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**Association between Auditors' experience and Perceived Audit Quality: A 3 - year trend
Analysis of Commercial Bank Industry Audit**

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Abstract

A trustworthy and prosperous firm has to have audits. As a result, academics have long researched the elements that influence audit quality and have proposed a wide range of variables, such as global auditing standards, auditing ethics, industry type, and the existence of independent and active audit committees. This research investigates the association between auditor experience and audit quality. A total of 1,455 observations across 247 commercial banks were selected, spanning from 2019 to 2021. A logistic regression model was fitted to determine the probability of audit quality as a function of auditors' experience and year of audit. The analysis showed a negative audit quality trend over the years for

commercial banks. In addition, auditors' experience increases the probability of perceived high audit quality for commercial banks by at least 12%.

Introduction:

The purpose of this paper is to investigate the association of auditors' experience and audit quality over 3 years. By enabling accurate and objective reporting of financial statements, audits play a key part in fostering the dependability of businesses. By assuring the correctness of financial statements, their clear measurement, and their presentation, which is an essential part of the evaluation of the business's credibility, they aid in the promotion of organizational integrity. This, however, is reliant on the audit quality, which can be influenced by a number of variables and is a hotly debated subject in the literature with no universally recognized definition or standard of measurement. The majority of the literature, however, uses DeAngelo's (1984) definition of audit quality, which he defines as "the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) identify a material misstatement in the audit report."

Many of the factors that scholars have suggested as influencing audit quality come from DeAngelo's definition of audit quality. Some of these conditions are outside the auditors' control, but not all of them. Because of this, studies that have focused on exogenous factors have highlighted the kind of industry, global standards for auditing, auditing ethics, and the presence of an independent and active audit committee as determining factors of audit quality (Abbott & Parker, 1999; Dunn et al., 2000; Abbott et al., 2001). Others have brought up the internal control structure of a corporation and even the size of the audit firm (Al-Khaddash et. al., 2013). On the other hand, according to Hameed (1995), those with more knowledge, experience, and integrity produce auditing standards that are superior.

Although there is a wealth of literature on audit fees, previous study has not taken into account how the lead auditors' personal traits may influence the fee that is charged to clients. Instead, the earlier research concentrated on the traits of the client company, the traits of the audit firm providing the service, or the traits of the particular engagement. Based on 85 separate investigations, Hay, et al. (2006) find strong evidence in favor of a Big 8/6/5/4 premium. Having a thorough understanding of the personal traits of the lead members of the

audit team may affect the client firm's reputational inferences, just as the Big N premium results from reputational inferences made by investors.

The quality of audits performed by external auditors is evaluated using the auditing theory and the attribution theory. The Auditing Theory is a manual for conducting a normative audit, according to Mautz and Sharaf (1961). The auditor must adhere to commonly acknowledged standards and regulatory criteria in order to conduct a quality audit. Generally recognized regulations and auditing standards are used to assess the audit's quality. "Attribution theory," according to Heider (1958), describes the method through which a person explains the reasons behind their own or other people's behaviors. This justification may be based on internal reasons like nature, character, attitude, etc. or external variables like the pressure of particular situations or circumstances that can influence a person's behavior. The majority of nations' commonly accepted auditing standards stipulate that auditors must be competent, experienced, independent, exercise appropriate professional care, have integrity, and be ethical. This provides a foundation for assessing the auditor's personal qualities in order to guarantee the high caliber of the audit results.

The whole of a person's knowledge, skill, attitude toward their career, and personality attributes constitutes their level of competence (Dinata, 2006). Incompetent auditors usually rely on the opinions of others to perform their audit responsibilities because they lack understanding. While the auditor needs to be knowledgeable with the pertinent auditing standards. When the auditors are more skilled, the quality of the audits that are produced is higher. This reveals a direct correlation between the audit's quality and the auditor's expertise. Experience is a further factor that influences the quality of audits, according to Ningrum and Budiarta (2017). The advantages of having solid professional experience as an auditor include the capacity to interpret errors, spot errors, and understand the relationships between judgements. An experienced auditor will exercise more caution while acting. Professional auditors can produce greater audit quality in comparison to novice auditors.

