

Factors affecting quality of External Auditing: The case of Ethiopian Commercial Banks

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Statement of Declaration

I, Solomon Kitata, declare that this thesis is my own work and that, to the best of my knowledge and belief, it contains no material previously published or written by another person, except where due acknowledgement has been made in the text. I confirm that no part of the material presented in this thesis has previously been submitted by me or any other person for a degree in this or any other institution.

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This is to certify that the thesis entitled, “*Factors affecting quality of External Auditing: The case of Ethiopian Commercial Banks*” was carried out by Solomon Kitata under the supervision of Ato Gebremedin Gebrehiwot submitted in partial fulfillment of the requirements for the degree of Master of Science in Accounting and Finance complies with the regulations of the University and meets the accepted standards with respect to originality and quality.

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List of acronyms

ABLLP: Abnormal Loan Loss Provision
AICPA: American Institute of Certified Public Accountants
ASC: Audit Service Corporation
CPA: Certified Public Accountants
DW: Durbin-Watson stat
EU: European Union
GDP: Gross domestic Product
IFAC: International Federation of Accountants
IAASB: International Auditing and Assurance Standards Board
ISA: International Standard on Auditing
LEV: Leverage
LLP: Loan Loss Provisions
NBE: National Bank of Ethiopia
OFAG: Office of Federal Auditor General
OLS: Ordinary Least Square
PCAOB: Public Company Accounting Oversight Board
ROA: Return on Assets
SEC: Securities and Exchange Commission
SIZE: Bank's Size

Abstract

Subjecting financial statements to external verification and assurance is a mechanism through which managers can add credibility to the reports, enhance and improve the quality of financial information, while increasing the reliance placed upon them (Jensen & Meckling, 1976; Watts & Zimmerman, 1986). Since DeAngelo's study (1981) on audit quality, there is little evidence about audit quality in the financial market. In Ethiopia, studies on audit quality began only in the 2000s, although without a specific focus on banks. The purpose of this study was to identify the quality determinants of audit work in Ethiopian banking institutions. Using the practice of earnings management as a proxy for audit quality - more specifically, the discretionary accruals related to the process of the constitution of the Loan Loss Provision (LLP) - tests were performed based on the annual information of commercial banks from 2005 to 2014. Empirical association tests of the audit quality proxy with the variables representing incentives for the performance of auditors have confirmed two of the seven research hypotheses, revealing that audit quality has the following relationships: positive with the bank size and negative with audit fee paid by the bank. Of the hypotheses tested, five were not confirmed empirically.

Keywords: Audit quality, Earning Management, Loan Loss Provision.

Chapter One

Introduction

This chapter introduces the research topic: ‘Factors affecting the quality of External Auditing: the Case of Ethiopian Commercial Banks. It also describes the background of auditing and defines the objectives and the problem definition of the research. In addition, this chapter contains a recapitulation of the research methodology and an overview of the outline of the research.

1.1 General Background of the Study

This paragraph describes the background of auditing and introduces research topic ‘Factors affecting quality of External Auditing: the Case of Ethiopian Commercial Banks’.

Factors affecting the quality of External Auditing

Financial reports are an important tool prepared and used by managers of the firm to communicate financial information to investors and stakeholders, while simultaneously reducing the level of information asymmetry that exists between owners and managers (Antle & Nalebuff, 1991). Subjecting financial statements to external verification and assurance is a mechanism through which managers can add credibility to the reports, enhance and improve the quality of financial information, while increasing the reliance placed upon them (Jensen & Meckling, 1976; Watts & Zimmerman, 1986). That is, financial statements are representations by management and the external audit function is placed over the top of these representations to assess if the statements present a ‘true and fair view’.

When the audit gives reasonable assurance there is always room for mistakes and errors that can decrease the audit quality and mislead a third party in his/her decision. This raises the question of what is audit quality and the determinant factors affecting it.

In 2010, International Auditing and Assurance Standards Board (IAASB) stated about

audit quality: “There have been a number of attempts to define audit quality in the past. However, none of them has resulted in a definition that achieved universal recognition and acceptance. Audit quality is, in essence, a complex and multi-faceted concept.”

The most used definition of audit quality is DeAngelo’s (1981) definition which expresses the quality in terms of auditor’s competency and independency. The quality is then dependent on the probability that the auditor will both detect material misstatements in the client’s financial statements and report the material misstatements (Ibid). Empirically, during the years after DeAngelo’s definition of audit quality, numerous studies have focused on the quality of the audit to see if they perform a low-or-high quality audit with focus on a number of variables.

As exemplified by the global financial crisis, there is a growing consensus among researchers that financial intermediaries play a fundamental role in the process of economic growth by channeling limited financial resources into the economy (Levine, 1997; Clotty, 2009).

On October 18, 2013 Ernst & Young was ordered to pay \$99 million to investors for its role in the fall of Lehman Brothers marking the first settled lawsuit against an audit firm related to the financial crisis (Brown 2013). The financial crisis led many to go as far as to question the role of auditing in improving financial information, particularly in banks (Alexander 2012), and auditors were accused of failing to issue warnings signs regarding banks’ deteriorating financial position. Investigating audit quality in Ethiopian banking sector is significant because one of the significant sectors in Ethiopia is the banking sector, this sector is vital to the Ethiopian economy. Consequently, one can argue that auditors are vitally important to the banking sector.

Basel Committee (2008) found that researches documented a positive association between audit quality and some factors attributed to audit firm such as internal control, quality control, firm size, audit fees, auditor independence, auditor reputation, industry specialization, auditor qualifications and proficiency.

Audit quality has been the focus of theoretical and empirical auditing research for the last three decades. Worldwide, the concepts of earnings management and discretionary accruals are dominating audit quality considerations on audit engagement level. Even though a plenty of studies investigated the determinants of audit quality in different countries especially in the western; there is a lack of empirical evidence from the developing countries context like

Ethiopia. Again, prior researches have documented inconsistent results on the evidence of the linkage between audit quality and its proxy.

In the context of Ethiopia, the related study conducted by Amsalu (2011) mainly assessed the impact of extended audit tenure on auditors independence and audit quality in Ethiopia. Accordingly, this study clearly failed to identify most of the factors that affect audit quality significantly as far as its main focus was an assessment of the impact of extended and short audit tenure on auditors' independence and audit quality in Ethiopia. That means this study clearly fails to fill the knowledge gap that exists in the area as far as it considers only one variable without putting proxy for audit quality measurement and ignores other audit firm related variables affecting external audit quality. The other recent study of Mekonnen (2011) assessed the impact of private ownership on financial reporting quality in privately owned companies in Addis Ababa -Ethiopia. This study limits its scope only on investigating financial reporting quality based on the qualitative characteristics of financial reporting information on an improved conceptual framework for financial reporting of the FASB and the IASB (2008) from the point view of auditors' perceptions. Besides, the study of Mekonnen (2011) fails to disclose the impact of some very important variables on Ethiopian privately owned companies' external audit quality such as company size, and audit firm related factors among others.

Moreover, a more concise research was conducted by Bethitina Leilina which included more variable and audit firm attribute. The research tries to assess audit firm attribute which affect audit quality particularly in the case of manufacturing companies. Even though the study included more variable and use proxy for audit quality but the researcher focus on audit firm attribute with selected manufacturing companies. Hence, as to the researcher knowledge there is no particular work regarding the captioned research title.

Researches in the area is very useful in giving an insight for both audit firms and bank stakeholders as to knowing the determinant factors affecting audit quality. It will also help regulatory and professional bodies to properly monitor the external audit profession and to maintain trust among the various stakeholders. Therefore; it would be worthwhile to ask audited client attribute and the audit firm related attributes that are considered to be the determinant factors affecting external audit quality in Ethiopia commercial banks. Beside, the relationship between discretionary (abnormal loss loan provision, proxy of earning management)

and external audit quality (measured by earnings management) has not been empirically researched for the Ethiopian audit market. Thus, this paper aimed to speak directly to such issues using Commercial banks -Ethiopia.

This study intends to identify the determinants of external audit quality in Ethiopian Commercial banks .

1.2 Statement of the problem

While there is the general motivation of understanding the factors impacting audit quality, there are particular concerns which dictate the specific focus of this thesis. Economic development of most countries in the world is based on economic conditions of the market, in which the establishment and operation of the system protecting owners' interests as well as information on the activities of economic entities, available to external users, is of great importance. Accordingly, this study provides empirical evidence on the factors that are perceived to affect audit quality, specifically the relative importance of audited client attribute and audit-firm attributes in affecting audit quality. Besides, research into perceptions of audit quality is important because it determines the credibility of the audit report (Shockley 1981), and that have the potential to erode public confidence in the integrity of the financial reporting system (Pany and Reckers 1988). Consequently, gaining an understanding of factors that affect perceptions of audit quality is important because it can help regulators and the accounting profession to formulate policy based on empirical evidence rather than on a priori assumptions (Schelluch and Thorpe 1995). This provides a unique context in which to evaluate the impact of audit quality on financial reporting outcomes.

Apart from these unique features, World Bank (2007) reported that Ethiopia does not have a quality assurance and professional indemnity insurance program for auditors and the country has not yet experienced litigation on financial reporting. This may indicate that the quality concern given to the audit service is relatively weak and may serve as a loophole for auditors to reduce audit procedures in their engagement while being competitive in the thin audit market. Given such intense competition along with lower concern for audit quality, it would be reasonable to expect such threats to arise in Ethiopian context.

However, to the best of the researcher knowledge, there is no single study conducted regarding audit quality in the giant Ethiopian commercial banks. Let alone Ethiopia, which

had problematic accounting and auditing practice, countries with advanced practices couldn't stop their high profile industry from falling. Therefore, given such a unique audit environment characterized by regulatory laxities in the accounting profession, and lower audit quality concern afforded in the country, it is imperative to investigate the factors that determine audit quality and its implication in the Ethiopian banks context.

Moreover, this study uses the recent data and increased number of variables in order to explore various clients and audit firm factors that determine the external audit quality. Since this is the first investigation of its type, the purpose of this study is to develop some preliminary ground work that a more detailed evaluation could be based and to fill the stated gap by analyzing the external audit quality of Ethiopian commercial banks, given that these banks as they collectively form the major chunk of the economy of any country while their financial transparency has a paramount importance to various stakeholders.

1.3 Research objectives and hypotheses

The study aims to examine some factors affecting auditing quality in the Ethiopian banks from client and external auditor's perspective. Consequently, objectives of the current study can be summarized as follows:

1.3.1 General Objective

The major objective of this study is to assess the audit quality determinant factors in Ethiopian commercial banks. Based on the client-audit firm specific factors that are found to significantly influence audit quality in prior studies, the study assesses the factors that banks consider in hiring of an audit firm for their audit service in Ethiopia. Specifically, the study evaluate whether audit quality is influenced by audit firm tenure, audit firm industry specialization, audit fee, bank size, leverage position of the bank and profitability of the bank.

1.3.2 Specific Objectives

1. Discuss the different measures of audit quality.
2. Investigate factors that may affect the audit quality in the Ethiopian commercial banks.
3. Determine the most important factors affecting audit quality from the perspectives of client-external auditors of the Ethiopian commercial banks.

1.4 Research Hypotheses

After reviewing the literature that covered the topic of audit quality, the researchers develop the following hypotheses that will set out to achieve the study objectives:

The quality of audits conducted in Ethiopian banks is positively related to the degree of auditor specialization in the industry.

H1: The quality of audits conducted in Ethiopian banks is positively related to the degree of auditor specialization in the industry.

H2A: The quality of audits conducted in Ethiopian banks is negatively associated with the auditor-client short-term relationship.

H2B: The quality of audits conducted in Ethiopian banks is negatively associated with the auditor-client long-term relationship.

H3: There is significant relationship between audit fee and audit quality.

H4: The quality of audits conducted in Ethiopian banks is positively related to the size of the bank.

H5: The quality of audits conducted in Ethiopian banks is negatively related to the leverage position of the bank.

H6: The quality of audits conducted in Ethiopian banks is positively related to the profitability of the bank.

1.5 Methodology of the study

This section gives a description of the research methodology that will be employed in achieving the objective of this study. It presents the research design, population, data collection, data analysis and the model specification.

The researcher used correlation research design to establish the relationship between quality determinant and the quality of audit of the commercial banks in Ethiopia. Data was obtained from the commercial banks. There are different determinants of the audit quality.

The study period of interest is nine consecutive years, covering the period of 2005-2014. The population of interest for this study comprised of the 18 commercial banks licensed to carry out banking business in Ethiopia. Since the aim of quantitative approach is to produce a study that is interchangeable, it is important to have an objective perspective. To this end, to collect the necessary data the study adopted structured review of documents and personal inquiry which are intended to elicit data relevant for the determinants of external audit quality.

Accordingly, the data related to a documentary analysis which is necessary to undertake this study was gathered from the audited financial statements particularly balance sheet and income statement of all commercial banks. The analysis basically concentrates on the data available in audited financial statements of commercial banks. Beside, in order to seek clarifications for some audit firms specific factors, personal inquiry was held with auditor (partners and managers) who have been engaged in those audit firms who provide external audit service for their respective banks.

Finally, the data obtained through the above mentioned data sources were analyzed through EViews 9 software package. The detail of the methodological aspects will be discussed in chapter three.

1.6 Significance of the study

The auditing profession has been under intense pressure due to rising public expectations. This thesis contributes to academic debate about the factors impacting audit quality, while providing evidence to regulators and policy makers in the following ways. The study findings will be used as source of literature in the library and will contribute to the knowledge in this area of need for determinant of audit quality in Ethiopia. The gaps mentioned in the study act as a guide to any intended research to assist in topic selection and identify areas that need further study.

Finally, the study will benefit both the regulators and the commercial banks in Ethiopia in making clearer the determinant of audit quality and its impact on the audit quality, and by extension benefit the shareholders of these institutions.

1.7 Scope and limitations of the study

The study has its own scope and limitations as it is presented below.

1.7.1 Scope of the study

It is important to define the boundaries of this study such that the readers will be aware of the direction to which this study is heading. The study is highly contemplated on the broadest and most interesting branch of auditing, external audit quality determinants for suppliers and users of the audit services. Despite that the topic of the study is delimited to examining audit firm and auditors determinant factors affecting the external audit quality that are frequently described in conventional auditing studies and literatures. However, the increasing use of the word auditors in this study does not by any means refer to both external and internal auditors. That is to say the

word auditors in this study refer only to external auditors. This is because the scopes of function for external and internal auditors are different in nature.

1.7.2 Limitations of the study

The results of the study may suffer from some limitation. First, this paper examines only audit firms and client-specific determinant factors that affect audit clients' external audit quality due to the nature of the research. Thus the study did not explore macro-economic factors determining audit quality.

1.8 Structure of the study

The paper is organized into five chapters. Chapter one presents introduction of the study. The literature review part of the study is presented in chapter two. The review of the literature includes the theoretical review in its first section which is followed by the review of the previous studies related to the area and conclusion and knowledge gap finally. Chapter three presents the research design and methodology. This is followed by an analysis of the results and discussion part of the paper concurrently in chapter four. Finally, chapter five presents the conclusions and recommendations.

Chapter Two

Literature review

In order to put the study within the context of the existing literature, the subsequent section of this chapter present the review of both theoretical and empirical studies related to external audit quality determinants.

This paragraph presents some of the theories on the demand concerning auditing. The agency theory is the most prominent of the existing theories. Less significant audit theories are the ‘policeman theory’ and the ‘lending credibility theory’.

The policeman theory claims that an auditor is responsible for searching, discovering, and preventing fraud. The focus of the audit however, has moved towards the verification of the truth and the fairness of the financial statements and the provision of reasonable assurance. The policeman theory is not able to explain fully the role and the purpose of auditing.

According to the lending credibility theory, the primary function of the audit is to add credibility to the financial statements. Audited financial statements increase the financial statement users’ confidence in the financial figures and the faith in management’s stewardship. The lending credibility does not explain other functions of performing audit services; this theory is limited in explanatory power.

Several factors influence external audit services and audit quality, recognizing and understanding the underlying concepts and definitions of audit quality is essential in order to vouch results and analyses. Hence, chapter two serves as background for this study by describing concepts of external auditing and factors that could influence audit quality. Subsequent chapters build on concepts and definitions described here. The review has three sections. Section 2.1 presents the theoretical under-pinning related to auditing and audit quality since they are related to the research question and need further clarification. Then the researcher review accrual accounting which is considered to allow accounting flexibility and managerial judgment which could pose a threat to audit quality. This is followed by the review of empirical studies regarding the determinants of external audit quality and related issues from the extant literature in section 2.2. Finally, conclusions on the literature review and identification of the knowledge gap are presented in section 2.3.

2.1 Theoretical review

The theoretical framework presents the background theories, upon which the study relies. The researcher presents the basic concepts first, such as issues related to auditing and audit quality. Thereafter, the researcher focuses on earning management as a measure of discretionary accrual and its connection with audit quality, and finally the study presents the determinants of audit quality in relation to defined corporate governance mechanisms. Those mechanisms are considered to be related to the nature of external audit scope.

2.1.1 Background to auditing and role of auditor

Before discussing the quality of audit services, it is essential to understand the need of and the demand for audit services. The word “audit” is derived from the Latin word “audire” which means the act of listening. The concept of auditing might be explained as a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicate the results to interested users (Eilifsen and McKee 2006). In the audit process, there are two parties; auditee and auditor.

An auditor is a professional whose task is to perform the audit by verifying the accounting and the decision-making by the management of an auditee and final report in an auditor report. This is necessitated by laws.

