EXTERNAL AUDITING AND CORPORATE GOVERNANCE PERSPECTIVES IN A SMALL STATE: THE CASE OF MALTA

by

Peter J Baldacchino

A Doctoral Thesis

Submitted in partial fulfilment of the requirements

for the award of

Doctor of Philosophy

of Loughborough University

20th December, 2017

ABSTRACT

This thesis stems from academic research following my MPhil in 1992. It presents a portfolio of fourteen selected papers offering insights on major issues affecting the accountancy-related areas of external auditing (EA) and corporate governance (CG) in the small state of Malta.

The commentary (Chapter 1) presents a background to the development of the portfolio and overviews the theoretical framework and methodology. It then introduces each paper, underlining common sub-themes. The contributions of the papers to knowledge are then indicated by (i) overviewing the development of each sub-theme contributing to the academic discourses in EA and CG, and (ii) laying out the relevance to the wider debates relating to small state literature. The commentary concludes by looking at the follow-up research agenda and the beckoning future. Chapters 2 to 15 then reproduce fourteen papers – an introductory paper and thirteen others in two parts. The introductory paper includes most major small state sub-themes recurring in different ways in the subsequent papers: issues relating to close relationships and independence, discipline, resistance to change, regulation, secrecy, small business units and other small state issues. The following first part includes seven papers on Maltese external auditing in owner-managed companies, auditor changes, auditor perceptions, qualified opinions, first-time auditor selection, fee development and dysfunctional audit behaviour. The second part then comprises six papers on Maltese CG including the CG statement, internal audit benchmarking, conflicts of interest in co-operatives, the board/management relationship, a CG index, and small shareholder participation in the AGM.

The portfolio contributes to literature notably by its original highlighting of the significance of the above-mentioned sub-themes on various aspects of EA and CG in a small state. Furthermore, the portfolio impacts Maltese EA and CG practices, particularly by emphasising the need to go beyond the adoption of imported regulatory frameworks.

DEDICATIONS

To my wife, Elsie I cannot thank you enough for the love, encouragement and continuous support throughout my academic career; this work would never have been carried out without you.

To my children Mariana and James, their respective partners Henry and Martha, and to my grandchildren Gabriel and Michela, I am proud of you and wish you all a bright future.

ACKNOWLEDGEMENTS

I would like to thank my co-authors in the portfolio papers, namely, Professor Frank Bezzina, Justine Agius, Joseph R. Azzopardi, Justin Baldacchino, Lara Balzan Justin Borg, Jeanelle Bugeja, Amy Camilleri, Christopher Cardona, Isabel Cutajar, Jonathan Desira, Konrad Farrugia, Dr Simon Grma, Josianne Magri, Norbert Tabone and Professor Darko Tipurić. It was a pleasure working with you.

Special thanks go to Dr Andrew H Higson and Dr Suzana Grubnic for their invaluable advice in the supervision of this work. You also helped to ensure that my return to the University of Loughborough would be a pleasant and rewarding experience – as it has been indeed.

I thank the present Rector of the University of Malta Professor Alfred Vella, the preceding Rector Professor Juanito Camilleri and Pro-Rector Professor Godfrey Baldacchino for their support, as well as all academic colleagues and staff at the Department of Accountancy, University of Malta for the sharing of the ups and downs of academic life, and in particular Paula Cutajar and Romina Mallia for their office help.

Finally, I thank Steve and Barbara Burgess for their hospitality whenever I visited Loughborough. It was wonderful sharing some days with you again after 25 years.

TABLE OF CONTENTS

CHAPTER 13 The Corporate Governance Relationship between the Board and Management in Maltese Listed Companies [CG-4] 370/401

CHAPTER 15 The Participation of the Small Shareholder in the Annual General Meeting [CG-6] 435/464

LIST OF TABLES

Chapter 1

Page

Chapter 2

Chapter 4

Chapter 5

Chapter 6

Chapter 7

Chapter 8

Chapter 9

Chapter 11

Chapter 12

Chapter 13

Chapter 14

LIST OF FIGURES

CHAPTER 1

Commentary

1. Introduction

I submit fourteen papers to be considered for a Ph.D by the graduate publication route. The main contributions of this portfolio is that it gives new insights on major issues affecting the accountancy-related areas of external auditing (EA) and corporate governance (CG) within a small state context.

Fourteen papers are presented – an introductory paper and thirteen others in two subsequent parts (see Table 1). It may be noted that the early papers are mostly descriptive as they set the scene for the innovative area of research of EA and CG within a small state context while the later papers contain the stronger analytical contributions.

The *introductory* paper (see Commentary Section 5.1) covers most of the major small state sub-themes which recur in the later papers dealing with Maltese EA and CG topics.

The *first* part (see Commentary Section 5.2) includes seven papers comprising studies on Maltese *EA* in owner-managed companies, auditor change decisions, auditor perceptions, qualified audit opinions, first-time auditor selection, audit fee development as well as on organisational culture, audit personnel characteristics and dysfunctional audit behaviour.

The *second* part (see Commentary Section 5.3) then includes six papers comprising studies on Maltese *CG* including the implications of introducing the CG statement, internal audit benchmarking, conflicts of interest in co-operatives, the board/management relationship in listed companies, a CG index, and the participation of the small shareholder in the Annual General Meeting (AGM).

This commentary is structured as follows. The next Section starts with a summary of my career history that gives the background to development of the papers within this portfolio. This is followed by Section 3, which lays out the theoretical framework. Next, Section 4 overviews the major research methodology and limitations of the papers. Section 5 then follows, introducing each of the papers in the portfolio, their small state sub-theme interlinks as well as my own contribution to the papers. The contribution to knowledge of the portfolio of papers is then overviewed in Section 6 while the following Section 7 describes the follow-up research studies. Finally, Section 8 gives the concluding remarks.

2. Career history and its link with the portfolio papers

After completing the first parts of the ACCA examinations, I started work as an accounting officer in a manufacturing business (1973/1975), after which I joined the Central Bank of Malta as an internal auditor (1975/1978), spent a spell as a project financial manager in a national airline group (1978/1980), this being followed by a position of financial accountant (1980/82) and Head of Administration (1982/83) at a leading Maltese telecom company. I furthered my studies in 1982, qualifying both as both as a UK (ACCA) and Maltese (Certified Public Accountant or CPA) accountant.

In 1983, I joined the University of Malta (UM) as a lecturer on its new professional accountancy degree. In 1989, the UM sponsored me for a part-time MPhil degree at the University of Loughborough, tying up a senior lectureship to its completion, which I effected in 1992. Given the commitments of my young family and employer reluctance to extend sponsorship, I did not consider upgrading this work to a Ph.D, a decision I later came to regret. Nonetheless, the MPhil experience led in 1992 to my first refereed article (Baldacchino,1992b [INTRO-1]), raising a number of small state issues recurring in the later articles and selected for this portfolio.

In 1993, I also became involved in part-time consultancy and directorships, providing services relating to co-operative governance and financing and public sector auditing (1993/1996), a Central Bank of Malta directorship (1996-1998) which also required acting as Bank Governor when necessary, and chairing Board sub-committees related to the restructuring of the financial reporting and internal auditing systems and to the introduction of the first audit committee. In 1999, I was elected to the Board of a small employee foundation, followed in 2002/2006 by a directorship of Maltacom plc, a major listed group with a number of small subsidiaries, and as Chairman of its Audit Committee. This varied experience mix led to the co-publication, mostly with different colleagues or postgraduate students, of refereed papers on the predicament in the small state of Malta of the statutory audit of owner-managed companies (Tabone and Baldacchino, 2003 [AUD-1]), of factors contributing to auditor change decisions (Magri and Baldacchino, 2004 [AUD-2], of jurors' and self-perceptions of the statutory auditors (Desira and Baldacchino, 2005 [AUD-3], and of qualified audit opinions (Farrugia and Baldacchino, 2005 [AUD-4]) A further study on benchmarking in Maltese internal audit units (Balzan and Baldacchino, 2007 [CG-2]) originated at this stage from the issues in benchmarking faced at the Maltacom internal audit unit. Furthermore, the insights gained on audit committees led to a paper discussing the implications on the CG of Maltese listed companies of a recent European regulation introducing the CG statement (Baldacchino, 2007 [CG-1]).

