

# The Effect of Auditor Characteristics on Audit Service Quality from an Audit Client Perspective in Libya: Proposing Conceptual Framework

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## Abstract

The recent collapse of several companies and high-profile frauds in the last two decades has called to question the integrity of the audit profession and resulted in a decline in shareholders' confidence in audit financial statement and the audit profession at large. This has called for the improvement in professional regulation and audit service quality in order to recover the confidence of investors and other users in the reliability of audited financial statement. To achieve this, this paper proposes a conceptual framework to investigate the role of individual auditor characteristics (auditor reputation, specialization, experience, and independence) on audit service quality by using a sample of all listed companies on the Libyan Stock Market (LSM). Evidence from previous studies indicated that the determinants of audit service quality should be more significant at the individual level. The technical abilities and individual characteristics of the external auditor are critical factors to improve and sustain audit service quality. This study argues that auditors with effective individual characteristics are more likely to provide high audit service quality.

**Keywords:** audit service quality, auditor characteristics, Libya.

## 1. Introduction

In recent years, several discussions about the auditing profession have arisen, particularly after the highly publicized collapse of Enron, which was followed by other major accounting scandals, such as those involving WorldCom and Parmalat (Li, 2007). These events and the ensuing investigations have resulted in changes to regulatory arrangements, such as the Sarbanes-Oxley Act of 2002 in the US, which reflect the considerable public dissatisfaction with the effectiveness of audit service quality and the roles of auditors. In response, regulators and accountants have formulated a number of policy measures to improve audit service quality. These policy decisions have been made despite the inconclusiveness of the empirical evidence regarding the factors that can enhance or impair audit service quality. Therefore, audit service quality is an increasingly important area of examination (Boon et al., 2008; Reheul et al., 2013).

Reheul et al., (2013) recognized that because of a series of accounting scandals and corporate failures, the quality of external auditing services remains a hot topic and continues to arouse much debate. The collapse of many large companies around the globe, as in the case of the collapse of Enron and the role of the external auditor "Arthur Anderson," put audit service quality under scrutiny and criticism. These collapses have increased the importance of audit service quality (Abdulsaleh, 2014). Awadallah (2006) recommended that confidence in the role of the auditing profession, in general, and in auditors, in particular, needs to be maintained and enhanced, and hence more empirical research is required to be undertaken.

By conducting a review of previous studies, we found significant research interest both at the local and international levels in investigating the relationship between the factors associated with the audit firm and audit service quality. However, less attention has been given to the factors associated with the auditor at the individual level despite the significant effect of these factors on audit service quality. As a result, the importance of factors related to the individual auditors in determining the audit service quality has received increasing attention from policymakers, practitioners, researchers, and academics. In this regard, DeFond and Francis (2005) suggested that the audit service quality analysis should be tested at the audit firm or office level down to the individual auditor level. In addition, Gul et al. (2013) highlighted the importance of understanding audit service quality at the individual auditor level. Similarly, Church et al. (2008) proposed that researchers investigate whether there is a systematic relationship between individual characteristics and audit service quality.

Service quality is a measure of how well a particular service matches customer expectations. In the audit function, service quality is best determined by the audit clients as they can provide unbiased opinions on the audit quality level (Ismail et al., 2006). Thus, the views of auditor clients who have access to auditor review reports and are involved in decisions on the selection of auditors are necessary. Mendonca and Persson (2014) concluded that the general description found in previous research does not give a detailed description of client companies' perception of audit quality. Considerable attention should be paid not only to the external users (third-parties), but also to the audit clients, as their perceptions of what constitutes a quality audit are subjective as well as the factors influencing it (Vaicekauskas, 2014).

This paper proposes a conceptual framework to investigate the relationship between individual auditor characteristics (auditor reputation, specialization, experience, and independence) and audit service quality from an audit client perspective by using a sample of all listed companies on LSM. The remainder of paper is

organized as follows: introduces the background of the study in section 2. Literatures review in section 3, the conceptual framework and hypothesis development presented in section 4. Summaries and concludes this paper in section 5.

## 2. Background of the Study

Libya is located in the middle of North Africa. Islam and the Arabic languages characterize Libyan culture. The Libyan society is characterized by the extended family, clan, tribe and village. These characteristics play a great role in people's lives and their relationship to the country (Ahmad and Gao, 2004). The Libyan economy largely depends on oil as the main natural source of wealth, and this commodity accounts for 99% of the country's exports (Al-Mabrouk and Soar, 2009). As a result, the Libyan oil industry has been a significant and attractive area for foreign investment. However, oil is a natural resource, and its over-use may lead to its total exhaustion. Consequently, Libya aims to decrease its dependence on oil revenue and move into global capital by moving towards privatisation and the establishment of the Libyan Stock Market (LSM).