Auditors are bound by law to enforce proper application of accounting standards and to assure that the financial reports present a true and fair view of the client’s income statements and balance sheets. However, these explanations would not grasp the depths of the complicated processes of auditing.

Zerni (2009) explained audit service as a unique among other professional services for two major reasons. First, auditors are hired and paid by the client, but their product is really used by the third-parties like investors to whom they owe a standard of care.

Second, the quality of an audit cannot be directly observed prior contracting and, in general, not even after the audit is conducted. The only observable outcome of the audit process is the issued audit report, which, at least in its standard form, does not contain much information about the audit quality.

The knowledge base of the audit process is fundamentally obscure and requires judgment. Even though the rhetoric and procedures of auditing imply an analogy to scientific practice, the actual

practice has only superficial similarities to the scientific practice, according to Pentland (2000). He writes that the rhetoric of science is a powerful legitimating device for audit practitioners, although auditing is not a science. He further claims that auditing should not be seen as a neutral rendering of facts, rather it is a depiction of reality through accounted and audited numbers. He argues that auditors act as buffers between two symbolic worlds, they are more to be seen like movie critics than scientists. They interpret accounting systems, which are themselves interpretative products and they do so by following a variety of rules which are also open to interpretation. The financial statement is a summary of transactions occurring every day.

Since the auditor is distanced and not able to witness the actual transaction or action there is a need for subjective interpretation by the auditor which requires judgmental skills (Francis 1994). If auditing is not a science but a practice subject to subjective interpretations and judgment as Brown (1999), Pentland (2000) and Francis (1994) suggest, then what is the value of auditing? An answer to that might be the production of comfort, where “the auditor can provide board members with reasonable assurances they need to sleep soundly at night” (Brown 1999).

Pentland (1993) writes that auditing can be interpreted as a ritual which transforms the financial statements from an inherently untrustworthy state into a form that the auditors and the public can be comfortable with.

Watkins et al. (2004) mention that the process and activities leading up to the production of the audit report such as evidence gathered are an important aspect of the professional conduct which is required of the auditor. An auditor cannot claim to have performed a test of a particular area if he or she cannot show documentation on it.

Thus Brown (1999) argues that to a large extent audit may be a collection of tests and an evidence gathering task. The evidence gathered in the form of documentation is important in order to defend any possible challenge from an authority or defend her or his professional appearance by showing that they were following routines that make sense and have value in the audit society.

Therefore, the auditors have been entrusted by the law to conduct statutory audits and that their role is of importance towards a well-functioning business life by enhancing the reliability of the information. This entrustment has been based on the societal roles of an auditor in terms of reducing contractual conflict leading to the so-called agency cost between board of directors

of the company who controlled the preparation of accounts and external owners by examining the management's behavior and the economic information provided by the company (Carson and Dowling 2005; Watkins et al. 2004; Chow 1982).

By having, an audit of the company the company assures that they have quality in the actions of the management and the company due to that the role of the auditor is a role of securing the quality for external users and the company. The claim that the audit has a role of assuring the quality for external users broadens the importance of the audit and shows that it is also performed for more users than the external owners (Carson and Dowling 2005).

In Ethiopian context external users most often encompass users such as tax authority, municipality or state, creditors, society, customers and suppliers.

The coming section highlights the necessity of audit for these listed users.

External owners

In larger companies the owners usually do not have the same information and are not a part of the management team. Most companies have a separation between ownership and management. Since they do not have same insight in to the company, the owners must be able to rely upon the information that the company provides them with, that the information give a true and fair view. At the end, it is this information that affects the owners' decision about their continuing ownership in the company and the auditor's opinion can play a crucial role in this decision (Knechel 2001). Therefore, it is important for the external owners that they can trust the auditor, audit report and that the audit performed is of high quality otherwise it would be futile to have an audit.

Creditors

When a company applies for a bank loan or other credits these lenders assesses the company's ability to repay the loan and hence it is important that the information the company bases its decision on is accurate and reliable, and the accuracy and reliability increases if there is third, independent party that reviews the information, the auditor. Therefore, the auditor is important for the creditors and that they have performed a high quality audit (Newbold et al. 2007).

Society and others

A reason for company to have external auditing is institutional requirements, from state or institutional investors. The company can also feel an obligation to have external auditing due

to the cost of not having one. This means that the company comes under much more scrutiny if they do not have an audit (Brown 2007).

Regulatory and public authorities, in Ethiopian most often the tax authority, municipality or the state, must be able to rely upon the information the companies provides because it is from this information the taxes and fees are dependent on. Since it is placed upon the company to pay the taxes, a review of an auditor increases the probability that this will be done correctly, and if not the auditor is obliged by law to comment upon that in the auditor report. Furthermore, auditors can provide help to companies who are eligible for benefits and grants from the state and municipality.

Others that are interested in that the information from the company is accurate are suppliers, customers and employees. For suppliers it is important to know if the company will continue to pay their bills and that their solvency is good. The customers want to know if the company is sound enough to continue its deliveries. The employees on the other hand has a more personal interest in the company, this is due to their dependence upon the company, they can then from the audited information make assessment on how the company performs and their future work situation.

2.1.2 Definitions and frameworks of audit quality

First of all, audit quality can be divided into perceived audit quality and actual audit quality (Jackson et al. 2008). This paper concerns actual audit quality, which can be measured by different proxies. Audit quality is much debated but little understood.

Audit quality is not a unitary concept. It should be divided into:

- 1. Quality of service;** that is, factors which affects the client's experience of the audit process
- 2. Quality of opinion;** that is factors which contribute to a process which is likely to reach the right answer which is the concern of this research.

The two aspects can sometimes be in conflict, but the key to success is delivering the highest "quality of service" without compromising on the "quality of opinion".

Despite more than two decades of research, due to the apparent conflicting roles of participants in the audit market there remains little consensus about how to define, let alone measure, audit quality. To start, it is important to note that the perception of audit quality can depend very much on whose eyes one looks through. Users, auditors, regulators, and society; all stakeholders in the

financial reporting process may have very different views as to what constitutes audit quality, which will influence the type of indicators one might use to assess audit quality. The user of financial reports may believe that high audit quality means the absence of material misstatements. The auditor conducting the audit may define high audit quality as satisfactorily completing all tasks required by the firm's audit methodology. The audit firm may evaluate a high-quality audit as one for which the work can be defended against challenge in an inspection or court of law. Regulators may view a high-quality audit as one that is in compliance with professional standards. Finally, society may consider a high-quality audit to be one that avoids economic problems for a company or the market. In the end, different views suggest different metrics.

To reconcile different viewpoints, and to begin to understand what the absence of high quality may look like, the researcher has reviewed the two main schools of thoughts in audit quality research.

Two main schools of thoughts

Deangelo's Definition of Audit Quality

DeAngelo (1981, pp. 14) defines audit quality as "the market-assessed joint probability that a given auditor will both discover a breach in the client's accounting system, and report the breach to the third parties." This definition contains two aspects of audit quality: (1) the probability to detect misstatements depends on the auditor competence, experience, procedure employed on a given audit, the extent of sampling, and auditor audit technology and (2) the independence of the auditor, how independent is the auditor from the client to report such misstatements.

Although this is the most cited definition of audit quality, the problem is that audit quality according to this definition cannot be observed let alone measured. Hence audit quality measures based on this definition are indirect methods of measuring audit quality with the aid of indicators. DeAngelo's definition connects audit quality one to one with financial reporting quality. A financial report where all accounting breaches have been detected and reported by the auditor represents high audit quality. Hence, the level of assurance that no material error remains undetected and unreported is the metric of audit quality in DeAngelo's definition.

Followers of this thought of school, for instance, are, Palmrose (1988) accuracy of information auditors provide to investors, Epstein and Geiger (1994) the probability that an auditor detects and reports misstatements and Knechel (2009) Audit quality is the achieved assurance level.

Level of Compliance with Standards

Another approach to define audit quality is a more normative way of thinking.

This approach where audit quality goes along with the level of compliance with auditing standards is represented, for instance, by Ang and Cole (1993), Becker et al. (1998), Bagnoli, Penno and Watt (2001).

The auditor performs with excellent quality if he/she complies completely with all relevant standards. In this perspective, the level of compliance with auditing standards reflects the level of audit quality. Peer review findings, inspection results of oversight boards (such as the OFAG in Ethiopia) as well as lawsuits against auditors are in this case the best indicators for audit quality. Criticism of this approach is evident. The overall objective of an audit is not to best comply best with relevant standards; instead it is to ensure high quality financial reporting.

The European Commission explicitly stated that "Audit Policies: lessons learned from the crises" that "more substance over form" is needed not only in IFRS accounting but also in financial statement auditing as the following citation describes:

“From a user perspective, auditors should provide a very high level of assurance to stakeholders on the components of the balance sheet and the valuation of those components at the balance sheet date. The Commission wishes to explore the case for 'going back to basics' with a strong focus on substantive verification of the balance sheet and less reliance on compliance and systems work, that is tasks that should primarily remain the responsibility of the client and in the main be covered by internal audit.

Auditors could disclose which components were directly verified and which were verified on the basis of professional judgment, internal models, hypotheses and management explanations. To provide a 'true and fair view', auditors should ensure that substance prevails over form.”

Regulatory frameworks on audit quality

IAASB Framework on Audit Quality

As research on audit quality is still unsatisfying, some non-academic institutions set up different frameworks. The latest framework (still in draft), an international one, have been conceived by the International Auditing and Assurance Standards Board (IAASB).

In an overall approach IAASB (2011) considered all possible influences of audit quality which are categorized as: (1) Inputs, (2) Outputs, (3) interactions amongst key stakeholders and (4) contextual factors.

The IAASB drafted the first version of its framework in a whitepaper in January 2011.

The whitepaper states that “there have been a number of attempts to define audit quality in the past; however, none of those definitions has achieved a universal recognition and acceptance.

“Audit quality is, in essence, a complex and multi-faceted concept.” After several IAASB sessions, a sketch of the framework was developed capturing the relationships between the elements: context, inputs, outputs, and interactions. Inputs are categorized into three groups: “(a) the values, ethics and attitudes of individual auditors, (b) the knowledge and experience of auditors and the time allocated for them to perform the audit; and (c) the effectiveness of the audit process and quality control procedures.” Outputs are “often determined by the context, including legislative requirements” and can be influenced by stakeholders; “for some companies’ stakeholders, the auditor's report is the primary output and this is relatively standardized.”

Interactions amongst key stakeholders include “both formal and informal communications”, which will be influenced by the context in which the audit is performed and allow a dynamic relationship to exist between inputs and outputs” elements of the framework.

The contextual factors include “corporate government requirements and the applicable financial reporting framework” as well as “legislative and regulatory requirements”, which also “shape the interactions amongst key stakeholder.”

UK Financial Reporting Council's Framework on Audit Quality

A similar framework was set up five years earlier by the UK Financial Reporting Council.

The Financial Reporting Council identified four main drivers for audit quality: (1) the culture within an audit firm; (2) the skills and personal qualities of audit partners and

staff; (3) the effectiveness of the audit process; and (4) the reliability and usefulness of audit reporting.

The focus in both frameworks (the UK FRC and the IAASB one) is on a process view of auditing where inputs are combined efficiently in order reach a certain outcome (assurance level), embedded in a specific contextual environment. On a content view, the UK Financial Reporting Council covers the same elements and attributes like the IAASB does. However, the IAASB framework on audit quality is more comprehensive and detailed. Hence, the FRC's framework on national level will probably be obsolete soon and replaced by the pending international one from the IAASB.

2.1.3 Underpinning theories of external audit quality

Theory helps researchers and individuals to understand the relationship between objects and related mechanisms and how the world moves around. The existence of a theory requires us also to use our reasonable expectations about objects. Hendriksen (1970) defines theory as a coherent set of theoretical, conceptual and pragmatic principles forming the general framework of reference for a field of inquiry. Theory is not considered just a simple 'hunch' and it is not a ready concept to be used on demand or when exceptional scenarios exist.

Therefore the coherent term is associated with the concept of theory that is based on logical reasoning (Hendriksen 1970). It is implied that the concept of theory should be coherent with human behavior to provide guidance and explanation about a certain phenomenon (Deegan and Unerman 2011). Due to the fact that auditing can only be performed with the existence of an auditor, auditing is considered to be a human activity.

As a result of this human nature of auditing, individuals' behavior is needed to be part of the financial auditing theories (Deegan and Unerman 2011). The descriptive or positive theory was used mainly in this research rather than the perspective or normative theories. Normative theories are about prescribing events and what shall be done, while the positive theory is based onempirical evidence and observations.

Though audit quality has been subject to research since early 1980s, there is no agreed theoretical base on audit quality (Dowling and Leech 2011). A review of the literature indicates that four main theoretical frameworks have been used to explain and analyze the association between earnings management and external audit determinants. These are Agency theory, Stakeholder theory, Stewardship theory, Signaling theory and Institutional theory.

Thus, each of the aforementioned theories related to external audit quality and its determinants are discussed in detail in this particular section in an orderly.

2.1.3.1 Limperg's Theory of Inspired Confidence

In 'The PCAOB and the social responsibility of the auditor' (2004), D.R. Carmichael; chief auditor at the Public Company Accounting Oversight Board (PCAOB), comments the social responsibility of the independent auditor and the possible mechanisms for ensuring that audits meet society's needs. Carmichael focuses on the role of the PCAOB and its performances in restoring the confidence of investors in the independent auditors of public companies.

In describing the PCAOB's focus, restoring the public confidence, Carmichael (2004, 128) recalls the work of Professor Theodore Limperg (1879-1961) of the University of Amsterdam. Limperg observed that when the confidence that society has in the effectiveness of the audit and the opinion of the audit is lost, the social usefulness of the audit has destroyed.

According to Carmichael (2004, 129), the principles of Limperg's theory are especially relevant in this phase of the development of the audit function. "We have a particular need in our current environment to try to understand and to appreciate the social significance of auditing and the implications concerning in which way an audit should be performed."

'The social responsibility of the auditor, a basic theory on the auditor's function', by Professor Theodore Limperg (1879-1961) of the University of Amsterdam (Limperg Institute, 1932 (1985)), is a booklet in which Professor Theodore Limperg's essays, exposing his general Theory of Inspired Confidence, are translated in English.

The Theory of Inspired Confidence connects the community's needs for reliability of financial information to the ability of audit techniques to meet these needs, and it stresses the development of the needs of the community and the techniques of auditing in the course of time (Limperg Institute, 1985, 3).

In developing his Theory of Inspired Confidence, Limperg (Limperg Institute, 1985, 16) describes the auditor's function / responsibility as follows: "The auditor-confidential agent derives his general function in society from the need for expert and independent examination and the need for an expert and independent opinion based on that examination. The function is rooted in the confidence that society places in the effectiveness of the audit and in the opinion of the

accountant. This confidence is consequently a condition for the existence of that function; if the confidence is betrayed, the function, too, is destroyed, since it becomes useless.”

One important citation concerning the Theory of Inspired Confidence (Limperg Institute, 1985, 18) is the next. “The normative core of the *Theory of Inspired Confidence* is this: the accountant is obliged to carry out his work in such way that he does not betray the expectations which he evokes in the sensible layman; and, conversely, the accountant may not arouse greater expectations than can be justified by the work done.”

According to the citation could be concluded that The Theory of Inspired Confidence does not prescribe definite rules about the behavior of the auditor in each particular case; the principle-based approach, signaled by Carmichael (2004, 129).

“.....the theory expects from the accountant that in each special case he ascertains what expectations he arouses; that he realizes the tenor of the confidence that he inspires with the fulfillment of each specific function” (Limperg Institute, 1985, 19).

According to the Theory of Inspired Confidence (Limperg Institute, 1985, 3), changes in the needs of the community and changes in the auditing techniques result in changes in the auditor's function. Assessing this statement, Carmichael (2004, 129) states that the touchstone for the auditor is always to perform the work and obtain the evidence necessary to provide the assurance that society needs and reasonably expects.

2.1.3.2 Agency theory

Ang, J.S., and Cole, R.A., 1993, agency theory is considered to be a contract between shareholders (principals) and external auditors to control the work of other agents (management). Shareholders (principals) delegate tasks to be performed by management (agents). Tasks cover mainly operating the organization on behalf of shareholders to meet their objectives. Auditors exercise an intermediary role between shareholders and management to validate financial statements prepared by management.

The most important basis of agency theory is that the managers are usually motivated by their own personal gains and work to exploit their own personal interests rather than considering shareholders' interests and maximizing shareholder value.

For example, managers may be attracted to buying lavish offices, company cars and other extravagant items, since the cost is borne by the owners. This pursuit of self-interest increases costs to the firm, which could include the costs of the formation of contracts, loss due to

decisions being taken by the agents and the costs of observing and controlling the actions of the agents. Leuz et al. (2003) assert that the effects of such behavior ultimately reflect in the company earnings.

Consequently, management has an incentive to manage the company's reported earnings in order to meet or beat earnings targets and, thus, to receive any bonuses that may be tied to the company's earnings (performance-related pay). This creates an information asymmetry in that managers can exercise the discretion they have on accruals, which in turn reduces the relevance and reliability of reported earnings, and the whole financial statements.

Davidson et al. (2005) argues that when management provides inaccurate financial reporting information, it introduces earnings management as a type of agency cost. As a result, managers cannot be fully trusted. Therefore, strict monitoring of managers by the principals or external auditors is seen as fundamental to protecting shareholders' interest from being compromised when managers maximize their self-interest at the expense of the organization's profitability.