The audit quality is the possibility that an auditor will find and reveal errors in his client's accounting system (Deangelo, 1981). Indonesian citizens' perceptions of how the entity being audited pays a bribe to secure a positive audit conclusion are expanded by the frauds performed by the nation's external auditors. Audit quality is difficult to achieve since

management and business owners have competing interests. While outside parties require third-party services to feel confident that the financial statements presented by company management can be relied upon as the basis for decisions made, corporate and government management need the services of an external auditor so that financial accountability presented to external parties can be trusted (Mulyadi, 2014).

Literature Review:

There is no agreed-upon definition of audit quality and it is challenging to define (Bédard et al., 2010; Gaynor et al., 2016; Knechel et al., 2012). The definition of audit quality varies depending on one's point of view (Gaynor et al., 2016; Knechel, 2016). DeAngelo (1981) gave the following definition, which is still in use and is frequently cited:

Audit quality is 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.

Later, a number of research with some variation from DeAngelo (1981) specified the definitions of audit quality (DeFond and Zhang, 2014). For instance, a quality audit is one that provides higher assurance (Carcello et al., 2002), necessitates more auditor work (Carcello et al., 2002), prevents audit failure (Francis, 2004), lowers the risk of litigation against auditors (Casterella et al., 2009), and aids in the discovery of material misstatements (Yu, 2011).

There is no universally applicable measure of audit quality (Gaynor et al., 2016) as a result of the various definitions of audit quality leading to numerous proxies for audit quality (Bédard et al., 2010). In their 2014 summary, DeFond and Zhang divided the measurements employed in earlier investigations into output and input measures. Indicators of output include material misstatements (such as restatements and "Accounting and Auditing Enforcement Releases" issued by the U.S. Securities and Exchange Commission), auditor communications (such as going-concern opinions), financial reporting quality (such as discretionary accruals,

meet/beat, accrual quality, and conservatism), and perception-based indicators (such as market reaction, cost of capital, change in market share, and PCAOB inspections).

The terms of the contracts between auditors and customers as well as auditor characteristics, such as being a Big N or having an industry specialization, are referred to as input measures (e.g. audit fees). This strategy is used in this study to assess the audit quality using the Big 4. Since there is no ideal gauge of audit quality, DeFond and Zhang (2014) outlined the advantages and disadvantages of each metric and proposed that using various measurement categories would be beneficial. According to DeFond and Zhang (2014), input measurements of audit quality only identify perceived, not actual, audit quality. Although commonly accepted, the use of auditor characteristics has a large measuring error. It is challenging to determine the precise relationship between audit fee and audit quality, notwithstanding the measurement error associated with the usage of the features of contracts between auditors and clients. Perception-based indicators for output measures do a good job of capturing perceived audit quality and audit quality variance, but they have a large measurement error.

Research Hypothesis:

Experience can be viewed as a process that helps someone develop a higher pattern of behavior, or it can be considered as a learning process that includes the potential for behavior growth from both formal and informal education (Knoers and Haditono, 1999). (2012) Saripudin et al. A person's mindset will psychologically change as a result of experience, making them smarter in both thinking and behaving since they will be able to feel their position in both positive and unfavorable situations (Bawono and Singgih, 2010). A person will act more cautiously. Professional auditors can produce greater audit quality in comparison to novice auditors. This is corroborated by studies showing that experience raises audit quality, including those by Ningrum & Budiarta (2017) among others.

Hypothesis 1 *The higher the auditors' experience, the higher the quality of the audit.*

Sample and Research Design

Sample

We obtained our sample data from Audit Analytics and Compustat (Financial ratios and financial statements) which have been used in previous studies. We extracted data on audit opinions from audit analytics while financial ratios and statements from computstat. From our initial sample of 10,501 company-year observations across 607 NAICS listed industries, we eliminated 9,030 observations for industries other than commercial banking. This reduces the to 1,471 company-year observations. A further exploration of the dataset revealed additional 16 missing observations for the the independent variable experience. This further reduced the sample used in the analysis to 1,455 comprising of 247 commercial banks which have been audited by 37 auditing firms. Of the 37 auditing firms, 4 were perceived as high audit quality (KPMG: KPMG LLP, EY: Ernst & Young LLP, DT: Deloitte & Touche LLP, PwC: PricewaterhouseCoopers LLP) and the remaining 33 were perceived as low audit quality. The detailed sample selection table is presented below.

