An investigation into audit quality in Libya

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Abstract

There are a number of audited companies in Libya which have gone into bankruptcy between 1995 and 2005. Therefore, there is a significant question about the audit quality situation in Libya. There is not itself much research about audit quality in Libya. In particular, there is not much research that has tried to measure audit quality in Libya. This study is an attempt to pursue further some of the issues around financial audit quality in Libya.

Secondary data analysis presents observations of Libyan companies from 2006 to 2009 to measure discretionary accruals. It applies an appropriate type of statistical method, to identify accruals and then examine the type of audit opinion related to these statements. Findings indicate that there is earnings management in almost all financial statements. The findings divided all companies into 113 positive and140 negative discretionary accruals. In addition, Findings indicate that auditors of the agency and auditors working for him/her self issued in general 85.7% unqualified (clean) audit opinion for financial statements that have earnings management, and 11% modified audit opinion. The results answer the first question in this study about the level of audit quality in Libya: audit quality level in Libya is low.

The semi-structured interviews support finding of the secondary data analysis, that is the level of audit quality in Libya is low. Also findings indicate that in Libya there are some fundamental elements which themselves are insufficient to deal to develop audit quality. Furthermore, the Libyan audit context suffers from some obstacles and problems that prevent the development of audit quality.

Declaration

I declare that the work in this thesis was carried out in accordance with the regulations of the University of Gloucestershire and is original except where indicated by specific reference in the text. No portion of the work referred to in this thesis has been submitted in support of an application for another degree or qualification of this or any other university or institute of learning in the UK or overseas.

Signed......

Date....28/09/2011..........

Dedication

I would like to dedicate this thesis to my late Father and Sisters. May Allah (God) bless them, grant them place in the hereafter and give them place in his paradise.

I wish also to dedicate this thesis to my beloved Mother, my Brothers and my Sisters, and my friends in Libya who have always given me courage and support.

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My grateful thanks to all the interview survey respondents of external auditors, professional academics, directors of the Financial Audit Agency, and presidents of Syndicates of External Auditors in Libya. Their help and cooperation made this research study a reality.

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List of Symbol and Abbreviations	
A	Accounting and Auditing Professional Academics Interviewee
AAA	The American Accounting Association
ACCA	Association of Chartered Certified Accountants
AICPA	The American Institute of Certified Public Accountants
ARM	The Audit Risk Model
ASB	The Auditing Standards Board
BSc	Bachelor of Science
CEM	Cosmetic Earnings Management
CEO	Chief Executive Office
CIGAC	Central Institute for General Administration Control
CPAs	Certified Public Accountant
D	Director of Branch of the Financial Audit Agency Interviewee
E	External auditor Interviewee
EPS	Earnings Per Share
FAA	The Financial Audit Agency
FIFO	First In, First Out
GAAP	Generally Accepted Accounting Principles
GAAS	Generally Accepted Auditing Standards
GAO	The Government Accountability Office
GMM	The Generalized Method of Moment
GPC	General People's Congress
IAASB	The International Auditing and Assurance Standards Board
IAPC	The International Auditing Practices Committee
IAS	International Accounting Standards

ICAEW	Institute of Chartered Accountants in England and Wales
IFRS	International Financial Reporting Standards
IPC	Institute of Public Control
IPFU	Institute for Public Follow-Up
IPO	Initial Public Offering
ISA	The International Standard on Auditing
ITC	International Trade Commission
IV	Instrumental Variable
KS	Kang and Sivaramakrishnan
LAAA	Libyan Auditors and Accountants Association
LCC	Libyan Commercial Code
LIFO	Last In, First Out
MAS	Management Advisory Services
MJM	The Modified Jones Model
MSc	Master of Science
NAS	Non-Audit Services
OLS	Ordinary Least Squares
P	President of Syndicate of External Auditors Interviewee
PCIE	President's Council on Integrity and Efficiency
PhD	Doctor of Philosophy
PMM	The Performance-Matching Model
RCC	Revolutionary Command Council
R&D	Research and Development
ROA	Return on Assets

SAB	State Accounting Bureau
SAIs	Supreme Audit Institutions
SAS	Statement on Auditing Standards
SCAS	Special Committee on Assurance Services
SEA	Syndicate of External Auditors
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SIC	Standard Industrial Classification
SOAL	State Office Accounting Law
SOX	Sarbanes–Oxley Act
TRA	US Tax Reform Act
UK	United Kingdom
UN	United Nations
USA	United States of America

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Chapter 1

Introduction

There are many social benefits resulting from the audit function, but this social function of audit cannot be realized except by setting standards and levels which guarantee high quality performance. The profession has become a system of social control, based on the responsibility and the trust that has been given to the audit profession. The audit profession earns the trust of society by providing accurate and high performing audit quality to confirm a true and fair view of financial statements. Meanwhile, audit is applied to various branches of activity, not just in the financial world. Its use is increasing in several other areas, such as education, health, and environmental auditing, which requires non-financial auditors and adds more challenge to the audit function.

Audits are supposed to be designed to provide reasonable assurance for the detection of errors and irregularities that are material to the financial statements. There is a strong criticism from some interested parties about the regulations which govern the audit profession, such as lack of independence, ineffective audit programmes, uninformative reports, lack of disciplinary schemes. There is also criticism that there have been instances of confirmation audit of responsibility for the detection of material omissions or misstatements in financial statements, and prediction of impending bankruptcy. Understanding these requirements helps to extend the knowledge relating to the audit profession and subsequently to audit quality.

Duff (2004) said that interest in audit quality is at an all-time high. As a result of negligence and misconduct from some auditors which caused audit failures, there is increased pressure to improve performance by legal process against some auditors. Laventhol Howarth, the 7th largest auditing firm collapsed after a lawsuit in 1991. The sudden collapse of Enron in the United States in 2001, followed by a number of other high-profile USA companies reporting financial difficulties, created a crisis of public confidence concerning the corporate governance and auditing of publicly-quoted companies in the USA. The deep concern about the quality of reported earnings led to the Sarbanes-Oxley Act, imposing new requirements on directors and audit committees and effectively ending the self-regulation of the auditing profession in the USA.

In Libya, there are a number of audited companies which went into bankruptcy between 1995 and 2005. Therefore, there is a significant question about the audit quality situation in Libya. There (also) was no warning from auditors through the issuance of appropriate audit reports about financial difficulties which lead these Libyan companies into bankruptcy; such kinds of audit report (going concern) possibly reflect the level of the audit quality in a Libyan context. Nowadays, the move to a market economy in Libya and the need to be more open to globalization requires more professional people and high audit quality, to earn the trust of society and to play the relevant role in order to protect the wealth of stockholders.

The development of the audit profession in Libya

Historical background

Libya is a developing Arab country located in the north central part of Africa. The country's population is 6 million (Al-Mabrouk and Soar, 2009). Arabic is the official language, while English and Italian are also used in business and trade. The Libyan social environment is characterized by the extended family, clan, tribe, village and Islamic religion. These play a major role in the community's life and people's relationships (Agnaia, 1997; Ahmed and Gao, 2004).

Libya was an Italian colony from 1911 to the end of the Second World War. The Italian administrative system developed the basic infrastructure of the country, such as roads, port facilities, and different projects for irrigation. Unfortunately, Italy did not influence the educational system and paid little attention to training the people in technology or agriculture (Shareia, 2006).

After the Second World War, the country was ruled jointly by the British and the French for a time (1943-1951). In 1951 the United Nations General Assembly passed a resolution recognizing the rights of Libya to independence under a monarchy. In 1969 the monarchy was overthrown, the army took control, and the country is now governed by a Revolutionary Command Council (Bait-El-Mal et al., 1973).

Until the discovery of oil in Libya in 1959, the economy of the country was poor and dependent mainly on agriculture, animal husbandry, fishing and trade. The transformation of Libya's economy from subsistence farming to a developing economy is impressive. This transformation changed the country from a poor to a rich country within that region, and it ranks twelfth among petroleum producers (since 1991). The economy has largely depended on oil as the main natural sources of wealth and constitutes 99% of Libya's exports (Al-Mabrouk and Soar, 2009). Due to the discovery and the increased exportation for oil after 1960, the wealth of the country increased rapidly and the increase in resources changed the situation for the better. The oil revenue increased from L£4,097,000 Libyan pounds at the beginning of oil export to L£116,861,000 Libyan pounds in 1963(Agnaia, 1996).

Libya's position as a less-developed economy with its embedded Arab and Muslim traditions and beliefs contrasts with the more developed economies such as the USA and the UK. Libya is representative of a significant number of less-developed economies with similar ethnic and religious traditions, which are striving to emulate the competitive structures and processes prevailing in the global economy. There are a number of examples of this; the Libyan auditing profession itself has been closely modeled on those of the USA and the UK over a period of 50 years. Initially, the exploration and production of oil and natural gas in Libya in the late 1950s involved investments by foreign oil-producing companies. These mainly British and American companies employed their own business practices, and accounting philosophies and systems in Libya. Following nationalization in the early 1970s, these nationalized companies have continued with the established practices and systems to the present day. This direct foreign oil investment in Libya has strongly influenced Libya accounting practices and promoted the audit profession to operate within these (Ritchie and Khorwatt, 2007).

The remainder of this part considers, in turn, the four areas of: historical background, accounting education, auditing profession, and government organizations. Ultimately, the histories such trajectories of these areas to some degree overlap, but each is treated separately here.

Accounting education in Libya

During the 400 years that Libya was a colony of various powers, there was little education provision. When independence came in 1952, more than 90% of the population was illiterate; very few Libyans had studied at university level or qualified as professional accountants. A general education system from primary level to university level was established, which included accounting education. As in other areas, Libya relied heavily on advisers from Britain, America and the UN to implement this system. Accounting education focused entirely on the intermediate level (pre-university), with the establishment of the first School of

Public Administration in 1953, the aim of which was to develop graduate clerks and book-keepers. Accounting education at university level started in 1957 with establishment of the Accounting Department in the Faculty of Economics and Commerce at the University of Libya (now called Garyounis University). Thus, the accounting education system after independence is divided into two levels: pre-university and university levels (Ahmed and Gao, 2004).

The British have influenced accounting education in Libya. The programme in the Faculty of Economics and Commerce at the University of Libya was completely of British orientation (1957-1976). Textbooks were mostly British, or were Arabic books either translated from English or written by Arabian professors who graduated from British universities. Since 1976/77 the Faculty of Economics and Commerce at the University of Libya has changed its programmes. The only difference between the old Libyan accounting education system and the new one is that, where the old system was British orientated, the new one is American orientated. That happened because of the changes in the Faculty administration and teaching staff, many of whom have graduated from American universities, and American textbooks in English or translated into Arabic have become widely used. Therefore, acceptance of American accounting principles in Libya may be viewed as the result of two forces: American companies operating in Libya and accounting education in Libya (Bait-El-Mal et al., 1973; Kilani, 1988; Bakar, 1997).

The government in Libya realized that education had to be developed because of its effects on all other aspects of life; therefore both the numbers of pupils and the number of schools were increased and many faculties in different subjects were opened, especially in the 1960s and 1970s (Agnaia, 1996). There are now more than ten universities with accounting departments or programmes and numbers of accounting students have significantly increased over the last decade.

However, as the current economic development plan progresses, the demand for competent accountants will play an even greater role, and accounting educators face several challenges, such as world economic integration, other globalization issues, not forgetting moves to globalize accounting. In line with the implementation of 'the Development Plans' of 1980, the emergence of a private sector, the growth of foreign investment and the effect of globalization, there is a strong demand for change to accounting and accounting education (Ahmed and Gao, 2004).

A major problem with accounting education in Libya is that it is centered on Western accounting theories that lack legitimacy not only because of the different system of economics and value, they espouse compared to those found in Libya, but also because in an Islamic society such as Libya, the philosophy and institutional framework in which the accounting education system is strongly influenced by other, foreign, systems. They brought mainly from Britain and North America, during the latter years of the colonial period and through the UN after independence (Ahmed and Gao, 2004).

Agnaia (1997) stated that the development of the education system has started only very recently; creating an education system that accommodates the Libyan environment and is independent from the western orientation takes time. In the similar vein, Shareia (2006) stated that accounting education policies, and the need to have academic research in this field, are incompatible with the economic development requirements of developing countries in general, and in the Arab world and Libya, in particular. The accounting education system must be amended so as to serve development needs by the creation of skills and the development of technical and organizational capacities, which the development plans need.

Auditing profession in Libya

Up to Libya's independence in 1952, there was no domestic auditing profession and most of the business firms depended upon foreign accounting firms from Italy and UK. No formal accounting education or training was available locally, and so, when independence came in 1952, there was even a shortage of personnel to fill clerical and technical positions in the administrative and public services. This was one of the country's most serious handicaps and meant that, throughout the 1950s, it relied greatly on advisers from the UK, USA and UN to establish rudimentary accounting systems. Indeed, at that time, many foreign agencies from the UK and the USA (e.g., the Libyan Public Development and Stabilization Agency, the Libyan American Reconstruction Commission, the Libyan and American Joint Service) came into the country to carry out various projects. These agencies were all administrated by non-Libyans and, through them, the British and Americans implemented their own accounting models, significantly influencing the accounting system in Libya (Bait-El-Mal *et al.*, 1973; Ahmed and Gao, 2004).

Others several factors that have influenced the development of the auditing profession in Libya since independence include accounting education, accountants coming from other countries, Libyan students returning from abroad (the USA and the UK), and the rapid change in the Libyan social, economic, political and legal environment. The influence of most of these factors has caused the Libyan auditing profession to follow the same path as its counterparts in the United States and the United Kingdom. Despite the impacts of these factors on the audit profession, the Libyan auditing profession for most of the 1950's had no regulation whatsoever: auditors could practise with no formal permission or licence. At the same time, there was no uniformity or consistency in the presentation of financial reports or certificates. In Libya, auditors have no defined or formal principles to work on; different auditors apply different accounting principles and different auditing standards and there is no theoretical foundation for the auditing profession in Libya. Auditors in Libya base their practices either on their experience with some of the international audit firms or on their accounting education in Libya or abroad. In either case little has been done to build any theoretical base for accountants to work from (Kilani, 1988).

An attempt has been made in Libya to regulate accounting practice through direct governmental laws and regulations. The significant impact thus has come from first the Commercial Code (LCC). The LCC was enacted in 1953 and has been amended a number of times. It includes rules on corporation books and records and certain aspects of financial reporting and auditing. Secondly, Income Tax Law the first Libyan Income Tax Law was issued in 1968. Previously (1923-1968) Italian income tax law was used with modification to suit the Libyan circumstances. Presently, Libyan Income Tax Law No. 64 of 1973 (The Law) is applied. The Law has had a major impact on accounting practice in Libya. Many companies have often adopted tax law provisions for external financial reporting. The third factor has been the Petroleum Law and Petroleum Regulations; the Libyan Petroleum Law was enacted in 1955 and has been amended several times. The accounting rules for oil and gas up-stream activities are generally prescribed under the Petroleum Law and Petroleum Regulations (Bakar, 1997).

Libya accredited a university degree as an adequate qualification for professional recognition without requiring further examinations, subject only to acquiring practical experience. In the

1970s, with the increase of accounting graduates from the University of Libya and the return of many Libyan graduates from abroad, many Libyan-run accounting firms were established. As a result of the increase of accounting and auditing standards and practices, there was an urgent need to set up a professional body, to take the responsibility for developing a general framework of accounting. To meet the demand, Law No. 116 was enacted in 1973. This is the first law to govern accountancy and related areas. It covers: (1) the establishment of the national professional association 'the Libyan Auditors and Accountants Association' (LAAA), which now is known as the Syndicate of External Auditors (SEA); (2) registration of accountants; (3) exercise of the profession; (4) fees; (5) pension and contribution fund; (6) obligations of accountants and auditors; (7) penalties; and (8) general and transitional provisions. The (LAAA/ SEA) was established in June 1975 with the following objectives: to organize and improve the conditions of the accounting profession and to raise the standards of accountants and auditors professionally, academically, culturally and politically; to organize and participate in conferences and seminars related to accounting internally and externally and to keep in touch with new events, scientific periodicals, lectures and so on; to establish a retirement pension fund for its members; to increase co-operation between its members and to protect their rights; and to take action against members who violate the traditions and ethics of the profession (Ahmed and Gao, 2004).

There are around 500 members of the (LAAA/ SEA). The (LAAA/ SEA) not only undertakes the sole responsibility for the implementation of the legal statutes on behalf of the government, but also manages every facet of the auditing profession. Auditors are not permitted to practice unless they are members of the LAAA/ SEA and all civil proceedings by clients can only be pursued via the LAAA/ SEA itself. The professional body can itself enforce suspension for up to 3 years, expulsion or imprisonment (the latter only with the support of the appropriate public authority) if the auditor situation deemed to have violated the professional requirements of honesty and integrity in their professional work. A recent example of exercising such powers was the imprisonment of an auditor for deception, producing two different sets of accounts, one for the tax authorities and a more profitable one for the commercial bank from whom the client was seeking a loan. The LAAA/ SEA also provides many of the services expected of a professional body: 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. Competition is constrained in the profession, since members are not permitted to advertise their services or to employ other intermediaries to undertake professional audit work on their behalf. Until very recently the LAAA/ SEA had no documented code of ethics (Ritchie and Khorwatt, 2007).

For the auditor, after becoming a member of the LAAA/ SEA, no continuing professional training is required. For this reason, audit firms normally do not conduct any training programmes for their auditing staff. These circumstances bring the competence of Libyan professional auditors into question (Ahmed and Gao, 2004).

In similar vein, Bakar (1997) stated that although the LAAA/ SEA was formed more than two decades ago, it has done nothing to build any theoretical base for accounting to be a profession in Libya. After this long period of time since it was established, the LAAA/ SEA has not suggested a code of ethics. This suggests that the LAAA/ SEA has failed to regulate itself and to recognize its obligation towards the public interest. Furthermore, it has not achieved its objectives of: (a) holding and participating in activities such as research, conferences, seminars, continued education and training programmes; and (b) following recent developments in the profession through accounting and auditing publications to improve the status of the profession and accordingly of its members. All these factors suggest that the status of the Libyan accounting profession is very weak. Shareia (2006) stated that accounting and auditing as a profession still do not play a vital role in the economic development of Libya.

Government Organizations

In 1955 the State Accounting Bureau (SAB) was established in Libya, which played a main role in the audit profession with LAAA/ SEA. The SAB was established by law No 31 of 1955 under the responsibility of the Ministry of Treasury. To guarantee its independence, SAB became responsible directly to the whole Ministries' Council of Libya by the Audit Bureau Law of 1966. The members of the office must have a university degree either in law, economics, or accounting (the State Office Accounting Law (SOAL), article 6) (Bait-El-Mal et al., 1973).

The Revolutionary Government of 1969 organized the government system to consist of an executive branch and a legislative branch represented by the Revolutionary Command Council (RCC). Accordingly, SAB was changed by the law No. 79 of 1975 to become responsible directly to the RCC. Article No. 1 of the SAB law of 1973 states the independence and objectives of the Bureau as follows: the SAB is an independent agency affiliated to the RCC; its purpose is to apply effective control over public funds. Since the RCC transferred its authority to the General People's Congress (GPC) in 1977, the SAB has become responsible directly to this new legislative body in Libya. According to the Law No. 7 of 1988, which was issued by GPC, the SAB was combined with the Central Institute for General Administration Control (CIGAC). The new name was the Institute for Public Follow-

Up (IPFU). As stated by the law, the IPFU was an independent body, which, after auditing all the government accounts, should report directly to the GPC. However, there was no change in the main functions of the SAB. In 1996, Law No. 11 was enacted by the GPC. This changes the name of the IPFU to the Institute of Public Control (IPC), and extends the responsibility of the IPC to the auditing of foreign companies operating in Libya (Ahmed and Gao, 2004).

The General People's Congress (GPC) issued the Law No. (13) of 2003, which was re-separation of the jurisdiction of financial control and technical management oversight in the Institute for Public Follow-Up (IPFU). The new institute for the jurisdiction of financial control is named General People's Committee of the Financial Audit Agency. The Financial Audit Agency (FAA) exercises all aspects of financial control in order to protect public funds, and is responsible for auditing the public sector in accordance with the law No. 13 of 2003. The Financial Audit Agency (FAA) is an independent body attached to the General People's Congress (GPC). It is a basic tool of the General People's Congresses to achieve financial control and effective audit over the public funds. The responsibility of FAA to put strict controls to confirm the confidence in outputs of this system, which helps in the preparation accurate reports, professionalism and objectivity, as well as uncovering the risks that appear in the financial systems and processing to prevent their recurrence, in addition to the audit procedure and the audit of performance in order to give more value to the organizations economically, financially, and socially, and the protection of public funds. FAA provides reports to the GPC reflecting the level of management of public funds (FAA, 2010).

An accountant who wants to qualify as a member of the IPC/ FAA must meet the following requirements: hold Libyan nationality, have a bachelor's degree in accounting, have five years of accountancy experience in the IPC/ FAA, be active over political and civil rights, be of good conduct, reputation and respectability, commensurate with the profession, and swear to do work with complete honesty and sincerity. The IPC does not require any study beyond a bachelor's degree, only practical experience (Ahmed and Gao, 2004).

Agnaia (1997) indicated that the circumstances of the country in the last six years had been characterized by an unstable environment, with many new laws, rules and regulations and the organizational structure in many organizations and secretariats had changed many times. The public sector usually faces many changes according to the political attitude of the country internally and towards other countries. Organizational life is also shaped by the instability of government policies as a result of political attitudes.

Figure 1.1: Factors affecting the audit profession in Libya

Contextualization

Audit quality has been widely studied in many parts of the world such as the UK, USA, Canada, Australia, Malaysia, Egypt, and the Kingdom of Saudi Arabia. Audit quality has been given much attention from different interested parties such as academics, regulators, and practitioners. However, there is not itself much research about audit quality in Libya. In particular, there is not much research that has tried to measure audit quality in Libya. This study is an attempt to pursue further some of the issues around financial audit quality in Libya.

Audit quality is explained in terms of the relation of audit reports and misstatements (particularly of earnings) in financial accounts. Hence, the relationship between audit quality and earnings management will be taken as base to measure audit quality (these statements are supported later). The appropriate type of statistical Models will be used to measure earnings management in financial statements of Libyan companies and show the type of audit report related to these statements to achieve the first research objectives.

Measures of earnings management in financial statements of Libyan companies and the determination of the type of audit report that has been given, related to these financial statements, is the way to achieve the first objective. The impact that some particular factors may have on audit quality in Libya will be investigated to develop some recommendations for strategies to support audit quality in Libya. This thesis examines the potential theoretical foundations for a study of the 'audit quality' concept. From that review, agency theory was selected as the most suitable framework to investigate some issues about audit quality in Libya.

The basic point in agency theory is that "the firm" means the contracting process which regulates the relationship between principals who own resources, and agents who have the right to make decisions to employ these resources.

The agency problem reflects the need to for certification of auditing to ensure truthful reporting. The contracting process and productive action are undertaken to make the most of the expected utility of the owner, and to guarantee that an equilibilibrium expected utility is received by the agent.

The empirical objectives of this study are:

1- To investigate the level of audit quality in Libya

2- To investigate factors that affect audit quality in Libya

3- To explore how audit quality in Libya can be improved.

The following research questions are formulated to achieve the research objectives.

1- What is the level of audit quality in Libya?
2- What are the factors which affect audit quality in Libya?
3- How can audit quality be improved in Libya?

The Structure of the Thesis

This thesis is structured around ten chapters. Figure 1.2 outlines the structure of this study. Following the introduction chapter two provides a conceptual framework; chapter three a review of the literature on earnings management as seen the range the lens of audit quality. Chapter four presents material on the range of potential models, whilst chapter five considers types of audit report, chapter six relates to factors affecting audit quality. Chapter seven research methodology, chapter eight secondary data analysis, chapter nine the data of the semi-structured interview, and chapter ten discussions and conclusions.

Chapter two provides the conceptual framework of the research. It covers the audit quality idea, starting with the audit as the main subject of this study in term of demand and supply of audit services; it concludes with definition of audit, identifies aim of audit and, audit services, and the role of auditor as insurance. It then provides a brief view of audit quality as the main propose of this study, in terms of the nature of audit quality. This includes definition of audit quality, the measures of audit quality, factors affecting audit quality, and development of audit quality. It then continues to state some assumptions on which the audit quality idea has been built, such as the difference in audit quality, the dimensions of audit quality, and credibility and independence.

Chapter three reviews the major idea of earnings management as the first approach which will be taken to measure audit quality in terms of definitions, patterns, approaches, motivations, and perspectives.

Chapter four presents some types of statistical methods to capture earnings management such as aggregate accruals models, specific accruals, discontinuities in distribution of earnings, and questionnaire survey. It then discusses the relevant model to measure discretionary accruals as the way to capture earnings management. It identifies audit quality, corporate governance, and the accounting standards as three key methods to detect and restrain earnings management.

Chapter five concentrates on different types of audit report, such as unqualified audit report, qualified audit report, adverse audit report, and disclaimer audit report. They are the second approach to measure audit quality. It then presents some problems related to financial statements such as going concern, accounting accruals, and consistency and the type of audit report that should be issued.

Chapter six discusses several factors that affect audit quality. In particular, the chapter concentrates on the main factors that are discussed in prior studies such as audit firm size, audit fees, provision of non audit services, audit tenure and mandatory auditor rotation, audit steps, and team characteristics. The chapter ends with the different results these factors have on audit quality. This provides the basis for developing audit quality through developing some strategies to support some factors, or restrain others, in order to develop audit quality.

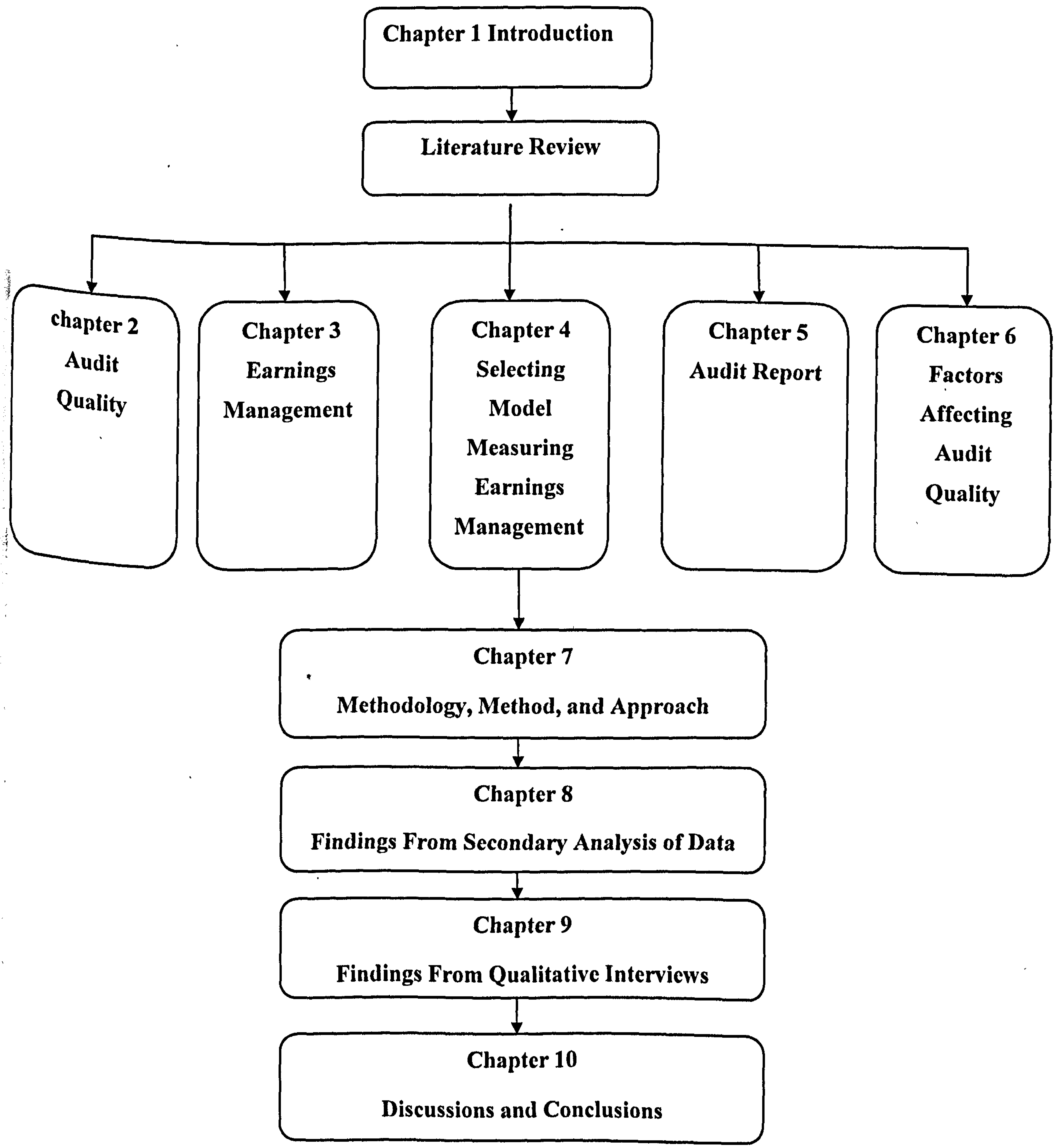
Chapter seven details the research methodology employed in this study. It presents a justification for using a combined quantitative approach and qualitative approach. It describes in detail the process followed to analyse the collected data related to secondary data analysis and semi-structured interviews.

Chapter eight presents secondary data analysis of numbers of Libyan companies to measure discretionary accruals using different types of statistical methods. Then audit reports related to these companies will be investigated to achieve the first objective.

Chapter nine continues with an analysis of the semi-structured interview from fifteen persons who have a relationship with audit quality. The first section is concerned with factors effecting audit quality in Libya, while the second section focuses on ways to develop audit quality in Libya, in term of strategies that should be adopted and barriers that should be removed.

Finally, chapter ten presents a discussion of the findings in the context of the research objectives and provides conclusions of the main findings of the research and draws out the resulting implications and the potential contributions of the study. It also reflects on limitations of this study and on further areas for research in audit quality in the Libyan audit context.

Figure 1.2: Thesis Structure



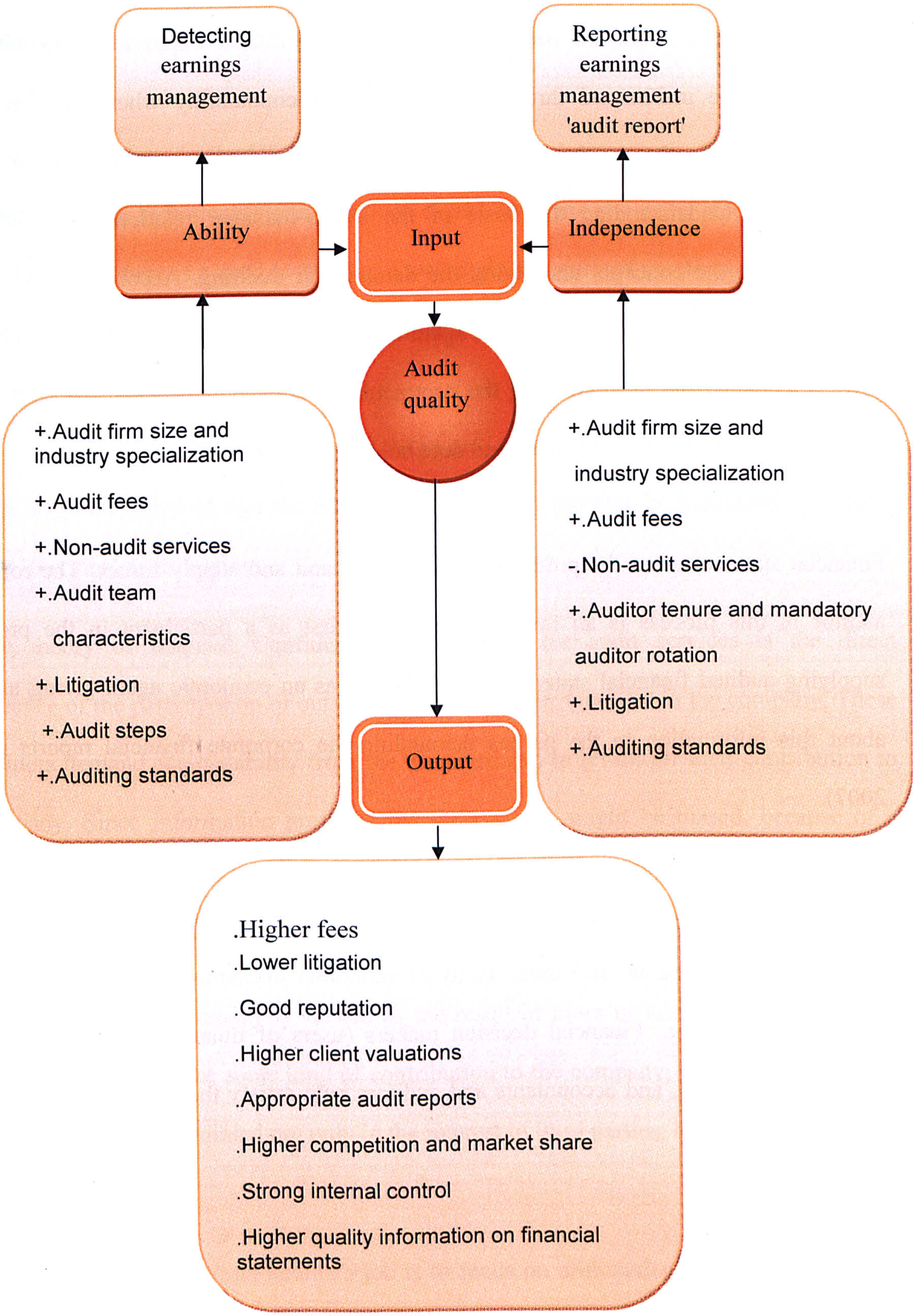
Chapter 2

Audit Quality

Introduction

Auditors realize the common audit objectives of auditing standards, even though there still exist variations in quality in terms of auditors' judgement and professional practices among audit firms. Audit quality, consequently, may be difficult to ensure, since many factors such as audit firm size, audit fees, provision of non-audit services, audit team characteristics, tenure, litigation, and audit steps may affect auditors' competence and independence. As the main purpose of this thesis is to measure the level of audit quality, in this chapter the literature on audit quality will be reviewed in terms of its components, such as demand and supply of audit services, agency theory, the auditor as insurance, the nature of audit quality which included (definition of audit quality, the difference in audit quality, the dimensions of audit quality), credibility and independence which included independence risk, measuring audit quality, factors affecting audit quality, and development of audit quality.

2.1: Audit quality framework



Demand and supply of audit services

The birth of modern accounting and auditing occurred during the industrial revolution, when companies became larger and needed to raise capital to finance expansion. The demand for auditing can be understood through the need for accountability when business owners (principals) hire others (agents) to manage their business, as is typical in modern corporations. Understanding the basic of the owner-manager relationship is helpful in understanding the concepts underlying the demand for auditing. Accounting and auditing plays important roles in this principal- agent relationship. Auditing is demanded because it plays a valuable role in monitoring the contractual relationships between the entity and its stockholders, managers, employees, and debt holders (Messier et al, 2008).

Financial statements are the product of diverse demand and supply forces. The role of the auditor in this process is an important element: first as a participant in the process of supplying audited financial statements: and second as an economic agent giving assurance about this information to the parties demanding the corporate financial reports (Soltani, 2007).

Decisions to purchase or sell securities, lend money, extend commercial credit, enter into employment agreements, and other kinds of economic decisions depend in large part on financial information. Financial decision makers (users of financial information) demand reliable information, and accountants and auditors help satisfy that demand (Robertson and Louwers, 1999).

As business become more complex and needs more reliable information, auditors play a vital role, both in providing assurance on information other than financial statements and providing consulting and tax services (Arens, Elder, and Beasley, 2003).

The current regulations in the USA and UK impose constraints and penalties on auditors if they fail to provide high quality audits. Given recent concerns about the role of auditors in financial markets, there is a need to develop a well defined theory of the demand for auditing, beginning with the fact that auditing is demanded as a solution to information asymmetry between contracting parties (Soltani, 2007).

Hayes et al. (2005) showed that the demand for audit services may be explained by several different 'theories' as following:

(1) The theory of Inspired Confidence: the demand for audit services is the direct consequence of the participation of outside stakeholders (third parties) in the company. These stakeholders demand accountability from the management, in return for their contribution to the company. Since information provided by management might be biased, because of a possible divergence between the interests of management and outside stakeholders, an audit of this information is required.

(2) Agency Theory: a company is viewed as the result of more or less formal contracts, in which several groups make some kind of contribution to the company, given a certain price. A reputable auditor is appointed not only in the interest of third parties, but also in the interest of management.

(3) The Policeman Theory: an auditor's job is to focus on arithmetical accuracy and on the prevention and detection of fraud.

(4) The Lending Credibility Theory: audited financial statements are used by management to enhance the stakeholders' faith in management's stewardship.

Fargher et al. (2001) compared audit fees across 20 different countries to consider both the demand and supply of audit quality, using the simultaneous-equations approach to account for the endogeneity between choice of auditor and audit fees. Audit quality and audit fees are considered mutually determined by the interaction between the client's demand for, and the audit firm's supply of, audit quality. They found that an association between greater disclosure requirements (related to information presented in the financial statements) and the choice of a large-firm auditor. They also indicate that increased litigation and regulation are associated with higher audit fees.

Agency theory

Robson (2002) explained the following:

> "Theory can mean very different things to different people. In general terms it is an explanation of what is going on in the situation, phenomenon or whatever that it is investigated, theories can range from formal large-scale systems developed in academic disciplines to informal hunches or speculations from laypersons, practitioners or participants in the research"(p.61).

The purpose of science concerns the expansion of knowledge and the discovery of truth. Theory building is the means by which basic researchers hope to achieve this purpose. Prediction and understanding are the two purposes of theory (Zikmund, 2000). Neoclassical economics and especially agency theory have had a significant role in the development of positive accounting theory. The neoclassical economic model is extended by explicitly recognizing the costs and benefits of information and the need to motivate managers to pursue the interests of the shareholders rather than their own interests. Despite positive accounting researchers' proclaimed aversion to theoretical speculation in the design of their empirical studies, neoclassical economics and agency theory are taken for granted (Ryan, Scapens, and Theobald, 2002).

In general, an agency relationship arises when one party (the principal) hires another (the agent) to perform a task. In most cases, this would involve the agent making decision on behalf of the principal. There are three paradigms of the agency framework can be adopted: Principal-Agent, Transaction Cost Economics, and Positivist (Hoque, 2006).

Delegating authority from the principals to the agents is the base of agency theory. As a consequence of the delegation of the decision-making authority, sharing payoffs created and unsystematic events "of an economic preparation" which will be done by the decision maker (Gjesdal, 1981; Eisenhardt, 1989).

Explained agency theory in terms agents have more information than principals and that this information asymmetry adversely affects the principals' ability to monitor effectively whether agents properly served the principals' interests (Adams, 1994). Eisenhardt, (1989) pointed out that the relationship between principal and agent assumptions are about people (self-interest, bounded rationality, risk aversion), organizations (goal conflict among members), and information acquisition (the availability and cost of acquiring information). At the same time, these assumptions represent problems of agency theory, because participants have diverse interests.

The basic principle-agent relationship, however, is confronted with a fundamental issue. Drawing from the traditional economics literature are the following two underlying assumptions of agency theory: (1) the principal and the agent are utility maximisers whereby both parties seek to maximize their returns, and (2) it is not always that the interests of the principal and agent are aligned. Consequently, inherent in any principal-agent situation is the 'agency problem' that the agent may not act in the best interests of the principal (Hoque, 2006). Eisenhardt, (1989) determined two types of agency problems: the first arises in cases (a) when the principal and agent's goals and desires conflict (b) what the agent is really doing for the principal is difficult or expensive to verify: the second arises when there is risk sharing that different attitudes toward risk are held by the principal and agent.

The agency problem is seen to exacerbate under conditions of information asymmetry, where one party has an information advantage over another party. Information asymmetry in turn may lead to two specific types of agency problems which are moral hazard and adverse selection (Hoque, 2006).

An inherent moral hazard problem is a type of agency problem. The main reason for this dilemma is that the agent/manager has self-interest, which he will seek to achieve and this might act against the welfare of the principal/owners of the firm. Tuttle et al., (1997) defined moral hazard as "incentive to act in one's self-interest in conflict with the organization's overall goals while being able to hide those actions through privately held information" (p.7).

The most important general point is that, the agents hold information not available to the principals (e.g. Ross, 1973; Ng, 1978; Adams, 1994: Tuttle et al., 1997), which leads to "adverse selection". It means the principals cannot possess full information about the position of the firm to assess the decision which has been made by the agents and whether it is for their welfare. This occurs because of problematic asymmetrical information between principals and agents. In general, it is the logical outcome of the nature of the contracting process between participants. The agent is the more knowledgeable about the actions and payoffs produced, and this is the core of the dilemma of asymmetrical information, in which the agent has more information than the principal. It makes him/her the part which has the better familiarity.

To solve the problem of asymmetrical information, Pareto-efficiency presents the optimal solution. Ross (1973) defined Pareto-efficiency as a situation where "perfect information is held by participants" (p. 138). Pareto-efficiency is extremely difficult to achieve due to both principal and agent seeking to achieve it via contracting costs; the principal by using an external auditor, and the agent by reducing the risk of sharing. Adams, (1994) explained that efficiency of Pareto-optimality is when both principals and agents can enhance their wealth at the expense of the other. Conflict between the principal and the agent is the characteristic of Pareto-efficiency; principal and agent co-operate in selecting Pareto-efficient fee schedules that increase a weighted amount of utilities, and so the principal understands the fee-to-act mapping introduced by the agent (Ross, 1973).

Hoque (2006) explained that agency problem may be mitigated through several strategies or courses of action that involve either monitoring their behaviour or providing incentives that engender behaviour congruent with the principal's interests. The costs associated with the strategies that help mitigate agency problems are called agency costs which can be classified under the following three headings:

1- Monitoring costs: which are the costs incurred in monitoring the agent's behaviour, such as mandatory audit costs, investment in governance structures, formal procedures, information systems, and other oversight processes that help curb opportunistic behaviour.
2- Bonding cost: which relate to those initiatives that help align the agent's interest with that of the principal's including private contracting, such as through bonus incentive schemes or reward structures that minimize loss through underperformance or opportunistic behaviour by the agent.
3- Residual costs: which are all other costs incurred as a result of incongruence between the principal and agent's interests despite monitoring and bonding processes.

Some of the common monitoring strategies include: undertaking external and internal audits, having more independent (versus non-independent) directors on the board, and designing effective budgetary and other performance evaluation systems. The provision of audited financial statements is usually regarded as a cost-effective contractual response to agency costs (DeAngelo, 1981; Watts and Zimmerman, 1986).

The agents are more likely to have opportunistic behaviour, which will work to make the most of their wealth rather, than maximize possessions of principals. Then the preferences of agents and principals are directly against each other. For instance, managers may take high levels of benefit expenditure. Meanwhile, agency costs are created by an inherent moral hazard problem, and they are the main reason for demanding a high-level audit quality. In general, high levels of audit quality are required, once the result of evaluation is that there are high value agency costs. Francis and Wilson (1988) explain that the moral hazard problem leads owners to discount the value of their initial investments and lower management compensation, in the case of the absence of manager ownership, then an incentive to choose a higher-quality audit arises as a means of increasing managers' compensation.

Transferring possessions from debt holders to stockholders is more likely to occur in agency theory, and that supports the demand from debt holders for higher-quality audits, hiring an auditor to confirm the report of the manager. Certainly such confirmation motivates managers to report truthfully, but estimation of performance may be affected via the report. The confirmation of the auditor is modeled to create information to guarantee the manager's information this will mitigate the cost of inducing truthful reporting as the core of auditing function, in order to clarify the contracting process between the owner and manager. If auditing increases the likelihood that reporting policies used by a firm are in conformity with GAAP, then external auditors will be of value to firm's owners (Ng, 1978).

The auditor as insurance

Auditor services are work that an audit firm performs for their clients. Except for consulting services, the work that auditors do is under the guidance of engagement standards set by the International Auditing and Assurance Standards Board (IAASB) (Hayes et al, 2005). Robertson (1996) points out that, the American Accounting Association (AAA) defines auditing as "a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between the assertions and established criteria and communicating the results to interested users"(p. 4).

External financial statement audits are necessary because the ownership and management functions of companies have become increasingly separated, and because of factors such as a potential conflict of interest between preparers and users of financial statements, and the inability of financial statement users to verify the information for themselves. As a consequence, a need has arisen for company managers to report to the organization's owners and other providers of funds such as banks and other lenders, on the financial aspects of their activities. Those receiving these reports (external financial statements) need assurance that external financial statements are reliable. They therefore wish to have the information in the reports 'checked out' or audited (Porter et al, 2008).

The objective of the ordinary audit of financial statements by the independent auditor is the expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles (Statement on Auditing Standards AU Section 110, SAS No, 1). The auditor's report is the medium through which he expresses his opinion or, if circumstances require, disclaims an opinion (The American Institute of Certified Public Accountants AICPA, 1972).

Soltani, (2007) explained audit's aim as following:

> "The objective of the auditor and the audit function is to assist users in determining the quality of information being received. The audit function ought to add to the credibility of information because the user of the information needs to have confidence in it when making decisions. The auditor's role and the confidence associated with his/her presence allow the potential value of the accounting information to be realized" (p. 29).

The auditor provides a written report containing a conclusion that conveys the assurance obtained as to whether the subject matter conforms, in all material respects, to the identified criteria. For instance, an audit of financial statements provides an opinion on conformity with International Financial Reporting Standards (IFRS). An audit opinion provides a reasonably high level of assurance about the truth and fairness of the view given by the financial statements, thus increasing their usefulness to readers of the statements (Hayes et al, 2005; Gray and Manson, 2005).

Robertson and Louwers, (1999) state that The American Institute of Certified Public Accountants (AICPA) Special Committee on Assurance Services (SCAS) presented a concise definition for assurance services as following: "Assurance services are independent professional services that improve the quality of information, or its context, for decision makers" (p.39). In similar vein, Certified Public Accountant (CPAs) provided a category of assurance services that a report about the reliability of an assertion is issued by audit firm that is the responsibility of another party.

The owner can attempt to protect him or herself against the possibility of improper use of resources by reducing the manager's compensation by the amount of company resources that the owner expects the manager to consume. But rather than accept reduced compensation, the manager may agree to some type of monitoring provisions in his or her employment contract, providing assurance to the owner that he or she will not misuse resources (Messier et al, 2008).

In SAS No 53, AU Section 316, *The Auditor's Responsibility to Detect and Report Errors and Irregularities,* the auditor has the responsibility to plan and perform the audit to obtain reasonable assurance that any material misstatements (including those caused by fraud) would be detected (AICPA, 1988).

The nature of audit quality

Definition of audit quality

DeAngelo (1981b) explains that, the quality of audit services is defined to be "the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach" (p.186). In the same context, Palmrose (1988) states that audit quality is defined in terms of "the level of assurances-the probability financial statements contain no material omissions or misstatements, higher levels of assurances correspond to higher quality services" (pp.56-57). Misstatements occur from violating generally accepted accounting principles (GAAP). It means that auditors' work should detect material misstatements and report these material misstatements which then reflect an auditor's competence and independence.

In the capital market economy, the auditor's responsibility is a most important issue in recent years. The auditor's responsibility is still an issue of public concern. The point here is what the user expects from the auditor's work and what the auditor understands he/she should be expected to provide for the external user. This issue is named 'the audit expectations gap' between audit and public perception of the auditor's work (Soltani, 2007).

Supreme Audit Institutions (SAIs) (2004) explained quality as the degree to which a set of inherent characteristics of an audit fulfils requirements, the following are these characteristics:

1- Significance and value of matters addressed in its audits
2- Reliability and validity of the opinions, or findings and conclusions, appropriateness of the recommendations and relevance of other matters presented in its audit reports and other products
3- Objectivity and fairness in the basis of assessments made and opinions given
4- Scope and completeness in the planning and performance of audits carried out
5- Timeliness of the issue of audit reports and other products in relation to statutory deadlines and the needs of anticipated users
6- Clarity in the presentation of audit reports and other products
7- Efficiency in the performance of audits and audit-related work
8- Effectiveness in terms of results and impacts achieved.

The difference in audit quality

Audit quality is defined as detecting and reporting a breach in the client's financial statements (DeAngelo, 1981b). It means an auditor needs the ability to discover a breach and this, depends on skilled professionals reporting such a breach, which requires the auditor independence.

There is a common consensus about the audit quality differential. The idea of high audit quality being associated with large audit firms has been supported by several studies. Prior theoretical and empirical studies show that because of litigation, large audit firms have more to lose than smaller auditors, thus supplying higher audit quality (see, e.g., Palmrose, 1988; Dye, 1991).

For example, Francis and Wilson (1988) tested the relation between the demand for a quality-differentiated audit provide by Big Eight and non Big Eight and agency costs. Francis and Wilson found that there is a positive association between Big Eight audit firms as higher audit quality suppliers rather than non Big Eight audit firm and agency cost proxies.

