

The Importance of Financial Audit: Benefits, Challenges and Service Quality towards Client Loyalty

Associate Prof Dr Zuraidah Mohd Sanusi

Accounting Research Institute/Faculty of Accountancy
Universiti Teknologi MARA, Malaysia

Yusarina Mat Isa

Accounting Research Institute/Faculty of Accountancy
Universiti Teknologi MARA, Malaysia

Mazurai Mohamed

Accounting Research Institute/Faculty of Accountancy
Universiti Teknologi MARA, Malaysia

Dr Lee Teck Heang

Department of Accounting
HELP University, Malaysia

Prof Dr Takiah Mohd Iskandar

Faculty of Economics and Management
Universiti Kebangsaan Malaysia, Malaysia

Abstract – The purpose of this paper is to analyze the level of client loyalty among the companies in Malaysia by considering several factors such as the benefits and challenges of an audit as well as the audit service quality provided by the audit firm. Based on 119 responses, the results indicated strong influence of audit service quality towards loyalty of the clients. Nevertheless, there is insignificant relationship contributed by audit benefits and audit challenges towards retaining clients with the audit firms. The results of the study on client loyalty have important implications to the management of the quality services provided by an audit firm. Once clients' perspectives on the dimensions of quality services are more clearly known and understood, the service providers will be in a better position to anticipate their clients' requirements rather than react to client dissatisfactions.

Keywords—Client loyalty; Audit service quality; Audit benefits; Audit challenges; Financial audit

I. INTRODUCTION

An audit is an essential medium in obtaining management and financial information of a company. The main objective of an audit is to express an opinion on the truth and fairness of the company's financial statements (Salleh et al., 2008). Under the Companies Act 1965, all companies in Malaysia regardless of their size, private or public have to ensure that their annual accounts are audited by an independent auditor and this requirement is stated in Section 169(1), Section 174(1) and Section 174(2) of the Companies Act. Due to the

mandatory audit, this would contribute to the loyalty of the client if the audit firm is able to fulfill its satisfaction and provide high quality of its service.

In Malaysia, the issue of client loyalty has always been related to the audit tenure and interval rotation of audit firms as audit partners were not explicitly addressed in any of the relevant Malaysian official documents such as the Companies Act 1965, the Securities Commission's regulations and approved auditing standard. However, client loyalty looks into the context of audit service quality provided by the audit firm. If they are satisfied with the audit service quality, they will probably use the services of their current auditor for a longer period. At the same time, they might also use the same audit firm for other services such as taxation, secretarial practices and others.

The objective of the study is to examine the relationship between audit benefit, audit challenges and service quality with the level of client loyalty among companies in Malaysia. This study contributes in a number of ways as it provides an overview of the audit benefits and challenges and simultaneously of the service quality received of companies in Malaysia through their mandatory annual accounts which are audited by an independent auditor. It also discusses on the issue of client loyalty and the criteria that drive the clients to use the same auditor for an extended period of time.

II. LITERATURE REVIEW

The audited financial statements of the companies are an important medium for raising finance, helping owners or managers to plan, control and make decisions as well as playing a number of other useful functions in promoting the well being of the enterprise (Collis and Jarvis, 2002). Audited financial statements are an important piece of information for investors and economists when judging the health of a company and the overall economy. Audits of a company's financial statements provide an external look into the heart of a company's operations (Arens et al., 2003). Carrera et al. (2007) found in their study that investors rely on these audited financial statements to determine whether the company is worthwhile to be invested in by them and how the company affects the overall business industry.

According to Delgado-Ballester and Munuera-Alema'n (2001), the client's loyalty will actually generate major benefits to the audit firm such as increased sales and forming an entry barrier to competitors of audit firms. While Ismail et al. (2006) found that client's satisfaction played an important role in enhancing the

client's behavioural loyalty due to the service quality offered by the audit firm. De Ruyter and Wetzels (1999) found that the cooperation between an audit firm and client had a positive relationship effect on continuance and that a positive perception significantly reduced the likelihood of the client changing the auditor. A proposal made by AICPA (1978), is to encourage the client to have an interval in the changing of the audit firm due to several reasons such as to increase the auditor's ability in protecting the public via the increase in alertness to any possible improprieties, increase in its quality service and prevent a closer relationship with the client (Brody and Moscove, 1998).