Panel A: Sample Selection (the unit of observation is a company-year)

Listed number of observations during (2012 – 2022)	10,501
Observations from industries except commercial bank	(9,030)
Observations from missing auditor's experience	(16)
Observations from high quality auditors (KPMG, EY, DT, PwC)	430
Observations from low quality auditors (Others)	1025
Final sample	1,455

Note: KPMG: KPMG LLP, EY: Ernst & Young LLP, DT: Deloitte & Touche LLP, PwC: PricewaterhouseCoopers LLP

Model

The conceptual framework of the audit quality model is given as

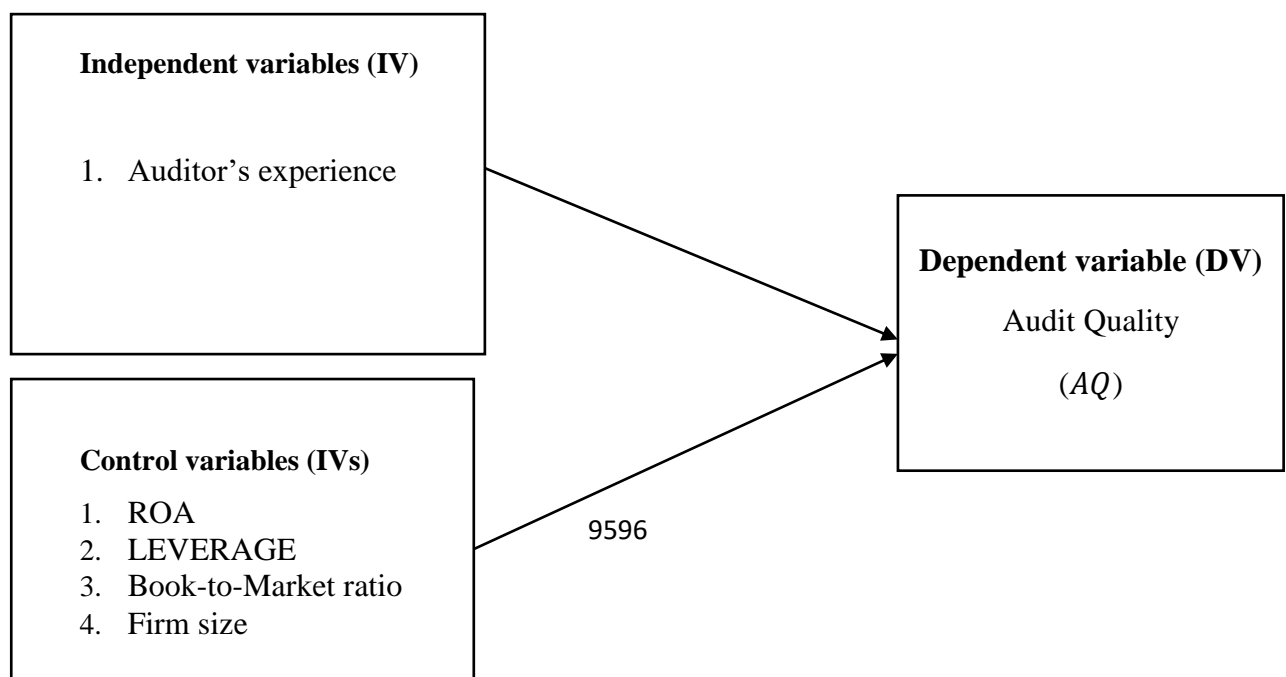


Figure 1: Conceptual Framework

The logistic regression model of perceived audit quality (AQ) defined as

$$AQ = \begin{cases} 1, & \text{High audit quality: Brand name} = \{KPMG, EY, DT, PwC\} \\ 0, & \text{otherwise: Low audit quality} \end{cases}$$

where KPMG: KPMG LLP, EY: Ernst & Young LLP, DT: Deloitte & Touche LLP, PwC: PricewaterhouseCoopers LLP.

The functional relation between perceived audit quality defined above and auditors' experience, year of audit is given below as:

$$\text{logit}(AQ) = \beta_0 + \sum_{t=1}^3 \beta_t \text{Year}_t + \beta_1 \text{Auditor Experience} + \gamma \sum \text{Controls}$$

where β_0 is the intercept, $\sum_{t=1}^3 \beta_t$ is the effect of each fiscal year which serves as trend effect, β_1 is the effect of auditors' experience, and γ is the effect of the control variables which include *SIZE*, equal to the natural logarithm of total assets; *LEVERAGE*, equal to the total liabilities divided by the total assets; *BM*, equal to the book-to-market ratio; and *ROA*, equal to audited profits divided by total assets.

