar perspective is held by Abu Bakar *et al.* (2005) whose findings identified the audit firm size as the most important factor that affects auditor independence. Other studies suggest large audit firms are more likely to behave independently because individual clients are not likely to build economic ties that could undermine auditor impartiality (Sori, 2005; Choi *et al.*, 2010; Sawan, 2010).

Basically, the bulk of existing studies suggest that larger auditors deliver higher quality audits (Reynolds & Francis, 2000; Francis, 2004; Tahinakis and Nicolaou, 2004; Lennox, 2005; Alleyne *et al.*, 2006; Michael, 2007; Kilgore *et al.*, 2011), thereby validating findings from this study. However, competing viewpoints from other studies suggest that audit quality is independent of the size of audit firm. In the same league, Fearnley *et al.* (2005), suggest that individuals are responsible for providing audit quality rather than audit firms as was the case in the Arthur Andersen fiasco with Enron. Interestingly, the foregoing findings are in sync with another key

research finding of this study, that is, the audit firm size is not positively related with auditor competence. The extent of the debate on this specific issue is perplexing. Nonetheless, many of the variations between large and small firms could be curtailed if countries strictly adhere to universal professional standards and international best practices in accounting and auditing. This can be bolstered by a more efficient regulatory framework.

Ritchie & Khorwatt (2007) conducted a study on the Libya and found the same results and mentioned it clearly that the audit firm size is positively associated with auditor independence. Means the large firm size will have a positive impact on the overall independence of the auditor. This actually is supporting the results of this study.

#### **4.8.1.4 Audit Firm Fees and Auditor Quality**

A critical factor that has been examined in many studies focusing on influences of audit quality is the fees for audit services (e.g. Abbott *et al.*, 2003; Jensen & Payne, 2005). Nonetheless the study's two propositions on the relationship between audit fees and auditor quality had different fortunes. The first result showed that no evidence in support of the hypothesis that the size of audit firms fees is negatively related with auditor independence. Undeniably, economic dependence is a recognisable danger to auditor independence (Al-Ajmi, 2011). In fact, auditing professional bodies across the globe are aware of the significant threat that arises when auditors become economically reliant on their audit clients (Barbadillo *et al.*, 2006; Hoitash *et al.*, 2007). In essence, a number of studies highlight the negative impact of audit fees on auditor independence and audit quality (Geiger & Rama,

2003; Hudaib, 2003; Abu Bakar *et al.*, 2005; Markelevich *et al.*, 2005; Alleyne *et al.*, 2006; Barbadillo *et al.*, 2006; Hoitash *et al.*, 2007; Huang *et al.*, 2007). For example, Abu Bakar *et al.* (2005) established that firms receiving large audit fees or income are perceived as having a greater risk of losing their independence. In much the same way, Huang *et al.* (2007) found a systematic relationship between NAS fees and biased financial reporting. Put another way, the higher the NAS fees the greater the biased financial reporting.

Although most of the extant literature or studies support the view that auditor independence is undermined by the economic dependence of auditors on their audit clients' income, other studies (including this study) have produced different results. This perspective is shared with DeFond *et al.* (2002) who established no association between audit fees and compromised auditor independence. Instead, DeFond and others attribute their findings to auditors' concerns over the loss of reputational capital as well as fears of litigation costs. In other words, these auditors felt that these costs (loss of reputational capital and costs of legal suits) outweigh the expected benefits accruing from impaired auditor independence. Similarly, Craswell *et al.*, (2002) demonstrated that the auditor's propensity to issue unqualified audit opinion was not affected by the level of auditor fees dependence. Despite that, some studies also suggested that auditor independence was not perceived to be affected by the economic reliance of auditors on their audit clients (Craswell *et al.*, 2002; Geiger & Rama 2003). However, as indicated earlier, the vast majority of existing studies take the opposite view indicating an inverse relationship between audit firm fees and auditor independence (e.g. Geiger & Rama, 2003; Hudaib, 2003; Alleyne *et al.*, 2006).

Nonetheless, the second proposition was supported by available evidence. In this regard, the study established a positive relationship between the size of audit fees and auditor competence. This is also in line with the findings of Sundgren and Svanstrom (2013) which reveal quality differentiation with regards to auditors in the Swedish audit market. According to Sundgren and Svanstrom (2013) audit fees are positively related with audit firm size (usually associated with more experience and expertise). They discovered that the fees of Big Six auditors are significantly higher than of non-Big Six auditors because the former is deemed to be more experienced and competent, thus validating the findings of this study. Some studies suggest that the amount of audit fees including those for the provision of NAS are not related with the audit opinion (DeFond *et al.*, 2002).

Faraj (2009) conducted a study on Libya to investigate the results regarding the relation of audit fee and audit quality and independence and found a negative relation between these two variables. On the other hand there is another aspect of audit fee which creates an impact on auditor's competence and generally the researchers found a positive relation between these two. Same is the case with Libya which is identified by (Abdulsaleh, 2014) which actually supports the results of this study in the reference of Libya.

#### **4.8.2 External Corporate Governance Mechanisms and Reliability of Audited Financial Statements (RAFS)**

##### **4.8.2.1 Provision of Non-Audit Services and RAFS**

The hypothesis that the provision of NAS is negatively associated with the RAFS was rejected. In a way, this finding of this study provides indirect proof that the provision of NAS is actually positively associated with RAFS. This is corroborated by an earlier study conducted by Sawan (2010) on the Libyan context. According to Sawan, the provision of NAS to audit clients was perceived by respondents as boosting auditors' experience and understanding of the client's industry and accounting system. Though the provision of NAS was seen as enhancing audit quality, Sawan also established that a delineation of NAS from audit services was advantageous since external auditors were perceived to have greater credibility when the separation is evident. Equally, other researches have indicated that the joint supply of NAS and audit services will boost the auditor's understanding of the client's industry and accounting processes which in turn increases auditor quality (Dopuch *et al*, 2003; Arrunada, 2010). Consequently, the knowledge spillover from such provision of NAS will enhance auditors' independence and objectivity in executing their duties such as financial reporting. In a related study, Lee *et al.* (2009) found that the provision of NAS had a significant negative relationship with audit report lags (audit delays). The study also reveals that the provision of NAS increases auditor learning, and hence reduces audit delays.