Thus, the key predicament indicated by agency theory is ensuring that managers pursue the interests of shareholders and not only their own interests. Most of researchers that examine the association between earnings management and audit quality relied upon agency theory to examine the role of external auditors in affecting a firm's management involvement in earnings management (Xie et al. 2003; Kao and Chen 2004; Davidson et al. 2005; Benkel et al. 2006; Goodwin and Seow 2009).

Principals appoint external auditors who, as agents under contract, are expected to be independent of the agents who manage their company. The role of the external auditor is to reduce agency costs by cutting information asymmetry in financial reporting (Piot 2001). Agency theory recognizes external auditing as the most important monitoring mechanism because it controls conflicts of interest and diminishes agency costs. Watts and Zimmerman (2006) confirm that hiring a high-quality external auditor will undermine agency cost introduced by management.

External auditors act on behalf of the shareholders and enable them to closely monitor the actions of managers. As a result, high audit quality involving a specialized independent auditor can decrease opportunities for managers to pursue self-interest at the expense of owners and, thus, principals obtain more favorable returns.

Taking agency theory into consideration, earnings management may be indicative of an agency problem. As a consequence, hiring external auditors who are supposed to provide high audit quality should result in a reduction in the practice of earnings management. Given these agency assumptions, independent variables are identified with the aim of detecting associations between audit firm attributes and earnings management.

2.1.3.3 Stakeholder theory

Stakeholder theory explains the relationship between organizations and their external environment (Freeman 1984). A stakeholder is defined as a human agency that can have an impact or affect organizations (Gray et al. 1996). Stakeholders represent the big umbrella for all individuals and parties that may have a direct or indirect interest in an organization.

Direct stakeholders are shareholders, employees, investors, customers and suppliers whose interests are aligned with the company. An example of an indirect stakeholder is the government, which is indirectly affected by the company's function (Kiel and Nicholson 2003). Due to this role of stockholders, organizations are not only accountable to shareholders only but also to stakeholders. As a result of this accountable relationship, many factors and conditions exist to maintain and manage the stakeholder-organizations relationship.

Stakeholder theory is an extension of the agency view, which is believed to better equip managers to articulate the shared purposes of their firm and board of directors to look after the interests of shareholders. However, this narrow focus on shareholders has been expanded to take into account the interests of many different stakeholder groups, including interest groups related to social, environmental and ethical considerations (Freeman 1984; Donaldson and Preston 1995; Freeman et al. 2004).

The linkage between stakeholder theory and earnings management is explained by Hodge (2006) who document that management may manipulate earnings in order to improve their private interests via expense of shareholders and additionally the rest of stakeholders. Stakeholders' theory views external audit as effective monitoring systems that could protect all stakeholders' interests. Mattingly et al. (2009) also find high-quality external audit is associated with high earnings quality and low earnings management in origination's stakeholder management.

Moreover, in terms of audit quality, Baker and Owsen (2002) suggest that the role of external auditor as monitoring mechanisms is not only directed for shareholders' benefit, but also for the interests of all stakeholders.

2.1.3.4 Stewardship (Monitoring) theory

Stewardship theory outlines a co-operative and optimistic view of relationships within the corporation by assuming that managers are good stewards and do not misappropriate corporate resources; their behavior is also conditioned by non-financial motives such as the need for recognition of their achievements and performance (Vanden et al. 2004). Thus the directors' role is to counsel and advice rather than to monitor.

Stewardship theory is based on agency theory (Jensen and Meckling 1976): the separation of ownership and control motivates the owners to incur costs to monitor the activity of the managers. One of these controls is the hiring of an external auditor who certifies the accuracy of the financial information provided by the managers.

Therefore, the stewardship (monitoring) theory considers external auditing as a mechanism that can contribute to control the conflict of interests among firm managers, shareholders and other external claimholders by enhancing the credibility of publicly reported financial information (Chow 1982). Stewardship theory considers the external auditors as an instrument of assistance to a steward chief executive officers rather than a controlling mechanism (Hay and Davis 2004). It also considers that management is less likely to practice earnings management. However, the problem lies in the extent to which the management aspires to attain a good corporate performance.

2.1.3.5 Signaling theory

Signaling theory covers the information asymmetry area and voluntary selection of auditors (Morris 1987). The signaling theory helps in reducing information asymmetry. This reduction happens by a party disclosing information and signaling it to others.

Historically, the signaling theory has been established and related to the labor market, but it can be applied to any market having information asymmetry problems. A simple example about the signaling theory would be as follows: a seller is perceived to have a good quality product, and buyers have no specific information but only a general perception that the seller's product has good quality. Buyers in this case are ready to pay more for a product that they perceive to have a better quality.

It is the role of the seller to communicate and send signals to buyers about their good quality products. When sellers manage to create quality signals, buyers will consider all other sellers to have poor quality products (Morris 1987).

The above explanation of the signaling theory is tailored to fit the use of such theory in the concept of audit quality. As mentioned, the core of signaling theory is about information asymmetry that includes appointment of external auditors as a tool to manage the information asymmetry problem. Big size audit firms are known to provide better audit quality compared with other audit firms.

The higher the perception of audit quality the more clients and corporations are ready to pay more for big size audit firms to audit their financial statements. Due to this fact that companies and organizations are willing to pay more to big size audit firms; audit fees are said to be a signaling factor for a better audit quality.

2.1.3.6 Institutional theory

The concept of initialization is related to organizations actions over time. Such actions are said to be legitimated within an organization and environment (Pfeffer 1982).

Institutional theory suggests that internal operating processes loosely coupled with the observable structures accomplish the real work of an organization.

As a result, organizations with the appropriate structures in place will avoid deep investigations of their function by external auditors (Meyer and Rowan 1977). Organizations are subject to rules and regulations to which they must conform in order to ensure their legitimacy and thus have access to resources and ensure their survival (DiMaggio and Powell 1983). However, these rules and regulations don't necessarily guarantee that organizations will continue to operate efficiently (Meyer and Rowan 1977; Scott 2008).

Different factors play role in deriving organizations behavior from a legitimate behavioral point of view. Some factors are industry common practices, organizations' history, cultural values, management philosophy and folklore (Eisenhardt 1988).

The choice made by individuals is constrained by the force of moral pressures and the cake of custom in strengthening the social order (Scott 2008).

Institutional elements comprise the institutions and over time the institutional elements are given priority. The key point is to identify what institutional elements reinforce or undercut other elements (Scott 2008). Functional pressure, political pressure and social sources are three possible factors that cause pressure on institutional common practices (Oliver 1991).

As mentioned above, the choice made by individuals is limited to moral pressure faced (Scott2008). Also there are different kinds of pressures (functional, political, social sources) that affect institutional common practices (Oliver 1991).

The institutional theory deals with factors affecting organizations within a social environment. External auditors behavior is assessed in relation to audit firm professional practices rather than social and political factors.

Moreover, their behavior is analyzed against different kind of pressures that are embedded within an audit firm rather than factors and sources found within an institutional context.

To conclude, this study draws on agency theory to test whether hypothesized relationships exist between audit firm attributes and the incidence of discretionary accrual as a measure of earnings management and hence external audit quality. The agency theory framework has the ability to explain the motivations for earnings management. It also explains the expected association between audit firm attributes and earnings management.

2.1.4 Proxy for external audit quality

Despite the significant role of quality audit in enhancing quality corporate financial reporting, consensus has not been reached on how audit quality should be measured. Audit quality is an elusive concept because financial statement users can never perfectly observe the amount of assurance the external auditor actually provides before and when an audit is performed, thus audit quality cannot be measured directly as is not quantifiable by itself. It is however possible to measure certain aspects that are closely related to audit quality. These measurable aspects are called proxies, as they are in proximity of the desired variable. For example, it is also not possible to measure the weather quality, but measuring the amount of rain, sunshine and the temperature is not complicated and together they proxy for the weather quality. The same applies for audit quality.

Chen and Zhou (2005) see audit quality as a function of auditor performance. They argue that audit quality is affected by the ability and professional conduct of auditors. Hence, auditors' failure to detect material misstatements or failure to report the misstatement would reflect poor audit quality. However, the quality of the audit work performed by auditors is not assessable for scrutiny by financial statements users because users are not privy to the working papers of the auditors nor can they observe what the auditors actually did. The question of what constitutes an audit quality remains unanswered.

Some observable indicators have often been adapted for financial statements credibility expected from high quality audit. These proxies based on DeAngelo's definition for example include magnitude of the discretionary accrual components of reported earnings, restatements, litigation against auditors, accounting (and auditing) enforcement releases and going concern reports. The overriding objective in choosing audit quality proxies is to use measures that are most appropriate for the research setting. In evaluating appropriateness, one broad consideration is whether the study examines the demand or supply of audit quality. Output-based measures are usually best suited for tests that examine the supply of audit quality, while input-based measures are usually best suited for tests that examine the demand for audit quality. However, based on the researcher evaluation, there is no single proxy capable of painting a complete picture of audit quality and it is neither practical nor desirable to use all possible measures in a single study.

The primary purpose of a financial statement audit is to provide users assurance that the statements are prepared in conformity with generally accepted accounting principles (GAAP). A key concept within GAAP is that financial reporting should provide information that is representational faithful (i.e., financial statements should correctly portray the information they purport to represent). Earnings, regarded as one of the most significant financial statement items, are at the basis of decision criteria for the companies to evaluate their performance and determine the value of the entity. The purpose of earnings report includes providing useful information for measuring the efficiency of management, predicting the entity's future performance and distribution of earnings, defining a base for determination of taxes, taking account of the price of products and so on (Hajizadeh and Rahimi 2012).

The agency problems arise from the asymmetric information in the principal agent contracts. Asymmetric information refers to a situation where one party to a transaction has more information than the other party. The existence of information asymmetry between firm management and firm shareholders is a necessary condition for management to engage in earnings management.

Schipper (1989) defines earnings management in the sense of purposeful intervention in the external financial reporting process, with the intent of either misleading stakeholders about an entity's performance or influencing contractual outcomes that are based on accounting numbers to obtain some private gain. Healy and Wahlen (1999) claim that earnings management occurs when the managers use their judgment in preparing financial statements with the intention

not to report the firm's actual economic performance or in order to gain benefit from the adjusted figure.

Consistent with this definition and description of earnings the present study views earnings management as the opportunistic behavior of management. The managers may use earnings to communicate private information that could potentially maximize a firm's value (Watt and Zimmerman 2006; Holthausen et al. 1995; Subramanyam 1996; Sankar and Subramanyam 2001; Arya et al. 2003; Louis and Robinson 2005). However, since earnings management is involved a higher degree of managerial judgment, the consideration of a high quality information content of earnings and the subsequent monitoring processes are very crucial. One of the monitoring processes is independent auditing done by professional individuals in order to increase the assurance of financial information for its users by constraining earnings management activities (Hajizadeh and Rahimi 2012). Thus, the present mainly focuses on the negative aspect of earnings management.

In sum, earnings management is appropriate to evaluate the financial reporting quality. However; Notwithstanding the definition applied, earnings management is inherently unobservable. There are two systems of measuring the performance and position of a company in accounting. One of them is accrual accounting and the other one is cash accounting. The general idea of accrual accounting is that the revenues are recognized when they are earned and expenses are recognized as they occurred.

Literature provides the central incentives (reasons) to use accrual as earnings management tool. Bonus compensation (Healy 1985; Gaver et al. 1995; Holthausen et al. 1995), avoidance of debt covenant violation (Sweeney 1994; DeFond and Jambalvo 1994), prevention of earnings decreases and losses (Bugstahler and Dichev 1997; Barth et al. 1999) and compensating for regulatory or political costs (Cahan 1992; Jones 1991; Han and Wan 1998) are the most underscored reasons for companies to engage in earning management through accruals.

Besides, Watts and Zimmerman (2006); Healy and Palepu (2008) noted that the management might misuse the flexibility in the accrual accounting system in order to elevate earnings. Accruals can be divided into the categories as non-discretionary (normal) and discretionary (abnormal) accruals. Ronen and Yaari (2008) describes non-discretionary accruals as 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; where the values are fixed. Example of this is payroll taxes.

The Discretionary accruals refers to accruals that arise from transactions made or accounting treatments chosen in order to manage earnings. With this measure, one is able to determine the extent of earnings management a firm has applied to its financial statements. If the auditor makes an estimation which deviates from the norm, a difference in audit quality can be stated. This difference is called discretionary or abnormal accruals by DeAngelo (1986) and Jones (1991). Thus, for supply studies, the most suggested and used proxy in audit quality research studies to capture earnings management which poses a threat to financial reporting quality and thus external audit quality as well is the statistical estimation of discretionary (abnormal) accruals which is one of the outcome related to audit quality in financial statements for the following reasons.

First, company managers have considerable discretion in estimating accrual. This discretion allows them flexibility in using accrual for income-increasing or income-decreasing earnings management, or for smoothing earnings.

Second, discretionary accruals are also by far the largest and most important accrual for companies, thus affording company managers wide latitude in its use (Chung and Kallapur 2003; Francis and Dechow 2008). Huang et al. (2008) noted that earnings management can occur because accrual basis income depends on the use of estimates made in the financial reporting process. For example, current earnings could be boosted by underestimating bad debts on credit sales or expected warranty costs on the goods sold. Higher levels of accruals that are not associated with the firm's fundamental earnings process are assumed to reduce the quality of earnings.

Therefore, the aim of the research presented in this paper is also to provide empirical evidence on the impact of external audit quality on discretionary (abnormal) accruals, as a measure of earnings management, in Ethiopian manufacturing share companies.

2.1.5 Determinants of external audit quality

Like any other suppliers of other professional services, external auditors take into account the quality of audit services when providing their services. The quality of financial reporting has to be maintained in order to ensure some measure of credibility on the information contained in it.

Determinants of audit quality have been intensively researched in the last three decades. A very short but good audit research summary was compiled by Wooten (2003). Based on DeAngelo's audit quality definition Wooten explains all factors influencing audit quality and depicts them in audit quality model. Inspired of his thoughts the “Globe of Audit Quality” has been developed.

It contains most of all researched determinations of audit quality in a cause and effect diagram that have been theoretically assumed and empirically furnished with correlation evidence. Similar to Wooten (2003) study, recent indications about the relative importance of selected audit quality determinants were given by Kilgore et al. (2013). In a questionnaire they asked 81 users of the relative importance (scores from 0 to 15) often selected audit quality attributes (audit firm size, partner/manager's attention to the audit, audit quality-assurance review, audit firm tenure, communication between audit team and client management, audit fee, provision of non-audit services, senior manager/manager knowledgeable about client industry, audit firm industry experience, audit quality-assurance review, partner knowledgeable about client industry, certified audit professionals ratio and very knowledgeable audit team). Apart from audit firm size, audit firm tenure, provision of non-audit services, audit firm industry experience, audit fee as well as certified audit professionals ratio has been the most important factors identified in this study from the audit firm perspective.

Therefore, the aim of the research presented in this paper is to find an acceptable answer to the question that whether audit firm size, audit firm tenure, joint provision of audit and non-audit services, audit firm industry specialization and certified audit professionals ratio, as criteria of external audit quality, can limit the applying of earnings management (proxy for audit quality) in Ethiopian Commercial banks.

Industry specialization

The relation between audit quality and auditor industry expertise or specialization has been extensively examined in prior research. Maletta and Wright, (1996) observed that there are fundamental differences in characteristics of errors and methods of error detection across industries and thus, auditors who have industry specific expertise are better equipped to detect errors or abnormalities than those auditors without such expertise. For example, Wright and Wright, (1997) found that significant experience in the retailing industry contributes to increased detection of errors of clients in the retail industry. Solomon et al., (1999) found that auditors who are specialists exhibit greater knowledge of non-error frequency relative to the non-specialists.

The significance of this finding is that clients tend to propose non-error explanations for fluctuations in ratios and therefore, accurate knowledge of non-error frequency is vital in detecting misstatements in financial statements. Prior research also documents other benefits of auditor's industry specialization. Carcello and Nagy, (2004) found that auditor's industry expertise mitigates financial fraud. Krishnan, (2003) documented that for non-financial firms, discretionary accruals, a commonly used proxy for earnings management is lower for clients of specialist auditors relative to the clients of non-specialist auditors. Krishnan, (2005) found that for a sample of clients of Big 5 auditors asymmetric timeliness of earnings, a fundamental characteristic of financial reporting is greater for clients of specialist auditors compared to the clients of non-specialist auditors. While the above evidence indicates that the ability to detect material misstatements in financial statements is associated with auditor's industry specialization, there is also evidence that specialist auditors attempt to protect their reputation capital through increased compliance with generally accepted auditing standards relative to non-specialist auditors O'Keefe et al., (1994). In summary, these findings are consistent with the notion that auditor industry expertise contributes to greater audit quality. Neal, Riley, and Richard, (2004) suggested that the specialization in the auditing industry changes in the audit market in recent years suggest that industry specialization is an important strategic goal of the largest accounting firms in the U.S. and is recognized by accountants as an important issue facing the profession.