Menon and Williams, (1991) found that qualified auditors do not homogeneously provide auditing services. They showed that in Initial Public Offering (IPO) investment, bankers prefer a credible auditor to investigate the value of the company to underwrite the offering. Similarly, Balvers et al, (1988) suggest that in the case of initial public offering using high reputation investment bankers and auditor reputation on minimizes the risk of under pricing.

Lee (1996) explains the impacts of auditor market share and product differentiation on audit fees. In Hong Kong the Big Six firms charged more than the non Big Six firms in auditing small clients, but not in auditing the big client. Product differentiation is the reason of receiving Big Six auditor high fees rather than the exploitation of market power.

The group of "Big Eight" was reduced to the "Big Six" after that to the "Big Five" by a series of mergers. The Big Five became the "Big Four" after the near-demise of Arthur Andersen in 2002, following its involvement in the Enron scandal. Mergers and the big auditors as following: Big Eight (until 1989), Big Six (1989-1998), Big Five (1998-2002), Big Four (2002-). Table 2.1 illustrates Big Four audit firms today (data from company reports).

Table 2.1: Big Four Audit firms

Firm	Revenues $ bn	Employees 000's	Fiscal Year	Headquarters
Deloitte Touche Tohmatsu	$27bn	170	2010	United States
PricewaterhousCoopers	$27bn	162	2010	United Kingdom
Ernst &Young	$21bn	141	2010	United Kingdom
KPMG	$21bn	138	2010	The Netherlands

The dimensions of audit quality

Arrunada (1999) explained that audit is considered to be a service and to understand the term "dimensions of audit quality", it must be recognized that audit services essentially concern information which is published in the client's financial statements. Auditors use a set of data to verify the validity of such information to issue appropriate opinion. In such cases, technical competence and independence have been viewed as the dimensions of audit quality.

Arrunada, (1999) defined the technical competence and independence in the following way:

> "Technical competence is the auditor's ability to detect errors or shortcomings in the financial statements being checked. Independence is taken to be the willingness of the auditor to reflect in the audit report all problems and defects he has detected in the financial statements" (p.9).

Therefore, technical competence means the likelihood of detecting defects in an accounting system requires a high quality auditor, who can use advanced techniques and therefore develop more effective programmes to discover defects in financial statements. Independence is the auditor being more willing to report defects once they have been discovered. Therefore, audit quality is defined as a process which implies that the auditor will detect and then report on breaches in the client's financial statements (see DeAngelo, 1981b; Bartov et al, 2001).

Warming-Rasmussen and Jensen (1998) studied audit quality dimensions in Denmark from the perspective of four groups which were public accountants, financial journalists, shareholders, and management directors. They found that there are six major dimensions to summarize different quality attributes which are: independence of auditor; understanding of the industry; reporting matters regarding of interest to shareholders and creditors; personal credibility; faithfulness to minority shareholders; and the auditor's sceptical attitude to the client.

Warming-Rasmussen and Jensen (1998) later report that fifteen auditor's attributes have resulted from dialogues with respondents relating to: quality and confidence; professional competence; overall honesty; sceptical attitude to company management; faithfulness to the welfare of minority shareholders; objectivity; independence of the board of directors; independence of the main shareholder; implementation of legislation on financial statements; credibility; the endorsing auditor's personal involvement in the audit; frankness in the report about matters of interest to shareholders; frankness in the report about matters of interest to creditors; conscientiousness; ability to express clearly and have insight into the industry. They found the same four groups assign different values to audit quality dimensions.

Duff, (2004) stated that the technical quality and service quality are important dimensions of audit quality. Duff identifies nine key dimensions of audit quality as following: the first the technical quality dimensions that consist of; (1) auditor reputation; (2) capability (competence of audit team staff); (3) independence; (4) expertise (market share by audit firm); and (5) experience (experience of audit manager): the second the service quality dimensions that consist of; (6) responsiveness (willingness to provide detailed cost information); (7) empathy (the engagement partner is pro-active and contributory); (8) client service (conducts client service reviews); and (9) non-audit services.

Credibility and Independence

Audit quality completely necessitates credibility from the auditors when they present the audit report. The credibility of the audit report is threatened by insufficient audit independence from their client. The integrity, objectivity and independence of auditors and the quality of their work are based for public belief in the credibility of auditors' opinions and reports (Soltani, 2007). Mautz and Sharaf (1982) explained that "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"(p. 204).

There are many definitions of audit independence, due to the interrelated layers of the independence concept. Arrunada (1999) stated that "earlier independence was defined as the auditor's willingness to reflect defects and problems which he/she has detected in the financial statements reviewed in the audit report" (p. 43). In a similar vein, DeAngelo (1981b) defined the level of auditor independence as "the conditional probability that, given a breach has been discovered, the auditor will report the breach" (p. 116). Likewise, Schulte Jr, (1966) defined audit independence as "a state of mind that is not subordinate to the client and which possesses objectivity or lack of bias in forming delicate judgments" (p. 722).

However, the concept of independence is not accurate and clear, because independence is difficult to prove and easy to challenge; the discussions about the suitable level of auditor independence and how the auditor achieves independence still persist. Thus, most accounting firms have developed controls specifically aimed at assuring independence in fact and appearance (Mednick, 1990). Mautz and Sharaf (1982) point out that there are two aspects of independence the real independence that the ability of the individual practitioner to maintain the proper attitude in the planning of his audit program, the performance of his verification work, and the preparation of his/her report, and the apparent independence that the image of auditors as a group brought to mind when the term "auditor" is used.

Independence risk

Several factors have been studied in the field of audit independence, which are assumed, by many authors, to somewhat harm independence or cause independence risk. Johnstone at el (2001) defined independence risk as "the risk that an auditor's independence may be compromised or may be perceived to be compromised" (p. 1).

Johnstone Sutton and Warfield (2001) The framework has been presented to explain how factors of incentives and situation such as corporate governance mechanisms, regulatory oversight, auditing firm policies, auditing firm culture, and individual auditor characteristics may have an impact on actual or perceived audit quality consequential from reduced risk of independence. Johnstone, Sutton and Warfield found that those factors that increase independence risk may mitigate audit quality, but heightened independence risk does not necessarily means low audit quality.

Prior studies have examined factors that might impair audit independence. For example, non-audit services (Porter et al.2008), client switch threats (Krishnan, 1994), low balling (Craswell and Francis, 1999), and mandatory auditor rotation (Ballantine et al. 2008) have all been considered.

Many theorists argue that the threat to auditor independence is related to simultaneous provision of NAS (Non-audit services) to clients. The client might switch to new audit firm. In this case, if the income from the NAS is likely to suffer because of potential losses, this will be a threat which may affect auditors' decisions to choose an appropriate report format (Chow and Rice, 1982; Krishnan, 1994).

Sutton (1997) explained that the auditor's independence could be impaired in the case of the close relationship between the auditor and the management of the firm, which a mutuality of interest may exist between them. The arguments for potentially impairing auditor independence through auditor/client relationship, and both the effects of auditor tenure and mandatory audit rotation on audit quality have been debated for decades. A level of closeness may be produced by long-term relationships between client and auditor, which is more likely to impair auditor independence and diminish audit quality. Such relationships have been considered by regulators to enforce compulsory rotation in order to enhance independence of auditor.

Simon and Francis (1988) their results enhance the *Commission on Auditors' Responsibility'* [AICPA, 1978] auditor independence is directly threatened by price cutting. Craswell and Francis (1999) show that in the United States there is both non-disclosure of audit fees and significant low balling. Their evidence is consistent with Dye's (1991), that independence problems occur from discounting, and initial engagement discounting is prevented by public disclosure of audit fees.

Following major US auditor failures (Enron, World Com, Sunbeam, Waste Management) the Sarbanes-Oxley Act of 2002 required the General Accounting Office (now the Government Accountability Office GAO) to study the potential effects of mandatory auditor rotation of audit firms which audit public companies registered with the US Securities and Exchange Commission (SEC). On November 21, 2003 GAO issued its report (GAO-04-216): Required Study on the Potential Effects of Mandatory Audit Firm Rotation. GAO believes that mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality. The potential benefits of mandatory audit firm rotation are harder to predict and quantify, the costs of rotation are more likely to supercede the benefits. These and more factors related to auditor independence and audit quality will be discussed in next chapters.

Measuring audit quality

Auditors have to present high quality audits which detect and report misstatement of financial accounts. Audit quality remains difficult to measure. Al-Magbel, (2006) points out that measuring the level of audit quality is problematic because the outcome of audit quality is not directly or immediately observable. It is difficult to have one absolute comprehensive measure.

Audit quality may be hard to define but there are different qualitative and quantitative ways to measure it. Whilst measurement techniques are fallible, audit quality should be measured and it can be improved. Those concerned with improving audit quality, including auditor oversight bodies, academic and audit firms may in the past have focused on quantitative measures. They should be encouraged to focus more on qualitative factors that affect auditor behavior including the quality of judgments, training, and feedback from shareholders and audit committees (Institute of Chartered Accountants in England and Wales ICAEW, 2006).

Several measures of audit quality have been used. For example: Francis (2004) states that audit quality is inversely related to audit failures: the higher the failure rate, the lower the quality of auditing, audit failures obviously occur on the lower end of the quality continuum. Audit failure results from auditors not applying GAAP, and not issuing modified audit reports in appropriate cases; in this situation financial statements contain misleading information to users (Francis, 2004). Audit failures can be determined through: auditor litigation (e.g. Palmrose, 1988), audit reports (e.g. Francis and Krishnan, 1999), business failures (e.g. Bell, 1994) and earnings management (e.g. Becker et al., 1998).

Palmrose (1988) assumes that litigation as a result of audit failures would occur, and litigation costs motivate auditors to present high quality audits to avoid audit failures. Palmrose shows a framework of the potential usefulness of litigation rates to determine the difference of audit quality among auditors. It has been found that auditors who have relatively lower litigation activity rates present higher quality audits, and auditors who have relatively higher litigation activity rates present lower quality audits. During the preiod1960-1985, for example the Big Eight firms had lower litigation occurrence rates than the non-Big Eight.

Lennox (2005) assumes that "the audit opinion reflects the joint probability that an existing problem is both discovered and reported" (p.207). SEC registrants recorded on

COMPUSTAT codes classified audit opinions into five classifications: (1) unqualified and unmodified, (2) unqualified but modified, (3) qualified 'except for', (4) opinion disclaimers, and (5) adverse opinions. Likewise, Porter et al., (2008) classified two types of audit report: an unmodified report (clean report) and a modified report (an except for opinion, an adverse opinion, and a disclaimer of opinion). Each type of audit report is suitable for specific circumstances.

Modified audit reports have been used as a measure of audit quality (e.g. Francis and Krishnan, 1999; Ireland, 2003). However, there is a probability of audit risk which is defined by Robertson and Louwers (1999) "the probability that an auditor will give an inappropriate opinion on financial statements" (p.125). Bell (1994) added the lowest payments of auditor are linked with litigation where auditors issue modified audit reports, and the highest payments of auditor are for observations where auditors issue none modified audit reports.

In prior research, the relation between audit failures and business failures has been studied. Lennox (1999) stated that there are some cases auditors failed to warn about impending bankruptcy and that leads audit function to criticism. Lennox's results point out that in the case of bankruptcy audit reports do not indicate useful incremental information. Carcello and Palmrose (1994) link the issue of modified audit reports prior to bankruptcy to the avoidance lawsuits claiming audit failure and to resolve payment questions.

Audit failures have occurred because of negligence and misconduct by auditors, some audit companies have gone into bankruptcy over a period of time. For example, Laventhol Howarth the seventh largest accounting firm collapsed in 1991, and Arthur Andersen collapsed in 2002 after the Enron bankruptcy in 2001. Francis (2004) defined audit failure in terms of rates of business failure.

Consistent with the hypothesis that the Big Six auditors present higher quality audits than others (e.g. DeAngelo, 1981b; Menon and Williams, 1991; DeFond et al, 2000), prior studies examine the effect of audit quality on earnings management through discretionary accruals, these studies found firms audited by non Big six auditors are more likely to engage in earnings management than firms audited by the Big six auditors (see DeFond and Jiambalvo, 1991; DeFond and Jiambalvo, 1993; Teoh and Wong, 1993; Becker et al. 1998). The ability and effectiveness of auditor to constrain earnings management differ with the level of audit quality. Therefore, earnings management is smaller in firms with higher-quality auditors than in firms with lower-quality auditors (Becker et al., 1998).

Factors affecting audit quality

Reisch (2000) divides the audit quality literature into two major areas. First, supply-side research focuses on factors affecting an auditor's ability to supply a quality audit such as knowledge and experience, technology, effort, firm size, industry specialization. Second, demand-side research focuses on factors affecting the client and audit report users (agency costs, institutional ownership and leverage, and the presence of active and independent audit committees).

Catanach and Walker (1999) provided a framework that determines the audit quality as a function of audit performance, and suggested two major factors that can affect audit performance: Firstly the auditor's ability, such as technical competence, knowledge (training, education), experience (professional, industry, client-specific), adaptability, and technological proficiency; and secondly professional conduct, such as independence, objectivity, integrity, due professional care, conflicts of interest, and judgement. The auditors' ability and professional conduct may be affected by an auditor's economic incentives [fees, costs, and profits], efficiency, innovation, management advisory services, and litigation. Furthermore, there is market structure which also has effect on audit quality that refers to competition [market share, and concentration], supply and demand, entry barriers [economies of scale, product differentiation, and diversification], and professional regulatory mechanisms. Auditor tenure refers to the length of audit engagement.

Development of audit quality

In today's business world there are new issues existing related to audit context such as the pressures, opportunities, and rewards for earnings management, and also the responsibility for outright financial statement fraud. These make the audit environment more complex, and these issues have added extra responsibilities on the auditor.

For example, four dimensions have been emphasized of the audit environment include: (1) Audited entities are employing new business models, business strategies, and processes: (2) There is heightened concern about and responsibility for detecting management fraud resulting in misstated financial statements: (3) There is consistent evidence that, although infrequent, when audit failures occur, they are typically due to inadequate control of non-sampling risk/error: (4) The Audit Risk Model (ARM) persists as a prominent aid for planning the audit and organizing audit quality control efforts on individual engagements. It is more difficult to detect financial statement fraud when the fraud has been committed by the client organization's senior management. For this reason the auditor needs to keep a sufficient knowledge of the business world, in particular the client's circumstances and an understanding of the client's industry is necessary to provide high quality audit (Peecher et al. 2007).

Due to the difference in each audit client, an auditor is unable to adopt a specific procedure. In an overall sense, the auditor must design a specific programme to obtain its objective by using some procedures, such as understanding management's internal control system, the client's business, confirming managers' assertion and objectives contained in financial statements, obtaining evidence, and assessing initial risk.

Conclusion

In this chapter was given a deeper understanding (the perception of audit quality), through reviewing some terms that relate to audit quality, such as demand and supply of audit services, agency theory, the auditor as insurance, the nature of audit quality which included (definition of audit quality, the difference in audit quality, the dimensions of audit quality), credibility and independence which included (independence risk), measuring audit quality, factors affecting audit quality, and development of audit quality. In order to measure audit quality many approaches have been used; one of these approaches is earnings management as mentioned in this chapter. Thus, the next chapter will review the literature on earnings management in terms of definitions, patterns, techniques, motivations, and perspectives of different interested party.

Chapter 3

Earnings Management

Introduction

This chapter begins by defining earnings management, this is the chief method that will be used to measure audit quality, and this will address the first research objective, by discussing earnings management concepts in terms of their patterns, techniques, and motivations, and explaining different perspectives on earnings management. A conclusion into its extent, size and may be reached. The main purpose of this chapter is to highlight a brief review of the literature on types of earnings management, how earnings are managed, and why earnings are managed, in order to have a clear understanding of earnings management. The first objective in this thesis is to investigate the level of audit quality which has been linked to the presence of earnings management. The remainder of this chapter is as follows: definition of earnings management, earnings management patterns, earnings management approaches, motivations to manage earnings, different perspectives of earnings management, and earnings management in emerging and developing countries

Earnings management definitions

When managers have motivations to manipulate reported earnings, they can use 'earnings management' as a channel to reach a required level of earnings. At this point, earnings management is created because of two problems. First, managers typically hold information which is not available to owners regarding the true economic value of business enterprise investment chances, and motivations to exaggerate their economic value. Once owners make a decision to invest in business enterprise, they face 'information problems or information asymmetries' that leads to 'adverse selection' because they do not have full access to all the enterprise data. Second when managers achieve owners' savings they have incentives to strip their worth which is called 'opportunistic behavior'. It should be clear that is an 'agency problem' (see Healy and Palepu, 2001).

There is no complete agreement on the definition of earnings management. Goncharov (2005) stated that "the definition of earnings management differs depending on the instruments of manipulation, on the purpose of the earnings management behaviour and the timing of earnings management" (p. 20). Different definitions of earnings management have been presented.

For example: Healy and Wahlen (1999) explained that "Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers" (p. 368). In a similar vein, Schippr (1989) defined 'earnings management' as "disclosure management in the sense of a purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain (as opposed to, say, merely facilitating the neutral operation of the process)" (p. 92). Likewise, Scott (2003) said that "Earnings management is the choice by a manager of accounting policies so as to achieve some specific objective." (p. 369). Similarly, Beneish (2001) explains earnings management as "managerial discretion is a means for managers to reveal to investors their private expectations about the firm's future cash flows" (p. 5). Similarly, a Watts and Zimmerman study as cited in Fields et al. (2001) defined earnings management as occurring "when managers exercise their discretion over the accounting numbers with or without restrictions. Such discretion can be either firm value maximizing or opportunistic" (p. 260).

In these definitions earnings management is a decision which is made by a manager responsible for announcing performance of the firm to concerned parties. Therefore, it can be deducted that, opportunistic behaviour of a manager can be motivated to manipulate reported earnings. Dechow and Skinner (2000), in their critique of these definitions, say that there is no clear division between earnings management and fraudulent financial reporting. They explained that although widely accepted, these definitions are difficult to operationalize directly using attributes of reported accounting numbers since they center on managerial intent, which is unobservable.

A clear definition showing the difference between the most extreme form of earnings management and financial fraud has been presented by Dechow and Skinner (2000). They defined earnings management as "the intentional, deliberate, misstatement or omission of material facts, or accounting data, which is misleading and, when considered with all the information made available, would cause the reader to change or alter his or her judgment or decision"(p. 238).

Management fraud or which sometimes is called 'fraudulent reporting'; it is defined by Robertson and Louwers (1999) as "deliberate fraud committed by management that injures investors and creditors through materially misleading financial statements" (p. 253).

Ronen and Yaari (2007) say that there are two main points in these definitions. First, there is no clear separation between earnings management and normal activities which lead to such earnings. Second, a generalization to 'misleading' in earnings management is not true in all cases. The differences of earnings management definitions lead to classify definitions into three different colours: white is 'beneficial earnings management' where advantage of the flexibility in the choice of accounting treatment to signal the management's private information on future cash flows is taken; gray is 'neutral earnings management' where an accounting treatment that is either opportunistic or efficiency enhancing is chosen; black 'pernicious earnings management' where the practice of using tricks to misrepresent or reduce transparency of the financial reports is adopted.

Earnings management patterns

Scott (2003) summarized four main patterns of earnings management based on their effect on earnings (taking a bath, income minimization, income maximization, and income smoothing).

Big bath accounting

If a firm must report a loss, management may feel compelled to report a large one - it has little to lose at this point. Consequently, it will write off assets, provide for expected future costs, and generally 'clear the decks. This will enhance the probability of future reported profits (Scott, 2003). Big bath accounting is a technique where management write-off or write down any essential expenses and assets from the financial statements in current period with the purpose of improving artificially its profits in subsequent periods. Taking a bath usually occurs in a period once there is loss in any case, then management makes it worse. Such action will report higher earnings in future periods; likewise it will reflect higher performance (Kirschenheiter and Melumad, 2002). Elliott, Shaw, and Waymire (1988) defined a big bath as "write-offs, reported as a special item in the financial statements, which represents more than 1% of the book value of assets"(p. 92). Big bath accounting has been used to describe large profit reducing write-offs or income-decreasing discretionary accruals in profit and loss statements (Walsh et al., 1991).

Management compensation plans may motivate managers to adopt this technique to reach the bonus threshold. Healy (1985) confirms that bonus plans motivate management to make decision to use different accounting treatment and accruals to achieve bonus awards. Income-decreasing accruals are used by management to reduce true earnings (taking a bath), once either true earnings are reached or exceed the bonus cap, or they are not able to achieve the bonus threshold.

Elliott, Shaw, and Waymire (1988) found that management tends to write-off through a period of negative stock performance with continued economic difficulty. Elliott and Hanna (1996) showed that firms reporting write-offs before the reported earnings may provide extra information, but investors' ability to evaluate firm performance is impaired. Management use write-offs in an appropriate manner to respond to difficult conditions or to achieve an objective of strategic earnings management. Furthermore, McNichols and Wilson (1988) investigate a manipulation in reported earnings. McNichols and Wilson provide evidence that once income is high or low, managers that decided to choose income-decreasing accruals "take a big bath" in that period recording in earnings .

Income minimization

Governments in some cases help firms (political cost) when they have a poor performance. Firms attempt to rewrite earnings downward through periods of high income to make governments more likely to give their help. This pattern of earnings management is similar to taking a bath, but less extreme, the reason for adopting this pattern might be a politically visible firm during periods of high profitability (Scott, 2003).

Jones (1991) empirically found that over a period of import relief investigation by International Trade Commission (ITC) firms make income-decreasing accruals to decrease reported earnings to achieve benefits (e.g. tariff increases and quota reductions).

In contrast, Cahan (1992) in his evidence, supports the hypothesis of political cost, i.e. that managers write earnings downward by adjusting discretionary accruals in response to the antitrust laws of the United States against making any monopoly.

Income taxation is another reason which motivates managers to manage income-decreasing accruals. Dopuch and Pincus (1988) stated that inventory accounting methods (LIFO and FIFO) may be the choices of managers, where inventory turnover rates are high and variance inventory is also high level, then tax rates have low effectiveness. Likewise, Monem (2003) stated that over a period between June 1985 and May 1988 Australian gold-mining company make downward earnings management because of tax-exempt cases and accelerated economic growth. In addition, Dhaliwal et al, (1994) showed that there is positive association between negative changes in earnings and the likelihood of LIFO liquidations to take place and reported earnings are decreased by LIFO liquidations. LIFO liquidations are motivated by earnings management, debt violation, and tax minimization.

Income maximization

Firms sometimes face inconvenient circumstances, they attempt to use earnings management to report a high income to avoid reducing earnings and losses in order to keep an actual situation secret to mislead interested parties (see Jacob and Jorgensen, 2007). For example, Enron inflated its reported earnings when it violated debt covenants. Scott (2003) explained that firms may maximize income when they are close to debt covenant violations. Firms manage earnings for one or more reasons. For example, bonus plans, dismissal threat, and reach benchmark may all stimulate earnings management. Beatty et al, (2002) found that private and public banks relatively adopt more an asymmetric pattern increasing lower earnings than increasing higher earnings.

Guidry et al. (1999) provided evidence those discretionary accruals decisions have been used by managers of business units to manipulate income for managing bonus maximization in the short-term. In a similar vein, Matsumoto (2002) stated that firms meet expectations at reported earnings; they make income move upward or direct analysts' predictions downward. Positive abnormal accruals and lower forecast earnings than expected are mechanisms to keep off unexpected negative earnings. The same result was presented by Guan et al (2004) who showed that earnings management is undertaken to maximize a manager's personal gain.

Burgstahler and Dichev (1997) confirmed that cash flow from operation and working capital changes are managed by firms to obtain higher earnings and to avoid lower earnings. Degeorge et al (1999) explain that exceeding thresholds such as analysts' predictions, announcing positive income growth, and maintaining current performance, motivate managers to undertake earnings management, so that if earnings come close to thresholds, firms will increase earnings to meet thresholds, and if earnings are far off thresholds, firms will change thresholds to make them more possible in the future. Moreover, Daniel et al, (2008) documented that managers manage income upward through earnings management to meet expectations of dividend levels as well as meeting earnings' threshold. Consistent with prior research, achieving expected dividend levels is one of the factors that motivate managers to mange earnings.

Income smoothing

When firms have an earnings benchmark, firms use this income smoothing either to increase income (if actual earnings are below the earnings benchmark) or decrease income (if earnings are above the actual earnings benchmark) (Gordon, 1964). When firms have earnings fluctuations, they are more likely to utilize accounting choices as the way to mitigate such fluctuations rather than to maximize or minimize reported earnings. In addition, Monsen and Downs (1965) argued that managers of firms might smooth reported earnings in order to enhance their personal interest. Ronen and Yaari (2007) explained that managers have a number of techniques to accomplish smoothing of reported earnings. They can use one or more of the following techniques:

> "Real smoothing - smoothing through production or investment activities, which affect cash flows; Intertemporal smoothing - cosmetic smoothing through allocating total accruals strategically among a few accounting periods; Classificatory smoothing - cosmetic smoothing through choosing where to place a certain item: above the line (in ordinary outcome) or below the line [as an extraordinary item]" (pp. 390-391).

Several studies support the smoothing income assumption; smoothing depends on borrowing or saving earnings between current and future periods (see DeFond and Park, 1997; Ronen and Sadan, 1975; Beidleman.1973; Dascher and Malcom, 1970). White (1970) argued that firms that face poor or good performance may employ discretionary accounting decision to smooth earnings. Dopuch and Drake (1966) stated that firms use historical cost methods to manipulate reported earnings. Lev and Kunitzky, (1974) found that sales and capital expenditures are used to smooth income. Hand (1989) stated that managers use debt-equity swaps to smooth income. Moses (1987) found evidence that firm size, the existence of bonus compensation schemes, and the deviation of expected earnings are associated with smoothing.

Earnings management approaches

Earnings manipulation can be managed by two main mechanisms: (1) change in accounting methods (2) and operating decisions. Dechow et al. (1994) stated that as a result of earnings–based incentives accounting methods, actual decisions have been used by managers to increase their cash compensation based on reported earnings. Clikeman et al. (2001) defined earnings management as "the practice of making discretionary accounting choices or timing operating decisions to move reported earnings toward a desired goal" (p. 389).

Nelson et al. (2002) provided a description of areas that have been used by managers to manage earnings as following: reserves, revenue recognition, business combinations, Non-R&D intangibles, fixed assets, investments, leases, accounting changes and prior period adjustments, compensation, consolidations and equity/ cost method, transfers of receivables, cash flows, taxes, long-term debt, pensions, other post-retirement benefits, segment reporting, R&D, foreign currency, EPS, related party disclosures, non-monetary transactions.

Nelson et al (2003) developed their framework to describe how managers manage earnings. They categorize manager's efforts to manage earnings into two approaches. First, techniques such as: (1) expense recognition, (2) revenue recognition, (3) issues unique to business combination (e.g., "over-or understating assets, liabilities and offset with good will" "over-or understating expenses in period of acquisition" "changing or not changing accounts established in an earlier acquisition period" "pooling treatment"), (4) and other issues (e.g., income statement classification, off-balance-sheet financing, modifying disclosures, avoiding equity method, and avoiding consolidation). The second type of approach contains: (1) specific approach (e.g., recognizing too much or too little asset impairment), (2) accounting area (e.g., fixed assets, investments, and intangibles), (3) current-period income effect (e.g., current income increasing, decreasing, or no effect apparent or determinable).

Changing accounting methods

The formal and informal contracts of a firm rely on accounting numbers to define amounts and schedule payments. The theory of accounting postulates that special accounting procedures are efficiently chosen by managers to increase the value of the company or to manage the manager's self interest at the expense of contracting stakeholders (Chistie and Zimmerman, 1994). The selection of practices is determined by management; such selection exposes manipulated earnings. The manipulation occurs because of the accessibility of a broad choice of accounting methods, when there are the same conditions and when a logical position should be just one accounting procedure being adopted (Simpson, 1969).

Cushing (1969) presented evidence that managements switch accounting methods, in order to achieve a favourable outcome. Firms apply a change in accounting policy on the specific periods to affect current targeted income. Gosman (1973) defined an accounting change as "any change in the method of applying generally accepted accounting principles"(p. 1). Fields et al. (2001) explained accounting choice as any decision of an accounting choice whose primary purpose is to influence the output of the accounting system, including financial statements published in accordance with GAAP, tax returns, and regulatory filings. Bremser (1975) studied the changes in accounting methods and estimates, such as depreciation method, inventory method, timing of expense recognition, and change in estimate, which were made by 80 firms during the period from 1965 to 1970. Bremser found that such changes affected earnings. The earnings goal is the incentive to manage voluntary accounting changes, rather than achieving better financial statements. For example, Brigham (1968) compared firms that adopt one of the three patterns of depreciation (accelerated, normalized, and straight-line). Such types of depreciation are different; taking into account the rates of asset growth; speeded earnings decrease when firms adopt the straight-line and normalize for a time, where there is an increase in the other firms at the same position.

Shank and Copeland (1973) said that the return back to straight-line depreciation from accelerated depreciation is an unjustified innovation from firms during the periods of 1950s - 1960s. Barefied and Comiskey (1972) state that managements choose different accounting methods in some areas such as research and development, depreciation, long-term contract accounting, and inventory to smooth earnings. Phillips et al (2003) state that to discover earnings management, they found when deferred tax expense has been related to total accruals and abnormal accruals, it is incrementally useful to prevent an earnings decrease and losses.

Operating decisions

Techniques of earnings management which are concentrated by GAAP-based are revenues and expenses, timing and recognition. An operating decision is made by managers, as real activities are required to achieve desired earnings. For example, in the case of reducing a sales price this in turn leads to increase sales subsequently obtaining an earnings goal (see Ortega and Grant, 2003).

Parfet (2000) explained the difference between earnings management's operation and Generally Accepted Accounting Principles-based or between 'Good' and 'Bad' earnings management. Good earnings management is operations that hold logical performance and business is reasonably operated. Bad earnings management is operations that create accounting innovations and overstate estimates.

Herrmann et al (2003) examined managing earnings management by managers through the sale of fixed assets and marketable securities in Japan. They found that firms use the sale of fixed assets and marketable securities to achieve earnings goal, once the actual operating income is more or less than required earnings. The same result in Bartov's study (1993) the timing of long-live assets sales and investments sales have been used by managers to manipulate earnings. Black et al. (1998) their evidence is consistent with Bartov (1993), firms employ the timing of assets sales once firms have less than average earnings to enhance debt-to-equity ratios. In addition, Moehrle (2002) confirms that firms restructuring accrual reversals to prevent earnings decreases by making earnings management.

Motivations to manage earnings

Ortega and Grant (2003) say firms manage earnings in order to maximize or minimize current-period income comparative to their target earnings, making too much revenue and gains, or reducing expenses and losses have been applied by managers to increase earnings or decrease earnings. Beneish (2001) stated that firms are unlikely to have the same incentives at the same time to engage in earnings management. Evidence of earnings management suggests that performance is the basis of managing earnings especially when either the firm performs abnormally well or abnormally badly.

The function of management is to make decisions, such as normal operating decisions, capital investment decisions, and financial decisions in order to design and execute a business strategy. For example, budgeting, issuing dividends, achieving debt targets and securities goals are all operational decisions. Management must have good knowledge of the firm's economics to make such decisions; this superior knowledge assists the management in engaging either good earnings to convey useful information to interested parties, or bad earnings management that misleads users (Ronen or Yaari, 2007).

Earnings management may be engaged in by managers for a variety of reasons, so earnings management practices may be created due to environmental conditions. The literature on incentives to manipulate earnings management identifies several groups of motivations for earnings management. For example, managers may engage in earnings management for: Capital motivations, Contractual motivations, Regulatory motivations, and Behavioural motivations (Goncharov, 2005).

Capital market motivations

Capital market motivations for earnings management have been studied through empirical research. For example, firms manage earnings management to avoid a drop in the short-term stock price and losses to meet an earning expectation (Burgstahler and Dichev, 1997; Degeorge et al., 1999; Kasznik, 1999; Matsumoto, 2002; Burgstahler and Eames, 2003), or maximize stock price before a share transaction. Also for example, to attract external financing (Dechow et al. 1996), seasoned equity offerings (SPOs) and initial public offerings (IPOs) (Friedlan, 1994; Teoh et al., 1998a; Teoh et al., 1998b; Rangan, 1998), and also stock for stock mergers (Erickson and Wang, 1999).

Achieving a long-term sustainable trend is the reason for smoothing earnings to increase stock price. It is useless to compare unstable earnings stream as a risk indicator with other more stable stock. Firms maximize share price by smoothing and fixing their earnings stream over the long-term (Ortega and Grant, 2003).

On the other hand, there are capital market motivations from the viewpoint of managerial self-interest. Managers attempt to manage earnings downwards when firms go private, which makes the stock price cheaper before a management buyout of public stockholders (DeAngelo, 1986). Hostile takeover is another motivation for managerial self-interest, where discretionary accruals related to reported earnings is increased by managers in firms that are targets of takeover (Easterwood, 1997/1998; Guan et al., 2004).

Contractual motivations

Lending contracts motivate managers to engage in earnings management in two key situations. Before debt is granted, earnings management will be used to convince lenders to obtain debt; when the debt is granted, earnings management is more likely to be used to reduce the likelihood of a bond covenant violation. Managers of firms that are close to violating debt covenants make accounting choices that reduce the likelihood of default (DeFond and Jiambalvo, 1994).

Jaggi and Picheng (2002) say that financially troubled firms attempt to increase income by discretionary accruals, if waivers for debt covenant violations may be obtained, and decrease income by discretionary accruals once debt restructuring or renegotiations take place due to waives not being obtained. The key assumption of agency theory is the conflict of interests between the principal (shareholders) and agent (managers). According to agency theory, there is a separation between ownership and control that yields informational asymmetry, and everyone attempts to maximize his/her own utility, therefore managers have strong incentives to engage in earnings management (Walkling and Long, 1984).

Also from the viewpoint of managerial self-interest managers have strong motivations for earnings management in the case of bonus contracts, particularly once there is earnings-based compensation agreement. Prior empirical research supports the 'bonus plan hypothesis' of positive accounting theory of Watts and Zimmerman (1986) which is ceteris paribus, managers of firms with bonus plans are more likely to choose accounting procedures that shift reported earnings from future periods to the current period. For example, Healy (1985) provides evidence that engaging in accrual policies of income-reporting is associated with managers' bonus contracts incentives, that managers alter accounting procedures according to the adoption of their bonus plan. Bonus plan income is an incentive that is a key component of management compensation. Guidry et al., (1999) results are consistent with Healy (1985) that discretionary accruals have been maximized by business-unit managers to increase their bonus plans of short-term.

Regulatory motivations

In the academic literature, regulatory earnings management motivations received much attention in the later 1970s. Watts and Zimmerman provided a theoretical background to explain accounting practices through a hypothesis called 'political cost'. Watts and Zimmerman (1978) argue that "the political sector has the power to affect wealth transfers between various groups" (p. 115). The hypothesis of political cost assumes that accounting policies will be adapted to increase the possibility of the wealth transfer from firms to other parties due to one or compilation of a regulatory act. Examples in the USA include import relief investigations, price regulation, and antitrust investigations.

Researchers have studied managing earnings management for political cost incentives. For instance, Jones (1991) found evidence that due to import relief investigations managers reduce earnings by using earnings management. In the same context, Magnan et al., (1999) state that during the year of investigation by the Canadian External Trade Tribunal, firms decrease reported earnings by an amount of 6.3% of lagged assets. Price control regulation is another sort of political cost that leads to specific accounting decision. Navissi (1999) provides evidence that manufacturing firms minimize income through discretionary accruals in order to apply price increase. In the case of antitrust investigations, Cahan's (1992) results support the political cost hypothesis that earnings are adjusted by managers in response to a monopoly to comply with the antitrust laws.

Earnings management in order to tax targets has been broadly discussed. The issue of wealth transfer from firms to other parties can occur due to tax reasons as well, in that firms attempt to reduce the current value of income tax expense. Research empirically documented that firms have a general tendency to manage earnings management for tax purposes. Keating and Zimmerman (1999) stated that a 1981 tax law affects a firm's depreciation methods. Likewise, Scholes et al. (1992) show that firms shift income to reduce tax rates by deferring revenues recognition and accelerating expense recognition. Boynton et al., (1992); Guenther, (1994); Maydew (1997) provided evidence that after the period of the US Tax Reform Act 1986 (TRA 86) net operating losses carrybacks were increased to save tax expense, by shifting the amount of income at the time of the statutory tax rate difference. Cushing and LeClere (1992) found evidence that anticipated tax savings affects inventory accounting policy choice.

Behavioural motivations

Prior empirical studies identified two types of behavioural motivations that represent 'managerial self-interest' for engaging in earnings management: (1) a desire to appear to have a superior performance than the previous Chief Executive Office (CEO) and (2) job security.

Behavioural motivations of a manager's reputation are positively influenced by the benchmark of performance of previous CEO. The desire to perform better than the former CEO may drive a manager to engage in earnings management to show a good performance. Wells (2002) studied undertaking earnings management 'big bath' by incoming CEOs. His results indicate that during the transition year, incoming CEO will minimize earnings and maximize earnings in the future, which is consistent with the hypothesis of new CEOs.

Job security is another concern which might motivate managers to increase income (decrease income), during the bad (good) performance. Job security may lead to income smoothing. Fudenberg and Tirole (1995) relate a theory of income smoothing with manager's incentive to keep his/her position or extend the length of his/her tenure, where managers manage earnings management over the period of bad performance to increase income in order to reduce the possibility of dismissal, and over the period of good performance, managers manage earnings downward to save income for future to extend their tenure. In addition, DeFond and Park (1997) found that managers have an incentive to smooth earnings in the cases of poor or good performance current or future period to decrease the risk of job dismissal.

Different perspectives of earnings management

There is a belief that earnings management is bad due to most people see earnings management as a means to reduce the reliability of financial statement information (Scott, 2003). Earnings management is viewed from either accountants or non-accountants as foe not friend. Accountants understand earnings management as a tool which reduces the reliability of information that is announced by financial statements, and non-accountants relate earnings management to fraud.

Beneish (2001) divided earnings management perspectives into the opportunistic perspective and the information perspective. The opportunistic perspective represents the view that earnings management is used by managers as a device to mislead investors and increase their bonuses (see Healy, 1985). The information perspective represents the view that managers use earnings management to communicate inside information to outside in order to reflect the firm's current and future performance on share prices.

Scott (2003) looks at the perspective of earnings management from another angle. Scott divided it into two areas: the perspective of contracting and the perspective of financial reporting. The first perspective is that managers use earnings management to protect the firm from the surprising results of unexpected situations. The second perspective is that the firm value may be affected by using earnings management through the market value of shares. Both Beneish and Scott agreed about both 'good' side to earnings management that is conveying information or the 'bad' side to earnings management that is opportunistic manager behaviour.

Parfet (2000) suggested that if earnings are managed rationally and appropriately then it will not be a bad act. Parfet stated that bad earnings management is improper earnings management, is intervening to hide real operating performance by creating artificial accounting entries or stretching estimates beyond a point of reasonableness, good earnings management is called operational earnings management, where management takes actions to try to create stable financial performance by acceptable, voluntary business decisions.

Dechow and Skinner (2000) discussed the reasons for different perspectives on earnings management between academic, regulator, and practitioner. Dechow and Skinner stated that academics are less concerned, because they consider incentives such as political costs, bonus schemes, and debt contracts that are less likely to motivate managers to manage earnings in an efficient market. Regulators and practitioners perceive earnings management as pervasive, and a dilemma. Regulators and practitioners tend to exaggerate the presence of such problems due to the flexibility of Generally Accepted Accounting Principles (GAAP).

Earnings management in emerging and developing countries

Al-khabash and Al-Thuneibat (2009) provide evidence from Jordan on the perspective of external and internal auditors on earnings management. They found different views between them. External auditors consider that firms engage in significant legal earnings management to maximize or minimize income, whereas internal auditors consider that firms engage in legal performance that maximizes income only.

Kamel (2006) studied earnings management in Egypt, Kamel provided that the overall sample of companies consists of two distinct groups: one using pre-IPO discretionary accruals to increase earnings and the other using them to decrease earnings. The results also reveal a positive relationship between pre-IPO earnings management measures, as reflected in discretionary accruals, and offering prices. The relationship between earnings management and subsequent earnings and share return performance was also examined and the findings suggest that pre-IPO discretionary accruals do predict a portion of the subsequent poor share return performance. In addition, the results indicate that the main motives for using earnings management in Egypt are: to enhance the chances of obtaining bank loans; to sustain last year's profit performance; to report profits and to avoid reporting losses; and to preserve high share valuation. The results also demonstrate that making inadequate provisions; capitalising rather than expensing expenditures; and overestimating the inventory value, as the most frequently used techniques in earnings management in Egypt. Finally, the results reveal a consensus among respondents on the importance of combating earnings management in Egypt through greater reliance on internal corporate governance mechanisms combined with other important actions, such as more detailed accounting legislation and greater disclosure policy.

Pornupatham (2006) examined earnings management, external auditors and corporate governance in Thailand. Results indicated that a desire to increase a company's share price primarily motivated earnings management and it was most often committed in family-owned companies with owners as controlling shareholders in the form of manipulation of related party transactions and early recognition of income. Big 4 auditors had greater resistance to management's discretion than their counterparts in non-Big 4 firms. If audit committees review related party transactions and material weaknesses identified in internal control systems by external auditors in the letter sent to management, this could substantially reduce earnings management and best safeguard investors' interests. Stringent penalties imposed on directors and management who commit earnings management, the promotion of professional ethics within the corporate environment, and an emphasis on economic substance over legal form were also expected to reduce earnings management in Thailand.

Sahlan (2011) examined the impact of Bursa Malaysia Listing Requirement (BMLR) reforms on the incidence of Earnings Management (EM) practices among the Malaysian public listed companies. The findings suggest that the corporate governance initiatives taken by the regulatory agencies did improve the quality of corporate governance among the listed firms, specifically in mitigating the incidences of Earnings Management (EM) and therefore improving the quality of information.

Karacaer and Pelin (2010) investigated the relationship between the earnings management and auditor size using 645 observations from the companies listed in the Istanbul Stock Exchange National All Index between 2005-2008. Discretionary accruals are used to measure the earnings management. According to the results, there is a negative and statistically significant relationship between the discretionary accruals and auditor size. This result suggests that the big four auditors constrain earnings management in Turkey. The other audit related variables, namely audit opinion and audit difficulty, are not found to be associated with earnings management for the whole sample. However, there is a positive relationship between the discretionary accruals and audit difficulty for the subsample of big four auditors, and the audit qualification for the subsample of non-big four auditors. Additionally, firm performance, firm size, leverage and income change are associated with the earnings management.

Conclusion

Earnings management represents reported earnings that reflect a desire of management, rather than the underlying economic substances of the company. Managers may use different techniques to manage earnings such as changing accounting methods or operating decisions, in order to manage one of several goals, such as 'big bath' accounting, income minimization, income maximization, and income smoothing. The reasons which motivate managers to manage earnings may be one of the following: capital market motivations, contractual motivations, regulatory motivations, and behavioural motivations. Earnings management has different perspectives in terms of bad or good practice between academic, regulator, and practitioner, and between external and internal auditors. In addition, the situation of earnings management in emerging and developing countries is not different with the situation of earnings management in developed countries. The next chapter highlights the statistical methods used to capture earnings management through examining accounting accruals methods in order to estimate the scale of the activity.

Chapter 4

Selecting the Model Measuring Earnings Management

Introduction

This chapter is a review of the literature on earnings management, in terms of statistical methods that have been used to measure discretionary accruals as the way to capture earnings management. Such statistical methods have been divided into three approaches. For example, aggregate accruals models, specific accruals, and discontinuities in the distribution of earnings. The overall purpose of this thesis is to investigate the level of audit quality by measuring the extent of earnings management through measure accounting accruals. In order to do this, statistical method will be used.

Approaches to measuring earnings management

Three main approaches have been applied by researchers to measuring earnings management. All researchers use statistical techniques for evaluating the existence of earnings management.

Aggregate accruals models approach

The first approach is aggregate accruals. For instance, Healy, (1985); DeAngelo, (1986); Dechow and Sloan, (1991); Jones, (1991); Dechow et al. (1995); Kang and Shivaramakrishnan, (1995); and Peasnell, (2000) all used regression models to calculate expected and unexpected accruals.

Aggregate accruals models or discretionary accruals models have been separated into simple models that concern the change in total accruals to measure discretionary accruals, and sophisticated models that divide earnings into discretionary and nondiscretionary components applying analysis of regression (Guay et al. 1996). Accruals, Non-discretionary accruals, and Discretionary accruals have been explained by Ronen and Yaari (2007) as following:

> "Accruals arise when there is a discrepancy between the timing of cash flows and the timing of the accounting recognition of the transaction.... Non-discretionary accruals are accruals that arise from transactions made in the current period that are normal for the firm given its performance level and business strategy, industry conventions, macro-economic events, and other economic factors. Discretionary accruals are accruals that arise from transactions made or accounting treatments chosen in order to manage earnings" (pp. 371-372).

Adopting the aggregate approach allows researchers to compare total accruals of each firm related to cross-time series. Therefore, other explanatory variables can be studied for example, mechanisms of auditors and corporate governance. The use of discretionary accruals to test earnings management and market efficiency is widespread (see for example, DeFond and Jiambalvo, 1994; Rees et al., 1996; Teoh et al., 1998a, b). The most popular seven discretionary accruals models are: the Healy (1985) model, the DeAngelo (1986) model, the Industry model (Dechow and Sloan, 1991), the Jones (1991) model, the Cross-Sectional Jones model (DeFond and Jiambalvo, 1994), the Modified Jones model (Dechow et al., 1995), and the KS model (Kang and Sivaramakrishnan, 1995) (see,. Bartov et al., 2001).The table 4.1 provides main aggregate accruals models and their proxies used to measure discretionary accruals.

Table 4.1 illustrates aggregate accruals models and their proxies for discretionary accruals

Authors	Discretionary accruals proxy
Healy (1985)	Total accruals.
DeAngelo (1986)	Change in total accruals.
Jones (1991)	Residual from regression of total accruals on change in sales and property, plant and equipment.
Modified Jones Model from Dechow et al., (1995)	Residual from regression of total accruals on change in sales and on property, plant and equipment, where revenue is adjusted for change in receivables in the event period.
Kang and Sivaramakrishnan (1995)	Residual from a regression of non-cash current assets less liabilities on lagged levels of these balances, adjusted for increases in revenues, expenses and plant and equipment.

Adapted from: McNichols, M. F. (2000, p. 317).

Specific accruals approach

The second approach concentrates on specific accruals. For example, McNichols and Wilson, (1988) who investigate accruals such as the claim loss reserve in the insurance industry or the provision for bad debts more generally.

In general total accruals consist of two components: (1) nondiscretionary accruals related to operational levels of control, (2) discretionary accruals manipulated by managers. The approach of specific accruals has been used by some researchers to measure earnings management. For example, McNichols and Wilson, (1988) studied how in the absence of earnings management, the provision for bad debts would be reported. Beatty et al., (1995) examined how taxes, regulatory capital, and earnings purposes will be achieved by banks through change in magnitude and timing of transactions and accruals. In the same context, Liu et al., (1997) study loan loss provisions of banks in the fourth fiscal quarter. Ayers, (1998); and Miller and Skinner, (1988) investigate under Statement of Financial Accounting Standards No. 109 (SFAS No. 109) how the net deferred tax assets will be disclosed. Beneish (1997) presents a model to examine firms that have extreme financial performance to detect earnings management. The table 4.2 provides main specific accruals models and their proxies to measure discretionary accruals.

Table 4.2 illustrates specific accruals models and their proxies for discretionary accruals

Authors	Discretionary accruals proxy
McNichols and Wilson (1988)	Residual provision for bad debt, estimated as the residual from a regression of the provision for bad debts on the allowance beginning balance, and current and future write-offs.
Petroni (1992)	Claim loss reserve estimation error, measured as the five year development of loss reserves of property casualty insurers.
Beaver and Engel (1996)	Residual allowance for loan losses, estimated as the residual from a regression of the allowance for loan losses on net charge-offs, loan outstanding, nonperforming assets and one year ahead change in nonperforming assets.
Beneish (1997)	Days in receivables index, gross margin index, asset quality index, depreciation index, selling general and administrative expense index, total accruals to total assets index.
Beaver and McNichols (1998)	Serial correlation of one year development of loss reserves of property casualty insurers.

Adapted from: McNichols, M. F. (2000, p. 317).

Discontinuities in the distribution of earnings

The third approach examines discontinuities in the distribution of earnings as more or less a particular benchmark such as, Burgstahler and Dichev, (1997); and Beneish, (2001). Burgstahler and Dichev (1997) approach of collective cross-sectional distribution has been used to measure earnings management to avoid earnings decrease and losses. Burgstahler and

Dichev found unusually small earnings decreases of low frequencies and small negative income and unusually small increases of high frequencies and small positive income. Furthermore, firms use operational cash flow and working capital changes to increase earnings. Degeorge et al., (1999) used distributions of earnings per share to measure earnings management which is managed for exceeding three thresholds: report positive profits, sustain recent performance, and meet analysts' expectations. They show how specific patterns of earnings management are applied in response to exceeding the threshold. The table 4.3 provides frequency distribution models and their tests for earnings management.

