

Factors Affecting Selection of External Auditors in Banking Industry in Bangladesh: An Application of AHP

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Abstract

The selection of external auditors has a paramount significance in ensuring transparency and accountability of the publicly traded business entities, particularly in the banking sector. This prompts us to investigate the factors that influence the clients in appointing external auditors in this industry. Analytic Hierarchy Process (AHP) is applied by choosing five criteria that affect the selection of external auditors. The results indicate that among the chosen five criteria, 'affiliation with the Big 4' is given the most importance (around 63%) in choosing the auditors. Experience (15%) and technical expertise of the auditors (14%) are ranked second and third followed by their independence (6%) and the audit fees (3%) charged by them. Inconsistency in the judgment being 9% falls below the threshold value of 10% demonstrating the acceptability of the results of the study. Addressing the limitations will open the door for future research. The implications of the research findings and avenues open for further studies are also put forward.

Key Words: External Auditor, Analytic Hierarchy Process, Agency Theory, Banking Industry

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1.0 Introduction

The appointment of an external auditor has always been viewed as an instrument to reduce the agency cost which arises due to the separation of ownership from management (Anderson et al., 2004). As suppliers of risk capital, general investors have to rely a great deal on the financial statements prepared by the management. Financial statements comprise statement of comprehensive income, statement of financial position, statement of cash flows, owner's equity statement and notes & disclosure (Bagherpour et al., 2010). While information contained in these reports is the primary indicator as to the financial health of a listed company, this also serves as the basis on which investors evaluate performance of the company. And, herein lies the importance of an independent auditor whose function lends significant credibility to the reports produced by the management (Watts and Zimmerman, 1983).

In Bangladesh every publicly traded company is required to appoint an independent auditor or auditors under the section 210, 212 and 213 of Company Act 1994 to examine the financial statements and to express an audit opinion as to those statements respectively. Guidelines of Bangladesh Securities and Exchange Commission (2006) also mandate that every listed company is bound to change its incumbent auditor with the appointment of a new one in every three years. However, despite such statutory instruction and even after knowing the fact that banks are actively involved in inflating their profit in the financial statements, appointed external auditors issue unqualified opinion (Siddiqui and Podder, 2002). This calls for an investigation vis-à-vis the factors that generally influence the clients in appointing independent auditors as required by the relevant law of the country.

Prior studies in this arena have been performed both in a voluntary as well as in a mandated setting. Voluntary setting implies that appointment of external auditor is not required by the law of the land. Mandated context requires that an external auditor must be appointed to protect the interest of the general shareholders under the existing laws of the land. According to Nagy (2005), attributes in selecting auditors in a voluntary setting may not fit in a compulsory context and can differ significantly due to the nature of obligation on the part of the client. Lorentzen (1992) states that, under a voluntary regime, an entity is unlikely to incur bidding cost, as long as it is satisfied with the service of the existing external auditor. Termination of an incumbent external auditor takes place due to the clients' dissatisfaction or their intention to change and when there is a less likelihood to retain the current auditor,

bidding for independent audit services is generally floated (Beattie and Fearnley, 1998a, b; Johnson, 1993). In a mandated setting as in Bangladesh, where an auditor is appointed in each Annual General Meeting (AGM), if the same auditor stays with entity for successive three years then it has to be terminated and a new auditor is appointed in the next AGM of the company.

A dearth of study as to the reasons for appointing auditors, particularly in the context of Bangladesh, has prompted us to conduct a research in this area. In this current regulatory and economic condition, a research on this topic would be of much relevance. The prime objective in our research is to prioritise the attributes generally considered by the publicly listed banks in Bangladesh in appointing their external auditors. This study is thus expected to fill the lacunae in the existing literature in this field, particularly in the context of a developing country, namely Bangladesh.

This paper is organized in five different parts. First, we mention by what law a publicly limited company is bound to appoint an external auditor and how this appointment can reduce the agency cost. Second, we present an extensive literature review to select the variables, shedding light on agency theory in appointing independent auditors and the current legislation of Bangladesh regarding such appointments. Third, we explain the methodology, analytic hierarchy process (AHP), applied in the study. This is followed by the findings of the study and a discussion *vis-à-vis* prior literature review as well as the implications for the companies in the banking sector of Bangladesh. The paper concludes by stating a few limitations and possible areas of future research in this regard.