As a result, the possible relation between audit quality and auditor industry specialization has been of increased interest to academics. Several studies have attempted to document the relation between industry specialization and audit quality, but have provided mixed results, possibly due to a lack of consensus as to how industry specialization should be measured. In response to these findings, a framework is presented to assist researchers in selecting the most appropriate auditor industry specialization metric to apply in a given setting. At the same time, widely publicized accounting problems at some of the world's largest companies have placed an increased emphasis on improving audit quality. Does industry specialization lead to better auditor decisions? Low, (2004) found that auditor's knowledge of client's industry improves audit risk assessments, and facilitates the refinement of the elements of audit knowledge, which in turn is expected to help auditors anticipate potential misstatements. This skill is critical given that there are significant differences in the incidence, magnitude, income effect, cause, and method of

detection of financial statement errors across a broad base of industries. The issue of industry specialization has become increasingly relevant to the auditing profession as firms organize their practices along industry lines rather than traditional service lines AICPA (1998). Furthermore, research has shown that specialized knowledge in an industry has a direct effect on an auditor's ability to assess audit risks, detect errors and misstatements, and improve earnings quality Maletta and Wright (1996); Owghoso et al. (2002); Krishnan (2003). Mixed evidence from research about audit fees also suggests that industry specialists may earn a fee premium over other auditors e.g., Ferguson and Stokes, (2003). For example, Craswell et al., (1995) found that specialist Big 8 auditors earn a 34 percent premium over non specialist Big 8 auditors but Hay et al., (2006) report that this premium may not be consistent across markets, firms, or time periods. Recent structural shifts by audit firms in the direction of greater industry focus also suggest that industry specialization may play an increasingly important role in audit quality Hogan and Jeter, (1999); Solomon et al., (1999). Researchers have identified a number of other possible reasons for switching auditors, including the possibility that a company may switch to a higher quality auditor in order to provide more credible information to investors and creditors Schwartz and Menon, (1985). Industry specialist offers a higher level of assurance than does a non specialist e.g., Craswell et al, (1995). For example, Owghoso et al., (2002) showed that industry-experienced auditors are better able to detect errors within their industry specialization than outside their specialization. O.Keefe et al., (1994) report significantly greater compliance with auditing standards for industry specialists than non-specialists.

Auditor's fees

Audit fees mean all charges that the companies pay to the external auditors against the audit services and non-audit services, e.g. management advisory and consultants. Auditing fees consist mainly of the wages and benefits of office and field personnel, travel costs, and other costs necessary to the audit and related support activities. The fees equal the estimated cost of staff time and the actual cost of travel for those activities, plus margin of profit. In their discussion of Kinney and Libby, (2002) suggested that the threat to auditor independence could be as strong when the audit fee is large. Several studies that have empirically examined the relationship between audit quality and audit fee; Francis and Simon, (1987) assume that audit services are quality-differentiated and that in a competitive market, quality differences are reflected in fees. However, since audit fees have a number of determinants, they are a noisy proxy for quality. A

previous study which examines whether, in an Australian setting, the existence of an audit committee, audit committee characteristics and the use of internal audit are associated with a higher level of audit fees concludes that a higher audit fee implies higher audit quality Francis, (2004). Several authors argued that managers and entrepreneurs are willing to pay higher audit fees to receive what are perceived to be higher quality audits.

For example, Beatty, (1993) reports greater compensation to Big 6 auditors than to non-Big 6 auditors in the IPO market. Numerous other audit fee studies, including Francis and Simon, (1987), and Craswell, Francis, and Taylor, (1995) documented a relationship between auditor prestige or reputation and audit fees. Craswell, Francis, and Taylor not only report an audit fee premium for the Big 8 name, but also an audit fee premium for audit specialization within the Big 8. Chaney, Jeter, and Shivakumar, (2002), were unable to find a significant Big 5 audit premium. Although there is some evidence that audit fees do not contain this premium, it appears that economic agents are willing to bear some increase in cost for what are perceived to be higher quality audits. Beatty, (1989) suggested that the auditors performed a certification role for IPOs by, in effect, staking their reputation on the quality of the audit. Firms can buy this certification by selecting an auditor with high reputational capital who will charge a higher audit fee. Results of Sharma, (2003) and Goodwin, and Kent, (2006) were indicating that higher audit fees are associated with more frequent audit committee meetings. Committee independence and accounting and finance expertise are not significantly associated with audit fees. Simon, and Francis, (1988) suggested that several studies of the U.S. market for audit services have found evidence of a large audit-firm fee premium. This premium has been interpreted as an indication that large audit firms (typically defined as the "Big five," now the "Big four"), considered as a group, receive higher fees than non-Big firms and thus are perceived to provide higher quality audit services. A common interpretation has been that there is a strong relationship between audit firm size and audit quality. That is, the observed big fee premium has been interpreted as evidence that this group of large auditors, as a whole, is perceived to provide higher quality audits.

2.1.6 Auditors' Responses to Earnings Management.

Considering earnings management as a non-neutral financial disclosure resulting from an intentional intervention of managers to produce some private gain (Schipper, 1989), associated with the precept that the auditor is responsible for acting on the assumption of ensuring non mis

leading disclosure, it becomes evident that this professional is accountable for acting to restrict/limit the actions that may be characterized as manipulative of the actual economic-financial situation of the company.

This understanding of the role of auditors as agents mitigating the discretionary action of management on financial disclosure is reinforced, among others, by Vincent et al. (2003) and Kanagaretnam, Lim et al. (2010).

Dang (2004) summarizes the relationship between audit and earnings management by stating that the role of the auditor is to mitigate the information asymmetry between the parties, which is why audit quality should be related to lower levels of asymmetry and uncertainty regarding the performance of the entity. Thus, the author concludes, audit quality should be negatively related to earnings management.

Summary

This chapter provided a theoretical framework for auditing, describing theories on auditing. The ‘agency theory’ is the most prominent of the existing theories on auditing and explains the purpose of audit services in communication between a company and its environment.

Perceiving the principal-agent relationship in which the principal and the agent have partly differing goals and risk preferences, the financial statement audit is functioning as a monitoring mechanism. The audit makes management accountable to shareholders for its stewardship of the company.

Limperg’s Theory of Inspired Confidence (1932); a basic theory on the auditor’s function, stresses the social responsibility of the auditor. According to Limperg, the auditor derives his general function in society from the need for expert and independent examination and independent opinion based on that examination.

Other theories (principles) on the role of the audit focus on, for example, the provision of audited information to enable users to take economic decisions. Here, the audit is valued as a means of improving the quality of financial information.

Based on a theoretical framework, describing the role and the purpose of the audit function, the next chapter more extensively addresses the contents of audit services and auditors’ communications, the audit report. In addition, this chapter will focus on the form and the content of the audit report and comments the shortcomings of the audit report.

2.2 Empirical studies on the determinants of external audit quality

Audit firms have to tailor their services to ensure a competitive supply of auditing services for their clientele. Since the pioneering work of DeAngelo (1981), concerns about audit quality and the factors that influence audit quality have been longstanding subjects of interest in academic, practitioner and regulatory debates about auditing. The objective of enhancing audit quality underlies standard setting activities and doubts about the quality of audit have motivated academic researchers to examine the links between various factors and the possibility of audit quality differentiation between audit firms in the provision of audit services.

Several studies have been conducted to examine the relationship between external audit quality and its determinants in developed and developing countries for different industry. Given the amount of empirical literature available on the topic of this research it would have been quite difficult to present the results of all the studies. Hence, the main theme of this empirical review involves the consideration of the relationship between audit clients' level of earning management (measure of audit quality) and the various audit firms' related determinant factors using discretionary (abnormal) accrual as a proxy for earning management.

Although mixed results have been reported, prior researches have recognized audit firm related factors such as the size of the audit firm, audit fees (as an indicator of audit effort), audit firm specialization in the industry, the presence of fees from non-audit services, duration of the client audit firm tenure and number of certified audit professionals in audit service per audit firm have commonly been tested for evidence of an association with audit quality (using proxy of earning management).

Thus, in line to audit quality determinant factors to be tested in Ethiopian manufacturing share companies, the discussion here concentrate on the key empirical evidences on attributes of audit firm determinant factors which have been empirically proven to have strong relationships with external audit quality, with a particular focus on those that have been conducted more recently, as far as they are the best indicators of the current situation.

Determinants of external audit quality studies conducted in single country are reviewed in section 2.2.1. This is followed by a review of determinants of audit quality studies carried out on a panel of countries in section 2.2.2. Finally, related studies conducted in the Ethiopian context are reviewed in section 2.2.3.

2.2.1 Single country studies

This section presents all the single country studies reviewed by the researcher chronologically as far as the writers' views have tended to change over time. The study of DeAngelo (1981) was the first study about the auditing quality and the determinant factors affecting it. The author examined the relationship between audit quality and the size of the audit firm for a sample of United States banks for the 1983-1992 time periods.

Using the granger causality model, she showed that the auditing quality and the size of the audit firm to be positively related. Further DeAngelo (1981) demonstrated analytically that larger audit firms have several clients and less likely to be economically dependent upon the revenue from simply one or two and this serves as an incentives to detect material errors and irregularities in order to maintain their professional reputation, resulted in increased auditor independence, which is a recognized principal component of audit quality.

In this context, it is predicted that a higher quality auditor is more likely to control inappropriate behavior of the client's management and, thus, more likely to control earnings manipulation and ensure accurate financial information is issued. On a similar theme, Krishnan and Schauer (2000) examined the relationship between audit firm size and audit quality in a sample of 164 Voluntary Health and Welfare Organizations (VHWOs), using their compliance with eight Generally Accepted Accounting Principles (GAAPs) disclosure requirements as the audit quality measure.

The authors used a multivariate logistic regression to control for variables associated with auditor reporting and argued that big size audit firms received larger audit fees compared to smaller firms and this larger audit fees reflect high audit quality through greater audit effort, which influences the ability of the auditors to detect material misstatements and constrain the incidence of earnings management.

Further, the study support the idea that the Big Four audit firms have regular training programs, standardized audit programs, and firm-wide knowledge sharing practices supported by information technology, this make possible for the reported earnings forecasts of companies audited by big size audit firms' auditors more accurate than non -big size audit firms' auditors, implying more accurate financial information.

In contrast to the above findings, using seventeen Korean manufacturing share companies that experienced corporate fraud, Louis and Robinson (2005) examined the determinant factors

of external audit quality by proposing the hypothesis that audit firm size has an effect on audit quality.

The authors used discretionary accruals as audit quality proxy and employed the modified Jones model in attempt to control for differences in client characteristics between the two audit firm groups while estimating the audit-quality effects. The empirical test resulted that since the audit that quality is produced by individual auditors rather than the firms for which they work, there is no significant difference in the reported discretionary accruals of clients audited by the differing size of audit firms.

Moreover, Louis and Robinson (2005) suggested that audit firm size alone should not be a prime determinant of higher level of audit quality that as long as professional standards and qualifications are maintained throughout the sector; otherwise small size audit firms may be replaced simply because they are less well known, even though they may well be providing as high or higher audit quality services. Thus, it is unfair to distinguish between large and small audit firms irrespective of the fact that larger audit firms have more resources.

In an experimental study, Najjar et al. (2011) examined the incidence of discretionary accruals of sampled industrial companies in Kenya. The goal of the study was to investigate the effect of client industry audit specialization on external audit quality. They used panel data derived from annual reports and financial statements of 65 manufacturing companies for the period of 2005-2009 and apply multiple linear regression analysis using SPSS.

Najjar et al. (2011) identified a strong relationship between the magnitude of discretionary accruals and client industry audit specialization which is one among audit firm attributes. The results of their study also revealed that when a given audit firm has a large group of clients in the same industry, auditors expertise increases and will have in-depth understanding of the nature of business and risks in that particular industry.

Hence, companies that use an industry specialist audit firms as its outside auditor have lower level of discretionary accruals with more reliable earnings used in predicting future cash flows than companies audited by non-industry specialists audit firms, and therefore provide a higher audit quality for the client.

Likewise, the authors suggested that, in the long run, due to increased knowledge about the industry, errors in the audit will be eliminated, resulting in an increased audit quality. Hence, client industry audit specialization is the vital element that creates, and subsequently

enhances, the learning curve of new auditors. This argument might seem simple at the outset, while in fact it is not.

Schauer (2008) provided further evidence on impact of audit firm-specific attributes on external audit quality for Indian private family firms that covered the period from 1999-2006. The study contributed to the literature which concentrates mainly on testing of the association between client industry audit specialization, measured by market share, and audit quality using the Jones (1991) abnormal accruals model, since prior research explained that it is the best measure of the discretionary portion of total accruals. The overall results suggested that client audit industry specialists have more industry expertise creating by sharing best practices and learning from serving the same industry clients. Therefore, this enables external auditors to be more effective at detecting misstatements in staff working papers during the audit review process in order to constrain the incidence of earnings management which is associated with higher audit quality. Thus, in this way audit firms meet their client needs, because clients always want the best audit quality.

In the contrast to the positive association between client industry audit specialization and audit quality findings, Grambling and Khurana (2010) examined the association between longitudinal effect of audit firm industry specialization on audit quality in the period 2004-2007. In this study industry specialization is determined based on the market share approach. Through the relative market share of an audit firm, with total assets as the base, a given audit firm can be identified as an industry specialist. The sample used in this study was divided into 63 industries, where in each industry the audit firm with the largest market share is the industry specialist. For determining the audit quality, the magnitude of abnormal accruals is used based on Jones (1991) abnormal accruals model. The absolute level of abnormal (discretionary) accruals of industry specialist audit firms are compared with those of non-specialist audit firms. After controlling for variables related to abnormal accruals, regression results showed that there is no significant longitudinal effect of auditor industry specialization on audit quality. The hypothesis was rejected, and the authors conclude that audit quality of clients of industry specialist audit firms is not significantly different in the upcoming year than those of non-specialist audit firms.

A study made by Mande (2007) examined the effect of the number of consecutive years that the audit firm has audited the client (referred to as audit firm tenure in the current study) on external

audit quality; evidence from Jordanian industrials companies over the period (2001-2005). He used absolute abnormal accruals to proxy for earnings management. Based on the statistical analysis, Mande (2007) suggested that since the initial low-balling encourages auditors to accommodate their clients so as to extract future quasi-rents, auditor independence may be impaired even in the early part of audit firm tenure. Here quasi-rents can be defined as “at risk quasi rent” explanation, pursuant to which the more extensive potential economic loss exposures faced by large audit firms provide a strong motivational framework for quality assurance and enhancement. These quasi-rents, when subject to loss from discovery of a lower quality audit than promised, serve as collateral against such opportunistic behavior.

Further the study suggested that as the audit firm-client relationship lengthens, it result for external auditors in reducing their reliance on management estimation and representation, which results in a more effective audit. Consistent with Mande (2007) findings, Meyer et al. (2006) examined weather the duration of the audit firm relationship with a client (referred to as audit firm tenure in this study) has an impact on audit quality for 840 firm-year observations of Australian companies that covered the period 1998-2004.

Using three-year audit-tenure segmentation, the empirical findings suggested serious disadvantages to audit firm tenure. Key among them was the loss of the current audit firm's cumulative client-specific knowledge (e.g. company's business, processes, systems, people, and risks), or a knowledge that is more general in scope but very essential to the audit process at hand (knowledge about the industry within which the client is operating and the accounting principles applicable in the country where the client is operating its business). Lack of the aforementioned client-specific knowledge during the startup period of the external auditors' decreases the likelihood of detecting material errors and misstatement in the financial reporting of the firm which is associated with lower audit quality.

Further, the study revealed that since the costs of audit firm rotation would outweigh the perceived benefits of a required periodic “fresh look” at the financial statements by a new audit firm, audit firm tenure (rotation) would reduce, not improve, audit quality. But, no rationale other than data availability was provided for the selection of three-year audit tenure segmentation by this study.

In contrast to Mande (2007) and Meyer et al. (2006) study; Deis and Giroux (2012) examined the impact of audit firm rotation on external audit quality from a sample of Taiwanese 622 private

companies and hypothesized that audit quality decreases as audit firm tenure increases. For this purpose, a multivariate regression where audit tenure was a continuous independent variable represented by the number of years the audit firm had audited the company client. The result of the regression model indicated that audit firm tenure was shown to be a significant component of audit quality for the following reasons. First, in order to maintain the auditor independence which otherwise would be eroded due to the personal attachments with the audit client, which in turn improves audit quality. Second, it is considered that audit firm tenure plays a key role in the transmission of learning experience to the outsiders, since the successor auditor gets information from his predecessor who helps him in assessing the firm's financial condition. At the same time this will improve the work of the audit firms as they know that sometime in the future their work will be reviewed by another audit firm when they are rotated after the specific period of time in order to enhance the audit quality through promoting the creativity in audit testing approaches and methods which might be affected by the increased familiarity with the client. Finally, the rotation also provides a new insight to the client's financial statements since the auditing practice is based on employing professional skepticism and the long run attachment with the client and working for long years for the same client can reduce the sharpness of auditors' professional judgment.

Frankel et al. (2009) conducted a questionnaire survey on Nigerian medium-sized manufacturing companies over the period of 2001-2007 to examine audit-clients and audit-firm related factors that could impair external audit quality. The joint provision of audit and non-audit services (NAS) to audit client was ranked as top threat factor by users (financial journalists) and preparers (financial directors). Based on the statistical analysis the study revealed that, the provision of non-audit services (NAS) in general and audit-related services in particular exacerbate the economic bond between the audit firm and its client which may potentially cause the audit firm to be financially reliant on the client.

As a consequence of such an audit firm-client relationship, the auditor is unwilling to challenge a client's management on questionable accounting choices for fear of losing lucrative NAS fees which create incentives for audit firms to compromise their objectivity, e.g., waive audit adjustments, in order to retain audit clients and this create more opportunities to conduct opportunistic earnings management by audit client managements. Hence, in this case the credibility of external audit work will be questionable.