To some extent, the above result of this study is not in line with the findings of Higgs & Skantz (2006) which imply that investors (the market) view "abnormally profitable non-audit engagements as a threat to auditor independence" (pp. 20-1).



Their findings provide limited support for the contention that the credibility of audited financial statements is impaired by abnormally high non-audit fees enjoyed by auditors. In much the same way, Gul *et al.* (2006) in a study conducted in Australia established a statistically significant negative relationship between the provision of NAS and the value relevance of earnings. They also found that the inverse relationship is fragile for the Big Six auditors. Put another way, the findings indicate that the provision of NAS is likely to negatively affect investors' perceptions of the credibility of financial statements, and that Big Six auditors because of reputational capital and the costs of legal suits, are likely to lower the adverse impact of the provision of NAS. However, in the Libyan context where the litigation costs are low, the market will perceive auditors providing NAS as less likely to preserve their independence (see Gul *et al.*, 2006) hence supporting the findings of this study.

#### **4.8.2.2 Auditor Rotation and Reliability of Audited Financial Statement (RAFS)**

This study also provides evidence that auditor rotation (Switching) is positively related with the RAFS. A number of studies support this finding (Nagy, 2005; Lu, 2006; Raiborn *et al.*, 2006; Kim, Song & Tsui, 2007; Davis *et al.*, 2009; Mohammed, 2010; Mohammed & Habib, 2013). For instance, advocates of rotation view auditor tenure as negatively affecting audit quality by compromising auditor independence which may result in auditors becoming lax when performing auditing or financial reporting (Lu, 2006). These studies also show that auditor rotation adds a new impetus to the assessment of client's financial statements. Despite the benefits associated with long audit firm tenure, the overall long-term implications of audit tenure have been identified as posing potential threats to auditor independence and ultimately financial reporting quality (see Vanstraelen, 2000; Johnson *et al.*, 2002;

Carey & Simnett, 2006). Undoubtedly, relationships between auditors and their clients can evolve into a special bond that may negatively affect auditor independence and decrease the reliability and quality of the audit in the long run. It has been observed that this form of close relationship has resulted in the external auditor's incapability to examine transactions and in the process contributing to recent audit failures at a number of high-profile firms such as Enron and World Com (Abu Bakar *et al.*, 2005; Gates *et al.*, 2007). In much the same way, Nagy (2005) demonstrates that since auditing practice is premised on using professional skepticism, the long run bond between the client and auditor which is common in long audit tenures, can decrease the sharpness of auditor's professional judgment. It is therefore scarcely surprising that several studies have concluded that the long association between audit firms and their clients may lead to some form of collusion which may jeopardise truly independent decision making in the external auditing process (Abu Bakar *et al.*, 2005; Abdul Nasser *et al.*, 2006; Gates *et al.*, 2007).

Meanwhile, some empirical studies indicate that long association between audit firms and their clients may lead to the development of an 'unholy alliance' that could negatively affect auditor independence and degrade the reliability and quality of the audit report (Chi & Huang, 2005; Alleyne *et al.*, 2006; Chen *et al.*, 2008). In order to remedy the situation, mandatory audit firm rotation was proposed. More specifically, Ghosh and Moon (2005) also observed that other things being equal, audited financial statements are viewed as less reliable if consumers of financial statements view lengthy audit tenure as having a negative impact on auditor independence and audit quality. This and many more reasons lead to the global suggestions of audit tenures should be rotated on a fixed limited terms. As argued by many scholars and

regulatory bodies across the globe, a continuously unchecked long-term relationship between the auditors and the clients could consciously or subconsciously undermine auditors' sense of objectivity (Wallman, 1996; Lee *et al.*, 2009; Lassila *et al.*, 2010). Several other studies on the impact of the external auditor's tenure, has availed additional evidence that longer tenure may in fact have an adverse effect on audit quality (Abu Bakar *et al.*, 2005; Son, 2005). In an earlier study that was undertaken in Malaysia by Teoh and Lim (1996), the independence of auditors was shown to be under threat whenever the services of an auditor is continuously engaged for more than five years.

Notably, many of the recent studies which examine the relationship between longer tenure, financial reporting quality and audit quality have revealed that auditor tenure positively affects audit quality (Geiger & Raighundan, 2002; Ghosh & Moon, 2004; Myers *et al.*, 2003; Gulet *et al.*, 2007; Knechel & Vanstraelen, 2007; Stanley & DeZoort, 2007; Gul, Fung & Jaggi, 2009; Lee *et al.*, 2009). Generally, it is indicated that most audit failures are due to lack of information and by implication if an auditor is to carry out a good audit he or she has to have an understanding of the client's financial and business systems in order to detect misstatements. As noted by Ghosh and Moon (2004) both auditor independence and auditor quality increase in the long run as he or she becomes more attuned with the client's system. According to Lee *et al.* (2009), long audit tenure allows firms to audit their clients more efficiently. The study establishes that audit report lags or audit delays decline as auditor tenure lengthens, suggesting that rotating auditors can be costly for companies because they cause audit delays.