The LSM is expected to play an important role in providing capital for investment, which in turn drives economic development in Libya (Aljabiri, 2012). Audit function represents the basic framework for the work of LSM. The high quality performance of this function is necessary to improve the effectiveness of the market to in turn protect investors and increase the confidence in LSM, which in turn achieves stability and boosts trust among dealers in LSM. In addition, transparent and accurate financial reporting achieved through high audit service quality represents the lifeblood of the LSM (LSM, 2009). The Libyan Accountants and Auditors Association (LAAA) was established in 1973 by Law No. 116 as the regulatory body tasked to organize and improve the conditions of the accounting profession, raise the standards for accountants and auditors professionally, academically, culturally, and politically, and participate in conferences and seminars related to accounting.

## 3. Literature Review

Audit service quality is one of the most significant topics in the auditing profession (Boon et al., 2008; Mohamed & Habib, 2013). Therefore, it is an increasingly important area of examination. Audit service quality has never been more important after the collapse of Enron in 2001 and the resulting turmoil in the auditing profession. Thereafter, the global financial crisis prompted policymakers to focus on the significance of an effective audit function as a key component in effective capital markets, and attempt to identify key drivers of audit service quality. Furthermore, Chang et al. (2009) has revealed that high audit service quality helps to reduce the cost of capital and increases access to equity financing, as well as having economic consequences for auditors, audit clients, and capital market participants.

Although the audit service quality has gained significant interest in developed and developing countries, up to now, there is still not an agreed-upon universal definition (Bing et al., 2014; Knechel et al., 2013; Anis, 2014). Audit quality has been divided into two categories: functional audit quality and technical audit quality (Dassen, 1995). Functional audit quality refers to the degree to which the expectations of stakeholders are met in terms of the processes involved in conducting the audit engagement, and then communicating the results of the audit. Users of audit services, comprised of auditees and the third-party beneficiaries, for the assessment of audit quality base their assessments on the reliability and responsiveness of the auditor. (Dassen, 1995). Technical quality relates to the core service as perceived by the client. Thus, both 'what' is delivered (the technical quality) and 'how' it is delivered (process quality) are both important in delivering overall service quality and value to clients (Sarapaivanich and Patterson, 2014).

The auditors may attempt to differentiate themselves via their levels of client service, that is the process quality and the rapport and effective two-way communication they have with clients. The audit process involves numerous service encounters between the auditor and client (Duff, 2009). Process quality takes on added importance in clients' assessments of value. Value is a broad term and has been used in varying ways, depending on the discipline. Moreover, given that value is partly driven by 'what is received', it stands to reason that perceptions of technical and process quality (i.e. service performance) will be associated with client perceptions (Cronin et al., 2000).

George (2009) argues that the quality of financial reporting depends partly on the auditor's ability to detect material misstatements, and partly on the auditor's behaviour subsequent to the detection of such misstatements. However, the utility of the auditing function depends on the audit service quality, which is determined by several factors. The literature and standards governing audit conduct highlight a number of factors that can promote and strengthen audit service quality. Auditor attributes cover such characteristics as ability to scrutinise, technical competence, knowledge, experience, industry specialisation, technological proficiency, which are considered prerequisites (Catanach & Walker, 1999). According to Mendonca and Persson (2014) the subjective nature of an audit is inherently dependent on the auditor as a person and his/her judgement, effecting factors, audit procedures and processes.

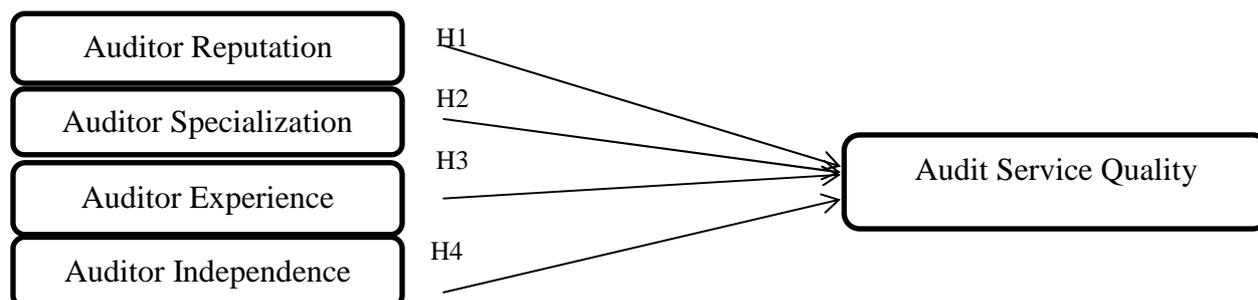
In order to obtain a high-quality audit, the auditor's personal attributes must include expertise, experience, high ethical values, business knowledge, and integrity (FRC, 2006). Mendonca and Persson (2014) also mentioned that Broberg (2013) lists the auditor's personal qualities and characteristics as one of drivers of audit