In 2006, I became Rector's Adviser in Financial Affairs at the University of Malta being primarily involved in the financial directorship of the University's companies. Since 2008, I have also been academic Head of the Department of Accountancy, which role involved me, *inter alia*, in the upgrade of the professional course to a Masters. As Head, I also represent the University in the Maltese accountancy regulatory body (currently I am also its Chairman), this being the national body regulating CPA warrants, overseeing auditor activity and quality assurance, proposing new accountancy legislation, and maintaining the necessary dialogue both locally with the Maltese profession and in Brussels with the other EU regulators in the Committee of European Auditing Oversight Bodies (CEAOB). These further experiences prompted more research studies including an examination of the factors influencing first-time external audit selection in Malta (Baldacchino and Cardona, 2011 [AUD-5], and an analysis of the conflicts of interest in Maltese co-operatives (Baldacchino and Bugeja, 2012 [CG-3]). When published, this paper on conflicts of interest had particular local impact on regulation regarding the monitoring of the funding of Maltese co-operatives. The Government took steps in line with the Co-operative Societies Act 2001 to monitor closely all the finances of the Maltese co-operative institution, the Central Cooperative Fund by the appointment of a Monitoring Board thereon. This Board, of which I was a member, continued to function until new regulations – the Central Co-operative Regulations (2016) – came into force. The publication of this and related papers on co-operatives also contributed to the Award of Pioneer in Maltese Co-operatives at the Co-operatives Europe General Assembly held in Malta in April, 2017. Further papers followed on the analysis and development of audit fees (Baldacchino and Borg, 2014 [AUD-6]), the CG relationship between the Board and Management in listed companies (Bezzina *et al*, 2014 [CG-4]), the applicability of a CG index in such companies (Baldacchino *et al*, 2015 [CG-5]), the participation of the small shareholder in the AGM (Baldacchino *et al.* 2016a [CG-6]) and organisational culture, personnel characteristics and dysfunctional audit behaviour **(**Baldacchino *et al.*, 2016d [AUD-7]**)**.

Refereed papers in this portfolio are those published by 31 December 2016, and exclude others which, although also focusing on Malta, are either unrelated to private sector auditing or CG e.g. Baldacchino *et al.* (2016c), Zammit and Baldacchino (2012) and Baldacchino and Camilleri (2014), or are deemed even less relevant than other published papers, e.g. Azzopardi and Baldacchino (2009), Baldacchino *et al.* (2014a), Baldacchino *et al.* (2014b), Baldacchino *et al.* (2016b) . Various publications in professional journals are also omitted.

Table 1 lists the portfolio papers, including each title and year of publication, author/s, journal/book where published, volume and page numbers as well as other remarks where relevant.

3. Auditing, corporate governance and small state networking: the theoretical framework

This Section presents the theoretical framework for the portfolio of papers. It starts by showing the link between EA and CG. The Section then defines the small state and its major characteristics, this being followed by delving into the applicability of the social networking model in such a state. Reference is then made to the significance of such small state networking to the application of EA and CG in Malta as indicated by the recurrence of a number of sub-themes in the papers.

3.1 External auditing, corporate governance and their commonalities

In a definition adapted from the Committee on Basic Auditing Concepts (1973:8), Porter *et al.* (2014) define EA as "a systematic process of objectively gathering and evaluating evidence relating to assertions about economic actions and events in which the individual or organisation making the assertions has been engaged to ascertain the degree of correspondence between those assertions and established criteria, and communicating the results to users of the reports in which the assertions are made" (p.3). EA (external or statutory auditing) is carried out for parties external to the auditee and is regulated by company law. The external auditor's roles include protecting the interest of the shareholders by providing reasonable assurance on the company reports being issued, promoting accountability, conducting continuous risk assessments, and maintaining strong relationships with regulators (Harlow, 2016). Furthermore, s/he communicates with various organs in the client company, including the Board, the audit committee and

TABLE 1: THE PORTFOLIO OF PAPERS

INTRODUCTORY PAPER

INTRO-1: **Baldacchino, P.J. (1992b).** Problems of the Accountancy Profession in a Microstate: A Maltese Viewpoint***,*** *Bank of Valletta Review,6* (Autumn)): 29-34**.**

PART 1: EXTERNAL AUDITING PAPERS

AUD-1: **Tabone, N and Baldacchino P.J. (2003*).*** The Statutory Audit of Owner-Managed Companies in Malta*. Managerial Auditing Journal,* 18(5): 387-398.
AUD-2: **Magri, J. and Baldacchino P.J. (2004).** Factors Contributing to Auditor Change Decisions in Malta*. Managerial Auditing Journal,* 19(7): 956-968.
AUD-3: **Desira, J. and Baldacchino, P.J. (2005*).*** Jurors' and Self-Perceptions of the Statutory Auditors in Malta*. Managerial Auditing Journal,* 20(7): 691-706.
AUD-4: **Farrugia K. and Baldacchino, P.J. (2005).** Qualified Audit Opinions in Malta*. Managerial Auditing Journal,* 20(8): 823-844***.***
AUD-5: **Baldacchino, P.J. and Cardona, C. (2011).** Factors Influencing First-time External Audit Selection in Malta*. The IUP Journal of Accounting Research and Audit Practices,* X(2): 45-69.
AUD-6: **Baldacchino, P.J. and Borg, J. (2014).** An Analysis of the Development of Audit Fees in Malta. *The IUP Journal of Accounting Research and Audit Practices,* April X111 (2): 27-52.
AUD-7**: Baldacchino, P.J., Tabone, N., Agius, J. and Bezzina, F. (2016d).** Impact of Organisational Culture and Audit Personnel Characteristics on Dysfunctional Audit Behaviour*. The IUP Journal of Accounting Research and Audit Practices,* XV (3):34 -63. (*Earlier version at the European Accounting Association Conference, Glasgow 28-30 April, 2015).*

PART 2: CORPORATE GOVERNANCE PAPERS

CG-1**: Baldacchino, P.J. (2007).** An EU-Inspired Corporate Governance Statement for Maltese Listed Companies: Boon or Scourge? In: *Civil Society Report Business Ethics and Religious Values in the European Union and Malta – for a Moral Playing Field*. Xuereb, P.G. (ed). European Documentation and Research Centre, University of Malta, Malta: 161-167.
CG-2**: Balzan, L. and Baldacchino, P.J. (2007).** Benchmarking in Maltese Internal Audit Units*. Benchmarking - An International Journal,* 14(6): 750-767*.*
CG-3: **Baldacchino, P.J. and Bugeja, J. (2012).** Conflicts of Interest in Maltese Co-operatives and their Financial Implications. *Bank of Valletta Review,* 46 (Autumn): 1-16. *(Particular Impact in Malta. See Commentary Section 2*)
CG-4: **Bezzina, F., Baldacchino, P.J. and Azzopardi, J.R. (2014**). The Corporate Governance Relationship between the Board and Management in Maltese Listed Companies. In *Rethinking Corporate Governance.* Tipurić, D., Raguž, V. and Podrug, N. (eds). Pearson, UK: 1-15.
CG-5: **Baldacchino, P.J., Baldacchino, J., Bezzina, F. and Tipurić, D. (2015).** Assessing the Applicability of a Corporate Governance Index in Maltese Listed Entities. *International Journal of Transitions and Innovation Systems,* 4 (1/2): 43-60.
CG-6: **Baldacchino, P.J., Camilleri, A., Cutajar, I., Grima, S. and Bezzina, F. (2016a).** The Participation of the Small Shareholder in the Annual General Meeting. *European Journal of Economics and Management,* 3(2):7-28.

the internal auditors (Karagiorgos *et al.*, 2010). EA in Malta is regulated by the Companies Act 1995 (originally mostly imported from the UK), backed by the Accountancy Profession Act, 1979 which, as also is the case with other EU states, follows European Union directives.

