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ECONOMIC BONDING AND AUDIT QUALITY

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Abstract: The purpose of this paper is to assess Economic Bonding and Audit Quality. Economic bonding happens when clients overpay auditors in exchange for granting managers financial reporting discretion. Following a string of significant accounting scandals involving Enron, Worldcom, and other companies, as well as the catastrophe of Arthur Anderson, a former Big Five audit firm, auditor independence and audit quality have come under intense scrutiny. It is imperative for regulators and investors to comprehend the circumstances and reasons behind auditors' potential compromise of independence and quality. The objective of this paper is to evaluate economic bonding and audit quality. The methodology adopted for this study is library approach which focuses on content review of extant literature on economic bonding and audit quality. We came to the conclusion that the economic bonding perspective, which sees unusually large audit fees as bribes or economic rents that the auditor receives, is correct. Therefore, an abnormally large fraction of audit fees above standard audit fee levels incentivize auditors to compromise their impartiality. Conversely, the "audit effort view" forms the foundation of the opposite theory. In order to preserve their reputation or stop auditors from raising audit risk in order to benefit management, higher audit fees are indicative of longer working hours and improved audit standards. The study suggested that management of publicly traded companies should use one of the larger audit firms; if this isn't feasible, management should choose an audit firm whose morality and ethics are unquestionable.

Keywords: Economic Bonding, Audit Quality, Abnormal Audit Fees, Auditor Independence and Normal Audit Fees.

1. Introduction

Overpayment of auditors by customers in exchange for administrative discretion in financial reporting is known as economic bonding (Choi et al, 2010). The audit effort theory, which holds that an abnormal audit fee compensates for the extra work auditors do to raise the quality of the audit, is the second explanation that has drawn a lot of academic interest. Following a string of significant accounting scandals including Enron, Worldcom, Palamat, and other companies, as well as the catastrophe of Arthur Anderson, a former Big Five audit firm, auditor independence and audit quality have come under intense scrutiny. It is imperative for regulators and investors to comprehend the circumstances and reasons behind auditors' potential compromise of independence and quality. As auditor independence and quality are generally unobservable (prior to costly investigations triggered by auditor litigation), researchers gain insights into this issue by identifying scenarios (for example, in the presence of large non-audit fees or lengthy auditor tenure) in which the auditors' economic interests from clients are likely to outweigh their potential, litigation costs, and reputation loss from audit failures, resulting in a lack of independence and poor audit quality. Regulators and academics are increasingly concerned about the auditor-client link and its impact on audit quality. (Menon and Williams, 2004; Lennox 2005; Carey and Simnett 2006).

According to the research committee of the Institute of Chartered Accountants of India, professional integrity and independence are crucial traits of learned professions, particularly in the accounting field. Therefore, the concepts of audit and independence are complementary to each other. Independence means that a person's judgment is not influenced by his or her own self-interest or by the desires or instructions of another person who may have engaged them. Tepalagul and Lin (2015) contend that the importance of the customer, non-audit services, auditor tenure, and association with audit firms are the four primary risks to auditor independence. Hope and Langli's (2010) study on the significance of clients found that auditors who charge greater audit fees are more likely to release a modified audit report. The assertion that Big Four audit firms are more conservative when auditing major clients is accepted, despite the fact that the evidence supporting the claim is weak (Tepalagul and Lin, 2015). Frankel et al. (2002) draw the conclusion from another study that there is evidence to support the idea that audit quality may be compromised when auditors perform non-auditor services to the same customer. Furthermore, it is against the law for an auditor to do non-audit services for a client for whom they are a statutory auditor under the Sarbanes-Oxley (SOX) Act. The results of earlier research on the connection between auditor independence and tenure have been conflicting. Longer audit tenures are said to cause auditors to report more favorably to their clients. Longer audit-client tenure, according to some academics, will improve the auditor's comprehension of the client's operations and could therefore improve the quality of the audit.

Auditors have been obliged to recognize, assess, and mitigate risks to their independence in a number of different circumstances. An economic relationship is formed between the auditor and the customer by the economic rents connected to audit fees (DeAngelo 1981; Magee and Tseng 1990). It's feasible that auditors will sacrifice their independence in order to keep these profits. According to DeAngelo's (1981) seminar paper, larger audit companies are more likely to provide higher-quality audits since they are more financially independent of a single client and stand to lose more if audit quality is compromised. Subsequent to DeAngelo (1981), empirical research has produced inconsistent results. According to some research, there is a correlation between economic tie and impaired auditor independence (e.g., Frankelet al., 2002; Knechel et al., 2013). The study conducted by Hardies et al. (2012) examined the correlation between the economic link between an individual engagement partner and their customer and the damage of auditor independence based on data from Belgium. Their findings did not support the notion that auditor independence is harmed by the financial significance of the client. Furthermore, Knechel et al. (2013) shown using Swedish data that the economic importance of the client grew and the wealth of the auditor (as a safety net) reduced the auditor's inclination to provide a modified (going concern) audit opinion for distressed enterprises. However, it was shown that the auditor's wealth had little impact on enterprises that were bankrupt or had lost equity.