Table 4.3 illustrates frequency distribution models and their approaches for testing earnings management

Authors	Test for earnings management
Burgstahler and Dichev (1997)	Test whether the frequency of annual earnings realizations in the region above (below) zero earnings and last year's earnings is greater (less) than expected.
Degeorge et al. (1999)	Test whether the frequency of quarterly earnings realizations in the region above (below) zero earnings, last quarter's earnings and analysts' forecasts is greater (less) than expected.
Myers and Skinner (1999)	Test whether managers of firms with a long series of consecutive increases in quarterly (Earnings Per Share EPS) practice earnings management.

Adapted from: McNichols, M. F. (2000, p. 317).

Questionnaire survey

Some researchers have used (alternatively) a postal questionnaire survey such as Mulford and Comiskey, (2002); Nelson et al., (2003) to evaluate earnings management. Questionnaire survey has been used by prior studies to obtain professionals' perspectives about how earnings are managed. For example, Nelson et al., (2003) used a questionnaire survey of 253 experienced auditors to describe how managers attempt to manage earnings based on a sample of 515 attempts of earnings management. Such attempts have been classified as a 'primary approach'; expense recognition, revenue recognition, issues unique to business combinations, and other issues. Then these attempts have been sub classified by the particular approach. Mulford and Comiskey (2002) showed 20 techniques of earnings management and 10 motivations and objectives of earnings by using survey questionnaire to 191 respondents of finance professionals. The respondents by occupational groups included: 59 accounting academics, 30 chief financial officers, 24 security analysts, 21 lenders, 21 certified public accountants, and 36 advanced MBA students.

Models measuring earnings management

The Healy Model (1985)

Healy (1985) models the mean of total accruals, scaled by lagged total assets, to measure earnings management. Healy detects earnings management by comparing mean total accruals across the sample firms divided into three groups conditional on the earnings management direction. For instance the first group will report upward earnings management and the other two groups will be report downward earnings management. It is predicted that systematic earnings management arises in all periods. Healy explained that the difference between reported accounting earnings and operational cash flow is the mean total accruals. The mean total accruals consist of both non-discretionary accruals and discretionary accruals components. For example, adjustments in property depreciation, plant depreciation, and equipment depreciation are non-discretionary accruals, which are ordered by accounting standard setting bodies. On the other side, adjustments in the depreciation methods are discretionary accruals. Healy (1985) assumed that non-discretionary accruals in the estimation period represent the mean total accruals for measuring earnings management. The following is Healy's non-discretionary accruals model:

$$NDA_{\tau} = \frac{\sum_{t} TA_{t}}{T},$$

where

NDA = estimated nondiscretionary accruals;
TA = total accruals scaled by lagged total assets;
t = 1, 2,...T is a year subscript for years included in the estimation period; and
τ = a year subscript indicating a year in the event period.

The discretionary accruals are the difference between total accruals in the event year *t* scaled by A_{t-1} and non-discretionary accruals as following:

$DA_t = (TA_t/A_{t-1}) - NDA_t$

The DeAngelo Model (1986)

The DeAngelo (1986) Model uses last period's total accruals (TA-1) scaled by lagged total assets (At-2) as the measure of nondiscretionary accruals. DeAngelo defines total accruals as in Healy (1985); total accruals are calculated as net income minus operating cash flows as following:

(AC1-AC0) = (NI1-NI0)-(CF1-CF0)

Where

AC= total accruals

NI= net income

CF=cash flows

That derived by adjusting working capital from operations for changes in all current operating accounts, except that the only difference between Healy and DeAngelo is that earnings reflect the impact of the equity method of accounting for inter corporate investment. This Model assumes that the difference between total accruals in the current year and nondiscretionary accruals is changes in discretionary accruals due to nondiscretionary might be constant all time and nondiscretionary accruals follow a random pattern. DeAngelo takes the total accruals in the prior year as a benchmark period to current year and attributes variations from the benchmark measure to earnings management (AC1-AC0) = (DA1-DA0) + (NA1-NA0).

Where

(AC1-AC0) = total accruals in current year minus total accruals in the prior year

(DA1-DA0) = discretionary accruals in current year minus discretionary accruals in the prior year

(NA1-NA0)= nondiscretionary accruals in current year minus nondiscretionary accruals in the prior year

Healy and DeAngelo assume that the change in average nondiscretionary accruals (N1-NA0) is zero. Such a model will not work if both of the following assumptions are not true: (1) nondiscretionary accruals are equal over time (2) discretionary accruals have a mean of zero in the estimation period. It is not realistic; Kaplan (1985) argued that the level of nondiscretionary accruals should change in response to changes in economic circumstances. Dechow et al. (1995) explained that failure to model the impact of economic circumstances on nondiscretionary accruals will cause inflated standard errors due to the omission of relevant (uncorrelated) variables. Friedlan (1994) argues that the random walk assumption is not valid for firms that tend to be growing.

The following is DeAngelo non-discretionary accruals model:

$NDA_t = TA_{t-1} / A_{t-2}$ (1)

Where

NDA_t = nondiscretionary accruals in year t scaled by lagged total assets;

AT = total accruals;

A = total assets;

DA = discretionary accruals, and

t = event year.

The discretionary accruals are the difference between total accruals in the event year t scaled by A_{t-1} and nondiscretionary accruals as following:

$DA_t = (TA_t/A_{t-1}) - NDA_t$ (2)

Industry Model (1991)

Dechow and Sloan (1991) presented the Industry Model to measure earnings management. The assumption that nondiscretionary accruals are constant over time is relaxed by the Industry Model. It also assumes that the variation in the determinants of non-discretionary accruals is common across firms in the same industry. Dechow and Sloan assumed that nondiscretionary accruals are the same figure to median value of total accruals of all firms in the same industry, and certain sensitivity to industry accruals existed in all firms. The median value of total accruals in year t scaled by lagged total assets for all non-sample firms in the same two-digit Standard Industrial Classification (SIC) industry (industry j). The Industry Model for nondiscretionary accruals is following:

$NDA_t = \beta 1 + \beta 2 \text{ median}_j (TA_t / A_{t-1})$ (1)

Where:

NDAt = nondiscretionary accruals in year t scaled by lagged total assets;

median j (TAt / At-1) = median value of total accruals in year t scaled by lagged total assets for all non-sample firms;

TA = total accruals;

A = total assets;

T = event year, and

$\beta 1$, $\beta 2$ = firm-specific parameters are estimated using ordinary least squares OLSs on the observations in the estimation period.

The discretionary accruals are the difference between total accruals and nondiscretionary accruals as following:

$$DAt = (TAt / At\text{-}1) - NDAt \qquad (2)$$

Where:

DAt = discretionary accruals.

Ronen and Yaari (2007) say that the Industry Model includes a couple of disadvantages: first, the model assumes all firms practice the same event. Second, it is a biased test of measuring earnings management, even if other firms in the industry make earnings in the same way or, the test will not detect earnings management, if other firms make it in different way. Hribar and Collins (2002) argued that studies using a balance sheet approach to test for earnings management are potentially contaminated by measurement error in accruals estimates. Dechow et al., (1995) explained that the Industry Model removes variation in nondiscretionary accruals that is common across industry. If changes in nondiscretionary accruals largely reflect responses firms in the same to changes in firm-specific circumstances, then the Industry Model will not extract all nondiscretionary accruals from the discretionary accruals proxy.

The Jones Model (1991)

In Jones (1991), the key assumption that has been used by prior models such as DeAngelo (1986), that nondiscretionary accruals are constant over time is relaxed. The Jones model has been applied to control for change in a firm's economic conditions, due to its effect upon nondiscretionary accruals. Jones assumed that the changes in economic circumstances will cause the changes in nondiscretionary accruals. Jones (1991) links total accruals with revenue changes, as well as the level of gross property, plant, and equipment .The following expectations model of a firm-specific time series has been developed to measure total accruals to control for changes in the economic conditions:

$TAt/At\text{-}1 = \alpha 1\ (1/\ Ait\text{-}1) + \alpha 2\ (\Delta REVt\ /\ At\text{-}1) + \alpha 3\ (PPEt/\ Ait\text{-}1) + \epsilon t$

Where:

At-1 = total assets at the end of year t-1;

ΔREVt = revenues in year t less revenues in year t-1;

PPEt = gross property, plant, and equipment at the end of year t;

ϵt = error term in year t, and

$\alpha 1$, $\alpha 2$, $\alpha 3$ = firm-specific parameters.

Jones assumes an unchanged relationship between nondiscretionary accruals and the independent variables, to control for changes in the economic conditions of a firm in the event year. The following is the Jones model for nondiscretionary accruals:

$NDAt = \alpha 1\ (1/\ Ait\text{-}1) + \alpha 2\ (\Delta REVt\ /\ At\text{-}1) + \alpha 3\ (PPEt/\ Ait\text{-}1)$

The following is discretionary accruals or prediction error:

Discretionary accruals = total accruals – nondiscretionary accruals

Or

$Up = TAt/At\text{-}1 = \alpha 1\ (1/\ Ait\text{-}1) + \alpha 2\ (\Delta REVt\ /\ At\text{-}1) + \alpha 3\ (PPEt/\ Ait\text{-}1)$

Where:

U = prediction error;

P = year index for years included in the prediction period;

$\alpha 1$, $\alpha 2$, $\alpha 3$ = estimated terms achieved by OLS technique.

The discretionary accruals level is represented in the Jones model as the prediction error at the time p, and earnings management of the firm is represented by the discretionary portion. The limitation of the model as recognized by Jones is that managers may increase sales recognition for earnings manipulation in the year- end period. Change in gross property, plant, and equipment are used to control for changes in the total accruals portion, associated with depreciation expense of nondiscretionary accruals, and changes in revenues are applied to control for the firm's economic environment. Jones (1991) uses lagged total assets to scale total accruals both (dependent and independent variables) to reduce heteroscedasticity.

Dechow et al., (1995) divided the components of accruals that managers can use to manipulate earnings into two groups: (1) expense manipulation that can be occurred through delaying in the expenses recognition (2) revenue manipulation that can be managed by premature revenues recognition. According to the Jones model assuming that revenue is the main tool of all manipulations, this will reduce the model's ability to detect earnings management. Detecting earnings management, the Jones model seems to be superior to the Healy model, the DeAngelo model, and Industry model. However, the Jones model does not properly specify extreme cash flow (Jeter and Shivakumar, 1999).

The Modified Jones Model (1995)

Dechow, Sloan, and Sweeney (1995) present modification to the Jones Model, designed to eliminate the conjectured tendency of the Jones Model to measure discretionary accruals with error when discretion is exercised over revenues. Accounts receivable treatment is an innovation of their modified model. The difference between the original Jones Model and Modified Model is only that they adjust the change in revenues for the change in receivables in the event period, as the Modified Model assumes no systematic earnings management. Dechow et al., (1995) hold that the original Jones Model assumes that, in either the estimation period or event period, discretion is not exercised over revenues. In a different manner, the Modified Jones Model assumes that all changes in credit sales are a consequence of earnings management in the event period, due to earnings management through credit sales recognition being easier than managing earnings through cash sales.

Ronen and Yaari (2007) say that the difference in time-series analysis is recognized in the Modified Model, if earnings are not managed in the estimation period and firms manage accounts receivables in the event period, then in the estimation period accruals of credit sales will be normal and in event period abnormal. The modified model uses the following approach: First, the model estimates normal accruals as in the original Jones model. Second, the model computes normal accruals in the event period by multiplying the estimated coefficient of the change in sales by the change in cash sales (the change in revenues minus the change in accounts receivable).

The following is the Modified Jones Model:

$NDAt = \alpha1\ (1/\ At\text{-}1) + i\ \alpha2\ [(\Delta REVt\text{-}\Delta RECt)/At\text{-}1] + \alpha3[PPEt/At\text{-}1] + \varepsilon t$

Where:

TAt = total accruals in year t;

$At-1$ = total assets in year t-1;

$\Delta REVt$ = revenues in year t less revenues in year t-1;

$\Delta RECt$ = net receivables in year t less net receivables in year t-1 scaled by

total assets in year t-1;

$PPEt$ = gross property plant and equipment in year t;

ϵt = error term in year t, and

$\alpha 1, \alpha 2, \alpha 3$ = firm-specific parameters.

The estimates of $\alpha 1$, $\alpha 2$, $\alpha 3$ are those obtained from the original Jones Model, not from the modified.

Guay et al. (1996) studied a market-based evaluation of discretionary accruals of the five models by regressing earnings on discretionary accruals and nondiscretionary accruals. Guay et al. (1996) provide evidence consistent with opportunism, that the firm performance in the Healy model, DeAngelo model, and Industry model are not effective in isolating discretionary accruals, while Jones and modified Jones models identify discretionary accruals consistent with performance and opportunistic smoothing of earnings. Therefore, both the original Jones model and modified Jones model are likely to provide valid estimates of discretionary accruals.

Dechow, Sloan, and Sweeney (1995) tested the ability of five models in detecting earnings management by using the model across discretionary accruals. They found that the most powerful test of earnings management is provided by the Modified Jones Model. Bartov et al., (2001) say evidence has been provided by audit qualifications that the greater cross-sectional Jones model and cross-sectional modified Jones have ability to detect earnings management compared to their time series counterparts. Kothari et al., (2005) identified the

Jones model and the modified Jones model to be the best specified across a broad range of simulated event circumstances for measuring discretionary accruals tend.

DeFond and Jiambalvo Model (1994)

DeFond and Jiambalvo (1994) presented a new version of a cross-sectional model which is different from the cross-sectional modified Jones model and the original model. DeFond and Jiambalvo (1994) estimate parameters by using cross-sectional data rather than time-series data. Hence, parameter estimates α1, α2, α3 from both original Jones model and modified Jones model are industry based and DeFond and Jiambalvo use year-specific measures rather than firm-specific ones. Some researchers have more recently applied cross-sectional models. For instance, DeFond and Jiambalvo, (1994); DeFond and Subramanyam, (1998); Teoh et al., (1998a,b); Becker et al., (1998); Guidry, (1999); DuCharme et al., (2001); Klein (2002b); Peasnell et al., (2005).

Although a time-series for each firm is not the basis of cross-sectional estimation in these approaches, but the problem in using such an approach is that, as McNichals, (2000) explained, "Researchers estimating nondiscretionary accruals by industry, as the cross-sectional Jones model is often applied, may well overstate the magnitude of nondiscretionary accruals and understate the magnitude of discretionary accruals, because industry-level controls include the average level of discretion exercised by the industry" (p. 324). At this point, such a cross-sectional approach might comparatively overstate nondiscretionary accruals and understate discretionary accruals. DeFond and Jiambalvo used data from firms in their corresponding matched portfolio to estimate total accruals as following:

TAijp/Aijp-1=αjp [1/Aijp-1]+β1jp[ΔREVijp/Aijp-1]+β2jp[PPEijp/Aijp-1]+εijp,

Where:

$TAijp$ = total accruals for estimation firm I matched with violation firm j on
industry for year p,

$\Delta REVijp$ = change in revenues for estimation portfolio firm I matched with
violation firm j on industry for year p,

$PPEijp$ = gross property, plant, and equipment for estimation portfolio firm I
matched with violation firm j on industry for year p,

$Aijp-1$ = total assets for estimation portfolio firm i matched with violation firm j on
industry for year p,

ϵijp = error term for estimation portfolio firm I matched with violation firm j
during year p,

i = 1,....Ij, estimation firm index for the number of firms in the estimation
portfolios,

p = prediction year (year of violation or prior year).

Ordinary Least Squares (OLS) is used to obtain estimates αjp, b1jp, b2ip of αjp, $\beta 1jp$, and $\beta 2jp$.

The Kang and Sivaramakrishnan Model (1995)

The KS model uses an Instrumental Variable (IV) method as a basis, and the Generalized Method of Moment (GMM) is used as an estimation system. Simultaneity, error in variables, and omitted variables are identified by the KS model (1995) as limitations of the original Jones model (1991). First, the simultaneity problem is the determination from GAAP and double-entry bookkeeping of dependent and independent variables, inconsistent coefficient estimates and incorrect standard errors are possible as well. Second, while independent variables are more likely to be unobserved for researchers that might lead to errors in variables and may be affected by earnings management. Inconsistent parameter estimates will be created due to the correlation between measurement errors regression and. Finally, another problem results from the omission of cost of goods sold and other expenses which causes the problem of omitted variables in the model. KS model (1995) attempts to reduce the first and the second problems by using the IV method, and cost of goods sold and other expenses are included to mitigate the third problem. The Kang and Sivaramakrishnan model (1995) can be presented as following:

$$ABit / TAit = \Phi o + \Phi 1 \, [(REVit / TAit\text{-}1)(ARit\text{-}1 / REVit\text{-}1) + \Phi 2 \, [(EXPit / TAit\text{-}1)(APBit\text{-}1 / EXPit\text{-}1)] + \Phi 3 \, [(PPEit / TAit\text{-}1)(DEPit\text{-}1 / PPEit\text{-}1)] + \epsilon it$$

Where:

AB = non-cash current assets less current liabilities and depreciation;

REV = net sales revenues;

AR = accounts receivable, excluding tax refunds;

EXP = operating expenses, including: the cost of goods sold, and selling and expenses before depreciation;

APB = current assets and liabilities that are related to expenses, measured as following:

[current assets- accounts receivable-cash- income tax refund-(current liabilities-income taxes payable)];

PPE = gross property, plant, and equipment;

DEP = depreciation and amortization;

TA = total assets;

ϵ = prediction error.

Kang and Sivaramakrishnan (1995) see that the (IV) models offer a significant enhancement over the Jones model; GMM method offers the greatest power and robustness. In contrast, Alcarria Jaime and De Albornoz Noguer (2004) explained that Kang and Sivaramakrishnan model is the least powerful of discretionary accruals models for both expense and revenues manipulation.

The Performance-Matching Model (2005)

Thomas and Zhang (2000) and Fields, Lys, and Vincent (2001) documented that the Jones model has poor performance. Kothari, Leone, and Wasley (2005) seek to improve the Jones model through introduce a performance adjustment. They argue that performance measures are important because of potential momentum in the economic activities and earnings of the firms. The linear version of their model adds some lagged performance measures, such as return on assets ROA. The linear performance matching model embodies two modifications of the Jones and the Modified Jones model: an intercept, and an additional control for the lagged rate of return on assets, ROAt-1, they also use the contemporaneous ROA, but since later studies used only the lagged ROA.

Because heteroskedasticity is still an issue, Kothari, Leone, and Wasley (2005) include an intercept to mitigate heteroskedasticity compared with Jones model that does not have an intercept, it just makes deflating by lagged assets in order to mitigate heteroskedasticity. Kothari, Leone, and Wasley find that an intercept yields higher symmetry around zero discretionary accruals, which enhances the power of tests for type I error. They report that excluding the intercept increases rejection rates by more than 20% over those reported for models including an intercept (Ronen and Yaari, 2007).

Kothari, Leone, and Wasley examine the specification and power of tests based on performance-matched discretionary accruals, and make comparisons with tests using traditional discretionary accrual measures (Jones and Modified Jones models). Performance matching on return on assets controls for the effect of performance on measured discretionary accruals. The findings suggest that performance-matched discretionary accrual measures enhance the reliability of inferences from earnings management research when the hypothesis being tested does not imply that earnings management will vary with performance, or where the control firms are not expected to have engaged in earnings management. The following is the estimation of nondiscretionary accruals of the Performance-Matching Jones model:

$NDAit1 = \alpha(1/ Ait\text{-}1) + \alpha 1[(\Delta REVit\text{-} \Delta RECit/Ait\text{-}1] + \alpha 2[PPEit/Ait\text{-}1] + \alpha 3[ROAit\text{-}1/ Ait\text{-}1]$

Where:

Ait-1 = total assets of firm i in year t-1;

ΔREVit = revenues of firm i in year t less revenues in year t-1;

ΔRECit = net receivables of firm i in year t less net receivables in year t-1 scaled by total assets in year t-1;

PPEit = gross property plant and equipment of firm i in year t;

ROAit-1 = Lagged rate of return on assets of firm i;

$\alpha 1, \alpha 2, \alpha 3$ = firm-specific parameters.

Detecting and restraining earnings management

Earnings management is achieved through accruals accounting and those accounting choices subject to manager's discretion, most probably in order to achieve private objectives. However, management undertakes to present judgments and estimates for regularly providing financial statements responding to GAAP requires. It is not easy to differentiate between some types of earnings management for example, income smoothing and appropriate accounting choices (Dechow and Skinner, 2000). If managers indeed have an incentive to manage earnings, they are likely to do so in a way that is difficult to detect, that is an additional problem, because this reduced the ability to detect earnings management and declined the power of our tests (Beneish, 2001).

Audit quality

An important role can be played by external auditors in restraining earnings management. External auditors are hired by shareholders to use as a means to resolve information asymmetries about the true economic performance of a company between them and the management (Goncharov (2005). Consistent with the assumption, an auditor will detect earnings management if they have an ability to use efficient tests, and report detected breaches on financial statements, if they act independently, to interested parties. DeAngelo (1981b) pointed out that "Audit services are demanded as monitoring devices because of the potential conflicts of interest between owners and managers as well as those among different classes of security holders" (p. 185).

External auditors reduce information asymmetries between managers (agent) and financial reports' users (principal) to enable users to verify the financial statements' validity. The ability to constrain earnings management relies on the effectiveness and the quality of the auditor, which differs among auditors. Thus, detecting and reporting questionable accounting practices are more likely from high-quality auditors (see DeAngelo, 1981b; Palmrose, 1988; Teoh and Wong, 1993; DeFond and Jiambalvo, 1991). Becker et al. (1998) argue that "the external auditor acts as a constraint on management's choice of accounting procedures, with the effectiveness of the constraint depending on audit quality" (p. 7).

Kinnunen and Koskela (2003) examined Cosmetic Earnings Management (CEM) by using a sample of approximately 87,000 earnings observations from almost 22,000 firms in 18 countries for the five-years period 1995-1999, results indicate that firms' tendency to exercise CEM worldwide, they confirmed that CEM decreases with spending on auditing, whereas it increases with the latitude of country's GAAP, its cultural values (power distance), and the importance of management bonus schemes.

Caramanis and Lennox (2008) concluded that when auditors present low audit effort (audit hours), abnormal accruals more likely be positive than negative, positive abnormal accruals will be larger, and firms attempt to increase earnings management to meet any earnings benchmark. As a final conclusion, managers may report aggressively high earnings.

Using Big Six auditors has been found to constrain earnings management (Becker et al, 1998; Vander Bauwhede et al, 2003; Krishnan, 2003). Myers et al, (2003) found evidence that length the auditor tenure decreases discretionary accruals. Frankel et al, (2002) state that the relation between non-audit fees and the magnitude of discretionary accruals is positive, while the relation is negative between earnings management and audit fees.

Corporate governance

Corporate governance has been defined by La Porta et al. (2000) as "a set of mechanisms through which outside investors protect themselves against expropriation by the insiders" (p. 4). Likewise, Shleifer and Vishny (1997) explained that "corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment" (p. 737).

Earnings management could be restrained by corporate governance mechanisms such as ownership structure, and board and auditing committee. Evidence has been provided by empirical research on the important role that can be played by corporate governance mechanisms to constrain earnings management (Goncharov, 2005).

The assumption of opportunistic behaviour supports the notion that there is a negative relation between earnings management and managerial ownership. In addition, the use of contractual constraints decreases with managerial ownership Warfield et al, (1995). The production of financial statements is the responsibility of audit committees. Earnings management is constrained by the board and audit committee activity; there is negative relation between their broad independence, the committee's independence and abnormal accruals (Klein, 2002b; Xie et al, 2003).

Accounting standards

The accounting standards provide different (amount of) accounting choices and therefore may supply earnings of different quality. Earnings management is expected to be more spread under lax regimes that leave sufficient space for making judgments. Despite theoretical evidence points to the fact that accounting standards themselves may play a substantial role in determining the extent of earnings management, it is still unclear whether the observed differences in accounting practices of entities using different accounting frameworks result actually from the allowed latitude of the accepted accounting principles (Goncharov, 2005).

Several studies indicated that tighter accounting standards may lead to a substitution effect in that the reduction of accounting earnings management is met with increased real earnings management. For instance, Ewert and Wagenhofer (2005) studied tightening accounting standards to restrict earnings management; findings indicate that tighter accounting standards strictly increase real earnings quality. Likewise, Chen et al. (2007) examined the role of conservative accounting standards in alleviating rational yet dysfunctional unobservable earnings manipulation; results confirmed that risk sharing and hence contract efficiency can be improved under a conservative accounting standards, where absent earnings management, accounting earnings represent true economic earnings with a downward bias, compared with under an unbiased standard, where absent earnings management, accounting earnings represent true economic earnings without bias.

Rentfro and Hooks (2005) used two standards to examine the earnings management behavior: one which provides preparers with relatively few opportunities to manage earnings, and one which provides several earnings management opportunities; findings stated that when the asset impairment decision is guided by a low earnings management opportunity standard, preparers across all experimental conditions made similar reporting decisions. However, under the high earnings management opportunity standards, preparers who had an economic incentive to manage earnings and who possessed private information about the impairment made different reporting decisions than those preparers who did not have an economic incentive and private information.

While there is no doubt that accounting standards are different in respect to the amount of accounting choices they allow, researchers failed to provide clear evidence for a link between an accounting regimes' properties and the level of earnings management (Goncharov, 2005). International Accounting Standards (IAS), now known as International Financial Reporting Standards (IFRS) and U.S. Generally Accepted Accounting principles (GAAP) are compared as two sets of competing accounting frameworks. For example, Bartov et al. (2002) used sample of German companies to investigate comparative value relevance of earnings reported under German GAAP, U.S. GAAP, or IAS/IFRS; results are consistent with expectations. Value relevance is higher for earnings prepared under either U.S. GAAP or IAS/IFRS over earnings prepared under German GAAP. For two subsamples: (1) Neuer Markt firms and (2) small firms earnings prepared under U.S. GAAP are superior relevance over earnings prepared under IAS/IFRS.

Jeanjean and Stolowy (2008) examined the effect of mandatory introduction of IFRS standards on earnings management for three IFRS first-time adopter countries, Australia, France, and the UK, results indicate that the pervasiveness of earnings management did not decline after the introduction of IFRS, and in fact increased in France.

In contrast, Leuz (2003) investigate whether firms using U.S. GAAP vis-à-vis IAS/IFRS exhibit differences in several proxies for information asymmetry, findings do not support that U.S. GAAP produce financial statements of higher informational quality than IAS/IFRS. Haiyan et al (2009) studied whether firms adopting IAS/IFRS have higher earnings quality in China; findings indicate that adopting firms are less likely to smooth earnings in the post-adoption period.

Conclusion

Previous studies have attempted to measure earnings management using accounting accruals models, such as the Healy Model, the DeAngelo Model, the Industry Model, the Jones Model, the modified-Jones Model, and the KS Model. The models classify total accruals into discretionary and non-discretionary accruals applying the ordinary least squares technique. The residual or measurement error from the multiple regressions represents the discretionary proportion of accruals or earnings management. Dechow et al. (1995) and Subramanyam (1996) suggest that the Jones and Modified-Jones models are superior to other models and have the most powerful test of earnings management, as they generate the fewest type II errors. Kothari, Leone, and Wasley (2005) improved the Jones model through introduce a performance adjustment. Several approaches have been suggested to detect and restrain earnings management, such as audit quality, corporate governance, and accounting standards

Chapter 5

Audit reports

Introduction

The audit report is the end stage of the audit process. The auditor has to examine and evaluate the client's financial statements, and communicates to the user the evaluation results of those financial statements by giving the opinion through issuing an appropriate audit report. The audit report represents the culmination of the auditor's task, and the auditor concludes if the client's financial statements portray the truth and fairness of the company's financial performance and if they are consistent with GAAP. The auditor's duty is to communicate to shareholders or any other interested parties satisfaction or dissatisfaction with the client's financial statements. This means that the audit report is the auditor's responsibility and that the auditor should take it seriously. There are different types of audit report depending on auditor satisfaction or dissatisfaction with the company's accounts. If the auditor sees that the financial statements represent a true and fair view, in this case he/she will issue an unqualified report. If the auditor sees that financial statements do not represent a true and fair view, then he/she will issue a qualified report. At the end of the audit examination total uncorrected misstatements will be aggregated by obtaining sufficient evidence. Once the auditor detects such uncorrected misstatements, he/she determines the effects of them on financial statements. If the misstatements are material, then the auditor has to express his/her opinion by issuing a qualified report, because the client's financial statements are materially misstated. In this chapter the literature on audit report will be reviewed in terms of its components, such as the opinion, types of audit reports which include (unqualified audit report, qualified audit report, adverse audit report, and disclaimer audit report), modified audit reports, nature of financial statements and audit report which includes (going concern, accounting accruals, and consistency), audit reports in emerging and developing countries.

The opinion

An auditor has to express his or her opinion on financial statements. This does not mean the auditor will give a guarantee about the client's financial statements. An audit of financial statements requires the exercise of judgment from the auditor; it is not just a mechanical procedure. The auditor, to express his or her opinion, has to critically evaluate the appropriateness of different accounting methods. The auditor is not infallible and is likely to make errors of judgment, but the audit process requires the auditor to collect sufficient evidence for evaluating financial performance to express an opinion about the truth and fairness with which the financial statements represent the company's financial performance (Messire et al. 2008).

The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements. The auditor's report should contain a clear written expression of opinion on the financial statements taken as a whole (The International Standard on Auditing, ISA 700 UK and Ireland, 2003). Hayes et al. (2005) explained that the opinion of the auditor on the financial statements communicates to the user the level of information that they can depend on in the financial statements, or disclaims an opinion on those financial statements.

The opinion paragraph is one of the basic elements of the auditor's report in addition to title, addressee, opening or introductory paragraph, scope paragraph, date of the report, auditor's address, and auditor's signature. The opinion paragraph of the auditor's report should clearly indicate the financial reporting framework used to prepare the financial statements, including identifying the country of origin of the financial reporting framework when the framework used is not International Accounting Standards, and state the auditor's opinion as to whether the financial statements give a true and fair view, or are presented fairly, in all material respects, in accordance with that financial reporting framework and, where appropriate, whether the financial statements comply with statutory requirements (ISA 700, 2003).

Types of audit reports

An independent external auditor expresses a formal opinion through the audit report, or disclaims an opinion, by evaluating and examining a legal entity's financial performance to determine if the financial statements describe accurately its financial performance. Subsequently, the audit report presents the auditor's opinion of the accuracy of the financial statements, which will be provided to a user such as a company, an individual, a government, a group of persons, and the general public. The financial statements are essentially worthless without the auditor's report, due to misleading or inaccurate information which they might contain. The audit function as an assurance service is required from the user in order to make decisions which rely on the auditor's report. The financial information communicated through the auditor's report is welcomed by the most users. The users require the financial information to be certified; for this reason, companies depend on auditor reports to certify their financial performance. The auditor's report is an important tool, because companies need to communicate certified financial information to the users (Porter et al. 2008: Hayes et al. 2005).

The auditor expresses his or her opinion in one of the four types of audit reports: unqualified, qualified, adverse, and disclaimer of opinion. The issuing of any type of report depends on particular circumstances, because each type of report is appropriate for specific situations (Porter et al. 2008: Hayes et al. 2005).

Unqualified audit report

An unqualified audit opinion is the most frequent type of report. It is called by many interested parties 'the clean report'. An auditor issues this type of report when the financial statements do not contain any material misstatements and are consistent with GAAP. In addition, the financial statements fairly present the operations, condition, and position of the company's finances. All four standard report types, including unqualified reports, require that the audit report should contain a clear-cut indication of the character of the auditor's work and the degree of responsibility taken for the financial statements (Porter et al., 2008). An unqualified audit opinion is an expression when the auditors' judgment on financial statements that gives a true and fair view on financial performance, and they have been prepared in accordance with relevant accounting or other requirements such as GAAP, or are presented fairly, in all material respects,) in accordance with the identified financial reporting framework (ISA 700,2003).

Arens et al (2003) defined two type of an unqualified audit report as follows:

> "Standard unqualified audit report - the report a CPA issues when all auditing conditions have been met, no significant misstatements have been discovered and left uncorrected, and it is the auditor's opinion that the financial statements are fairly stated in accordance with GAAP. Unqualified audit report with explanatory paragraph or modified wording - an unqualified report in which the financial statements are fairly presented, but the auditor believes it is important, or is required, to provide additional information" (p. 63).

In the case of an unqualified audit report, the auditor must be independent, and applicable standards must be used throughout the audit process. There must be no significant limitations on the audit's procedures, and there must be no material departures from GAAP on the company's financial statements (Messire et al. 2008).

Qualified audit report

A qualified audit opinion is very similar to an unqualified audit opinion. The qualified audit report states that the financial statements do not comply with GAAP. Although the financial statements are fairly presented, they are otherwise 'misstated' because a few accounts are affected by accounting 'problems' in the financial statements. However, such problems are not pervasive. The auditor will issue a qualified opinion because of a single deviation from GAAP, a scope limitation, or inadequate disclosure (Soltani, 2007).

Adverse audit report

The auditor issues an adverse audit report when he or she believes that the material misstatement is contained in the client's financial statements and, once they have been seen as whole, is not presented consistently with GAAP. An adverse opinion report and an unqualified opinion report are considered complete opposites. The adverse type of report identifies information in the client's financial statements which is materially incorrect, inaccurate, and unreliable for evaluating the company's financial performance by users seeking to make decisions. The auditor explains the nature and size of the misstatement contained in the client's financial statements in an adverse report (Messire et al. 2008). An adverse opinion should also be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements (ISA 700, 2003).

Disclaimer audit report

The auditor refuses to give an opinion on the client's financial statements and issues a disclaimer audit report when he or she tries to audit the company but could not complete the audit due to various reasons such as a lack of independence or material conflicts, significant scope limitations, insufficient evidence, going concern issues, and significant uncertainties. The auditor explains the reasons for disclaiming an opinion and clearly signifies that he or she cannot express an opinion (Soltani, 2007). A disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements (ISA 700, 2003).

Modified audit reports

There are two different situations where an auditor may issue a modified audit report: (1) the auditor will add an emphasis of matter paragraph, if matters do not affect the auditor's opinion, (2) the auditor will issue a qualified opinion, disclaimer of opinion, or adverse opinion, if matters affect the auditor's opinion. In addition, modified wording or added explanatory language to the standard unqualified statement audit report may be required in five different situations: where opinion based in part on the report of another auditor, issues of going concern, lack of consistency in the financial statements due to accounting changes, auditor agreement with a departure from GAAP, and the emphasis on a matter (Hayes et al. 2005; Messire et al. 2008).

Prior studies have investigated the issue of modified audit report in cases of going concern uncertainties. For example, Dopuch et al. (1987) developed a model based on financial and market variables with dependent variables to predict whether an auditor will issue qualified opinion. They indicate that the highest scores among different types of qualifications are with going concern opinions and prediction accuracy as well. Louwers, (1998) studied the relation between going concern opinions and the auditor's loss function. Findings indicate that factors which auditors take into account when they decide to issue a going concern opinion are the client's financial performance and financial difficulties of the company, not litigation or the loss of her/his function. Lennox (1999) attempted to evaluate audit reports in terms of their accuracy and informativeness in predicting bankruptcy. It has been found that useful incremental information about the likelihood of bankruptcy has not been held in audit reports. In addition, audit reports are not as accurate as a bankruptcy model for prediction purposes.

Keasey et al. (1988) stated that receiving audit qualification was more likely for a small company that has been audited by a large audit firm, had a qualified report in a previous year, had few directors, had long, large audit lags, and fewer non-director shareholders than other companies.

Ireland, (2003) examined the relation between different types of companies (public, private, listed, and non-listed), and both non going-concern modified audit reports related to either disagreements or limitations on scope, and going concern modified audit reports. Findings show that going-concern modification is less likely to be issued to large companies those have good liquidity, pay dividends, and pay high audit fees; from another side, it is more likely to be issued to companies which have high gearing, bad financial performance, and had a modified audit report last year. A non going concern modification is less likely to be issued to public companies, and it is more likely to be issued to private companies. In contrast, the non going-concern modification is less likely to be given to subsidiary companies, and it is more likely to be given to independent companies. In addition, for subsidiary companies there was a negative relation between large auditors and non going-concern modifications, and a positive correlation with going concern modifications. For independent companies the association was positive with going concern modifications, and there was no relation with non going concern modifications.

The relation between issuing a qualified audit report and auditor switching has been examined in previous studies. For instance, Chow and Rice (1982) indicated that companies tend to switch auditors after receiving a qualified audit report. Craswell (1988) provided evidence related to the association between an auditor switch and a qualified opinion in an Australian context which is the same as in Chow and Rice's study. Krishnan (1994) examined auditor switches for using conservative judgment. Findings indicate that the auditor switching rate is high for qualified opinions related to conservative standards. Krishnan et al. (1996) confirmed the hypothesis of auditor switching and qualified opinions. Furthermore, switchers are more likely to receive qualified opinions.

On the other hand, Schwartz and Menon (1985) provide evidence that failing companies tend to switch auditor more than healthier companies. In contrast, auditor switching is not associated with qualified opinions or management changes in failing companies.

Prior studies examined whether legal liability motivates auditors to issue a modified audit report, before bankruptcy, to protect themselves from lawsuits claiming audit failure. For example, Carcello and Palmrose, (1994) found that companies which are not related to litigation have higher rates of modified opinions, and auditor litigation is related to a low rate of modified opinions. In addition, modified opinions have the lowest payments rates and weaker claims, and no modified opinions have the highest payments rates. Buchman and Collins (1998) provided evidence that, due to litigation uncertainty, auditors who issue modified audit reports are less likely to lose lawsuits than auditors who issue an unqualified audit reports. Gaeremynck and Willekens (2003) confirmed the endogenous relationship between voluntary litigation and type of audit report. Mong and Roebuck (2005) examined the effect an audit opinion with a going-concern on possible litigations. They found that a modified audit opinion reduces the tendency of claimants to litigate against auditors.

The incremental information contained in the modified audit report through an explanatory paragraph has been debated. For example, Bamber and Stratton (1997) investigated the influence the information content in modified audit reports on specific financial statements users - bank loan officers. The responses of 77 participants suggest that the loan officers' decisions to risk assess, charge an interest rate, premium and whether to grant the loan or not, are affected by the uncertainty-modified audit report. In addition, they support the assumption that the modified audit report is more informative. In the same context, Guiral-Contreras et al. (2007) examined to what extent loan officers depend on the qualified audit report to rate loans. Findings based on 106 loan officers from international financial institutions indicate that the qualified audit report may affect the perceptions of loan officers. Furthermore, the qualified audit report is more independent and useful once it becomes inverse to favorable expectations.

In Malta small companies are more likely to receive a qualified audit opinion of limitation-on-scope by non Big Four audit firms, and large companies are more likely to receive qualified audit on opinions of disagreement by Big Four audit firm (Farrugia and

Baldacchino, 2005). In Finland, companies who have low profitability, low growth, high indebtedness, low share of equity in balance sheet, and have small number of employees are more likely to receive qualified audit reports (Laitinen and Laitinen, 1998).

Nature of financial statements and audit report

Fundamental accounting concepts (going concern, accrual, and consistency) are the basis on which the information in financial statements is prepared, consistent with GAAPs and different methods of applying to accounting treatments. The management must hold these concepts carefully to obtain fairness of information in financial statements in the end. The auditor's responsibility for financial statements is to give his or her opinion through reporting on the fairness of the financial statements (Calpin, 1990).

Going concern

One of the basic assumptions underlying the preparation of financial statements is the assumption of 'going concern'. The company is normally supposed to be a going concern if the company considers continuing in operation in the foreseeable future, which is approximately the next twelve months. (Hayes et al. 2005). GAAPs are based on the concept of going concern, which means the company is expected to continue in operation and meet its obligations as they become due (Robertson and Louwers, 1999). Venuti, (2004) said that "The going-concern assumption is fundamental to accrual accounting, to assume that an entity will continue in business is to say that the entity expects to realize its assets at the recorded amounts and to extinguish its liabilities in the normal course of business" (p.42).

It will have a material and negative effect on the financial statements, if the validity of the assumption of going concern does not exist; that means the company is either bankrupt, dissolved, or shutdown. Venuti (2004) studied the twenty largest bankruptcy filings in the period from 2001 to 2002 in U.S; she found that, all 12 companies received an unqualified opinion on their most recent financial statements filed prior to the bankruptcy filing, none of the audit opinions included an explanatory paragraph reflecting the auditor's substantial doubt about the entity's ability to continue as a going concern. The auditor must assess whether it is appropriate for the governing body to use the going concern assumption in preparing the financial statements and whether the disclosures in the financial statements are appropriate, to this they need to evaluate the actions of those charged with governance and their assessment to continue as a going concern (Fisher, 2009). The financial statements must be viewed by the auditors in terms of the directors' disclosures regarding the assumption of going concern (Nolan, 2009).

ISA (UK and Ireland) 570 requires that the auditor's responsibility is to evaluate the appropriateness of management's use of the going concern assumption in the preparation of the financial statements and conclude whether there is a material uncertainty about the entity's ability to continue as a going concern that need to be disclosed in the financial statements. In the same context, SAS No.59 (AU Section 341.02) states that the auditor has a responsibility to evaluate whether there is substantial doubt about the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited.

Robinson (2008) provides evidence on issuing going concern opinions during the provision of tax services by the auditor and the likelihood of impairment of auditor independence. The study concluded that there is positive association between issuing going concern opinion and the level of tax services in the previous auditor's report before the bankruptcy filing, and no correlation between the going concern opinion and both audit fees and the non tax component of NAS fees.

DeFond et al, (2002) provided evidence that non audit fees do not impair audit independence, and there is no relation between going concern opinions and both total fees and audit fees. In the same case, Geiger and Rama (2003) found that there is significant positive relation between audit fees and going concern opinion, but no relation between audit opinion and non audit fees or the ratio of nonaudit fees to audit fees. Callaghan et al. (2009) examined the relationship between the tendency of auditor to issue going concern opinion to bankrupt U.S. companies in the previous year to bankruptcy filing and non audit fees. They go far to investigate other related auditor fees such as audit fees, total fees, and the ratio of nonaudit fees to total audit fees. Their finding confirms that there is no association between going concern opinions and non audit fees or other auditor fees.

Fargher and Jiang (2008) who stated the high profile collapses in the period from 2000 to 2002, pointed out that they resulted in raised litigation against auditors, increased media scrutiny, higher insurance costs, and changed regulatory review of the auditing profession. Fargher and Jiang compared the periods before and after 2000-2002. After the auditors' reports became more conservative, because auditors tended to issue going concern opinions after this period. Their results indicate that the likelihood of issuing going concern opinions to companies which were financially troubled was more likely directly after the period of 2000-2002.

Accounting accruals

Calpin (1990) defined accruals as "Revenues and costs are recognized in the accounts as they are earned or incurred, not as money is received or paid. This also embraces the "matching" concept whereby, in determining income for the period, costs are included in the income statement of the same period as the revenue to which they relate" (pp.5-6).

Butler et al. (2004) examined the association between modified audit opinions and abnormal accruals. Their results confirm that there is a correlation between companies that have going concern opinions with levels of abnormal accruals and modified audit opinions. Francis et al. (1999) provided evidence that Big Six auditors constrained firms from reporting aggressive and potentially opportunistic accruals over the period from 1975 to 1994. Francis and Krishnan, (1999) their findings are consistent with Big Six auditors being more conservative and firms of high-accruals are more likely to have modified audit report from the Big Six auditors. Krishnan (2003) found that accruals-based earnings management is reduced and the effects on the quality of earnings by specialist auditors are more marked than for nonspecialist auditors. Cahan and Wei (2006) examined the changes and the abnormal accruals level of ex-Andersen clients. They indicate that the level of abnormal accruals is lower and there is a larger decrease in abnormal accruals of ex-Andersen clients in 2002, and the Big Four auditors are more conservative when they audit financial statements of their ex-Andersen clients.

Frankel et al. (2002) argued that there is a positive relation between nonaudit fees and discretionary accruals, and a negative association between audit fees and such indicators of earnings management. Likewise, Larcker and Richardson, (2004) stated that there is a positive association between the ratio of nonaudit fees to total fees and accruals, and a negative relation between both audit fees and nonaudit fees and accruals.

Gul et al. (2007) in their findings show that firms with short auditor tenure have a positive relation between their nonaudit fees and discretionary accruals, particularly for small clients, but not for big clients. In addition, the auditor independence is impaired by high nonaudit fees in the case of small clients and short auditor tenure. Srinidhi and Gul (2007) provided evidence that nonaudit fees negatively affect accrual quality and audit fees positively affect accrual quality. Chih-Ying et al. (2008) studied changes in earnings quality associated with audit partner tenure and audit firm tenure. Findings indicate that audit partner tenure decreases the positive discretionary accruals. In addition, audit partner rotation could adversely affect earnings quality.

In general, Bradshaw et al. (2001) their evidence indicates that auditors do not warn information users as to the future earnings problems of companies who have high accruals by means of their audit reports.

Consistency

Calpin (1990) defined consistency as "The accounting principles selected and their method of application are the same from year to year" (p. 6). The second standard of reporting (referred to herein as the consistency standard) is: The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period (SAS No.1AU 420).

Lack of consistency or departure from generally accepted accounting principles are the circumstances in which an auditor might be unable to give an unqualified audit report. Once the financial statements are prepared, depending on accounting methods conflicting with generally accepted accounting principles or the financial statements being materially affected by a departure from GAAP, such as using an unacceptable accounting principle, inadequate disclosure or a lack of justification for a change in accounting principle - in these cases, a qualified or adverse audit report should be issued by the auditor (Messire et al. 2008).

The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements: a change in accounting principle and an adjustment to correct a misstatement in previously issued financial statements (SAS No. 58). The standard unqualified audit report requires the financial statements of a company to present fairly, in all material respects, the financial position of that company as of the end of a given year, and the 'conformity' with generally accepted accounting principles (GAAP).

Johnson et al. (1983) studied perceptions related to perceivable audits (conformity with generally accepted accounting principles GAAP, free from clerical errors, and free from fraud). They found that audited financial statements are more likely to be in conformity with GAAP, free from clerical errors, and free from fraud. Hopwood et al. (1989) investigated incremental explanatory power of the audit report qualifications for bankruptcy. They used a framework of one univariate and two multivariate models. Findings indicate a significant association between consistency, going concern, and other subject-to qualifications and bankruptcy. Trompeter (1994) examined the effect of the compensation plans of an audit partner and GAAP on an auditor's judgment under the assumption of auditor client conflict.

Findings show that audit partners are more likely to constrain clients from increasing their income and that GAAP required partners to decrease the client's income, and also constrain clients from influencing the judgment of auditor.

Audit reports in emerging and developing countries

Chuntao, Song, and Wong (2008) document a continuous relation between audit firm size and the issuing of modified opinions in China using a panel data set of audit firms and listed firms from 2001 to 2003. In addition, the association between audit firm size and the accuracy of audit report has been tested. Li et al. (2008) stated that, in China modified audit reports are more likely to be issued by larger audit firms than smaller ones.

In the case of China, the issue of new auditing standards designed to increase audit independence, has led to the modified audit report increasing nine-times and large auditors audit market share has decreased after adopting the new standards. Large audit firms have relatively more independence than the others. Hence, managers prefer to hire smaller auditors in order to avoid the likelihood of receiving a modified audit report as a result of adopting the new auditing standards (DeFond et al. 2000). In the same context, Lin et al. (2003) studied the understanding of financial statements by users - in particular credit and loan officers - of audit reports in China. They found that Chinese users believe that there is negative impact from a qualified audit report on the financial statements credibility. In Jordan, a qualified audit report has no significant impact on share prices and returns (Al-Thuneibat et al. 2008).

Shireenjit, Christine, and Keith, (2007) examine auditor reporting behaviour in the presence of aggressive earnings management in the context of the Asian Economic Crisis as it affected

Malaysia. The interaction between discretionary or abnormal accruals and **audit** quality, as indicated by auditor size and auditor industry specialisation, is examined. Their findings were consistent with earlier findings using Western data, Big 5 auditors in Malaysia appear to qualify more frequently than their non-Big 5 counterparts when high levels of abnormal accruals are present. However, the interaction between auditor industry specialization and abnormal accruals is not significant in predicting the incidence of qualification.

Hsu, Young, and Chu, (2011) studied audit reports in Taiwan; they found negative abnormal returns five days following the audit report day. Returns that are more negative are associated with a decrease in insider ownership during the several months before the audit report day. These results imply that investors can infer qualified opinions or that there is information leakage of qualified opinions. They also found that the average cumulative abnormal return over the 20 days following the announcement day of qualified reports is about −25%, which is much more pronounced than that in Anglo-Saxon countries.

Conclusion

Auditors have to issue appropriate audit report to ensure high audit quality, through giving an independent audit opinion which reflects the real situation of the company's financial performance. As mentioned in the previous chapter, the audit report itself is considered as one of the different approaches to measuring audit quality; through the audit report, the quality of audit services can be measured. According to the audit quality definition the emphasis is to 'discover a breach in the client's accounting system, and report the breach' (DeAngelo, 1981b). Thus, the audit report has to be appropriate, informative, and communicates to users of financial statements useful information about the company's financial performance in order for the auditor to be considered as presenting high audit quality. In addition, the situation with regard to audit reports in emerging and developing countries is not different with the situation of audit reports in developed countries.