The established definition of CG in the Cadbury Report is "the system by which organisations are directed and controlled" (Cadbury,1992, Section 2.5). CG is also described by the Australian Institute of Company Directors, 2016 as "a broad-ranging term which, amongst other things, encompasses the rules, relationships, policies, systems and processes whereby authority within organisations is exercised and maintained" (p.1). The practice of good CG keeps the organization's management accountable to the stakeholders and this retains management ethically diligent and effective (Pandya, 2013). The CG of Maltese listed companies is basically guided by a similar regulatory framework to that of EA, involving the same Companies Act 1995 yet backed up by the Listing Rules (Listing Authority, 2017) and the Code, that is the comply-or-explain Code of Good Corporate Governance for Listed Entities (MFSA, 2017) .

CG and EA are clearly highly interrelated. Notably, the principal-agent, or finance, model of CG, which is the dominant academic one, recognizes that "monitoring and bonding expenditures paid out to align the behaviour of the manager-agents with the interests of owner-principals...provide innovations in corporate governance" (Keasey *et al*., 1997, p.3). One such expenditure is EA, a "basic institution" in this model, working together with other institutions such as a board accountable to shareholders. CG and EA are therefore so strongly interlinked because they are both part of the same accountability process in the interest of the corporate entity: CG is meant to hold the board of directors and its management accountable, in the first instance, to the shareholders. Complementarily, EA is meant to render credibility to such accountability by having the auditor examine the annual financial statements provided by the directors and management and also report thereon to the shareholders. However, such auditing work is effected independently of the directors and management, who remain primarily responsible for showing a true and fair view in the financial statements.

3.2 The small state and its characteristics

The World Bank (2016) defines small states as "countries with a population below 1.5 million" (p.1), noting that more than one-fourth its members fall within this definition. On its part, the Commonwealth Secretariat (2017a) defines 31 of its 53 member states as small also using a similar population benchmark of "around 1.5 million people or less" (p.1), but including five large states that share similar characteristics. Although diverse in size, state of economic development and location, such countries are characterized by major challenges which may be summarised as follows:

– limited human and institutional capacity (Commonwealth Secretariat, 2014).

– an investment scenario which lacks readily available information (Secretariat, 2017b) and which often needs to improve in order to ensure the appropriate regulations, a level playing field, and adequate infrastructure (World Bank, 2016).

– economic limitations such as vulnerability to external economic shocks including fluctuations in world trade (Commonwealth Secretariat, 2014) as well as high transport costs owing to remoteness and insularity, and..dependence on strategic imports (such as fuel) and a narrow range of exports (Commonwealth Secretariat, 2017b).

DeBattista (2016) also refers to this small state predicament within the European Union, claiming that small states such as Cyprus, Estonia, Latvia, Luxembourg, Lithuania, Slovenia and Malta face some "challenges that other EU members may not share, including administrative and logistical limitations, possible diseconomies of scale and geo-strategic concerns" (p.40). Notably, despite the limitations, the World Bank (2017) classifies both Malta and Estonia, together with three other small oil-rich states in the far East, as having advantages lacking in other small states. These include high incomes, making the most of their specific combinations of fossil fuels, strategic location on the crossroads of trade, a highly educated workforce, strong legal systems, and well-developed financial sectors.

Most small state literature is dedicated to the implications of the challenges identified above in the fields of national governance (e.g. Baldacchino, 2009), education (e.g. Mayo (2013) or economics (e.g. Briguglio, 2016). Yet, beyond the papers in this portfolio, no known published studies to date have linked such small state challenges to EA and CG. This submission is aimed at filling the gap in this connection. Taking the case of Malta, it presents the small state sub-themes of published articles in these related areas. Malta is the smallest member of the European Union, an ex-British colony consisting of three islands in the middle of the Mediterranean Sea with a population of around 400,000 and occupying a small area of 316 sq kilometres.

3.3 Social networking within a small state

A working definition of social networking (amended from Merriam-Webster, 2017) is the activity of creating and maintaining personal and business connections. The expression has become increasingly popular with the advent of the social media, although this is not being used in this context here. In the literature (e.g. Kadushin, 2012 and Scott, 2012), the social networking model is typically represented by a sociogram, or a set of "nodes" or points (the individuals) and a mapping or description by lines of the relations between them (see Figure 1). The application of this model is relevant within the context of a geographically small state like Malta. In particular, within such a state, propinquity (or proximity) is naturally present with residents being located so near to each other. Furthermore, in such a country, homophily thrives strongly in both its forms as distinguished by Lazarsfeld and Merton (1954), that is status-homophily and value-homophily:

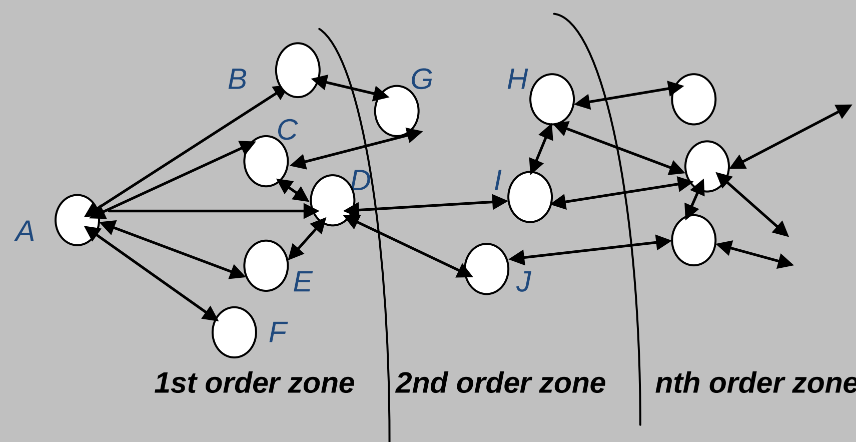
indeed, most residents also have common attributes of an ascribed status (such as Maltese nationality, white race) and/or an acquired one (such as Catholic religion) as well as of value or homogeneity such as norms and attitudes. The prevalence of both propinquity and homophily, as Kadushin (2012, pp.18/19) also points out, renders the "nodes" or persons, much more likely to be connected to one another.

In his alternative view of networking, Boissevain (1974) argues against adopting such a structural-functional model laying out a "system of enduring groups composed of statuses and roles supported by a set of values and related sanctions" (p.4). He maintains that rather than the network being a matter of one's status and/or values, individuals build up such a network of relations, allies, and "friends of friends", to their own advantage – a network which each individual constructs and tries to manipulate but also through which each is manipulated. Alliances with allies may be shifting, informal and temporary and are meant for the individual goals to be achieved.

Nonetheless, even taking into account both perspectives, it is much more likely in such a small state for the "nodes" to be closely connected and for the network to be evidently shorter because of the perennial presence of propinquity. In other words, with reference to the sociogram in Figure 1 below (amended from Boissevain, 1974), A may be able to connect with anyone needed in the state (B-F) as these are all confined within the first-order zone, i.e. in possible direct contact. Furthermore, if not all so reached, there may be only a few Individuals (G to J) in the second-order zone, i.e. reachable in two steps as friends of friends, and there are rarely, if ever, any individuals in any zone beyond.

Clearly, within such a state, it may be more commonly possible to establish close relationships with almost anybody, whether or not homophily and/or manifest manipulations are also at work. As stated by Burgoon *et al.* (2002), "physical proximity promotes psychological closeness", this "creating a sense of mutuality, of connection, common ground and shared understandings" (p.662). Furthermore, proximity may raise other issues such as resistance to change and role conflicts. This may be because of group structural cohesion (White and Harary, 2001 and

Figure 1 Network Relationships in a Simple Sociogram



Key to terms:

A/J *Nodes representing Individuals*

1st Order Zone*= Set of Nodes directly linked to Node (or Individual) A, i.e. friends*

2nd...nth Order Zones *= Sets of Nodes only indirectly linked to Node (or Individual) A ,i.e. friends of friends*

(Amended from Boissevain,1974, p.26)

Moody and White, 2003), wherein social network participants, particularly in small groups, may tend to resist any disruption to their *status quo*, even informally demanding the loyalty of each other over that given to the formal organisation. Therefore, for progress to be achieved, those in charge of CG need to look for and find ways to create and support healthier networks (Cross *et al.,* 2002).