#### **4.8.2.3 Audit Firm Size and Reliability of Audited Financial Statements (RAFS)**

Notably, this study provides evidence supporting the proposition that audit firm size is positively associated with RAFS. In other words, bigger audit firms are more likely to have high-quality audits. Likewise, smaller audit firms are more likely to produce low-quality audits. As mentioned earlier, this finding is not surprising considering that existing studies regard audit firm size (including office size) as a key characteristic that reinforces audit quality and reliability of financial reports (Francis, 2004; Al-Ajmi, 2009; Francis & Yu, 2009; Choi, Kim, Kim & Zang, 2010; Francis, Michas & Yu, 2013). Thus, the findings of this study reinforce prior literature. According to Al-Ajmi (2009) the credibility of financial statements is a function of the size of the audit firm. Respondents in a study conducted by Al-Ajmi (2009) also indicated that the attributes of Big Four audit firms enable them to produce higher quality financial reports than those of non-Big Four firms.

As assumed by many studies, big audit firms tend to be more superior in terms of possessing modern technology and skilled employees than the small audit firms. For example, Francis & Yu (2009) establish that Big Four auditors in large offices produce higher quality audits relative to smaller offices due to their superior in-house experience and knowledge in the audits. Meanwhile, in a related study, Francis, Michas & Yu (2013), find that small audit offices produce lower quality audits than large audit offices, and this hold for both the Big Four firms and the non-Big Four firms. Occupying that perspective are a number of previous studies such as Kilgore *et al.* (2011) that shows that the audit firm size is rated as the most important attribute in perceptions of audit quality. After all, several studies have established that larger audit firms are more capable and independent vis-à-vis smaller audit

firms, and therefore produce audits of a higher quality. Ritchie & Khorwatt (2007) studied the impact of audit firm size on RAFS in banking sector of Libya and he also showed the same results as showing by this study.

#### **4.8.2.4 Audit Firm Fees and Reliability of Audited Financial Statements (RAFS)**

A key proposition of this study which was rejected by evidence is the following hypothesis: size of audit firms' fees is negatively related to RAFS. To put it differently, results did not support this proposition, and indirectly imply that there is a positive association between the two variables. This result is also in line with some of the existing studies, for example, Willekens and Bruynseels (2009) who noted that an increase in abnormal fees decreases the amount of earnings management. Similarly, Geiger and Rama (2003) also found that higher audit fees increase the chance of a going-concern modification. Furthermore, Basioudis *et al.* (2008) in a study conducted in the UK established a positive association between audit fees paid and receiving a going-concern modified audit opinion. It is evident that these results support the view that audit quality improves with audit firm size. Faraj (2009) also showed the same results in the reference of Libya which supports the findings of this study.

### **4.8.3 Internal Corporate Governance Practices and Auditor Quality**

#### **4.8.3.1 Audit Committee and Auditor Independence**

Another key objective of this study is to investigate the relationship between internal corporate governance (represented by audit committee characteristics) and auditor quality. Meanwhile, evidence deduced from this study does not support the

proposition that audit committee attributes are positively related with auditor independence. To put it differently, this study establishes that there is no statistically significant association between audit committee characteristics and auditor independence. In a way, the findings of this study debunk Faraj and Akbar's (2008) notion that the audit committee plays a critical role in monitoring auditors as well as safeguarding their independence. Basically, evidence from this study challenges findings from other studies which established that increased audit committee roles contribute to auditor independence and audit quality (Carcello & Neal, 2003; Fearnley & Beattie, 2004; Alleyne *et al.*, 2006; Al-Ajmi, 2009; Hoitash & Hoitash, 2009; Sori *et al.*, 2009). For instance, Carcello and Neal (2003) show that audit committees with certain attributes (such as more independence, greater governance proficiency, lower stockholdings) are more effective in ensuring auditor independence by protecting auditors from being dismissed in the aftermath of the issuance of new going-concern reports. In a related study, Sori *et al.* (2009), indicate that the majority of participants in their study believe that auditor independence is maintained and safeguarded by the existence of an actively functioning audit committee whose members are knowledgeable, independent, and committed to enhance ideals of corporate governance without fear or favour.

Nonetheless, there are a number of existing studies which validate the finding found in this study (Gibbins, Salterio & Webb, 2001; Cohen *et al.*, 2002; Gibbins, McCracken, & Salterio, 2005; Lin *et al.*, 2008). For instance, Cohen *et al.* (2002) indicate that auditors believe that the audit committee is ineffectual and does not have adequate power to withstand pressure and demands from the client's management. Meanwhile, Fearnley and Beattie (2004) shows that support from the

audit committee during auditing is not always imminent and coming. Other studies established that audit committees only rarely played a crucial role in the audit process (Gibbins *et al.*, 2005). Similarly, Lin *et al.* (2008) demonstrate that most managers and auditors in China view the roles and responsibilities of audit committees as merely ceremonial and targeted primarily at sprucing up the image of good corporate governance, strengthening communication between board members and auditors, and resolving conflict between management and auditors. Their study also suggests that management and independent directors of Chinese firms do not fully appreciate or recognise the more concrete audit committee monitoring roles and duties for enhancing internal control systems, rules compliance, sound corporate financial reporting and auditing processes. To put it another way, the study results show that audit committee operations in practice are ineffective even though a significant number of Chinese listed firms have established these bodies as part of the growing corporate governance culture. In the reference of Libya Faraj (2009) tried to investigate the mechanism of audit committee and its impact on RAFS. And he revealed that audit committees have a positive impact on RAFS. Same results are shown by some other researchers in the reference of Libya (Abdulsaleh, 2014).