Chapter 6

Factors Affecting Audit Quality

Introduction

The second and third objectives of this thesis are to investigate factors affecting audit quality, and to explore how audit quality can be improved. Consequently, the main purpose of this chapter is to review the literature and highlight factors which affect audit quality, such as firm size, audit fees, non-audit services, audit tenure, litigation, audit steps, and team characteristics; and at the same time, to conclude how audit quality can be improved, through supporting factors that have a positive impact on audit quality. In addition, this chapter will present some suggestions to constrain factors that have a negative impact, by setting some strategies to enhance the audit quality in Libyan auditing. Reisch (2000) stated that there is a rapidly changing environment and the auditing profession does not respond to this change, which leads to the need to evaluate the factors affecting audit quality.

Audit firm size

Audit firm size is the most common factor which has been studied. The hypothesis that larger audit firms provide high audit quality has been examined by numerous researchers. Prior studies empirically support a summation of a positive impact of the firm size on the audit quality, and that audit quality increases with the size of audit firms, such as DeAngelo (1981b), Davidson and Neu (1993), and Becker et al. (1998). There is evidence to suggest that the reasons why larger audit firms provide higher audit quality are that larger firms can manage more useful audit programmes and provide superior technology for their auditors, because they possess more and better resources and research facilities than smaller firms, and they also can conduct the strongest tests (Reisch, 2000). Furthermore, DeAngelo (1981b) stated that the reason why higher audit quality is produced by larger audit firms compared with smaller firms is that the likelihood of losing any client does not excessively influence larger audit firms because they have a broad client base. Krishnan and Schauer (2000) studied the differentiation of quality among auditors, they explain that the extent of compliance increases as one moves from the small non-big six to the large non-big six to big six, this means there is a positive association between auditor size and audit quality.

The fact that industry specialization has a positive impact on audit quality has been confirmed by researchers. Specialization enhances the ability to determine and identify the problems and industry specific issues. For example, Krishnan (2003) argued that specialist auditors are more likely to reduce discretionary accruals and affect the earnings quality than non-specialist auditors. Lowensohn et al. (2007) used the Big Five and smaller audit firms to measure the effect of specialization on audit quality. They found that there is a positive association between specialization and perceived audit quality.

Previous studies stated that the incentive to behave independently is more likely with Big Four auditors than smaller auditors, where the latter are more likely to produce a personalized services model (McLennan and Park, 2003). Larger audit firms do not depend on one client's revenue, because they have several clients which lead to increased auditor independence. Audit independence is a main element of audit quality; audit independence is linked to auditor size, and the assumption that there is a positive relationship between audit quality and audit size has been supported (Arruñada, 1999; Niemi, 2004; Alleyne et al., 2006).

Davidson and Neu (1993) studied an assumption that companies may attempt to close the gap between forecasted earnings and reported earnings by maximizing the actual income, and firms of higher audit quality have a positive association with forecast errors. They found that high-quality audits are associated with larger audit firms rather than smaller audit firms. Becker et al. (1998), in the light of the relationship between the audit quality and earnings management examined the hypothesis on the difference of the audit quality, and they found that discretionary accruals for increasing income are relatively higher with companies of non-Big Six auditors rather than companies of Big Six auditors. In the same context, Francis et al. (1999) argued that Big Six auditors are more likely to constrain aggressive earnings management. Davidson et al. (2006) found that companies which switch from Big Six auditors to non Big Six auditors after receiving modified audit reports have higher level of earnings management than others. Hussainey (2009) examined the investors' ability to predict future earnings for profitable and unprofitable firms. Findings indicate that investors' ability to predict future earnings is better when financial statements audited by the big four audit firms. In addition, the hypothesis that issuing accurate audit reports by Large audit firms is supported by a great deal of empirical research, such as Lennox (1999), and Gaeremynck and Willekens (2003).

In contrast, Imhoff (1988) suggested that there is no systematic difference between auditors and that accounting quality is relatively equal among most audit firms. Likewise, Chandler (1991) affirmed that it is individual auditors who produce audit quality, not firms. Lee, Cox, and Roden (2007) state that the big audit firms losses the audit quality advantage, that is consistent with changes in the audit environment including both increased non-audit services and lowered litigation risk for big audit firms.

Audit fees

An auditor's independence is the key point that gives the auditor the ability to issue appropriately an opinion which reports a material misstatement. Audit quality will be reduced if the auditor's independence has been affected in any way, through emotional concerns, or falling prey to personal or financial pressure. The audit fees are theorized to affect both auditor's independence and the ability of the auditor to detect and report financial statement misstatements (Wooten and Colson, 2003).

Simunic (1980) explained that lower fees are more likely to be charged by the Big Eight compared with non-Big Eight. It was not found that the audit services are monopolized by the Big Eight. In the same context, Palmrose (1986) examined the fact that the Big Eight firms charge higher audit fees for two main reasons; higher quality services or monopoly pricing. Findings support the fact that hiring one of the Big Eight is a quality surrogate, and that the Big Eight increase audit hours, which reflects highly productive audits which supply higher audit quality to clients. Niemi (2004) stated that auditor size is associated positively to audit pricing. Gonthier-Besacier and Schatt (2007) studied the determinants of audit fees in France. They found that firm size influences audit fees in France, and that audit fees will be adjusted to become higher if the audit services are provided by one of the Big Four firms. Hoitash et al. (2007) tested the relationship between auditor fees and audit quality through using two proxies for auditor independence (unobservable auditor risk and effort), and two measures of audit quality (discretionary accruals and accruals quality). Findings indicate that total fees are negatively associated with two proxies of audit quality over all years, and positively associated with two measures of audit quality.

The SEC is concerned that 'situation where the auditor agrees to a fee significantly less than is normal in order to obtain the client' may constitute a lessening of independence (Securities Act Release No. 33-5869). DeAngelo (1981a) defined the practice of 'low balling' as "setting audit fees below total current costs on initial audit engagements"(p. 113). Low balling is the initial pricing below total costs at the first engagement which an auditor is ready to offer with an understanding that audit fees can be increased in future periods over total costs.

Simon and Francis (1988) examined the impact of audit fee price-cutting on auditor independence over the period 1979-1984. They found that reduction of fees is different depending the year of engagement; there is a 24% reduction for the initial engagement, 15% for the next two years, and then an increase in the fourth year to normal fee level for continuing engagement. Ettredge and Greenberg (1990) extended Simon and Francis's study, using 389 firms over the period 1983-1987 to determine the effect of auditor switching on fee cuts for initial engagements. They found that the mean and median fee cuts were 25% and 23% respectively. Craswell and Francis (1999) found the same results in the Australian context. Hua-Wei et al. (2009) examined the hypothesis that initial-year audit fee discounts in the post-SOX period are less than in the pre-SOX period. Findings indicate that Big Four clients receive 24% in initial-year audit fee discounts pre-SOX period, and 16% in post-SOX period; the Big Four are more conservative with their pricing after SOX.

Dopuch and King (1996) examined the impact of Lowballing on audit quality. They found that Lowballing did not materially reduce service quality, relative to benchmark settings without Lowballing when subjects interacted in markets. Lowballing did have a material effect in a setting with the combined conditions of a high degree of Lowballing and no competitive market for the services. Likewise, low balling may impair audit independence is an unjustified negative view, and that audit independence can be enhanced by Lowballing (DeAngelo, 1981a; Chi-Wen and Zhaoyang, 1998).

Niemi (2005) studied three types of audit client ownership (manager-owned, foreign-owned, and state-owned) and their effect on audit effort and auditor fees in Finland, using audit hours and audit fees of four Big Six audit firms as proxies of audit quality. Findings indicated that there is a differential between types of ownership which influences both audit hours and auditor fees. The first type of ownership where the greater part of the company is owned by its manager has lower audit hours and auditor fees; the second type of ownership has higher than others, and the impact was not different between state-owned and diverse ownership structure. In addition, the results documented that state-ownership is not the main concern in terms of audit quality.

Non-audit services

Arruñada (1999) defined non-audit services as "services provided by audit firms which do not involve auditing, including advice and consultancy, assistance in applying methods and support in implementing transactions and supplying staff for specific tasks" (p. 69). In general, any factor may lead auditors to compromise their independence; ultimately, it will be to detriment of audit quality. For example, it could be incentives that compromise an auditor's independence, when auditors engage in the provision of non-audit services to clients, or where there is economic dependence on major clientele, and when there is a business relationship between the auditor and their client. In addition, the provision of non-audit services to audit clients is generally regarded as a serious threat to auditors' independence (Porter et al. 2008).

On the other hand, Advantages have been drawn from important economies of scope; the provision of non-audit services diminishes total costs, induces more strong competition, and enhances technical competence. In addition, the provision of NAS does not essentially harm each of the non-audit services quality or independence of auditor (Arruňada, 1999).

Previous research on audit quality examined the impact of the provision of non-audit services NAS on audit independence. For instance, DeBerg, Kaplan, and Pany (1991) show that the level of NAS is not associated with audit change decision. In a similar vein, DeFond et al. (2002) examined the relation between non-audit services fees and auditor independence in terms of issuing going concern opinions. Findings indicate no relationship between non-audit services fees and the tendency to issue going concern opinions by an auditor and its ability to impair auditor independence. Similarly, other studies indicate that there is no association between issuing going concern opinions and the magnitude and relative degree of non-audit services fees, audit fees, total fees, or the ratio of non-audit fees to total fees (Geiger and Rama,2003; Callaghan et al, 2009).

Furthermore, Ashbaugh et al. (2003) studied the effect of the provision of non-audit services on discretionary accruals in order for the firms to meet analysts' forecasts; they found no evidence that providing relatively more non-audit services to audit client's auditors impairs their independence. Brandon et al. (2004) investigated the impact of the magnitude of non-audit services on the bond rating process, their results indicate that there is no economic effect on the bond rating as result of supplying the provision of non-audit services.

Abbott et al. (2003) [due to requirements of the SEC Effective February 5, 2001 of disclosure and description of audit, non-audit services, and information technology fees paid to an auditor]. This research was studied the provision of non-audit services to SEC audit clients, suggesting that the current disclosures at a minimum should be maintained, and SEC should strive for disclosures in order to improve the clarity and granularity of non-audit services.

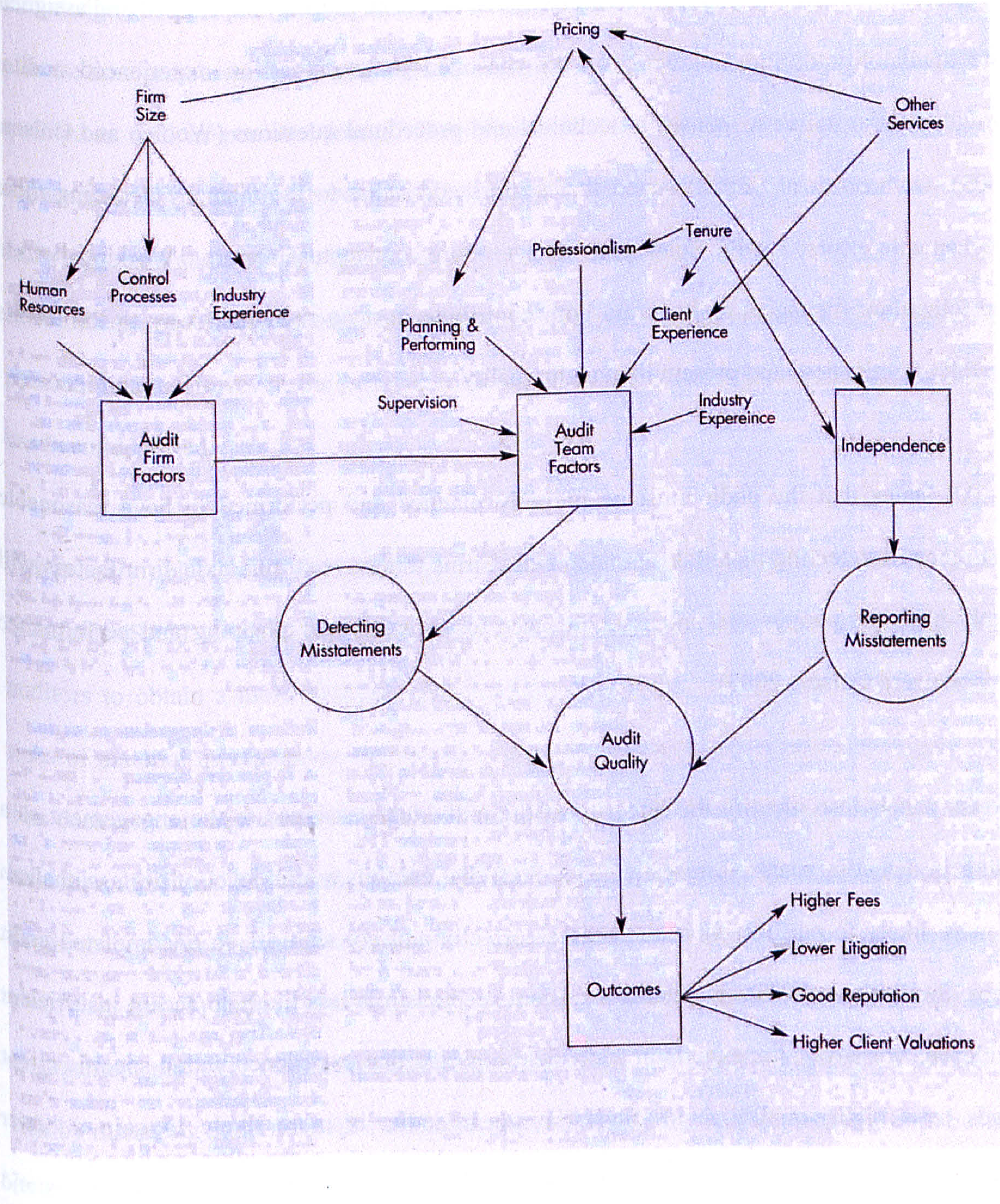
In contrast, Schulte Jr (1966) mentioned that a possible conflict of interest between audit independence and acting as a management consultant may be produced; this is a great danger to both real and apparent independence. Simunic (1984) found that audit fees for auditors who supply Management Advisory Services (MAS) are higher than audit fees for those who do not supply MAS. Wines (1994) found that if provision of NAS provided by auditors to their client is at a higher level; then the possibility exists for impairment of the appearance of auditor independence. Firth (1997) argued that the auditors' economic bonding with their audit clients, in the case of the provision of non-audit services, might impair auditor independence. Frankel et al (2002) stated that there is a positive relation between non-audit fees and the magnitude of discretionary accruals, and a negative relation between audit fees and earnings management indicators. Francis (2006) explained that there are actual economic effects from non-audit services, resulting in lower share prices for companies which receive non-audit services and pay higher non-audit services fees.

Audit team characteristics

Audit quality is viewed to be a function of auditor performance. The auditor's ability and professional conduct are argued to be major factors affecting performance (Catanach and Walker, 1999). Frantz (1999) stated that regardless of whether or not auditors' levels of skill are observable, the quality of audit supplied by any auditor is shown to be increasing in the auditor's level of skill.

The four factors reported to be most important in determining audit quality were audit team and firm experience with the client, industry expertise (especially within the audit team), responsiveness to client needs, and compliance with the general standards (competence, independence, and due care) of Generally Accepted Auditing Standards (GAAS) (Carcello et al., 1992). Wooten and Colson (2003) suggested that audit team factors were more important than firmwide factors in determining audit quality. The audit firm that hires well, implements a strong control process, and has industry experience, will likely field a high-quality audit team.

Figure 6.1: A Model of Audit Quality



Adapted from: Wooten and Colson (2003.p.51).

The experts in audit field reported that partner and manager attention to the engagement is associated with audit quality. GAAS requires that audits be properly supervised and assigned. The availability during fieldwork of the seasoned judgment of an experienced auditor provides authoritative responses to technical and procedural questions (Wooten and Colson, 2003). Owhoso et al. (2002) stated that seniors add value to the team by detecting more mechanical errors, while managers detect more conceptual errors. Working within specialization: managers and seniors both contribute in a no redundant way to the team's overall effectiveness and present high audit quality.

GAAS states that the audit must be properly planned and performed to have reasonable assurance of detecting material misstatements. Firms that have strong audit firm factors will likely have the people and processes in place to ensure proper planning and performance (Wooten and Colson, 2003).

Expert panels also identify the integrity of the individuals assigned to the engagement as a factor in detecting material misstatements. Staff that exhibits a high level of professionalism is more likely to perform their audit tasks correctly and not sign off on uncompleted audit steps. Similarly, staff that maintains persistent scepticism is less likely to accept insufficient evidence. Moreover, the experts in audit field reported that experience with a specific client leads to a higher-quality audit. Staff on repeat audits is more likely to gain a better understanding of how the client's business processes work and the particular strengths and weaknesses in the client's accounting systems. They are able to more readily identify the areas that had the most risk and errors from the previous year and then devote additional time to these areas (Wooten and Colson, 2003).

Tangpinyoputtikhun and Ussahawanitchkik (2008) examined the influence of professional knowledge on personal image, through to audit quality, and investigated two moderate effects: time pressure influence on the relationship between professional knowledge and audit quality, as well as personal image. They found that there is a positive social recognition influence on the relationship between audit quality, and a relationship between professional knowledge and audit quality, but no influence of moderator-time pressure. Surprisingly, they also indicate no effect of social recognition on the relationship between audit quality and personal image. However, the positive relationship between audit quality and personal image has been identified.

The primary objective of The Auditing Standards Board (ASB) and Statements on Auditing Standards (SAS) 104 is to enhance auditor' application of the audit risk model by requiring auditors to obtain a more in-depth understanding of a company in order to better identify risks of material misstatement of financial statements (McConnell Jr and Schweiger, 2007). The decision to accept a new client or continue the contract of an existing client is a difficult task for audit firms. Every time a firm considers signing a contract for attestation services, it needs to consider the three components of engagement risk: (1) client's business risk, (2) audit risk, and (3) auditor's business risk. The client's business risk is the one component of engagement risk over which the auditor has no control. The auditor attempts to control this risk by managing audit risk, which is solely determined by the auditor, and auditor's business risk, which can be control by the auditor, and auditor's business risk (Kerr et al, 2007).

Working on multiple clients within the same industry allows the staff to become expert in the processes and procedures unique to that industry. By understanding the common weaknesses, risks, and issues faced by a particular industry, an auditor can be more confident and persistent when assessing the evidence presented by the client (Wooten and Colson, 2003). O'Keefe et al. (1994) showed that industry specialization is associated with fewer violations of GAAS reporting standards. Balsam et al. (2003) found that a specialist's knowledge of the industry and its accounting will yield a greater ability to detect earnings management. In addition, clients of industry specialists report lower discretionary accruals and having higher earnings quality than clients of no specialists.

Auditor tenure and mandatory auditor rotation

Auditor tenure is the period of time (usually number of years) that an auditor contracted with the same audit clients to audit their financial statements (Jenkins and Velury, 2008). Regulators are concerned that as audit firm/partner tenure (the length of the audit-client relationship) gets longer, auditors are more likely to compromise on their client's accounting and reporting choices because they are too familiar with the management and because they want to retain the client's business. Thus, the proponents of mandatory auditor rotation argue that setting a limit on the number of years that an audit firm/partner may audit the same company will improve auditor independence and audit quality. On the other hand, the opponents of mandatory auditor rotation argue that as auditors gain more experience from longer tenure, they have better knowledge to determine whether the client's accounting and reporting choices are proper. This argument suggests that audit quality improves as the length of auditor tenure increases (Chih-Ying et al, 2008). The Sarbanes-Oxley Act of 2002 requires the lead audit or coordinating partner and the reviewing partner to rotate off the audit every five years (Manry et al, 2008).

Studies have focused on the consequent effects of auditor tenure and compulsory rotation on audit independence and audit quality. Many researchers have supported the assumption of a positive association between auditor tenure and audit quality. There are some studies which have used discretionary accruals as a proxy to test the relationship between auditor tenure and audit quality. For example, Carey and Simnett, (2006) indicated that long audit partner tenure is associated with abnormal working capital accruals. Gul et al. (2007) stated that non-audit fees are positively associated with discretionary current accruals for firms with short audit tenure. Similarly, audit partner tenure decreases significantly the positive magnitude of discretionary accruals, and the quality of earnings is not decreased with audit partner tenure (Manry et al., 2008).

Some studies have focused on the type of audit report to measure the association between audit tenure and audit quality. For example, Knechel and Vanstraelen (2007) studied the impact of auditor tenure on audit quality in Belgium, using going concern opinion as proxy of audit quality. With a sample of bankrupt companies, they found that the evidence supports either increasing or decreasing audit quality. Likewise, Jackson et al, (2008) used the propensity to issue a going-concern opinion and level of discretionary accruals to investigate the effect of audit firm tenure on audit quality. Their findings indicate that auditor tenure has no negative impact on audit quality, and there is an increase in audit quality with the length of audit tenure.

Some researchers find that auditor tenure positively associates with earnings quality (Johnson et al, 2002; Myers et al, 2003; Ghosh and Moon, 2005). For example, Johnson et al. (2002) studied the effect of the relationship (audit-firm tenure) between audit firm and audit clients on the quality of financial report. Findings indicate that short associations of two to three years and medium associations of four to eight years are associated with poor financial-reporting quality, and long associations of nine years are not associated with low financial-reporting quality.

A notion of mandatory rotation has been supported by (Brody and Moscove, 1998). Nagy (2005) presents evidence that after smaller companies changed from Arthur Andersen to others, their level of audit quality was enhanced. Other empirical research found that, Dopuch et al, (2001) stated that mandatory rotation increases audit independence. Burton and Roberts, (1967) explained that in their study, the employment of the same audit firm year after year tends to reduce the independence with which that firm approaches the audit. Deis and Giroux, (1992) say that long relationships with clients may lead to self-satisfaction, less strict audit procedures, and dependence on management representations. In addition, Vanstraelen, (2000) indicated that long-term auditor-client relationships significantly increase the likelihood of an unqualified opinion or significantly reduce the auditor's willingness to qualify audit reports.

In contrast, Blouin et al. (2007) say their study does not support the idea that compulsory rotation improves financial statements. In the same vein, Jenkins and Velury, (2008) explained that there is a positive relation between the length of audit tenure and conservatism in reported earnings.

Litigation

Disclosures by Big Eight (now Four) firms showed that between 1980 and 1984 nearly 180 million dollars were paid to settle audit-related litigation. An additional cost to firms associated with this litigation is reflected in the rise of malpractice insurance rates (Stice, 1991). Palmrose (1988) explained that litigation arose as a consequence of audit failures. Litigation is costly and litigation costs provide additional incentives to higher quality auditors for avoiding audit failures. Findings indicated that the Big Eight, as quality-differentiated auditors, have lower litigation activity than non-Big Eight firms. Auditors can offset litigation risk in a number of ways, including improved audit quality and planning, increases in audit fees and increases in the issuance of modified opinions (Krishnan and Krishnan, 1997).

Narayanan (1994) modelled auditor litigation under 10 (b) and Rule 10b-5 of Securities Exchange Act 1934. Findings indicated that moving to proportionate liability may actually increase audit quality.

Kadous (2000) studied whether providing higher quality audits increases auditors' chances of avoiding legal liability. Kadous found that providing higher quality audits will not necessarily protect auditors from legal liability when the consequences of audit failure are severe. Lys and Watts (1994) stated that lawsuits naming auditors as defendants are more likely to be filed when client firms are larger, experience financial difficulties, have poor stock price performance, and receive qualified audit reports. A lawsuit is also more likely if the auditor employs an unstructured audit technology and if the client represents a relatively larger proportion of the auditor's revenues. In addition, lawsuits are associated with both misleading financial statements and audit failures.

Venkataraman et al. (2008) found that both audit quality and audit fees are higher in a higher-litigation regime, consistent with the effects an increase in litigation exposure should have on auditor incentives. In a previous study Fargher et al (2001) indicated that increased litigation and regulation are associated with higher audit fees.

Vanstraelen (2002) examined in Belgium the relationship between auditor economic incentives and the propensity to issue going-concern opinions in a limitedly litigious business environment. The findings suggest that auditors in Belgium are significantly less likely to issue going-concern opinions to clients that pay higher audit fees. In the same vein, Mong and Roebuck (2005) stated that a modified (but not qualified) audit report effectively acts as a 'red flag' and reduces potential litigants' propensity to initiate litigation.

Audit steps

Auditors who express an opinion on the financial statements of publicly held enterprises must perform a series of risk assessments as the basis for selecting the appropriate audit procedures to be performed. Although many auditing expert systems have been developed for individual components of the audit risk assessment process (such as inherent and control risk assessment) none of these integrate these assessments to arrive at the ultimate objective of assessing the allowable level of detection risk, which drives the audit procedure selection (Bharadwaj et al., 1994).

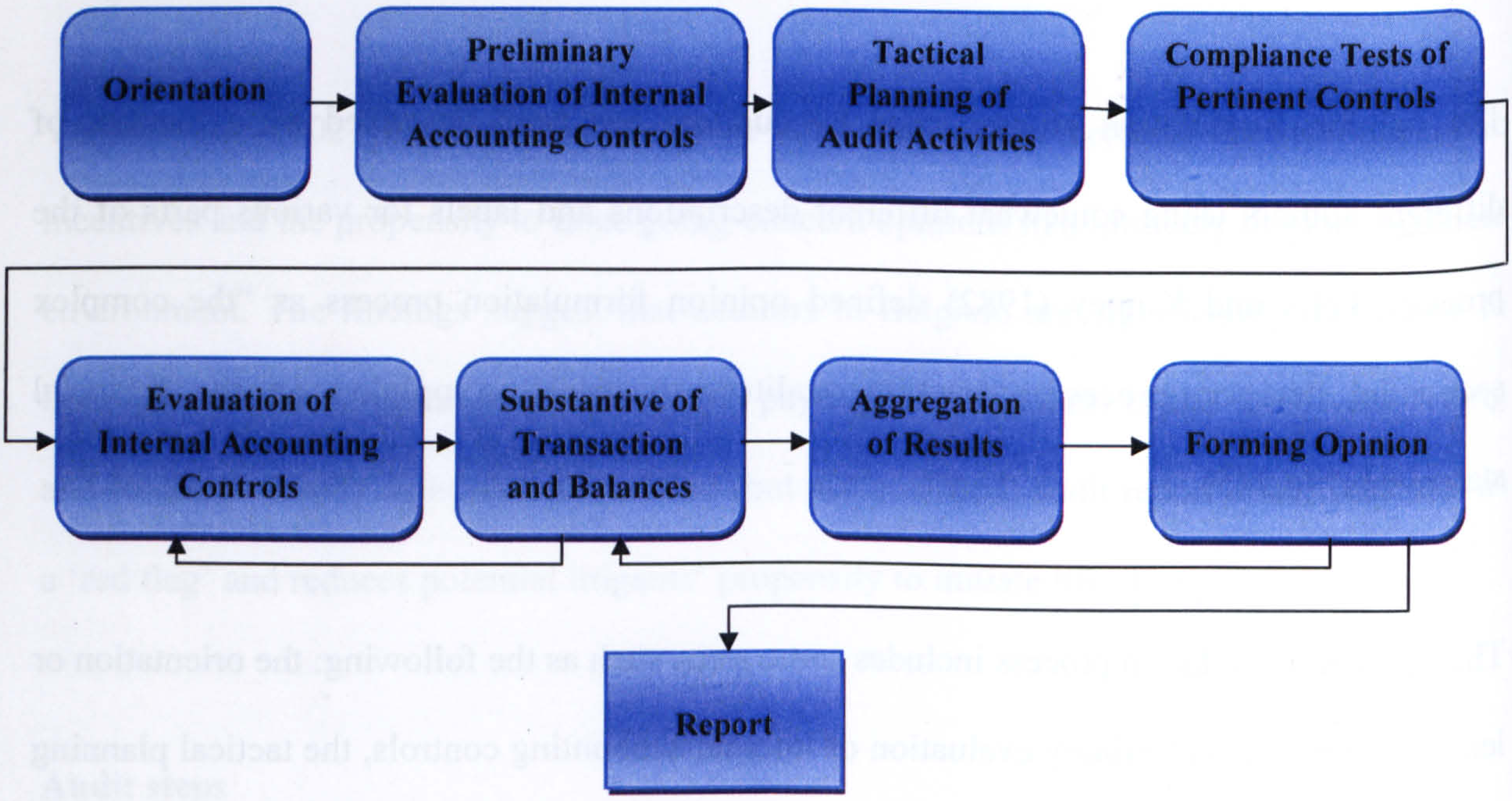
Policies, system and procedures of audit should be established that will encourage actions leading to high quality and discourage or prevent actions that might impair quality. These quality controls should be developed and implemented with respect to all phases of the audit process: Selecting matters for audit; Deciding the timing of the audit; Planning the audit;

Executing the audit; Reporting the audit results; and Follow-up and evaluation of audit findings, conclusions and recommendations (Supreme Audit Institution SAI, 2004).

The opinion formulation process used by auditors has been described by a number of different authors using somewhat different descriptions and labels for various parts of the process. Felix and Kinney (1982) defined opinion formulation process as "the complex sequential decision processes used by auditors to reach an opinion on the financial statements" (p.245).

The opinion formulation process includes some steps such as the following: the orientation or learning step, the preliminary evaluation of internal accounting controls, the tactical planning of evidence collection activities, compliance tests of pertinent controls, evaluation of internal accounting controls, substantive tests of transactions and balances, and aggregation of results. As a result of this subjective aggregation process, the auditor is in a position to express an opinion in the auditor's report on the financial statements taken as a whole (Felix and Kinney, 1982). It is interesting to note that the structure adopted by Felix and Kinney continues in use today, almost 30 years later. In a similar vein, Porter et al. (2008) say that the audit steps of external auditors may comprise the following audit methods: understanding of clients' businesses and industry, risk assessment, analytical procedures, tests of controls, substantive procedures, and subsequent event reviews.

Figure 6.2: An Overview of the Auditor's Opinion Formulation Process



Adapted from: Felix and Kinney (1982, p.246).

An auditor obtains an understanding of the client business in order to plan and perform the audit in accordance with generally accepted auditing standards. Understanding the client's business and its environment should enable the auditor to assess the potential effect of business risks on the financial statements. In order to properly examine the validity of financial statement assertions, an auditor must have a thorough understanding of the client business (Messier, 2008). Diaz and Wolfe (2007) stated that senior auditors experience difficulty in implementing professional guidance which requires the use of client business risk to inform the risk of material misstatement of the financial statements. Auditors should assess and identify clients' business risks that may affect the financial reporting objectives and determine an appropriate audit approach to address those risks.

Analytical procedures are increasingly being used in place of, and as a supplement to, substantive tests of details, in response to increased concerns about efficiency and effectiveness (Hirst and Koonce, 1996). Porter et al. (2008) explained that analytical procedures consist primarily of ratio, percentage, trend and comparative analyses, although they also include more sophisticated statistical techniques such as regression analysis. Analytical procedures are required during the completion phase of the audit. Such tests are useful at that point as a final review for material misstatements or financial problems and to help the auditor take a final objective look at the financial statements that have been audited (Arens et al. 2003). Analytical review procedures can be used not only as an alternative to tests of details but also in an expanded role throughout the audit process. This versatility helps account for auditors' increasing interest in analytical review (Tabor and Willis, 1985). Lin and Fraser (2003) studied the use of analytical procedures by external auditors in Canada; they found that analytical procedures are extensively applied in practice, particularly by large firms, and that their use demonstrates the final review stage of the audit regardless of firm size.

Tests of controls are audit procedures to test the operating effectiveness of controls in support of reduced assessed control risk (Arens et al., 2003). During the initial review of the accounting system, the auditor identifies internal control strengths. These controls, if operating properly, will help to ensure that the data which passes through the accounting system is complete, valid, and accurate as to amount, account classification and reporting period (Porter et al. 2008). When auditors assess internal controls, they should perform tests to obtain sufficient and appropriate audit evidence that such controls are operating effectively at relevant times during the period under audit.

Substantive procedures have the intent to verify the validity, completeness and accuracy of the financial statement balances and note disclosures, and analytical procedures and tests details are broad categories of substantive procedures (Porter et al. 2008). Messier et al. (2008) stated that substantive analytical procedures are used as a substantive procedure to obtain evidential matter about particular assertions related to account balances or classes of transactions. Auditors may use several methods, such as confirmation, inspection, observation, reconciliation, and count, in order to obtain sufficient appropriate audit evidence. Porter et al. (2008) explain that the auditor has an obligation to consider events which take place between the balance sheet date and the date on which the audit report is signed, which might affect a financial statement user's assessment of the entity's financial position and/or performance as at the balance sheet date.

Auditing standards

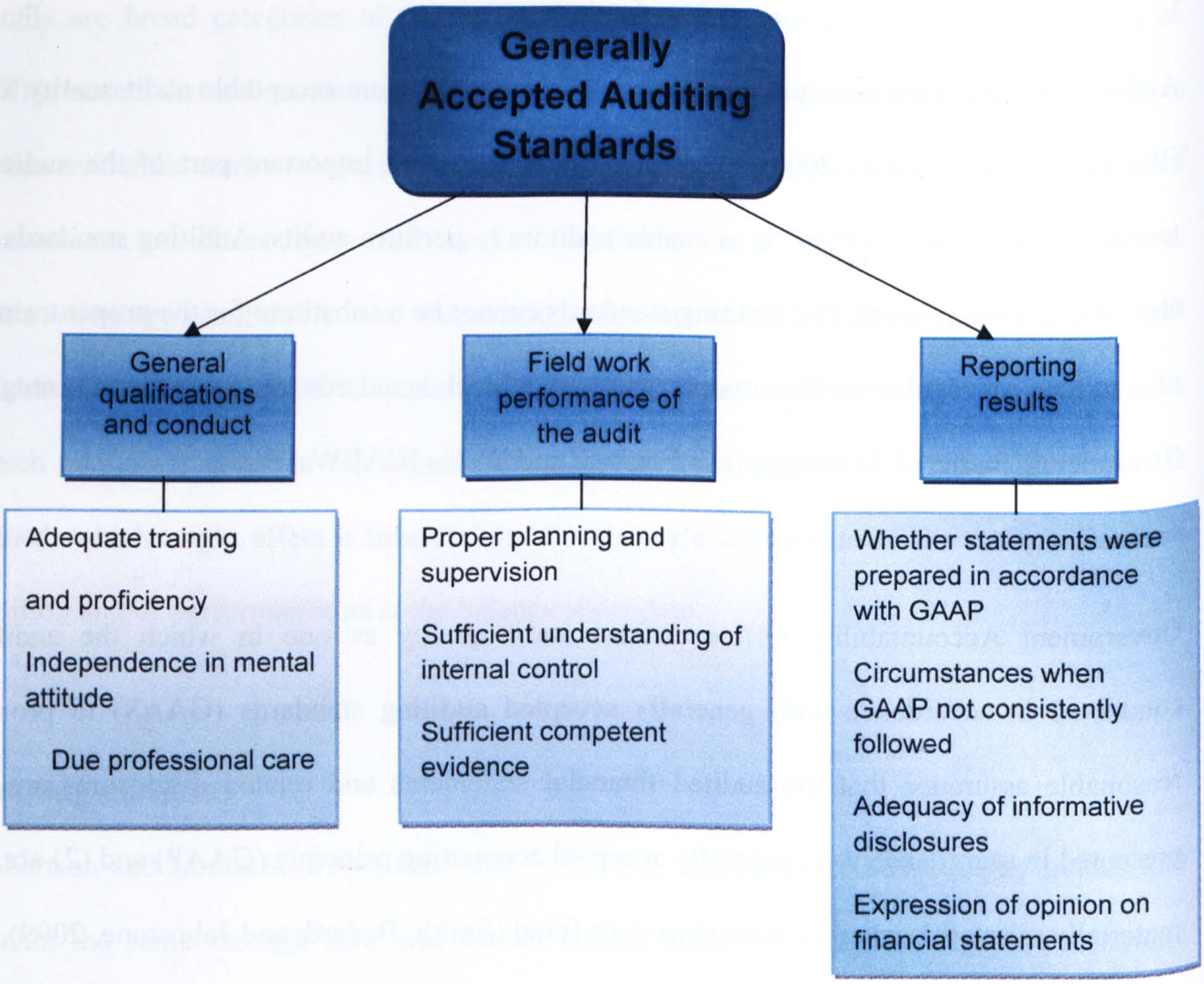
Robertson and Louwers (1999) state that " Auditing standards are audit quality guides that remain the same through time and for all audits, including audits of complex electronic accounting systems" (p.25). In a similar vein, Arens et al. (2003) stated that "Auditing standards are general guidelines to aid auditors in fulfilling their professional responsibilities in the audit of historical financial statements; they include consideration of professional qualities such as competence and independence, reporting requirements, and evidence" (p. 32).

The AICPA Generally Accepted Auditing Standards (GAAS) were first written as a short statement of 10 standards. Since 1939, these 10 have been augmented by additional explanations and requirements in statements on Auditing Procedures (1939-72). GAAS are classified as general standards, field work standards, and reporting standards (Robertson and Louwers, 1999).

Auditing standards are generally viewed as defining a minimum acceptable audit quality level (Willekens and Simunic, 2007). Auditing standards are an important part of the auditors' toolkit. Their primary purpose is to enable auditors to perform audits. Auditing standards are also helpful to regulators. But auditing standards cannot be a substitute for the proper training of auditors or regulators, the maintenance of ethical standards or professional integrity (Institute of Chartered Accountants in England and Wales ICAEW, 2006).

Government Accountability Office defines audit quality as one in which the audit is conducted in accordance with generally accepted auditing standards (GAAS) to provide reasonable assurance that the audited financial statements and related disclosures are (1) presented in accordance with generally accepted accounting principle (GAAP) and (2) are not materially misstated, whether due to errors or fraud (Smith, Bedard, and Johnstone, 2009).

Figure 6.3: Summary of Generally Accepted Auditing Standards



Adapted from: Arens et al. (2003. P. 33).

Principles-based auditing standards only work if the auditors who use judgement in applying them display professional integrity. The solution to the problem of a lack of integrity in some parts of the profession is not the promulgation of detailed rules, which perpetuate an avoidance mentality, but the development or restoration of high-quality, clear and unambiguous auditing standards and an effective principles-based system of oversight (Institute of Chartered Accountants in England and Wales ICAEW, 2006).

Previous research on audit quality examined the impact of auditing standards on improving the level of audit quality. For instance Willekens and Simunic (2007) showed that decreasing the precision of GAAS initially induces an auditor to produce higher audit quality by exerting more effort. But beyond a certain critical value, decreasing precision leads to decreasing effort and auditors gamble on violating GAAS. When vagueness exceeds a second critical value, auditors exert no effort at all. The demand decisions of directors with respect to the overall quality of a firm's financial reporting system are more complex. Findings show that when legal due care standards are precise, or somewhat imprecise, directors will demand levels of financial reporting system quality that comply with due care standards. But as legal standards become more imprecise, the precision of GAAS becomes important and affects the quality of internal control and audit quality demanded. Initially, directors will gamble on violating due care standards, and if the degree of vagueness in legal standards becomes sufficiently large, directors will have no demand for financial reporting system quality. Overall, a relatively small degree of imprecision in GAAS causes an auditor to exert more effort, thereby increasing. the quality of auditing produced. As GAAS become more imprecise, the auditor exerts less effort and risks being held liable to third parties, with extremely imprecise GAAS. The auditor does nothing, and simply bears the legal consequences. In situations where the auditor risks being held liable to investors or is liable with certainty, the audit fee incorporates an expected loss or 'risk premium'.

Ping (2007) studies the effect of the public's expectations of auditors on audit quality and auditing standards, findings indicate that if accounting profession's objective is to set appropriate auditing standards with which auditors consistently comply, the public's expectations of auditors should be high and should be influential in the legal system. If the legal system alone fails to maintain high audit quality, a regulatory monitoring system will help to improve audit quality. Schwartz (1998) stated that a liability regime that consists of a vague negligence rule supports and amplifies the credibility of GAAS: In this regime auditing standards were shown to be used by courts as the lower bound on due care. As such, any effort that is below the standard would be considered negligent and would therefore result in heavy monetary penalties. Thus auditors could use auditing standards as a means to commit.

Factors affecting audit quality in emerging and developing countries

Chen et al. (2005) investigated audit quality in Taiwan through auditor size and industry specialization. Findings indicate that auditor size and industry specialization are associated with lower earnings management and more transparent information. In contrast, Jeong and Rho (2004) investigated audit quality in Korea through examining the relation between Big Six and non-Big Six auditors and discretionary accruals. Findings indicate that there is no noticeable difference between discretionary accruals of companies audited by Big Six and non-Big Six.

Naser, Abdullhameed, and Nuseibeh (2007) investigated the structure of audit fees in an emerging economy, Jordan. The results of the analysis revealed that corporate size, status of the audit firm, industry type, degree of corporate complexity and risk are the main determinates of audit fees in the Jordanian environment. However, variables such as corporate profitability, corporate accounting year-end and time lag between year-end and the audit report date appeared to be insignificant determinants of audit fees in the sampled companies. Chen et al. (2007) studied market competitiveness of Big Five pricing in China. Results indicate that the Big Five earn higher fees in a less competitive market and lower in a competitive market. That confirms the assumption that the Big Five charge high fees, not for providing high audit quality, but because of the lack of competition in the audit market.

Chi, Liao, and Xie, (2009) studied the effect that mandatory audit partner rotation on the quality and perceptions of quality for audits in Taiwan. They stated that absolute and signed abnormal accruals were used as proxies to determine audit quality. They commented that the audits were not significantly different in quality compared to companies that did not rotate auditors in that year. They study examines the earnings response coefficient of companies subject to mandatory audit partner rotation to determine perceptions of audit quality and found it was not significantly different than companies not subject to the audit rotation.

Al-Thuneibat, Issa, & Baker, (2011) analyze the effect of the length of the audit firm-client relationship and the size of the audit firm on audit quality in Jordan. Their statistical analysis shows that audit firm tenure affects the audit quality adversely (negatively). Audit quality deteriorates, when audit firm tenure is extended as a result of the growth in the magnitude of discretionary accruals. Meanwhile, data analysis did not reveal that the audit firm size has any significant impact on the correlation between audit firm tenure and audit quality.

Hakim, and Omri, (2009) stated that in Tunisia, the bid-ask spread is negatively related to the employment of an industry specialist auditor and Big 4 auditor and positively related to audit firm tenure. However, further tests refine those conclusions, in that the positive association between tenure and bid-ask spread differs between specialist and non-specialist auditors and between Big 4 and non-Big 4 auditors. Specifically, they found that bid-ask spread is increasing in tenure for non-specialist and non-Big 4 clients. These findings are consistent with a market that perceives audit quality diminishing with tenure for non-specialist auditors and non-Big 4 auditors and a market that finds audit quality increasing with industry specialization and Big 4 auditors.

The rapid growth of global markets has put renewed emphasis on the development of and need for international standards on auditing. As the world continues to become smaller and international investment more and more frequent, the use of a common set of international standards presents clear benefits to investors, regulators and audit firms. The IAPC (International Auditing Practices Committee) in the role of a standard setter of international auditing standards, must work vigorously towards the creation of a set of high quality auditing standards that can be accepted globally – standards that will outline what is required for completion of a high quality audit (Turner (2001a).

The Libyan context

In general, the literature shows that there are significant environmental differences between developed and developing countries. Due to these differences, Western accounting appears to be deficient and irrelevant for the needs of developing countries. Further, it might have an adverse effect on their economic development. In addition, in examining alternative standard setting strategies for developing countries, it has been found that, all existing strategies are based on Western accounting and thus bear its intrinsic limitations (Bakar, 1997). A number of studies have been assessed the impact of Western accounting systems especially from the UK and the US on the Libyan accounting systems which include (education, standards, practice and profession) (Bait-El-Mall et al., 1973; Kilani, 1988; Bakar, 1997). The current orientation of accounting in developing countries towards the UK and the US accounting may be positively harmful to developing countries (Scott, 1968; Briston, 1978). It can be reasoned that accounting practice in a developing country should be fashioned in a manner consistent with the socio-economic and political environment of that country (Bakar, 1997).

The Libyan audit context suffers from an absence of auditing standards, binding laws and guidance on professional ethics and conduct. Different Western practices were moved by different means from developed to developing countries, including colonization of the developing countries, education efforts and the entry foreign companies, and the provision of financial assistance by developed countries to the developing countries. The existence in Libya of these influences from developed countries, particularly influences from English and American education were significant. Thus there is diversity in practice depending on the type of education of the practitioner (English and American education). In addition, the other problem is that there is no binding requirement to follow any standards in Libya, either local, or British, or American, or international, which reflects a weak profession and the related factors (such as audit firm size, audit fees, provision of non-audit services, audit tenure and mandatory auditor rotation, audit steps, and audit team characteristics). In conclusion, the audit profession in Libya does not have a binding legal framework for regulating its work, and which is designed in a manner consistent with the socio-economic and political environment of Libya.

Conclusion

There are different effects resulting from various factors related to audit quality, and there is disagreement about the relationship between some factors and audit quality. Some researchers support the assumption of a positive impact from some factors on audit quality and others do not support such assumptions: factors such as audit firm size, audit fees, auditor tenure and mandatory auditor rotation, and litigation are in this category. Some have found that there is no impact result from particular factors, such as non-audit services on audit quality, while other researchers found different effects. There is an agreement about other factors, such as audit team characteristics, audit steps, and auditing standards. In emerging and developing countries the case is nearly the same, there are different effects from these factors on audit quality. In Libya the main point is that, the Libyan audit context suffers from an absence of some required fundamental elements, such as auditing standards, binding laws and guidance on professional ethics and conduct. In addition, there are no big audit firms, audit tenure is uncontrolled, and litigation is extremely rare.

Chapter 7

Methodology, Methods and Approaches

Introduction

The preceding chapters presented a brief summary of the literature on audit quality and its relation to earnings management. Identifying such a link is the main approach that has been used to measure audit quality. Consideration of the audit report, which is the second approach taken, has been used with earnings management to investigate the level of audit quality. The factors that might affect audit quality have been reviewed. The main purpose of this chapter is to detail the research methodology employed to efficiently and effectively fulfil the research aims and objectives. This chapter is structured as follows: type of research, research philosophy, categories of accounting research, qualitative and qualitative methods, research approach which includes deductive and inductive elements, research strategies which include survey, research choices which include multiple methods, time horizons which includes a cross-sectional approach, and techniques and procedures which includes data collection and data analysis. Data collection and analysis divides into two phases: first phase is secondary data analysis, the second phase semi-structured interviews. Ethical considerations, and finally a summary of the chapter's content end the chapter.

The present study was conducted in two phases. The first phase analysed secondary data to identify whether earnings management activities exist in Libyan companies and at the same time determine which type of audit report was issued related to the financial statements of these companies. The second phase included 15 semi-structured interviews with persons who are familiar with the issues of audit quality in Libya. These interviews were conducted in an attempt to obtain data related to audit quality, in terms of its level, factors that affect audit quality, and what strategies can be suggested to improve audit quality in Libya. This chapter, therefore, describes the rationale and the method followed in each phase, and the foundation of the statistical methods applied to analyse the research data.

Types of research

Research can be classified from three perspectives (Kumar, 2005).

. Application of the research study;

. Objectives in undertaking the research; and

. Inquiry mode employed.

The application: to examine a research study from the perspective of its application, there are two broad categories: pure research and applied research in the social sciences.

Pure research: it is concerned with the development, examination, verification and refinement of research methods, procedures, techniques and tools that form the body of methodology.

Applied research: most of the research in social sciences is applied. In other words, the research techniques, procedures and methods that form the body of research methodology are applied to the collection of information about various aspects of a situation, issue, problem or phenomenon so that information gathered can be used in other ways such as for policy formulation, administration and the enhancement of understanding of a phenomenon. This study is considered as being applied research, in terms of the collection of information about several aspects of a situation, issue, problem or phenomenon.

The objectives: to examine a research study from the perspective of its objectives; is broadly to clarify a research endeavour as descriptive, correlational, explanatory or exploratory.

Descriptive research: this type attempts to describe systematically a situation, problem, phenomenon, service or programme, or provides information about, say, the living conditions of a community, or describes attitudes towards an issue.

Correlational research: the main emphasis in this type is to discover or establish the existence of a relationship/association/interdependence between two or more aspects of a situation.

Explanatory research: this type attempts to clarify why and how there is a relationship between two aspects of a situation or phenomenon.