3.4 External auditing and corporate governance within a small state network

Such small state networking as referred to above has a notable bearing on EA and

CG in Malta, and this becomes unequivocal with the recurrence of a number of sub-themes in the papers in the portfolio.

3.4.1 Sub-theme interlinks in the papers .

Despite several years since the publication of Baldacchino (1992b), the first paper in the portfolio, a number of sub-themes, which were mostly identified for the first time in that paper (see Commentary Section 5.1), recurred in the subsequent 13 studies published since 2003, this indicating a high degree of homogeneity. Such sub-theme interlinks include issues relating to close relationships and independence, discipline, resistance to change, regulation, secrecy, small business units, as well as other small state issues. These will be explored in detail throughout Commentary Section 5, which, as already stated, will introduce each of the papers in the portfolio.

3.4.2 The relevance of small state networking .

The relevance of social networking to the application of EA and CG within a small state like Malta does indeed become evident in the above stated sub-themes. For example, as amplified in the articles themselves, it is difficult for an auditor to be independent with clients who are easily traceable as friends or friends of friends. For similar reasons, given also the smallness of the institutions and commercial entities, appropriate EA and CG regulation cannot be imposed so easily as in larger countries, and undisclosed but informal alliances commonly tend to oppose change and even render much more difficult the maintenance of professional secrecy. Furthermore, non-compliance with the Code without adequate explanation will not necessarily lead to any form of discipline.

Further to the stated references to the small state sub-themes in introducing the papers in Commentary Section 5, the contribution to knowledge of the papers in the portfolio will then be overviewed in Commentary Section 6.

4. Research methodology and limitations

In studying the application of EA and CG within a small state network, the 14 papers employ pragmatism as their paradigm foundation. As stated by Robson (2011) a feature of this approach is that it "rejects the traditional dualisms and generally prefers more moderate and commonsense versions of philosophical dualisms based on how well they work in solving problems" (p.28). Thus the choices between one position and the others delved into by ontology (such as objectivism v subjectivism), and epistemology (such as positivism vs interpretivism) are considered "somewhat unrealistic in practice" (Saunders *et al.* 2007,p.110). On this basis, a deductive approach followed by an inductive one was most commonly adopted in the papers, with the mixing of quantitative and qualitative elements through the collection and an analysis of both self-administered questionnaires or documentation and one-to-one face-to-face interviewing or even personal experiences. Such a mixed methods approach enabled triangulation by the corroboration of both types of findings. As also stated by Creswell and Clark (2011**),** such a design offsets the strengths and weaknesses of both its quantitative and qualitative strands. Additionally, the time horizon was commonly cross-sectional, with a combined fixed-emergent continuum.

Yet, as might be expected in a pragmatic approach with varying objectives and research questions, while six papers adhered to the above multi-strategy design, other papers varied in their specific design. Two (INTR0-1 and CG-1) were exploratory discussion ones and excluded empirical testing. Another two (AUD-3, AUD-5) employed only quantitative data collected by questionnaires, while, given the small size of the population, two further papers (CG-2,CG-3) collected only qualitative data, employing face-to-face semi-structured interviewing. Additionally, two reversed (CG-5 and CG-6) the data collection order, starting with the interviewing and then moving on to a questionnaire and/or document analysis.

The results of the various studies are subject to the limitations encountered in their scope and conduct. Among such limitations listed in the individual papers, a number tended to have limited response rates, and therefore despite employing quantitative data analysis, the results may not be totally representative of the population. Furthermore, in considering the applicability of the findings and implications of the various studies based in Malta to other small states, one needs to take into account the various limitations emanating from the particular economic, political and legal contexts of each state.

5. The Ph.D portfolio of papers, sub-theme inter-links and own contribution

This Section introduces each of the fourteen papers in the portfolio with a focus on the interlinks of each paper with small state sub-themes. As stated in the introduction, most such sub-themes are clearly specified in the first introductory paper (see next sub-section 5.1). Against this background, Sub-sections 5.2 and 5.3 then analyse the sub-theme interlinks of papers in the respective areas. In each section, papers are introduced in chronological order.

5.1 The introductory paper

My first paper (Baldacchino, 1992b [INTRO-1] , which is reproduced in Chapter 2, raised a number of accountancy "microstate" issues, which to my knowledge were unexplored at the time, and of which I had become first aware during my MPhil research on the auditor/management relationship in Malta (Baldacchino, 1992a). The MPhil thesis itself had not focused on such issues, but mostly on the communication barriers in such a relationship, a topic itself later being the subject of a working paper (Baldacchino and Higson, 1993).

Such issues or sub-themes related to the small state of Malta, and included those regarding close relationships and independence **(CRI)**, disciplinary weaknesses **(DI),** the small business units **(SU)**, as well as secrecy/confidentiality issues **(SI)** for auditors in an environment where many had to "go to great pains to keep information secret or at least unclear" (Ch 2, Section 6). In addition, there were other small state ones **(O)** such as the few users. The significance of this early paper – a first version of which had been presented to the International Conference on Small States held in Malta in 1991– was that it was the first known publication to point out most of the sub-themes related to small state EA and CG, which sub-themes kept clearly recurring in my later publications. Such recurrence, as well as the emergence of two others – resistance to change **(RC)** and regulatory issues **(RI)** – in the portfolio of articles is overviewed in Table 2, which also includes my estimated percentage contribution to each paper. The latter involved most stages of the research, but reaching its peak in the discussions emanating from the findings, conclusions, recommendations as well as the write-up itself.

5.2 Part 1: The external auditing papers

Tabone and Baldacchino (2003) [AUD-1] is reproduced in Chapter 3 on the statutory audit of owner-managed companies in Malta. This paper took up elements of the smallness of units **(SU)** sub-theme in detail, while implications were also raised with respect to other sub-themes - disclosure issues, resistance to change and regulatory issues. Despite EA being a bulwark of CG, its relevance in owner-managed and predominantly small companies had already long been questioned in the literature (e.g. English, 1978). This 2003 mixed methodology article, based on questionnaire and interview responses from both Maltese auditors and owner-managers, examined such relevance in Malta and that of any possible alternatives to this requirement. It indicated that, beyond the claimed relevance, as in larger countries, of such audit to outside third parties, or for the sake of financial statement reliability or even owing to the ever-increasing business complexity, there was the perception, particularly by statutory auditors

TABLE 2:
THE PORTFOLIO OF PAPERS AND THEIR SUB-THEME INTERLINKS

SUB-THEME

PAPER TOPIC	CRI	DI	RC	RI	SI	SU	O	REF	*BALDACCHINO CONTRIBUTION TO PAPER*
INTRODUCTORY									
Microstate Issues in Accountancy	x	x			x	x	x	INTRO-1 (1992b)	*100%*
PART1: EXTERNAL AUDITING	CRI	DI	RC	RI	SI	SU	O		
Audit in Owner-Mged Companies			x	x		x		AUD-1 (2003)	50%
Auditor Change Decisions	x				x	x		AUD-2 (2004)	*50%*
Auditor Perceptions					x			AUD-3 (2005)	*50%*
Qualified Audit Opinions	x	x				x		AUD-4 (2005)	*50%*
First-time Auditor Selection	x							AUD-5 (2011)	*50%*
Audit Fee Development	x						x	AUD-6 (2014)	*50%*
Dysfunctional Audit Behaviour		x				x		AUD-7 (2016d)	*25%*
PART 2: CORP GOV	CRI	DI	RC	RI	SI	SU	O		
Corp Governance Statement				x				CG-1 (2007)	*100%*
Internal Audit Benchmarking			x		x		x	CG-2 (2007)	*50%*
Conflicts of Int In Co-operatives	x			x			x	CG-3 (2012)	*50%*
Board & Mangmt Relationship	x	x		x	x			CG- 4 (2014)	*33%*
Corp Governance Index	x		x	x	x		x	CG-5 (2015)	*40%*
Small Shareholder In AGM	x		x					CG- 6 (2016a)	*25%*

CRI = close relationships and independence issues, DI = disciplinary issues, RC= resistance to change issues RI = regulatory issues, SI = secrecy issues, SU = small business unit issues , O = Other small state issues

– but also by owner-managers themselves – of the audit's positive relevance to "impose financial discipline" on owner-management and staff (Ch 3, Section 4.1,Table 1 and Section 6) **(SU)** . This supported an earlier finding by Baldacchino (1992a, p.106).