Further, the results obtained from the t-test suggested that the offering of non-audit services by an audit firm does not lead to significant high knowledge spillover effects, which could lead to an increase in the auditors' ability to detect inappropriate accounting practices. The study by Sharma (2011) empirically analyzed the influence of the joint provision of audit and non-audit services on Tunisian manufacturing companies' audit quality during the period 2005-2009. Using discretionary accruals as an indicator of audit quality, the regression analysis discovered a significant positive relationship between lower abnormal accruals indicate that earnings quality is higher, which is a proxy of audit quality and the practice whereby external auditors providing non-audit service to its audit client.

The finding suggested that providing NAS to audit clients ensure auditors potentially to have more extensive knowledge about the client's operations, e.g., the auditors know the extent and effectiveness of the information technology used within a company if he or she had a hand in designing the system. Moreover, task-specific knowledge and experience affected auditors' performance more than general business knowledge or years of experience gained simply through the audit process, suggesting that the incremental knowledge gained from performing non-audit services enables the auditors to perform the audit more efficiently and effectively.

The study also hypothesized that "knowledge spillover" can occur when NAS is provided to audit client which may enhance the auditors' understanding of the client and its risks. If investors believe this knowledge spillover exists, the auditor who performs NAS might be perceived to be more knowledgeable and competent regarding their client, and more likely to detect an error in the system or the output (financial information).

Furthermore, the author suggested that, the main question that arises when external auditors provide or could provide both audit and non-audit services is whether the auditors are able to conduct their audits impartially, without being concerned about losing or failing to gain additional services, and the subsequent economic implications for the audit firm. Causholli et al. (2013) investigate the audit quality issue by investigating whether and how audit quality is associated with the joint provision of audit and non-audit services (NAS) by the external audit firm to its audit client. Using a sample of 1,008 firm observations of major Malaysian listed industrial share companies for the sample period 2004-2011, the study found either no or negative association between provision major classes of non-audit services and

actual audit quality as measured by discretionary accruals. Hence, the authors have not obtained any pervasive evidence indicating that joint provision of audit and non-audit services erode actual audit quality.

2.2.2 Panel country studies

Gaeremynck (2010) analyzed the determinants of audit quality in four countries of the ASEAN members, namely Malaysia, Indonesia, Philippine and Thailand, for the period from 2003 to 2007 with sample of 155 medium-sized comparable manufacturing firm-year observations. In the study, the unit of analysis was the external auditor who has worked in (Certified Public Accountant) CPA firm; the author takes the CPA Firm in the aforementioned ASEAN member countries.

Based on the empirical result, he found that the CPA firm size and audit fees (as an indicator of audit effort) for all selected ASEAN countries reveal statistical significant with positive relationship with audit quality. Whereas provision of non-audit services has significant negative impact on audit quality mainly for Indonesia companies only. Audit firm being professional society membership shows a positive significant relationship for Malaysia and Philippine sampled companies. Also he found that client-effect variables; client size and financial leverage indicate significant impacts on audit quality while country-effect variables GDP growth rate and inflation show insignificant relationship with audit quality.

In a comparative study, Chang et al. (2003) investigated whether factors affecting audit quality in Malaysia are similar to those variables influencing Chinese industrial companies' audit quality. The objective of the study was to investigate the existence of earnings management practices in sampled peer industrial companies and testing the impact of auditing quality characteristics (the auditing firm size, contacts with other global auditing firms, client retention period, auditing fees and the specialty in client's industry) on the enhancement of the level of audit quality. Towards realizing the objectives of the study, data of 76 industrial companies for the period 2001-2006 were arranged in a way that made it possible to apply the Pooled Data Regression and the relationship was estimated and examined through multiple regressions of (Ordinary Least Squares OLS). The study found significant results indicating a low level of earning management in the financial statements issued by sampled industrial corporations.

In addition, the study showed that the auditing firm size and client retention period had a statistically significant impact on audit quality. The study provides no evidence supporting the

effect of contacts with other global auditing firms on audit quality. Finally, the findings were not varied across the two countries so they concluded that audit quality in some other countries was affected by factors similar to those that influence the Malaysia and Chinese industrial companies. Bedard et al. (2002) undertook a comparative study to measure the effects of 10 country-specific and audit firm-specific variables on audit quality, including inflation and GDP growth rate for country-specific variables, while the size class of an audit firm, the skills and personal qualities of audit partners, industry specific expertise of audit firm, audit fees, number of certified audit professionals ratio per audit firm, concurring partner review and geographic location of audit firm offices for audit firm-specific determinants reflecting audit quality of investigate the issue of earnings management in European context. OLS estimation model was used to analyze sample data included 294 U.K, 669 Denmark and 345 Singaporean peer industrial firms for the period 1993-2001.

Overall they found that except for the geographical dispersion of audit firm offices variable, all those identified audit firm-specific variables have an impact on audit quality status. A key result is that industry expertise of audit firm has statistically significant relationship with earning management, which provides evidence in support of agency theory; it reduces information asymmetries between managers and firm stakeholders by allowing outsiders to confirm the financial statements validity. As pointed out in the theoretical section of this chapter, less information asymmetry is indicative of less earnings management and hence the higher level of audit quality. The results also indicated that inflation and GDP growth rate have statistically insignificant relationship with the level of earning management.

Using the collapse of Arthur Andersen and Enron, Carello (2008) examined the effects of the client company losing the agency benefits inherent in the relationship with the audit firm. By proposing the hypothesis that the audit firm tenure and provision of non-audit services have an effect on the audit quality, this questionnaire-based study examined the variables and observes the correlation of these variables by taking sample from privately held comparable industrial firms from some developing countries, namely Tanzania, Zimbabwe and Nigeria during the period 1996-2005.

The study focused specifically upon how investors perceive some of the main audit firm-client relationships that may have contributed to the collapse of Arthur Andersen and Enron: long relationships between audit firm and clients, and the joint provision of both audit and non-

audit services, in order to determine whether, the owners still have faith in the role of the external auditor. The results suggest that, having long audit firm-client relationship is perceived as greater threats to audit quality than the provision of both audit and non-audit services.

Thus, the paper gave some support to the policy of imposing mandatory audit firm rotation in the region to promote audit quality. Daniels and Booker (2009), using a sample of peer 286 oil processing companies, representing percent of industrial companies listed in the Middle East and North Africa countries at the end of March 2006, he studied the determinants of audit quality over the period 1998-2006. Findings of the study showed that audit firm with large number of certified audit professionals' ratio per audit firm, provision of assurance services only and specialization in client's industry might be an indicator of a higher level of quality. Although with a negative sign in all regressions, the number of certified audit professionals' ratio per audit firm was relevant in explaining external audit quality, which is measured by abnormal (discretionary) accruals, as a measure of earning management.

Lin et al. 2010 analyzed the level of discretionary accruals determinants by examining them empirically with reference to sample of peer 869 textile firm-year observations operating in all countries of American continent, specifically North, South and Central America during the years 1999-2004. The authors extended empirical work on audit quality theory in three ways. First, they examined a much broader set of audit quality theories, many of which have not previously been analyzed empirically. Second, the authors developed five audit firm specific explanatory variables, namely senior auditor turnover rate, audit firm size, expertise gained from prior industry audit experience, audit fees and extended audit firm engagement with audit client; since the theories have different empirical implications in regard to different earning management determinants.

The results of cross-sectional OLS regression showed that both the asymmetric information theory and the stakeholder theory are pertinent theories to sampled countries companies' level of earning management whereas there was little evidence to support the institutional theory. Abnormal high audit fees and lack of expertise gained from prior audit experience of a given client may have an impact on agency costs, as shareholders who are unable to offload their shares might exert pressure on management to act in their

best interests. The results also indicated that higher rate of auditor turnover rate per audit firm has statistically insignificant relationship with the level of audit quality.

More recently Knechel and Vanstraelen (2013) investigated the determinants of audit quality on non-financial firms in Sub-Saharan Africa countries. The objective of the study was to examine the relationship between the earning management level and a set of audit firm-specific explanatory variables which include specific industry experience on the job, size of audit fees (as an indicator of audit effort), number of audit clients per audit firm, provision of non-audit services and other audit client relationships, length of audit firm engagement in specific audit client firm, number of certified audit professionals per audit firm and the size of audit firms by using panel data analysis to establish the determinants of audit quality of textile manufacturing companies over the period 2004-2010.

The OLS results showed that there is a negative relationship between earning managements (as a measure of audit quality) and long audit-firm client relationship which is consistent with the prediction of the stewardship theory. In the same way, audit quality is negatively related with provision of non -audit services and other audit client relationships and lack of industry specific knowledge but positively related to number of certified audit professionals per audit firm as well as size of audit firms which is consistent with signaling theory. In general as per Knechel and Vanstraelen (2013), number of audit clients per audit firm is not significant determinants of audit quality.

2.2.3 Review of previous studies in Ethiopia

While reviewing the literatures in relation to determinants of external audit quality in Ethiopia; first the determinant factors affecting external audit quality in Africa must be kept firmly in mind. In the context of Ethiopia, to the knowledge of the researcher, there appears to be very limited work on the assessment of the determinants of external audit in private companies. These studies include the recent studies of Amsalu Gelaneh (2011), Mekonnen Aboneh (2011) and Bethitina Leilina (2015). Previous studies conducted examined the impact of extended audit tenure on auditors' independence and audit quality, which is considered from the viewpoint of the external auditors and the impact of private ownership on financial reporting quality of privately, owned companies in Ethiopia respectively.

Thus, this particular section provides a detailed review of the two related studies conducted in the context of Ethiopia. A study made by Amsalu Gelaneh (2011) examined whether extended

audit tenures or auditor client relationship can lead to the emergence of threats to auditor independence which will impair audit quality. It also attempted to examine the impacts of lengthy audit tenure on auditors' independence and audit quality to see what extent the impact of extended audit tenure affects auditors' independence and audit quality when it is compared with short audit tenure.

Having this, the researcher analyzed the perceptions of external auditors based on how extended audit tenure affects auditors' independence and audit quality. The long tenure or as referred to in his paper as the extended audit tenure, is assumed would positively affect the audit quality. As he suggested this is due to the reason that a newly appointed auditor might fail because of a lack of a thorough understanding of the client, means that new auditors would make more mistakes than the experienced auditors. Moreover, the results also suggested that long-term auditor client relationships did not reduce the auditors' independence when it is compared with the short audit tenure. On the other hand, Mekonnen Aboneh (2011) assessed the overall financial reporting quality of sixty privately owned companies in Addis Ababa. The researcher constructed a compound measurement tool to comprehensively assess the quality of financial reporting in terms of five fundamental qualitative characteristics namely the relevance of financial reports, faithful representation of the actual happenings, understandability of the accounting reports, comparability of the reports by looking at the consistency of the accounting assumptions and methods the companies use, and timeliness of the financial reports as defined in 'An improved Conceptual Framework for Financial Reporting' of the FASB and the IASB (2008).

Furthermore, the study applied both primary data where structured questionnaire have been distributed to the executives of the sampled companies and secondary data obtained from the accounting reports and auditor reports of those sampled companies. The estimation results suggested that depending on the audit works of sampled companies the financial statement provided by private companies are faithfully represents what happened and the actual results of the financial figures. Besides, the study findings conclude that the sampled companies did not all in all comply with the qualitative characteristics of the financial reports, which implied that the overall financial quality of these companies is generally questionable.

Moreover, a more concise research was conducted by Bethitina Leilina which included more variable and audit firm attribute. The research tries to assess audit firm attribute which affect audit quality particularly in the case of manufacturing companies. Even though the study

included more variable and use proxy for audit quality but the researcher focus on audit firm attribute with selected manufacturing companies.

2.3 Conclusions and knowledge gap

Audit quality has been the focus of theoretical and empirical auditing research for the last 30 years. Worldwide, the concepts of earnings management and discretionary accruals are dominating audit quality considerations on audit engagement level. Even though a plenty of studies investigated the determinants of audit quality in different countries especially in the western; there is a lack of empirical evidence from the developing countries context like Ethiopia. Only a limited studies had been conducted in the area from developing countries as far as the researcher knowledge is concerned e.g. Nigeria, Lebanon, South Africa, Jordan. Again, prior researches have documented inconsistent results on the evidence of the linkage between audit quality and its proxy.

In the context of Ethiopia, the related study conducted by Amsalu (2011) mainly assessed the impact of extended audit tenure on auditors independence and audit quality in country. Accordingly, this study clearly failed to identify most of the factors that affect audit quality significantly as far as its main focus was an assessment of the impact of extended and short audit tenure on auditors' independence and audit quality in Ethiopia.

That means this study clearly fails to fill the knowledge gap that exists in the area as far as it considers only one variable without putting proxy for audit quality measurement and ignores other audit firm related variables affecting external audit quality. The other recent study of Mekonnen (2011) assessed the impact of private ownership on financial reporting quality in privately owned companies in Addis Ababa, Ethiopia. This study limits its scope only on investigating financial reporting quality based on the qualitative characteristics of financial reporting information on an improved conceptual framework for financial reporting of the FASB and the IASB (2008) from the point view of auditors' perceptions. Besides, the study of Mekonnen (2011) fails to disclose the impact of some very important variables on Ethiopian privately owned companies' external audit quality such as company size, and audit firm related factors among others.

Researches in the area is very useful in giving an insight for both audit firms and company stakeholders as to knowing the determinant factors affecting audit quality. It will also help regulatory and professional bodies to properly monitor the external audit

profession and to maintain trust among the various stakeholders. Therefore; it would be worthwhile to ask the audit firm related attributes that are considered to be the determinant factors affecting external audit quality in Ethiopia. Besides, the relationship between discretionary (abnormal) accruals (proxy of earning management) and external audit quality (measured by earning management) has not been empirically researched for the Ethiopian audit market. Thus, this paper aimed to speak directly to such issues using Commercial banks - Ethiopia.

Chapter Three

Research methodology

Introduction

The previous chapter dealt with review of related literature on the determinants of audit quality. This chapter outlines and explains the methodology employed to achieve the research objective and test the research hypotheses formulated in the study. Specifically in this chapter, the Research Design, Data Collection Methods, Sampling Design, model specification and Data Analysis are discussed in detail. All the elements in this chapter are constructed based upon the purpose of the research which is identifying factors affecting external audit quality using secondary data. Data will be gathered from National Bank of Ethiopia, Ministry of Finance and Economic Coordination and Commercial Banks in Ethiopia covering the time period of 2005 to year 2014.

3.1 Research approaches

Research approach is the general framework for the study that links, knowledge claims, strategies of enquiry and specific methods. The research approach implicitly reflects the researcher attitude as to how knowledge is constructed and also commands what method to be employed in the study. According to (Creswell 2009), Quantitative, qualitative and mixed methods based their assumption towards knowledge creation on post-positivism, social constructivism and pragmatic philosophical grounds respectively.

Quantitative research: this approach is based upon an empirical cycle that has a deductive nature. The researcher often uses an established theory to develop the hypothesis to be tested. Jonker and Pennink (2010) contended that the essence of quantitative research is to use a theory ‘to frame and thus understand the problem at hand. Quantitative purists believe time and context free generalizations are desirable and possible, and real causes of social scientific outcomes can be determined reliably and validly (Johnson and Onwuegbuzie 2004). It is grounded in the basic attitude that knowledge about reality can also be obtained through the eyes of the researcher’. It is he who elaborates theory based on findings. In order to make this happen, theory is most often translated into a conceptual model and elaborated predominantly by means of hypotheses. For

the researcher conducting quantitative research implies carefully operationalising a theory and subsequently measuring it by means of variables and questions.

Qualitative research: is an inquiry process of understanding where the researcher develops a complex, holistic picture, analyzes words, reports detailed views of informants, and conducts the study in a natural setting (Creswell, 2002, p. 15). In this approach, the researcher makes knowledge claims based on the constructivist (Guba & Lincoln, 1982) or advocacy/participatory (Mertens, 2003,) perspectives. In qualitative research, data is collected from those immersed in everyday life of the setting in which the study is framed. Data analysis is based on the values that these participants perceive for their world. Ultimately, it produces an understanding of the problem based on multiple contextual factors (Miller, 2000).

Mixed methods research: Johnson, R. B and Onwuegbuzie, A. J. (2004, pp 17) defined mixed methods research as the class of research where the researcher mixes or combines quantitative and qualitative research techniques, methods, approaches, concepts or language into a single study. Philosophically, mixed research makes use of the pragmatic method and system of philosophy. Its logic of inquiry includes the use of induction (or discovery of patterns), deduction (testing of theories and hypotheses), and abduction (uncovering and relying on the best of a set of explanations for understanding one's results). It employs strategies of inquiry that involve collecting data either simultaneously or sequentially that best suit to understand the problem Creswell (2003)

3.2 Research approach adopted

The major objective of this panel study is to assess the audit quality determinant factors in Ethiopian commercial banks based on factors which are found to significantly influence audit quality in prior studies. The research problem tend to be explanatory which seeks to explain the relationship between audit quality and audit firm level factors as well as auditor attributes. Therefore, quantitative research design is appealing for this study to achieve the objectives of the study and to test the hypothesis. Creswell (2003) indicated different methods associated with quantitative methods mainly focusing on survey and experimental designs. In this study the researcher used survey research method.

3.2.1 Survey design

A survey design provides a numeric description of trends, attitudes, or opinions of a population by studying a sample of that population so that inferences can be made about the population

(Creswell 2003). Surveys include cross-sectional and longitudinal studies using questionnaires or structured interviews for data collection, with the intent of generalizing from a sample to a population. Fowler (1984, p. 12) noted that the strengths of survey methods that result in their wider use included the value of statistical sampling, consistent measurement, and the ability to obtain information not systematically available elsewhere or in the form needed for analysis. Survey design is used to make statistical inferences for bank audit quality determinants and the economic bond between auditors and client banks.

