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Audit firm, corporate governance, and audit quality: Evidence from Bahrain

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ABSTRACT

The aim of this research is to document the perceptions of credit and financial analysts with regard to the relationship between the effectiveness of audit committee, size of the auditing firm and audit quality in the context of Bahrain, which is characterized by a developed financial sector, low-liquidity stock market, low turnover in board of directors of listed firms, an inactive merger and acquisitions market and almost non-extent litigation. A survey of 300 credit and financial analysts shows that analysts considered auditors' opinion useful. Both credit and financial analysts see the credibility of financial statements to be a function of the size of the auditing firm. Both groups assume that the characteristics of Big-Four firms allow them to produce better-quality reports than non-Big firms. Non-audit services were found to affect auditor's independence and hence impair audit quality. Both the groups of analysts believe that effective audit committee enhances the quality of audit reports. Financial analysts perceive financial statements to be more credible than do credit analysts.

1. Introduction

Audit service is perceived to play an important role in reducing information asymmetry (Beatty, 1989; Willenborg, 1999) as well as in mitigating agency problems between managers and shareholders and between shareholders and creditors (Jensen & Meckling, 1976). Therefore, owners hire auditors to produce information used in contracting with managers (Antle, 1982; Watts & Zimmerman, 1986).

Meeting these two roles depend on audit quality. While audit quality is considered an important element of corporate governance, it is unclear whether audit quality and other aspects of corporate governance (such as director knowledge and independence) are fundamentally complements or substitutes, according to Defond and Francis (2005).

Audit quality is a concept that has different definitions for different people. DeAngelo (1981a) hypothesizes a two-dimensional definition of audit quality that has set the standard for addressing the issue. First, a material misstatement must be detected, and second, the material misstatement must be reported. Audit quality as such is the increasing function of the ability of an auditor to detect accounting misstatements and is related to the degree of auditor independence. Titman and Trueman (1986) propose that a good auditor provides precise information regarding the firm's value. Because the purpose of an audit is to provide assurance as regards the financial statements, audit quality is defined by Palmrose (1988) as the probability that financial statements contain no material misstatements. Davidson and Neu (1993) define audit quality as the ability of the auditor to detect and eliminate material misstatements and manipulations in the net income reported.

Users of financial statements perceived audit reports to provide absolute assurance that company financial statements have no material misstatements and do not perpetrate fraud (Epstein & Geiger, 1994). However, auditors perceive audit quality in terms of strict adherence to GAAS/ISA requirements. Auditors working with a company also strive to reduce their business risk by minimizing auditees' dissatisfaction, avoiding litigation, and limiting the damage to their reputation, which could result from audit failure. The demise of Arthur Andersen in 2002 is an example of the ultimate results of audit failure.

Regardless of any differences in the definition of audit quality, and even when users and providers of audit services question the quality of audit service, they agree on its importance. I acknowledge that measuring audit quality is problematic. The quality of an audit is not directly or immediately obvious, especially to creditors and investors. Audit quality-control procedures are intended to maintain high standards of control over the process of an audit, but an audit failure usually becomes known only in the case of a business failure; witness Enron.

An auditor's role is to assuage agency problems resulting from the separation of ownership and control (management). This role can be successful only if an audit opinion reflects the true findings of the audit engagement.

According to the Statement of Financial Accounting Concepts No. 1 (SFAC No. 1, Paragraph No. 8, p. 9), "financial statements are often audited by independent accountants for the purpose of enhancing confidence in their reliability."

American Institute of Certified Public Accountants (AICPA) (1994) also acknowledges the importance of considering perceptions of investors on auditor independence. A former chairman of the AICPA, Elliott (2000)

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says "[The AICPA] believe[s] that appearances are very important and capital markets require confidence in financial statements and audit reports, and the member firms of the AICPA are basing their business of auditing on their reputations, and that is heavily affected by appearance."

Despite considerable research on audit quality, studies on audit quality in Bahrain are scarce. This might be due to the relatively low number of audit failures. Since the establishment of the first shareholding companies until 2008, there were only three reported cases of audit failure. These cases involve the General Trading and Food Processing Company (1994), the Bahrain Islamic Investment Company (2002), and the Bahrain Saudi Bank (2002). The fraud involved in the first case was carried out by the company's accountant, and the court ruled against the accountant. As for the second company, the case was settled out-of-court, and the partner involved in the case was asked to leave the firm, whereas the third instance resulted in replacement of the auditors without the auditors being taken to court. The low number of reported cases of audit failures does not ensure that audits of Bahraini listed firms are of good quality and should not mean that users of company reports should be complacent as to the quality of an audit. Therefore, this study investigates the way users of financial statements determine the quality of audit reports. Accordingly, a survey of the major users of financial statements (investors and lenders) with respect to their perceptions of the factors that determine audit quality, particularly with respect to the impact of corporate governance and size of audit firms on the quality of an audit report, is carried out.

This research makes three contributions to the literature. First, although most of the research in the area uses different methodologies to investigate the determinants and the role of audit quality on integrity and quality of accounting information, studies on markets such as Bahrain, which is characterized by dominance of few accounting firms; largely uncommon cases of switching audit firms; weak enforcement of regulation reverent to audit industry, with exception of those related to financial institutions; low-liquidity stock market; and considerably less number of different institutional setup. Hence, this research provides additional insights to audit quality. Second, it responds to calls for empirical testing of the relationship between corporate governance and audit quality, according to Defond and Francis (2005). Third, Defond and Francis (2005) argue that research on the effectiveness of audit committee suffer from a number of problems such as weak statistical explanatory power and multi-colinearity problem. A survey method that asks respondents to state their perception of the effect of effective audit committee on audit quality overcomes these problems.