Tauringana and Clarke (2000) identified the major reason why some small companies continued to be audited as to help control the conflict of interest among managers, shareholders and outside creditors. Audits provide these users of financial statements reasonable assurance that the report is prepared in compliant with the accounting standards and ensure the credibility of its information (Arens et al., 2003). Annie (2010) agreed that audit can benefit an SME although the types of benefits obtained by companies may differ from those enjoyed by large entities operating in the global capital markets. Qually (2002) stated in his study that the role of auditors have been to bring credibility to audited financial statements by giving their true and fair view on the financial information.

The companies need an audit as one of the tools to extend the credit or sometimes needs of loan finances. Because of the obstacle on financing, companies rely on audited financial statement to represents the credibility of their financial situation. Collis et al. (2004) suggested that small companies that are hopeful in becoming large companies will be more likely to continue to have the account audited. This was also agreed by Davies (2004) who stated that where a company is to any substantial extent dependent on outside finance and credit, the company will need to provide reliable evidence to outside parties of the soundness of its finances, and it is here that the existence of audited account brings direct commercial value to a company. This is supported by the survey results of ICPAS in 2000 that showed that the audited financial statements were useful in dealings with banks and other lenders, leasing companies, supplier of goods and services, the tax authorities and other government agencies. Tauringana and Clarke (2000) stated that if lenders base their credit granting decisions on financial statements, they may likely suffer financial losses. Strawser (1994) also suggested that a bank loan officer is more likely to grant loans to companies providing audited financial statements, and that lenders associate greater reliability with such statements. As a result, it is clear that an audit aids companies in the raising of finance and capital.

Audit quality is a critical component of a client's perception because it is an antecedent to client

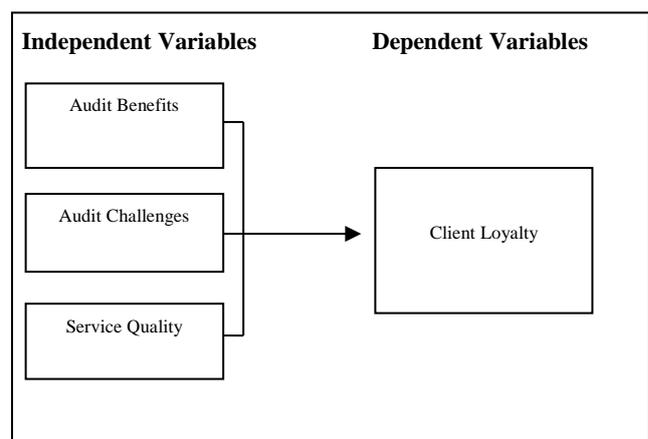
satisfaction. Arrunada (2004) highlighted that audit quality is viewed as one of the important factors that affect the credibility of financial statements. This is also agreed by Brinkley (2006) that the assessment of audit quality of audit firms ensure that an audit firm's processes are systematic and effective. DeAngelo (1981) defines audit quality as the probability that an auditor will both discover and report an error in a client's accounting system. On the other hand, the qualities of the audit service provided by the audit firm is called audit service quality. Audit is a service and audit service quality is defined as the "quality of the input provided by the audit firm while performing the audit services" (Pandit, 1999). That is, "quality occurs during service delivery, usually in an interaction between the client and the contact person from the service firm" (Parasuraman et al., 1985). Lewis and Mithell, (1990) also highlighted commonly service quality as the extent to which a service meets client's needs or expectations. Zeithml (1990) defined service quality as the client's judgment about the superiority or excellent of products. Service quality is also defined by Parasuraman et al. (1985) as the comparison that the clients make between their expectations about a service and their perception of the way the service has been performed.

Yi (1990) who mentioned that client's satisfaction is influenced by two factors, namely experience and expectations with service performance. Crosby et al. (1990) demonstrated that the client's past satisfaction affects their decisions to have a continuing relationship with the service provider. Similarly, Fornel (1992) found that a satisfied client tends to maintain his consumption pattern and will consume similar products or services. Thus, client satisfaction has become an important indicator of quality and future revenue (Andreassen, 1994).