Furthermore, the article indicated that Maltese auditors were "sceptical" [Ch 3, Section 6] about any other such alternatives being appropriate, although owner-managers themselves were more open to changes in this regard. Yet, the effectiveness of the imposition of this type of audit of "discipline on management and staff" could be questioned - and can still be today - if the profession itself continued to lack discipline**,** as more clearly indicated in a later paper in the portfolio by Farrugia and Baldacchino (2005) [AUD-4]. Resistance to change **(RC)** was also being implied, this beckoning towards the survival of this type of audit, despite the fact that Maltese accounting regulation and practices traditionally followed those of the United Kingdom, where this had been abolished (**RI**). It is no therefore surprise that this type of audit in fact still survives to date, such resistance as yet needing to be dealt with.

In their EA paper on factors contributing to auditor change decisions reproduced in Chapter 4 , Magri and Baldacchino (2004) [AUD-2] claimed that EA bears "magnified responsibilities towards the Maltese community" as, owing to its smallness, Malta is "heavily characterized by close interveaving personal relationships" [Ch 4, Section 1] (**CRI**), which lead to business transactions often being carried out among people who already know each other and therefore, to confidentiality being "even more difficult to maintain than in larger countries". This is also in line with the "secrecy dilemma" **(SI)** of the introductory paper. The paper [Ch 4, Section 1] adds that the independent attitude **(CRI)** finds "tougher barriers in such close-knit communities" where a predominant characteristic remains the "strength of the behavioural relations between parties". The paper solidifies such arguments by its analysis of factors contributing to client-initiated auditor changes in Malta. A mail questionnaire was responded to by 97 companies, such response being supplemented by semi-structured interviews with 15 representatives of companies changing their auditors. In contrast to foreign findings, results indicated **(CRI**) that the factors that would induce most auditor changes are behavioural, rather than economic, foremost among which were the working relationship with the auditor deteriorating substantially and the auditor rarely being accessible.

As for the working relationship **(CRI),** "most likely, it is the fostering of a sound relationship with top company management which makes the major difference" (Ch 4 , Section 5). As for auditor accessibility, auditors "are expected to be responsive to queries without delay and to be available to provide their advice on the operations of the company which may concern matters apart from those relating to the statutory audit." (Ch 4, Section 5). Furthermore, auditor-client relationships **(CRI)** were at a more personal level in the case of small companies, while more at a firm/corporate level with large companies; thus, in the latter case, a personal change in the audit engagement partner did not effectively jeopardize the relationship. It also emerged that small companies **(SU)** were probably more willing to replace an auditor with a reputable image with one having a decent fee level, this implying that in the case of small companies the audit fee level may override quality considerations.

The purpose of the paper by Desira and Baldacchino (2005) [AUD-3], reproduced in Chapter 5, was to determine any divergencies in juror/external auditor perceptions and whether any particular issues relating to such divergencies emerged from Malta. For the purpose of the study, jurors were taken to be those members of the public with the potential to be called to serve as jury. Divergencies mainly related to the auditor's perceived responsibilities for various issues. These included jurors attributing responsibility to auditors for fraud prevention and detection, maintenance of company accounting records, the security of company control structure, and absolute assurance of no misstatements in financial statements. While auditors were aware of the lack of transparency **(SI)** of their own procedures, the public seemed under the erroneous impression that they communicated enough about the work they performed. Remarkably, such prevailing secrecy seemed beneficial to the auditors themselves, as, in contrast to elsewhere in the literature, they were held in a very positive light in Malta by jurors. Notably such a secretive attitude could ultimately boomerang given, as Pany (1992) was quoted, "jurors' importance in determining the outcome of any litigation against auditors" (Ch 5, Section 2.4). Interestingly, however, litigation in Maltese Courts, at the time practically inexistent, is as yet to date at a relatively low level: the full price of secrecy, if ever to be paid, has been slow to come within this smallness context.

Farrugia and Baldacchino, (2005) [AUD-4] on qualified audit opinions used a mixed methodology, carrying out both an analysis of auditor's reports and semi-structured interviews with auditors. A major point made by them was the high occurrence of the limitation-on-scope qualifications (65.5% of qualifications), a type also often recurring for more than three years. In itself, this was not surprising given "the smaller-sized company scenario" (Ch 6, Section 4.9) **(SU)** in a small state. However, most such qualifications were issued by sole practitioners and were deficient by existing standards because they were not specific, this indicating that a number were outdated on standards **(DI).** Further professional deficiencies related to going concern and disagreement-with-management qualifications, the relative infrequency of the latter type by smaller audit firms and sole practitioners raising questions about their independence (Ch 6, Section 4.9) **(CRI)**, although this was consistent with UK findings (Abulizz *et al.*, 1990). The prevailing higher qualification rate among smaller, private exempt companies (Ch 6, Section 4.1,Table 1) also extended the debate previously referred to in the introductory paper as to "whether such (small) companies should be exempted from the full scope audit" (Ch 6, Section 5) **(SU).** This paper also confirmed the continued existence of the weak professional disciplinary machinery raised in the introductory paper **(DI).** It is also to be noted that a recent paper by Baldacchino *et al.* (2014b) also confirmed that most of these findings persist.

The paper by Baldacchino and Cardona (2011) [AUD-5], reproduced in Chapter 7, followed up the AUD-2 study with one on factors influencing first-time external audit selection. It involved an analysis of various factors – behavioural, economic and others. Findings were based on a mailed questionnaire responded to by 33 auditors and 68 company representatives.

While the two types of respondents tended to place highly positively correlated rankings on both behavioural and economic factors in such selection, overall **(CRI)** both tended to give behavioural factors more priority than economic and other ones. Foremost among such behavioural factors was that of having auditors available when needed (accessibility) and of establishing a long-term relationship with the auditor, this pointing to similarities to factors pointed out earlier in Paper AUD-2. Notably, the economic factors of quality of service and of the work proposed by the auditor meeting the client's expectations were also ranked highly by both groups as influencing auditor selection. Yet, interestingly, the audit fee was ranked and also considered less important for selection by companies than by auditors.

It was further noted that where client companies were located on the even smaller sister island of Gozo, they considered as significantly more important (than where client companies were located in Malta) the following three factors for external auditor selection (i) that the auditor does not perform the audit of the client competitor(s); (ii) the proximity of the auditor's office(s) to the client's office (iii) that the auditor provides tax services. Therefore, one implication is that the extra smallness **(CRI)** of the sister island was probably rendering clients less amenable to accepting the engagement of a common local auditor, as this could easily have independence conflict of interest implications. Besides company location, the relative importance of factors influencing first-time auditor selection were also found to vary significantly with other client characteristics such as the type of audit firm selected by respondent's company, whether or not respondent company intended to list on the stock exchange or formed part of a group of companies.

The paper by Baldacchino and Borg (2014) [AUD-6], reproduced in Chapter 8, analysed the factors influencing audit fees in Malta, building up on a preceding study by Baldacchino *et al.* (2014a). It assessed how audit fees reacted to movements in their determinants in the years 2004/2011, the trends exhibited in the period and the relevance, if any, of the general financial crisis and other events on the Maltese audit market. It employed a mixed methods approach, employing changes analysis on fee data from a sample of 110 active Maltese companies over the 8-year period 2004-2011, this being supplemented by 10 interviews with audit partners from Big Four and other audit firms. Within this imperfect audit market, audit fees increased significantly over the period. However, they did not seem to respond instantaneously to the forces of demand and supply. Furthermore, auditors seemed unable to institute price changes for audit engagements in response to variations in determinants such as auditee characteristics including client size (Ch 8, Section 4.1.2). Such delayed or non-responses could lead to diminished EA efforts, this possibly compromising audit quality (Ch 8, Section 4.1.2). This became even more apparent by the effects on the audit fees of the crisis, wherein while raising their fee levels, auditors appeared not to have been willing do so in line with the required extra input, probably taking into account the economic pinch felt by their clients: this might have led to auditors being tempted to cut corners by curtailing the required extra audit effort in times of crisis, and there might therefore also have been independence **(CRI)** implications in the auditors helping to "salvage" any sinking ship by such sharing of "economic pain" (Ch 8, Section 4.3.1).