#### **4.8.3.2 Audit Committee and Auditor Competence**

In a related finding, this study provides evidence which suggest that audit committee attributes are not positively related with auditor competence. A significant number of existing studies which have investigated the role of audit committees in the auditor choice process support this key finding. These studies have revealed relatively little impact of the mere presence of such committees on the audit process (Gibbins *et al.*, 2001; Cohen *et al.*, 2002; Beattie *et al.*, 2004; Gibbins *et al.*, 2005; Lin *et al.*, 2008).

For example, Lin *et al.* (2008) establish that most stakeholders in China view the audit committees at best as a ceremonial relic of corporate governance. The results of this study show that though a significant number of Chinese listed firms have set up audit committees, many of these committees did not operate at all, or were inactive. Besides, the study finds that most of the audit committees were not involved in auditor selection and in other key areas. In a way, these findings show that audit committee activities in practice are far less than satisfactory in China. In fact, the importance of audit committees roles and responsibilities are visible in appearance rather than in substance. This may be the case in Libya. Nonetheless, results from other studies show that independent directors have incentives to establish an active, viable and independent audit committee to minimise their liability and litigation costs. In much the same way, Sharma, Boo & Sharma (2008) discovered that corporate governance mechanisms such as the audit committee influences auditors' assessments of audit risk.

#### **4.8.4 Internal Corporate Governance Practices and Reliability of Audited Financial Statements (RAFS)**

Notably, this study also established that audit committee characteristics are positively associated with RAFS. In existing studies, the audit committee is conceptualised as playing a key role in the assessment of financial reporting processes including communicating with the auditors, and reviewing internal controls systems (Goddard & Masters, 2000; Johnstone *et al.*, 2001; Walker, 2004; Vafeas, 2005; Stewart & Munro, 2007; Mangena & Taurigana, 2008; Baxter & Cotter, 2009; Adeyemi & Fagbemi, 2010; Zaman *et al.*, 2011; Gana & Krichen, 2013; Kim, Segal, Segal, & Zang, 2014; Bedard & Compernelle, 2014). As hypothesised by this study, Vafeas



(2005) found that properly structured and functioning audit committees help increase financial reporting quality. This is consistent with the findings of Baxter and Cotter (2009), who established a positive relationship between the presence of an audit committee and an increase in earnings quality.

According to Beasley *et al.* (2009), the bulk of existing empirical studies which examine the efficacy of audit committee characteristics generally find that an effective audit committee is related with higher quality financial reporting and auditing. Similarly, Kim *et al.* (2014), indicate that audit committees which are larger, more independent and more competent experience a significant improvement in financial reporting quality, thus proving proof and justification for SOX-inspired reforms to audit committees. On the other hand, Zaman *et al.* (2011), reveal that effective audit committees perform more monitoring which broadens the audit scope (and in the process assuring financial reporting quality and corporate accountability). They argue that the risk of lawsuits and loss of reputational capital galvanise audit committee members to perform their duties effectively. In other words, firms with effective audit committees are more likely to monitor the external audit process than firms with ineffective audit committees. In a related study, Stewart and Munro (2007) establish that there is a significant association between the presence of an audit committee (including certain attributes such as diligence and activity) and a reduction in perceived audit risk.

Given the above findings, it is therefore unsurprising that audit committee development in most countries has been triggered by concerns about financial reporting quality in the aftermath of a chain of high profile corporate failures and

scandals (Huang & Thiruvadi, 2010). After all, many researchers acknowledge the audit committee's major role in the verification and safeguarding of company's financial statements and internal control processes (Abbott *et al.*, 2004). From this line of observation, one of the most frequently expressed views is that the degree of audit quality is hugely affected by the audit committee (Mansouri *et al.*, 2009; Bedard & Compernelle, 2014). Bedard and Compernelle (2014), for instance, indicate that effective audit committees influence audit quality. In this regard, it should be noted that several existing studies have established a significant relationship between certain attributes of the audit committee and earnings quality (e.g. Abbott *et al.*, 2004; Dhaliwal *et al.*, 2006). In this regard, Abbott *et al.* (2004), discover that certain attributes of audit committees, particularly independence and diligence exhibit a significant association with occurrence of financial restatements. In other words, the greater the independence and activity levels of audit committees the less the occurrence of restatements. Furthermore, the study also found that restatement is negatively related with the financial expertise of audit committee directors.

Generally, effective audit committees are expected to enhance financial reporting quality since a number of its functions involve analysing and approving accounting policies, as well as reviewing the financial statements. Unsurprisingly, a litany of studies have indicated that enhanced financial reporting quality is one of the main benefits for companies which have established audit committees (Ramsay, 2001; Dhaliwal *et al.*, 2010). Other functions of the audit committee that enhances the quality of financial reporting include assuming responsibilities for the appointment and remuneration of auditors, and designing the scope of the auditors work (Dhaliwal

*et al.*, 2010). In a related study, Stewart and Munro (2007) discovered that the audit committee and its diligence are related with the reduction in perceived audit risk. The foregoing discussions indicate the importance of the audit committee in making sure that auditors produce financial reports that contain reliable financial statements information (Robinson & Owens-Jackson, 2009; Sori *et al.*, 2009). This is because information in the audit report is very important for decision making processes on investment and financing decisions. It thus confirms the unique roles that audit committee is playing in the process of enhancing quality financial reporting and maintaining market confidence. However, Rainsbury, Bradbury and Cahan (2009) revealed that there is no significant association between an effective audit committee and the quality of financial reporting. In a way, the findings of this study indicate that the benefits of audit committees may be overstated by regulators and policy makers. Similarly, Cohen *et al.* (2002) established that the audit committee played a less critical role in the audit process vis-a-vis senior management and the board. On closer inspection, the review of the existing studies found mixed evidence as far as the impact of audit committees on the perceived RAFS.