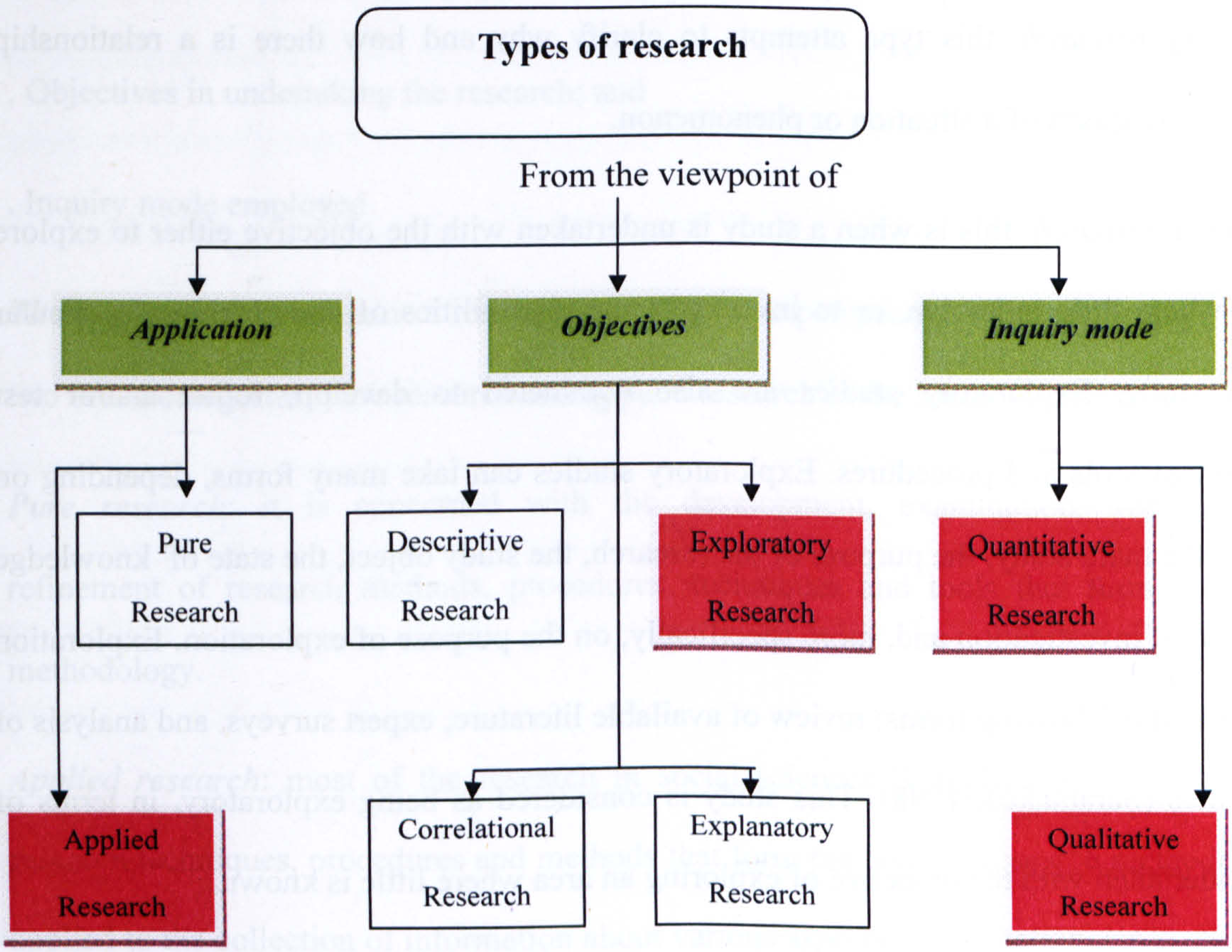
Exploratory research: this is when a study is undertaken with the objective either to explore an area where little is known, or to investigate the possibilities of undertaking a particular research study. Exploratory studies are also conducted to develop, refine and/or test measurement tools and procedures. Exploratory studies can take many forms, depending on nature of the main study, the purpose of the research, the study object, the state of knowledge in the area of investigation and, more specifically, on the purpose of exploration. Exploration can refer to the following forms: review of available literature, expert surveys, and analysis of case studies (Sarantakos, 1998). This study is considered as being exploratory, in terms of being undertaken with the objective of exploring an area where little is known.

The inquiry mode: concerns the process that has been adopted to find answers to research questions. Broadly, there are two approaches to inquiry: the structured approach and the unstructured approach. The structured approach to inquiry is often classified as 'quantitative' research, and unstructured as 'qualitative' research. This study uses a mixed approach in terms of both quantitative and qualitative methods.

The structured approach: in this approach everything that forms the research process objectives, design, sample, and the questions that you plan to ask of respondents is predetermined.

The unstructured approach: it is more appropriate to determine the extent of a problem, issue or phenomenon; the unstructured, to explore its nature.

Figure 7.1: Types of Research



Adapted from: Kumar (2005, p. 9).

Philosophical assumption

The driving force behind any type of social research is its philosophical framework. This dictates not only the general perception of reality and social relations, but also the type of methods and techniques available to researchers and the motives and aims of social research

(Sarantakos, 1998). The research philosophy that has been adapted contains important assumptions about the way in which the world has been viewed. These assumptions will underpin the research strategy and the methods that have been chosen as part of that strategy. In part, the philosophy that has been adopted will be influenced by practical consideration. However, the main influence is likely to be the particular view of the relationship between knowledge and the process by which it is developed in the study. Choosing one topic rather than another suggests that has been thought one of the topics is more important. The choice of philosophical approach is a reflection of the value of the study, as is the choice of data collection techniques (Saunders, Lewis, and Thornhill, 2007).

The assumptions which the researcher holds regarding the nature of the phenomenon's reality (ontology), will affect the way in which knowledge can be gained about that phenomenon (epistemology), and this in turn affects the process through which research can be conducted (methodology). Consequently, the selection of an appropriate research methodology cannot be done in isolation of a consideration of the ontological and epistemological assumptions which underpin the research in question (Ryan, Scapens, and Theobald, 2002).

Quantitative and qualitative data analysis may be distinguished by reference to their underlying philosophy. This is seen most vividly in the contrasting views about the essential nature of the world being studied and in the preferred logic of analysis used to describe them. Quantitative methods are seen as reflecting an empiricist and realist view of the world and using a deductive logic of inquiry. Qualitative methods tend more often to be idealist and to use an inductive logic of inquiry (Gibbs, 2002).

Gibbs (2002) defined realism and idealism "realism is the view that the world has an existence independent of us ..... idealism, not only are all the contested objects as universals, moral facts and social structures creations of the human mind, but so is the material world itself" (pp. 4-5). Ritchie and Lewis, (2003) stated that "realism claims that there is an external reality which exists independently of people's beliefs or understanding about it" (p.11). The choice of research methodology and whether it is quantitative or qualitative are linked to the three core philosophical assumptions (epistemology, ontology, and methodology).

The epistemological assumption: Scheurich (1997) stated that "Epistemology is the study of how we know or of what the rules for knowing are" (p. 29). Likewise, Ritchie and Lewis, (2003) explain epistemology as "ways of knowing and learning about the social world and focuses on questions such as: how can we know about reality and what is the basis of our knowledge?" (p.13). Epistemology concerns what constitutes acceptable knowledge in a field of study. Epistemological positions include positivism, realism, and interpretivism. With quantitative methods the researcher is seen as 'completely independent' from that being researched, while qualitative methods attempt to reduce the distance between the researcher and what is being researched by engaging in different forms of participative enquiry (Saunders, Lewis, and Thornhill, 2007). The central problem of epistemology is to decide how we can acquire knowledge (Ryan, Scapens, and Theobald, 2002).

The ontological assumption: Ryan, Scapens, and Theobald (2002) say that "Ontology is the study of existence and in this context is concerned with what we discern to be (real)" (p. 13). Ontology is concerned with the nature of reality. To a greater extent than epistemological considerations, this raises questions of the assumptions researchers have about the way the world operates and the commitment held to particular views. Ontology has two potential aspects: objectivism and subjectivism. Objectivism has the position that social entities exist in reality, external to the social actors concerned with their existence. Subjectivism holds that social phenomena are created from the perceptions and consequent actions of those social actors concerned with their existence (Saunders, Lewis, and Thornhill, 2007). In addition, Ritchie and Lewis, (2003) explain that key ontological questions concern "whether or not social reality exists independently of human conceptions and interpretations; whether there is a common, shared, social reality or just multiple context-specific realities; and whether or not social behaviour is governed by 'laws' that can be seen as immutable or generalisable" (p.11). Under this assumption, those who hold to the quantitative paradigm believe that the reality is objective and external to the researcher, whereas those in the qualitative paradigm consider the reality as subjective and only understood by examining the perceptions of human actors. In considering different methodological approaches researchers to begin by looking at different ontological assumptions (Ryan, Scapens, and Theobald, 2002).

The methodological assumption: methodology is concerned with the process of doing research and, as such, it has both ontological and epistemological dimensions. Furthermore, it is important to distinguish methodology from methods. The latter are the particular techniques used in the research. In this sense, statistical techniques are methods, not a methodology; although their use in a particular research process, with its implicit ontological and epistemological assumptions, is a methodology (Ryan, Scapens, and Theobald, 2002). Remenyi et al. (1998) say that "Research methodology refers to the procedural framework within which the research is conducted; it describes an approach to a problem that can be put into practice in a research programme or process" (p. 28).

Categories of accounting research

In most of the discussions of methodology in the accounting literature there are similar presumptions. These presumptions are both ontological and epistemological. That is, they concern how the world is perceived and how knowledge of it can be obtained. Despite the different research methods employed, because the ontological and epistemological presuppositions are the same, the methodological underpinnings have remained fairly constant. If this is true, the basis of recent authors' claims to reliable knowledge can be subjected to the same criticism as their predecessors (Gaffikin, 1988).

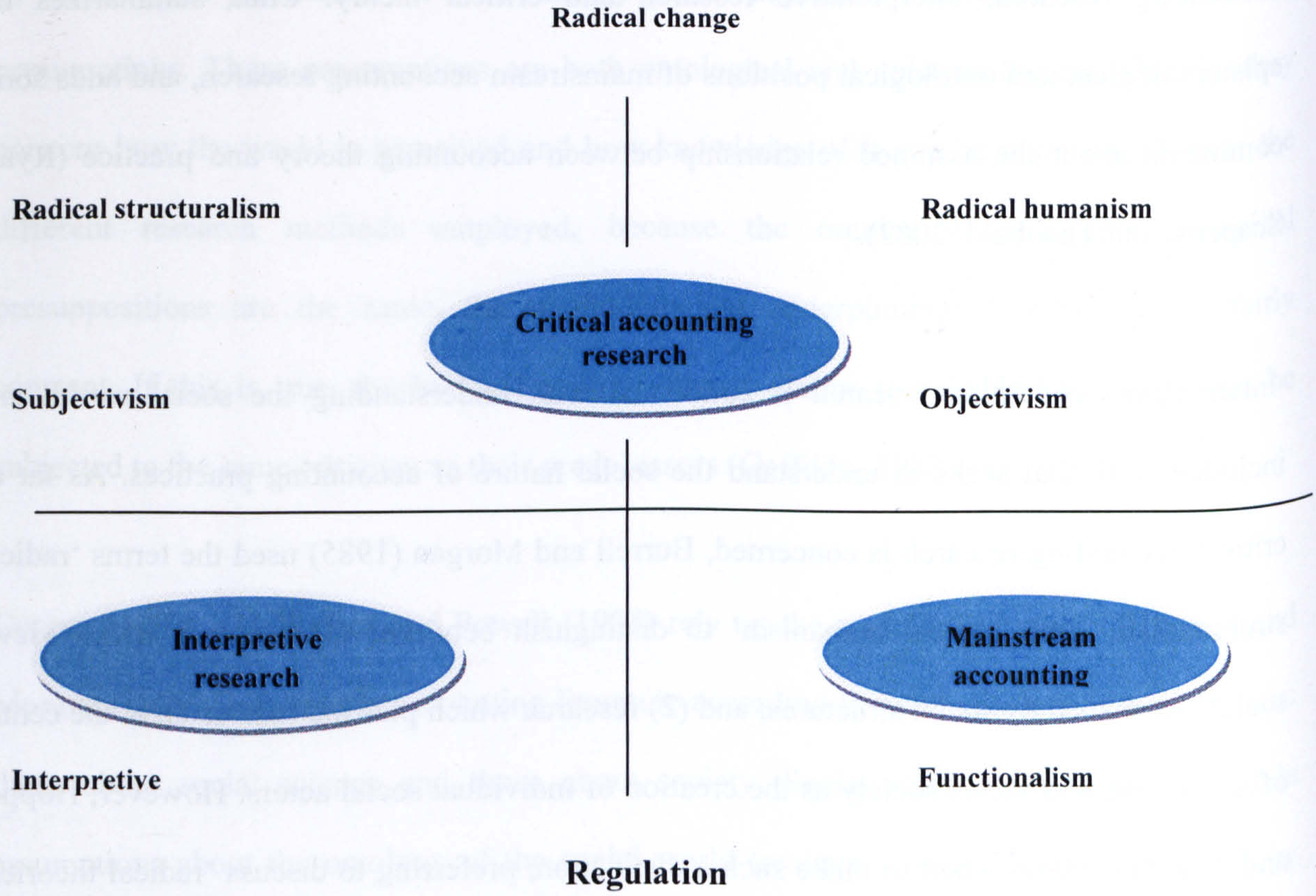
Cooper (1983) and Hopper and Powell (1985) rely on the sociological work of Burrell and Morgan (1979) and classify accounting literature according to two main sets of assumptions: those about sociál science and those about society. Social science assumptions include assumptions about the ontology of the social world (realism v. nominalism), epistemology (positivism v. anti-positivism), human nature (determinism v. voluntarism), and methodology (nomothetic v. ideographic). The assumption about society characterizes it as either orderly or subject to fundamental conflict (Chua, 1986).

Functionalism, interpretivism, radical humanism, and radical structuralism, these are the terms used by Burrell and Morgan to categorize organizational research. Ryan, Scapens, and Theobald (2002) linked these categories into accounting research, creating three research groups that had been identified earlier by Chua (1986): mainstream research, interpretive research, and critical research.

Chua (1986) defined mainstream accounting as "Grounded in a common set of philosophical assumptions about knowledge, the empirical world, and the relationship between theory and practice" (p. 601). Chua (1986) described the dominant assumptions of mainstream accounting research, interpretative research and critical theory. Chua summarizes the epistemological and ontological positions of mainstream accounting research, and adds some comments about the assumed relationship between accounting theory and practice (Ryan, Scapens, and Theobald, 2002).

Interpretive accounting research is concerned with understanding the social world, and includes work that seeks to understand the social nature of accounting practices. As far as critical accounting research is concerned, Burrell and Morgan (1985) used the terms 'radical structuralism' and 'radical humanism' to distinguish between: (1) research which views society as shaped by social structures; and (2) research which puts the individual at the centre of the picture and views society as the creation of individual social actors. However, Hopper and Powell were reluctant to make such a distinction, preferring to discuss 'radical theories' as one category of accounting research. This is partly due to the problematic nature of the subjective – objective distinction and especially its manifestation in the action – structure (Ryan, Scapens, and Theobald, 2002).

Figure 7.2: Taxonomy of accounting research



Adapted from: Ryan, Scapens, and Theobald (2002, p. 102).

Table 7.1 summarizes a threefold classification of assumptions: (1) beliefs about knowledge (the epistemological and methodological): (2) beliefs about physical and social reality (ontological, human intention and rationality, and societal order/conflict): and (3) relationship between theory and practice linked to three categories of accounting research: mainstream accounting research, interpretive accounting research, and critical accounting research.

Categories of accounting research	Beliefs about knowledge	Beliefs about physical and social reality	Relationship between accounting theory and practice
Mainstream research	Theory and observation are independent of each other, and quantitative methods of data collection are favoured to provide a basis for generalizations.	Empirical reality is objective and external to the subject (and the researcher). Human actors are essentially passive objects, who rationally pursue their assumed goals. Social and organizations are basically stable, and dysfunctional behaviour can managed through the design of control systems.	Accounting is concerned with means, not ends – it is value neutral, and existing institutional structures are taken for granted.
Interpretive research	Theory is used to provide explanations of human intentions. Its adequacy is assessed via logical consistency, subjective interpretation, and agreement with the actors' common – sense interpretations.	Reality is socially created and objectified through human interaction. Human action is intentional and has meaning grounded in the social and historical context. Social order is assumed and conflict mediated through shared meanings.	Accounting theory seeks to explain action and to understand how social order is produced and reproduced
Critical research	Criteria for judging theories are always temporal and context bound. Social objects can only be understood through a study of their historical development and change within the totality of relations.	Empirical reality is characterized by objective, real relations, but is transformed and reproduced through subjective interpretation. Human intention and rationality are accepted, but have to be critically analysed because human potential is alienated through false consciousness and ideology. Fundamental conflict is endemic in society because of social injustice.	Theory has a critical imperative; in particular the identification and removal of domination and ideological practices.

Adapted from: Ryan, Scapens, and Theobald (2002, pp. 41-43).

Qualitative and qualitative methods

Methodology is defined in at least two ways. First, methodology is identical to a research model employed by a researcher in a particular project, including basic knowledge related to the subject and research methods in question end the framework employed in a particular context. Second, a methodology offers the research principles which are related closely to a distinct paradigm translated clearly and accurately, down to guidelines on acceptable research practices. Methodology is determined not by the research model but rather by principles of research entailed in a paradigm (which is often used to mean the over-arching principles or philosophy that guide the research approach). The methodologies that result from this definition are the quantitative methodology and the qualitative methodology (Sarantakos, 1998). Denzin and Lincoln (1998) explain that "the word qualitative implies an emphasis on processes and meanings that are not rigorously examined, or measured, it terms of quantity, amount, intensity, or frequency. In contrast, quantitative studies emphasize the measurement and analysis of causal relationships between variables, not processes. Inquiry is purported to be within a value-free framework" (p. 8).

Both qualitative and quantitative methods may be used appropriately with any research paradigm. The answer to the question which method is the best is that there is no 'better' or 'right' method. Both methods are good and right, depending on the circumstances. Quantitative and qualitative methods are the tools of the trade of social scientists and both are useful and have a purpose. The one complements the other, and both together offer a stereoscopic picture of the world (Sarantakos, 1998). Recognizing that all methods have limitations, researchers felt that biases inherent in any single method could neutralize or cancel the biases of other methods. Using 'triangulation' of data sources is seen as a means of seeking convergence across qualitative and quantitative methods (Creswell, 2009). This research employed both quantitative and qualitative methods, in order to enrich data quality and attempting to fill the gap in the literature.

Quantitative research

Saunders, Lewis, and Thornhill, (2007) say that "Quantitative is predominantly used as a synonym for any data collection technique (such as a questionnaire) or data analysis procedure (such as graph or statistics) that generates or uses numerical data" (p. 145). Grix, (2004) explained that quantitative research is characterized by three basic phases: finding variables for concepts, operationalising them in the study, and measuring them. Quantitative research refers to the type of research that is based on the methodological principles of positivism and neopositivism, and adheres to the standards of strict research design developed before the research begins. It employs quantitative measurement and the use of statistical analysis. The quantitative method enables researchers to test a theory with a large sample size, but it does not provide insight into the phenomenon under study. One of the important qualities of quantitative research is the requirement that the sample employed reflects the attributes of the target population, the findings it produces relate to the whole population, and the conclusions drawn through the study are pertinent to the whole population. This attribute of social research is referred to as representativeness; the higher the representativeness, the higher the generalizability of the findings and therefore the higher the quality of the study (Sarantakos, 1998).

Qualitative research

Saunders, Lewis, and Thornhill, (2007) say that "Qualitative is used predominantly as a synonym for any data collection technique (such as an interview) or data analysis procedure (such as categorizing data) that generates or uses non – numerical data" (p. 145). Likewise, Ritchie and Lewis, (2003) defined qualitative as "a situated activity that locates the observer in the world. It consists of a set of interpretive, material practices that makes the world visible. These practices turn the world a series of representations including field notes, interviews, conversations, recordings and memos to the self" (p.2). Qualitative research refers to a number of methodological approaches, based on diverse theoretical principles (e.g. phenomenology, hermeneutics and social interactionism), employing methods of data collection and analysis that are non-quantitative, and aiming towards exploration of social relations, and describes reality as experienced by the respondents. Qualitative research enables the researcher to gain an in-depth understanding of the research problems. Representativeness and generalizability are differently approached in qualitative research. While some qualitative researchers reject the notion of representativeness as employed by quantitative researcher, others find it a useful and indispensible element of qualitative research and make an effort to assure that principles of representativeness are adhered to (Sarantakos, 1998).

Table 7.2: Comparison between qualitative and quantitative research.

Quantitative research	Qualitative research
Its purpose is to explain social life	Its purpose is to understand social life
Is nomothetic – interested in establishing law-like statements, causes, consequences, etc.	Is idiographic – describes reality as it is
Aim at theory testing	Aim at theory building
Employs an objective approach	Employs a subjective approach
Is etiological – interested in why things happen	Is interpretative – interested in how
Is ahistorical – interested in explanations over space and time	Is historical – interested in real cases
Is a closed approach – is strictly planned	Is open and flexible in all aspects
Research process is predetermined	Research process is influenced by the respondent
Researcher is distant from respondent	Researcher is close to the respondent
Uses a static and rigid approach	Uses a dynamic approach
Employs an inflexible process	Employs a flexible process
Is particularistic, studies elements, variables	Is holistic – studies whole units
Employs random sampling	Employs theoretical sampling
Places priority on studying differences	Places priority on studying similarities
Employs a reductive data analysis	Employs an explicative data analysis
Employs high levels of measurement	Employs low levels of measurement
Employs a deductive approach	Employs an inductive approach

Adapted from: Sarantakos. (1998, p. 55).

Triangulation

Flick, (2002) stated that "Triangulation is key word which is used to name the combination of different methods, study groups, local and temporal setting, and different theoretical perspectives in dealing with a phenomenon" (p.226). Collis and Hussey (2003) argue that the use of different research approaches, methods and techniques in the same study is known as 'triangulation' and can overcome the potential bias and sterility of a single method approach. Triangulation assumes that the use of different sources of information will help both to confirm and to improve the clarity, or precision, of a research finding. There is some debate among qualitative researchers about the extent to which triangulation is useful in checking the validity of data or whether it is more a means of widening or deepening understanding of a subject through the combination of multiple readings. Nevertheless a number of authors argue that triangulation also has some role in the validation of findings.

There are different forms of triangulation, based on one conceptualization, these forms comprise:

. *Methods triangulation*: comparing data generated by different methods (e.g. qualitative and quantitative)

. *Triangulation of sources*: comparing data from different qualitative methods (e.g. observations, interviews, documented accounts)

. *Triangulation through multiple analysis*: using different observers, interviewers, analysts to compare and check data collection and interpretation

. *Theory triangulation*: looking at data from different theoretical perspectives (Ritchie and Lewis, 2003).

Deductive and inductive approaches

Research on any given question at any point in time falls somewhere within a cycle of inference processes, often referred to as the research cycle, the chain of reasoning, or the cycle of scientific methodology. The cycle may be seen as moving from grounded results (facts, observations) through inductive logic to general inferences (abstract generalizations, or theory), then from those general inferences (or theory) through deductive logic to tentative hypotheses or predictions of particular events/outcomes (Tashakkori and Teddlie, 1998). Saunders, Lewis, and Thornhill, (2007) argue that "Insofar as it is useful to attach these research approaches to the different research philosophies, deduction owes more to positivism and induction to interpretivism, although there is a belief that such labelling is potentially misleading and of no real practical use" (p. 117).

Deductive logic

Potter (2000) stated that "Deduction is a form of inference where you move from the general to the particular, from the universal to the particular" (p. 37). Likewise, Collis and Hussey, (2003) pointed out that "Deductive research is a study in which a conceptual and theoretical structure is developed and then tested by empirical observation; thus particular instances are deduced from general inferences, for this reason the deductive method is referred to as moving from the general to the particular" (p. 15). In addition, Sanders and Liptrot (1993) state that "Hypothetico – deductive method – a scientific method whereby we formulate a hypothesis that predicts what is going to happen in a given situation, we then set about testing the hypothesis to see if its prediction is true" (p.11).

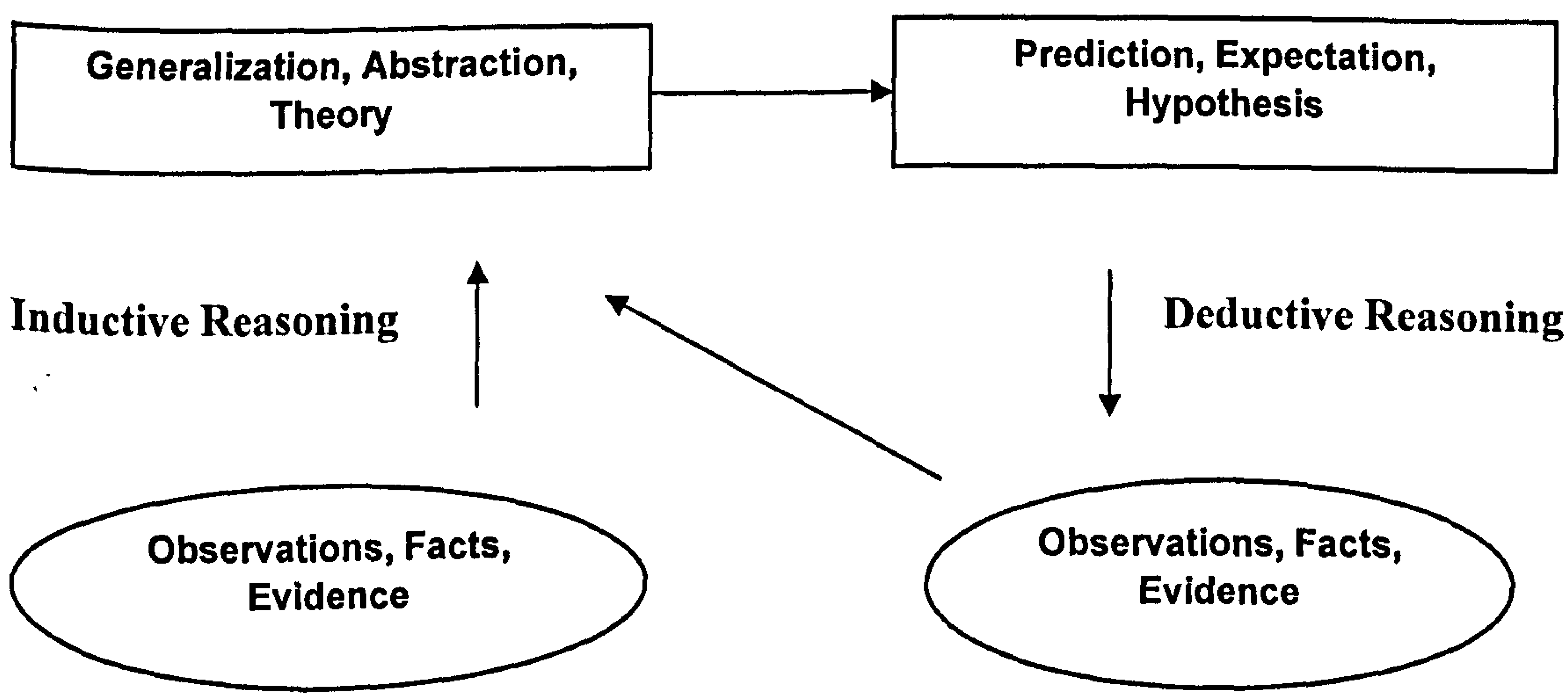
The deductive tradition in the social sciences clearly specifies what is involved in being 'scientific knowledge'. Often the approach is called the 'hypothetico – deductive method'. It emphasizes that what is important in 'science' is not the source of the theories and hypotheses that the scientist starts out with; rather it is the process by which those ideas are tested and justified that is crucial. Generally, the hypothetico – deductive approach to research is intimately bound up with what is often termed 'positivism' (Gill and Johnson, 2002). The reasoning process employed in theory testing research is called deductive reasoning – it involves deducing or predicting that certain things will follow (will be empirically observable) if the theory is true. To test the theory we use the theory to guide our observation: we move from the general to the particular (Vaus, 2002).

Inductive logic

Collis and Hussey (2003) state that "Inductive research is a study in which theory is developed from the observation of empirical reality; thus general inferences are induced from particular instances, which is the reverse of the deductive methods" (p. 15).). In a similar vein, Andreewsky and Bourcir (2000) explain that "Induction, in contrast to deduction, goes from facts to theory. It is a very usual reasoning process, being, for instance, the (implicit) way we learn our mother tongue (the theory – here the rules of the language – being implicitly inferred out of day to day linguistic interactions)" (p. 838).

Research using an inductive approach is likely to be particularly concerned with the context in which such events were taking place. Therefore the detailed study of a small sample of subjects might be more appropriate than a large number as with the deductive approach, as researchers in this tradition are more likely to work with qualitative data and to use a variety of methods to collect these data in order to establish different views of phenomena (Saunders, Lewis, and Thornhill, 2007). Bridges, (2007) says that it may be useful to adopt an inductive approach that allows theory building, when there is limited literature related to the topic under study. Figure 7.3 shows the research cycle.

Figure: 7.3: The Research Cycle (Cycle of Scientific Methodology)



Adapted from: Tashakkori and Teddlie. (1998, p. 25).

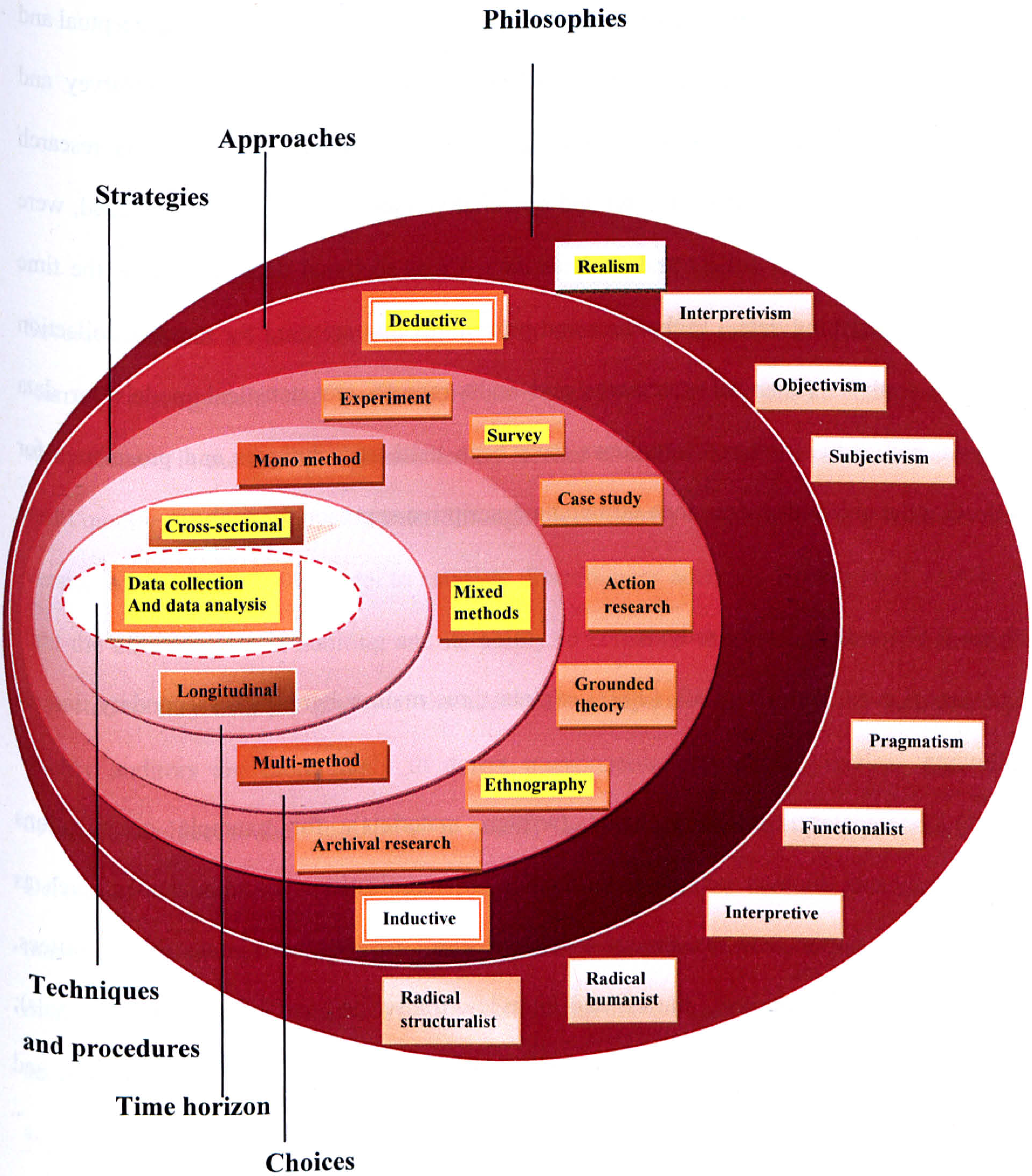
Research strategies

Remenyi et al. (1998) state that "At a strategic level the research process is defined in broad terms that take into account the general philosophical approach adopted by the researcher. This includes being aware of the ontological and epistemological assumptions that underpin each different research methodological strategy" (p. 44).

The research strategy is concerned with the general approach adopted in a project. The following sections have been required in one form or another as research strategies: (a) sample or data source, that define the unit of observation/analysis (who or what being studied), how they are selected (sampling procedures), sample size or number of units observed, (b) variables and their measurement, that is defining variables one by one and identifying their possible relationship, (c) procedures, that is the details of the research method, design, and procedures for the study, and (d) data analysis plan, that is a summary of how obtained information/data is analysed (Tashakkori and Teddlie, 1998).

No one research strategy is inherently superior or inferior to any other. Consequently, what is most important is not the label that is attached to a particular strategy, but whether it will enable the research to answer particular research question(s) and meet its objectives. The choice of research strategy will be guided by the research question(s) and objectives, the extent of existing knowledge, the amount of time and other resources available, as well the philosophical underpinnings. Finally, it must be remembered that these strategies should not be thought of as being mutually exclusive. The strategies that have been considered here are: experiment, survey, case study, action research, grounded theory, ethnography, and archival research (Saunders et al. (2007).

Figure 7.4: The Research 'Onion'



Adapted from: Saunders et al. (2007, p. 102)

This research is placed as' realism' in terms of research methodology, as the core philosophical assumption to meet the questions of research. A deductive logic is the approach adopted in this study: the researcher moves from general to the particular, as a conceptual and theoretical structure is developed and tested by empirical observation. Both survey and ethnography have been adopted as strategies in this research. Mixed methods research qualitative (semi-structured interview) and quantitative (secondary data) were utilized, were the procedures used to collect and analysis data. Cross-sectional data is used, as the time horizon for analysing data. Techniques and procedures that are used for the data collection and data analysis (financial statements and audit report), are statistical models for data analysis, and semi-structured interviews have been used as techniques and procedures for collecting the qualitative data, then utilizing a descriptive approach for analysis.

Phase I: Secondary Data Analysis

Saunders, Lewis, and Thornhill, (2007) explain three main subgroups of secondary data as following:

(1) Documentary, which includes (written materials); for example organizations databases such as personnel production or organizations communications, such as emails Letters, memos, organisations websites, reports and minutes of committees, journals, newspapers, diaries, and interview transcripts, and (non-written materials); for example media accounts, including television and radio, voice recordings, and video recordings.

(2) Multiple sources which include (area based data); for example Financial times country reports, government publications, books, and journals, and (time-series based); for example Industry statistics and report, government publications, European Union publications, books, and journals.

(3) Survey, which includes (censuses); for example governments' censuses; such as population and employment, (continuous and regular surveys); for example Government, such as family spending, labour market trends, and organisation, such as BMRB international's Target Group Index, employee attitude surveys, (Ad hoc surveys); for example governments' surveys, organisations' surveys, and academics surveys.

Several measures of audit quality have been used in prior research. The approaches of 'earnings management' and 'audit report' have both been used to measure audit quality. This study follows in the tradition established by Becker et al. (1998) who examined the effect of audit quality on earnings management through discretionary accruals; using a cross-sectional version of the Jones 1991 model to estimate discretionary accruals. Becker et al. (1998) say that the effectiveness of auditing and its ability to constrain the management of earnings is expected to vary with the quality of the auditor. In comparison to low-quality auditors, high-quality auditors are more likely to detect questionable accounting practices and, when detected, to object to their use and/or to qualify the audit report. Additionally, Healy (1985); DeAngelo (1986); Jones (1991) stated that high discretionary accruals indicate earnings manipulations. In this study discretionary accruals are also used as a proxy for earnings management. Bartov et al. (2001) said a relationship should exist between high discretionary accruals and audit qualifications. In addition, questionable accounting practices are not acceptable from auditors with higher quality and those more likely to issue qualified reports to illustrate errors and irregularities. Further, Butler et al. (2004) believe that when earnings management is detected and managers refuse to correct earnings, in this case, under Generally Accepted Auditing Standards (GAAS) auditors must issue a qualified, disclaimed, or adverse audit report.

Secondary data include both quantitative and qualitative data, and they are used principally in both descriptive and explanatory research. The data used may be raw data, where has been little if any processing, or compiled data that have received some of selection or summarising (Saunders, Lewis, and Thornhill, 2007). In this case, the secondary data consist of the companies financial statements prepared for the authorities. The statements are accompanied by the auditors' report.

Sample Selection

Having chosen a suitable sampling frame and established the actual sample size required the need to select the most appropriate sampling technique to obtain a representative sample. Saunders, Lewis, and Thornhill, (2007) state five main techniques can be used to select a probability sample: (1) Simple random which involves selecting the sample at random from the sampling frame using either random number or a computer: (2) Systematic sampling which involves selecting the sample at regular intervals from the sampling frame: (3) Stratified random sampling that is a modification of random sampling in which divides the population into two or more relevant and significant strata based on one or a number of attributes: (4) Cluster sampling that is on the surface similar to stratified sampling, as in the need to divide the population into discrete groups prior to sampling: (5) Multi- stage sampling a development of cluster sampling. It is normally used to overcome problems associated with a geographically dispersed population when face-to-face contact is needed or where it is expensive and time consuming to construct a sampling frame for a large geographical area.

Although random selection of samples is usually deemed desirable, it may not produce a sample that is either representative or useful. Thus, random sampling of companies may not give us any representatives of a particular industry. A systematic sampling approach is often preferred in practice for example (choosing every twentieth item, say, from the sampling frame) but this may still not solve the problems alluded to above. Directed sampling obtained from specified groupings, perhaps random or systematic at this lower level, may therefore be preferred in practice. The determination of the most appropriate sample size is largely a cost-benefit exercise. There is a need for the biggest sample size that can be afforded to be collected, in terms of both time and money. Larger sample sizes are usually more expensive in every aspect of performing the research. The representativeness of the research findings and their statistical significance will generally increase as the sample size increases, in all but the most exceptional circumstances. At the very least it should be have a sample size large enough to allow conducting the required tests of the research question, and it should be aware of this minimum requirement at the outset (Smith, 2003).

In this study two main ways will be adopted to gathering secondary data information to achieve first objective. These two approaches are the secondary data analysis (and collection of financial statements of companies) and the audit reports related to such companies.

Cross-sectional and time series data

In this study, the data set is processed, summarized, and presented in terms of cross-sectional data. For the purposes of statistical analysis, distinguishing between cross-sectional data and time series data is important. Cross-sectional data are collected at the same, or approximately the same, point in time. Time series data are data collected over several time periods (Anderson et al., 2002).The cross-sectional Jones model and the cross-sectional Modified Jones model in comparison are consistently able to detect earnings management better than their time series competitors (e.g.Guary et al., 1996; Beneish, 1997; Bartov et al., 2001).

Statistical Analysis of Data

Descriptive Statistics

Descriptive statistics enable the description and comparison variables numerically (Saunders, Lewis, and Thornhill, 2007). Most of the statistical information consists of data that are summarized and presented in a form that is easy for the reader to understand. Such summaries of data, which may be tabular, graphical, or numerical, are referred to as descriptive statistics. Numerical descriptive statistics are used to summarize data. The most common numerical descriptive statistic is the average, or mean (Anderson et al., 2002). In this study central tendency, such as mean and median are summarized and presented. In addition, for the dispersion of data, the standard deviation is used.

Inferential Statistics

A multiple regression analysis model is used to see if a dependent variable (total accruals) is related to an independent variable set (non-discretionary accruals), in order to capture discretionary accruals. The correlation coefficients are accounted in order to determine the relationship direction among variables. The adjusted R^2 is used to compare between models for the power of explanation variables by selected models. In addition, variables were tested at the conventional guideline of the 1% significance level, using the F-test.

Models for Secondary Analysis of Data

In terms of models that are used to capture earnings management, the Modified Jones Model (MJM) (1995) is the most powerful test of earnings management (e.g.Dechow et al., 1995; Guary et al., 1996; Beneish, 1997; Bartov et al., 2001). The Performance-Matching Model (PMM) Kothari, Leone, and Wasley (2005) introduced a performance adjustment in the Jones model. The Modified Jones Model 1995 (MJM) became the Performance-Matching Model. The PMM & MJM will be compared to determine the stronger one, by using the adjusted R^2, to capture earnings management. These two models have not previously been compared using Libyan data. Findings of the strongest model will be reported. This 'test' of the MJM against the PMM will ensure that the more powerful model, in terms of explanation, is used for this study.

Audit report

For the second stage, the earnings management results (either from MJM or PMM) need to be matched to audit reports. DeAngelo (1981b) states that audit quality consists of detecting and reporting earnings misstatements in audit reports, so audit quality is defined as detecting and reporting earnings misstatements. Then, the likelihood of receiving a modified audit opinion is more likely in the case of earnings management existing in the financial statements. The auditors' decisions to issue modified audit reports depend in part on detection of material errors and omissions (auditor ability), and in part on the incentives in order to report audit findings truthfully (auditor independence). For auditors to provide high audit quality, they have not to fail to issue a modified audit report when one is required. This study will try to investigate of the relation between abnormal accruals and the presence of certain modified audit reports.

Phase II: Interviews

The objective of the second phase of this study is to investigate factors drawn from prior research that might (audit size, audit fees, provision of non audit services, audit tenure and mandatory auditor rotation, audit steps, and team characteristics) affect audit quality, and then to create recommendations out of the findings of semi-structured interviews (after exploring the level of audit quality in first phase), that would help improve audit quality in Libya.

Keats (2000) stated that "An interview is a controlled situation in which one person, the interviewer, asks a series of questions of another person, the respondent" (p.1). In the social research interview, the aim is for the interviewer to elicit from the interviewee or respondent, as he or she is frequently called in survey research, all manner of information: interviewees' own behaviour or that of others; attitudes; norms; beliefs; and values (Bryman , 2008).An interview has a direction and a shape, it serves a specific purpose. The special quality of the interview is that it is designed for this specific purpose. It may be that no other skill is as important to the survey research worker as the ability to conduct good interviews. The longer, the more difficult and the more open-ended the question schedule is, the more we should prefer to use interviewers. Interviews are preferable for some problems, or under some conditions (Oppenheim, 1992).

Types of interview

Bryman (2008) says that the interview is a common occurrence in social life, because there are many different forms of interview. There are job interviews, media interview, social work interviews, police interviews, appraisal interviews. And then there are research interviews. In similar vein, Sarantakos (1998) said that there are many types of interviews, each of which differs from the others in structure, purpose, role of the interviewer, number of respondents involved in each interview, and form and frequency of administration. Saunders, Lewis, and Thornhill, (2007) categorized interviews as one of: structured interviews, semi – structured interview, and unstructured or in – depth interviews.

Structured interviews

Structured interviews involve tight control over the format of the questions and answers. Each respondent is faced with identical questions. And the range of pre-coded answers on offer to respondents ensures that data analysis is relatively easy. The structured interview, in this respect, lends itself to the collection of quantitative data (Denscombe, 1998). Campion et al. (1997) define structure very broadly as "any enhancement of the interview that is intended to increase psychometric properties by increasing standardization or otherwise assisting the interviewer in determining what questions to ask or how to evaluate responses" (p. 656). Bryman (2008) said that survey researchers typically prefer the structured interview, because this kind of interview promotes standardization of both the asking of questions and the recording of answers. This feature has two closely related virtues from the perspective of quantitative research: reducing error due to variation in the asking of questions, and greater accuracy in and ease of, processing respondents' answers.

van der Zee, Bakker, and Bakker (2002) summarize reasons of underutilization of structured methods as follows: practitioners may be unaware of the academic literature supporting the use of structured interviews; in structured interviews important interviewer needs are frustrated; structured interviews may harm the ability to recruit applicants, and (further) social pressures may be responsible for the limited use of structured interviews.

Semi-structured interview

In semi-structured interviews, the interviewer has a clear list of issues to be addressed and questions to be answered. However, the interviewer is prepared to be flexible in terms of the order in which the topic are considered, and, perhaps more significantly, to let the interviewee develop ideas and speak more widely on the issues raised by the researcher. The answers are open-ended, and there is more emphasis on the interviewee elaborating points of interest (Denscombe, 1998). Open-ended questions are important in allowing the respondents to say what think and to do so with greater richness and spontaneity. Floyd et al. (1990) say that open-ended or narrative answers do tell researchers more about what is going on in the mind of the respondent; however, they do not provide information which is as amenable to quantitative analysis as do the closed-response answers (Oppenheim, 1992). Semi-structured interviews are employed in qualitative and quantitative research (Sarantakos, 1998).

Unstructured or in-depth interviews

In unstructured interviews, the researcher 'starts the ball rolling, by introducing a theme or topic and then letting the interviewee develop his/her ideas and pursue his/her train of thought (Denscombe, 1998). Researchers working within a narrative paradigm frequently engage in in-depth conversations with participants. Analysis and interpretation of these conversations often involves reducing long stretches of text to codes and recombining the codes into themes that move across stories, across people and across contexts (McCormick, 2004).

Advantages of semi-structured interviews

Researchers sometimes employ the term 'qualitative interview' to encapsulate unstructured interview and semi-structured interview (Bryman, 2008). With semi-structured and unstructured interviews, the researcher allows the interviewee to use their own words and develop their own thoughts as a better way of discovering things about complex issues. Allowing interviewees to speak their minds is a better way of discovering things about complex issues. Semi-structured and unstructured interviews tend to be more about discoveries rather than 'checking'. The one–to-one variety is the most common form of semi-structured and unstructured interview; this has several advantages such as: only two people's diaries need to coincide, it is relatively easy to arrange and control, opinions and views expressed throughout the interview stem from one source, the researcher has one person's ideas to grasp and interrogate, and one person to guide through the interview agenda (Denscombe, 1998).

The group interview was not considered appropriate for this research since it would have been very difficult to gather interviewees together from different cities in one place at the same time. The one–to-one semi-structured interview is conducted in a conversational style, so it is more flexible than other methods and more appropriate for use in the Libyan context. This approach was chosen for conducting interviews in stage two of the research procedure, to address the second and third objectives. For this reasons semi-structured interview will be adopted with open-ended questions in this study.

In order to conduct interviews a question schedule was developed for using with all participants (see Appendices 1&2). Specific questions were asked, based on the research questions, to clarify and seek further opinions and suggestions related to the research topic in order to address the research objectives. Prior to actual interviews, the researcher sent letters signed by the first supervisor to participants to ask for their cooperation. Letters introduced the researcher and provided a brief about research topic in order to help participants be more confident in the researcher and the research project.

Sample Selection

Fifteen participants took part in semi-structured interviews drawn from four groups (external auditors; the President of the Syndicate of External Auditors [SEA, the national professional association]; the President of the local branch of the Syndicate of External Auditors; the directors of branches of the Financial Audit Agency; and finally professional academics).

External auditors who have experience for many years were selected as participants; those experienced auditors are more likely to be familiar with the topical issues under research. Accounting professors might provide a fruitful discussion from the academic perspective, especially with those who have research related to audit quality in Libya. The directors of branches of the Financial Audit Agencies would likely contribute useful information on policy and regulatory framework issues that regulate the audit function in Libya related to governmental auditors. The Presidents of Syndicates of External Auditors were felt more likely to clarify the role that professional body plays to regulate audit function, might provide insight into the audit quality issue from a practical perspective, and identify auditing standards issues relevant to this research topic.

Table 7.3: Selected sample for semi-structured interviews.

Agency	Job title of participant	Qualifications	Years of experience in current post
EI1	External auditor	MSc	21
EI2	External auditor	MSc	15
EI3	External auditor	BSc	20
AI1	Accounting professor	PhD	22
AI2	Accounting professor	PhD	14
AI3	Auditing professor	PhD	32
AI4	Auditing professor	PhD	12
AI5	Auditing professor	PhD	12
DI1	Director of branch of the Financial Audit Agency	BSc in Accounting	5
DI2	Director of branch of the Financial Audit Agency	BSc in Accounting	6
DI3	Director of branch of the Financial Audit Agency	BSc in Accounting	11
DI4	Director of branch of the Financial Audit Agency	BSc in Accounting	5
DI5	Director of branch of the Financial Audit Agency	BSc in Accounting	7
PI1	President of Syndicate of External Auditors	BSc in Accounting	12
PI2	President of Syndicate of External Auditors	MSc in Accounting	15
Total number of participants			15
Average years of experience			14

Process of Semi-structured Interviews

An agreement verbally was made with all interviewees to guarantee that collected data would be only used within the scope of this study. Permission was granted by the majority of participants to use a digital-recorder, and then transfer it onto interview transcripts. A recorder was used to help the researcher to focus on the answers of participants for asking for more explanations to obtain clear opinions, and the digital recordings were copied onto a hard disk in a laptop. In case of damage the researcher had a back up. Four participants refused to have the interview recorded. It should be noted that with interviewees in the developing countries, this is not uncommon. In these cases, notes were taken to write up directly after each interview. Because the researcher may have a bias or technical issues which may cause distortion, transcribing was carefully performed. Data obtained from interviews were coded and analysed by Nvivo8 software. This part of the study consists of just 15 participants; analysis of the data by Nvivo8 software was conducted, because it has several advantages, such as data management, managing of ideas, query data, the graphical model, and reporting from the data more readily.