III. RESEARCH METHODOLOGY

Figure 1.0 shows the dependent and independent variables used in this study. To accomplish the research objectives, this study will examine whether the audit benefit, challenges, service quality and client will cause an effect on the level of client loyalty among companies in Malaysia. In addition, audit service quality will be classified under three dimensions which are responsiveness, tangibles and reliability.

Figure 1: The Framework of the Study



Bloemer et al. (1998) found a positive relationship between perceived service quality and preference loyalty and price indifference loyalty. DeRuyter et al. (1998) found that poorly perceived service quality may also result in high service satisfaction for those clients who may not necessarily buy the highest quality service. Rust and Zahorik (1993) and Storbacka et al. (1994) studied the impact of service quality on client satisfaction, and client satisfaction on client loyalty. They found service quality to be positively correlated with client satisfaction that will lead to increased loyalty. A similar study by Behn et al. (1997) and GAO (2003) found that attributes of audit service quality were positively associated with client satisfaction. Stauss and Neuhaus (1997) also found a significant positive relationship between client satisfaction and client loyalty. Contrary results by Bowen et al. (2001) verified that client satisfaction did not equal client loyalty. Therefore, hypothesis for this study are:

H1: There is a significant relationship between audit benefit in terms of reliability with client loyalty.

H2: There is a significant relationship between audit challenges with client loyalty.

H3: There is a significant relationship between audit service quality in term of responsiveness, reliability and tangible with client loyalty.

Sample

This study relies upon primary data which is collected through the distribution of a structured questionnaire (Appendix A) to companies in the Klang Valley. A sample of 459 companies in the Klang Valley was randomly selected from the Business Directory 2008. The method chosen to collect the data was a seven-page postal questionnaire to be sent to the CEO of every company selected. A total of 119 responses were received bringing the response rate to 26 percent.

IV. DATA ANALYSIS

Reliability Test

Reliability test provides evidence on the measurement scales and the items in the questionnaire are related to each other. Table I shows the statistical test of reliability of ethical orientation constructs. The scale had a Cronbach's alpha reliability coefficient of .509, .555 for both reliability and finance strategy and also a standardised item alpha of .513 and .559 respectively. Although the value was less than 0.7, it indicated that each dimension of audit benefit had a low sufficient internal consistency where Nunally (1967) suggested that the modest reliability ranging between 0.5 and 0.6 would be sufficient. On the other hand the audit challenges had a Cronbach's alpha reliability coefficient of .494 and a standardised item alpha of .523. In order to increase the value to 0.7 or higher, 3 items were excluded from the

questionnaire but the result did not also reach 0.7 and above. As a result, after deleting 3 items, the Cronbach's alpha reliability turned to .636 with a standardised item alpha of .643. This indicated that each dimension of audit challenges had sufficient internal consistency.

Table I: Reliability Test

Reliability coefficients	Cronbach's Alpha	Standardised Item Alpha	No of Item
Audit benefit			
• Reliability	.509	.513	3
Audit challenges	.636	.643	6
Audit service quality			
• Responsiveness	.782	.780	6
• Tangibles	.574	.577	3
• Reliability	.549	.552	3
Customer loyalty	.716	.715	5

Besides that, for the audit service quality, factor analysis was divided into three factors which were responsiveness, tangibles and reliability. The results of the Cronbach's Alpha test showed .782, .574 and .549 respectively. These results indicated that the internal consistency for the 12 items in the questionnaire was reliable. Table 4.3 also presents the variables client satisfaction and loyalty. The results of the Cronbach's Alpha test showed .676 and .716 respectively. These results also indicated that the internal consistency for 9 items in the questionnaire was reliable.

Factor Analysis

The survey instrument was validated to confirm the validity of the questionnaire by using factorial analysis. This test is important to determine whether the items are tapping into the same construct (Coakes et al., 2009). The Kaiser-Meyer-Olkin Measure of Sampling Adequacy (KMO) value is .6 and above and the Bartlett's Test of Sphericity reached statistical significance of less than .05, indicating that the correlation matrix was significantly different from an identity matrix, in which the correlations between the variables are all zero (Coakes et al., 2009; Pallant, 2003). Thus, the Kaiser-Meyer-Olkin coefficients for these data were 0.644 for audit benefit, 0.565 for audit challenges, 0.819 for audit service quality and 0.777 for client satisfaction and loyalty. The Bartlett tests of Sphericity for all the variables were statistically significant. Thus, these results supported the factorability of the correlation matrix. The factor loading for each item was between .912 and .324. In interpreting the factor loadings, factor loadings of .30 are considered to meet the minimal level; factor loadings of .40 are considered more important; and any factor loadings of .50 or greater are considered practically significant (Hair et al., 1998). As the minimum factor loadings of the item in the questionnaire in this study is .324, therefore this means that all factor loadings for this study meet the minimum level as it above .30. This indicates that the data is suitable for factor analysis.

