

# Determinants of auditor choice in emerging markets: evidence from Saudi Arabia

Dina S. Fadaly

University of Business and Technology (UBT), Jeddah, Saudi Arabia

---

## Keywords

Audit market. Auditor choice, Emerging market, Audit committee.

---

## Abstract

**Purpose:** This study aims to analyze the choice of auditor in Saudi Arabian firms. The study investigates the main audit characteristics that influence firms' decision to go for either Big Four or a local audit firm.

**Design/methodology/approach:** the design and research method are empirical using a questionnaire survey to collect data on the determinants of the choice of auditors. The study adopted Oxera (2006) questionnaire. A representative sample of 124 firms out of a total of 183 listed firms in Saudi stock market have been selected. The questionnaire was distributed to members of audit committee to ensure reliable responses regarding the selection process.

**Data analysis:** data collected were analyzed using both descriptive and inferential statistics-Logistic Regression Analysis method.

**Findings:** only four variables were proved significant in the selection decision; namely; auditor fees, audit firm reputation with investors, geographical proximity and long-term relationship with current auditor.

**Research limitations/implications:** difficulty to generalize the findings of the study due to the uniqueness of the Saudi economic, political, educational and culture environment.

**Practical implications:** the increased competition in the audit market in Saudi Arabia called for the necessity to understand what influences the selection decision. Most researches were conducted in developed countries and little in emerging markets; so, this study will help auditor identify their competitive advantage in Saudi Arabian market.

**Originality/value:** this study contributes to better understanding of the firms' auditor choice and will stimulate further research in the same vein to investigate other factors on the side of the firm characteristics that affect the auditor selection decision. As well as more comparative analysis with other emerging markets in the Middle East.

---

## 1. Introduction

The choice of a firm's auditor is considered one of the most important decisions taken by any firm. This is due to the vital benefits resulting from having the financial statements audited by a reputable auditor. First, it reduces information risk; as argued by the agency theory; firms with higher agency costs are motivated to choose a high-quality auditor to strengthen their corporate governance and thus lessen potential agency conflicts (Francis & Wilson, 1988; Mansi et al., 2004; Knechel et al., 2008; Matonti et al., 2016) specially in complex organizations where management interests could differ from shareholder interests (Ekumankama & Uche, 2009). It has been documented by Farooq and Kacemi (2011) that stock price performance improved in the MENA region because of choosing one of the big-four auditors. Second, an audit might result in improving internal processes operational efficiency and effectiveness since the auditor must assess the client's internal control reliability, moreover, it helps firms better comply with legal and regulatory constraints (Wallace, 1981).

Olowooker (2016) mentioned that there is a market share gap between the Big Four and smaller firms in Nigeria, as 90 percent of listed companies are audited by the Big Four; while the 15 national firms audit the remaining 10 percent. In Saudi Arabia, as reported by the Saudi Ministry of

Commerce and Investment (2018) there is 176 auditing firm. A large number that shows a severe competition in Saudi audit market, that triggered the need to investigate the market share of the Big Four as compared to the Non- Big Four auditors in Saudi market and the factors behind the firm selection of its auditor to help auditors rely on their competitive advantages.

In addition, most of the research investigating this area has been conducted in developed countries as US and other developed economies such as UK (Beattie & Fernley, 1995), Australia (Craswell, 1988), Finland (Knechel, et al., 2008), and Italy (Matonti, et al., 2016), and Few research were conducted to investigate the factors affecting the firm selection of auditor in emerging markets; such as in Greece (Citron & Manalis, 2001), in Turkey (Aksu, et al., 2007), in MENA Region (Farooq & Tabine, 2015) and in Nigeria (Tommasetti, 2016). Beattie and Fernley (1995) suggest that auditor choice is motivated by three possible sources – audit environment, audit firm characteristics, and client characteristics. Revier and Schroé (2010) also concluded that three groups of variables can explain the auditor choice - the audit firm variables, the institutional variables and the firm variables. The objective of this study is to examine the determinants of external auditor choice in Saudi listed firms with a focus on only some audit firm characteristics. This paper is organized into six parts. Other than this Introduction, the second part is the Literature Review, followed by the Methodology, the fourth part is The Analysis and Results, part five is the Discussion and Conclusion, and finally the Research Limitations and Direction for further Research.