The purpose of quantitative studies is for the researcher to project his or her findings onto the larger population through an objective process. Data collected, often through surveys administered to a sample or subset of the entire population, allow the researcher to generalize or make inferences. Results are interpreted to determine the probability that the conclusions found among the sample can be replicated within the larger population. Conclusions are derived from data collected and measures of statistical analysis (Creswell 2002; Thorne and Giesen 2002). Therefore, the investigator is capable of studying a phenomenon without influencing it or being influenced by it; inquiry takes place as through a one way mirror (Guba and Lincoln 1994: 110). The goal is to measure and analyze causal relationships between variables within a value-free framework (Denzin and Lincoln 1994).

3.2.2 Sampling design

A sample is a portion of the population that inferences are to be made about the population. The population for this study consists of all commercial banks operating in Ethiopia, Out of which 2 of them are state owned while the remaining banks are privately owned. The sample frame for the study was determined based on the availability of each bank data from the year (2004 -2014) including the one year ahead data for some variables used in the study. There are only eight commercial banks operating in the country during the whole study period. Since the number of banks in the sample frame is relatively small and manageable, all the banks were included in the sample. According to Brooks (2008, p 105), while there is no definitive answer for an appropriate sample size for model specification, it should be noted that most testing procedures in econometrics rely on asymptotic theory. This theory dictates that as the sample size approaches to the population, the results from the sample estimates are more appropriate for generalizing to the general population. Thus in this case the sample size is equal to the

population in the sample frame which enabled to make appropriate generalization to the overall population.

The sample for the study is composed of 6 private and 2 state owned banks. Namely, Awash international Bank, Dashen Bank, Abysinia bank, Nib international bank, Wegagen bank, United bank, commercial bank of Ethiopia and Construction and business bank are included in the sample.

In this study only secondary data is utilized. The structured review of documents enables this study to critically investigate bank audit quality determinants than the primary data sources would allow given the confidentiality nature of the data, biased responses among the respondents and response rate considerations. A ten year audited annual report data was obtained from each of the eight banks (80 firm-year observations). In addition to financial statement data for each bank, data was also obtained from NBE for items which are not reported in the bank's annual reports. One year ahead data was also used for some variables in which lagged values are required in the regression. Information regarding the auditor Grade was obtained from OFAG.

3.3 Data presentation and analysis

In this study various statistical analysis were employed to analyze the data and test the research hypothesis. First, descriptive statistics is used to highlight the nature of the data and describe the variables used in the study in terms of trends and variation among the cross-section. Second, correlation analysis is also conducted to see the relationship among the dependent and independent variables. This would help to get an initial picture as to the nature of the relationship among the variables before proceeding to regression analysis. Finally the panel least square regression analysis is used to determine the significant relationships between bank audit quality and its various determinants and to test the hypothesis there on. Various tests were also conducted to determine the appropriate regression model and to test the validity of its assumptions.

3.4 Research hypotheses development

The major objective of this panel study is to investigate the impact of the factors that are believed to influence audit quality from prior studies in the determination of audit quality in the audit of commercial banks of Ethiopia. Using different audit firm attribute peculiar to the auditing industry and other factors which are found to influence audit quality in prior studies, the study

assess factors that external auditors consider in engaging in their audit service for Ethiopian commercial bank clients. Specifically, the study assess whether audit quality is influenced by auditors specialization in audit of banking industry, importance of the client to the audit firm, short versus long term relationship, litigation risk and presence of audit committee.

In order to achieve the objective of the study the researcher developed six hypotheses. The factors that determine audit quality with their theoretical underpinnings are discussed in detail in the second chapter. In this section, the researcher provides a brief theoretical discussion on the relationship of the determinant factors with audit quality and the hypothesis developed for the study.

1. Audit Firm Industry Specialization

As industry specialization is not directly observable, prior studies use several proxies (e.g. market share and portfolio share) to measure it. Most measures are based on the market share of a firm, because industry expertise is obtained by repetition of the audit task in similar settings and therefore people perceive that auditing a large share of a certain industry indicates expertise (Balsam et al. 2003). An industry expertise and proficiency measure an audit professional's knowledge within a particular industry. This particular measure could examine the substance and amount of specific industry training received by an audit professional and/or the years of experience devoted to a particular industry by an audit professional. Academic research in the area of auditor industry experience has been found to be positively related to the quality of audits.

Using the assumption that knowledge concerning the client and his business increases the auditor's ability to identify potential material distortion, authors such as Behn et al. (2008) and Romanus et al. (2008) use the level of specialization in the industry as a proxy for audit quality. It is expected that the greater is the relevance of the economic segment to the auditor, the greater is their ability to provide quality services, considering their greater expertise in that type of business.

This understanding is reinforced by Gul, Fung and Bikki (2009) and Chambers and Payne (2008), in stating that auditor specialization in a given industry leads them to have a broader understanding of accounting practices and trends in the segment, increasing their ability to evaluate evidence and identify problems in the statements. The results found by Carcello and

Nagy (2004) and Krishnan (2005) also indicate that auditor specialization is an element that enhances the quality of financial disclosure and mitigates the probability of fraudulent statements.

Particularly, regarding the banking industry, Kanagaretnam, Lim et al. (2010) emphasize that auditors who are experts in the banking industry can assess more appropriately the suitability of the information produced by management. An example of this relationship is given by Kanagaretnam, Krishnan et al. (2009) who, when examining the role of auditor reputation on audit quality perceived by the market, found a positive association between the discretion of the Loan Loss Provision (LLP) with the stock returns of banks audited by companies with greater expertise in the banking industry.

Given the above, the following research hypothesis is formulated:

H1: The quality of audits conducted in Ethiopian banks is positively related to the degree of auditor specialization in the industry.

This research focuses on within industry market share approach because this approach is the most often used measurement in the literature. The variability offered by the different proxies and assignments in the market share approach is sufficient to test whether different auditor industry specialization measures lead to consistent or inconsistent results. Using only market share approach enables us also to keep the measurement concept constant. According to Gramling and Stone (2001), within industry market shares of auditor firm *i* in the industry *k* is measured as the total audit fees earned by auditor firm *i* in industry *k* deflated by the total audit fees generated by all the clients in the industry *k*.

2. Length of Contract between the Auditor and Financial Institution

By relating the issue of professional skepticism to audit quality, Lys and Watts (1994) argue that long-term auditor-client relationships tend to reduce professional independence, which should be reflected in the quality of the audit. The interaction between auditor and client is also underlined by Demski (2004) as one of the elements that may be important in the performance of the audit work. To prevent such situations, the idea of a mandatory rotation of auditors has been discussed, the purpose of which would be, according to Nagy (2005), to limit the relationship between auditors and clients, assuming that when this relationship lasts a long time, professional independence could be compromised.

Siregar et al. (2012), however, note distinct nuances in relation to audit tenure. For them, the early years of contracts may be perceived as less effective, considering it takes time to evaluate audit risks, whereas maintaining the contract for a long period of time may compromise professional skepticism. Due to this duality, several studies have tested the relationship between audit tenure and audit quality, without homogeneous results. As an example, Ghosh and Moon (2005) found a positive relationship between the length of the auditor-client contract and audit quality, defined by the response coefficient of return-earnings regressions, while Dao, Mishra and Raghunandan (2008) found an inverse relationship between audit tenure and the ratification of auditors by shareholders, indicating that shareholders see the long length of relationships as an element that negatively affects the quality of the audit.

Given this duality, two research hypotheses are formulated:

H2A: The quality of audits conducted in Ethiopian commercial banks is negatively associated with the auditor-client short-term relationship.

H2B: The quality of audits conducted in Ethiopian commercial is negatively associated with the auditor-client long-term relationship.

3. Audit fee

Auditor's independence may be defined as an auditor's unbiased mental attitude in making decisions throughout the audit and financial reporting process. An auditor's lack of independence increases the possibility of being perceived as not being objective. This means that the auditor will not likely report a discovered breach (Deangelo, 1981). The major threats to auditor independence are the fees perceived by the auditor for audit and non-audit services.

To the extent that audit fees are indicative of audit quality (Blankley et al. 2012; Lobo and Zhao 2013; Eshleman and Guo 2013a), audit quality should be higher in markets where audit fees are higher.

Given the above, the following research hypothesis is formulated:

H3: There is significant relationship between audit fee and audit quality.

4. Banks' Size

Large clients tend not to dismiss external auditors (Francis and Wilson, 1988),(Haskin and Williams, 1990) since large clients care for a better reputation to have good-quality auditors due to the level of expertise and better audit quality expected from Big Four audit firms. It was also revealed in previous literature that company's size plays a significant role in minimizing

disagreements with external auditors that may lead to dismiss external auditors, since larger companies tend to retain their auditors to avoid being scrutinized by financial markets and analysts (Carcello and Neal, 2003).

The majority of corporations comprising the sample of this model are assets-based companies where assets are the main driver for future economic growth and profit. Taking into consideration that net income is transferred to retained earnings in the equity section of the balance sheet, which will be indirectly reflected in total assets measurements; companies' size is measured by total assets.

Given the above, the following research hypothesis is formulated:

H4: The quality of audits conducted in Ethiopian banks is positively related to the size of the bank.

5. Leverage

Previous literature has shown that debt is considered to be a healthy factor to companies' value. It provides managers with incentives for good performance to avoid creditors' pressure and the possibility of losing their jobs in a financial crisis (Masulis et al., 2007; Chen et al., 2010). Including a leverage variable to control companies' risk is essential to show if external auditors are performing a corporate governance role (Fan and Wong, 2005). Garvey and Hanka (1999) conclude that firms operating in antitakeover law regions tend to increase significantly their leverage to avoid a hostile takeover.

Monitoring creditors and lenders, measured by leverage, are insufficient in preventing directors from over-optimistic financial reporting regardless of their companies' going concern problems (Uang et al., 2006). Broye and Weill (2008) state that the higher the disclosure requirements and the more creditors' rights are protected, the higher the demand for audit quality by highly-leveraged companies. Leverage is measured by long-term debt divided by total assets.

Given the above, the following research hypothesis is formulated:

H5: There is negative significant relationship between audit quality and leverage position of the bank.

6. Profitability

Profitability variable has been used to assess the impact on the auditor selection process, since more profitable companies are more likely to pay premium fees to have better audit quality

(Abott and Parker, 2000). Dao et al. (2008) included return on assets ratio (ROA) to control the relation between auditor tenure and shareholder ratification, because it has been evidenced that the support for management proposals is weaker at low performance companies. Less financially distressed company directors tend to change and deviate from external auditors' going-concern modification, regardless of the real concerns of a going-concern problem, rather than companies with poor financial performance (Uang et al., 2006). Due to the fact that ROA's denominator includes total assets (both equity and debt), this can help in assessing how well a company is using its two financing options that can be reflected in corporate operational performance.

Comparing ROA to other ratios, return on equity (ROE) for example, ROE's profitability is reflected by income over equity only, excluding debt. Companies' profitability is measured by return on assets ratio. It is calculated by dividing net income over total assets.

Given the above, the following research hypothesis is formulated:

H6: The quality of audits conducted in Ethiopian banks is positively related to the profitability of the bank.

3.5 Model Specification

The aim of this research is to investigate the relationship between audit quality which is proxy by (discretionary accruals) with, audit firm specialization, importance of clients force auditor portfolio, length of audit contract between bank and audit firm, and existence of audit committee.

The regression model of this study is estimated in the following form:

3.5.1 Model for Calculating the Audit Quality Proxy

Due to the reasons explained in Section 2, the audit quality proxy used in this study will be based on identifying the practice of earnings management - more specifically, discretionary accruals. The assumption is that opportunistic manipulation compromises the quality of the information and that the finding of this practice indicates that the auditor did not fulfill their mission of preserving the neutrality of the statements.

Despite the relevance of the logic implicit in this reasoning, it is important to emphasize some methodological limitations: (i) unusual non-discretionary factors may also influence abnormal accruals (Bernard & Skinner, 1996); (ii) discretion by management in the production of information is not necessarily negative, when considering an informational component, which is the communication of private information of the entity (Kanagaretnam, Krishnan, & Wolf, 2009; Kallapur, Sankaraguruswamy, & Zang, 2010); and (iii) the reversal nature of accruals makes the

assumption of a continuous, direct or inverse relationship of accruals with another variable untenable (Gu, Lee & Rosett, 2005).

To address these limitations, the calculation of the proxy will not consider the discretionary accruals, but the difference between two periods in a row - the first difference, in absolute value, according to equation (4.1). Thus, rather than seeking to identify the level of discretionary accruals allowed by the auditors, whether the practice of accruals recognition is changed from one period to another is evaluated. This procedure is consistent with studies that argue for the persistence of accruals as the most appropriate parameter to assess its reliability, as in Chambers and Payne (2008). Finally, this difference is multiplied by (-1) to adjust the metric to precept that, the higher the bias, the worse the audit quality will be. The use of the absolute value and multiplication by (-1) to determine the audit quality proxy is inspired in Kallapur et al. (2010), with the difference that these authors did not work with the concept of the first difference.

$$AQ_{i,t} = |DA_{cci,t} - DA_{cci,t-1}| * (-1) \quad 3.1$$

Where: $AQ_{i,t}$ is quality of the audit performed in bank i in period t and $DA_{cci,t}$ are the discretionary accruals that correspond the error term of the model (3.2).

The calculation of the variable DA_{cc} , in turn, is based on the identification of discretion practiced in relation to the LLP, which is the area that recorded the highest number of studies on the practice of earnings management in banks. This concentration is justified by Kanagaretnam, Lobo and Mathieu (2003) because these allowances represent the largest accruals of banks, playing a key role in decisions by managers about possible accounting manipulations. According to Alali and Jaggi (2010), there is a widespread belief in the market that bank managers extensively use LLP to manipulate the results reported, which have been a focus of concern by regulators.

To identify this discretion, the model (4.2) developed by Dantas, Medeiros and Lustosa (2013) is used³:

$$LLP_{i,t} = \beta_0 + \beta_i + \beta_1 \Delta LOAN_{i,t} + \beta_2 NPL_{i,t-1} + \beta_3 \Delta NPL_{i,t} + \beta_4 LCO_{i,t} + \beta_5 LLAI_{i,t-1} + \beta_6 INT_{i,t} + \beta_7 GDP_{i,t} + \epsilon_{i,t} \quad 3.2$$

Where:

$LLP_{i,t}$: provision for loan losses of bank i in period t ;

$\Delta LOAN_{i,t}$: change in the value of loans from period $t-1$ to t of bank i ;

$NPL_{i,t-1}$: nonperforming loans in period $t-1$ of bank i ;

$\Delta NPL_{i,t}$: change in the value of nonperforming loans from period t-1 to x of bank i;

$LCO_{i,t}$: net loan write-offs of bank i in period t;

$LLA_{i,t-1}$: loan loss allowance of bank i in period t-1;

$INT_{i,t}$: average implicit interest rate of the loan portfolio of bank i in period t, corresponding to the ratio between revenues from credit operations and the portfolio's average balance;

GDP_t : rate of change in Gross Domestic Product in basic prices, in period t; and

$E_{i,t}$ is the error term, corresponding to the discretionary portion of $LLP_{i,t}$ of bank i in period t.

By adopting a common procedure in quantitative accounting studies, such as the one by Kanagaretnam, Lim et al. (2010), the variables LLP, $\Delta LOAN$, NPL, ΔNPL , LCO and LLA are normalized by the total assets at the beginning of the period.

It is important to note that, although the tests are based on financial information produced by Ethiopian banking institutions, prepared in accordance with the standards determined by the OFAG, which can be defined as rule-based, there is room for management discretion. NBE's licensing and supervision of banking business Directives no SBB/43/2008 Asset classification and provisioning, determines that loan operations should be classified in an order of increasing risk, with a ratio of allowance for losses for each risk level, in accordance with a scale ranging from 0% for risk level pass to 100% for risk level loss. There is guidance, for example, for banks to consider, among other factors, the economic sector to which corporate debtors belong, as well as aspects relating to the loan operations, such as the nature and purpose of the loan and the amount and characteristics of the guarantee. It should also be noted that institutions may make allowances at a level higher than the minimum required for the rating of the operations, which characterizes an additional opportunity for discretion by management in the composition of the LLP.

3.5.2 Model for Identifying Determinants of Audit Quality

After identifying the audit quality proxy, the next step to test its determinants, based on the research hypotheses proposed in Section 3, is based on the estimation of model (3.3):

$$AQ_{i,t} = \beta_0 + \beta_i + \beta_1 AS_{i,t} + \beta_2 CI_{i,t} + \beta_3 ST_{i,t} + \beta_4 LT_{i,t} + \beta_5 AC_{i,t} + \epsilon_{i,t} \quad 3.3$$

Where

$AQ_{i,t}$ is the quality of the audit performed in bank i in period t, calculated in accordance with model (4.1);

$AS_{i,t}$ is the degree of auditor specialization in the financial statements of bank i at period t , in the Ethiopian banking industry, calculated based on the total assets of the audited banks;

$CI_{i,t}$ indicates the relative importance of bank i for the auditor's client portfolio at period t , calculated according to the total assets of the banks (in the impossibility of accessing the compensation charged from clients);

$ST_{i,t}$ indicates that, at the time t when the audit was conducted on bank i , the auditor-client relationship was of short term, assuming 1 for the audits performed during the first year of contract and 0 for the others;

$LT_{i,t}$ indicates that, at the time t when the audit was conducted on bank i , the auditor-client relationship was of long term, assuming 1 for the audits performed after the sixth year of contract and 0 for the others⁴; (To define a long-term relationship, the parameter considered for the institution of auditor rotation by the Securities and Exchange Commission of Brazil (Comissão de Valores Mobiliários - CVM) is used as a reference—five years.)