2.0 Literature Review

This section analyzes the prior research relating to the factors considered by the clients in selecting external auditors for their companies. At the beginning, we explain the rationale for external audit; next, we identify the factors as discussed in various studies. Finally, we highlight different scenarios which affect such appointments in the context of Bangladesh.

2.1 Rationale for external audit

According to rational choice theory, managers are driven by opportunistic behavior and will always try to maximize his or her utility in a given condition. Alchian and Demsetz (1972) stress that a business entity is a set of contracts

among the factors of production, where each factor seeks to gain maximum return for its own interest. From a long-term perspective, this self-interest keeps them work together in harmony in an organizational context. Watts and Zimmerman, (1983) argue that managers' opportunistic behavior is significantly diminished in executing this contract if they stick to its core principle i.e. protecting the interest of each quarter by maximizing its own self benefits. However, they also state that audit work by an independent auditor in enforcing this contract helps reduce the agency cost which arises owing to non-participation of the owners. According to them, appointment of an external auditor is successful if the auditor is able to detect any breach of this contract and assist in protecting the interest of general owners of the firm. They emphasize that independence of an external auditor depends on the potential discovery of a non-compliant activity by the management in preparing financial statements.

In another seminal study by Jensen and Meckling (1976) observe that agency cost cannot be brought to level zero because there will always be some cost even after taking all the necessary measures due to the inability of the owners to take part in the management of the company. They also assert that audit opinion reduces cost arising from asymmetrical distribution of information among various stakeholders. So, to reduce this agency cost, publicly listed companies appoint auditors which in turn give credibility to the financial statements produced by those entities. Another research by Johnson and Lys (1990) find that both clients and audit firms are encouraged by competition in the market to be equipped with characteristics that meet the needs and demands of one another. External audit diminishes this agency conflict by giving a reasonable assurance that prepared financial reports are in compliance with required standards, paving the way for a better and efficient contract between managers and general shareholders (Cohen et al., 2002).

2.2 Factors affecting selection of auditors

Most of the prior studies shed light on the engagement of independent auditors under a voluntary regime (Butcher et al., 2011). Our literature covers the attributes found by different studies in the reappointment of an incumbent auditor as well as appointing a new one when rotation is mandated by law. According to Hermanson et al. (1994), in both cases, some attributes are found to be common. Amount of payment paid as audit fees and discontentment with the current auditor are the two principal reasons for auditor change (Beattie and Fearnley 1995). Level of fees is perceived to be the most important consideration when appointment of auditor depends upon the

discretion of the client which could ultimately compromise the quality of audit and independence of auditors (Beattie and Fearnley, 1998a, b). On the other hand, in a compulsory environment, audit quality gets much higher priority than the amount of fees charged by an external auditor (Butcher et al., 2011). Joher et al., (2000) argue that to ensure the quality, clients may change the existing incumbent auditors with the one who are more competent in executing audit work.

Apart from statutory requirement of published financial statements for publicly trading companies, there are other practical factors, such as audit quality, reputation, technical expertise and independence that have significant influence in appointing external auditors (Bagherpour et al., 2010). Nagy (2005); Blouin et al. (2007) and Bewley et al. (2008) analyze the attributes considered by the clients of the former Arthur Anderson in choosing new auditors. In these studies they examine the behavior of the clients of the demised Arthur Anderson in appointing independent auditors. Generally, switching to new auditors is determined by features of the clients, attributes of the auditors and the condition in which audit work is performed (Beattie and Fearnley, 1998). In addition, they state that switching to new auditors can have significant consequences, for instances, impact on stock prices, audit opinion, audit fees and the level of non-audit services taken from the incumbent auditors. Beattie and Fearnley (1998) contend that staying with a particular client for long period of time results into lower audit fees and questionable independence. Wallace (1988) find that there are three powerful reasons that make a client to go for an external audit; these relate to the conflict owing to agency problem, the demand of information on the part of stakeholders other than employees and the demand arising from insurance cost. Besides, clients are influenced by other factors such as lack of consensus regarding the contents of financial statements (Addams and Davis, 1994), dispute regarding opinion of auditor (Haskins and Williams, 1990) and appointment of new management (Beattie and Fearnley, 1995). DeFond et al. (1997) produce evidence supporting auditor switch on the ground of weakening financial condition of client as well as for increasing disagreement between them. Both the reasons, according to Stice (1991), might lead to a litigation and resignation of the incumbent auditor or the appointment of a new one.