Regression Analysis

The hypotheses were tested using multiple regressions as the study attempts to find the effect of the independent variables on the dependent variables, which was measured on a continuous scale.

Table II: Regression Results on Client Loyalty

Variables	Coefficients	Std Error	t-stat	p-value	VIF
Constant		3.508	1.932	0.056	
BEN_REA	0.021	0.128	0.261	0.795	1.120
AUD_CHAL	-0.001	0.085	-0.010	0.992	1.186
SERVQ_RESPON	0.221	0.075	2.388	0.021*	1.575
SERVQ_TANGIB	0.137	0.134	1.500	0.136	1.466
SERVQ_RELIAB	0.097	0.123	1.058	0.292	1.477
	R			= 0.609	
	R ² (Adjusted R ²)			= 0.371 (0.332)	
	F-statistic (p-value)			= 9.371 (0.000)	
	Durbin Watson statistics			= 1.810	

Notes: BEN_REA: Audit Benefit Reliability, BEN_FINSTRA: Audit Benefit Finance Strategy, AUD_CHAL: Audit Challenges, SERVQ_RESPON: Responsiveness, SERVQ_RELIAB: Reliability, SERVQ_TANGIB: Tangibles, CLI_SATIS: Client Satisfaction

** Significant at 1% level * Significant at 5% level

Table II shows the regression results for audit objective, challenges, service quality and client satisfaction with client loyalty. The adjusted R² indicates that 33.2 percent of the various variables is associated with client loyalty. Table II revealed that only audit service quality in terms of responsiveness and client satisfaction had a significant relationship with client loyalty. Nevertheless, audit benefit, challenges and audit service quality in terms of tangible and reliability had no significant relationship with client loyalty.

V. CONCLUSION AND IMPLICATIONS

The studies done by Nasser et al. (2006) who stated that in a long term relationship between the client and audit firm, the auditors become less independent and apply less effort towards the detection of material misstatements. Thus, the audited financial statement seemed to be not reliable to the users. Due to that, the results from the data analysis showed that there was no significant relationship between customer loyalty and audit benefit. This meant that the loyalty or disloyalty faced by the customer was not influenced by the audit benefit felt by the companies. The reliability of audited financial statements audited by an auditor was not necessarily relevant to measure their loyalty to the current audit firm. At the same time, it being easy to get a loan with the financial institutions if they had audited financial statements also did not affect their loyalty to the audit firm. The result was also the same for the audit challenges, whereby there was no significant relationship between client loyalty and audit challenges. The companies did not look at the audit fees charged by the audit firm as a burden and being very costly when either

of them was loyal or disloyal to the same audit firm. Therefore, it can be concluded that audit benefit and challenges were two factors that did not influence the loyalty of the companies in Malaysia.

Finally, to investigate if the audit service quality provided by the audit firm with client satisfaction influenced loyalty among the companies in Malaysia to the current audit firm. The hypotheses continued to determine whether client loyalty was influenced by audit service quality and client satisfaction. However, the results showed that both the audit service quality and client satisfaction had a significant relationship with client loyalty. Responsiveness as a dimension of audit service quality had positive significant effect on client loyalty compared to another two dimensions, namely reliability and tangibles which were found to not be significant. This meant that the companies expected their auditor to be more willing to deliver a prompt service to them to continue their loyalty. Besides that, client satisfaction also had a positive significant effect on client loyalty. This meant that client satisfaction played an important role in enhancing client loyalty. This view of result was consistent with study done by Ismail et al. (2006) which concluded that audit service quality and client satisfaction were influenced by client loyalty. These findings also in line from the descriptive analysis that found the majority (37 percent) of the companies had 4 years of audit tenure with the current auditor. It believes that once client satisfied on service provided by audit firm, they can be loyal for the longer period.