$AC_{i,t}$ indicates whether bank i in period t has an established Audit Committee, assuming 1 for entities that have the Committee and 0 for the others;

3.6 Data Analysis

First, this study will collect the needed data from national bank of Ethiopia, ministry of finance and economic development and commercial banks according to the description set in the above table. After that, collected data will be rearranged, edited and calculated in order to become complete data that is needed for this study. Next, these collected data will be analyzed by using E-views. The next step is interpreting the result of E-view. The Econometric view which also known as E-View is the technique used to conduct this research. This software will be used to analyze the collected data and to examine the relationship between the economic and bank specific factor with the bank's NPL. In addition to E-view, Spreadsheets will be used in order to come up with appropriate charts and tables for data presentation.

3.6.1 Ordinary Least Square

According to Brooks (2008), ordinary least squares (OLS) or linear least squares is a method to estimate the slope and intercept in a linear regression model. This study will use an ordinary least squares (OLS) regression to estimate the linear equation.

According to Brooks (2008), the assumptions of ordinary least squares are:

The errors have zero mean.

The variance of the errors is constant and finite over all values.

The errors are linearly independent of one another.

There is no relationship between the error and corresponding x variate.

3.6.2 Diagnostic Analysis

Diagnostic checking will be used to test whether the sample is consistent with these assumptions:

The model is correctly specified

There is no relationship between independent variables (No multicollinearity).

There is no relationship among the error term at the period t and the error term at period before t
(No autocorrelation problem)

The error term is constant across the number of observations (Homoscedasticity).

The error term is normally distributed.

If all the above assumptions are not violated accordingly the regression will be conducted as we are sure of its accuracy and reliability of our estimates.

3.6.2.1 Model Specification

According to Chris (2008), Specification error occurs when omitting a relevant independent variable, including unnecessary variable or choosing the wrong functional form, so that regression model will be wrongly predicted. If the omitted variable is correlated with the included variable, the estimators are biased and inconsistent. If the omitted variable is not correlated with the included variable, the estimators are unbiased and consistent. Ramsey RESET test will be used to see whether the developed model is correctly regressing.

H₀: the model is correctly specified

H₁: the model is not correctly specified

Decision Rule: Reject H₀ if p-value is greater than significance level. Otherwise, do not reject H₀.

3.6.2.2 Multi co linearity

According to Chris (2008), Multicollinearity will occur when some or all of the independent variables are highly correlated with one another. If the multicollinearity occurs, the regression model is unable to tell which independent variables are influencing the dependent variable. The consequences of Multicollinearity are OLS estimators still Best, Linear and Unbiased, large variances and covariance of OLS estimators, wider confidence interval, insignificant t ratio, high

R^2 but few significant t ratio, sensitivity of OLS estimators and their standard errors to small changes in data. There do not have one unique method to detect the multicollinearity problem, it only have some rules of thumb, which are high R^2 but few significant t ratio, high pair wise correlation coefficient and Variance Inflation Factor (VIF) or Tolerance (TOL). In this case, this study chooses to use high pair-wise correlation coefficients method because it can see the correlation of independent variables between each other one by one. If the correlation coefficient will be higher than 0.8, the model will be considered as it consists of serious Multicollinearity problem.

3.6.2.3 Autocorrelation

According to Chris (2008), when the error term for any observation is related to the error term of other observation, it indicate that autocorrelation problem exist in this model. In the case of autocorrelation problem, the estimated parameters can still remain unbiased and consistent, but it is inefficient. The result of T-test, F-test or the confidence interval will become invalid due to the variances of estimators tend to be underestimated or overestimated. Due to the invalid hypothesis testing, it may lead to misleading results on the significance of parameters in the model. Breusch-Godfrey Serial Correlation LM Test will be used to detect Autocorrelation problem.

H0: There is no autocorrelation problem in the model.

H1: There is autocorrelation problem in the model.

Decision Rule: Reject H0 if p-value greater than significance level. Otherwise, do not reject H0.

3.6.2.4 Heteroscedasticity

According to Chris (2008), Heteroscedasticity means that error terms do not have a constant variance. If heteroscedasticity occur, the estimators of the ordinary least square method are inefficient and hypothesis testing is no longer reliable or valid as it will underestimate the variances and standard errors. There are several tests to detect the Heteroscedasticity problem, which are Park Test, Glesjer Test, Breusch-Pagan-Goldfrey Test, White's Test and Autoregressive Conditional Heteroscedasticity (ARCH) test. In this case, this study chooses to use ARCH test to detect Heteroscedasticity.

H0: There is no Heteroscedasticity problem in the model.

H1: There is Heteroscedasticity problem in the model.

Decision Rule: Reject H0 if p-value greater than significance level. Otherwise, do not reject H0.

3.6.2.5 Normality

Normality tests are used to determine if a data set is well-modeled by a normal distribution. With the normality assumption, ordinary least square estimation can be easily derived and would be much more valid and straight forward. This study will use JarqueBera Test (JB test) to find out whether the error term is normally distributed or not.

H0: Error term is normally distributed

H1: Error term is not normally distributed

Decision Rule: Reject H0 if p-value of JB test greater than significance level. Otherwise, do not reject H0.

3.7 Conclusion

Chapter three included the methodology that will be used to perform data analysis in Chapter four. This study will use quantitative and secondary data and Ordinary least square method to test the relationship between macroeconomic factors and bank specific factors with NPLs in Ethiopia. Besides that, diagnostic tests will be conducted to confirm the reliability of the results. Chapter four will show out in details regarding the hypothesis testing and diagnostic tests carried out for the collected data

Chapter Four

Data analysis and presentation

The empirical tests used data contained in the Annual Financial Information reports of commercial banks from 2005 to 2014. To ensure the robustness of the results, the panel data models were estimated by SUR (seemingly unrelated regression) fixed cross-sectional effects, which provides robust coefficients and standard errors, even in the presence of heteroskedasticity and contemporaneous correlations in the errors of the equations.

4.1 Diagnostic Test Results for the Models

4.1.1 Test of normality

Normality test was applied to determine whether a data is well-modelled by a normal distribution or not, and to compute how likely an underlying random variable is to be normally distributed. If the residuals are normally distributed, the histogram should be bell-shaped and the Jarque-Bera statistic would not be significant. This means that the p-value given at the bottom of the normality test screen should be greater than 0.05 to support the null hypothesis of presence of normal distribution at the 5 percent level.

Theoretically, if the test is not significant, then the data are normal, so any value above 0.05 indicates normality. Jarque-Bera formalizes this by testing the residuals for normality and testing whether the coefficient of skewness and kurtosis close are zero and three respectively. Skewness refers to how symmetric the residuals are around zero. Perfectly symmetric residuals will have a skewness of zero.

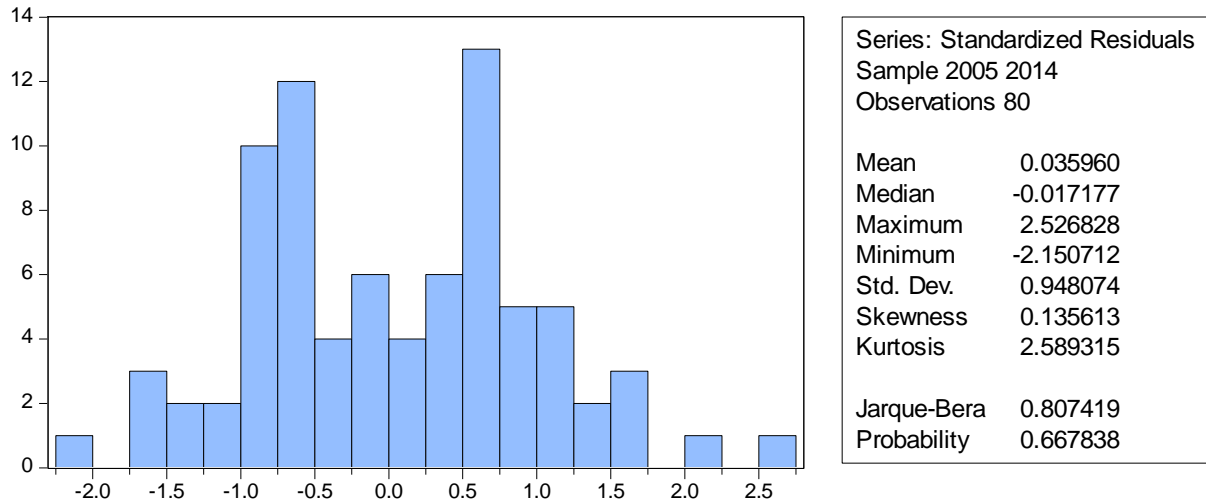
Skewness measures the extent to which a distribution is not symmetric about its mean value. Kurtosis refers to the “peakedness” of the distribution. For a normal distribution the kurtosis value is 3. Kurtosis measures how fat the tails of the distribution are, the Jarque–Bera test for normality is based on two measures, skewness and kurtosis. The Jarque-Bera probability statistics/P-value is also expected not to be significant even at 10% significant level (Brooks 2008).

The hypothesis of normality distribution is:

H0= residuals follows a normal distribution

H1 = residuals do not follows a normal distribution

Figure 1 Normality test for residuals



Source: own computation from sampled banks through Eviews 9

As shown in the histogram above in the figure 4.3 kurtosis close to 3 (i.e. 2.589315) and skewness approaches to 0 (i.e. 0.135613). The Jarque-Bera statistics was not significant even at 10% level of significance as per the P-values shown in the histogram (i.e. 0.947884). Hence, null hypothesis of the residuals follows a normal distribution is failed to reject at 5 percent of significant level. Hence, it seems that the error term in all of the cases follows the normal distribution and it implies that the inferences made about the population parameters from the samples tend to be valid.

4.1.2 Heteroskedasticity

When the scatter of the errors is different, varying depending on the value of one or more of the independent variables, the error terms are heteroskedastic Brooks (2008). Heteroscedasticity test is very important because if the model consists of heteroskedasticity problem, the OLS estimators are no longer BEST and error variances are incorrect, therefore the hypothesis testing, standard error and confident level will be invalid. A white' test has been made, to ensure that this assumption is no longer violated. The hypothesis for the heteroskedasticity test was formulated as follow;

H0: There is no heteroskedasticity problem.

H1: There is heteroskedasticity problem.

$\alpha = 0.05$

Decision Rule: Reject H0 if P value is less than significant level 0.05. Otherwise, do not reject H0.

Table 1 Heteroskedasticity Test: ARCH for Proxy of Audit Quality

Heteroskedasticity Test: ARCH

F-statistic	1.997176	Prob. F(1,57)	0.1630
Obs*R-squared	1.997271	Prob. Chi-Square(1)	0.1576

Source: own computation from sampled banks through Eviews 9

Table 2 Heteroskedasticity Test: ARCH for Audit Quality

F-statistic	1.145594	Prob. F(1,77)	0.2878
Obs*R-squared	1.158119	Prob. Chi-Square(1)	0.2819

Source: own computation from sampled banks through Eviews 9

As shown from the above table, all versions of the ARCH test statistic (F-statistic and Obs*R-squared) gave the same conclusion that there was no evidence for the presence of heteroscedasticity in this particular study. Since the p-values of 0.1878 and 0.2819 for F-statistic and Obs*R-squared respectively were in excess of 0.05, the null hypothesis should not be rejected.

4.1.3 Autocorrelation

It is assumed that the distribution errors are uncorrelated with one another and that the errors are linearly independent of one another. Autocorrelation error occurs when there is a serial correlation between residuals and their own past values. In this study, BreuschGodfrey Serial Correlation LM Test is used to carry out the autocorrelation test. The p-value is obtained to examine whether the autocorrelation problem occurs in the model. If the p-value is more than 5% significant level, it implies that there is no autocorrelation problem in the model. The hypothesis for the model specification test was formulated as follow;

H0: There is no autocorrelation problem.

H1: There is autocorrelation problem.

$\alpha = 0.05$

Decision Rule: Reject H0 if P value is less than significant level 0.05. Otherwise, do not reject H0.

Table 3 Breusch-Godfrey Serial Correlation LM Test for Proxy of Audit quality

Breusch-Godfrey Serial Correlation LM Test:

F-statistic	0.011772	Prob. F(2,70)	0.9140
Obs*R-squared	0.012927	Prob. Chi-Square(2)	0.9095

Source: own computation from sampled banks through Eviews 9

Table 4 Breusch-Godfrey Serial Correlation LM Test for Audit quality

F-statistic	0.060905	Prob. F(2,70)	0.9410
Obs*R-squared	0.138970	Prob. Chi-Square(2)	0.9329

Source: own computation from sampled banks through Eviews 9

From table, 4 and 5 it can be concluded that this research do not reject null hypothesis (H₀), since the p values are above the critical level 5% respectively. Thus, it can be concluded that the model does not consists of autocorrelation problem.

4.1.4 Choosing Random effect (RE) Vs. fixed effect (FE) models

The results so far indicate that all CRLM assumptions are not violated, so the ordinary least square regression can be safely applied. However, since this study uses a panel data, there are two types of panel estimator approaches that can be employed, namely: fixed effects models (FEM) and random effects models (REM) (Brooks C. , 2008).

The simplest types of fixed effects models allow the intercept in the regression model to differ cross-sectionally but not over time, while all of the slope estimates are fixed both cross-sectionally and over time. The random effects approach proposes different intercept terms for each entity and again these intercepts are constant over time, with the relationships between the explanatory and explained variables assumed to be the same both cross-sectionally and temporally (Brooks C. , 2008)

To examine whether individual effects are fixed or random, a Hausman specification test was conducted providing evidence in favor of the REM model (Baltagi, 2005). The null hypothesis for this test is that unobservable heterogeneity term is not correlated or random effect model is appropriate, with the independent variables. If the null hypothesis is rejected then we employ Fixed Effects method. (Brooks C., 2008).

The Hausman test hypothesis is:

H₀= Random effect model is appropriate

H1= Fixed effect model is appropriate

Table 5 Hausman Test for Proxy of Audit Quality

Correlated Random Effects - Hausman Test
Equation: Untitled
Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	0.870595	4	0.9287

Source: own computation from sampled banks through Eviews 9

Table 6 Hausman test for Audit quality

Correlated Random Effects - Hausman Test
Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	6.108103	7	0.5272

Source: own computation from sampled banks through Eviews 9

Table 4.6 above shows Hausman specification test, the P-value of models is more than the critical value, which is more than 5% level of significance. Hence, the null hypothesis of the random effect model is appropriate is failed to reject at 5 percent of significant level. This implying that, random effect model is more appropriate than fixed effect model and gives more comfort that random effects model results are valid

4.2 Calculation of the Audit Quality Proxy

The first stage of the tests consists of calculating the audit quality proxy, from the application of equation (3.1), which depends on the identification of discretion in the process of constituting the LLP by the banks, based on model (3.2).

The results shown in Table 1 are consistent with those calculated by Dantas et al. (2013), where detailed analyses on the behavior of the variables can be found. In this study, the estimation of model (3.2) has the purpose of calculating the variable representing discretionary accruals (the error term), which will be the basis for calculating the audit quality proxy, through equation (3.1)

Table 7 Estimation of the discretion of expenses with LLP - model (3.2)

Cross-section random effects test equation:
 Dependent Variable: LA
 Method: Panel Least Squares
 Sample (adjusted): 2006 2014
 Periods included: 9
 Cross-sections included: 8
 Total panel (unbalanced) observations: 65

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	52234708	25838406	2.021592	0.0483**
CNPL	0.357457	0.103398	3.457088	0.0011*
NPL	0.233911	0.067132	3.484340	0.0010*
WO	1.469389	0.193863	7.579504	0.0000*
CLOAN	0.021162	0.033795	0.626185	0.5339

Effects Specification

Cross-section fixed (dummy variables)			
R-squared	0.897265	Mean dependent var	1.63E+08
Adjusted R-squared	0.875942	S.D. dependent var	2.90E+08
S.E. of regression	1.02E+08	Akaike info criterion	39.88669
Sum squared resid	5.53E+17	Schwarz criterion	40.28812
Log likelihood	-1284.317	Hannan-Quinn criter.	40.04508
F-statistic	42.08077	Durbin-Watson stat	2.093389
Prob(F-statistic)	0.000000		

Source: own computation from sampled banks through Eviews 9

Where LLP is the loan loss provisions; Δ LOAN is the change in the value of loans; NPL the value of nonperforming loans; Δ NPL the change in the value of nonperforming loans; WO the net loan write-offs; LA is the loss allowance; GDP is the rate of change of the Gross Domestic Product;

Note: p-values with asterisk * and **, denote significance at the 5% and 1% levels respectively.

4.2.1 Results for Banks earning management

As previously discussed in the methodology section, in order to see the link between audit quality and level of earning management the researcher used a two stage procedures since both are not directly observable. Therefore, discretionary accrual (the residual from model 1) and abnormal loan loss provision are used as a proxy for the audit quality and the level of earning management respectively. This requires decomposing the abnormal component of loan loss provision from the normal (non-discretionary accrual). To do so, the researcher regressed loan

loss provision on various factors which are usually considered influencing it in Model 2. The Estimation results for this model are presented in Table 4.1 above

$$LLP_{i,t} = \beta_0 + \beta_i + \beta_1 \Delta LOAN_{i,t} + \beta_2 NPL_{i,t-1} + \beta_3 \Delta NPL_{i,t} + \beta_4 LCO_{i,t} + \beta_5 LLAI_{T-1} + \beta_6 INT_{i,t} + \beta_7 GDP_t + \epsilon_{i,t}$$

As can be seen from the table, all of the variables attain significance at conventional levels except CLOAN with their expected coefficient sign.