quality. Thus, it seems likely that individual characteristics of the auditor could affect the audit service quality being undertaken. The importance of auditor characteristics in determining audit quality has received increasing attention in recent years. For example, in a review paper, DeFond and Francis (2005) suggest that the audit quality analysis be pushed from the audit firm or office level down to the individual auditor level. Similarly, Church et al. (2008) advocate for more research as to whether there is a systematic relationship between auditor characteristics and audit quality.

In addition to the previous discussion, the role of the individual auditor characteristics is fundamental to improve audit service quality in the Libyan market. Some researchers and practitioners pointed out that the lack of audit service quality in Libya may be due to the lack of Libyan auditor's characteristics, such as specialization, qualification, experience, and independence (Eldarragi, 2008; Faraj, 2009; Gaballa & Ning, 2011; Tumi, 2013; Zakari, 2013). In the following section, auditor characteristics, such as auditor reputation, specialization, experience, and independence, that may affect audit service quality in the Libyan market, are discussed for their influence on audit service quality in literature review.

#### 4. The Conceptual Framework and Hypothesis Development

Auditor characteristics and their relationship with audit service quality are integrated in one conceptual framework. The diagram for the proposed framework is illustrated in Figure 1. In this framework, auditor characteristics is an independent variable and audit service quality is a dependent variable. The present study thus attempts to bridge the gap by providing a basis for a comprehensive discernment of the impact of auditor characteristics and audit service quality. In order to make practical statements about auditor characteristics and its associations with audit service quality, the model requires further analysis. Sub-sections 4.1 till 4.4 will discuss the hypotheses that are developed from the conceptual framework.



**Figure (1) Auditor characteristics and audit service quality**

##### 4.1. Auditor Reputation

Because investors are unable to directly observe audit quality, auditor reputation serves as an important proxy for the quality and accuracy of client financial statements (DeAngelo, 1981). According to Aronmwan et al., (2013), auditor's reputation refers to the corporate image auditors build over time. It may be as a result of the array of auditors the firm possesses, the brand name, the perceived audit quality resulting from little or no litigations, or the fees charged, among others. Datar and Alles, (1999) have used two aspects of reputation. First, the auditor's local reputation with the client depends on the behavior of the auditor as observed by the manager (such as whether it is a Big Five or a non-Big Five firm). Second, the auditor's reputation affects the behavior of the client in future interactions by influencing the client's beliefs about how thorough the audit will be.

Fargher et al., (2001); Jin et al., (2011); Aronmwan et al., (2013) were consistent with previous study, and they chose a large-firm auditor (Big four) as a proxy for auditor reputation. Chang and Monroe (1994) have argued that, since auditor's reputation is one of the most visible, low cost, and easily available information regarding an incumbent auditor, it should be included in any experimental study on the perceptions of audit service quality because these assessments cannot be complete if the auditor's reputation is excluded or unknown.

In fact, generally speaking, the larger and better-known firms are perceived to offer better quality services. Previous studies have, thus, differentiated the auditor's quality according to whether or not the firm, office, or auditor belongs to one of the Big Four (Siala et al., 2009). In this context, Krishnamurthy et al., (2006) investigated whether the decline in Andersen's reputation adversely affected the stock market's perception of audit quality. The results indicated that the indictment period abnormal return is significantly more negative when the market perceived the auditor's independence to be threatened. Their empirical results support the notion that auditor reputation has a material impact on perceived audit quality. In line with the previous study, Skinner and Srinivasan (2012) used events surrounding ChuoAoyama's failed 2006 audit of Kanebo, a large Japanese cosmetics company, to provide evidence of the importance of auditors' reputation for audit quality. They found

that one quarter of ChuoAoyama's audit clients switched away from the firm after its suspension consistent with the importance of auditors' reputation for delivering quality.