Factors as considered by the clients in appointing an independent auditor show that size of the company, level of debt in the capital structure and ownership of share by management ultimately dictate whether or not an external auditor would be chosen based on its quality of audit and apparent independence. Besides, it has also been observed that characteristics such as

industry specific expertise, technology used in conducting audit and the degree of relationship with audit team influence the choice of auditors (Beattie and Fearnley, 1998).

Audit by Big 4 or by firms affiliated with Big 4 is reflected positively reflected in the share price of the clients (Teoh and Wong, 1993). In addition, reputation helps auditors to resist any undue pressure and acts as an incentive to report any material departure from the applicable standard (Lombardo and Pagano, 2002). One of the principal benefits of having been audited by Big 4 is that it lowers the firm's cost of capital (Khurana and Rahman, 2004). According to Mansi et al. (2004), outside USA, only the reputation acts as a deterrent to ensure the quality audits by the Big 4 firms.

DeAngelo (1981a) suggests that there are two dimensions of audit quality. One is competence i.e. the ability of an auditor to detect any fraud or misstatement in the financial documents produced by the client and the other is independence defined as the commitment on the part of the auditor to report any such fraud or misstatement. Herrbach (2001) also states that audit quality comprises technical expertise as well as professional conduct during audit work. Besides, as argued by Moizer (1997), image of the audit firm is also an element of quality. Thus, when a client is not in a position to make an assessment about the quality of the audit firm then it has to rely on its reputation.

According to Addams and Alfred (2002), clients should have substantial amount of confidence on the technical expertise of the audit firm's partners, managers and professional staff because this confidence finally drives a client to choose a new auditor if the current one is to be replaced. Professional and technical qualifications, general audit experience and expertise both at firm level as well as team level are commonly viewed as the technical competence of an audit firm (Butcher et al., 2011). Excellence in these areas ensures the quality of work rendered by it. Audit experience and expertise have also been defined differently by Ghosh and Moon (2005). Experience indicates the on-the-job knowledge acquired over the period of job life and expertise comes with the industry specific experience (Velury et al., 2003). Expertise gives an auditor to identify loopholes and problems which are unique to an industry and thus puts him or her in an advantageous position over an auditor lacking such quality (Chaney et al., 1997).

According to Richard (2006), independence of an auditor has two dimensions: independence in facts and independence in appearance. In order

to maintain professional attitude towards the audit profession, an auditor is required to maintain both dimensions in executing attestation services. When an auditor performs audit works in an unbiased and objective way, it is deemed that she or he possesses the independence of facts. Independence in appearance, on the other hand, indicates the perception held by the third party as to the impartiality, objectivity and ability of the auditor to resist the pressure.

Fees charged by the external auditor have also been a significant factor for a listed company to go for a new auditor. DeAngelo (1981a) in his study opines that if the current audit fees seem to be high for a client, the successive auditor is naturally forced to charge lower fees for attestation job. In such cases, as argued by Simon and Francis (1988), for the first two years audit price stays low but from the third year, it increases to the normal audit fees. They assume that both clients and auditors operate in a perfectly competitive market.

In their study, Messier and Schnieder (2010) apply AHP to analyse the criteria considered by the external auditors to measure the effectiveness of internal audit operation. Performed among the audit supervisors and managers, the study finds that the competence of the internal auditors turns out to be the most important criterion, followed by their objectivity in the jobs. Another study by Webber et al (2004) is conducted among the forensic experts to assess the risk factors specified in SAS (Statement on Auditing Standards) no. 82, which increase the likelihood of fraud by the management. One of the models produced the assessment is AHP, which coupled with the other subjective model is then used to evaluate the self-insight of and the extent of consensus among the forensic experts. The authors observe that the experts possess a moderate to high degree of self-insight as well as of agreement amongst themselves when it comes to assessing the relative importance of fraud risk factors.

2.3 Factors in the context of Bangladesh

As we have already discussed external audit has been introduced to reduce the agency cost. In Bangladesh existing ownership structure of public limited companies does not fit into the text book idea of agency theory that we have spoken of so far. Most of the listed companies in Bangladesh are controlled by families (Imam and Malik, 2007). In contrast to the typical agency scenario here manager and owner is the same individual. In a study Farooque et al. (2007) reveal that majority of outstanding shares belong to a few persons who happen to be the family members. According to Bertrand and Schoar (2006), general shareholders are better protected in a family controlled structure. They tend to

be more cautious in building human resources within the organization as well as fostering a long term vision in developing their investment strategies. Agency problems generally faced by a family owned company lead to the siphoning off entity's resources through related party transaction, disproportionate allocation of compensation package among family members and inappropriate distribution of intangibles (Enriques and Volpin, 2007).