Additionally, the paper confirmed two fee-related Maltese-specific factors which had first been identified in the preceding Baldacchino *et al.*(2014a) study. With respect to companies with foreign ownership, these were confirmed as having higher audit fees than those of their local counterparts. In contrast, companies with government involvement had lower fees than those privately owned. Furthermore, in the case of the foreign-owned companies fees were found to be changing more than those of their Maltese-owned private counterparts, which, on their part, were changing more than those with government involvement. While private companies had a relatively higher fee level, this was even more so in the case of foreign-owned ones **(CRI).** The paper attributes this to client companies which are not government-controlled attaching "a value to the relationship and sense of mutual trust" (Ch 8, Section 4.1.3) with their auditors, and not being ready to change their auditors for less expensive ones, an attitude which is clearly not so forthcoming in the case of government-controlled companies. Given the smallness of the country **(CRI),** auditors and private clients were being extra careful prior to effecting (for auditors) or rejecting (for clients) audit fee changes, even where this could scarcely be justified from an economic perspective. However, the paper also indicated the different reality in the case of companies with government involvement **(O),** where it was mostly a cheap fee that could buy the desired prestige of a large, public sector audit.

Baldacchino *et al.* (2016d) [AUD-7], reproduced in Chapter 9, examined the extent to which organizational culture and personnel characteristics in Maltese audit firms impact on dysfunctional audit behaviour (*DAB)*, particularly on under-reporting of time *(URT*) and audit quality reduction *(AQR)* acts such as premature sign-off (PMSO). The work employed a mixed methodology, with a survey on 252 audit personnel followed by semi-structured interviews with eight audit partners representing the Big Four and other smaller audit firms. One issue of discipline (**D1**) was that the majority of audit personnel (74.5%) acknowledged that URT is unethical, yet 83.2% of such respondents were still somewhat engaged in it. While such high level of engagement is comparable to findings elsewhere (e.g. 88% in Malaysia as per Nor, 2011) it was indicative of personnel "going against their own ethical beliefs" (Ch 9, Section 6.2). One predictor of such URT, and indeed also PMSO, was found to be the perceived reinforcement of superiors, such as by ostensibly forsaking disciplinary measures for the sake of attaining their budgets. A second predictor was that of superiors themselves engaging in DAB: in this connection, only 41.3% (Ch 9, Section 6.3) of respondents stated that their superiors had never engaged in PMSO, an incidence also comparable to other studies elsewhere (e.g. 40% in Ireland as per Otley and Pierce, 1996). As for personnel characteristics, individual audit experience predicted lower DAB, while having an external locus of control predicted a higher DAB. While audit firm type was found to be only a suppressor variable helping to explain better the variability in DAB acceptance, the indications were that having to audit all small companies **(SU),** such as owner-managed ones, in Malta, increased the proneness, particularly by audit personnel in smaller audit firms, to "take shortcuts and justify resorting to AQR acts" (Ch 9, Section 6.6). There was even a claim by a non-Big Four audit firm that such audit clients "were too small and did not really need to be audited" and that, after all, the audit was "something we know nobody wants" (Ch 9, Section 5.1). Furthermore, such companies were associated with "low audit fees" and "routine and uninteresting engagements"(Ch 9,Section 6.6) and their smaller audit firms probably had lower internal support mechanisms.

Part 1 has overviewed seven papers related to EA. Part 2 will now overview the remaining six papers on CG.

5.3 Part 2: The corporate governance papers

In the first paper in this part, Baldacchino (2007**)** [CG-1], which is reproduced in Chapter 10, took the case of new EU regulation regarding the Corporate Governance Statement *(CGS)* and queried such and similar regulation in the European Union, and therefore including Malta, in its attempt at registering progress in CG. The paper questioned this increasing type of regulation **(RI)** which continued to prioritize information disclosure, rather than the appropriateness of those in charge of the CG process. Such priorities possibly needed reshuffling, with more consideration being given to, say, the minimum qualifications required of directors, what was to render them fit and proper in non-financial companies, whether they were to be required to take proper induction courses for new directorships upon engagement, or the wisdom of the director tenure being an annual one. In itself, the proposed CGS, requiring new disclosures yet without specified benchmarks, was not a scourge, but not a boon either. The paper concluded that such and similar regulation could have had little impact and was mostly futile. What was definitely more useful was to insist in the first place that companies engage directors of an appropriate calibre. For more relevance, particularly within the Maltese context, **(RI)** a different type of European CG regulation was sorely needed: one where the emphasis would be on the *quality* rather than the *quantity* of regulation.

Balzan and Baldacchino (2007) [CG-2], reproduced in Chapter 11, dealt with benchmarking in Maltese internal auditing, a bastion of sound CG. Semi-structured interviewing revealed a weakness in benchmarking awareness among internal audit executives and also cultural barriers in the implementation of this process. Such barriers included a lack of awareness of the ethical dimension, a lack of benchmarking partners and network and an incompatible organizational culture. As for the ethical dimension, the quest for secrecy **(SI)** played a particular role: audit executives "are concerned that benchmarking will reveal confidential information to competitors" (Ch 11, Section 5.3). They still needed to agree to a Code of Conduct ensuring no breach of confidentiality. As for benchmarking partners and network, the smallness **(O)** of the country again became relevant - one could seldom find Maltese same-industry or even same-scale networking partners, although similar scale and industry might not be so essential (Iacobucci and Nordheim, 2000). On the other hand, benchmarking with international partners could also present problems of comparability owing to, say, differences in the environment in which they operated including the state of market competition. As for the incompatibility of the organizational culture, there was commonly a general complacency, particularly government-owned organizations, resisting the need to accept change **(RC)** before seeking to improve. Furthermore, top management support was as yet rarely forthcoming in this respect.

Baldacchino and Bugeja (2012) [CG-3], reproduced in Chapter 12, dealt with behavioural issues, specifically conflicts of interest (COIs), in the *CG* of another type of corporate entity – the co-operative. A COI "arises when the personal or professional interests of one who is authorised to take decisions have the potential to be at odds with corporate and societal values" (Ch 12, Section 3, amended from Brown, 2008). The analysis was based on semi-structured interviewing with nine representatives of the three co-operative institutions and 22 co-operative representatives at management or committee of management level. Most respondents stressed the need for a general Code of Ethics for co-operatives. This could include requirements for the prior full disclosure of potential COI*s* and principles for decisive action on such disclosures (**RI**). More COI awareness was called for at both the institutional and individual levels. As for the institutional level, restructuring could start with the clarification and distinction of the roles of each of the regulatory, financing and operational institutions, as well as with the introduction of more relevant appointment or election systems. Furthermore, the prevalence of hat-changing – having too many same persons as members in two of the institutions – was an inevitable source of conflicts of interest. Country smallness placed a strain on the number of experts available (**O**), but the independence of each institution had to be safeguarded. Furthermore, institutional restructuring could include the introduction of internal auditing. At the individual co-operative level, the existing skill gaps at the director or committee of management level needed to be closed, such as by the removal of the restrictive legal requirement of co-operative membership for election to such committee (**RI**). One could work towards the congruence of members and the interests of the company. One way towards helping to achieve this is to carry out a re-assessment of the statutory ineligibility of members to have prior-year surpluses distributed, a restriction as yet commonly inhibiting the possibility of retaining surpluses as a future source of finance. Finally, COIs may not necessarily involve direct pecuniary gain yet still ultimately have even wider implications such as undermining faith in those in governance and their reputation. Therefore, doing away with them is doing away with "a clear symptom of inadequate corporate governance" (Ch 12, Section 10) (**CRI**). As already stated in Section 2 of this Commentary, this paper had particular impact in Malta.

Two crucial parties in CG are the Board of Directors and Management. The book chapter by Bezzina *et al.* (2014**)** [CG-4], reproduced in Chapter 13, evaluated the general level of adherence of both parties to the Code, assessed the role of the CEO and Management vis-a-vis that of the Board and investigated the locus of corporate control and its impact on CG. Data was mostly collected from the Annual Reports of 20 companies with equity listed on the Malta Stock Exchange (MSE) as at December 31, 2010, with the authors also drawing upon their personal experiences in top management and/or director roles within a number of such companies.