Furthermore, a behavioural study conducted by Zulkarnain and Yusuf (2006) aimed to examine the impact of auditor reputation (i.e. size of audit firm) on auditor independence in Malaysia. The results indicated that clear majority of the auditors, loan officers, and senior managers of public listed companies agreed that auditors in Big Four firms are superior to their counterparts in non-Big four firms in regard to all of the reputation issues presented to them. Hosseinnikani et al., (2014) also aimed to review the different audit quality factors, comparing the results achieved by the related recent studies. In this regard, auditor reputation was found to affect audit quality significantly. In the same context, Aronmwan et al., (2013) evaluated the relationship between auditor's reputation and audit quality using a sample of listed companies of the Nigerian Stock Exchange. The findings showed that there is a positive significant relationship between audit firm reputation and audit quality.

Sakka and Jarboui (2015) investigated the combined effect of internal governance mechanisms, along with the auditor reputation, on audit reporting quality. The results shown the persistence of substitution effects between control effectiveness, as implemented by the directors' Board or by the ownership structure in quest for a brighter external audit reputation, for the sake of ensuring prompt and reliable information. Moreover, according to Susanty and Gunawan, (2015) the performance of audit firms and auditors that concerns sustainable reputation can also be viewed as a catalyst towards a new direction where individual performance becomes the competence indicator of auditors. At this point, there is a need to have continuous incremental improvements. Auditors of the future must build good individual reputations in order to have a sustainable competitive advantage and achieve high audit service quality. According to the previous discussion, auditors with a good reputation will have the tendency to protect their reputation through providing high audit service quality. The auditor's reputation is also perceived to be important as one of the competitive advantages in the audit market, therefore this research builds the following hypothesis:

**H1:** Auditor's reputation has a positive and significant effect on audit service quality.

#### **4.2. Auditor Specialization**

Auditor specialization refers to an auditor's unique expertise in an industry (Casterella et al., 2013). Furthermore, auditor specialization also requires excellent genius to perform a complex and diverse structured task in a higher manner, which is the most important driving force of audit service quality (Wooten & Colson, 2003). Industry specialization is a goal of increasing importance for some auditors, if not all. Azham Md et al., (2009) indicated that specialization in the audit market is considered of utmost important in the United States, which is also reflected by the fact that in 1998 a sample of the nation's accountants had viewed it as critical for the future survival of the audit firms (AICPA, 1998). Thus, not surprisingly, the same study identified specialization as one of the five top issues impacting the CPA profession in the 21st century. In addition, AICPA (1998) stated the issue of industry specialization has become increasingly relevant to the auditing profession as firms organize their practices along industry lines rather than traditional service lines (Al-Khaddash et al., 2013).

Working with multiple clients in the same industry allows the staff of accounting firms to become experts in the processes and procedures unique to that industry. An auditor can be more confident and persistent when assessing the evidence presented by the client by understanding the common weaknesses, risks, and issues faced by a particular industry (Wooten & Colson, 2003). Thus, industry-specialist auditors have greater opportunities to develop more in-depth knowledge of the industry in which they specialize. Such in-depth knowledge should lead to greater audit effectiveness (Low, 2004). Habib and Bhuiyan (2011) argue that industry specialist auditors are able to develop industry-specific knowledge and expertise, and to familiarize themselves quickly with the clients' business operations and, therefore, are likely to complete the audit sooner than their non-specialist counterparts.

In large firms, individual auditors specialize by auditing clients in the same industry. A report on the US audit market issued by the US General Accounting Office (GAO) in 2008 acknowledges the significance of industry expertise, noting that "a firm with industry expertise may exploit its specialization by developing and marketing audit-related services specific to clients in the industry and providing a higher level of assurance (GAO 2008; p. 111)." Developing an industry specialization is costly since it requires a significant investment of resources. From a cost-benefit perspective, such an investment is justified because audit firms making those investments are expected to provide high audit quality, attract more clients, and ultimately make a profit on their investments (Casterella et al. 2004; Numan & Willekens, 2012).