CNPL, NPL, and WO are statically significant at 1% level exhibited a positive coefficient (0.357457, 0.233911 and 1.469389 respectively) with a highly significant at less than 1% levels (t- statistic 3.457088, 3.484340 and 0.0000 with p-value of 0.0011, 0.0010 and 0.0000 respectively). Comparatively, the model has good explanatory power for normal (non discretionary) component of LLP, with adjusted R-square 87.59% (for example, using similar model Dantas et al. (2013), adjusted R2 was about 47.30%). After estimating the audit quality proxy, the next step is to conduct tests of association of this measure with variables representing auditor incentives, based on model (3.3), to test the research hypotheses.

4.3 Regression analysis results

The hypotheses tested in this study cover the relationship between audit quality as a dependent variable and the impact of auditor industry specialization, short and long term client-auditor relationship, audit fee, banks' size, leverage position of the bank and profitability of the bank independent variables (H1, H2, H3a, H3b, H4, H5, H6). The regression results presented are discussed in greater detail in this section. The research hypotheses are also tested and alternative explanations are provided for the reported result among the relationship between the dependent variable and independent variables. The first section presents discussion of the results for audit quality determinants factors while the section deals with discussions regarding the audit quality.

4.3.1 Testing determinants of audit quality

This section presents discussion of the results for audit quality model in considerable detail. Alternative explanations are provided for the reported relationship among audit quality and the determinant factors taking in to account the country context.

For this model the residuals from model 2 were taken as an abnormal component of LLP to examine the link between audit quality and abnormal LLP that banks usually use as earning management tool. Table 4.1 reported the results for model 3 in which ABLLP is regressed on

AQ controlling for Auditor industry specialization (AS), short term tenure (ST), long term tenure (LT), Audit fee (AF), Bank size (BS), Leverage (LEV) and Bank profitability

Table 8 Estimation of the determinants of audit quality - model (3.3)

Dependent Variable: AQ
Method: Panel EGLS (Cross-section random effects)
Date: 05/15/16 Time: 00:43
Sample: 2005 2014
Periods included: 10
Cross-sections included: 8
Total panel (balanced) observations: 80
Swamy and Arora estimator of component variances
White period standard errors & covariance (d.f. corrected)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	2.47E+08	1.14E+09	0.216815	0.8290
LAF	-8.04E+08	2.50E+08	-3.219070	0.0019
LEV	-5.26E+08	1.02E+09	-0.515704	0.6076
LT	39488968	53009413	0.744943	0.4587
ROA	-2.41E+09	3.89E+09	-0.620820	0.5367
SIZE	4.50E+08	1.05E+08	4.268048	0.0001
ST	42171087	17820885	2.366386	0.0207
AS	-36216432	44669388	-0.810766	0.4202

Effects Specification		S.D.	Rho
Cross-section random		0.000000	0.0000
Idiosyncratic random		3.20E+08	1.0000

Weighted Statistics			
R-squared	0.286227	Mean dependent var	25287943
Adjusted R-squared	0.216833	S.D. dependent var	3.59E+08
S.E. of regression	3.18E+08	Sum squared resid	7.29E+18
F-statistic	4.124637	Durbin-Watson stat	1.332937
Prob(F-statistic)	0.000732		

Unweighted Statistics			
R-squared	0.286227	Mean dependent var	25287943
Sum squared resid	7.29E+18	Durbin-Watson stat	1.332937

Source: own computation from sampled banks through Eviews 9

AQ is the quality of the audit, calculated in accordance with model (4.1); AS is the degree of auditor specialization in the Ethiopian banking industry; LAF indicates audit fee paid by the bank; ST indicates that the auditor-client relationship was short term (first year of contract); LT indicates that the auditor-client relationship was long term (after the five year of contract); SIZE

indicates the bank size; LEV indicates leverage position of the bank; ROA reflects profitability of the bank in terms of return on asset. After calculating audit quality proxy and estimation of determinant of audit quality, in the next section the hypothesis result detailed and interpreted by aligning with their respective empirical theory stated on the literature section.

Hypothesis One: Audit Firm Industry Specialization versus audit quality

The compatibility of the results shown in Table 2 with the predictions of the research hypotheses reveals that, initially, no statistically significant relationship was found between audit quality and auditor specialization degree (AS) in the banking industry. Thus, hypothesis H1, which predicted a positive relationship between these variables, considering that specialization would represent a broader understanding of accounting practices and trends in the segment, increasing the ability to assess evidence and identify problems in the statements, is not empirically confirmed. A potential explanation for this result may be that the most banks are audited by one of the big audit firms, perhaps making it impossible to identify a significant difference in relation to the audits conducted by companies with less participation in the banking market. Several studies have attempted to document the relation between industry specialization and audit quality, but have provided mixed results, possibly due to a lack of consensus as to how industry specialization should be measured. Neal, Riley, and Richard, (2004) suggested that the specialization in the auditing industry changes in the audit market in recent years suggest that industry specialization is an important strategic goal of the largest accounting firms in the U.S. and is recognized by accountants as an important issue facing the profession. On the other hand, José Alves Dantas and Otavio Ribeiro de Medeiros, (2014) found no statistically significant relationship between audit quality and auditor specialization degree (AS) in the banking industry.

Hypothesis Two: Length of Contract between the Auditor and Financial Institution versus audit quality

To test the effect of the length of the contract between the auditor and financial institution on the audit quality, it was considered that the assumptions discussed in the literature on audit quality are compromised in short-term and long-term relationships - hypotheses H3A and H3B, respectively - characterizing a non-linear relationship between the variables. The compatibility of

the results shown in Table 2 with the predictions of the research hypotheses reveals that, initially, no statistically significant relationship was found between audit quality and auditor long term relationship with client (LT) in the banking industry. Thus, hypothesis H3B, which predicted an inverse relationship between audit tenure and the ratification of auditors by shareholders, indicating that shareholders see the long length of relationships as an element that negatively affects the quality of the audit, is not empirically confirmed. A potential explanation for this result may be that the most in short-term relationships, considering that the auditor does not know in depth about the risks of the business, in addition to being more prone to opportunistic arguments by management to attract the new client; and in long-term relationships, considering that the self-confidence of the auditor can reduce their skepticism or increase their ties with the client.

The empirical tests conducted on the variable ST, which indicates the audits carried out during the first year of contract, reveal that they are not significantly different from those conducted during other periods, rejecting hypothesis H3A. Similarly the case of the variable LT, which indicates the audits conducted after the five year of the contract, reveal that they are not significantly different from those conducted during other periods, rejecting hypothesis H3B. In summary, the result is consistent with prior period research which indicates varied result between audit tenure and audit quality.

Hypothesis Three: Audit fee versus audit quality

As one can understand from the above table two, Audit fee has strong, negative relationship with audit quality, which is in line with earlier established correlation analysis. Auditor's independence may be defined as an auditor's unbiased mental attitude in making decisions throughout the audit and financial reporting process. An auditor's lack of independence increases the possibility of being perceived as not being objective. This means that the auditor will not likely report a discovered breach (Deangelo, 1981). The major threats to auditor independence are the fees perceived by the auditor for audit and non audit services.

Several studies that have empirically examined the relationship between audit quality and audit fee; Francis and Simon, (1987) assume that audit services are quality-differentiated and that in a competitive market, quality differences are reflected in fees. To the extent that audit fees are indicative of audit quality (Blankley et al. 2012; Lobo and Zhao 2013; Eshleman and Guo 2013a), audit quality should be higher in markets where audit fees are higher. In summary, the

finding is consistent with the prior period researches which indicate that there is a positive relationship between audit quality and audit fee paid by the bank.

Hypothesis Four: Bank Size versus Audit Quality

In line with prior studies (both industrial and financial firms), the size of the bank is highly significant at less than 1% level (p-value 0.0002) with (coefficient 4.50) and t-static 3.91). From table 2 it can be understood that the significant size coefficient can be interpreted as a 1% change in the bank's total asset accompanied by 45% increase in audit quality. This result is consistent with various prior empirical studies recurring finding of a positive relationship between the client size and audit quality, both in financial and non financial sectors. Bank audit literature demonstrates the same effect of bank size. Cullen et al. (2012) reported the client size by itself explains over 70% variances in audit quality. It is also argued that Banks size reflects its effect on quality through direct and indirect way, since various bank characteristics are correlated with size. Generally, the positive and significant relationship between size and audit quality in the result leads to fail to reject the fourth hypothesis (i.e. bank size has positive and significant relationship with audit quality).

Hypothesis Five: Leverage versus audit quality

As the above random effect regression output table 4.2 presented that, the correlation between audit quality and company leverage is weak, negative but not statistically significant at 5% level of significance. The negative relationship means that the more leverage position of the bank resulted in the more professional skepticism utilized to scrutinize the going concern of the bank. Previous literature has shown that debt is considered to be a healthy factor to companies' value. It provides managers with incentives for good performance to avoid creditors' pressure and the possibility of losing their jobs in a financial crisis (Masulis et al., 2007; Chen et al., 2010).

Monitoring creditors and lenders, measured by leverage, are insufficient in preventing directors from over-optimistic financial reporting regardless of their companies' going concern problems (Uang et al., 2006). Broye and Weill (2008) state that the higher the disclosure requirements and the more creditors' rights are protected, the higher the demand for audit quality by highly-leveraged companies. In summary, the finding indicates an inverse position from the hypothesis which indicates that there is negative relationship between leverage and audit quality.

Hypothesis Six: Profitability versus audit quality

From table 4.2 one can infer that there is a significant negative relationship between ROA and audit quality negative relationship which reject the null hypothesis which state there is positive between audit quality and profitability of the bank. This finding is in line with (Joshi and AL-Bastaki (2000) cited in Naser, et al., 2007) argument that companies with a higher level of profit are subject to a further inspection of the related revenue and expense accounts leading to raise audit effort/time on the auditor part and hence the auditor charges a higher audit fee to a more profitable banks. Prior audit fee studies used various financial performance proxies (ROA, ROE and loss) for both industrial and financial companies. This study used ROA only for the fact that the sampled banks do not experienced loss during the studied period.

Summary

Empirical association tests of the audit quality proxy with the variables representing incentives for the performance of auditors have confirmed two of the seven research hypotheses, revealing that audit quality has the following relationships: positive with the bank size and audit fee paid by the bank. Of the hypotheses tested, five were not confirmed empirically. The correlation between audit quality and audit fee is negative, strong and statistically significant. The negative relationship means that the quality of audit is dependent on the audit fee; the lower the audit fee, the more qualitative the audit work will be. The correlation between audit quality and company size is strong, positive and statistically significant. The positive relationship means that the bigger the firm, the higher the quality of audit is likely to be. This may be unconnected to the fact that larger sized firms (expectedly with wider spectra of stakeholders), can afford to pay auditors better which in turn implies that such auditors are likely to do more qualitative job, partly because of the large audit fee and partly because of the need to protect the interest of the wider stakeholder group in such large firms.

Chapter Five

Conclusion and Recommendation

5.1 Conclusion

This chapter contains a recapitulation of the research, and provides an answer to the main research question. The research results are compared with the results of prior research and the recommendations is taking place. Finally, this chapter attends to the limitations of the research.

The chapter includes the results of the statistical relationship between audit quality and factors affecting audit quality. As noted above the reliability of financial information is an essential condition for the proper functioning of markets - in particular, the banking market - given that its institutions are subject to the systemic risk known as "bank run" in the case of suspicion by depositors. One of the aspects that can contribute to an environment of trust is the work of independent auditors, historically associated with the purpose of ensuring the credibility of the financial disclosure process.

The review conducted by the auditors assumes an even greater significance considering that the preparation of financial information increasingly incorporates subjective aspects of professional judgment, facilitating potential opportunistic behavior by managers in the sense of concealing an occasionally unsatisfactory financial situation.

Considering this context, coupled with the lack of empirical evidence on the audits conducted in the banking markets, particularly in the Ethiopian market, this study aimed to identify the determinants of the quality of audits of Ethiopian banks conducted by independent auditors.

Regression Analysis was identified as the most appropriate tool for econometric analysis of the data. Based on the results, the researcher concludes the following:

- Considering that specialization would represent a broader understanding of accounting practices and trends in the segment, increasing the ability to assess evidence and identify problems in the statements, is not empirically confirmed. A potential explanation for this result may be that the most banks are audited by one of the big audit firms, perhaps making it impossible to identify a significant difference in relation to the audits conducted by companies with less participation in the banking market.
- Empirical association tests of the audit quality proxy with the variables representing incentives for the performance of auditors have confirmed two of the seven research

hypotheses, revealing that audit quality has the following relationships: positive with the bank size and audit fee paid by the bank. Of the hypotheses tested, five were not confirmed empirically. The correlation between audit quality and audit fee is negative, strong and statistically significant. The negative relationship means that the quality of audit is dependent on the audit fee; the lower the audit fee, the more qualitative the audit work will be. The correlation between audit quality and company size is strong, positive and statistically significant. The positive relationship means that the bigger the firm, the higher the quality of audit is likely to be. This may be unconnected to the fact that larger sized firms (expectedly with wider spectra of stakeholders), can afford to pay auditors better which in turn implies that such auditors are likely to do more qualitative job, partly because of the large audit fee and partly because of the need to protect the interest of the wider stakeholder group in such large firms. The statistics revealed the data to be normal. Also the assumptions needed to be fulfilled for OLS were tested; the data was found to be homoskedastic, free of autocorrelation free of Multi-collinearity and normally distributed.

- The study infer that there is a significant negative relationship between ROA and audit quality negative relationship which reject the null hypothesis which state there is positive between audit quality and profitability of the bank. In this regard companies with a lower level of profit are not subject to a further inspection of the related revenue and expense accounts leading to less audit effort/time on the auditor part and hence the auditor charges a lower audit fee to less profitable banks.
- Moreover, the finding indicates an inverse position from the hypothesis which indicates that there is negative relationship between leverage and audit quality.

5.2 Recommendation

It is hoped that the identification of the determinant factors of the audit quality of Ethiopian banks contributes to deepen the discussion concerning the role that independent auditors can perform for an environment of transparency and solidity of the financial system, including their role as a complementary or auxiliary supervisor. This study carries even greater importance when considering that the preparation of financial statements increasingly incorporates subjective aspects of professional judgment, possibly facilitating opportunistic behavior by management to conceal occasionally unsatisfactory financial situations.

In order to make Ethiopian auditing firms more effective in their activities, so that they can continue to play their appropriate roles in the growth and development of commercial banks and the economy at large, the following measures are recommended for adoption and practice:

- Seeing that audit fee is negatively related with audit quality banks external auditors' approving committee should be aware of low-bidding in which case the audit firm offer unreasonably low audit fee to win the bidding. Thus selection and remuneration of auditor should be based on prior period auditors experience, expected work load and time budget, and banks' size.
- Auditors of commercial banks in Ethiopia should live up to the expectations of their clients, their professional bodies, the laws of the land and the general public. These can be achieved by upholding the ethics of their profession as they observe ethical codes such as integrity, objectivity and confidentiality.
- It is also recommended that the auditor should be remunerated on the basis of work experience, qualification, duration of the audit assignment, and background profile. The payment of the adequate fee will encourage the auditor to do the assurance engagement assignment according to the high degree of standardization expected.
- The professional bodies should always watch governmental actions and raise alarm on policies which could hinder smooth discharge of Auditors' responsibility, especially in the audit of commercial banks in Ethiopia.

5.3 Further research suggestion

Naturally, the study is subject to limitations. The main one is that the phenomenon under study, audit quality, is not an externally verifiable factor - at least simultaneously to its performance - imposing the need to use proxies. It should also be stressed that the models developed here and concomitant construction of the variables considered the specificities of the Ethiopian banking market, not being applicable in another context without the necessary adaptations.

Thus, the researcher suggest further research to test the validity of the models and research hypotheses in other settings, in addition to performing tests with other proxies of audit quality for the corroboration of the evidence obtained here and to identify other explanatory variables for the pattern of audit quality.

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APPENDIX

Table 9 List of Commercial banks in Ethiopia

No	Name of Banks	Year of Establishment
1	Commercial Bank of Ethiopia	1963 E.C.
2	Construction and Business Bank	1975 E.C.
3	Awash International Bank	1994 E.C
4	Dashen Bank	1995 E.C.
5	Bank of Abyssinia	1996 E.C.
6	Wegagen Bank	1997 E.C.
7	United Bank	1998 E.C
8	Nib International bank	1999 E.C.
9	Cooperative Bank of Oromia	2004 G.C.
10	Lion International Bank	2006 G.C.
11	Zemen Bank	2008 G.C
12	Oromia International Bank	2008 G.C.
13	Buna International Bank	2009 G.C.
14	Berhan International Bank	2009 G.C
15	Abay Bank S.C	2010 G.C
16	Addis International Bank S.C	2011 G.C
17	Dehub Global Bank S.C	2012 G.C
18	Enat bank	2012 G.C

Source: National Bank of Ethiopia

Table 10 List of banks selected for this research (Sample Banks)

No	Name of Banks	Year of Establishment
1	Commercial Bank of Ethiopia	1963 E.C.
2	Construction and Business Bank	1975 E.C.
3	Awash International Bank	1994 E.C.
4	Dashen Bank	1995 E.C.
5	Bank of Abyssinia	1996 E.C.
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8	Nib International bank	1999 E.C.