The results of the study on client loyalty have important implications to the management of the quality service provided by an audit firm. Once clients' perspectives on the dimensions of quality services are more clearly known and understood, the service providers will be in a better position to anticipate their clients' requirements rather than react to client dissatisfactions. This study also demonstrated the usefulness of the SERVQUAL approach as a good measure of the service quality provided by the audit firm.

The audit firm needs to promote a new service such as consultancy. Besides that, it will prepare the auditors to face the greater competition and challenges locally and globally. While in terms of quality of service, the audit firm should strive to improve. For example, the audit firm should send their staff for training on a continuous basis.

Besides that, it would be beneficial if the users could be categorised into various segments based on the individual SERVQUAL scores. These segments could then be analysed by the relative important five dimensions in influencing service quality. In this manner, the companies would be able to target the specific quality programmes of these segments. In addition, future studies can examine only one aspect of the service offered by audit firms; for example, only the audit work instead of generalising to all the services offered by the audit firm.

ACKNOWLEDGMENT

We would like to thank the Malaysian Ministry of Higher Education (MOHE) for their financial support in providing us research grant to conduct the study.

REFERENCES

- AICPA (1978b). Report of Progress, American Institute of Certified Public Accountants, New York, NY.
- Andreassen, T. W. (1994). Satisfaction, Loyalty and Reputation as Indicators of Customer Orientation in the Public Sector. *International Journal of Public Sector Management*, 7(2): 16-34.
- Annie L. (2010). SMEs Can Benefit from Independent Audit, Retrieved 2nd February 2010 from <http://biz.thestar.com.my/news/story.asp?file=/2010/2/2/business/5590278&sec=business>.
- Arens, A.A., Elder, R.J. and Beasley, M.S. (2003), Auditing and Assurance Services: An Integrated Approach. 9th ed., Prentice-Hall, Upper Saddle River, NJ.
- Arrunada, B. (2004). Audit Failure and the Crisis of Auditing. *European Business Organization Law Review* 5: 635 – 643.
- Brinkley, M. (2006). Health Check for the Audit Brands. *Internal Auditor*: 79 – 83.
- Brody, R. G. and Moscovice, S. A. (1998). Mandatory Auditor Rotation. The National Public Accountant: 32-5.
- Carrera, N., Gómez-Aguilar, N. and Ruiz-Barbadillo, E. (2007). Mandatory Audit Firm Rotation in Spain: a Policy That was never Applied, *Accounting, Auditing & Accountability Journal*, 20 (5): 671-701.
- Collis, J. and Jarvis, R. (2002). How Owner-Managers Use Accounts, Centre for Business Performance, ICAEW, London.
- Collis, J. (2003). Directors' Views on Exemption from the Statutory Audit, *URN 03/1342, London : DTI*, October.
- Collis, J., Jarvis, R and Skerratt, L. (2004). The Demand for the Audit in Small Companies in the UK. *Accounting & Business Research*, 34 (2): 87 – 100.
- Companies Act 1965. International Law Book Services, Petaling Jaya.
- Crosby, L. A., Evans, K. and Cowles, D. (1990). Relationship Quality in Service Selling: An interpersonal Influence Perspective. *Journal of Marketing*, 54: 68-81.
- Davies, J. (2004). Audit Exemption : Freedom or Danger? *Metalworking Production*, April issue.
- DeAngelo, L.E., (1981). Auditor Size and Audit Quality. *Journal of Accounting and Economics* 3 (3): 183–200.
- Delgado-Ballester, E. and Munuera-Alema'n, J. L. (2001). Brand Trust in the Context of Consumer Loyalty. *European Journal of Marketing*, 35 (11/12): 1238-58.
- DeRuyter, K. and Wetzels, M. (1999). Commitment in Auditor-Client Relationships: Antecedents and Consequences. *Accounting, Organizations and Society*, 24(1): 57-75.
- Fornell, C. (1992). A National Customer Satisfaction Barometer: The Swedish Experiences. *Journal of Marketing*, 56 (1): 1-2.
- ICPAS. (2000). Submission on Audit Exemption for Private Limited Companies: Incorporating Findings and Analysis of Survey Results, Institute of Certified Public Accountants of Singapore, Singapore.
- Ismail, I., Haron, H., Ibrahim, D.N. and Isa, S.M. (2006). Service Quality, Client Satisfaction and Loyalty towards Audit Firms: Perceptions of Malaysian Public Listed companies. *Managerial Auditing Journal*, 21 (7): 738 – 756.
- Kon, Y. and Storey, D. J. (2003). A theory of Discouraged Borrower, Small Business Economics, 21: 37-49
- Lewis, B R. and Mithell, V. W. (1990). Defining and Measuring the Quality of Customer Service. *Marketing Intelligence & Planning*, 8 (6): 11 - 17.
- Pandit, G.M. (1999). Clients' Perceptions of their Incumbent Auditors and their Loyalty to the Audit Firms: an Empirical Study. *The Mid-Atlantic Journal of Business*, 35 (4): 171-88.
- Parasuraman, A., Zeithaml, V.A. and Berry, L.L. (1985). A conceptual Model of Service Quality and its Implications for Future Research, *Journal of Marketing*, 49 (4): 41-50.