A number of weaknesses were found in the CG of Maltese listed companies. These included common cases of non-compliance to the Code **(RI)**, including a lack of performance evaluation of the Board, insufficient attention to shareholder communication (e.g. few having a shareholder relations officer) and corporate social responsibility, and long tenures of directors, the latter raising doubts on their claimed independence (**CRI**). The common non-disclosure of the aggregate emoluments of senior executives as required by the Code also pointed to an undue tendency towards secrecy, this being corroborated by the fact that, despite the Code being on a "comply or explain" basis, non-compliance was rarely supported by valid or sufficient explanations (**SI**). Furthermore, the indications were that there was "no particular regulatory or auditing supervision" on issues of non-compliance - regulatory discipline seeming as yet deficient (**DI**).

As for the role of the CEO and management vis-a-vis that of the Board of Directors, most CEOs were significant shareholders in their company or did "previously work for a major shareholder" (Ch 13, Section 4.2) this indicating possible management influence and close relationships at Board level which could also effectively forestall the separation of ownership and control (**CRI**). In the smaller listed companies "the combination of a small board, no Executive Committee and a dominant CEO is bound to raise serious CG issues". Such CEO's were "at the same time Executive Directors, significant shareholders as well as technical experts which the business did not afford to do without, this rendering them with unfettered powers of discretion in the company" (Ch 13, Section 4.2). On the other hand, in the larger listed companies, where an Executive Committee commonly existed, few Board meetings were held during the year and the danger was that the Board would be "reduced to mere formality." (Chapter 13, Section 4.2). As I stated in a related conference presentation, one could here also tend to question who the real boss is (Baldacchino, 2013).

As for the locus of control and its impact on CG, most companies were found to have a high concentration of ownership, with one major shareholder having either a 51% shareholding or one between 30% and 50%. Related to this, around one-third of directors were being appointed directly by such shareholders rather than elected at the AGMs. Therefore, such powerful shareholders "dominated most boards and management teams" (Ch 13, Section 4.3), such direct links rendering CG even more difficult, particularly in ensuring the effective protection and exercise of the rights of the remaining dispersed small shareholders on any material decisions. Furthermore, this was also being possibly exacerbated by the manipulation in their interest of voting proxies at the Annual General Meetings (AGMs). Such close inter-party links, clearly much more easily possible in a small country, were probably being instrumental in degrading the level of CG (**CRI**).

As its objectives, Baldacchino *et al* (2015) [CG-5], which is reproduced in Chapter 14, included assessing the needs and attitudes in Maltese Listed Entities (MLEs) towards the Corporate Governance Index (CGI), determining the entity that may be responsible for the provision and assessment of such CGI, ascertaining the construction of a CGI index for MLE's as well as testing such constructed CGI on two MLEs, assessing its impact, benefits and limitations. The methodology consisted of semi-structured interviews with seven financial analysts and 13 MLE's, followed by an analysis of their Annual Reports for the three-year period 2011–2013 and a CGI survey sent to such MLEs, this leading to the testing of the CGI model constructed for this purpose on two MLE's.

Findings indicated that although they "agreed" in principle to the introduction of the CGI, most MLE representatives did not see going for more disclosures as a priority, even in this way (**SI**). In fact, they "foresaw no added benefit" in such reporting (Ch 14, Section 4.1), and indicated that they might be "adhering to the Code simply because they are forced to do so" (Ch 14, Section 4.1) by the listing rules. They presented various reasons for their resistance **(RC**) in practice to the CGI, this including that no standard CGI could be suitable to all companies and that the MSE as an institution was too small **(O**) for the construction of an adequate CGI standard for companies in varying industries. They also pointed out the need for simpler financial statements and competition issues. On the other hand, financial analysts found a proper CGI as an "indication of better accountability and transparency", helping to address the "several CG defaults of MLEs, including the "lack of transparency" or secrecy (**SI**) of Board members, a "lack of communication on board meeting outcomes" and "conflicts of interest" (Ch 14, Section 4.1).

As for the CGI provider and assessor, respondents opted for the local MSE regulator, the Malta Financial Services Authority (MFSA), emphasizing that, subject to CGI provision and assessment being segregated in such authority, the MFSA would probably be stronger, have fewer possibilities of conflicts of interest (**CRI**) and probably more CG expertise within the Maltese context in comparison to foreign credit-rating agencies.

Respondents also preferred a CGI based on an international model like the OECD Code rather than the local Code so as to minimize the number of unaddressed issues (**RI**). However, they considered index modifications would still be necessary, these possibly being "costly and confusing" to the Maltese market. The CG areas and attributes were selected by respondents. The four governance areas selected and weighted were board structure, transparency and disclosure, audit committee and process, and shareholder rights. Two other areas – director remuneration and ownership structure – were excluded as being least important, possibly owing to the greater difficulty in benchmarking remuneration policies and to the lack of shareholder activism in a small state (**O**). Furthermore, the original attributes were rated and only the top 65% of them were retained. The indications were that CGI criteria and methodology depended on the market size (**O**), the market need for this information and the scope of the CGI itself.

Most respondents were also after a compulsory CGI so as to overcome any initial resistance towards MLE adoption (**RI**). This was because "given their small-island state culture, businesses have a strong tendency to resist change at initiation stage" (Ch 14, Section 4.7.2) – in fact stronger at such stage than at later stages, or what was called a "cold-hot phenomenon" (**RC**) in Baldacchino (2011). In testing the constructed CGI, it became clear that the sub-indices in each governance area were relevant for the appropriate interpretation of the overall index.

Among its recommendations, the paper still opted for the adoption of the MFSA Code as a basis for the CGI in order to ensure the overcoming of such initial resistance and for the CGI to become easily acceptable (**RC)**.

The Annual General Meeting (AGM*)* is an essential part of a company's CG system as it "provides the opportunity to shareholders to exercise their ownership rights, including that of directing any questions to the Board" (Association of British Insurers, 2013, p.13)**.**

Baldacchino *et al.* (2016a) [CG-6], reproduced in Chapter 15, examined the actual level of small shareholder *(SS)* participation in the AGM, assessing how this reflects upon the *CG* of listed entities. It focused on *SS* attendance, voting and proposals (excluding those of institutional and majority shareholders), improving SS participation and the significance of such AGM proceedings to listed company CG. Empirical mixed methodology research was carried out in a Maltese listed company (MLC) setting by means of semi-structured interviews with seventeen MLC secretaries, five stockbrokers, an online questionnaire responded by fifty-four small shareholders in different MLC's, as well as the analysis of company notices and documentation relating to the AGM. Results indicated that SS participation was weak. Attendance was poor, and was often spurred both by legitimate factors such as information on current financial performance and by questionable ones such as refreshments served and venue. Shareholders seemed uncomfortable in asking management formal questions and even in voting by show of hands, and therefore opted for informal interaction with management and for voting by poll, the latter often rendering attendance fruitless and even unnecessary by permitting proxies. Much of this shareholder attitude was probably aggravated by the greater possibility of close relationships (**CRI**) existing in a small country, where, "shareholders and directors are more likely to know each other" (Ch 15, Section 5.1.2). As for proposals, these could induce management's later action despite seldom, if ever, being approved, but their submission was rare and mostly considered frivolous, commonly hampered by a lack of financial knowledge. For the sake of better direction and control, and, in particular, for more transparency and accountability, the AGM had to be less stage-managed, as well as more interactive and engaging towards such shareholder. This called for more management commitment towards change (**RC**), particularly towards more investor education and guidance and also for MLCs to exploit more technology such as by increased AGM webcasting and the introduction of electronic voting.

6. Contribution to knowledge of the published papers

This Section now brings together the major theoretical insights provided by each of the seven recurring sub-themes referred to earlier in Table 2 involving issues relating to close relationships and independence, discipline, resistance to change, regulation, secrecy, small business units and other small state issues. It overviews the development of each sub-theme over time, thus contributing to the academic discourse in EA and CG. The Section then goes into how the papers contribute in terms of the wider debates relating to small state literature.