The remaining part of the article is organized into four sections. The following section provides brief accounts of the audit market in Bahrain. Section 3 offers brief literature review on the relationship between effectiveness of audit committee, firm's size, and audit quality. Section 4 describes the data collection and research methodology. Section 5 presents the research findings of questionnaire survey. The final section provides conclusions of the study, its implications, and suggestions for future research.

2. Audit market in Bahrain[1]

Some important features of the audit market in Bahrain must be understood to perceive the context in which this study was undertaken.

As of the end of February 2008, audit services in Bahrain are provided by 24 accounting firms. Five of these are considered local; four are operating as foreign branches; and the remaining are linked to international firms. The Big Four; i.e., Ernst & Young (E&Y), Deloitte & Touche (D&T), KPMG, and PricewaterhouseCoopers (PWC) have a strong presence in Bahrain. D&T and KPMG operate as a joint venture, whereas the other two operate as branches of international firms. BDO Jawad Habib and E&Y are the only two firms registered with the United States (US) Public Company Accounting Oversight Board (PCAOB).

The Bahrain Stock Exchange (BSE) was established in June 1989. As of July 2007, there were 41 listed Bahraini incorporated firms (two of these have been de-listed and did not issue their reports of 2006). The majority of the companies are retail banks, wholesale banks, and investment companies.

The Central Bank of Bahrain (CBB) requires financial institutions to be audited by one of the big audit firms. Audit services are regulated by the Amiri Decree Number 26 of 1996, which requires auditors to obtain a license to practice and set the minimum requirements for a license. In effect, audit firms got two licenses, one to practice auditing and the second specifically to offer auditing services to financial institutions.

Appointments of auditors, as per article (205) paragraph (e) of the Bahrain Commercial Companies Law Number 21 of 2001, should be made on a yearly basis at firm annual stockholder meetings. However in practice, boards of directors are empowered by annual meetings to appoint auditors and to determine their remuneration. This practice is subject to criticism on the grounds that an auditor's role is to mitigate agency problems that might exist between the board and the shareholders.

The CBB's authority is based on article, (61) paragraph (a), of The Central Bank of Bahrain and Financial Institutions Law Number 64 of 2006, which states: "Every Licensee shall appoint one or more qualified and experienced external auditors for its accounts for every financial year. Prior written approval by the Central Bank will be required before appointing an auditor." This approval is needed annually. In cases wherein a decision has been taken to replace the external auditors before the end of the year, the respective financial institutions are also required to inform the CBB about the reasons for this decision.

Since 2002, only three of the Big Four have been approved to audit the financial statements of the locally incorporated banks. Exclusion firm of the Fourth came after its audit failure of the financial statements of locally incorporated retail banks. CBB guidelines specify experience of the auditors, experience of the firm, and number of partners, among other requirements. Currently, only Big Four firms audit small financial institutions.

The internal guidelines of the CBB allow non-big firms to audit small investment companies. As of September 2007, Bahraini incorporated financial and non-financial firms listed on the Bahrain Stock exchange are audited by five companies, the Big Four and one other company, which is connected with an international firm. The other two companies are a joint venture between a local audit firm and regional or international companies. Unlike some other countries in the region where listed firms are audited by two audit firms, all companies in Bahrain are audited by only one audit firm.

Audit services industry is dominated by the Big Four. A total of 82.5% of the 41 listed companies on the BSE that published their annual reports in 2007 are audited by one of the Big Four, and the other 17.5% are audited by a non-Big Firm company.

In Bahrain, it is not mandatory to switch audit firms. In fact, in 2006, the CBB took a position against a motion in the parliament to mandate such a requirement on the ground that small markets are distorted by such decisions. Experience has shown that switching of audit firms takes place in very rare cases and generally occurs only after an audit failure. The CBB does require auditors of financial institutions to switch auditing partners at least every five years. Auditing firms claim that

[1] Most of the contents of this section are based on interviews with the following persons: Adnan Yusuf, Chief Executive Officer of Albarka Banking Group; Ibrahim Zainal, Chairman of TRAFCO; Jamal Fakhro, CPA (US), Managing Partner of KPMG Fakhro and Ex-Chairman of the Bahrain Accountants Association (BAA); Elham Hasan, CPA (US), Managing partner of PWC-Bahrain; Abbas Radhi, CPA (US), a partner from BDO Jawad Habib, and Chairman of the BAA; Hameed Rahma, Assistant Undersecretary for domestic trade at the Ministry of Industry and Commerce; Jassim Abdulaal, CA (UK), Senior Partner, Grand Thornton-Gulf Audi-Bahrain; Yusuf Hassan, director of bank supervision at the Central Bank of Bahrain (CBB); Khalil Noor Eldeen, CFA, Ex-investment banker, Ex-director of BIBF, and a member of the audit committee of Ethmar Bank Group; and Waleed Bangash, CA (UK), Director, Financial Control (Strategic Planning), Unicorn Investment bank. The interviews took place between the 5th of January and the 4th of March, 2008.