Generalizing from qualitative research

Generalization is discussed as 'empirical' and 'theoretical' generalization. Empirical generalization concerns the application of findings from qualitative research studies to populations or settings beyond the particular sample of the study. Some prefer the terms 'transferability' or 'external validity' to describe this. The second type involves generalization of theoretical concepts or propositions which are deemed to be of wider, or even universal, application. Conclusions are drawn from features or constructs developed in local or single study which are then utilised in developing wider theory (Ritchie and Lewis, 2003). Flick (2002) stated that the problem of generalization in qualitative research is that its statements are often made for a certain context or specific cases and based on analyses of relations, conditions, processes in them. This attachment to contexts often allows qualitative research a specific expressiveness. However, when attempts are made at generalizing the findings, this context link has to be given up in order to find out whether the findings are valid independently of and outside specific contexts.

Reliability and validity

The concepts of reliability and validity were developed in the natural sciences. Because of this, and the very different epistemological basis of qualitative research, there are real concerns about whether the same concepts have any value in determining the quality or sustainability of qualitative evidence. Certainly, tests or measures of reliability and validity, as used in mathematical or physical sciences, are wholly inappropriate for qualitative investigation and cause considerable confusion when applied. But in their broadest conception, reliability meaning 'sustainable' and validity meaning 'well grounded' will have relevance for qualitative research since they help to define the strength of the data. This is of particular concern in the context of generalisation where the ability to transfer findings to other contexts or wider theory will be circumscribed by the soundness of the evidence (Palys, 1997).

Reliability

Silverman (2004) defined reliability as "the degree to which the finding is independent of accidental circumstances of the research" (p.285). Reliability is generally understood to concern the replicability of research findings and whether or not they would be repeated if another study, using the same or similar methods, was undertaken. The extent to which replication can occur in qualitative research has been questioned on a number of counts. The 'constructivist' school, for example, argue that there is no single reality to be captured in the first place so replication is an artificial goal to pursue. Flick (2002) explains three forms of reliability: quixotic reliability which includes the attempt to specify how far a particular method continuously lead to the same measurements or results, diachronic reliability which includes the stability of measurements or observations in their temporal course, synchronic reliability which includes the constancy or consistency of results obtained at the same moment but by using different instructive. In a limited way, qualitative researchers can use reliability to check for consistent patterns of theme development among several investigators on a team. They can also generalize some facets of multiple case analysis to other cases. Overall, however, reliability and generalizability play a minor role in qualitative inquiry (Creswell, 2003).

Validity

The validity of findings or data is traditionally understood to refer to the 'correctness' or 'precision' of a research reading. It is often explained as a concept with two distinct dimensions, the first, known as internal validity, concerned with whether you are 'investigating what you claim to be investigating', and the second, termed external validity, concerned with extent to which 'the abstract constructs or postulates generated, refined or tested' are applicable to other groups within the population or to other contexts or settings (Ritchie and Lewis, 2003). Creswell (2003) explains that although validation of findings occurs throughout the steps in the process of research, this discussion singles it out in order to emphasize its importance. Proposal developers need to convey the steps they will take in their studies to check for the accuracy and credibility of their findings.

Trustworthiness

Validity is seen as strength of qualitative research, but it is used to suggest determining whether the findings are accurate from the standpoint of the research, the participant, or the readers of an account. Terms abound in the qualitative literature that speak to this idea, terms such as trustworthiness, authenticity, and credibility (Creswell, 2003).

Lincoln and Guba (1985) stated that the conventional criteria for trustworthiness are internal validity, external validity, reliability, and objectivity. They present the following questions underlying the establishment of these criteria:

· How can one establish confidence in the truth of the findings of an inquiry for the respondents with which and the context in which the inquiry was carried out?

· How can one determine the degree to which the findings of an inquiry may have applicability in other contexts or with other respondents?

· How can one determine whether the findings of an inquiry would be consistently repeated if the inquiry were replicated with the same or similar respondents in the same or similar context?

· How can one establish the degree to which the findings of an inquiry stem from the characteristics of the respondents and the context and not from the biases, motivations, interests, and perspectives of the inquiry?

Flick (2002) presented five strategies for increasing the trustworthiness of qualitative research:

· Activities for increasing the likelihood that credible result will be produced by a prolonged engagement and persistent observation in the field and the triangulation of different methods, researchers and data;

· Peer debriefing: regular meetings with other people who are not involved in the research in order to disclose one's own blind spots and to discuss working hypotheses and results with them;

· The analysis of negative cases in the sense of analytic induction;

. Appropriateness of the terms of reference of interpretations and their assessment;

. Member checks in the sense of communicative validation of data and interpretations with members of the fields under study.

Ethical considerations

Ethical concerns emerge from a research plan, seeking access to organizations and from individuals in collecting, analysing and reporting the data. In the context of research, ethics refers to the appropriateness of researcher behaviour in relation to the rights of those who become the subject of research work, or are affected by it (Saunders, Lewis, and Thornhill, 2007). Writers on research ethics adopt different stances concerning the ethical issues that arise in connection with relationships between researchers and research participants (Bryman, 2008). The basic ethical principle governing data collection is that no harm should come to the respondents as a result of their participation in the research (Oppenheim, 1992). Likewise, Denzin and Lincoln, (2000) explain that because the objects of inquiry in interviewing are human beings, researchers must take extreme care to avoid any harm to them. Traditionally, ethical concerns have revolved around the topics of informed consent (receiving consent by the subject after having carefully and truthfully informed him or her about the research), and protection from harm (physical, emotional, or any other kind).

The researcher has followed the University of Gloucestershire's research ethics requirements. Informed consent was gained from all participants. The researcher made the interviews by appointment with the participants by arranging a time which was convenient for the participant. The anonymity of the respondents is preserved, and their right to withdraw or decline to respond to any question was emphasized and there was no pressure on participants for a response. The conduct of the interview confirms a response to requirements and wishes of interviewees. The respondent was informed at the beginning of the interview about using a recorder and/or the taking of notes during the interview. Additionally, in the interview the participant was not asked to participate in anything which intruded into their privacy. It was taken into account that the use of any data gained may have harmful consequences for the disclosing participant. Respondents here, in general, content that their answers might be associated with them, particularly the Directors of branches and the Presidents of Syndicates.

Conclusion

This chapter presented the methodology that was adopted to address the objectives of the research. In terms of type of research exploratory research was selected as the best suitable framework to achieve the objectives. A 'realism' research methodology was adopted as the core philosophical assumption to meet the questions of research. Mixed methods research qualitative (semi-structured interview) and quantitative (secondary data) were utilized, the procedures used to collect and analyses data were also mixed, using a deductive logic.

Secondary data analysis reviewed the data collected (financial statements and audit report), how it was analysed (statistical analysis data and models for secondary analysis of data). In order to achieve the most useful results related to the second and third objective, interviews were reviewed in terms of types, advantages, sample selection, and process. Finally, ethical considerations were pointed out in terms of how this research was conducted, such as plan research, seek access to organizations, to meet and talk to individuals, and collect, analyse, and report data.

Chapter 8

Results and Findings from Secondary Analysis of Data

Introduction

This chapter presents secondary data analysis of observations of Libyan companies from 2006 to 2009 to measure discretionary accruals. It applies an appropriate type of statistical methods, to identify accruals and the type of audit opinion related to these statements. This is to achieve the first objective of this study, which is to measure the level of audit quality in Libya. Although it is common in Libya to find the majority of audit reports are unqualified (clean report), there were a large number of companies in Libya which have gone into bankruptcy between 1995 and 2005. The main question which has to be asked is what is the situation of audit quality in Libya? Auditors are expected to play an important role in warning about financial difficulties that would lead Libyan companies into bankruptcy. Auditors are expected, in this case, is that they detect misstatements or errors (detect earnings management), and after that they do not have to issue unqualified report (report earnings management). So, if an auditor detects misstatements or errors and firm managers refuse to adjust the financial statements, the auditor's reporting options under Generally Accepted Auditing Standards (GAAS) are to issue an adverse, disclaimed, or qualified opinion.

Audit quality is defined as the probability that the auditor will both discover and report a breach in the client's accounting system (DeAngelo, 1981a). In order to investigate of the level of audit quality, misstatements in financial accounts and the type of audit report related to this accounts have to be identified, because the relation between audit reports and misstatements in financial statements explains the level of audit quality.

As some authors, (such as Scott ,2003; Beneish, 2001; Dechow and Skinner, 2000; Healy and Wahlen, 1999; Schippr, 1989) explain earnings management as 'misstatements', so earnings management will be taken as a proxy for misstatements in financial accounts to measure the level of audit quality. Earnings management will be taken as one of two bases to measure audit quality; therefore, a statistical model will be used to capture abnormal accruals, as a proxy to measure earnings management in financial statements of Libya companies. The second base to be used to measure audit quality is the type of audit report related to the financial statements of companies with abnormal accruals.

Audit quality can be conceptualized as a theoretical continuum ranging from very low to very high audit quality. Audit failures obviously occur on the lower end of the quality continuum. Audit quality is inversely related to audit failures: the higher the failure rate, the lower the quality of auditing. An audit failure occurs in two circumstances: (1) when generally accepted accounting principles are not enforced by the auditor (GAAP failure); and (2) when an auditor fails to issue a modified or qualified audit report in the appropriate circumstances (audit report failure). In both cases, the audited financial statements are potentially misleading to users (Francis, 2004). The way to achieve the first objective of this research, which is identifying the level of audit quality in Libya, requires first measuring earnings management in financial statements of Libyan companies, and secondly determining the type of audit report that has been given related to these financial statements.

The remainder of this chapter is organised as follows: the next section describes the period of study and sample selection and data, the third section produces the proxies for earnings management for trying to answer the question of whether Libyan companies manage earnings; the fourth section investigates the relation between abnormal accruals as a proxy for earnings management in financial statements, and then the type of audit report related to such financial statements. This addresses the first objective through determining if auditors detect and report earnings management by issuing modified audit opinions. The findings from this element will conclude the chapter.

Sample selection

The initial sample consisted of 90 companies which are national and private unlisted companies which reported earnings between December 2007 and December 2009. These companies were in the Industrial sector. The sample contains about 270 observations, as the financial statements of December 2006 have been used to account for changes in some variables, which are required by statistical method used to capture abnormal accruals. Observations have been reduced to 253 observations due to some financial statements not containing audit reports (that is, missing data). In some cases, the report may have been absent from the beginning. In most cases, the audit report, which is a separate document in Libya, may have simply become detached, so 17 observations were excluded from the final sample. Private companies account for150 about (59%) of observations and national companies' account for 103 about (41%) of observations. Table 8.4 details the type of company, auditor, number of observations, and the percentage of each type of audit opinion.

Listed companies were also excluded from the sample, as in the Libyan Stock Market there are only companies from the finance and insurance sectors. These companies have fundamental differences in the nature of their accruals. Financial statements for companies' years from 2006 to 2009 were hand-collected personally from the companies themselves and the Financial Audit Agency, because in Libya there is no database for obtaining financial statement data. In addition, in some cases there were difficulties in obtaining full financial statement data and the audit reports related to this data of some companies.

The abnormal accruals as proxy for earnings management

Most of the research has linked the presence of discretionary accruals (abnormal accruals) to the tendency of firms to manage earnings, so many researchers use discretionary accruals as a proxy to identify earnings management. For example, Healy, (1985); DeAngelo, (1986); Jones, (1991); Dechow and Sloan, (1991); DeFond and Jiambalvo, (1994); Dechow, Sloan, and Sweeney, (1995); Kang and Shivaramakrishnan, (1995); Kothari, Leone, and Wasley, (2005).

Ronen and Yaari (2007) explain that "Accruals arise when there is a discrepancy between the timing of cash flows and the timing of the accounting recognition of the transaction" (p. 371). The majority of previous studies consider total accruals, consisting of both non-discretionary accruals and discretionary accruals components. Non-discretionary accruals come from transactions in normal performance and business strategy for the company, and discretionary accruals come from transactions arising from abnormal performance, in order to mange earnings. A separation of total accruals into expected and unexpected components should help improve the accuracy of prediction of earnings management being used.

There are several empirical approaches that examine earnings management through abnormal accruals, but the milestone in the accruals approach is the study of Jones (1991) and its modifications. Dechow et al., (1995) evaluate the ability of the DeAngelo model (1986), the original Jones model (1991), an Industry model (Dechow and Sloan, 1991), and Modified

Jones model (Dechow et al., 1995) to detect earnings management. They find that a modified version (Dechow et al., 1995) of the original Jones model provides the most powerful test of earnings management.

The original Jones model (1991)

The original and modified Jones models lie at opposite ends of a continuum of possible earnings management behaviour. Thus, whilst the modified Jones model is certain to generate relatively high power tests, the assumption that all changes in credit sales in the event period are the result of earnings management activities is unlikely to be any more descriptive of reality than the original Jones model which assumes no sales-based manipulation during the period. The following 'expectations' original Jones model (1991) for nondiscretionary accruals in the event year is:

$$NDAit = \alpha 1\ (1/\ Ait\text{-}1) + \alpha 2\ (\Delta REVit\ /\ Ait\text{-}1) + \alpha 3\ (PPEit/\ Ait\text{-}1)$$

Ait-1 = total assets of firm i at the end of year t-1;

ΔREVit = revenues of firm i in year t less revenues in year t-1;

PPEit = gross property, plant, and equipment of firm i at the end of year t;

$\alpha 1, \alpha 2, \alpha 3$ = firm-specific parameters.

The Modified Jones model (1995)

Dechow, Sloan, and Sweeny (1995) present a Modified Jones model. Its novelty is the treatment of accounts receivable. If the firm does not manage earnings in the estimation period and manages accounts receivable in the event period, then accruals of credit sales are normal in the estimation period and abnormal in the event period. Then accruals of credit sales are normal in the estimation period and abnormal in the event period. The modified model recognizes this difference in time-series by making the following adjustment:

estimating normal accruals is similar to the Jones model; in the event period, normal accruals are computed by multiplying the estimated coefficient of the change in sales by the change in cash sales (the change in revenues minus the change in accounts receivable) instead of the overall change in sales.

Beneish (1997) used a version of the Modified Jones model (1995) in cross-section rather than in time series. Beneish stated that cross-sectional estimation has advantage of not restricting the analysis to firms with long time series of data. Guary et al., (1996) explain that the computational demands of the accrual models require further data restrictions. Since the Jones and modified Jones models require time-series OLS estimation, a minimum data requirement for each firm must be established. They chose a threshold of fifteen years as a compromise between data availability and the demands of regression estimation. Beneish (1997) and Guary et al., (1996) explain that if the Modified Jones model is controlled for the time-series reversals of accruals, this model might be further improved. Bartov et al., (2001) evaluate the ability of the cross-sectional Jones model and the cross-sectional Modified Jones model to detect earnings management, in comparison with their time series counterparts, by examining the association between discretionary accruals and audit qualifications. They find only the two cross-sectional models are consistently able to detect earnings management, rather than time series models. Hence, this study was motivated to estimate discretionary accruals by using a cross-sectional version of the Modified Jones model (1995).

The Modified Jones model of the nondiscretionary accruals of firm *i* in the event period *t* are computed as follows:

$$NDAit = \alpha 1\ (1/\ Ait\text{-}1) + \alpha 2\ [(\Delta REVit\text{-}\Delta RECit)/Ait\text{-}1] + \alpha 3\ [PPEit/Ait\text{-}1]$$

Where:

Ait-1 = total assets of firm i in year t-1;

ΔREVit = revenues of firm i in year t less revenues in year t-1;

ΔRECit = net receivables of firm i in year t less net receivables in year t-1 scaled by total assets in year t-1;

PPEit = gross property plant and equipment of firm i in year t;

α1, α2, α3 = firm-specific parameters.

The estimates of α1, α2, α3 (coefficients) are those obtained from the original Jones Model, not from the modified. They are estimated from the regression of accruals on ΔREVit and PPEit.

The Performance-Matching Model (2005)

Performance affects the estimation of earnings management because nondiscretionary accruals may be erroneously classified as discretionary when performance is abnormal and the relationship between accruals and performance is non-linear. Kothari, Leone, and Wasley (2005) developed a performance-matching model. Their motivation is to address the non-linear relationship between normal accruals and performance. They explain that accruals of firms that have experienced unusual performance are expected to be systematically non-zero. A correlation between performance and accruals is problematic in tests of earnings management, because commonly used discretionary accrual models, such as original Jones model (1991) and Modified Jones model (1995) are misspecified when applied to samples experiencing extreme performance.

Ye (2006) stated that having an ROA (return-on-assets) as a regressor in the performance-adjusted Jones model improves the Jones model, increasing the R^2 from8.09% to 11.13%. Kothari, Leone, and Wasley (2005) find that including an ROA in regression reduces discretionary accruals, when they expect the null hypothesis of no earnings management to hold. In addition, they find that the discretionary accruals from the Jones and modified Jones models without performance matching are -0.31 and -0.61, respectively, but with ROAit-1 they are 0.08 and -0.14, respectively. They observe that the standard error of the discretionary accruals increases with the lagged ROA*it*-1. Jones, Krishnan, and Melendrez (2008) stated that matching, based on the current year ROA performance, is better than matching on the prior-year ROA, and this performance matched approach is superior to including a performance variable in the discretionary accruals regression.

Kothari, Leone, and Wasley (2005) conclude that the Jones and modified Jones models remain misspecified, but the rejection rates are less extreme than when the event period is one year. The performance-matched discretionary accrual models continue to offer specification and power advantages over the Jones and modified Jones models across the sample partitions examined by. They provide a systematic treatment of the specification and power of the test using performance-based discretionary accruals. (Kothari, Leone, and Wasley 2005) analysis should aid in the design of future earnings management. This model has become quite popular because it yields stronger results than the Jones model. The following definition summarizes the Performance-Matching Jones model:

$$NDAit1 = \alpha(1/ Ait\text{-}1)+\alpha1[(\Delta REVit\text{-} \Delta RECit/Ait\text{-}1]+\alpha2[PPEit/Ait\text{-}1]+\alpha3[ROAit/ Ait\text{-}1]$$

Where:

Ait-1 = total assets of firm i in year t-1;

ΔREVit = revenues of firm i in year t less revenues in year t-1;

ΔRECit = net receivables of firm i in year t less net receivables in year t-1

scaled by total assets in year t-1;

PPEit = gross property plant and equipment of firm i in year t;

ROAit = rate of return on assets of firm i;

$\alpha 1, \alpha 2, \alpha 3$ = firm-specific parameters.

Jones, Krishnan, and Melendrez (2008) evaluated the abilities of 10 measures of discretionary accruals and probabilities of earnings manipulation derived from nine models to detect fraudulent earnings. They stated that since discretionary accruals are a component of total accruals, when both are included in the same model, due to multicollinearity, discretionary accruals could become insignificant. This outcome is more likely when the model used to estimate the discretionary accruals has low R^2.

In version (1) the Modified Jones model in table 8.1 and version (2) the performance-adjusted Jones model in table 8.2 adjusted R^2 is used as benchmark to compare the ability of different models to capture the abnormal accruals. For the period of 2006-2009, the proposed models estimated based on a simple cross-sectional regression, the Modified Jones model and the performance-adjusted Jones model estimated separately for each year combination, the two versions have the sample selection mean adjusted R^2 27% and 29%, respectively.

Consistent with Jones, Krishnan, and Melendrez (2008) explain that if the underlying model is well specified, discretionary accruals may have power for fraud incremental to total accruals, since the adjusted R^2 is higher for models from which accrual estimation errors are derived. Version (2) of table 8.2 illustrates that the adjusted R^2 for the second version tends Libyan companies (2006-2009) to be much higher than for the other model in table 8.1.

Table 8.1 and 8.2 report multiple regression analysis for observations of 253 for the Modified Jones model and the performance-adjusted Jones model. Mean F-statistics were 17.4486 and

12.85772, respectively and significant at the 1% level, indicating that the regression models were statistically valid.

Total accrual models and a selection sample of observations of 253firm-years have been used to estimate the coefficients. Year-by-year regressions were estimated for the period 2006-2009 (cross-sectional method) using two versions of Jones model (the Modified Jones model and the performance-adjusted Jones model).

The distributions of coefficient estimates in table 8.1 for the version (1) and in table 8.2 for the version (2) appear to be similar for the change in revenues variable and there is difference for the gross property, plant, and equipment variable. For example, for the version (1) in multiple regressions the 'change in revenues' variable has an average estimate of the coefficient of 0.431248 and of 0.417191 for the version (2). In similar vein, for the variable of the 'gross property, plant, and equipment', the mean estimated coefficients for version (1) and version (2) are -0.02297 and -0.05229, respectively. Comparing the two versions, the mean coefficients estimated sign is higher for the version (1).

In table 8.1, for version (1), the mean and median P-value was just significant at the level of 1% for the variable of the change in revenues. Likewise, in table 8.2 for version (2) the mean and median P-value was just significant at the level of 1% for the variable of the change in revenues.

In this study the accruals Linear-Performance-Matched Jones Model (2005) has been chosen to estimate the abnormal accruals as proxy to identify earnings management.

Table 8.1: the estimated coefficients of the accruals modified Jones Model (1995) of a Sample of 253 Selected Firm-Years (2006 -2009).

Version (1)

Multiple Regression Analysis for Observations (n=253)

Total accruals: $TAt/At\text{-}1 = \alpha\,(1/A\text{-}1) + \alpha 1\,[(\Delta REVt/At\text{-}1] + \alpha 2[PPEit/At\text{-}1] + \epsilon t$

Variables	Mean	Median	Minimum	Maximum	Mean P-value	Median P-value
α	-0.04337	-0.01464	-0.14056	0.025085	0.427835	0.309668
α1	0.431248	0.182588	0.133983	0.977172	7.94E-06	2.7E-07
α2	-0.02297	-0.08815	-0.12058	0.139841	0.319152	0.241077

Mean F-statistics 17.4486

Mean adjusted R^2 27%

Table 8.2: the estimated coefficients of the accruals Linear-Performance-Matched Jones Model (2005) of a Sample of 253 Selected Firm-Years (2006 -2009).

Version (2)

Multiple Regression Analysis for Observations (n=253)

Total accruals: $TAt/At\text{-}1 = \alpha(1/A\text{-}1) + \alpha 1[(\Delta REVt/At\text{-}1] + \alpha 2[PPEit/At\text{-}1] + \alpha 3[ROAt/At\text{-}1] + \epsilon t$

Variables	Mean	Median	Minimum	Maximum	Mean P-value	Median P-value
α	-0.03612	-0.02183	-0.12186	0.035329	0.377707	0.165877
α1	0.417191	0.158689	0.133206	0.959678	6.94E-05	4.74E-07
α2	-0.05229	-0.10446	-0.12829	0.075875	0.396724	0.522904
α3	0.163897	0.295828	-0.26486	0.460722	0.159727	0.134263

Mean F-statistics 12.85772

Mean adjusted R^2 29%

Table 8.3 contains figures for version (2) of the Performance-Matched Jones Model, which provides descriptive statistics on parameter estimates and test statistics generated by the Performance-Matched Jones Model, when applied to the sample of 253 selected firm-years.

The table 8.3 has been divided into seven rows as following, mean discretionary accruals, median of discretionary accruals, standard deviation of discretionary accruals, the row of the minimum of discretionary accruals, maximum of discretionary accruals, positive figures of discretionary accruals, and negative figures of discretionary accruals.

The distributions of estimated figures demonstrate that there are discretionary accruals which lead to inferences about the existence of earnings management. For instance, the mean and median of the estimated discretionary accruals is -0.02735 and -0.02077, respectively. Standard deviation for discretionary accruals is 0.453385; this figure indicates that discretionary accruals are spread out over a large range of values, which is clear by obtaining minimum and maximum discretionary accruals between -1.80815 and 4.37559, respectively. The result divides the sample selected as having discretionary accruals into 113 positive cases about 45% and 140 negative cases about 55%.

Table 8.3: results of tests for earnings management using the Linear-Performance-Matched Jones Model (2005).

Version (2) to Measure Discretionary Accruals. The Results are Based on a Sample of 253 Selected Firm-Years (2006 -2009).	
NDAt1 =α(1/ A-1)+α1[(ΔREVt- ΔRECt /At-1]+α2[PPEit/At-1]+α3[ROAt/ At-1],	
Description	**Discretionary Accruals**
Mean	**-0.02735**
Median	**-0.02077**
Standard Deviation	**0.453385**
Min	**-1.80815**
Max	**4.375559**
Positive – 113	**45%**
Negative -140	**55%**

Abnormal accruals and auditor reporting

Previous research studied the relation between abnormal accruals and the presence of certain modified audit reports: for example, Francis and Krishnan, (1999); Bartove, Gul, and Tsui, (2001); Bradshaw, Richardson, and Sloan, (2001); Butler, Leone, and Willenborg, (2004); Davidson, Jiraporn, and DaDalt, (2006): Ajona, Dallo, and Alegria, (2008). They assume that the likelihood of receiving a modified audit opinion is more likely in the case of earnings management existing in the financial statements. (In this study 'modified opinions' refer to both qualified opinions such as scope limitations, departures from GAAP, and inadequate disclosure and unqualified opinions with explanatory language such as going concern, abnormal accruals, consistency, material uncertainty, auditor agreement with a deviation from GAAP, and opinion is based on report of another auditor).

Prior empirical research studies of audit quality try, often, to distinguish between high and low audit quality. The milestone in determining of audit quality is DeAngelo (1981a); she states that audit quality consists of detecting and reporting earnings misstatements, so audit quality is defined as detecting and reporting earnings misstatements. Empirical evidence is available to support this categorization of audit quality by detecting and reporting earnings misstatements, (Pierre and Anderson, 1984; DeFond and Jiambalvo, 1991; Teoh and Wong, 1993; DeFond and Jiambalvo, 1993; Aharony, Lin, and Loeb, 1993; Becker, DeFond, Jiambalvo, and Subramanyam, 1998).

Empirical studies such as those of Francis and Krishnan, (1999); Bartov, Gul, and Tsui, (2000); Bradshaw, Richardson, and Sloan, (2001) assume that modified audit opinions should be a function of discretionary accruals. They argue that pervasive earnings management should lead to modified audit opinions. Francis and Krishnan (1999) explain that a modified report is more likely to be appropriate for high-accrual firms.

Content analysis of audit opinion types

Table 8.4 reports the frequency distribution of audit opinions by categorization of the type of audit opinion, including unqualified, qualified, disclaimer/no opinion, unqualified with explanatory language, and adverse, and the type of companies and auditor. This table again contains 253 observations. Such observations are detailed into national companies with Auditors of the agency accounting 103 for observations and private companies where auditors work for him/her self account for150 observations.

Auditors from the agency issued 103 audit reports as following: 82 unqualified (about 80%), 10 qualified (about 10%), 8 unqualified with explanatory language (about 8%), and 3 adverse (about 3%), 0 disclaimer/no opinion. The majority of the sample for auditors from the agency (79.6%) is unqualified opinions. Likewise, auditors working for him/her self issued 150 audit reports as following: 135 unqualified (about 90%), 6 qualified (about 4%), 3 disclaimer/no opinion (2%), 4 unqualified with explanatory language (about 3%) and 2 adverse (about 1.3%). The majority of the samples for auditors working for him/her self (90%) are unqualified opinions. In total, there are 217 unqualified audit reports (about 86%), 16 qualified audit reports (about 6%), 3 disclaimer/no opinion (about 1%), 12 unqualified with explanatory language (about 5%), and 5 adverse (about 2%).

Overall patterns are similar for both types of auditors (Auditors of the agency and auditors work for him/her self), they issued in general 85.7% unqualified (clean) audit opinion for financial statements that have earnings management.

Table 8.4 content analysis of audit opinion types by auditor, and company type (2007-2009).

Type of audit opinion	National companies: Auditors of the agency		Private companies: auditors work for him/her self		Total	
	observations	percentages	observations	percentages	observations	percentages
1 Unqualified	82	79.6%	135	90%	217	85.7%
2 Qualified	10	9.7%	6	4.0%	16	6.3%
3Disclaimer/no opinion	0	0%	3	2.0%	3	1.2%
4Unqualified with explanatory language	8	7.7%	4	2.7%	12	4.7%
5 Adverse	3	2.9%	2	1.3%	5	2%
Totals	103	100.00%	150	100.00%	253	100.00%

In order to confirm that two types of auditors are similar in terms of patterns for issuing audit opinions, the Two-Sample Kolmogorov-Smirnov test has been used at the 0.05 level; the two distributions are not significantly different. Table 8.5 contents analysis of Two-Sample Kolmogorov-smirnov test as following:

Table 8.5: Two-Sample Kolmogorov-smirnov test

Test statistics	X (y1) and X(y2)
(y1)	5
(y2)	5
Most extreme differences absolute	.400
Kolmogorov-Smirnov Z	.632
P-value	.819

Content analysis of modified audit opinions

Table 8.6 illustrates a content analysis, by auditor and company type, for modified audit opinions. Modified audit opinions were categorized into two categories following GAAS (qualified opinions and unqualified opinions with explanatory language); after that partition into subcategories was undertaken(qualified opinions include: scope limitations, departures from GAAP, and inadequate disclosure, and unqualified opinions with explanatory language include: as going concern, abnormal accruals, consistency, material uncertainty, auditor agreement with a deviation from GAAP, and opinion is based on report of another auditor). The content analysis of modified audit opinions serves two purposes. First, it provides an analysis of the reasons underlying auditors' decisions to issue modified audit opinions.

Second, it allows determining if there is a relation between modified audit opinions and abnormal accruals.

In table 8.6 findings indicate that modified audit opinions have been issued by auditors of the agency detailed as following: qualified opinions account for 10 out of 18, including 2 scope limitations, 6 deviations from GAAP, and 2 inadequate disclosure: unqualified opinions with explanatory language account for 8 out of 18, which comes just from an adjustment to previous correct a misstatement. Modified audit opinions which have been issued by auditors work for him/her self detailed as following: qualified opinions account for 6 out of 10, including 5 scope limitations, and 1deviations from GAAP: unqualified opinions with explanatory language account for 4 out of 10 such modified audit opinions comes from going concern detailed as following: 3 Going concern (opinion contains the phrase going concern), and 1material business uncertainty. Qualified opinions are relatively more than unqualified opinions with explanatory language.

Overall, there is no evidence that auditors issue modified audit opinions because firms manage earnings through discretionary accruals. In this sample there is no modified audit opinion due to abnormal accruals for both expense manipulation and revenue manipulation, for both types of auditors. In addition, the reasons provided for these modified opinions appear unrelated to abnormal accruals and is thus inconsistent with the view that auditors with high audit quality have to detect and report earnings management in financial statements. These results lead to inferences about audit quality in Libya being low, by linking the findings on the part of earnings management with the findings on the part of audit report.

The level of audit quality in Libya compared to other countries is somewhat different. For example, Ireland, (2003) studied audit quality in the UK where findings indicate that companies which hire large (Big 6) audit firms are less likely to engage in earnings management. In the USA (Francis et al., 1999; Francis and Krishnan, 1999; Krishnan, 2003 Cahan and Wei, 2006) provided evidence that Big Six auditors constrained firms from reporting aggressive and potentially opportunistic accruals and firms with high-accruals are more likely to have a modified audit report from the Big Six auditors. From the majority of studies, it seems clear that earnings management is less frequently found. Where present, the UK is likely to lead to a qualified report. This contrasts with the general situation in Libya, where earnings management is prevalent but seldom leads to a qualified report.

Table 8.6: content analysis of modified audit opinions by auditor, and company type (2007 – 2009).

Type of audit opinion	Nationalization companies: Auditors of the agency	Private companies: auditors work for him/her self
	observations	observations
Qualified opinions		
. Scope limitations	2	5
. Deviation from GAAP	6	1
. Inadequate disclosure	2	0
Total qualified opinions	10	6
Unqualified with explanatory language		
Going concern		
. Going concern (opinion contains the phrase "going concern")	0	3
. Bankruptcy	0	0
. Material business uncertainty	0	1
Total going concern	0	4
Abnormal accruals		
. expense manipulation	0	0
. revenue manipulation	0	0
Total abnormal accruals opinions	0	0
Consistency		
. Accounting change	0	0
. Change in accounting entity	0	0
. Error or irregularity	0	0
. An adjustment to previous correct		

a misstatement *. Other reasons*	**8** **0**	**0** **0**
Total consistency opinions	**8**	**0**
Material uncertainty *. Change in corporate control* *. Litigation risk* *. Asset realization uncertainty* *. Extractive industry uncertainty* *.Other contingent Liability*	 **0** **0** **0** **0** **0**	 **0** **0** **0** **0** **0**
Total material uncertainty opinions	**0**	**0**
Auditor agreement with a deviation from GAAP *. A change from one GAAP to another GAAP* *. The GAAP formerly used is no longer GAAP* *. A change in the method of applying GAAP*	 **0** **0** **0**	 **0** **0** **0**
Total Auditor agreement with a deviation from GAAP opinions	**0**	**0**
Opinion is based on report of another auditor	**0**	**0**
Total unqualified with explanatory language	**8**	**4**
Total modified opinions	**18**	**10**

Conclusion

This chapter has presented findings of the management of earnings in financial statements in Libyan companies, in the first part in this chapter, and the type of audit report related to these financial statements in the second part. The initial section reports the analysis of data obtained using the Performance-Matched Jones Model (2005), Findings within this part indicate that there is earnings management in all financial statements, as results show; findings divided all companies into 113 positive discretionary accruals about 45% of the sample and 140 negative discretionary accruals about 55% of the sample. Results indicate that managers are more likely to attempt that increase current-year income rather than decrease current-year income. The second part of the chapter reports analyses of data obtained from audit reports related to financial statements of companies under study. Auditors are most likely to issue an unqualified audit report (clean report). In general, there are 217 unqualified audit reports (about 85.7%), 16 qualified audit reports (about 6.3%), 3 disclaimer/no opinion (about 1.2%), 12 unqualified with explanatory language (about 4.7%), and 5 adverse (about 2%). In addition, findings show that there is no relation between the modified opinions and abnormal accruals. Nevertheless, results indicate that there are 28 modified audit reports (about 11%), but there is no modified audit report because of abnormal accruals. For example, the company which has the largest amount of discretionary accruals (max 4.375559) in the sample received an unqualified audit report, and the company which has the smallest amount of discretionary accruals (min -1.80815) in the sample also received an unqualified audit report.

Chapter 9

Findings from Qualitative Interviews

Introduction

This chapter presents the results of the semi-structured interviews implemented with four groups of interested parties of audit profession in Libya that include professional academics, directors of the Financial Audit Agency, professional practitioners (external auditors), and presidents of Syndicates of External Auditors.

The findings are presented in two sections. The first section is divided into two parts; the part number one is related to first objective that supports findings in chapter eight which explains those findings that help to identify the level of audit quality in Libya; the part number two is related to second objective that describes those findings that help to capture factors affecting audit quality in Libya. The second section is divided into two parts are related to third objective; the part number one deals with information about the strategy that would help to improve audit quality in Libya; the part number two describes those findings that explain the obstacles and problems which prevent the improvement of audit quality in Libya.

As presented in chapter seven in table 7.3, interviewees were to be anonymous and therefore the data presented in this chapter do not reveal their names. In spite of the desire to remain anonymous, interviewees authorised the researcher to mention the position and the location of their job. Quotes from Accounting and Auditing Professional Academics are identified as A1, A2, A3, A4, and A5; quotes from Directors of the Financial Audit Agency are identified as D1, D2, D3, D4, and D5; quotes from External Auditors are identified as E1, E2, and E3; and quotes from Presidents of Syndicates of External Auditors are identified as P1, and P2. As mentioned in chapter seven in interviews stage collected data is used just for the study purpose, and that was guaranteed to all interviewees.

The majority of interviews have been done by tape-recorder except some cases which were done by writing notes then write up directly after each interview. All interviews transferred onto interviews transcripts. Due to the fact that all interviews have been done by Arabic language, the interviews transcripts have been written by Arabic language in word files. The translation of interviews have been done from Arabic to English language due to the fact that the researcher has used Nvivo8 software to analysis the data, and this software does not deal with Arabic language (see appendices 3&4).

Nvivo is designed to approach qualitative analysis as researchers do. A project may start simply with a question or a purpose. Nvivo will store those first ideas in rich text documents, and let to edit them as they change, and link what it has been written to other files as you go (Bazeley and Richards, 2000).

There are five principal ways in which Nvivo supports analysis of qualitative data (Bazeley, 2007):

Manage data; to organize and keep track of the many messy records that go into making a qualitative project. These might include not just raw data files from interviews, questionnaires, focus groups or field observations, but also published research, other documentary sources, rough notes and ideas jotted into memos, information about data sources, and conceptual maps of what is going on in the data.

Manage ideas; to organize and provide rapid access to conceptual and theoretical knowledge that has been generated in the course of the study, as well as the data which supports it, while at the same time retaining ready access to the context from which those data have come.

Query data; to ask simple or complex questions of the data, and have the program retrieve from its database all information relevant to determining an answer to those questions. Results of queries are saved to allow further interrogation, and so querying or searching becomes part of an ongoing enquiry process.

• *Graphically model;* to show cases ideas or concepts being built from the data, and the relationships between them, and to present those ideas and conclusions in visual displays using models and matrices.

Report from the data; using contents of the qualitative database, including information about and in the original sources, the ideas and knowledge developed from them, and the process by which these outcomes were reached.

Simply put, software can provide tools to help you analyze qualitative data, but it cannot do the analysis for you, not in the same sense in which a statistical package like SPSS or SAS can do, say, multiple regression. Many researchers have had the hope for others it is a fear that the computer could somehow read the text and decide what it all means. That is, generally speaking, not the case. Thus it is particularly important to emphasize that using software cannot be a substitute for learning data analysis methods: the researcher must know what needs to be done, and do it. The software provides tools to do it with (Denzin and Lincoln, 2000).

Many argue that the results interviews should be expressed in a descriptive, rather than a numeric form. Likewise, because the samples are purposive, rather than random, it is unwise to convert the results into percentages. However, the use of modifiers such as, some, several, many, all, or the majority can be used. These are not considered part of a statistical analysis, but rather an aid to describe the qualitative data (Miles and Huberman, 1994). In this chapter, the researcher adopted a descriptive approach to analyses the qualitative collected data. But the researcher used numbers only inside matrices to describe general direction of opinion of participants.

The level of audit quality

This part in section one will present a general overview of the level of audit quality in Libya, which will support findings that have been obtained in chapter eight in order to address the first objective of this study. Also this information will help to determine the main weaknesses of the audit profession in Libya in the case of the audit quality will be low, or strengths of the audit profession in the case of the audit quality will be high. Interviewees were asked about the level of audit quality in Libya.

How do you see the quality level of the audit services in Libya?

The respondents' view on the level of audit quality in Libya is that more than half of them exactly two groups (professional academics and external auditors) see the level of audit quality in Libya is low. In contrast, less than half of participants believe that the level of audit quality is high they are (directors of the Financial Audit Agency and presidents of Syndicates of External Auditors). All interviewees talked about the level of audit quality in Libya.

The table 9.1: illustrates the number and opinion of each group of respondents on audit quality.

No.	Audit quality	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	High	0	5	0	2	7
2.	Low	5	0	3	0	8
Total		5	5	3	2	15

Professional academics and external auditors believe that there are many factors that cause to be audit quality in Libya to be low, such as a lack of interest in the audit reports from financial information users, there is no auditing standards, no professional ethics, no continuous education and qualify, The supply more than demand for audit profession, and there is no active professional body; these issues will be discus later in second part and second section.

"...I believe that the quality of audit services in Libya is very low, weak. And I can say what are the reasons that made the quality of audit services in Libya is weak. We note that most of the economic companies in Libya are semi-collapsed, they started with financial failures, financial difficulties, and then go into bankruptcy, then filtered, and then ceased altogether. The reason is that the external audit is a general framework and is considered the last tool in order to make control on financial information, if the external auditor does not indicate a defect in the accounting system, the defect in the operations, misstatements in financial information, errors, fraud, embezzlement, misuse of resources, then how can problems will be discovered and treated before reaching to the stage of collapse and bankruptcy..." **(A4).**

"... So I can say that the auditor did not completely do his/her duty, because the auditor did not indicate to the problems that were exist in the company, the company has been stopped this means the company was achieving losses, the company had problems in the sources of funding and liquidity, problems in sales, problems in production. The External Auditor supposed to pay attention to these problems and refers on them in his/her audit report..." **(A4).**

"... I believe that audit quality in Libya very low and the evidence is the clean auditor's report, which is supposed not to be clean in many cases..." **(A3).**

"...There is a lack of interest in the audit reports from financial statements users in Libya. For example, the tax offices are major users in Libya of financial statements they are not interested in the audit reports, as well as banks do not care about audit reports. In the sense that there is a refuse or complete ignore of the audit report by a user of financial statements in Libya, and this leads to the low level of audit quality in Libya..." **(A1).**

"...The other problem is that there are no "bound to follow" standards in Libya, either local or British or American or international, which reflects a weak profession, the audit profession in Libya does not have binding legal framework for regulating..." **(A2).**

"...From my point of view there are several problems concerning the issue of quality that there is no body to regulate the profession to do all what is missing from: the development of auditing standards and professional ethics, and evaluation and development of the profession in Libya. There is no continuous education and qualify. Therefore, these have a negative impact on the quality of the audit. The supply and demand is very weak in capital market in Libya; these problems prevent the audit profession to play its role in providing a higher audit quality..." **(E2)**

This is off-set to a small degree by membership of international organizations in the field of auditing and accounting, but respondents did not in general indicated experience in countries other than Libya.

Factors affecting audit quality

The second part in the section one will present a general overview of some factors, which are both available and not available in Libya which affect audit quality. The researcher has chosen eight factors which are the most factors have been studied in the literature review in this topic, in order to address the second objective of this study. These factors are: (1) audit firm size, (2) audit fees, (3) non-audit services, (4) audit tenure, (5) litigation, (6) audit steps, (7) audit team characteristics, and (8) auditing standards.

Factors found in Libya

Interviewees were asked two questions about these factors.

What are the factors which affect audit quality in Libya? And why do these factors affect the quality?

Qualitative data has shown that some factors are available in Libya and some not. Also there is disagreement between participants about some factors. It is important to note that some differences in the opinion about these factors refers to the nature of audit profession in Libya, that there are two kinds of practitioners in audit market in Libya: auditors belong to the Financial Audit Agency which is government agency and external auditors those are work for themselves. This point was highlighted in the chapter (1) of audit profession in Libya.

1- Audit fees

When respondents were asked about audit fees the majority of them indicated that audit fees are one of the most important elements to exist and which affect the quality of audit services in the Libyan environment. In general, nearly all participants from three groups (professional academics, external auditors, and presidents of Syndicates of External Auditors) emphasized that audit fees in Libya are very low compared with audit fees in other countries.

"*... It is important to note that audit fees in Libya are very low compared to other countries .There is a big difference between audit fees in Libya and other countries...*" **(A4- P2).**

"*... I believe that due to the fact that the business process in Libya is simple and the demand on the audit profession is simple due to the fact that economic process and companies size is small and are not widespread, then audit fees in Libya are low compared to other countries...*" **(E2).**

The results have shown that there are variety of opinions of respondents about the impact and the reason of the impact of audit fees on audit quality in Libya.

Table 9.2: illustrates the number and opinion of each group of respondents on audit fees.

No.	The impact of audit fees on audit quality	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	Ineffective	0	1	3	1	5
2.	Negative	4	0	0	1	5
3.	Positive	1	4	0	0	5
Total		5	5	3	2	15

It can be seen in table (9.2) there is nearly agreement in each group about the effect audit fees on audit quality: the group of directors of the Financial Audit Agency expressed the view that there is a positive impact from audit fees on audit quality, because audit fees make job satisfaction, an important economic incentive, and consider enough and convincing.

"... *There is a positive relationship between audit fees and audit quality, the effect of audit fees is the increase in the quality of the audit services...*" **(A1, D1, D2, D3, and D5)**.

"... *Whenever there are high audit fees an auditor feels satisfied, then the auditor produces a good work and a serious effort, therefore this will be reflected in the high quality of audit services in Libya...*" **(A1, D3)**.

"... *I believe that audit fees are enough and convincing to motivate auditors both from inside the agency or outside the agency to provide higher audit quality...*" **(D1)**.

"... *I can say that the audit fees are a positive influential factor in the audit quality, because audit fees give an economic incentive to auditors to make more effort and take more professional care when they audit the financial statements of companies, this effort will ultimately be reflected in higher audit quality...*" **(D2)**.

It is important to explain the system inside the financial audit agency to know why approximately all directors of the agency believe that audit fees have a positive impact on audit quality.

The system of work in the financial audit Agency is through the Mandate auditors to audit companies under the agency control. Sometimes the auditor audits the financial statements of companies through the hours of normal duty, but in most cases and because of limited time, the auditor audits the financial statements of companies in overtime, in which case there is a fixed schedule containing numbers of standard hours and the price of hours determined on the basis of the experience and length of work that the auditor has done in the agency. Sometimes the agency uses auditors from outside the agency who have a license to practice the profession, have sufficient experience, recognized competence, and effectiveness, due to there being much work and limited time, to audit the financial statements of companies under the control of the agency.

The majority of participants from the group of professional academics emphasized the fact that there is a negative impact from audit fees on audit quality, because the fees are not convincing and enough, the supply is higher than the demand.

"*... An audit fee has a negative impact on the quality of audit services in Libya...*" **(A2, A3, A4, A5, and P1).**

"*... I can say that the reason for this is that there is no demand for the audit profession and the supply is higher than the demand, therefore the audit fees in Libya are very low and almost negligible compared to audit fees in other countries. Audit fees are not a positive effect on audit quality because the auditor's effort becomes the same level as the audit fees...*" **(A2).**

"*... From my point of view audit fees in Libya are not convincing and not enough compared to the effort required to implement audits of high quality...*" **(A5).**

All participants from the group of external auditors stated that there is an ineffective impact from audit fees on audit quality, because the client does not link audit fees with the level of quality of audit services, and prices determine.

"*... Audit fees are an ineffective factor on audit quality in Libya...*" **(D4, E1, E2, E3, P2).**

"*... I would say that the quality of work is not related to the price. It will be true if the auditor controlled the price then in that time you can link the price with the quality of work, but the* *price comes predetermined to the auditor which is set by the company offering its financial statements to audit...*" **(P2)**.

"... *Audit fees in Libya are not determined on the basis of the quality of work or the level of the reputation of the auditor, this factor does not have any link to the level of service that is provided by the auditor...*" **(E1)**.

In conclusion, except respondents from the Financial Audit Agency, the respondents' view on audit fees is very negative and an ineffective factor. The reason for this opinion refers to some elements such as the nature of audit market in Libya, and users of financial information. On the other hand, respondents from the Financial Audit Agency see that audit fees have a positive impact on audit quality in Libya. This opinion may refer to a special situation inside the Agency, such as laws and regulations. That the market of audit services in Libya remains divided in this way (FAA, independent auditors) this is an impediment to effective market function. This also works to damage audit quality. Here, time pressure arises as there are too few auditors employed by the Agency. With private auditors, there is an over-supply (ie. many small firms), who compete strongly on price.

2- Audit team characteristics

When respondents were asked about audit team characteristics, In general, all participants from three groups (directors of the Financial Audit Agency, external auditors, and presidents of Syndicates of External Auditors) stated that there are auditors who have some characteristics which help to solve complex issues and conduct audits through advanced methods. But many of them emphasized that high-quality characteristics found in the auditors are limited in a large number of them in terms of the length of experience and different academic qualification.

Qualitative data has shown that there is nearly agreement between groups about the impact and the reason of the impact of audit team characteristics on audit quality in Libya, except the group of professional academics.

Table 9.3: illustrates the number and opinion of each group of respondents on audit team characteristics.

No.	The impact of audit team characteristics on audit quality	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	Ineffective	0	0	1	0	1
2.	Negative	0	0	0	0	0
3.	Positive	1	5	1	2	9
Total		1	5	2	2	10

The results have shown that all participants in table (9.3) except **(E2)** stated that audit team characteristics have a positive impact on audit quality, and the reason is that the audit team which has more skills and characteristics conduct sophisticated and advanced tests, accuracy and in-depth analysis, the flexibility in the application of audit standards, and the competence and independence and the due professional care in terms of planning, supervision and follow-up the performance of audits processes, knowledge and experience in the use of information technology and experience in the industry of the client. This available potential to the audit team will be reflected in its performance by using these skills to solve complex issues, and then this team will provide higher audit quality.

"*... Audit team characteristics are an effective positive factor in the audit quality in Libya...*"

(Nearly all three groups).

"*... High-quality characteristics found in the auditors are limited in a large number of them in terms of the length of experience and different academic qualification, these two elements do not affect audit quality in Libya, because the business process in Libya is simple and uncomplicated, so it does not need long experience or high qualifications, in summary there is the same level of quality for all cases...*" **(E2)**.

"*...I believe that whenever the audit team has special characteristics of knowledge and experience in the use of information technology and experience in the industry of the client, whenever this is reflected in the quality of the audit team work and the performance of its work in a reasonable and good time then the quality of audits is better than the team that possesses no such technical and substantive skills...*"**(D3)**.