## 2. Literature Review

### The agency problem and the need for quality audit

It has been recognised that firms acquire financial statement audit even when it is not mandatory because of its economic value (Sundem, et al., 1996). Watts and Zimmerman (1987) presented evidence that auditing has been developed to reduce agency costs and conflicts of interest among parties to the firm and not because of governmental requirement. According to DeAnglo (1981) firms must deal with a changing amount of agency costs, which vary over time and place and create an incentive for managers to find ways to lessen these changing agency costs by hiring a high-quality auditor to ensure the appropriateness and adequacy of his provided service. Other studies similarly supported this view about the ability of reputable auditor to signal outside investors that a firm is governed properly and has less agency problems (Datar et al., 1991; DeFond, 1992; Simney & Tanewski, 2000; Fan & Wong, 2005; Cheng & Leung, 2011; Farooq & Tabine, 2015). Nichols and Smith (1983) provided evidence that the stock market reacts more favourably when a company switches to a large auditor rather than to a small auditor. Broye and Weill (2008) suggested that the likelihood of having a Big Four auditor increases when the firm is listed. The study of Moizer (1997) investigating auditor reputation, revealed that company managers perceive a Big Four auditor as different from others as they are expected to provide higher quality services as compared to Non-Big Four auditors. Consistently, most researches define Big Four auditors as high-quality auditors (Simunic and Stein, 1987; Revier and Schroé, 2010; Olowookere & Inneh, 2016). Thus, in the literature, audit selection is based on a distinction between Big Four auditors and Non-Big Four auditors.

According to Farooq and Tabine (2015) the importance of reputable auditors increases many folds in emerging stock markets, where agency problems rise and information disclosure decreases. In the same vein, Leuz, et al. (2003) documented on the increased agency problem in emerging markets which necessitate the use of superior reputable auditors to give credibility to information disclosed by firms. Nevertheless, still the decision to have an auditor and the decision to switch auditors are considered complex decisions (Knechel, 2002).

Therefore, this study is conducted in Saudi Arabia, which is an emerging economy, and collected data from only listed firms; regarding the determinants of their choice of auditor; as listed firms face more agency problem due to the separation between the management and the external stockholders.

### Factors affecting firms' selection decision

Niemi and Sundgren (2008) investigated the Finnish auditor choice environment. Also, Knechel et al. (2008) analysed the auditor choices for small and mid-sized Finnish firms. They proved that the need for a higher quality auditor is driven first by complexity, then, by the use of debt and the need of equity and debt financing. Revier and Schroé (2010) used data from 12 European countries including the Czech Republic, Estonia, Hungary, Latvia, Poland and Slovakia, to test the impact of the country a company is based in, next to the impact of internal firm characteristics and debt on the auditor choice. They proved the positive influence the internal complexity has on the auditor choice.

Wang (2013) argued that there could be a lot of factors that influence companies' auditor choice such as audit fees; auditor's reputation; industry specialization of an auditor, audit opinion, geography proximity, size of an audit firm, listed companies' own characteristics, political and legal factors. The paper provided evidence on Chinese listed companies' preference in choosing external auditors with a consideration to the Chinese special political influence on state-owned Chinese listed firms.