In Bangladesh, external auditors are appointed in accordance with the Company Act 1994 for one year period and extension can be made for another two years for an incumbent auditor. Rules regarding the rotation of an incumbent auditor were imposed by the Bangladesh Securities and Exchange Commission (BSEC) in a corporate governance order in 2006. This notification also prohibits an incumbent auditor to engage in non audit services such as tax advising, system design and financial policy setting. Current legislation does not require a compulsory tendering for selecting an audit firm. Existing company law allows any member of the company to propose a name of a person or firm to be appointed as an independent auditor. Under the corporate governance guidelines issued in 2012 by BSEC, audit committee of a publicly traded company has been attached with the responsibility of playing an active role in the selection of independent auditors for the entity.

Commercial banks have always played an important role in economy by providing short-term credit to business institution with the former getting increasingly interested in making long-term credit to industry (Rose and Hudgins, 2005). Among all the service sectors in Bangladesh, banks contribute most significantly to national economy by converting savings into investment and by facilitating foreign trade (Siddiqui and Islam, 2001). Since banks deal with the money of depositors, this phenomenon warrants greater transparency and accountability in assessing the reports generated by them. Besides, recent discovery of monumental frauds and irregularities in the banking sector calls for more scrutiny by independent auditors. In this regard, such a study focusing this sector would be germane to different stakeholders.

Price at which external audit services are provided in Bangladesh is found to be quite low (Karim and Moizer, 1996). In their study, Sobhan and Werner (2003) disclose that most of the participants in their survey do not have faith on the audit report of a listed company. In this research it is said that audit work is apparently a part of a vicious cycle. General shareholders do not believe that external auditors are able to perform their jobs in an independent and objective way. According to Siddiqui (2010b) auditors in Bangladesh lack required level of competence, skill and objectivity. The author further observes

that collusion of auditors with various parties has also been one of the principal reasons for stock market collapse in 2011.

The above observations convey an ominous sign of the prevalent culture of compulsory audits rendered by the appointed auditors. For the banking industry of Bangladesh, this could spell far reaching ramifications as evidenced by the revelations of recent governance failure in both public and private sectors. In light of such a scenario, this study is undertaken to ascertain the factors influencing the selection of external auditors by taking into account their technical expertise, experience, independence, audit fees and affiliation with Big 4.

3.0 Methodology

The present study applies analytic hierarchy process (AHP) as the method to find out the ranking of the criteria concerned with the selection of external auditors. A description of the AHP method highlighting the steps and the scale used in the process is provided below.

Analytic Hierarchy Process (AHP), originally developed by Thomas Saaty in 1971, is a multi-criteria decision-making approach that allows managers to determine their subjective preferences of selection criteria, quantify those preferences, and then synthesize them across diverse criteria (Onesime et al., 2004). It is a widely used technique used to consider subjective decision making attributes and divides a complex decision problem into a hierarchical system of decision elements (Saaty, 1980; Saaty and Vargas, 1981; Saaty and Vargas, 2000). A pair-wise comparison matrix of these elements is constructed, and then the normalized principal eigenvector is calculated for the priority vector, which provides a measure of the relative importance (weight) of each element. The procedure for the AHP can be summarized as follows:

- Constructing the hierarchical system: First, a hierarchy with two or more levels for evaluating candidate alternatives is constructed. The AHP, in general, divides a complicated problem into three levels of hierarchy: the overall goal of the problem; the evaluation criteria used; and the decision alternatives considered. In the present study, however, there are two levels shown in Figure 1, as it is aimed only at finding out the ranking of the criteria influencing the selection of external auditors.