"*... Audit team characteristics are influential in the audit quality. In addition, there is a difference in the strength of the effect between high qualifications and the length of practice, the academic qualification has less impact on quality than the length of practice...*" **(P2)**.

In conclusion, except professional academics group, nearly all the respondents' view on audit team characteristics is that there are some positive characteristics that influence audit quality in Libya in particular the length of practice and the academic qualification.

3- Audit steps

When respondents were asked about audit steps, In general, two groups (directors of the Financial Audit Agency, and external auditors) stated that Integrated and comprehensive audit steps according to generally accepted auditing standards are found relatively often among the audit practitioners of the profession in Libya.

Qualitative data has shown that there is an agreement between participants who talked about audit steps in terms of the impact and the reason of the impact of this factor on audit quality in Libya.

Table 9.4: illustrates the number and opinion of each group of respondents on audit steps.

No.	The impact of audit steps on audit quality	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	Ineffective	0	0	0	0	0
2.	Negative	0	0	0	0	0
3.	Positive	1	5	3	1	10
	Total	1	5	3	1	10

Collected data has shown that all participants in table (9.4) agreed that audit steps have a positive impact on audit quality, and the reason is that there is a direct correlation between audit steps and audit quality, that is, in order to discover and report misstatements in the financial statements of companies which are the main assumptions to provide high audit quality, there must be integrated and comprehensive audit steps to provide a high audit quality.

"*... Auditors in the agency implement audit steps according to generally accepted auditing standards when they audit the financial statements of companies which fall under control of the agency, in order to provide a high quality of audits and to obtain accurate results...*" **(C5).**

"... *In Libya, there is a discrepancy in implementing audit steps between auditors in accordance with generally accepted auditing standards...*" **(P1).**

"... *There is a positive relationship between integrated and comprehensive audit steps and a high audit quality...*" **(All respondents).**

"... *If auditors implement integrated and comprehensive audit steps according to generally accepted auditing standards they will discover and then report misstatements in the financial statements of companies, which will reflect in high quality audits...*" **(E3).**

In conclusion, all the respondents' view on audit steps is that there is a positive impact from audit steps on audit quality in Libya, and the reason is that integrated and comprehensive audit steps is an important factor to discover and report misstatements in the financial statements of companies in order to provide high audit quality.

4- Non-audit services

When respondents were asked about non-audit services, In general, three groups (professional academics, external auditors, and presidents of Syndicates of External Auditors) stated that in Libya there is no law to prevent the auditor from providing non-audit services to the client.

Table 9.5: illustrates the number and opinion of each group of respondents on non-audit services.

No.	The impact of non-audit services on audit quality	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	Ineffective	0	0	0	0	0
2.	Negative	4	0	2	0	6
3.	Positive	1	0	1	2	4
	Total	5	0	3	2	10

The results have shown that there is disagreement between respondents in table (9.5). Nearly all in the professional academics group and external auditors group stated that there is a negative relationship between non-audit services and audit quality in Libya. The reason is that there are no audit standards or laws to regulate the practice of providing Non-audit services, which causes a complete loss of auditor independence and integrity. In contrast, presidents of Syndicates of External Auditors emphasized that there is a positive relationship between non-audit services and audit. The reason is that increases the ability of the auditor, and understanding of the work.

"*...Non-audit services have a negative impact on the audit quality in Libya...*" **(A2, A3, A4, A5, E2, and E3).**

"*... In general there are no specific binding auditing standards of the profession or laws to regulate the practice of the profession and in particular there are no audit standards or laws to regulate the practice of providing Non-audit services to the client. Thus this leaves it to the* *personal whims of individuals' practitioners; this will be reflected in different practices which will have a negative impact on the audit profession...*" **(A2).**

"*... I think that non-audit services must be separated from normal audit processes, because non-audit services affect the independence of the auditor...*" **(E3).**

"*... Non-audit services may increase the level of the audit quality but do not decrease the audit quality...*" **(A1, E1, P1, and P2).**

"*... I believe that the auditor, by providing these services, will gain experience, be familiar with the problems of the client, and gain a good knowledge of the accounting system of the client which will enable the auditor to perform audits of high quality...*" **(E1).**

In conclusion, there are two opinions on non-audit services; the first indicated that there is a negative impact from non-audit services on audit quality, because non-audit services affect auditor independence, the second one stated that there is a positive relationship between non-audit services and audit quality in Libya, because the provision of non-audit services expands perceptions of the auditor, increases experience, increase the ability of the auditor to discover errors, and understanding of the work, but will not diminish the knowledge or ability to introduce audits with high quality.

5- Auditor tenure and mandatory auditor rotation

When respondents were asked about auditor tenure and mandatory auditor rotation. In general, just the group of directors of the Financial Audit Agency stated that there is a compulsory rotation in the Libyan audit environment, but not by law or regulation, it is something familiar in the agency.

Table 9.6: illustrates the number and opinion of each group of respondents on Auditor tenure and mandatory auditor rotation.

No.	The impact of auditor tenure and mandatory auditor rotation on audit quality	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	Ineffective	0	0	0	0	0
2.	Negative	0	0	0	0	0
3.	Positive	0	5	0	0	5
	Total	0	5	0	0	5

The results have shown that there is an agreement among the group of directors of the Financial Audit Agency in table (9.6), that there is a positive relationship between auditor tenure and mandatory auditor rotation and audit quality, and the reason is that auditor tenure leads to maintaining independence. It is important to note that the Financial Audit Agency has a special situation as government agency, for this reason there is auditor tenure and mandatory auditor rotation in the Agency.

"*... Mandatory auditor rotation exists in the agency but there is not any law or regulation for doing that, but it is something recognized by these who do commissioned auditors to audit the financial statements of companies that fall under the control of the agency, for both auditors inside the agency and outside the agency...*" **(D1).**

"*... The auditor tenure is an element which positively affects the audit quality...*" **(D1, D2, D3, D4, D5).**

"... I believe that whenever there is a longer contact with the same client a relationship forms one way or another between the client and the auditor so the auditor loses independence, which is a basis to provide the best quality of audit, then in this case the auditor will not be able to provide high quality..." **(D5).**

In conclusion, there is an agreement among the group of directors of the Financial Audit Agency that auditor tenure and mandatory auditor rotation exist in the Agency, and has a positive impact on audit quality, because auditor tenure helps to ensure and protect the independence of auditors.

Factors not found in Libya

Interviewees were asked another question about factors affecting audit quality.

What are the other factors which are not available in Libya and which affect audit quality in Libya? And why does the absence of these factors affect the quality?

Qualitative data has shown that there are some factors are not available in Libya which affect audit quality in Libya. Also there is disagreement between participants about the effect and reasons of effect of some factors on audit quality in Libya.

1- Audit firm size

The test was of the effect of the absence of some factors on audit quality in Libya. Audit firm size was one of the unavailable factors that did not apply in Libya. The view represents only an opinion, as there is no basis for comparison but, when respondents were asked about audit firm size, in general, all participants of four groups explained that In Libya there are no big audit firms as they exist in other countries. The practice in Libya is proscribed by Law No. 116, which legislates audit by individual practitioners. It is interesting to note that auditors in a Libyan context are appointed by the Financial Audit Agency in the case of national companies, and by the companies themselves in the case of private companies.

Table 9.7: illustrates the number and opinion of each group of respondents on audit firm size.

No.	The impact of the absence of audit firm size on audit quality	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	Ineffective	2	1	0	1	4
2.	Negative	3	4	3	1	11
3.	Positive	0	0	0	0	0
	Total	5	5	3	2	15

The results have shown that there are two directions of opinions in table (9.7); the first the majority of respondents see that there is a negative impact of the absence of audit firm on audit quality in Libya, because these firms have huge potential through which they could provide high quality audits, also there will be competition between the auditors, another opinion was from some respondents that this element has no effect on audit quality in Libya, because the absence of the basic components of the audit profession. In Libya there are no binding international standards or local standards. The other issue is morality; there are no rules to regulate the behaviour of auditors or the ethics of the profession.

"... *I think the absence of this element negatively affects on the Libyan...*" **(The majority of respondents).**

"... *The reason is that there is a huge potential available from these companies such as experts, qualified auditors, and possession of advanced technologies for testing to resolve complex issues...*" **(D4).**

"... *The reason is that, there will be competition which will be located between the auditors to enter the classification of big audit companies in the audit market in Libya...*" **(E2).**

"... *The absence of this element does not affect the quality of audit services in Libya...*" **(A3, A4, D5, and P2).**

"... *Size may have a reverse-effect; a large number of clients sometimes does not lead the auditor to take due professional care for each audit process. A large number of clients and a lack of qualified auditors negatively reflect on the audit quality. A better performance may be obtained by the office that includes just one person, who works harder than the office which includes a group of people. In addition, expertise and experience have a significant impact on audit quality. So we cannot say that the larger the size of the audit office, the higher the audit quality, size may not affect audit quality in Libya, this fact is consistent with some other studies that have shown that in some other countries such as Jordan, size does not affect audit quality...*" **(A3).**

"... *The absence of this element has no influence in Libya due to the absence of the basic components of the profession. The profession in Libya is considered a weak entity its services do not required, legally binding is not available, there is no fear of the law to punish them...*" **(A4).**

In conclusion, there two opinions of respondents; the majority believe that the absence of audit firms have a negative impact because particular reasons mentioned above and some other see that the absence of audit firms have no an impact on audit quality also they have some reasons mentioned earlier.

2- Auditing standards

When respondents were asked about auditing standards, In general, all participants of four groups stated that there is no binding local or U.S.A or the UK or international auditing standards in Libya.

Table 9.8: illustrates the number and opinion of each group of respondents on auditing standards.

No.	The impact of the absence of auditing standards on audit quality	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	Ineffective	0	0	0	0	0
2.	Negative	5	5	3	2	15
3.	Positive	0	0	0	0	0
	Total	5	5	3	2	15

Qualitative data has shown that there is agreement between participants in respondents about the impact and the reason of the impact of auditing standards on audit quality in Libya in table (9.8). They expressed the view that the absence of binding auditing standards considered the main reason which causes the problem that is why the audit profession in Libya is very low.

"... *The absence of binding auditing standards negatively affects audit quality in Libya...*" **(All respondents).**

"... *The situation is that there are foreign auditing standards moved by Libyan students studying in the U.S. and the UK, but there are non-binding by law, it is just considered that the standards are recognized and used by auditors according to educational background.*

These standards are not bound by specific regulation; the absence of binding standards negatively affects the audit profession, and results in a low quality of audit in Libya..." **(A5).**

"*... This is one of the reasons that audit quality is low in Libya, audit standards are important to regulate audit profession in order to provide high audit services...*" **(E1).**

"*... I understood that there was a committee set up by the syndicate of Auditors from ten years ago to establish auditing standards in Libya. Nearly thirty standards set by the Committee and submitted to the General People's Committee for adoption and the General People's Committee form a technical committee to evaluate these standards, but this project, which was seeking to develop standards for the audit profession in Libya for the development of the profession, it is over and was not adopted and did not see the light of day...*" **(E2).**

"*... There are no binding auditing standards in the Libyan audit environment. Auditing standards are general standards in its concept and so far no regulatory institution can define what this concept means or this standard. Maybe some professors who have experience in audit area are able to explain what is meant by the concepts; they may apply audit concepts well. But no one is allowed, because the audit report is just attached to financial statements of the company. Auditing standards are not available and non-binding and professional ethics are not available and non-binding. The most important point is that there is no body to regulate the profession to do all that is missing: the development of auditing standards and professional ethics, and evaluation and development of the profession in Libya...*" **(A4).**

In conclusion, in spite of all respondents agreed that the absence of binding auditing standards has a negative impact on audit quality in Libya, some interviewees pointed out that there are some auditors apply different auditing standards, such as U.S.A, the UK, and international auditing standards, but these standards are not bind by law in order to regulate the audit profession in Libya.

3- Litigation

When respondents were asked about litigation, in general, all participants of four groups stated that lawsuits in front of the courts against auditors because of the failure of audit process do not exist in the Libyan audit environment.

Table 9.9: illustrates the number and opinion of each group of respondents on litigation.

No.	The impact of the absence of litigation on audit quality	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	Ineffective	0	2	0	0	2
2.	Negative	5	3	3	2	13
3.	Positive	0	0	0	0	0
	Total	5	5	3	2	15

Collected data has shown that the majority of participants in table (9.9) emphasized that litigation in the Libyan audit environment does not exist because there is no clear auditor responsibility, and the user of audit report does not aware his/her rights and it's absence has a negative impact on audit quality, and the reason is that auditors will make to avoid paying fines and compensations.

"... *This element is very important and its absence has a negative impact on the quality of the audit profession in Libya...*" **(The majority of participants).**

"... *The absence of this element has not an impact on the auditor of the agency...*" **(D3, D5).**

"*... There never ever has been any auditor who went to court because of a lawsuit for the failure of the audit process. The absence of litigation against auditors in Libya is due to the lack of knowledge of the user of financial statements of their rights...*" **(A1)**.

"*... There is not any responsibility for audit report. Thus, auditor responsibility must be clear by laws to push auditors to provide high quality...*" **(A5)**.

"*... I believe that If the auditors appear in court in the case of the failure of the audit process they would make a greater effort to provide a higher audit quality to avoid standing front of the court and for the consequences of paying fines and compensations...*" **(D1)**.

In conclusion, the majority of interviewees indicated that the absence of litigation has a negative impact on audit quality. It is important to note that several respondents explained that there is no criteria to measure the failure of the audit, therefore there is no litigation, because there is no specific responsibility of the auditor, there is nothing by the profession or any other law which sets out a process failure of the audit, and the auditor responsibility for that. There must be measurement for a responsibility in the case of failure of the audit process, and it must reflect all the requirements and the work nature of measurements, and then auditors can litigated for negligence in the same measurements, rules and laws binding. And therefore it will pay auditors to make more effort, thus the auditor will introduce a better quality services.

4- Auditor tenure and mandatory auditor rotation

When respondents were asked about auditor tenure and mandatory auditor rotation, In general, three groups of participants (professional academics, external auditors, and presidents of Syndicates of External Auditors) stated that there is not any law for preventing the auditor to stay with the same client for long periods.

Table 9.10: illustrates the number and opinion of each group of respondents on auditor tenure and mandatory auditor rotation.

No.	The impact of the absence of auditor tenure and mandatory auditor rotation on audit quality	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	Ineffective	1	0	0	0	1
2.	Negative	3	0	3	2	8
3.	Positive	1	0	0	0	1
	Total	5	0	3	2	10

Qualitative data has shown that the majority of participants in respondents about auditor tenure and mandatory auditor rotation stated that the absence of auditor tenure and mandatory auditor rotation in the Libyan audit environment has a negative impact on audit quality, and the reason is that to maintain the auditor's independence.

"... *The absence of auditor tenure has a negative impact on the audit quality...*" **(The majority of participants).**

"... *There is no mandatory auditor rotation in Libya. This element has no effect on the level of the audit quality in both cases, a short or long period of contact, because there is no quality at all...*" **(A4).**

"...*I believe that the length of the contact between the auditor and the same client will result in the formation of personal relationships between auditor and client, which would affect the independence of the Auditor and will therefore affect the quality of audit services...*" **(E1).**

In conclusion, the majority of respondents stated that there is not any law for preventing or limiting the length of the contact between the auditor and the client. The absence of compulsory auditor rotation is due to the absence of audit standards, laws and binding rules in the Libyan audit environment. At the same time, some interviewees mentioned that the period of three years is a good period for the rotation of auditors and should be determined by binding legislation to ensure the independence of the auditor and provision of high-quality audit profession.

5- *Audit steps*

When respondents were asked about audit steps, in general, nearly all participants of professional academics group stated that there is a lack from auditors in the Libyan audit environment of the implementation of all audit steps.

Table 9.11: illustrates the number and opinion of each group of respondents on audit steps.

No.	The impact of the absence of audit steps on audit quality	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	Ineffective	0	0	0	0	0
2.	Negative	4	0	0	1	5
3.	Positive	0	0	0	0	0
Total		4	0	0	1	5

The results have shown that respondents agreed that the absence of implement integrated and comprehensive audit steps that auditors has a negative impact on the quality of audit in Libya.

"... It can be observed in Libya, there is a lack of planning and re-evaluation of accounting systems, these steps do not exist in the audit processes in Libya..." **(A3).**

"... I would say that a lack of implementation of integrated and comprehensive audit steps has a negative impact on the audit quality in Libya..." **(All respondents).**

In conclusion, all respondents indicated that audit steps according to generally accepted auditing standards are relatively implemented by the auditor. There are some auditors who implement the audit process according to generally accepted auditing standards; they are very few compared to the total number of auditors practicing the profession in Libya.

6- Non-audit services

When respondents were asked about non-audit services, In particular, the group of directors of the Financial Audit Agency explained that this element does not exist in the agency. The law explicitly and clearly prevents the auditor who works in the agency for providing non-audit services to the client.

Table 9.12: illustrates the number and opinion of the group of respondents on non-audit services.

No.	The impact of the absence of non-audit services on audit quality	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	Ineffective	0	0	0	0	0
2.	Negative	0	0	0	0	0
3.	Positive	0	5	0	0	5
Total		0	5	0	0	5

Qualitative data has shown that interviewees from government organizations explained why there is no provision of non-audit services to the client in the Financial Audit Agency. They said that the provision of non-audit services by the auditors in the agency to the client is prohibited by law, as it is not allowed for the auditors in the agency to provide non-audit services. The reason for preventing auditors in the agency to provide non-audit services to the client is that in the case that the auditor provides non-audit services to the client, this will create a relationship between the auditor and the client based on a material benefit, then the auditor will be afraid to lose the interest from providing non-audit services, which influence the auditor to maintain this benefit. As a result of this the auditor's independence will be affected and harmed, and finally outcome auditor will not provide high audit quality.

" *... The absence of this element contributes to providing better audit services by auditors of the agency...*" **(Directors of the Agency group).**

"... *In the case of the existence of any relationship that has a financial benefit between the auditor and the client through the provision of non-audit services, this relationship would impair the independence of the auditor...*" **(D2).**

In conclusion, the group of directors of the Financial Audit Agency believed that the prevention of non-audit services in the Agency helps to provide higher audit services by the Financial Audit Agency.

7- *Audit team characteristics*

When respondents were asked about Audit team characteristics, in particular, nearly just participants of professional academics group stated that in Libya is the lack of practitioners of the profession who have multiple and varied skills to help provide high-quality audits.

Table 9.13: illustrates the number and opinion of the group of respondents on audit team characteristics.

No.	The impact of the absence of audit team characteristics on audit quality	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	Ineffective	1	0	0	0	1
2.	Negative	3	0	0	0	3
3.	Positive	0	0	0	0	0
Total		4	0	0	0	4

Collected data has shown that in Libya there is no distinction between the auditors in terms of characteristics, there are just length of experience and different level of qualifications.

"... *There is a small difference between auditors with long or short years of experience and high or low qualification. The quality of audit in Libya is already weak by the auditors with many years of experience or qualifications of high level...*" **(A5).**

"... *In short, if this factor existed there would be a positive effect on the quality of the audit in Libya...*" **(A4).**

"... *I would say that the auditor does not reject the work because he/she is non-specialized or he/she has not the potential to implement audit processes...*" **(A4).**

In conclusion, professional academics group believed that in Libya there is no distinction between the auditors in terms of characteristics, there are just length of experience and different level of qualifications. In the Libyan audit environment there is no client to ask the auditor to audit financial statements of companies based on his/her experience and specialization of audit. Also they believed that the absence of audit team characteristics one of the reasons for the low level of audit services in Libya.

Strategies to develop audit quality

This part in the section two will present a general overview of the strategy to develop audit quality in Libya. This part is an attempt to obtain findings that help to address the third objective of this study. In general, this section will help to achieve future information in order to make recommendations to cover the main weaknesses of the audit profession in Libya, or support strengths of the audit profession.

Current strategies

Interviewees were asked about the current strategies to develop audit quality in Libya.

What are the current strategies and plans being used to develop audit quality in Libya?

The results have shown that there are two opinions; the first one represents more than half of participants of interview, they are all professional academics group and external auditor group, they said that there are no strategies in Libya to develop audit quality, the second represents less than half of participants of interview. In general, they are all the group of directors of the Financial Audit Agency and presidents of Syndicates of External Auditors, they mentioned some strategies that are applied in order to develop audit quality in Libya, which are administrative and financial incentives, commercial law, conferences, program of high degree in education, journals and magazines, membership in (ARABOSAI, AFROSAI, and INTOSAI), rules of professional conduct and ethics, and training.

Table 9.14: illustrates the number and opinion of the group of respondents on current strategies.

No.	Current strategies	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	No strategies	5	0	3	0	8
2.	Strategies	0	5	0	2	7
2.1	Administrative and financial incentive	0	4	0	0	4
2.2	Commercial law	0	0	0	1	1
2.3	Conferences	0	2	0	0	2
2.4	Journals and magazines	0	2	0	1	3
2.5	Memberships in ARABOSAI,AFROSAI, AND INTOSAI	0	5	0	0	5
2.6	Program of high degree education	0	4	0	0	4
2.7	Rules of professional conduct and ethics	0	0	0	1	1
2.8	Training	0	5	0	2	7

"... *There is no strategy, no training, and no fellowship, no conferences, no magazines or journal in order to develop the audit profession in Libya, except some writings from academics in the framework of scientific research...*" **(A4).**

"... *In the Agency there is a training administration whose task is to organize training courses for auditors to increase their professional competence and practice. The administration organizes training courses inside and outside Libya in different areas and disciplines such as accounting, information technology, and languages to help employees in the agency to develop their abilities and communication with the development in different areas...*" **(D3).**

1- Administrative and financial incentives

Qualitative data has shown that nearly all participants of Agencies indicated that there are administrative and financial incentives as strategies to develop audit quality in Libya.

"... *There are incentives for exceptional management of upgrades for active auditors. Also the agency provides financial rewards for outstanding Auditors to stimulate and encourage them to provide the highest quality of audits...*" **(D4).**

2- Commercial law

Collected data has shown that just (P1) talked about commercial law, the respondent considered commercial law one of the strategies to develop audit quality in Libya.

"... *There are some existing laws in Commercial Law to regulate the audit profession...*" **(P1).**

3- Conferences

The results have shown that participants of Agencies just talked about Conferences as available strategy to develop audit quality in Libya particularly in the Agency.

"... *The training administration manages scientific conferences from time to time, to highlight some of the problems identified in audit work, in order to find solutions. These conferences are sometimes at a local level or regional or international...*" **(D2).**

4- Program of high degree in education

Qualitative data has shown that nearly all participants of Agencies talked about high degree in education program, they said that there is support from the Agency to auditors in order to achieve higher level of education as strategies to improve the skills of the auditors in the Agency.

"... *There is a chance for auditors to continue to obtain higher studies of the master's and Ph.D. inside and outside Libya, in order to increase the efficiency of auditors affiliated with the agency at the expense of the agency...*" **(D1).**

5- Journals and magazines

Collected data has shown that some participants from different groups talked about journals and magazines as strategy to develop audit quality, they agreed that there are some specialized journals in the field of accounting and auditing to highlights existing problems in order to find solutions to these problems as strategy in order to develop audit quality in Libya.

"... *There are some scientific journals on accounting and auditing profession, these journals highlight some problems and attempt to address such problems of the audit profession in Libya, which is a good attempt in order to develop the audit profession...*" **(E1).**

6- Membership in ARABOSAI, AFROSAI, and INTOSAI

The results have shown that just participants of Agencies talked about membership in ARABOSAI, AFROSAI, and INTOSAI, they said that he agency has membership in "ARABOSAI" the Arab Organization of Supreme Audit Institutions, membership in

"AFROSAI" the African Organization of Supreme Audit Institutions, and membership in "INTOSAI" the International Organization of Supreme Audit Institutions as available strategy to develop audit quality in general in Libya in particular in the Agency.

"...*I would say that these memberships have great benefits through conferences which introduce the latest developments in the audit work. In addition, these memberships help the agency to obtain information, experiences, means, methods, and practices from members of these organizations through conferences, publications, newsletters, journals, laws and regulations in the Member States. Joining Libya to these organizations is useful for the audit work to increase the quality of the audit...*" **(D1)**.

7- Rules of professional conduct and ethics

Qualitative data has shown that just participants of the group of presidents of Syndicates of External Auditors talked about rules of professional conduct and ethics, they stated that there is a roster regulation of the audit profession as strategy to develop the audit profession in Libya.

"... *There is a regulation of the profession in order to regulate the exercise of Auditors of the profession...*" **(P1)**.

8- Training

Collected data has shown that all participants from two groups (directors of the Financial Audit Agency and presidents of Syndicates of External Auditors) emphasized that there is training courses in order to improve auditor's skills as one of strategies to develop audit quality in Libya.

"... *In the agency there is training administration which manages annual training courses inside and outside Libya, in order to develop auditors in the agency. Courses are sometimes* *specialized in accounting and auditing, and sometimes are not specialized such as languages, computer, Mathematics, and statistics...*" **(D5).**

"... *The syndicate manages courses for training auditors from time to time...*" **(P2).**

In conclusion, collected data has shown that professional academics group do not believe that there is a strategy to develop audit quality in Libya. In contrast, the agencies groups and the syndicates groups believe that there are some strategies available in Libya in order to develop the audit profession. It is important to note that most of available strategies are in the government agency, and there is no much to talk about outside the Financial Audit Agency.

Sufficient strategies

Interviewees who talked about some available strategies were asked if these strategies are sufficient or not to develop audit quality in Libya.

Do you think these strategies and plans are sufficient to develop audit quality in Libya?

Qualitative data has shown that all respondents believed that available strategies are not sufficient in order to develop audit quality.

Table 9.15: illustrates the number and opinion of the group of respondents on the impact of current strategies.

No.	The impact of strategies	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	Insufficient	0	5	0	2	7
2.	Sufficient	0	0	0	0	0
	Total	0	5	0	2	7

"... *I think this strategy is not sufficient for developing the audit profession in Libya. There is more to do in this context especially in terms of the laws that regulate the profession. There is* *a lack of these laws, existing laws need to be reviewed and modified to delete some and make some new laws, to ensure the high quality of the audit profession...*" **(All respondents from the Agencies).**

"... *I believe that the current strategy is not sufficient to develop the audit profession in Libya, and there is more to do to develop the audit profession in Libya...*" **(P1 and P2).**

In conclusion, it can be seen that all participants from the Agencies who believe that there are some strategies in the Agency in order to develop the audit profession stated that there are weaknesses in some laws to regulate the audit profession better than it is, that will be reflected in the performance of auditors and thus the quality of the audit profession.

Future strategies

Participants were asked about strategies could be adopted in future to develop audit quality in Libya.

What are strategies and plans which could be adopted for the development of the audit quality in future in Libya?

The results have shown that respondents agreed that there are some strategies could be adopted in order to develop the audit quality in Libya, such as a board of accounting principles, active professional body, audit fees, audit firm size, audit tenure, auditing standards, conferences, fellowship, laws, litigation, non-audit services, quality control, rules of professional conduct and ethics, and training.

Table 9.16: illustrates the number and opinion of the group of respondents on Future strategies.

No.	Future strategies	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	Active professional body	5	0	3	0	8
2.	Rules of professional conduct and ethics	5	0	3	1	9
3.	A board of accounting principles	5	0	3	1	9
4.	Laws	5	2	3	0	10
5.	Fellowship	5	0	3	1	9
6.	Conferences	5	0	3	1	9
7.	Training	4	3	3	1	9
8.	System of quality control	5	1	3	0	9
9.	Auditing standards	5	0	3	2	10
10.	Audit fees	3	1	3	2	9
11.	Audit tenure	3	0	3	2	8
12.	Non-audit services	4	0	2	0	6
13.	Audit firm size	2	2	2	1	8
14.	Litigation	5	0	2	2	9

1- Active professional body

Qualitative data has shown that all participants from two groups (professional academics and external auditors) emphasized that there must be found an active body or activate the syndicate in order to develop audit quality in Libya.

"*... In terms of future strategy in order to develop the audit profession in Libya, the most important point finding the active body or activate the syndicate...*" (**Academics and auditors groups).**

2- Rules of professional conduct and ethics

The results have shown that nearly all participants of three groups (academics, auditors, and syndicates) explained that the most important element that is missing in order to develop the audit profession in Libya is a guide of professional ethics and conduct, which must be found to be binding by law.

"... *Clear rules of professional conduct must be found...*" **(P1).**

3- A board of accounting principles

Collected data has shown that all participants from two groups (professional academics and external auditors) stated that there must be a board of the accounting principles as mean which helps to develop the audit profession in Libya.

" ... *A board of the accounting principles must be found in Libya...*" **(Academics and auditors groups).**

4- Laws

Collected data has shown that two groups (academics and auditors) stated that binding laws must be issued in order to develop the audit profession in Libya.

".. *Modifying some trade laws to regulate the economy to be consistent with the open market that will activate the audit profession...*" **(E2).**

5- Fellowship

Qualitative data has shown that two groups (academics and auditors) emphasized that there must be an examination as a condition for exercising the profession, such as CPA in the U.S. and ACCA in the UK.

"... *There must be a mechanism for the exercise of the audit profession. There must be a classification of auditors, this classification must define the duties and obligations and the* *work of each class of auditors, such as type of practice, audit fees, the size of work, type of work, and other points that you should be clear...*"**(P2).**

6- *Conferences*

The findings have shown that two groups (academics and auditors) stated that there should be different types of conferences in issues of accounting and auditing in Libya, such as local conferences, regional conferences, and international conferences in order to develop the audit profession in Libya.

"... *There should be established international scientific conferences in order to obtain developed practices of the profession through interaction with developed countries in this area...*" **(E3).**

7- *Training*

The findings have shown that the majority of participants stated that intensive training courses for practitioners of the profession must be found as strategy to develop the audit quality in the Libyan audit environment.

"... *Specialized training courses must be conducted in certain areas, due to a shortage in the skills of some auditors. No auditors can perform specialized audits in areas, such as the oil industry, agriculture, medicine, banking, and others, this problem facing the financial audit agency due to the lack of qualified auditors who can perform audits of companies with a particular specialty. The agency must develop a strategy to solve this problem by training auditors to enable them to carry out such audits of companies with a particular speciality...*" **(D5).**

8- System of quality control

The results have shown that all participants of two groups (academics and auditors) stated that system of quality control must be found in Libya in order to develop the audit profession.

"*... I think that continuous assessment of the quality of practitioners of the profession must be found in Libya...*" **(E1).**

9- Auditing standards

The results have shown that all participants of three groups (academics, auditors, and syndicates) pointed out that local standards must be found or international standards adapted to the Libyan environment.

"*.... For nearly sixty years scientific research has proved that, western accounting is inappropriate to an environment of developing countries, and Libya is one of the developing countries. The process of transfer of what is in the advanced countries in this area as it is, and it is applied in developing countries, is not useful to improve the economic and social development in developing countries. The solution to this problem is either: first it must create and innovate local standards and laws to be appropriate to the environmental factors of the developing country, resulting in the interaction of internal environmental factors to assist in the development and growth of the community: second adopting what exists in developed countries, but it should take into account features of the internal environment of the country...*" **(A2).**

10- Audit fees

The results have shown that the majority of participants pointed out that audit fees in Libya are not sufficient for the required amount of work it must be increased, and must be linked to the level of the audit quality services to be provided by the auditor.

"... *The fees are not convincing and are not enough compared to the effort required to implement an audit of high quality, so audit fees must be increased...*" **(A2).**

11- Audit tenure

The findings have shown that nearly all participants of three groups (academics, auditors, and syndicates) explained that there must be law for preventing or limiting the length of the contact between the auditor and the client, the creation of this element should be based on scientific studies in order to be consistent with the Libyan audit environment.

"... *I believe that the period of three years is a good period for the rotation of auditors and should be determined by binding legislation to ensure the independence of the auditor and provision of high-quality audit profession...*" **(E1).**

12- Non-audit services

The results have shown that nearly two groups (academics and auditors) have talked about non-audit services, there are two opinions between prevent and regulate non-audit services.

"... *I believe that non-audit services must be prevented by law in Libya because they have a negative impact on audit quality...*" **(A5).**

"... *In order to provide Non-audit services the audit offices must have the potential such as various and different audit teams can provide non-audit services and audit teams for the normal audit processes. Meaning, there must be laws to regulate the provision of Non-audit services in Libya in order to increase the quality of the audit profession...*" **(E3).**

13- Audit firm size

Collected data has shown that more than half of participants indicated that audit firms must be found. The reason is that, these big audit companies have the ability and potential, qualified and competent elements, the use of technical information, the use of sophisticated and effective methods, and specialized auditors in the client industry in order to issue accurate audit reports by highlighting any mislead financial information, so the result will be audits of high-quality and developed audit profession.

"... *I would say that audit firm if found in Libya it would help to increase the level of audit quality...*" **(E2).**

14- Litigation

The findings have shown that nearly three groups (academics, auditors, and syndicates) mentioned that if there are lawsuits against auditors because of the audit failure then auditors would be more careful, and would make a bigger effort. Auditors will try to avoid going to courts by providing a higher audit quality and later paying fines and compensation. Litigation if existed would positively reflect in a higher quality of audit profession in Libya.

"... *In Libya the auditors do not care about what may result from the audit report to users, there is not any responsibility for this report. Thus, auditor responsibility must be clear by laws to push auditors to provide high quality...*" **(A5).**

"... *There is no auditor in Libya who has gone to court due to the pretext of victims of the audit report, and therefore the audit report is issued without a sense of responsibility towards the report or user of the report. For example, in the U.S. the audit quality has improved after a large number of famous litigation in front of the courts. Therefore auditing standards are created by the litigation against accountants and auditors...*" **(A3).**

In conclusion, it can be seen that professional academics and external auditors groups suggested the most future strategies to develop audit quality in Libya over other two groups. They believe that there are many factors missing in Libyan audit market that help to provide high audit services.

Obstacles and problems preventing the development of the audit quality

The second part in the section two will present a general overview of some obstacles and problems, which prevent the development of audit quality in Libya. Interviewees have talked about ten points which they have considered the most important obstacles and problems that prevent the development of audit quality. These obstacles and problems are: (1) instability, (2) nature of audit market, (3) active professional body, (4) binding accounting principles, (5) binding auditing standards, (6) binding laws, (7) continuous training and education, (8) rules of professional conduct and ethics, (9) system of quality control, (10) qualified directors.

Interviewees were asked about obstacles and problems that prevent the development of audit quality in Libya.

What are the obstacles and problems which prevent the development of the audit quality in Libya?

The results have shown that there are several points have been talked by different participants as obstacles and problems that prevent the development of audit quality in Libya.

Table 9.17: illustrates the number and opinion of the group of respondents on obstacles and problems.

No.	Obstacles and problems	Groups				Total
		Academics (A)	Directors (D)	Auditors (E)	Presidents (P)	
1.	Instability	0	4	0	0	4
2.	Nature of audit market	4	0	3	2	9
3.	No active professional body	4	0	3	1	8
4.	No binding accounting principles	5	0	3	0	8
5.	No binding auditing standards	5	0	3	1	9
6.	No binding Laws	3	3	1	1	8
7.	No continuous training	4	1	3	0	8
8.	No rules of professional conduct and ethics	5	0	3	0	8
9.	No system of quality control	5	0	2	0	7
10.	Unqualified directors	0	3	0	0	3

1- Instability

The findings have shown that just participants of the Agencies group have talked about instability; they explained that there is instability in the administrative structure of the agency. There is sometimes the annexation and separation of the agency with another agency in the country.

"*... Decisions of annexation and separation of the agency from other agencies in the State causes the absence of an administrative stability. Thus, the agency cannot implement plans and strategies for developing the work...*" **(D2).**

2- Nature of audit market

Qualitative data has shown that nearly all members of two groups (academics and auditors) have talked about the nature of audit market in Libya as one of the most problems that prevent the development of audit quality in Libya. They determined some points in this side, such as low fees, no competition and participation, supply is greater than demand, a lack of interest from audit report users, no diversity in productivity, no effective capital market, no professional responsibility or legal responsibility, a lack of interest from decision makers in the state to develop the audit profession, and entry barriers to the profession.

"*... I can see that audit fees are unprofitable; there is no competition and participation in the Libyan audit market, and supply for the profession is greater than demand. In addition, there is a lack of interest in the audit reports from financial statements users in Libya...*" **(A1).**

"*... I would say that there is no demand for the audit profession, and the fees are very low. There is no respect for the profession by the client or user of accounting information. There is a lack of interest in the profession by society as a whole...*" **(E1).**

"*... You can see that in Libya there is a lack of interest in developing the audit profession in Libya from decision makers in the State. Also there are no entry barriers to the profession, and the requirement is just a BSc and five years of experience. There is no difference in production...*" **(P1).**

3- Active professional body

Collected data has shown that nearly two groups (academics and auditors) have talked about active professional body; they stated that there is no effective syndicate to develop the profession, through developing auditing standards and rules to regulate the audit profession.

"*... Nobody cares about the development of the audit profession and the issuance of auditing standards which govern and follow up the behaviour of auditors and accountants. If a professional body were found all the problems mentioned earlier would be solved...*" **(A3).**

4- Binding accounting principles

The results have shown that just two groups (academics and auditors) have talked about binding accounting principles, they explained that the absence of binding accounting principles are considered one of the problems that makes the audit profession weak in Libya due to accounting principles are the framework that the auditors build their decision about the fair of the financial statements.

"*... There is an absence of accounting principles in the preparation of financial statements and the emphasis on compliance with them...*" **(E3).**

5- Binding auditing standards

The findings have shown that two groups (academics and auditors) have talked about binding auditing standards, they considered the most problem is available in the Libyan audit environment that prevent to develop the profession is that there is no binding auditing standards in Libya audit market.

"*... In Libya there is no binding local or U.S.A or the UK or international auditing standards...*" **(E2).**

6- Binding laws

The findings have shown that more than half of the participants talked about the absence of binding laws as one of the obstacles that prevent to develop the audit profession in Libya.

"*... In the agency there are restrictive laws to improve the audit quality in Libya...*" **(D2).**

"... It can be seen that the audit profession in Libya does not have binding legal framework for regulating..." **(A2)**.

7- Continuous training and education

Qualitative data has shown that nearly two groups (academics and auditors) have talked about continuous training and education; they stated that there are no continuous training and education in Libya.

"... I believe that auditors in Libya have many problems, such as continuous development and qualifying, there are no institutions which ask the auditor to develop like the U.S. and the UK. There is in these countries a commitment to qualify and develop through spending about 120 hours of training over three years..." **(A4)**.

"... There is a lack of specialized training courses such as in the computer field, to enable the external auditor to audit in electronic systems. As well there is a lack of specialized training courses in the different accounting areas which require expertise and prior and deep experience in these areas such as in industry banking, and construction, industry oil, and others..." **(D5)**.

8- Rules of professional conduct and ethics

The results have shown that just two groups (academics and auditors) have talked about rules of professional conduct and ethics; they emphasized that guide of professional ethics and conduct is considered the absence one of the most obstacles that faces the development of the audit profession in Libya due to this guide is important to regulate auditors' behaviour in order to ensure both the auditor's independence and ability.

"... In Libya there is no written or binding guide of professional conduct and ethics..." **(Academics and auditors)**.

9- System of quality control

The findings have shown that nearly two groups (academics and auditors) have talked about system of quality control; they stated that in Libya there is no system of quality control, and this does not help to develop audit quality, they said that the system of quality control is important to discover the weakness in auditor's job and try to solve them out to keep high audit quality.

"... *There is no system of quality control in audit firms, for example there is no regular checking of the office every three years...*" **(A4).**

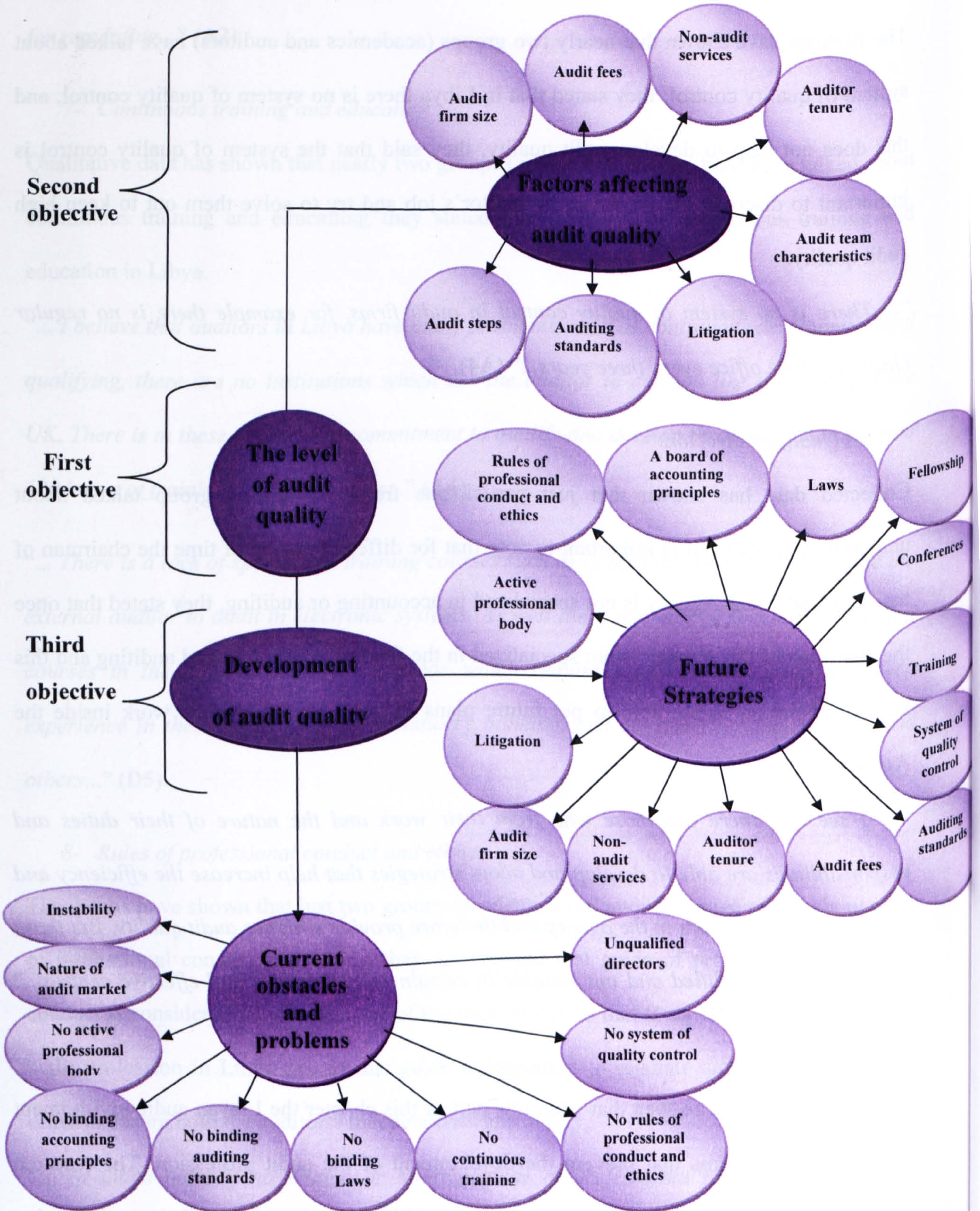
10- Qualified directors

Collected data has shown that just participants from the agency group talked about unqualified directors. It is important to note that for different period of time the chairman of the Financial Audit Agency is not specialized in accounting or auditing, they stated that once the chairman of the Agency is not specialized in the field of accounting and auditing and this kind of chairman is not able to put future plans in order to develop the work inside the Agency.

"... *I see that there are those who from their work and the nature of their duties and responsibilities are able to develop and adopt strategies that help increase the efficiency and effectiveness of auditors in the agency and therefore provide a higher audit quality. But those people are not qualified and not suitable in certain administrative and effective centres...*" **(D4).**

In conclusion, it can be seen that from this part of this chapter the Libyan audit environment suffer many problems that prevent the development of the audit profession. The research findings have show that there are many important things missing in the Libyan audit market that cause obstacles in order to develop the audit profession.

Figure 9.1: Interviews framework



Conclusion

This chapter stated the research findings which is an attempt to address the research objectives in this study. The researcher tried in the first part in the first section to support the findings that have been achieved in chapter eight which is an attempt to measure the level of audit quality in Libya that is related to first objective, the second part in the first section is an attempt to find out about factors that affect the audit quality in Libya which is related to second objective. In terms of the second section, it is related to third objective that is development audit quality in Libya which is divided into two parts; first part about the strategies to develop audit quality, and second part about the obstacles and problems that prevent the development audit quality in Libya.

Chapter 10

Discussion and conclusions

Introduction

This chapter summarizes the main conclusions from the preceding chapters of the thesis and links the main conclusions with the literature review. There are seven key sections in this chapter. The next one following the introduction provides a discussion of secondary data analysis findings that links with the literature review related to this part of the study. The main findings of the qualitative interviews will be discussed in third section. The fourth section presents recommendations of the study. The fifth section identifies the contributions of the study. Limitations of the study are in the section six, and the final section deals with future research.

Secondary data analysis findings

The secondary data analysis was used to address the first research question, which was the determination of the level of audit quality in Libya. Discussions and conclusions parts related to main findings of secondary data analysis are summarized as follows:

1- In this study the mean adjusted R^2 is used to test the power of models that employed to capture the discretionary accruals. Consistent with Kothari, Leone, and Wasley (2005) and Ye (2006), the findings showed that in the Performance-Matching Model (2005) the mean adjusted R^2 seemed to be a little higher than for the Modified Jones Model (1995). Therefore, the Performance-Matching Model (2005) was used to test data of Libyan companies as to the best version of accruals models. Subsequently, collected findings from all those tests were related to the Performance-Matching Model (2005).

2- Findings indicate that all Libyan companies which have been tested in this study manage earnings. The results showed that there were mixed earnings management: some Libyan companies' managers use more income-increasing discretionary accruals (about 113 positive cases, 45%), and others Libyan companies' managers use more income-decreasing discretionary accruals (about 140 negative cases, 55%). As a result the sample selected in this study indicates that possibly all Libyan companies manage earnings.

3- As regards the audit report as the second part of secondary analysis data, earlier studies such as (Francis and Krishnan, 1999; Bartov e, Gul, and Tsui, 2001; Bradshaw, Richardson, and Sloan, 2001; Butler, Leone, and Willenborg, 2004; Davidson, Jiraporn, and DaDalt, 2006: Ajona, Dallo, and Alegria, 2008) confirm that companies manage earnings are more likely to receive a modified audit opinion, and modified audit opinions should be a function of discretionary accruals. Findings indicate that auditors of the agency and auditors working for him/her self issued in general 85.7% unqualified (clean) audit opinion for financial statements that have earnings management, and 11% modified audit opinion.

4- Prior empirical research such as (Pierre and Anderson, 1984; DeFond and Jiambalvo, 1991; Teoh and Wong, 1993; DeFond and Jiambalvo, 1993; Aharony, Lin, and Loeb, 1993; Becker, DeFond, Jiambalvo, and Subramanyam, 1998) which studies audit quality and tries to distinguish between high and low audit quality. These studies categorize audit quality by examining the extent to which detect and report earnings misstatements.

In light of the above findings and consistent with the audit quality definition by DeAngelo (1981b) that, in order to provide high audit quality, auditors should detect and report earnings misstatements, we can conclude that this is not the case in Libya. As result of the fact that all Libyan companies included in the sample manage earnings, and that there are a very small number of modified audit opinions that are issued by Libyan auditors. In addition, the results did not confirm any strong relationship between discretionary accruals and modified audit opinion in Libyan context, auditing can be questioned. It is important to note that there is an influence of the socio-political and economic situation on the audit profession in general and audit quality in particular, consistent with the previous study of Kilani, (1988) who stated that there are several factors that have influenced the development of the auditing profession in Libya since independence. These factors include accounting education, accountants coming from other countries, Libyan students returning from abroad (the USA and the UK), and the rapid change in the Libyan social, economic, political and legal environment. The influence of most of these factors has caused the Libyan auditing profession to follow the same path as its counterparts in the United States and the United Kingdom. Despite the impacts of these factors on the audit profession, the Libyan auditing profession for most of the 1950's had no regulation whatsoever: auditors could practise with no formal permission or licence. At the same time, there was no uniformity or consistency in the presentation of financial reports or certificates. In Libya, auditors have no defined or formal principles to work on; different auditors apply different accounting principles and different auditing standards and there is no theoretical foundation for the auditing profession in Libya. Auditors in Libya base their practices either on their experience with some of the international audit firms or on their accounting education in Libya or abroad. Whatever the case, little has been done to build any local theoretical or standards base for Libyan accountants to work from. The results in this section answer the first question in this study about the level of audit quality in Libya: audit quality level in Libya is low.

Qualitative Interviews analysis Findings

Qualitative interviews analysis was used to address the first, second and third research questions. In terms of the first question, it was as a support to the secondary data analysis to determine the level of audit quality in Libya. The second question asked about some factors affecting audit quality, and the third question related to how the audit quality in Libya could be improved. Discussions and conclusions parts related to key qualitative interviews analysis findings are summarized as follows:

1- As support to the secondary data analysis findings in the first section, the qualitative interviews analysis findings also indicated that the level of audit quality in Libya is low. For example, more than half of respondents in two groups (professional academics and external auditors) see the level of audit quality in Libya as low, and that there are many factors that cause this situation (which will be discussed below). The results of this section support the results in first section concerning to the level of audit quality in Libya.