Audit is a type of examination, and there are two main types of audits. The internal audit, which is conducted by an employee who is typically a member of the firm and works in management, and the independent audit, which is an external audit. Remarkably, external audits are the subject of most audit mentions. The way the phrase is used in this context follows that pattern. Akhalumeh et al. (2017) explain that the goal of an audit is to ensure that assurances are given regarding financial statements, and that the audit serves as a measure of the assurance that such financial statements do not contain serious misstatements. The ability of the auditor to determine the standards of accounting violations as well as their motivations for such breaches to be reported is used to assess audit quality. That is to say, audit quality is determined by the auditor's skill as well as independence. Akhalumeh et al. (2017) noted in their study that audit quality is regarded as one of the most important concerns facing the auditing profession. The audit exercise's capacity to detect major errors and fraud that result in material misstatements of various financial statements is what is deemed audit quality. Audit quality assesses the possibility that a quality auditor, whether internal or external, will discover and disclose substantial errors, fabrications, and omissions in a client's accounting system (DeAngelo, 1981). This is dependent on the auditor's technical abilities to detect misreporting and his independence to report any identified errors. Accountants, as defined by the code of professional behavior, play an important role in society. In accordance with that responsibility, they are expected to use professional and moral judgment in their work in order to retain public trust. As a result, the quality of auditing services is regarded to be higher when the auditor is independent and has the ability to critically evaluate client firms' financial reporting. These qualities are built on the auditor's values, ethics, knowledge, and experience (International Auditing and Assurance Standards Board (IAASB), 2013). Audit quality is critical to sustaining an effective market environment; an independent quality audit supports confidence in the authenticity and integrity of financial statements, which is required for well-functioning markets and improved financial performance. External audits performed in accordance with high quality auditing standards can help reporting entities implement accounting standards and ensure that their financial statements are reliable, transparent, and useful. Sound audits can help reinforce strong corporate governance, risk management, and internal control at firms, thus contributing to financial performance.

1.1 Objective of the Study

The broad objective of this paper is to evaluate economic bonding and audit quality.

2. Literature Review

2.1 Conceptual Review

2.1.1 Economic Bonding

One fundamental concept that explains this relationship is economic connection between auditor and client, which is based on worries about impaired auditor independence, which may affect audit quality. Economic bonding occurs when clients overpay auditors in exchange for granting managers financial reporting discretion (Choi et al., 2010). Another hypothesis that has garnered significant study attention is the audit effort viewpoint, which holds that an anomalous audit fee pays auditors for extra efforts that contribute to an increase in audit quality. Due to the severe rivalry in the audit service market in Korea, clients regularly demand fee discounts. It contributes to the frequent fee discounting phenomenon in the first year of audit (Lee et al., 2011), as well as preventing proper price increases from reflecting relevant risk assessed by auditors. Furthermore, audit risk is lower in Korea than in other affluent nations when measured by the Wingate litigation index (Wingate 1997; Choi et al., 2008). As a result, auditors are less motivated to do high-quality audits. In such a case, if customers pay higher-than-usual fees in expectation of auditor approval for specific accounting treatments, audit and client can economically bind, resulting in poor audit quality (Choi et al., 2010). However, in the context of the Korean local audit service market, where audit fees are generally discounted due to overheating competition, abnormally high audit fees paid to auditors are likely to compensate auditors' efforts that have not previously been adequately compensated, which subsequently contributes to an increase in audit quality to some extent. Economic bonding theory may not be applicable in the Korean audit service market in this scenario.

Because International Financial Reporting Standards (IFRS) are principle-based, accounting standards on how each principle should be implemented are not detailed. This will almost certainly result in managerial discretion and subjectivity (Ahmed et al., 2012). As a result, auditors' professional judgment concerning the firms' discretion is required in order for auditors to approve the proposed accounting treatment. Auditors must devote greater resources to a broader range of accounting options and complexity. As a result, audit fees have grown generally due to increased audit efforts following the introduction of International Financial Reporting Standards (IFRS). IFRS can be an excellent opportunity for corporations that want to manipulate earnings in order to meet their financial targets in conjunction with auditors.

The audit fee is separated into two parts: normal audit fee and abnormal audit fee. Normal audit fees are those that are reasonable in light of the client's size, risk, and complexity. As a result, any audit fee paid in excess of the standard audit fee is considered abnormal (Eshleman et al., 2014). The abnormal audit fee is unusually high, therefore it may better capture the profitability of the services supplied to auditors. Researchers are interested in the relationship between atypical audit fee and audit quality, specifically if obtaining abnormally high audit fee increases or decreases audit quality. This relationship is explained by two separate theories. The first theory is based on the economic bonding perspective, which considers unusually large audit fees to be bribes or economic rents earned by the auditor (Kinney and Libby 2002). Thus, auditors are incentivized to lose independence if they get an abnormal portion of audit fees over the regular level. Several previous studies have demonstrated audit firms' economic reliance on their clients. (DeAngelo 1981, Beck et al., 1988; Magee and Tseng 1990; Choi et al., 2010). The other theory is based on what is known as the "audit effort view." Higher audit fees represent more working hours and better audit characteristics in order to retain their reputation or to keep auditors from increasing audit risk of earning management (Francis and Krishnan 1999). Blankley et al. (2012)'s findings are likewise consistent with the audit effort viewpoint in that clients who pay unusually high audit fees provide higher quality accounting information with less restatement subsequently. Higgs and Skantz (2006) discover a positive and statistically significant relationship between anomalous audit fees and audit quality. As a result, existing literature provides conflicting conclusions on the relationships between audit characteristics and atypical audit fees.