Choi et al. (2012) find that about 80 percent of firms choose the auditor located in the same area and more reputable. Another study provided evidence from U.S. companies that firms with independent audit committees are more likely to hire industrial specialists (Abbott and Parker, 2000). In the same vein, Craswell et al. (1995) proved that in addition to size and reputation of the auditor, a premium is given to industry specialization, indicating that industrial-related knowledge is also an important factor considered by client firm. Data from U.K. showed that changing auditor can be strongly encouraged by fees reduction, also audit fees proved to be an important factor in selecting a new auditor (Beattie and Feamly, 1995, 1998) Thornton and Moore (1993) also investigated how audit fees influence the audit choice. On the other hand, Gatumia (2012) concluded in his study conducted in Kenya that audit fees do not affect the choice of external auditor. Matonti et al. (2016) investigated auditor choice in Italian non-listed firms. The results showed that organizational complexity including firm size, investment in inventories, subsidiary status and complexity are main drivers of auditor choice. Evangelia (2013) used regression model to investigate internally-driven and external influencers of audit choice in 22 European countries. The level of internal complexity in a company had negative association with the selection of a Big Four auditor, while higher leverage increases the probability of engaging with a Big Four auditor.

Olowookere and Inneh (2016) investigated the determinants on the side of the auditor characteristics affecting manufacturing firms' choice in Nigeria. The study tested the effect of eight independent variables (technical accounting skill, sector-specific expertise, international coverage, management preference of specific auditor, long-term relationship with current auditor, reputation of audit firm with investors, reputation of audit firm with corporate broker, reputation of audit firm with other external advisers) on the choice of hiring a Big Four or a none-Big Four auditor. The results supported only international coverage and long-term relationship with current auditors. Based on the preceding researches the following hypotheses have been developed to be tested in this study:

H1: Firm choice of external auditor is affected by audit firm characteristics.

### 3. Methodology

The data for this study was collected based on both primary and secondary sources. The secondary data was collected from the firms' published financial statements, while the primary data was collected using a well-structured questionnaire. The questionnaire on the determinants of the choice of auditor used by Oxera (2006) has been adopted for the study. Listed firms in the Saudi Stock Exchange Market totalled 177 firm as published in Argaam website. A representative sample of 124 firm has been chosen from all industries as shown in Table (1). The questionnaire was

distributed to a member in the audit committee to ensure reliable responses from a knowledgeable member involved in the auditor selection process.

Data were collected between October 2017 to February 2018. Both descriptive statistics and inferential statistics were used to analyse collected data. Logistic Regression method was used to analyse the data since the dependent variable is qualitative in nature (Gujarati & Porter, 2009).

## Variables and Measurement

### 3.1.1 Dependant Variable

The dependent variable is the firm choice of the auditor which is classified into either Big Four or Non-Big Four. A dummy variable will take the value of (1) when respondent is using Big Four and (0) if otherwise.

### 3.1.2 Independent Variables

The dependent variable; audit firm characteristics; is measured by eight variables as suggested by the literature which are listed below:

Audit firm fees ( $X_1$ )

Audit firm reputation with investors ( $X_2$ )

Audit firm reputation with corporate broker ( $X_3$ )

Audit firm reputation with external advisor ( $X_4$ )

Industrial specialization ( $X_5$ )

Geographic proximity ( $X_6$ )

Management preference for specific auditor ( $X_7$ )

Long-term relationship with current auditor ( $X_8$ )

Each variable is assigned (1) if the respondent opinion is it does affect his choice and (0) if otherwise.

## 4. Data analysis and results

Analysis was conducted with the help of SPSS 23. First frequency test has been conducted and the results showed that 46.8% of respondent choose one of the Big Four and 53.2% chose other local auditor. 52.4% perceived audit fees as important factor in the auditor choice, 50% considered audit firm reputation with investors as important factor; audit firm reputation with corporate broker collected 54%, 49.2 selected audit firm reputation with external advisor; industry specialization collected 48.4%, geographic proximity 48.4%; management preference for specific auditor 44.4%; and finally long-term relationship with current auditor 49.2%.