2- Respondents' opinions on the effect of audit fees on audit quality in Libya vary. The findings indicate that the professional academics identifying a negative effect of fees. External Auditors take the view that audit fees do not affect audit quality, as audit fees in Libya are very low compared with audit fees in other countries. In contrast, and more consistent with the findings of previous research such as Simunic, (1980); DeAngelo, (1981); Palmrose, (1986); Simon and Francis, (1988); Ettredge and Greenberg, (1990); Dopuch and King, (1996); Craswell and Francis, (1999); Niemi, (2004); Niemi, (2005); Gonthier-Besacier and Schatt, (2007), the others respondents see that audit fees have a positive impact on audit quality in Libya. This opinion may refer to a particular situation inside the Financial Audit Agency, such as laws and regulations, therefore support previous findings.

3- Consistent with prior studies such as O'Keefe et al., (1994); Owhoso et al., (2002); Balsam et al., (2003); Wooten and Colson, (2003); Tangpinyoputtikhun and Ussahawanitchkik, (2008), the results overall confirmed that audit team characteristics are seen as having a positive impact on audit quality. The reason is that the audit team which has greater skills and relevant characteristics conduct sophisticated and advanced tests, leading to accuracy and in-depth analysis, flexibility in the application of audit standards, and the competence and independence and the due professional care in terms of planning, supervision and follow-up the performance of audits processes, knowledge and experience in the use of information technology and experience in the industry of the client. This view is not shared by the academics; they suggest that the derived characteristics are not, in fact, available in Libya. In their view, the lack of these characteristics has a negative effect on audit quality.

4- Even though, the professional academics did not confirm the existent of integrated and comprehensive audit steps according to generally accepted auditing standards (GAAS), and this absence cause a negative impact on audit quality in Libya. But others groups confirm that integrated and comprehensive audit steps available in the Libyan audit context and have positive impact on the audit quality. These results are consistent with previous research such as that of Hirst and Koonce, (1996); Lin and Fraser, (2003); Diaz and Wolfe, (2007).

5- Interestingly, non-audit services are not allowed to be supplied by the auditors of the Financial Audit Agency. This is prevented by law and such absence has a positive impact on audit quality in Libya. But for auditors from outside the Financial Audit Agency there is no law to prevent the auditor from providing non-audit services to the client. Professional academics and external auditors confirm that this factor has a negative impact on audit quality in Libya. Findings from this study related to this factor are consistent with earlier studies such as Schulte Jr, (1966); Simunic, (1984); and Wines, (1994). In contrast, presidents of Syndicates of External Auditors see that non-audit services have a positive impact on audit quality in Libya; this result is supported by several studies such as (DeBerg, Kaplan, and Pany, 1991; Arruñada, 1999; DeFond et al., 2002; Ashbaugh et al., 2003; Brandon et al., 2004). The findings are clearly consistent with the legal positions of agency and non agency auditors. On balance, it may be that most appropriate response in Libya would be to regulate the additional provision based on a resource and competence model.

6- As regards the auditor tenure and mandatory auditor rotation, just directors of the Financial Audit Agency confirm the existence of such a factor and its positive impact on audit quality. But in terms of the existence of such a factor, professional academics, external auditors, and presidents of Syndicates of External Auditors did not confirm its existence, and the absence of such a factor has a negative effect on audit quality. These findings consistent with the results of Burton and Roberts, (1967); Brody and Moscove, (1998); Vanstraelen, (2000); Dopuch et al., (2001); Johnson et al, (2002); Myers et al, (2003); Nagy, (2005); Ghosh and Moon, (2005);

Carey and Simnett, (2006); Chen et al., (2008); Manry et al., (2008); Jackson et al., (2008).

7- The findings supported the assumption that big firms provide higher audit quality. Findings indicate that no big audit firms exist in the Libyan audit context and such absence causes a negative impact on audit quality. These findings are consistent with the majority of studies to this factor such as DeAngelo, (1981b); Davidson and Neu, (1993); Becker et al.,(1998); Lennox, (1999); Francis et al., (1999); Reisch, (2000); Krishnan and Schauer, (2000); McLennan and Park, (2003); Gaeremynck and Willekens, (2003); Niemi, (2004); Chen et al., (2005); Alleyne et al., (2006); Davidson et al., (2006); Geiger and Rama, (2006); Lowensohn et al., (2007); Li et al., (2008); Hussainey, (2009).

8- Institute of Chartered Accountants in England and Wales (ICAEW), (2006) explained that auditing standards are an important part of the auditors' toolkit. Their primary purpose is to enable auditors to perform audits. Auditing standards are also helpful to regulators. But auditing standards cannot be a substitute for the proper training of auditors or regulators, the maintenance of ethical standards or professional integrity. In light of the above statement, results indicate that the absence of auditing standards in Libya causes a negative impact on audit quality; this result is consistent with several studies such as O'Keefe et al., (1994); Willekens, Steele, and Miltz, (1996); Schwartz, (1998); Turner, (2001a); Ping, (2007); Willekens and Simunic, (2007).

9- Analysis of qualitative data shown that the litigation in the Libyan audit environment does not exist, because there is no clear auditor responsibility, and the user of audit reports is not aware of his/her rights. The absence of litigation has a negative impact on audit quality. These results are consistent with prior research (Palmrose, 1988; Narayanan, 1994; Krishnan and Krishnan, 1997; Fargher et al., 2001; Vanstraelen, 2002; Mong and Roebuck, 2005; Venkataraman et al., 2008).

10- In line with previous research, the results have been given support for determining the effect of these factors on audit quality in Libya. The results in this section answer the second question in this study about factors which affect audit quality in Libya, thus the second objective of this study is addressed by determining factors that affect audit quality in Libya.

11- In order to address the third objective, it was been asked how can audit quality be improved in Libya? This objective deals with two main points: strategies for developing audit quality and obstacles and problems preventing the development of the audit quality. In terms of strategies, results indicate that there are fundamental elements which are themselves insufficient to lead to developing audit quality in Libya. These include factors such as administrative and financial incentives, commercial law, conferences, program of high degree in education, journals and magazines, membership in ARABOSAI, AFROSAI, and INTOSAI, rules of professional conduct and ethics, and training. In order to develop audit quality in Libya, these findings provide support for adopting fundamental elements as strategies for developing audit quality, such as an active professional body, rules of professional conduct and ethics, a board of accounting principles, laws, fellowship, conferences, training, and system of quality control. Other findings related to this point were supported by earlier studies mentioned above factors such as auditing standards, audit fees, audit tenure, non-audit services, audit firm size, and Litigation. Attention to these factors should help improve audit quality in Libya.

12- The second point as regards the third objective was obstacles and problems, which prevent the development of the audit quality in Libya. Findings indicate that the Libyan audit context suffers from some problems that prevent the development of audit quality due to the absence of fundamental elements. This has to be faced in order to develop audit quality in Libya. Factors such as instability, nature of audit market, no active professional body, no binding accounting principles, no binding auditing standards, no binding laws, no continuous training, no rules of professional conduct and ethics, no system of quality control, unqualified directors are all important here. This help address the third objective of this study is determining how audit quality in Libya can be improved.

There are others several factors that have influenced the development of the auditing profession in Libya, such as the socio-political and economic situation. Following nationalization in the early 1970s, nationalized companies have continued with the established practices and systems to the present day. Direct foreign oil investment in Libya has strongly influenced Libyan accounting practices and promoted the audit profession to operate within these wider international rules (Ritchie and Khorwatt, 2007). A major problem with the accounting education and auditing profession in Libya is that it is centered on Western accounting theories that lack legitimacy, not only because of the different system of economics and value of westerners espouse compared to those found in Libya. Returnees brought mainly from Britain and North America, during the latter years of the colonial period and then through the UN agencies after independence (Ahmed and Gao, 2004). Shareia (2006) stated that accounting education policies, and the need to have academic research in this field, are incompatible with the economic development requirements of developing countries in general, and in the Arab world and Libya, in particular because they do not reflect the specific context. The accounting education system must be amended so as to serve development needs by the creation of skills and the development of technical and organizational capacities, which the development plans need. This emphasis on development contrast strongly with the focus in western systems.

Recommendations

The recommendations are prepared from the literature review and the findings of the empirical investigation. Due to an unfavourable picture from the results of the secondary data and primary data, the following are some recommendations in order to solve the obstacles and problems in improving audit quality in Libya.

1- A board for accounting principles should be created for an appropriate framework to be developed based on the Libyan environment. This should generate binding accounting principles as a fundamental element, in order to help the audit profession achieve higher audit quality.

2- The current professional body should be more active, or a new, strong, professional body should be established. An effective role should be taken by such organization in order to develop the audit professional. This is in terms of creating and modifying some trade laws to regulate the Libyan economy to be consistent with the open market that will activate the audit profession, generate guide rules for professional conduct and ethics, create a fellowship through an examination as a condition for exercising the profession such as CPA in the U.S. and ACCA in the UK, organize different types of conferences at local, regional and international level, develop continuous training for practitioners of the profession, and institute a system of quality control for continuous assessment, in order to discover the weakness in the profession and take any necessary steps for enhancing audit quality.

3- Binding local auditing standards and laws must be created and innovated to be appropriate to the environmental factors of the developing country. This should result in the interaction of internal environmental factors to assist in the development and growth of the community, or adopting what exists in developed countries, but it should take into account features of the internal environment of the Libyan audit situation.

4- Consistent with the literature review, and based on the results of primary data analysis, laws should be created to regulate and support factors that have proven impact on audit quality: factors such as audit firm regulation, audit fees content, audit tenure limits, provision of non-audit services, and litigation for clients.

5- Efforts should be made to generate more stability in the Financial Audit Agency, decisions of annexation and separation of the agency from other agencies in the State causes the absence of an administrative stability. Thus, the agency cannot implement plans and strategies for developing their work. In addition, the chairman of the Financial Audit Agency should be specialized in accounting and auditing.

6- The nature of audit market in Libya is so weak, attempts should be made in Libya to develop higher fees, more competition and participation, demand should be more related to supply, interest should be stimulated further for audit report users, extra diversity in productivity, capital market should be more effective, it should be made professional responsibility or legal responsibility, entry barriers to the profession should be created, and decision makers in the state should concentrate on the audit profession, deciding how audit quality can be improved and then to take the steps to do so.

The contributions of the study

In the light of the results of this study, contributions have been made by this thesis to an understanding of audit quality in Libya. The following are some contributions:

1- It provides empirical evidence and adds to our understanding of audit quality in Libya. For example, it found that auditors in the Libyan audit market provide low audit quality services.

2- This study used qualitative and quantitative methods, primary data (semi-structured interviews) and secondary analysis of data in order to enhance the study results. This was the data triangulation approach which is novel in this field. Using primary data (semi-structured interviews) led to an in-depth understanding of factors effecting audit quality. An analysis of cross-sectional data (secondary analysis of data) derived from sample of Libyan companies, which would help to achieve the powerful and reliable of the results of this study. This type of approach could be of benefit elsewhere.

3- This study contributes to research on earnings management in Libya, and provides literature about discretionary accruals and the association between discretionary accruals and audit opinion. There is no previous work that has tested the association between discretionary accruals and audit opinion in Libya before.

4- It provides auditing literature with more evidence on the effect of some related factors on audit quality in Libya such as audit firm size, audit fees, audit team characteristics, audit steps, non-audit services, the auditor tenure and mandatory auditor rotation, auditing standards, litigation. Some of these have not been studied by researchers in Libya before.

5- The policy recommendations developed in this study that has been taken from the findings for Libyan regulations. These may be useful in improving audit quality in Libya.

6- The study would contribute to opening up an exchange of ideas within Libya and other developing countries on the issues of the audit profession, in terms of audit quality. It highlights the contribution, which could help improve audit quality in Libya through cooperation between academics, external auditors, regulators, and governments.

Limitations of the study

Although this research study was conducted on a systematic basis under supervision, it might suffer from some limitations. Nevertheless, a significant effort was placed on ensuring that the objectives of the study were met and the research questions were answered. The following are some limitations with this study:

1- This study, as with any other, has limitations. A considerable emphasis was placed in achieving the goals of the research through effective use of appropriate techniques applied within a framework suitable to the task. Some specific issues, of course, remain. Developing countries often have specific social and economic characteristics in common which directly influence the conduct of social research. As a basic principle, one should have adequate knowledge about the local environment of the country in which the research is going to be undertaken. This condition is met here. However, in translating research from western countries to the Libyan context, it might not in fact be appropriate for Libyan circumstances, or those of other developing counties have specific social and economic environments not present in the west. Contextual effects may be strong, but a different research design would be needed to test this.

2- As seen in prior studies, the literature on audit quality has deeply concentrated on audit quality in terms of the difference in audit quality between types of auditors such as (Big 4 *vs* No Big 4). Further, the literature on audit quality has been mostly supply-driven. Treating audit firms size as exogenous creates concerns about the true causal relation between audit firm size and audit quality. In other words, do bigger audit firms provide higher audit quality because they are bigger or are larger audit firms bigger because they deliver higher quality? The arguments build essentially on supplier characteristics and auditors are assumed to cater to one specific segment of the audit market based on their size. How key characteristics of the demand for audit services affect audit behaviour are ignored. As such, the literature offers no explanation as to why any one segment of the audit market should dominate the other.

3- This study relies on two key approaches to collect information to investigate audit quality in Libya. Such approaches are the secondary data analysis and primary data gathered through semi-structured interviews. In terms of secondary data analysis, the initial sample has consisted of ninety companies which are 'national' and major private unlisted companies. These companies were all in the industrial sector. Listed companies were excluded from the sample, due to the fact that on the Libyan stock market there are only companies from finance and insurance sectors, and these companies have fundamental differences in the nature of their accruals. The approach, and the lack of truly comprehensive data on company financial reports in Libya, creates a limitation that cannot be directly addressed at this time.

4- Financial statements of companies were hand-collected personally from companies themselves and the Financial Audit Agency, because in Libya there is no database for obtaining the financial statement data. In addition, access to data in developing countries is very difficult and it often takes a long time to obtain necessary permission. Thus, in some cases there were difficulties in obtaining full financial statement data and audit reports related to this data for some companies. Some respondents saw data as secret or sensitive, and were initially reluctant to release it. It also seemed at times that the data were, in fact, lacking.

5- Researcher bias is always presents when conducting interviews, so it is possible that a different interviewer would have obtained different result.

6- The empirical test results based on secondary analysis of data in the first stage of this study using discretionary accrual models should be treated with concern since discretionary accrual models are only a statistical proxy of earnings management at the firm level. Results might not necessarily mean that the selected companies essentially managed their earnings. Further, the adjusted R^2 or the coefficient of determination of the regression model was around 29%, implying that 71% of the variation could be explained by other an included variables, or models. The approach taken has explained around 29% of the studied effect. This might, in absolute terms, be seen as low – but the model developed here out performs others, where R^2 may reach 13% or even 8%. This shows that the model approach is capable of development, and type used here is perhaps the best available. However, explaining the total variation may require the inclusion of further variables outside current parameters. This limitation of the model, in its current form needs to be recognized. Further extensive research would however be required to address this issue.

Future research

Based on the above findings of secondary and primary data analysis, it can be concluded that the level of audit quality in Libya is low, and is expected to remain so in the near future. As result, regulators have much to do in order to improve audit quality in Libya by creating some necessarily elements such as, new laws, auditing standards, a board of accounting principles, an active professional body, rules of professional conduct and ethics. Overall, taking these considerations into account and the main limitations of this study, the following paragraphs highlight some of the points that could be considered interesting potential for future research:

1- The existence of earnings management in Libya needs further examination through using different approach, such as the specific accruals approach, or the frequency distribution approach; it would be useful to confirm the investigation of earnings management in Libyan companies.

2- It would be important to gain a deeper understanding of the relationship between the modified opinions and abnormal accruals in Libya, to find out if firms receive modified audit opinions because they are engaging in extreme earnings management.

3- Due to the scope of the study being necessarily restricted several important factors related to audit quality such as laws, auditing standards, a board of accounting principles, an active professional body, rules of professional conduct and ethics were identified as needed. Further studies should be conducted in the future related to these factors to confirm these requirements.

4- Another area that requires deeper research is the effect of some existing factors in the Libyan audit market such as audit fees, audit team characteristics, audit steps, non-audit services, and the auditor tenure and mandatory auditor rotation, distinguishing between auditors in terms of a availability of these factors and their impact on audit quality, through measuring discretionary accruals and the modified audit opinion issued by different auditors.

Personal reflection

For me this PhD has been a journey of much more than three years of hard work. This thesis is to some extent a reflection of who I was, who I am, and where I am going. I believe that some factors such as our academic background, our previous work experiences, and our culture have a strong influence in the manner we choose, in the way we approach problems, and in our analytical capability. One aim of the PhD process is to train you to be a professional researcher: this is why I think that I am now on the beginning of the way to be a fully professional researcher, to start to research by myself, to extend the area which I have chosen. I think I am now capable of making such extensions.

During my stay in the UK I learned much more than I thought I would achieve, through knowing a new culture and different things in general, and in my daily life. This was not just to learn a new language, but also the use to technology in order to research and to be able to use words, so as what find out about any of the phenomenon under study.

Before I come to the UK I had questions about the audit profession in my country Libya; what is the situation? As there is little research about this profession in Libya, I could learn little about the audit profession in Libya. So I started to ask myself what is the level of audit quality in Libya? How can audit quality be measured? And why is the situation like that?

I started my research more than three years ago, investigating audit quality in Libya, by going back to a literature review to find out, in different studies, how researchers elsewhere dealt with the same topic. Through reading what seemed a huge number of articles and books, I found one way to achieve the aim. Earnings management and audit report were the two main approaches to address the first objective. For me this was new knowledge, I did not know anything about first point (earnings management) such as definitions, motivations, and techniques, and the statistical models which use to capture earnings management. In addition I have obtained information about the audit report in Libya. Furthermore, I learned how to use specific methods to collect data, to analyses data, and to abridge results from both primary and secondary data.

Data collection was one of the most challenging parts of this study. I never thought that it would be so difficult and time consuming to gather the required data. Financial statements for companies' years from 2006 to 2009 were hand-collected personally from the companies themselves and the Financial Audit Agency, because in Libya there is no database for obtaining financial statement data. In addition, in some cases there were difficulties in obtaining full financial statement data and the audit reports related to this data of some companies. For conducting semi-structured interview I faced refusals to have the interview recorded from some participants. (It should be noted that with interviewees in the developing countries, this is not uncommon, as developing countries have many social and economic characteristics in common which directly influence the conduct of social research, so Libya is no exception).

Personally, I think that to some extent this study reflects the evolution of my analytical manner. This PhD lets me draw a more complete picture of the reality of audit quality in Libya and to identify some factors that play the key role in driving audit quality in Libya.

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Appendices

Appendix 1

The interview agenda (English version)

The level of audit quality

Q 1 how do you see the quality level of the audit services in Libya? Why?

Factors affecting audit quality

Q 2 What are the factors which affect audit quality in Libya? Why and how do these factors affect the quality?

Q 3 What are the other factors which are not available in Libya and which affect audit quality in Libya? How? Why?

Strategies to develop audit quality

Q 4 what are the current strategies and plans being used to develop the audit quality in Libya?

Q 5 Do you think these strategies and plans are sufficient to develop audit quality in Libya?

Q 6 what is the strategies and plans could be adopted for the development of the audit quality in Libya?

Q7 what are the obstacles and problems which prevent the development of the audit quality in Libya?

Appendix 2

The interview agenda (Arabic version)

مستوى جودة خدامات المراجعة

س1 ما هو في اعتقادك مستوى جودة خدامات المراجعة في ليبيا؟

العناصر التي تؤثر في جودة خدمات المراجعة

س2 ماهي في اعتقادك العناصر الموجودة حاليا في البيئة الليبية التي تؤثر في جودة خدمات المراجعة؟ كيف ولماذا تؤثر هذه العناصر في جودة خدامات المراجعة؟

س3 ماهي في أعتقا دك العناصر الغير موجودة في البيئة الليبية التي بغيابها تأثرت جودة المراجعة في ليبيا؟ كيف ولماذا أثر غياب هذه العناصر في جودة خدامات المراجعة في ليبيا؟

الإستراتيجية والخطط لتطوير جودة خدامات المراجعة

س4 ماهي الإستراتيجية والخطط المتبعة حاليا لتطوير جودة خدامات المراجعة؟

س5 هل تعتقد أن هذه الإستراتيجية كافية لتطوير جودة خدامات المراجعة؟

س6 ماهي الإستراتيجية التي يمكن أن يتم تبنيها لتطوير جودة خدامات المراجعة؟

س7 ماهي العوائق التي تعتقد أنها تحول دون تطوير جودة خدامات المراجعة؟

Appendix 3

The Transcript of interview with Auditing Professional Academics (English version)

Personal Information:

Position: Auditing professor

Educational qualification:Doctoral degree

Years of Exerience in the Position: 12 years

Q 1 how do you see the quality level of the audit services in Libya?

I believe that the quality of audit services in Libya is very low, weak. And I can say what are the reasons that made the quality of audit services in Libya is weak. We note that most of the economic companies in Libya are semi-collapsed, they started with financial failures, financial difficulties, and then go into bankruptcy, then filtered, and then ceased altogether. The reason is that the external audit is a general framework and is considered the last tool in order to make control on financial information, if the external auditor does not indicate a defect in the accounting system, the defect in the operations, misstatements in financial information, errors, fraud, embezzlement, misuse of resources, then how can problems will be discovered and treated before reaching to the stage of collapse and bankruptcy.

So I can say that the auditor did not completely do his/her duty, because the auditor did not indicate to the problems that were exist in the company, the company has been stopped this means the company was achieving losses, the company had problems in the sources of funding and liquidity, problems in sales, problems in production.

The External Auditor supposed to pay attention to these problems and refers on them in his/her audit report. This explains the external auditor is only interested in financial matters. Even the financial matters that are interested by the external auditor unfortunately are not given a good work that conforms to auditing standards that must exert adequate professional care.

Q 2 What are the factors which affect audit quality in Libya? Why and how do these factors affect the quality?

A. Audit fees

Audit fees in Libya are very low compared to other countries .There is a big difference between audit fees in Libya and other countries. The perception of financial statements of a big company is audited for the amount of 5000 dinars. As you say the fees are very low, the manager's company tells you to audit three months of the year only: the first month; the medal month; and the end month. Audit fees in Libya do not fit with the required amount of work and thus audit fees have a negative impact on audit quality in Libya.

B. Non-audit services

This element exists in the Libyan audit environment. Auditors in Libya provide non-audit services to the client. But the important point is the impact of providing these kinds of services on the audit quality. I can say that the provision of non-audit services in communities aware of the importance of the audit will result in positive effects, not negative, because these communities recognize the importance of the audit profession and thus they put the necessary conditions and rules to avoid negative impacts on the profession through providing such kind of services. But this element has a negative impact on the audit profession in Libya. In other words, the audit office must have the potential such as various and different audit teams can provide non-audit services and audit teams for the normal audit processes. Also it should not affect the provision of non-audit services on the auditor to issue a dissenting or inappropriate or undesirable opinion to the client, in this case the auditor can provide non-audit services to the client. But the Libyan audit environment is weak in terms of income, the number of audits is few for both big or small audit offices, except two or three offices dominating the audit market in Libya and the dominance is not because they provide higher audit quality processes but because they have good relationships with many companies. In short, the provision of non-audit services is the factor which has a negative impact on the quality of audit in the environment such as Libyan environment. The reason is that there is low audit income, the demand on audit services is low, and therefore this element represents the proportion of high income and may affect the decisions of auditors.

C. Audit team characteristics

In this regard I have another study on the basis of the selection of the External Auditor. Here you mean that the auditor who has the qualification, experience, and knowledge in the industry of the client. In the Libyan audit environment there is no client to ask the auditor to audit financial statements of companies based on his/her experience and specialization of audit, but audits in Libya are based on relationships, the auditor does not reject the work because he/she is non-specialized or he/she has not the potential to do the work. In short, if this factor existed there would be a positive effect on the quality of audit in Libya.

Q 3 What are the other factors which are not available in Libya and which affect audit quality in Libya? How? Why?

A. Audit firm size

The absence of this element has no influence in Libya due to the absence of the basic components of the profession. The profession in Libya is considered a weak entity its services do not required, legally binding is not available, there is no fear of the law to punish them, and it is just completing worksheets. It is not a profession in the form located in the U.S. and the UK which provides benefits to the community.

B. Auditor tenure and mandatory auditor rotation

There is no mandatory auditor rotation in Libya. This element has no effect on the level of the audit quality in both cases, a short or long period of contact, because there is no quality at all. You can see that in Libya the auditor gives a conservative audit report always, the auditor is looking for simple things that do not affect the kind of report, and in the end the auditor issues a conservative report. The length of the contact between the auditor and the same client exists in the Libyan audit environment, but in my belief this element in the environment such as the Libyan environment does not work and does not affect in any way, the quality which is low in all cases, either a long period or short period. The reason is that there are no auditing standards and professional ethics in order to regulate the audit profession in Libya.

C. Litigation

There are those who use this element as an indicator of quality, and I am against this opinion because there are other audit environments where there is no lawsuit, such as Libya and the level of quality is also very low. Libyan courts also have not encountered auditors until this moment. There have been no cases of lawsuits against auditors, since companies are state-owned, the state did not make claims against the auditors who failed to express an opinion. The reason for this is that, the information users are unaware of the benefits anticipated by the External Auditor, and thus limitation of liability is not known, such as in the U.S. and the UK. Also the reason for the lack of prosecutions against auditors is because there is no criteria to measure the failure of the audit, therefore there is no litigation, because there is no specific responsibility of the auditor, there is nothing by the profession or any other law which sets out a process failure of the audit, and the auditor responsibility for that. There must be measurement for a responsibility in the case of failure of the audit process, and it must reflect all the requirements and the work nature of measurements, and then we can litigate for negligence in the same measurements, rules and laws binding. And therefore it will pay auditors to make more effort, thus the auditor will introduce a better quality services. The absence of this element has a negative impact on the quality of the audit profession in Libya.

D. Audit steps

There are no audit steps in accordance with generally accepted auditing standards from assessing the internal control system and planning, etc. In the sense that, what exists in Libya is that, something is random and does not represent audit steps according to generally accepted auditing standards. This is another reason why the audit quality in Libya is very low.

E. Auditing standards

There are no binding auditing standards in the Libyan audit environment. Auditing standards are general standards in its concept and so far no regulatory institution can define what this concept means or this standard. Maybe some professors who have experience in audit area are able to explain what is meant by the concepts; they may apply audit concepts well. But no one is allowed, because the audit report is just attached to financial statements of the company. Auditing standards are not available and non-binding and professional ethics are not available and non-binding. The most important point is that there is no body to regulate the profession to do all that is missing: the development of auditing standards and professional ethics, and evaluation and development of the profession in Libya. There is no continuous education and qualifying. Therefore, these have a negative impact on the quality of the audit.

Q 4 what are the current strategies and plans being used to develop the audit quality in Libya?

There is no strategy, no training, and no fellowship, no conferences, no magazines or journal in order to develop the audit profession in Libya, except some writings from academics in the framework of scientific research. In addition, the syndicate did not do anything for developing the audit profession.

Q 5 Do you think these strategies and plans are sufficient to develop audit quality in Libya?

There is no strategy in the basis for developing the audit profession in Libya.

Q 6 what is the strategies and plans could be adopted for the development of the audit quality in Libya?

There must be a professional body to regulate the audit profession in Libya. The syndicate exists just for the administrative procedures of the registration for those leaving and entering the profession. The syndicate does not have any role in the development and training, it is politicized. Meaning that no body puts an integrated structure, a criterion is related to the profession, professional ethics, and how the profession can be evaluated and controlled. Indeed, in Libya, the quality of the audit does not exist, and the elements to achieve this quality do not exist, and the demand for quality is low. There must be continuous training, there must be a continuous assessment, binding standards, and binding professional ethics. All these requirements do not exist in the Libyan audit environment in order to obtain a higher audit quality. However, it is by empirical study of Master degree, it has been found that certain standards have been contained in commercial law and the law profession in Libya, No 116 for the year 1973, the law says that the auditor must hold bachelor's degree and says that the auditor must stay for five years of training in the audit office before being allowed to practice the audit profession, and the person who holds a Master's degree in accounting be granted a license to practice the profession without a period of training. But an examination as a condition for exercising the profession does not exist, such as CPA in the U.S. and ACCA in the UK. In Libya quality control is not required.

Q7 what are the obstacles and problems which prevent the development of the audit quality in Libya?

There are no specialists in the field of the client industry.

Also there are no institutions to control the economic companies because they are public sector. Auditors in a few cases are exposed to a small number of problems, perhaps auditors refer to some minor problems which do not affect the type of the audit report, because auditors in the end will give a clean report or in the worst circumstances, a conservative report.

In addition, it does not build on the audit report in cases which are very important issues, such as lending, and investment. There is not an effective capital market which could activate the audit profession. The reason the capital market activates the audit profession, is that the investor needs someone to ensure future investments. The investor needs to ensure that the investment will generate profits in the future. Therefore it is not enough for the auditor to say that the financial information is consistent with the books, but they are required to say that the company will continue or not, whether there is fraud or not in the company, whether there is optimal use of resources or not in the company, whether there is good operation in the company or not, and if there is efficiency and effectiveness or not.

In addition, the lending institutions are not interested in the audit report; perhaps because their orders come from higher places in the state, and in these state-owned companies, even if a company is losing money, the state will simply step in to give it a loan.

It can be said that the audit report is a process or a legal requirement just to complete routine financial procedures. The audit report is not to preserve assets, the accuracy of data, the development of efficient work, or to ensure the administrative and financial policies set for the company, and the company's development and growth.

The demand for the audit profession is now very weak. The reason for this is that no one benefits from the audit profession, users of financial statements are rejecting the idea of paying the cost of the audit, they are not willing to bear this cost, because they do not feel the benefit from this information and the audit report does not add anything to their business. Therefore, I think that there is an absence of auditing standards, lack of professional ethics, the absence of continuing education, auditors in Libya do not attend seminars, do not attend conferences, do not attend scientific debate. I expect when auditors hear that there is a discussion Master or PhD related to the audit they will attend, because many of them do not know anything about the evidence, independence, and assessment of the internal control system.

I believe that auditors in Libya have many problems, such as continuous development and qualifying, there are no institutions which ask the auditor to develop like the U.S. and the UK. There is in these countries a commitment to qualify and develop through spending about 120 hours of training over three years. There is no system of quality control in audit firms, for example there is no regular checking of the office every three years. The supply and demand is very weak in the capital market in Libya.

In conclusion in Libya there are several problems concerning the issue of quality, these problems prevent the profession from playing its role to provide a higher audit quality.

Appendix 4

The Transcript of interview with Auditing Professional Academics (Arabic version)

قائمة أسئلة المقابلات الشخصية

المعلومات شخصية

المهنة: أستاذ مشارك في المراجعة

المؤهل الدراسي : دكتوراه

سنوات الخبرة في هذه المهنة : اثنتي عشرة سنة

س1 ما هو في اعتقادك مستوى جودة خدامات المراجعة في ليبيا؟

أنا في اعتقادي أن مستوى جودة خدامات المراجعة في ليبيا منخفض جدا, ضعيف. و لعلي أستطيع أن أقول ما هي الأسباب التي جعلت مستوى جودة خدامات المراجعة في ليبيا ضعيف. نلاحظ أن معظم الشركات الاقتصادية في ليبيا شبه انهارت, بداء بتعثر مالي, ومن ثم عصر مالي, بعدها صفيت, وبعدها توقفت تماما. السبب في ذلك أن المراجعة الخارجية هي أطار عام قناة أخيرة من قنوات الرقابة, فإذا كان المراجع الخارجي لا يبين الخلل في النظام المحاسبي, الخلل في التشغيل, الخلل في المعلومات المالية, الأخطاء والغش والاختلاسات, سؤ استخدام الموارد لكنوا تمكنوا من اكتشاف الحقيقة وتمت المعالجة المشاكل قبل الوصول إلى مرحلة التعثر ثم الإفلاس. أذن أستطيع أن أقول إن المراجع كان مقصر, لأن المراجع لم يشير إلى المشاكل التي يعاني منها المشروع. بمعنى أن المشروع توقف, هذا يعني أن المشروع كان يحقق في خسائر, معنى أن المشروع لديه مشاكل في مصادر التمويل والسيولة, لديه مشاكل في المبيعات, مشاكل في الإنتاج. هذه الأمور مفروض على المراجع الخارجي أن ينتبه أليها ويشير أليها في تقريره, وهذا يدل على أن المراجع الخارجي لا يهتم ألا بالأمور المالية.

حتى الأمور المالية التي يهتم بها المراجع الخارجي للأسف لم يعطها نصيبها من العمل الجيد الذي يقابل على الأقل معايير المراجعة, أنه لا بد من بذل العناية المهنية الكافية.

س2 ماهي في اعتقادك العناصر الموجودة حاليا في البيئة الليبية التي تؤثر في جودة خدمات المراجعة؟ كيف ولماذا تؤثر هذه العناصر في جودة خدامات المراجعة؟

ج2-1 أتعاب المراجعة

إضافة إلى ذلك انخفاض الأتعاب, أتعاب المراجعة في ليبيا منخفضة جدا مقارنة بالدول الأخرى بشكل غير عادي. تصور أن قوائم مالية لشركة كبيرة يتم مراجعتها بمبلغ 5000 دينار فقط. لما تقول يا جماعة الأتعاب منخفضة جدا يقولك راجع ثلاث أشهر من السنة فقط : السنة الأولى: وسنة من الوسط: وسنة من الأخير. أتعاب المراجعة في ليبيا لا تتناسب مع حجم العمل وبالتالي لها تأثير سلبي.

ج2-2 تقديم الخدمات الأخرى

هذا العنصر موجود في بيئة المراجعة الليبية, والمراجعين في ليبيا يقدموا خدامات أخرى غير المراجعة للعميل. ولكن والمهم هو أثر تقديم هذه الخدامات الأخرى على جودة المراجعة. أستطيع أن أقول أن تقديم الخدامات الأخرى في المجتمعات التي تدرك أهمية المراجعة سينتج أثار ايجابية وليس سلبية, لأن هذه المجتمعات تدرك أهمية مهنة المراجعة وبالتالي ستضع الشروط والقواعد اللازمة لمفاداة التأثر السلبي للمهنة بتقديم هذه الخدمات الاستشارية.لكن هذا العنصر له تأثير سلبي على مهنة المراجعة في ليبيا. بمعنى أخر أنت كمكتب مراجعة يجب أن يكون لديك إمكانيات أي فرق عمل مختلفة تستطيع أن تقدم خدامات المراجعة وفرق تقدم الخدامات الأخرى.

أيضا يجب أن لا يؤثر تقديم الخدامات الأخرى على المراجع فيما لو أعطى رأى مخالف أو غير مناسب أو غير مرغوب فيه من قبل العميل, في هذه الحالة يستطيع المراجع أن يقدم الخدامات الأخرى للعميل. لكن بيئة المراجعة ضعيفة من حيث الدخل, عدد عمليات المراجعة لا تذكر سؤ كانت مكاتب مراجعة كبرى أو صغرى.باستثناء مكتبين أو ثلاثة مكاتب مسيطرة على شغل المراجعة في ليبيا والسيطرة ليست بجودة الخدامات ولكن بمستوى العلاقات. باختصار تقديم الخدامات غير المراجعة عنصر موجود في البيئة الليبية وله تأثير سلبي على جودة خدامات المراجعة في ليبيا. والسبب دخل المراجعة منخفض, الطلب على خدامات المراجعة منخفض, وبالتالي هذا العنصر يمثل نسبة عليا من الدخل وبالتالي ربما يؤثر على قرارات المراجع.

ج3-2 مميزات فريق عمل المراجعة

في هذا الخصوص لديه دراسة أخرى حول أسس اختيار المراجع الخارجي. وهنا أنت تقصد المراجع الذي يتوفر فيه التأهيل والخبرة والدراية والمعرفة قي مجال عمل العميل. في بيئة المراجعة الليبية لا يوجد تكليف بمراجعة قوائم مالية للشركات أسس على خبرة وتخصص المراجع, ولكن تكليف المراجعين مبني على العلاقات, و المراجع لا يرفض العمل باعتباره غير متخصص ولا يملك الإمكانيات للقيام بهذا العمل. باختصار هذا العنصر إذا توفر سيؤثر بالإيجاب في جودة المراجعة في ليبيا.

س3 ماهي في أعتقا دك العناصر الغير موجودة في البيئة الليبية التي بغيابها تأثرت جودة المراجعة في ليبيا؟ كيف ولماذا أثر غياب هذه العناصر في جودة خدامات المراجعة في ليبيا؟

ج3-1 حجم شركة المراجعة

غياب هذا العنصر ليس لها تأثير في ليبيا في ظل غياب المقومات الأساسية. لأن المهنة في ليبيا عبارة عن كيان ضعيف غير مطلوبة خداماته, حتى الإلزام القانوني غي متوفر وليس هناك خوف من القانون أن يعاقبهم, هي مجرد استكمال أوراق. هي ليست مهنة بالشكل الموجود في أمريكيا وبريطانيا مهنة تقدم منفعة للمجتمع.

ج3-2 دوران المراجع الإجباري

لا يوجد دوران إجباري للمراجع في ليبيا, وليس له تأثير على مستوى الجودة سؤ كانت الفترة قصيرة أو طويلة, لأنه لا توجد جودة في الأساس. لأن المراجع دائما يعطي تقرير متحفظ وهو يبحث عن الأشياء الشكلية التي لا تؤثر وفي النهاية يعطي تقرير متحفظ. طول الفترة هو عنصر موجودة في بيئة المراجعة الليبية, ولكن أنا في اعتقادي أن هذا المتغير في البيئة الليبية متغير لا يعمل ولا يؤثر بأي حال من الأحوال لأن الجودة متدنية في جميع الأحوال سؤ في طول الفترة أو قصر الفترة وذلك بسبب غياب معايير المراجعة وأخلاقيات المهنة.

ج3-3 المقاضاة أمام المحاكم

هناك من يستخدم هذا العنصر كمؤشر للجودة, وأنا ضد هذا الرأي لأن هناك بيئات مراجعة أخرى لا يوجد فيها دعوى قضائية مثل ليبيا و مستوى الجودة متدني جدا أيضا. والسبب في ذلك أن مستخدمي المعلومات غير مدركين للمنافع المتوقعة من قبل المراجع الخارجي وبالتالي حدود مسئوليته غير معروفة مثل أمريكيا وبريطانيا. والسبب في عدم وجود

مقاضاة ضد المراجعين لأنه لا يوجد معايير لقياس فشل المراجعة وبالتالي لا يوجد مقاضاة لأنه لا يوجد مسئولية محدد للمراجع لا يوجد أي شيء صادر عن المهنة أو أي قانون يحدد عملية فشل المراجعة ومسئولية المراجع اتجاه ذلك, أي يجب أن يكون هناك مقاييس للمحاسبة في حالة فشل عملية المراجعة, ويجب أن يبين كل شيء المتطلبات وطبيعة عمل المقاييس ومن ثم تحاسب المقصرين بنفس المقاييس والقواعد والقوانين الملزمة. وبالتالي سوف تدفع المراجعين لبذل مزيد من الجهد وبالتالي سيقدم جودة خدمات أفضل. فلغياب هذا العنصر تأثير سلبي على مهنة المراجعة في ليبيا.

أيضا القضاء الليبي لم يحتك بالمراجعين إلى هذه اللحظة. لا يوجد قضايا قضائية ضد المراجعين, باعتبار أن الشركات مملوكة للدولة فالدولة لم تتقدم بدعاوى ضد مراجعين أخفقوا في إبداء الرأي.

ج3-4 خطوات المراجعة

لا يوجد خطوات مراجعة طبقا لمعايير المراجعة المقبولة من تقييم نظام الرقابة الداخلية وتخطيط إلى أخره بمعنى أن الموجود شيء عشوائي وأن وجد لا يمثل نسبة تذكر. وهذا سبب أخر في تدني مستوى جودة خدامات المراجعة في ليبيا.

س4 ماهي الإستراتيجية والخطط المتبعة حاليا لتطوير جودة خدامات المراجعة؟

لا يوجد إستراتيجية للتطوير.لا تدريب, لا زمالة, لا مؤتمرات, لا مجلات, لا نشرات إلا بعض الكتابات من بعض الأساتذة في أطار البحث العلمي. النقابة لم تقوم بأي شيء لتطوير المهنة.

س5 هل تعتقد أن هذه الإستراتيجية كافية لتطوير جودة خدامات المراجعة؟

لا توجد إستراتيجية في الأساس للتطوير.

س6 ماهي الإستراتيجية التي يمكن أن يتم تبنيها لتطوير جودة خدامات المراجعة؟

المطلوب جسم لتنظيم المهنة. الموجود حاليا نقابة فقط للإجراءات الإدارية لتسجيل من يخرج ومن يدخل فقط , ليس لها دور في تطوير والتدريب وهي مسيسة. أي لا يوجد جسم يضع هيكلية متكاملة: معايير متعلقة بالمهنة, أخلاقيات مهنية, كيف يتم التقييم والرقابة على المهنة.

الحقيقة أنه في ليبيا جودة المراجعة ليست موجودة و مقومات تحقيق هذه الجودة غير موجودة, و الطلب على الجودة منخفض. يجب أن يكون هناك تأهيل مستمر, يجب أن يكون هناك تقييم مستمر, معايير ملزمة, أخلاقيات مهنة ملزمة وهذا غير موجود في بيئة المراجعة في ليبيا.

ألا أنه ومن خلال دراسة ماجستير أجريناها, تبين أن هناك بعض المعايير الواردة في القانون التجاري والقانون المهنة في ليبيا 116 لسنة 1973 قانون صادر من الرقابة يقول أن المراجعة يجب أن يكون حامل درجة البكالوريوس ويقول أن المراجع يجب أن يبقى خمس سنوات تحت التدريب في مكتب المراجعة قبل أن يسمح له بممارسة المهنة, ويمكن لحامل درجة الماجستير في المحاسبة أن يمنح الترخيص لمزاولة المهنة بدون مدة تدريب.

غير موجودة, رقابة ACCA, CPAلكن عملية الامتحان كشرط لممارسة المراجعة كموجود في أمريكيا و بريطانيا الجودة غير مطلوبة, معايير المراجعة غير متوفرة وغير ملزمة, أخلاقيات المهنة غير متوفرة وغير ملزمة.

س7 ماهي العوائق التي تعتقد أنها تحول دون تطوير جودة خدامات المراجعة؟

لا يوجد معايير مراجعة ملزمة التطبيق قانونا في بيئة المراجعة الليبية.

معايير المراجعة هي معايير عامة في مفهومها و للآن لا يوجد مؤسسة رقابية تستطيع أن تحدد ما المقصود بهذا المفهوم أو هذا المعيار.

تخيل في أحدى الدراسات عرضنا مفاهيم المراجعة. أذا كنت تعرف ما هو المعيار وكيف يتم التطبيق. تصور أننا عرضنا مفهوم التخطيط, أي ما هو المقصود بمفهوم التخطيط لدى المراجع. المراجع في ليبيا لا يعرف ما هو المقصود بمفهوم التخطيط, فالمراجع أختار المفاهيم الخاطئة: ما معنى الأشراف على المساعدين, هو يعتقد أن الأشراف على المساعدين أنه بمجرد أنك ترى المساعد موجود في العمل. وهو لا يعتقد أن المساعد يجب أن تتم متابعته إلى أين وصل التقدم في العمل, ما المشاكل التي تواجهه, كيف يطبق معيار جمع الأدلة, ما هي الأدلة والبراهين التي يجب أن يجمعها, ما هي الأدلة التي يجب أن يتجاهلها, فهو لا يعرف.

ربما بعض الأساتذة المحترمين المخلصين في مجال عملهم الذين لديهم خبرة في مجال المراجعة ولديهم بعد علمي في مجال المراجعة ويستطيعوا أن يفسروا ما هو المقصود بالمفاهيم, ربما يطبقوا مفاهيم المراجعة بشكل جيد. لكن لا احد يسمح لهم, لأن التقرير يرفق بالتقرير المالي للمؤسسة وينهي بعدها كل شيء.

لدي دراسة عن تخصص المراجعة بمعنى لا يوجد لدينا متخصصين في مجال العميل.

أيضا لا يوجد جهات تتابع المؤسسات الاقتصادية بحكم أنها قطاع عام, هذه ليست جمعية عمومية تعرض تقرير المراجع وتدرسه, حتى ولو أن المراجع وفي أحيان قليله جدا تعرض لعدد بسيط لا يذكر من المشاكل, ربما المراجع يشير إلى بعض المشاكل البسيطة التي لا تؤثر في نوعية التقرير, لأن المراجع في النهاية سيمنح تقرير نظيف أو في أسوء الظروف تقرير متحفظ.

بالإضافة إلى أنه لا يعتمد علي تقرير المراجعة في قضايا مهمة جدا مثل قضايا الإقراض, الاستثمار. أذا كان لدينا سوق مالي يستطيع أن يحرك مهنة المراجعة, لأن سوق المال يحرك مهنة المراجعة والسبب لأن المستثمر يحتاج إلى شيء يضمن له استثماراته المستقبلية, والمستثمر الحالي يحتاج إلى أن يضمن أن استثماراته ستدر أرباح في المستقبل. بالتالي ليس المطلوب من المراجع أن يقول أن المعلومات المالية الموجودة تتوافق مع الدفاتر, بل المطلوب هو هل الشركة سوف تستمر أو لا, الشركة يوجد فيها اختلاسات أو لا, الشركة يوجد فيها استخدام أمثل للموارد او لا, الشركة يوجد فيها تشغيل جيد, يوجد كفاءة وفاعلية أو لا.

بالإضافة إلى أن مؤسسات الإقراض لا تهتم بقضية تقرير المراجعة نهائيا, لأن هذه أوامر ربما تأتيها من مؤسسات عليا. لأن هذه شركات مملوكة للدولة, وربما تقول هذه الشركة خاسرة, فيقول المسئولون لا أمنحها قرض.

أستطيع أن أقول أن تقرير المراجعة هو عملية أو متطلب قانوني روتيني لإتمام الإجراءات المالية فقط. ليس لكونه للمحافظة على الأصول ودقة البيانات وتنمية كفاءة العمل والالتزام بالسياسات الإدارية والمالية المرسومة للشركة و تطوير الشركة ونموها.

ربما الآن في ظل الخصخصة وتحول بعض الشركات من القطاع العام إلى القطاع الخاص, سوف يزداد الطلب على المراجع. هل تعلم أن الطلب الآن على المراجع هو ضعيف جدا. والسبب في ذلك هو أنه لا أحد مستفيد من المراجعة, مستخدمين القوائم المالية شبه رافضين مبدأ تحمل تكلفة المراجعة, لأن المراجعة تكلفة تتحملها المؤسسة, وبالتالي سيتم تحميلها على حقوق المالكيين للشركة, هؤلاء غير مستعدين لتحمل هذه التكلفة لأنهم لا يشعرون بالاستفادة من هذه المعلومات وتقرير المراجعة لن يضيف أي شيء. وبالتالي أنا أعتقد أن غياب المعايير, غياب أخلاقيات المهنة, غياب التعليم المستمر, لا يوجد شيء أسمه التعليم المستمر. المراجع في ليبيا لا يحضر ندوات, لا يحضر مؤتمرات, لا يحضر مناقشات علمية, أنا أتوقع عندما يسمع المراجعين أن هناك مناقشة رسالة ماجستير أو دكتوراه لها علاقة بالمراجعة أنهم

سوف يحضرون, لأن الكثيرين لا يعلمون أي شيء عن أدلة الإثبات, أوراق عمل المراجعة, الاستقلالية, تقييم نظام الرقابة الداخلية. مثلا كثرين لا يعرفون ما معنى تقييم نظام الرقابة الداخلية, مخاطر المراجعة لا يعرفون مخاطر المراجعة.

أن في اعتقادي أن مشكلة المراجعين في ليبيا هي مشكلة تأهيل. لا يوجد تأهيل وتطوير مستمر, لا يوجد مؤسسات تطالبه بنوع من التطوير كالذي موجود في أمريكيا وبريطانيا. هناك في هذه الدول التزام بالتأهيل و بالتطوير عن طريق قضاء 120 ساعة تدريب على مدار ثلاث سنوات. لا يوجد نظام للرقابة على الجودة في مكاتب المراجعة مثلا هناك فحص دوري للمكتب كل ثلاث سنوات.

النقطة الأهم لا يوجد جسم ينظم المهنة للقيام بكل ما هو مفقود من: وضع للمعايير و أخلاقيات المهنة و التقييم وتطوير المهنة في ليبيا. لا يوجد تعليم وتأهيل مستمر وبالتالي هذا سيكون له تأثير سلبي على جودة المراجعة. السوق في ليبيا يتمثل في شركات عامة بنسبة حوالي 90% و العرض والطلب ضعيف جدا.

و الخلاصة فلدينا مشاكل عدة تتعلق بقضية الجودة وما ترتب عليها من انعدام قيام مهنة المراجعة في ليبيا بما هو مطلوب منها. أي كل العمل الذي يؤدى هو عمل روتيني نتيجة ممارسة روتينية لا تختلف من سنة إلى أخرى.