The industry specialization literature suggests that performance is optimal when industry specialists spend most, if not all, of their time auditing clients in one industry setting (Low, 2004; Hammersley, 2006). Schauer (2002) contended that one of the most important factors that influences the level of audit quality is industry specialization, providing evidence that audit quality increases as the level of auditor specialization increases. In the same context, the findings of Robkob et al. (2011) indicated that a higher degree of audit specialization may help achieve higher audit quality. Dao and Pham (2014) examined the impact of auditor industry specialization on the association between audit firm tenure and audit report lag. They found that auditor industry specialization

weakens the positive association between audit report lag and short audit firm tenure. In the same context, Habib and Bhuiyan (2011) investigated the relationship between industry specialization and the audit report lag. They demonstrated that the audit report lag was shorter for firms audited by industry specialist auditors. Bafqi et al., (2013) examined the impact of auditors' characteristics including auditor tenure and expertise on the audit service quality. The findings indicated that there is a significant association between audit expertise and audit quality.

Moreover, Chi and Chin (2011) examined whether auditor industry expertise, measured as both individual partner- and audit firm-level leadership, effects on auditor service quality using a sample of listed firms in Taiwan. They found that clients of lead signing auditor specialists, either alone or in conjunction with concurring auditor specialists, have smaller accruals and are more likely to receive a modified audit opinion compared to those of non-specialists. They concluded that industry expertise is not homogeneous across individual auditors within the same audit firm. Accordingly, based on the above discussion, the following hypothesis is developed:

**H2: Auditor's specialization has a positive and significant effect on audit service quality**

### **4.3. Auditor Experience**

Enofe et al., (2014) stated that experience is the knowledge and proficiency gained by someone with the passage of time. It is assumed that repeated work by an auditor over a long period of time will improve the quality of audit. Kolodner (1983) as quoted in Enofe et al., (2014) identified two dimensions of experience, such as the tenure of the audit job (how long the auditor has been doing the audit job) and the frequency of carrying out the audit engagement. According to IFAC (2010), experience is comprised of skills, knowledge, and experience in a particular field. Experienced auditors generally have a complete knowledge base and engage in more complex cognitive processing. Prachsriphum et al., (2010) stated that auditor's experience is skills that are obtained from accumulate audit tasks. Thus, experience is shown to be an important aspect of knowledge and ability. IAESB (2009) stated that practical experience is the ongoing experience of professional auditing in the accountancy field and on-the-job execution of tasks that are relevant to the field of auditing and accounting.

Experience is shown to be an important aspect of knowledge and ability (Libby & Frederick 1990). One issue that has earned special attention in the literature is the relationship between experience and performance (Tirta & Sholihin, 2004). The signs of behavioral studies that have focused on the subject of experience that the quality of performance in a particular area increases with their experience in that field (Gaballa & Ning, 2011). In addition, professional experience is one of the key determinants for the efficiency of performance in professional practice. In the audit profession, after completing educational requirements, most professionals enter their careers as assistants in audit firms. They keep learning and gaining expertise through "learning by doing". Thus, as time passes, auditors build human capital in the form of individual skills (Cheng et al., 2008). Prior studies in this area provide contradictory findings. Some studies indicated that experience should be regarded as an important factor in the quality of auditors' performance (Bonner & Lewis, 1990; Libby & Frederick, 1990; Knapp & Knapp, 2001). On the other hand, some studies indicated that there no differences between experienced auditors and inexperienced auditors on the auditors' quality (Ashton, 1991). Thus, several studies have began to concern themselves with the effect of engagement auditor experience on audit quality. They have not drawn consistent conclusions about the association between engagement auditor experience and audit service quality. The use of experience as an independent variable is based on the assumption that repeated work over a long period will improve the quality of works. Abdul Halim et al., (2014) found that auditor's competence and independence positively affect on audit service quality. Experience was considered the most important indicator by respondents to form auditor's competence and audit quality. In addition, Shoommuaangpak (2007) found that auditor experience plays an important role that affects the reliability and credibility of financial reports. He also indicates that auditor experience have a significant impact on the audit service quality. Wang et al., (2015) explored Chinese market data to examine the relation between the experience of the engagement audit partner and audit service quality. The findings indicated that audit partner experience increases audit service quality. In addition, Atoijer and Annafaabi (2008) investigated auditors' perspectives on the factors that may have an effect on audit quality in Saudi Arabia; their results show that one of the strongest factors affecting audit quality is auditors' experience. According to Kaplan et al., (2008), auditors with more experience in auditing are likely to have a greater quality of audit.