#### **4.8.5 Auditor Quality and the Reliability of Audited Financial Statements (RAFS)**

One of the major objectives of this study is to investigate the relationship between auditor quality (auditor independence & auditor competence) and the RAFS. Notably, the hypotheses on the effect of auditor quality on financial reporting quality were supported by evidence from the study as shown in the following sections.

#### **4.8.5.1 Auditor Independence and Reliability of Audited Financial Statements (RAFS)**

Results show that the proxy for auditor quality, that is, auditor independence is positively associated with RAFS. This finding is reinforced by existing studies. For instance, Kabiru and Rufai (2014) establish that auditor independence does significantly enhance the quality of audited financial statements of money deposit banks in Nigeria. They also realised that consistency and reliability of financial statements can be achieved if the auditing process is independent. It is therefore not surprising that some accounting literature highlights auditor independence as the fundamental attribute from which other attributes such as integrity, objectivity, and professional scepticism follow. As aptly put by Pike (2003), auditor independence is the foundation of the auditing profession. After all, the extant literature review also revealed that auditor independence is the backbone of the auditing profession, given its essential value of judging the RAFS (Adebayo, 2011; Al-Ajmi & Saudagaran, 2011; Bedard *et al.*, 2004). As such, the extent to which an audited financial statement can be accepted as being reliable significantly depend on auditor independence (Flaming, 2002; Faraj & Akbar, 2008; Adebayo, 2011). As is evident in the existing literature, auditor independence is crucial to the auditor as it is considered as being one of the basic requirements underlying the auditing activity. It is no wonder then that auditor independence is regarded as the essence of the auditing profession and audit quality. Thus, if auditors are not truly independent, their opinions will add no value to their clients' financial statements. As indicated by Adebayo (2011), auditor independence is essential to the realisation of credible financial statements.

#### **4.8.5.2 Auditor Competence and the Reliability of Audited Financial Statements (RAFS)**

Likewise, the hypothesis that auditor competence is positively related with the RAFS was also supported by available evidence. After all, most of the conventional accounting literature reviews both competence and independence as two separate attributes of an auditor (Richard, 2006). Notably, auditor competence highlights the importance of audit team attributes such as the abilities and experience of the audit team; the audit team's understanding of the client industry; ethical standards of the audit team; and technical ability of the audit team (Kilgore *et al.*, 2011). In a related development, most respondents in the study cited the problem of weak auditor quality in Libya due to the non existence of a code of ethics in the country that would assist auditors to set up an auditing standards regime. This finding coincides with existing studies which highlight the weak regulatory and legal regime that is not comprehensive enough to sustain and maintain auditor quality (Alhsadi, 2007; Eldarragi, 2008; Almahuf, 2009; Sawan, 2010). These studies are also critical of the Libyan Accountants and Auditors Association for virtually doing nothing to promote the interests of the accounting profession either by publishing or enacting auditing standards or a code of ethics.

#### **4.8.6 Mediating Effects**

This study also set out to examine the mediating effects of auditor quality proxies on the relationship between corporate governance mechanisms and the RAFS. Basically, a mediating variable helps one to model a process by sometimes intervening between the predictor and the outcome variable to influence outcomes (Sekaran & Bougie, 2009). In essence, a mediator is both a product of the predictor variable and a cause

of the outcome variable. As indicated by Creswell (2012), a mediating variable transmits the effects of the predictor variable on the dependent variable. In our study, this will help us to understand how reliable audited financial statements can result from having effective corporate governance mechanisms. However, the findings on the mediating effects of auditor independence and auditor competence are mixed.

The majority of hypotheses testing the mediating effect of auditor independence on the relationship between corporate governance mechanisms and the RAFS were supported by research evidence. The hypotheses supported are as follows:

- Auditor independence negatively mediated the relationship between the provision of NAS and the RAFS.
- Auditor independence positively mediated the relationship between audit committee characteristics and the RAFS.
- Auditor independence positively mediated the relationship between audit firm size and the RAFS.

The only exceptions were the following two hypotheses which were rejected: (1) auditor independence positively mediated the relationship between auditor rotation and RAFS, and (2) auditor independence negatively mediated the relationship between audit firm fees and RAFS. By failing to capture the mediating effects of auditor independence on these two external corporate governance attributes, this suggests that there might be other factors or variables affecting the relationship between the independent variable and the dependent variable.

On the other hand, most of the hypotheses on the mediating effect of auditor competence on the relationship between were not supported by evidence from the study. Only one hypothesis was supported by evidence from the research that is,

auditor competence negatively mediated the relationship between audit firm fees and RAFS with a p-value of 0.03 when rounded. Perhaps this is because auditor independence is a much needed attribute rather than auditor competence (Boritz, 1992). As suggested by Boritz, auditor independence is the core or heart of auditing activity. However, in differentiating these two concepts Boritz wonders if an auditor really needs to be an expert in order to perform an audit effectively. This study seems to concur with Boritz. Nonetheless, most of the conventional accounting literature reviews both competence and independence as two separate key attributes of an auditor (Richard, 2006).

Specifically, the results of the study indicate that there is a direct significant positive association between corporate governance mechanisms and the RAFS, there is a direct positive relationship between corporate governance practices and auditor quality, and there is a direct strong positive relationship between auditor quality and the RAFS. In terms of mediation, the findings of the study indicate that auditor independence partially mediate the relationship between corporate governance mechanisms and the reliability of audited financial statements. The results also suggest that auditor competence does not mediate the relationship between corporate governance mechanisms and the reliability of audited financial statements. Overall, these relationships indicate that auditor quality partially mediates the relationship between corporate governance mechanisms and the RAFS. Furthermore, it suggests that the impact of auditor quality on the RAFS is much greater than that impact of corporate governance mechanisms. This means that financial reporting quality is more responsive to auditor quality, such as auditor independence, than to actual corporate governance mechanisms.