- Qually, C. (2002). Future Role of Auditors, Deloitte & Touche.
- Strawser, J. R. (1994). In Investigation of the Accountant Involvement with Forecasts on the Decision and Perception of Commercial Lenders, *Journal of Accounting, Auditing and Finance*, 9: 553 – 560.
- Tauringana, V. and Clarke, S. (2000). The Demand for External Auditing: Managerial Share Ownership, Size, Gearing and Liquidity Influences. *Managerial Auditing Journal*, 15 (4): 160 – 168.
- Yi, Y. (1990). A Critical Review of Consumer Satisfaction, in Zeithaml, V. (Ed.), *Review of Marketing*, American Marketing Association, Chicago, IL: 68-123.
- Zeithaml, V.A., Parasuraman, A. and Berry, L.L. (1990), *Delivering Quality Service*, Free Press, New York, NY.

Appendix A

Respondents were asked to rate on a scale of 1-7 their agreements with the following statements.

1. Audit increase the reliability of account and thus their value to all users.
2. Audit of financial statements inculcates honesty and integrity in a company's management and the assurance of the quality of accounting information placed on public record.
3. As long as there is a requirement for companies to publish their annual accounts, there is a need for statutory audit to ensure reliability of information placed on public record.
4. Audit aids companies in the raising of finance and capital.
5. The removal of mandatory audit, coupled with absence of minimum capital requirements, would leave creditors with practically no protection.
6. Audited accounts are useful in dealings with banks and other lenders, leasing companies, suppliers of goods and services, the tax authorities and other government agencies.
7. Audit process provides the benefits of regular professional input in compliance with accounting standards.
8. Audit improves controls within the company.
9. The possibility of company personnel committing fraud will be greatly increased if companies are exempted from statutory audit.
10. Audit reduces the risk of material errors and misstatements in annual accounts and provides uniformity and comparability in financial reporting.
11. Statutory audit acts as an assurance for stakeholders that the company has complied with its reporting and disclosure obligations.
12. A special purpose audit is costly, as the auditor will need to consider the purpose audit.
13. Small and medium sized companies do not or are not able to hire qualified accountants to handle the accounting and finance functions.
14. The audit firm is equipped with the latest information technology.
15. The physical facilities are visually appealing.
16. The auditors are well dressed and appear neat to show professionalism.
17. The audit firm delivers services within a certain time frame as promised.
18. The audit firm is dependable in providing its/ their services.
19. The audit firm has employees who are technically competent to perform the service.
20. The audit firm provides prompt services.
21. The audit firm provides timely services.
22. The audit firm has proper documentation of the audit work performed.
23. Reports prepared by audit firm are easily understood by my organization.
24. The audit firm does inform my organization exactly when services will be performed.
25. The service rendered by the audit firm commensurate with the fees charged.
26. Our auditor is the best auditor in the business.
27. Our auditor consistently delivers superior service compared to other auditors.
28. I say positive things about our auditor to others.
29. I will tell other people about our positive experience with our auditor.
30. I would use the auditor again.
31. For the next year's audit, our auditor is my preferred choice.
32. I intend to buy other services from my auditor in the future.
33. My company will consider using the auditor for related services.
34. For additional services, our auditor would be my first choice.