Moreover, Januarti and Ghozali (2013) found that auditor experience is associated with performance improvement, impression management, and feedback seeking. Another study carried out by Wang et al (2012) examined the relationship between individual audit partner experience and actual, as well as perceived, audit quality. The result of the study reveals that audit partner experience increases both actual and perceived audit quality. A recent study conduct by Bouhawia et al., (2015) aimed to investigate the influence of personal characteristics of the auditor on the audit quality from perspective of auditors. The results showed that work experience has significant influence on audit service quality. In contrast to previous studies, a recent study conducted by Enofe et al., (2014) revealed that auditor experience is not a factor affecting audit service quality in Nigeria. Suyono, (2012) analyzed determinant factors affecting the audit quality, namely independence, experience, and accountability. The findings reject that experience affects audit quality. In the same context,

Ussahawanitchakit and Intakhan (2011) found audit experience does not effect audit professionalism, audit independence, and audit effectiveness. Another recent study conducted by Qi et al., (2015) found that engagement auditors with short audit experience and engagement auditors with longer audit experience have no significant incremental power in explaining variance in audit service quality. Accordingly, based on the above discussion, the following hypothesis is developed:

#### **4.4. Auditor Independence**

Auditor independence is becoming increasingly important because of its effect on audit quality. The integrity, objectivity, and independence of auditors and the quality of their work are bases for public belief in the credibility of auditors' reports (Soltani, 2007). When the auditor does not remain independent, the auditor is less likely to report irregularities; thus, the audit quality is impaired. With respect to the importance of audit independence, definitions of audit quality emphasize auditor competence and independence (De Angelo, 1981). Audit independence is defined as a judicial impartiality that recognizes an obligation for fairness to the management and owners of a business, as well as to the creditors and others who may rely on the reports of independent auditors (Roberts, 2010). Auditor independence is a necessary element for the trustworthiness of financial statements. Independent auditors increase the reliability of financial statements because they are more likely to prevent, detect, and correct material errors and omissions.

In the framework for understanding and researching audit quality, Francis (2011) argues that the audit service quality will be higher when the auditors implementing audit tests are competent and independent. A lack of independence impairs an auditor's ability to exercise objective audit judgments and affects confidence in the audit process (Treasury, 2010). According to Richard (2006), high levels of audit service quality rely on the proper balance between the auditor's independence, competence, and professional and personal relationships. Additionally, Octavia and Widodo (2015) found empirical evidence that auditor's independence had a significant and positive effect on audit service quality. Research conducted by Duff (2004) also indicated that audit quality is affected by four dimensions, one of which is the independence of the auditor. Similarly, Suseno (2013) shows that independence of public accountant office has a significant and positive influence toward audit quality. Samelson et al. (2006) also found that independence is one of the factors that affect the quality of the audit. In addition, Baotham and Ussahawanitchakit (2009) showed that audit independence has a significant impact on audit quality.

Mansouri et al., (2009) argue that audit service quality is highly dependent on the independence of the auditor. Carolina (2013) also found that auditor independence has a significant impact on audit service quality. A Libyan study was conducted by Faraj, (2009) and examined the factors that may impact on the independence of auditors and consequently affect the reliability of financial statements from the perspective of auditors and users in Libya as a typical developing country. The results reveal that users consider auditor independence as an important ground for reliable financial statements on which they base their decisions. In contrast to prior studies, recent study conducted by Al-Khaddash et al., (2013) aimed to identify the most important factors affecting audit service quality in Jordanian Commercial Banks (JCBs). The perceptions of JCBs' internal and external auditor's, in addition to financial managers, have been investigated. The results indicate that auditor independence seems to has no effect on audit service quality. Accordingly, based on the above discussion, the following hypothesis is developed:

#### **5. Summary and Conclusions**

Credibility of the audit function and perceptions of audit service quality are key components of effective and efficient capital markets. However, audit service quality is not easy to judge, which makes it particularly sensitive to the behaviour of the individuals who engage in audit work. The perceptions of the public regarding the audit service quality are directly reflected on its credibility, as well as on the auditors' characteristics. Positive perceptions sustain the audit credibility, while negative ones contribute to undermine the utility and legitimacy of the audit profession. The individual auditor characteristics are fundamental to improving audit service quality in the Libyan market. Some researchers and practitioners pointed out that the lack of audit service quality in Libya may due to the lack of Libyan auditor's characteristics. Thus, this study discusses some of the characteristics of the auditor.

Specifically, this paper intends to investigate the role of auditor' characteristics on audit service quality from perspective of listed companies in the Libyan Stock Market (LSM). To achieve this, four auditor characteristics are proposed, namely, reputation, specialization, experience, and independence. In turn, four hypotheses are developed. To validate the hypotheses, a research survey will be undertaken.

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