#### **4.9 Chapter Summary**

As indicated earlier, this chapter presents the results of the data analysis as well discussing the findings of the study. The techniques utilised to test the hypotheses comprise both descriptive and inferential statistics. The chapter also highlights the achieved response rate, which can be considered as enough response. Moreover, the chapter descriptively presents the distributed demographic variables of the respondents. The goodness of data is checked using several tests such as content validity, and construct validity, convergent and discriminant validities, criterion validity, and the reliability. Additionally, the chapter includes the methods of regression and correlation analysis to test the hypotheses of the study. Specifically, the researcher conducted regression analysis to test the mediating effects of auditor quality (auditor independence & auditor competence) on the relationship between the supply of NAS, auditor rotation, audit firm size, audit firm fees, audit committee characteristics and the RAFS. With regards to the questions related to mediating effect, the results show that auditor quality partially mediates the relationship between corporate governance mechanisms and the RAFS.



## **CHAPTER FIVE**

### **CONCLUSION AND RECOMMENDATIONS**

#### **5.0 Introduction**

This chapter consists of several sections. Nonetheless, its main task is to provide an overview of the major results as well as outlining the implications of the study. Limitations and alternative suggestions for future research are also discussed in this chapter.

#### **5.1 Research Findings Summary**

Banking sector is considered the most regulated sector in any economy as it's the part of financial sector and plays a vital role in the development of an economy. Banking sector is known as the main sector of economy. Same is the case of Libya. Libyan banking sector consists of 16 commercial banks which are basically performing the many important roles in the development of economy. So it becomes of more importance to investigate this sector. People are usually more conscious about the performance of banking sector and the main source of reliable information regarding banks and other sectors is audited financial statements. So, audit and its reliability are of much concern. This study is basically added in the existing knowledge related to audit and its related features specifically in the reference of banking sector of Libya.

There are a number of studies which include these variables but in the reference of Libya (to the knowledge of the researcher) there is no such study which actually addressing the set of these variables simultaneously and discussing the banking

sector of Libya exclusively. And since banking sector is considered one of the most important sectors in the economy and have a core importance even in building and development of other sectors. So conducting such study in the reference of corporate governance to protect the interest of all the stakeholders has become even more important.

Issues pertaining to corporate governance practices, auditor quality and financial reporting have been the focus of many scholarly and regulatory debates all around the globe in recent times. The relationship between these variables is based on the agency theory (Jensen & Meckling, 1976). Basically, the use of an external audit quality is regarded as a tool for reducing managerial opportunism and agency conflicts. It also “protects shareholders’ interests by ensuring the relevance and the reliability of financial statements” (Gana & Krichnen, 2013, p. 69). Hence, the board of directors especially its sub-committee on audit issues as well as external auditors have been recognised as the mechanisms which have the ability to ensure financial reporting quality and as such are consistent with the agency theory proposition.

This study investigates the relationship between corporate governance practices, auditor quality and financial reporting in the context of banking sector of Libya. Unfortunately, the bulk of existing studies on these variables are predominantly fixated with the Western context where the litigation environment, governance structure and auditor reputation are perceived to be different from those existing in developing countries, thus limiting the generalisability of these prior findings to other countries.

The findings of this study revealed the impact of certain independent variables on auditor quality as well as on RAFS. Another key research aim of this study was to determine the mediating impact of auditor's independence in the relationships between provision of NAS, auditor rotation, audit firm size, audit firm fees, audit committee characteristics, and the RAFS. In a way, this study was primarily undertaken to provide answers to three research questions, namely: (1) What is the relationship between corporate governance mechanisms (provision of NAS, auditor rotation, audit firm size, audit firm fees, audit committee characteristics), and RAFS? (2) What is the relationship between corporate governance mechanisms (provision of NAS, auditor rotation, audit firm size, audit firm fees, audit committee characteristics) and auditor quality (auditor independence and auditor competence)? (3) What is the mediating impact of auditor quality in the relationship between corporate governance mechanisms and the RAFS?

As indicated in Chapter Four, this study collected survey data from the accounting and auditing industry as well as the banking sector, where questionnaires were distributed to the respective auditors and accounting professionals and loan officers in Libyan commercial banks. For ease of generalisability of the research findings, 500 questionnaires were randomly distributed via mail and web survey or delivered by hand. This kind of data collection technique is in line with the extant literature such as Abu Bakar *et al.* (2005) and Desira and Baldacchino (2005). From this number, only 213 questionnaires (42.6%) were returned out of which 25 were rejected because they were unusable.

More specifically, there are several empirical associations that have been examined in this study. First, there is an examination of the association between auditor characteristics and auditor quality and by implication the RAFS. Generally, the results of the study on these variables are mixed. On one hand, auditor characteristics such as the provision of NAS, and size of audit firms' fees are shown to have an inverse relationship with auditor independence and RAFS. Interestingly, the same variables (provision of NAS and size of audit firms' fees) are also indicated to have a positive and strong relationship with auditor competence which is the flip side of auditor quality. On the other hand, the following auditor dimensions, namely, auditor rotation and size of audit firms are indicated as having a positive and significant relationship with auditor independence and RAFS. Generally, the results of the study establish that an effective audit committee is positively related to auditor independence, auditor competence as well as the RAFS.