Industry	Count	survey sample	% Sample
Banks	12	8	6.45%
Diversified financials	4	2	1.61%
insurance	33	24	19.35%
telecommunication services	4	3	2.42%
utilities	2	1	0.81%
REITS	5	4	3.23%
Real estate management & development	10	7	5.65%
retailing	6	4	3.23%
food & staples	4	3	2.42%
food & beverages	12	8	6.45%
health care equipment & SVC	6	4	3.23%
pharma biotech & life	1	1	0.81%
energy	4	3	2.42%
materials	42	30	24.19%

capital goods	12	8	6.45%
commercials & professional SVC	2	1	0.81%
transportation	5	4	3.23%
consumer Durables & apparel	5	4	3.23%
consumer services	6	4	3.23%
media	2	1	0.81%
	177	124	100%

Table 1: Sample selection

Then by conducting the logistic regression test variables  $X_1$ ;  $X_2$ ;  $X_6$ ;  $X_8$  where accepted to have an effect on the firm choice of auditor selection as shown in table (2).

Auditor_choice	B Coef.	S.E.	Wald	df	Sig.		Exp(B)
Step 1 <sup>a</sup> X1	.836	.435	3.693	1	.050	Accept	2.307
X2	.991	.445	4.947	1	.026	Accept	2.694
X3	.406	.448	.820	1	.365	Refused	1.500
X4	-.091	.439	.043	1	.836	Refused	.913
X5	.131	.440	.088	1	.767	Refused	1.139
X6	.870	.445	3.815	1	.050	Accept	2.386
X7	.503	.443	1.290	1	.256	refused	1.653
X8	1.156	.428	7.306	1	.007	Accept	3.176
Constant	-2.240	.552	16.461	1	.000	Accept	.106

Table 2 : Logistic Regression Result Predicting External Auditor Choice in Saudi listed firms  
Number of obs = 124 p-value less than 0.05

Cox & Snell R Square = .253 ,

Nagelkerke R Square= .338

LR chi2(8) = 36.185 sig. = 0.00 Log likelihood = 135.199 .

The results can be summarized in the table above as follows:

$$Y = (.836) * X1 + (.991) * X2 + (.406) * X3 + (-.091) * X4 + (.131) * X5 + (.870) * X6 + (.503) * X7 + (1.156) * X8 - 2.24$$

$$Wald = (3.693) X1 , (4.947) X2 ,(0.82) X3 , (0.043) X4 ,( 0.088)X5 ,( 3.815) X6 , (1.29) X7 , (7.306) X8 , (16.461)constant$$

It is clear that the estimated logistic model is consistent with economic logic; the logic of the estimated parameters in terms of parameter reference, the increase in the independent variable by plus and decrease by minus of coefficient. The coefficient of determination (R square) indicates that considering all the variables, it explained just 25.3% of the determinant of external auditor choice in Saudi listed firms. So the second metric was chosen. This is as a result of four significance of other eight variables. This presents the result of logistic regression. It also confirms that the estimated model represents the data as a complete representation and supports the latent intrinsic value of a model according to the Hosmer-Lemeshow test, which is based on the Kai-square test and shows that the observed (original) frequencies and expected (estimated) frequencies of the dependent variable were exactly identical, The square is small and equal (0.000) and the value is (0.000) The chi-square value which shows that overall model fit is significant less 1% level. Equally, the correct classification of the sample was categorized into the two classification groups (0, 1) by 100%; the sample observations were categorized in full without any error rate. This affected the value, morale and accuracy of the Wald test for the significance of the parameters.

## 5. Discussion and conclusions

The market share of the Big Four proved to be less than the other national auditors in Saudi Arabia. A finding that contradicts with the literature regarding the high agency cost in listed firms in

emerging markets which is supposed to increase the need of firms to hire reputable, high quality auditors, as suggested by Leuz, et al. (2003) and Farooq and Tabine (2015). The findings of the logistic regression analysis showed that only four out of the eight variables were significant namely; auditor fees, reputation with investors, audit firm geographical proximity, and long-term relationship with current auditor. This finding agrees with the results of Olowookere and Inneh (2016) in Nigeria, who found international coverage and long-term relationship significant, and with Thornton and Moore (1993) regarding the audit fees. But contradicts with Gatumia (2012), in Kenya, regarding the audit fees having no effect on the firm choice.