- Making pair-wise comparisons for the criteria and for the decision alternatives: Next is to construct pair-wise comparison matrices for all the criteria and the alternatives using a 9-point scale (Table 1) as suggested by Satty (1980). From the above matrices, weights of the criteria and the local weights of the alternatives are determined through normalization procedure.
- Calculating the weights and testing the consistency: Finally, the global weights of the alternatives are calculated by synthesis, i.e., by multiplying the local weights of each alternative with the priority of the same criterion and then adding them for all the criteria. In order to test the consistency of the intuitive judgment, the consistency ratio (C. R.) is to be measured that indicates the degree of consistency; this should be less than 0.10. If C.R. is greater than 0.10, serious inconsistencies are assumed to persist

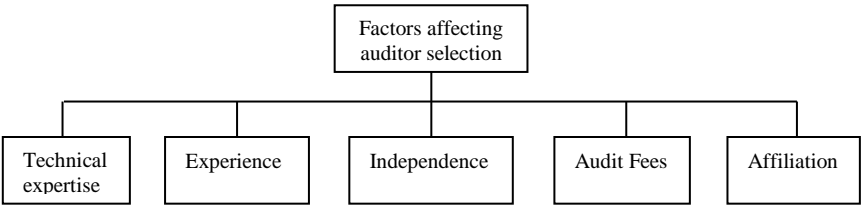


Figure 1: AHP Hierarchy Process in Auditor Selection

Table 1: Fundamental Scale for Pair-wise Comparisons

Verbal Judgments of Preferences	Numerical Values
Equally important	1
Moderately more important	3
Strongly more important	5
Very strongly more important	7
Extremely more important	9
Intermediate values reflecting compromise	2, 4, 6, 8

Data Collection and Data Analysis

In the application of AHP, it is not required to have a certain minimum number of respondents to garner an idea regarding a particular problem; instead, the respondents must be knowledgeable enough to offer their judgments on the particular issue at hand (Benu et al., 2013). In this study, the

AHP questionnaire was prepared with the five criteria that affect the selection of external auditors, and was delivered to a group of bank managers, who are chartered accountants and CFOs. The questionnaire was filled out using the pair-wise comparison scale as shown in Table 1. It is to be noted that responses in only one side of the diagonal is necessary, since the values on the other side of it is the inverse of the former. Table 2 presents a filled out questionnaire. Expert Choice software is employed to find out the weights of the criteria affecting the choice of external auditors.

Table 2: Pair-wise Comparison Matrix for the Weights of the Selection Criteria

Matrix	Technical Expertise	Experience	Independence	Audit Fee	Affiliation
Technical Expertise	1	1	3	5	1/5
Experience		1	3	9	1/9
Independence			1	3	1/9
Audit Fee				1	1/9
Affiliation					1

Findings of the Study

As generated through Expert Choice software version 11 and shown in Figure 2, the criterion, ‘affiliation with the Big 4’ assumes an overwhelming importance (around 63%) in choosing the auditors. This is followed by their experience and technical expertise of about 15% and 14%, respectively. The criteria of auditors’ independence and the fees charged by them turn out to be of much lesser importance with about 6% and 3%, respectively. The result is judged satisfactory as the inconsistency in the judgments is found out to be 9%, which is below the threshold value of 10%.

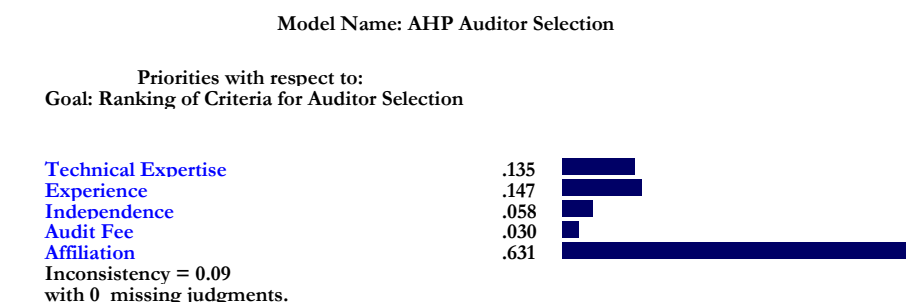


Figure 2: Ranking of the Criteria in Selecting External Auditors

Discussion of the Findings

This research reveals that affiliation with the Big Four firms has been the most important for the clients under our study. This factor secured 63.1% importance among the five criteria we have chosen. In our paper reputation has been substituted by the affiliation with the Big 4 – Ernst & Young, PwC, KPMG and Deloitte Touche Tohmatsu (Toffler, B. (2003). According to Firth and Smith (1992), the reason for choosing Big 8 (the then time it was Big 8) by the audit firms is to reduce the agency cost as well as to send a signal to the market that management is uncompromising in protecting the interest of outside shareholders. Healy & Lys (1986) in their study revealed that clients are interested in continuing with the incumbent audit firms, not the members of the reputed Big 8, after the acquisition or merger of firms with Big 8 due to reputation or increased capacity to provide highly specialized services.