Many other researches are also showing the same results. And basically an independent audit committee is considered as the key factor of a fair audit so it enhances the efficiency and reliability of audit team which eventually results in a fair and true picture of financial matters of the organisation, RAFS. Banking sector is considered the most regulated sector of any economy and same is the case of Libya. People and Govt. both are more conscious about the banking sector and its performance as it's a pure financial sector and even more then this it has some practical implications in the economy of a country. And that's the reason that this is considered to be the regulated more then any other sector in the economy. By having more reliable audited financial statements (RAFS) banks in Libya can gain even

more public confidence and will be resulted in more business development and eventually in economic development.

Meanwhile, the results of this study also indicate that there is a positive and significant relationship between auditor independence and RAFS. Furthermore, the findings show that auditor independence has positively mediated the relationship between the following dimensions that is, auditor rotation, audit firms size, audit committee characteristics and RAFS. However, the findings of the study also demonstrate that auditor independence has negatively mediated the relationship between provision of NAS, audit firm fees and RAFS. Notably, auditor competence is shown to be positively related with the RAFS. The findings of the study also suggest that auditor competence positively mediate the relationship between auditor rotation, audit firm size, audit committee characteristics and RAFS. Finally, the findings indicate that auditor competence negatively mediate the relationship between provision of NAS, audit firm fees and the RAFS. These findings are robust to various model specifications and tests.

A major key finding of this study is the significance of complementarities between several conditions or factors necessary for effective auditing or high audit quality. The issue of complementarity highlights the problem that several things or factors must work well enough, simultaneously, to achieve high auditor quality and by implication reliable financial reports. By and large, when complementarities are present, an action taken by one audit firm, audit committee, or organisation increases the incentives for other agents to take similar measures. In other words, effective audit committees yield high auditor independence which in turn results in reliable

audited financial statements. The main argument here is that the effectiveness of corporate governance structures is related to the adoption of good governance practices. As pointed out by Carcello *et al.* (2002), non-executive board directors have a tendency of appointing an external auditor which exhibits a good quality of control because administrators strive to protect shareholders interests and their reputational capital by avoiding any situation that may attract litigation. Thus, the independence of audit committee members and external auditors are two complementary control mechanisms.

However, in countries like Libya, it is not enough to have just effective audit committees or independent and qualified auditors to produce reliable audited financial statements. This study also established that other factors are at play such as the country's accounting standards, cultural factors, political and regulatory environment as well as the litigation environment (which is weak). It is interesting to see how these factors integrate with corporate governance practices, auditor quality and financial reporting. Overall, the findings of this study are largely consistent with agency theory, which states that corporate governance mechanisms are essential monitoring devices that improve auditor quality which in turn helps to enhance financial reporting quality. Future studies will possibly touch this area. Already, some emerging studies such as Gana and Krichnen (2013) confirm that external audit quality and board characteristics (particularly independence and diligence) are complementary mechanisms.

## 5.2 Research Implications

The findings of this research is of potential interest to decision makers, professionals, boards of directors and academics, particularly on issues relating to auditor quality, corporate governance practice and financial reporting. The main contribution of this study has been its in-depth examination of financial reporting and providing an understanding of the key role played by external and internal corporate governance mechanisms in enabling or forestalling financial misstatements in Libya, albeit a form of investigation rarely found in existing literature in developing countries. From a methodological angle, this study was conducted by using primary data (survey method) and secondary analysis of extant literature to enrich the research findings through the data triangulation approach. There is no doubt that the use of primary data enabled the research to have a deep appreciation of corporate governance mechanisms.

The study adds in the existing knowledge in the following ways:

- This is the first study in reference of Libya which deals with the reliability of audited financial statements, corporate governance and audit quality simultaneously. So, it adds the new dimensions on the said topic categorically in the reference of Libya.
- It allows the banking sector of Libya to have a deep insight in the matters of audit quality, corporate governance and reliability of audited financial statements to improve their qualities and to gain more customer confidence, as banks are always in need to gain more customer confidence.
- In the reference of conducting an audit the audit rotation, competence and other related features are important to consider. This study comes up with the empirical

evidence on such things especially in the reference of Libya. So, it facilitates the banking sector in Libya to have more quality audit and produce the more reliable audited financial statements.

- Generally, this study resulted in an enhanced understanding of the concepts of corporate governance, auditor quality and reliability of financial statements. The study contributes to the growing corporate governance literature by empirically investigating the link between corporate governance mechanisms, auditor quality and RAFS. Additionally, this study also developed an integrated approach to the definition of corporate governance mechanisms that encompass both internal and external dimensions. This implies that a broad perspective of corporate governance mechanisms is immensely useful to both academics and professionals. More interestingly, the study highlights the significance of the audit committee as a corporate governance mechanism, showing its impact over many decades and exploring the dynamics in its understanding and perceptions in the Libyan context. From the auditing perspective, this study offers a number of implications for decision makers and practitioners. Mainly, the study elaborates on the relevance of the audit committee in ensuring audit quality as well as its impact on financial reporting. More specifically, the study also enhanced our understanding of the effect of the audit committee on auditor quality and improved our understanding of the relationship between auditor quality and RAFS.
- Audit fee is also an important variable of this study and it is added to identify its impact on audit quality and ultimately on the reliability of audited financial statements. It is empirically proved that audit fee has a positive relation with audit quality. As many other researchers including Gana & Krichnen, (2013)



depict the same that reward stimulates the person to work hard to bring desired results. And the main purpose of audit is to bring the true and fair picture of financial statements to give the clear financial position and performance of the organisation to the investors and lenders to take more wise economic decisions.

- Finally, the study's findings add to the developing body of literature analysing the relationship between corporate governance mechanisms and auditor quality. They also offer a better understanding of the determinants of external audit quality in the Libyan context.