Hardies et al. (2012) investigated the association between auditor independence impairment and the economic bond between an individual engagement partner and his or her client using Belgian data. Their findings found no evidence that client economic importance had a negative impact on auditor independence. Furthermore, Knechel et al. (2013) used Swedish data to demonstrate that for distressed firms, the client's economic importance increased and the auditor's Wealth (as a safeguard) lowered the auditor's proclivity to offer a modified (going concern) audit opinion. However, the influence of the auditor's wealth was found to be small for bankrupt and equity-lost enterprises. Oladipupo and Monye-Emina (2016) looked into how unusual audit fees affected the caliber of audits in the Nigerian audit industry. They found that, in Nigerian quoted businesses, audit fees had no discernible effect on the quality of audits. Hope and Langli's (2010) study on the significance of clients found that auditors are more inclined to issue a changed audit report if they receive greater audit fees. The notion that Big Four audit firms tend to be more conservative when auditing major clients is accepted, despite the fact that the evidence supporting the claim is weak (Tepalagul and Lin, 2015).

2.1.2 Audit Quality

According to DeAngelo (1981), audit quality is the likelihood that the everlasting auditor will find and notify the client of any infractions in the accounting system. According to Nyaboke and Omwenga (2016), there are two aspects of audit quality: firstly, identifying financial statement errors and misstatements, and secondly, making sure that these errors and misstatements are disclosed. According to Akhalumeh et al. (2017), the goal of an audit is to ensure that assurances are given regarding financial statements. As a result, the degree of assurance that there are no substantial misstatements in these financial statements indicates the quality of the audit. The capacity of the auditor to determine the standards of accounting violations and their incentives for reporting such breaches is a measure of the audit's quality. In their study, Akhalumeh et al. (2017) noted that one of the most important concerns facing the auditing profession is audit quality. The capacity of an audit exercise to identify fraud and major errors that result in material misstatements of different financial statements is what is regarded as audit quality. According to Davidson and Neu (1993), the ability of the auditor to identify and guarantee the removal of substantial misstatements and manipulations that lead to reported net income is what constitutes audit quality.

Reports regarding the actual state of the examined company are anticipated from the auditor, who serves as a mediator between management and the scattered owners. The ongoing discussion about the quality of audits is due to the global financial reporting scandals, which appear to have been a recurrent decimal that has primarily impacted users' observation and reception of accounting information regarding the services provided by both accountants and auditors (Mgbame et al. 2012). The demise of well-known corporations, linked to widespread deception by directors acting in collusion with auditors, as evidenced by the Enron, Worldcom, Parmalat, Polly Peck, Cadbury PLC, and financial scandals involving certain Nigerian deposit money banks, has exposed the dark side of subpar auditing. In Nigeria, for example, Akintola William and Deloitte were charged with poor auditing and financial statement manipulation during the Cadbury corporate fraud investigation process. Poor auditing can mislead stakeholders about the actual financial situation and foster a conflict of interest between management and owners. Corporate failures that have been reported in Nigeria over the past few years have prompted serious concerns about the validity and dependability of audit findings in the event that shareholders' interests are not safeguarded (Egbunike and Okafor, 2017). A lot of businesses experienced corporate collapse as a result of subpar auditing.

3. Methodology

The methodology adopted for this study is library approach which focuses on the content review of extant literature on economic bonding and audit quality.

4. Conclusion

The paper looks at audit quality and economic bonding conceptually. Examining the available research, it can be seen that economic bonding has conflicting results regarding audit quality. When clients overpay auditors in exchange for permitting managerial discretion in financial reporting, this is known as economic bonding. This association is explained by two separate explanations. The "economic bonding view," which forms the basis of the first theory, views unusually large audit fees as bribes or economic rents that the auditor is receiving. Therefore, an abnormally large fraction of audit fees above standard audit fee levels incentivize auditors to compromise their impartiality. The "audit effort view," on the other hand, is the foundation of the opposite idea. In order to preserve their reputation or stop auditors from raising audit risk in order to attract management, higher audit fees are indicative of longer working hours and improved audit standards.

5. Recommendations

The following policy recommendations were offered in line with the theoretical findings of this study.

- The management of listed companies should employ the services of one of the big audit firms and where this is not possible, management should go for an audit firm whose character and integrity is beyond question.
- The Nigerian Stock Exchange (NSE) should also ensure that companies listed in the stock exchange comply with its code of corporate governance like the Central Bank of Nigeria (CBN) does with banks.

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