It can be concluded that the study of the firm choice of the auditor still needs more investigation to find an acceptable justification to a firm choice to one Big Four or a domestic audit firm.

## 6. Research limitations and direction for further research

One limitation of the paper is that results cannot be generalized to other emerging economies given the uniqueness of the Saudi economic, political, educational, religious and cultural environment.

Further investigation of the effect of firms' characteristics and degree of complexity of operation on the choice of a Big Four auditor is required since analysing the side of the auditor characteristics solely is not enough to explain the firms' selection process. Moreover, comparative studies are to be conducted in the middle east to reach points of similarities between such emerging markets as well as documenting any differences to better understand the factors behind the firms' choice and to investigate the importance of quality audit in the middle east to encourage foreign investment in the middle east by increasing trust and lowering agency costs.

## References

- Abbott, L.J. & Parker, S. (2000). Audit Selection and Audit Committee Characteristics. *AUDITING: A Journal of Practice & Theory*, 19(2), 47-66.
- Argaam, (2018). Listed firms Financial Report. [on line] Available at: <https://www.argaam.com/ar/company/financial-pdf> [Accessed 20 Sep. 2017-15 Jan. 2018]
- Aksu, M., Onder, T. & Saatcioglu, K. (2007). Auditor Selection, Client Firm Characteristics, and Corporate Governance: Evidence from Emerging Market. <http://www.research.sabanciuniv.edu/819/>. Retrieved: September 20, 2017.
- Beattie, V. & Fearnley, S. (1995). The Importance of Audit Firm Characteristics and the Drivers of Auditor Change in UK Listed Companies. *Accounting and Business Research*, 25(100), 227-239.
- Beattie, V. & Fearnley, S. (1998). Audit Market Competition: Auditor Changes and the Impact of Tendering. *British Accounting Review*, 30(3), 261-289.
- Broye, G. & Weill, L. (2008). Does leverage Influence Auditor Choice? A Cross-country Analysis. *Applied Financial Economics*, 18(9), 715-730.
- Cheng, T. W. & Leung, T. Y. (2011). Management Demography and Auditor Choice: The Case of China. *International Review of Accounting, Banking and Finance*, 3(2), 104-121.
- Choi, J.H., Kim, J.B., Qiu, A.A. & Zang, Y.S. (2012). Geographic Proximity Between Auditor and Client: How Does It Impact Audit Quality? *AUDITING: A Journal of Practice & Theory*, 31(2). 43-72.
- Citron D.B. & Manalis G. (2001). The International Firms as New Entrants to the Statutory Audit Market: An Empirical Analysis of Auditor Selection in Greece, 1993 to 1997. *The European Accounting Review*, 10(3), 439-459.
- Craswell, A.T., Francis, J.R. & Taylor, S. L. (1995). Auditor Brand Name Reputations and Industry Specializations. *Journal of Accounting and Economics*, 20(3), 297-322.
- Datar, S.M., Feltham, G.A. & Hughes, J.S. (1991). The Role of Audits and Audit Quality in Valuing New Issues. *Journal of Accounting and Economics*, 14, 3-49.