### **5.3 Limitations of the Study**

This study has several limitations. Firstly, the sample for this study is drawn mainly from a selection of professionals working in the banking sector, which is a leading exponent of governance practices due to the sensitive nature of the industry. Thus, the findings of the study may not be applicable to other sectors in Libya because the strength of the firms' governance mechanisms varies according to sector.

Secondly, the independent variables were drawn from the corporate governance practices resulting in the exclusion of other key factors that affect audit quality such as accounting standards, competition in the audit market, regulatory and socio-economic dimensions.

Thirdly, the audit quality variables are restricted to DeAngelo's (1981) conceptualisation which is premised on auditor independence and competence. However, these two attributes of auditor quality are unobservable. Consequently, the

majority of studies focused on audit quality use a number of substitutes or proxies such as auditor's reputational capital, commonly known as a big auditor (DeAngelo, 1981), audit fees (Hay *et al.*, 2008) and seniority of the auditor (Kaplan & Williams, 2012). Other measures include financial restatements, auditor's litigation, auditor performance, auditor responsibility and auditor statement reliability (e.g. Nieschwietz & Woolley, 2009, p. 94). In other words, the use of other audit quality measures may be instructive. To put it differently the use of other measures may help to generalise the actual audit rather than perceived audit quality (Rohaida, 2011, p. 274). On the other hand, other scholars like Bennecib (2002) argue that the presence of a second audit firm (co-auditor) is also likely to raise audit quality, particularly if it is a big audit firm.

Fourthly, financial statement reliability is the only measurement for financial reporting in this study and yet there are other measures such as timeliness, comparability, understandability to decision makers, completeness, and relevance (Bullen & Crook, 2005; Bribesh, 2006). There is no doubt that a number of accounting bodies and scholarly works document a number of characteristics that disclosed financial information should possess in order to be valuable (Al-Hussein, 2001). Fifthly, the results of the study were based on respondents' perceptions which may not reflect the actual practices of the participants. For instance, sometimes respondents may answer questions to satisfy what they think the researcher imagines.

Finally, the cost and time constraints limited the researcher to the use of a mailed questionnaire survey technique. Therefore, unlike an interview method, in-depth and rich information could not be gathered from the mailed questionnaire survey.

However, being the first formal perception survey on financial statements in Libya after Gaddafi regime's collapse, and in line with the objective of the study, a mailed questionnaire survey was drawn up to cover a wide range spectrum of issues concerning the reliability financial statements after audited.

Given the above limitations, the findings and implications of this study needed to be interpreted with caution. After all, since this study is conducted in Libya which is considered a developing country, caution should be exercised when generalising the findings of the study because these findings may be generalised only in a similar environment. As indicated by Francis and Wang (2008) a country's characteristics influence the provided audit quality in a particular country. Basing on this observation, the findings of this study are peculiar to the Libyan context and are difficult to replicate in other countries.

#### **5.4 Recommendations for Future Research**

There are several ways to extend the study examined in this thesis. In other words, the research results indicated new areas for future research that can also have important implications. Firstly, future research may be beneficial, if more variables and better measures are integrated into the study to enrich the outcome variable. In this regard, it is important that other factors which affect audit quality such as accounting standards, competition in the audit market, regulatory and socio-economic dimensions are added to the conceptual framework. This would allow us to have a deeper knowledge of the factors that affect audit quality. Similarly, future studies should use all existing measures or proxies of audit quality including auditor's reputational capital, financial restatements, auditor's litigation, auditor

performance, auditor responsibility and auditor statement reliability. This would allow us to draw more reliable conclusions about the effect of auditor quality on the RAFS. To put differently, future research should design a comprehensive measure of audit quality.

Since this study focused on the banking sector, it is thus proposed that future research be conducted in other sectors such as manufacturing or oil industries. Thus, it might be worthwhile to include other industries in order to gain a comprehensive understanding of the relationship between corporate governance practices, auditor quality and RAFS. Finally, the investigation of the research topic area can be extended to other Arabic countries like Egypt, Morocco, Algeria, Iraq and others, in order to provide more proof on the link between corporate governance mechanisms, auditor quality and RAFS. This would certainly enrich the extant literature and might provide more useful insights of corporate governance practices. Future studies may also examine the effect of complementarity. As indicated earlier, the findings of the study suggest a positive relationship between certain attributes of corporate governance practices and auditor quality. This is in favour of the complementarity effect which needs further probing. Interestingly, similar results are provided by existing studies employing data from Eurocentric context (Gana & Krichnen, 2013).

## **5.5 Conclusion**

This study investigated the relationship between corporate governance mechanisms, auditor quality and the RAFS. The key findings of this study support the significant relationship between corporate governance mechanisms and the RAFS. It was also found that there is a direct positive relationship between corporate governance

practices and auditor quality as well as between auditor quality and the RAFS. In terms of the mediating effect, the results suggest that auditor quality partially mediates the relationship between corporate governance mechanisms and the RAFS. Overall, the results of this study coincide with agency theory, which states that corporate governance mechanisms are essential monitoring devices that improve auditor quality which in turn helps to enhance financial reporting quality. Crucially, this study has opened up possibilities for further research into the complementarity effect of other factors which need further probing in Libya and other developing countries and worldwide.

Some researchers worked on the variables discussed in this research but most of them are related to the developed countries, which gives results only in the reference of the specific economies. Some studies are also conducted in the reference of developing countries but no such study exists in the reference of Libya. As all the economies have their own specific features so it should be done to obtain empirical results. Specifically this study becomes even more important as it is conducted on banking sector of Libya. And the banking sector is considered as the backbone of any economy so it becomes even more vital to conduct such researches to investigate such important relations (auditor quality, corporate governance and reliability of audited financial statements) on the sector of core importance.

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