Results

Panel B: Table 2: Univariate analysis results

Variable Name	High quality firms (n=430)			Low quality firms (n=1025)			Difference	
	Mean	Median	SD	Mean	Median	SD	Diff in Means	T-test
Experience (yrs)	23.76	20.00	18.00	5.71	2.00	8.33	18.05	19.93***
Firm size (log)	10.30	10.16	1.66	8.04	7.94	0.98	2.26	26.43***

Leverage	0.09	0.08	0.06	0.06	0.05	0.05	0.02	7.19***
ROA	0.03	0.02	0.02	0.02	0.02	0.02	0.01	2.89***
BM	0.91	0.90	0.31	0.95	0.94	0.26	-0.04	-2.69***

Sig. 1% ***, 5% **, 10% *, >10%, SD: Standard Deviation.

Table 2 results showed that there were experienced in terms of length of years in the high quality audit firms than the low quality firms. In fact, there is evidence that high quality audit firms tend to hire experienced auditors than the low quality audit firms on ($t = 19.93$, $p < 0.001$) at the 0.05 significance level. This implies that auditors in high quality audit firms are at least 18 years more experienced than low quality audit firms. Similarly, high quality audit firms also tend to have larger firm size, leverage (total liability to asset), and return on assets than low quality audit firms. However, high quality audit firms tends have lower book-to-market ratio compared to low audit quality firms.

Table 3: Correlation Matrix

Variable	Audit quality	Experience	Firm size	Leverage	ROA	BM
Audit quality	1.00					
Experience	0.57***	1.00				
Firm size	0.65***	0.53***	1.00			
Leverage	0.20***	0.22***	0.22***	1.00		
ROA	0.10***	0.00	0.00	-0.03	1.00	
BM	-0.08***	0.04	0.04	0.13***	-0.24***	1.00

Sig. 1% ***, 5% **, 10% *, >10%.

Table 4: Logistics regression

$$\text{logit}(AQ) = \beta_0 + \sum_{t=1}^3 \beta_t \text{Year}_t + \beta_1 \text{Auditor Experience} + \gamma \sum \text{Controls}$$

	Expected Sign	Estimate	Std. Error	Z	P-value	Sig	Decision
(Intercept)		-15.996	1.054	-15.176	< 0.001	***	

Experience	+ve	0.110	0.010	11.450	< 0.001	***	Accepted
Firm size	+ve	1.657	0.109	15.266	< 0.001	***	Accepted
Leverage	+ve	3.247	2.021	1.606	0.1082		NS
ROA	+ve	26.078	6.486	4.021	< 0.001	***	Accepted
BM	-ve	-1.725	0.446	-3.871	< 0.001	***	Accepted
2020		-0.084	0.255	-0.328	0.7426		
2021		-0.615	0.240	-2.565	0.0103	*	

Sig. 1% ***, 5% **, 10% *, >10%, NS: Not Significant. Year-2019 is the base year.

The year effects showed that there is an overall decrease in audit quality over the years, starting from the year 2020 upward when compared to the base year 2019. The primary hypothesis tested: ***The higher the auditors' experience, the higher the quality of the audit*** is accepted at the 5% level. It was observed that increase in experience (length of years of engagement) of auditors increases logit of audit quality by 0.111 and correspondingly the odds ratio by 1.12. Overall, a one year increase in experience increases the probability of perceived high audit quality by 12%. In addition, the control variables firm size increases the probability of perceived high audit quality by 424% while book-to-market ratio reduces the probability of perceived audit quality by 83%.

Conclusion

There have been several attempts to define audit quality as well as the associated determinants. While there have been many studies that have considered audit fees and account restatement approaches, none of the existing literature considered unidimensional measurement of auditor's experience as a determinant. This study closed this gap by measuring auditor's experience using the duration of engagement of auditors as a predictor for perceived audit quality. Here, we have defined perceived audit quality as audit by the Big-4 auditing firms which include KPMG LLP, Ernst & Young LLP, Deloitte & Touche LLP, and PricewaterhouseCoopers LLP. Our study finds an overall decrease in audit quality in recent years for the sampled commercial banking firms. Also, we found a significant increase in audit quality as a result of increased in auditors' duration of engagement for commercial banks.



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