From the findings, it is found out that 'Experience' factor holds the second position with a 14.7% overall importance among the five factors in our study. Here, experience stands for duration of practical contact with the specific industry which ultimately gives the auditors a competitive advantage to perform their duties impeccably. The criterion 'Technical expertise' ranks third with 13.5%. This criterion reflects the ability of an audit firm to execute audit job with sufficient knowledge to discover any potential irregularities or discrepancies. Besides, technical competence also demonstrates the possession of certain skills to perform audit works according to relevant standards and simultaneously taking into account real world scenario in providing assurance services to clients (IFAC, 2010).

The factor 'Independence' of the auditors is ranked fourth, getting 5.8% importance, while 'Audit Fee' scores the lowest, acquiring only 3 % significance among the five factors in our study. As for independence, the finding does not fall in line with the prior studies; however, the result for audit fees is in agreement with the outcome stated by Beattie & Fearnley (1995) in their work, where level of audit fees found to be the seventh from the last out of twenty nine audit firm attributes. Audit fee is rarely found to be the sole cause of changing an incumbent auditor and in some cases new auditors may quote significantly low prices due to the stiff competition in the existing audit market (Beattie and Fearnley, 1998a). The fact that audit fees ranks much lower compared to the audit quality falls in line with the extant literature (Butcher et al., 2011) that states in a mandated environment, the latter gets much higher priority than the former.

In the context of Bangladesh, putting excessive importance on the affiliation with Big 4 implies that those not affiliated with them are not in a position to deliver audit services as demanded by the clients in the banking sector. This finding is in agreement with Sobhan and Werner (2003) that reveals majority of the audit firms are not able to conduct quality audit in Bangladesh. This is also corroborated by the findings of Gerakos and Syverson (2014) where they observe that 67% of total statutory audits are conducted by the Big 4 firms in USA. According to Velte and Stiglbauer (2012), audit market throughout the world is highly concentrated among the Big 4 due to their exposure to complex cross border transactions and high industry experience.

Conclusion

Selection of external auditors holds paramount importance in lending credibility to the financial reports provided by the companies. The present study is undertaken to figure out the weights or the rankings of the criteria influencing the selection of such auditors in the banking sector of Bangladesh. In this regard, five criteria are considered: technical expertise, experience, affiliation with 'Big 4', independence of the auditors and the audit fees charged by them. In doing so, Analytic Hierarchy Process (AHP) is employed as it quantifies the qualitative judgments through a standard scale. For this, Expert Choice software version 11.0 is used. The results of the study reveal an overwhelming importance (about 63%) of the criterion of affiliation with big four followed by the experience and technical expertise of about 15% and 14%, respectively. The criteria, namely, independence of the auditors and the audit fees charged by them are ranked fourth and fifth, with about 6% and 3%, in that order.

The current study has some limitations that need to be addressed. These limitations and possible areas of future research in this regard are presented below.

- This study considers only the five criteria affecting the selection of external auditors. Besides these, there are other criteria that are not taken into account here. A wide ranging survey is thus called for so as to figure out, first, the factors influencing such selection for which factor analysis would be appropriate. Also, each criterion might have some sub-criteria, which are not addressed in this study. Any future research in this regard could consider these issues to get a greater insight into the choice of external auditors on the part of the management of the companies.

- The present study is confined only to find out the ranking of the criteria in choosing the auditors. It should be extended by taking into consideration of a number of possible alternatives of auditing firms in the AHP hierarchy and finding out as to how these alternatives are ranked as well. The management of the companies would then be armed with greater information in their choice of external auditors.
- In any future study, it would be a worthwhile exercise to investigate the impact of these criteria on the level of trust reposed by the relevant stakeholders of the client companies. Thus, various hypotheses could be formulated and multiple regression be carried out which would show the level of relationships among these variables and highlight whether any multi co-linearity exists among the criteria to be chosen in that particular study.
- The study is conducted where only a few experts' opinions are considered. In order to gather a more comprehensive picture, opinions of the relevant personnel from other hierarchical levels also need to be taken into account. Apart from this, a comparison vis-à-vis various other sectors might also be carried out to gain a better insight in this regard.

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