- DeAngelo, (1981). Auditor Size and Audit Quality. *Journal of Accounting and Economics*, 3, 183-199.
- DeFond, M.L. (1992). The Associations between Changes in Client Firm Agency Cost and Auditor Switching. *AUDITING: A Journal of Practice and Theory*, 11(1), 16-31.
- Ekumankama, O. & Uche, C. (2009). Audit Committee in Nigeria. *Corporate Ownership & Control*. 6 (3), Spring, 117 - 125.
- Evangelia, S. (2013). Determinants of Auditor Choice in the European Market. Master Thesis. School of Economics and Business Administration. International Hellenic University.
- Fan, J.P.H. & Wong, T.J. (2005). Do External Auditors Perform a Corporate Governance Role in Emerging Markets? Evidence from East Asia. *Journal of Accounting Research*, 43(1), 35-72.
- Farooq, O. & Kacemi, Y. (2011). Ownership Concentration, Choice of Auditors, and Firm Performance: Evidence from the MENA Region. *Review of Middle East Economics and Finance*, 7(2), 1-17.
- Farooq, O. & Tabine, S. (2015). Agency Problems and the Choice of Auditors: Evidence from the MENA Region. *Review of Middle East Economics and Finance*, 11(1), 79-97.
- Francis, J.R. & Wilson, E.R. (1988). Auditor Changes: A Joint Test of Theories, Relating to Agency Costs and Auditor Differentiation. *The Accounting Review*, 63(4), 663-682.
- Gatunia, G. N. (2012). Determinants of Choice of External Auditors: The case of Commercial Banks in Kenya. Retrieved from <http://erepository.uonbi.ac.ue:8080/xmlui/handle/123456789/9209>.
- Gujarati, D.N. & Porer, D.C. (2009). Basic Econometrics. *McGraw-Hill International Edition, fifth edition*, 543-546.
- Knechel, W. R., (2002). The Role of Independent Accountant in Effective Risk Management. *Tijdschrift voor Economic en Management*, (February), 65-86.
- Knechel, W. R., Niemi, L. & Sundgren, S. (2008). Determinants of Auditor Choice: Evidence from a Small Client Market. *International Journal of Auditing*, 12(1), 65-88.
- Leuz, C., Nanda, D. & Wysocki, P. D. (2003). Earnings Management and Investor Protection: An International Comparison. *Journal of Financial Economics*, 69(3), 505-527.
- Matonti, G., Tucker, J. & Tommasetti, A. (2016). Auditor Choice in Italian Non-Listed Firms. *Managerial Auditing Journal*, 31(4/5), 458-489.
- Moizer, P. (1997). Auditor Reputation: The International Empirical Evidence. *International Journal of Auditing*, 1(1), 61-74.
- Nichols, D. & Smith, D. (1983). Auditor Credibility and Auditor Changes. *Journal of Accounting Research*, (Autumn), 534-544.
- Olowookere, J.K. & Inneh, G.E. (2016). Determinants of External Auditors Choice in Nigerian Quoted Manufacturing Companies. *Kuwait Chapter of Arabian Journal of Business and Management Review*, 5(9), 10-22.
- Niemi, L. & Sundgren, S. (2008). Auditing, Trust and Governance - Regulation in Europe (eds. Quick, R., Turley, S. & Willekens, M.), London. Routledge.
- Oxera. (2006). Competition and Choice in the U.K. Audit Market: Prepared for the Department of Trade and Industry and Financial Reporting Council. Oxera Consulting (Oxford, England).
- Simunic, D. A. & Stein, M.T. (1987). Product Differentiation in Auditing: Auditor Choice in the Market for Unseasoned New Issues. *Vancouver, BC: The Canadian Certified General Accountants' Research Foundation*.
- Sundem, G.L., Dukes, R. E. & Elliott, J.A. (1996). The Value of Information and Audits, New York. Coopers & Lybrand.
- Revier, E. & Schroé, R. (2010). Determinants of Auditor Choice. Master Thesis. Faculteit Economie en Bedrijfskunde. Univeriteit Gent.

- Thornton, D. B. & Moore, G. (1993). Auditor Choice and Audit Fee Determinants. *Journal of Business Finance & Accounting*, 20(3), 306-349.
- Wallace, W. (1981). The Economic Role of the Audit in Free and Regulated Markets. <http://raw.rutgers.edu/raw/wallace/homepage.html>.
- Wang, Y. (2013). Evidence on The Choice of External Audit Firms by Chinese Companies. Master Thesis. School of Economics and Management. Tilburg University.
- Watts, R. L. & Zimmerman, J. L. (1978). Toward a Positive Theory of the Determination of Accounting Standards. *The Accounting Review*, (January), 112-134.
-