6.1 Development of the sub-themes over time

6.1.1 Close relationships and independence

With respect to *close relationships and independence, insofar as they relate to EA*, Paper INTRO-1 first referred to professional COIs arising in Malta which were not specifically covered by the then current Code of Ethics (Malta Institute of Accountants, 1992). Such COIs could result from auditors and their clients coming from the same, small community and having a higher chance of their being connected or friends. Paper AUD-2 later pointed out that in the EA literature (e.g. Beattie and Fearnley,1995; Bedingfield and Loeb,1974; Woo and Koh, 2001) – economic factors, in particular the audit fee – are most commonly cited as a main reason for changing auditors. In contrast, the paper found that, in the Maltese environment of kinship and proximity, behavioural factors such as the auditor/client working relationship and auditor accessibility commonly override economic ones. This was having possible independence implications, particularly in auditing smaller companies, where the "personal" factor of clients with their auditors was most relevant. The dominance of similar behavioural factors was also echoed in Paper AUD-5 on first-time auditor selection in Malta, although, in that context, literature in larger countries on whether economic or behavioural factors really dominate (e.g. Addams and Davis,1994; Glass Lewis & Co, 2006) is inconsistent. Paper AUD-5 also pointed out one specific issue of extra smallness: in the case of the smaller sister island of Gozo, it was even more important for clients to avoid the possible COIs in EA arising when engaging one of the few audit firms having an office there as these might also be involved with competing clients. Additionally, in consistence with UK findings by Abulizz *et al.* (1990), Paper AUD-4 found that Big Four firms were more likely than smaller ones or sole practitioners to issue disagreement-with-management audit report qualifications, this implying that smaller firms and sole practitioners were facing particular independence issues in this type of qualification. Finally, Paper AUD-6 confirmed the possible adverse independence implications – also pointed out earlier in the USA by Magee and Tseng (1990) – of auditors agreeing to audit fee restrictions: auditors could be doing so in order to share the economic pain of the client during a recession. Yet, in Malta, similar fee restrictions appeared to be more in companies with Government involvement than in other Maltese-owned companies, and particularly more than in foreign-owned companies.

As for *close relationships and independence as they relate to CG,* Paper CG-3 noted a lack of awareness about the deeper meaning of what constitutes a COI in the CG of Maltese co-operatives and their institutions. Analysing such COIs, the paper found that – as also argued elsewhere by Olear (2008) and Brown (2008) – these presented risks which, unless dealt with, could go beyond financial penalties and remedies to undermining faith in those in CG and their reputation. Additionally, Paper CG-4 referred to the assessment of managerialism elsewhere by Herman (1981) and Hofstetter (2005), who argued that the effective control and corporate power of large companies lies with managers. The paper found that most Maltese CEOs had significant shareholdings in their listed companies or previous links with major shareholders. This indicated close personal inter-links between the CEOs, shareholders and directors. Such powerful inter-links could therefore be effectively forestalling the separation of ownership and control and thus degrading the level of CG. In addition, the long tenures of directors in a number of Maltese listed companies were also raising doubts on their claimed independence. Paper

CG-5 also claimed, in line with IOSCO, 2004, that one would best do away with CGIs being provided and assessed by commercial rating agencies to avoid COIs and build up CG expertise. Instead, the Paper therefore proposed the government company regulator as the appropriate institution to act as CGI provider and assessor in Malta, provided that the two roles would be appropriately segregated. Finally, Paper CG-6 found that a specific close relationship issue in the small state of Malta was that shareholders felt uncomfortable in exercising their voting and related rights because they were more likely to know the directors personally. In comparison, whether or not shareholder voting at European AGMs in larger European states serves the purpose assigned to it by corporate law has been a moot issue in the literature (Lafarre, 2014).

6.1.2 Disciplinary issues

As for the effectiveness of *discipline, with respect to EA*, a barrier indicated by INTRO-1 was that the main financial users were refraining, on client confidentiality grounds, from complaining to the profession's regulator, this corroborating an earlier similar local claim by Casapinta, 1987. Further disciplinary defaults were exemplified in Paper AUD-4 by the high amount of faulty audit reports being issued by smaller audit firms in comparison to larger ones - a practice tallying with the comments by Audit Report (2002a) on the UK situation. Additionally, Paper AUD-7 pointed to several audit firm personnel commonly engaging in URT, in doing so often going against their own ethical beliefs: an antithesis of discipline, also found in the literature elsewhere (Nor, 2011; Svanberg and Ohman, 2013) .

As for the effectiveness of *discipline, with respect to CG,* Paper CG-4 indicated that, in contrast to what was expected in the EU following the Green Paper (COM, 2011), there was scarce, if any, supervision and follow-up to non-compliance to the Code and explanations for such non-compliance by listed companies. Clearly, it was not just a matter of a lack of clarity of rules but also that of implementing them within the small state context.

6.1.3 Resistance to change

As for *attitudes towards change, with respect to EA*, the indications are that, given the small state culture, auditors imply, if not openly display, a stronger tendency to resist the initiation of change. In this context, Paper AUD-1 found auditor scepticism towards the proposed alternatives to the statutory small audit - an attitude still probably contributing to the survival of a type of audit long questioned elsewhere in the literature (e.g. English, 1978; Jones, 1985) and even abolished in several European states including the UK.

Similarly, as for *attitudes to change with respect to CG*, Paper CG-2 found complacency working against the introduction of benchmarking in Maltese internal audit units, particularly in government-owned entities – this resulting in companies doing away with a tool found elsewhere to have accelerated and managed change (Cook,1995). Furthermore, Paper CG-5 found that, in contrast to larger state literature extolling the introduction of a CGI (e.g. Grimminger and Di Benedetta, 2013; Sarkar *et al.,* 2012), listed entities foresaw no added benefit in introducing it: even their adherence to the Code was declared a matter of simply being forced to do so by the Listing Rules. For such resistance to be overcome – particularly at initiation – the CGI had to be based on a Code which was to be locally adapted. Additionally, in line with Baldacchino (2011), which had claimed that, within their small-island culture, Maltese businesses, have a stronger tendency to resist change at initiation stage and less later, the Paper further found that, for the successful introduction of a CGI, this was best rendered compulsory. Furthermore, Paper CG-6 implied that in the AGM of listed companies there were other bouts of resistance owing to insufficient management and Board of Director commitment towards small shareholder interaction and engagement, despite improvements in this regard elsewhere (e.g. Ertimur *et al*., 2010).

6.1.4 Regulatory issues

As for the state of *EA regulation*, AUD-1 pointed out that, while the traditional regulatory framework in Malta was the UK one, then current changes were influenced more by EU regulatory requirements. Therefore, the fact that the abolition of the statutory small audit is only a state option and not a requirement in the EU may help further explain why - as already stated, in contrast to the long questioning in the literature and the situation in several other European countries - this type of audit did survive to date. This situation persists despite, as shown in Paper AUD-1, client owner-managers having been more open to revisiting this requirement than their auditors.

As for CG regulation, long outstanding regulatory framework measures are similarly called for. Paper CG-1 argued that, despite investor need for quality in CG standards (McKinsey, 2004), EU regulatory requirements did not seem to focus sufficiently on the more relevant matters in a small state such as the appropriateness of those in charge of the CG process. The paper also questioned the sufficiency of the comply-or-explain basis of compliance with the Code, suggesting that it may be better to require by law both Code compliance and reporting thereon as in EA. Similarly, Paper CG-3 found that, while Campbell and Houghton (2005) emphasised that ethical behaviour goes beyond legal and professional rules, the CG of Maltese co-operatives could be clearly improved by a more appropriate regulatory framework which would be less restrictive but would include a general code of ethics. Additionally, as already referred above as a resistance-to-change issue, Paper CG-5 preferred the adoption of compulsory regulation in introducing CGI to counteract initial resistance. Furthermore, while literature (e.g. Standard and Poor's, 2004 versus Khancel, 2007) differed as to whether or not it was better for a CGI to be based on the respective national code or an international one, if one were to base a CGI on an international code, the Paper indicated, as stated earlier, that such a code would clearly first need to be adapted, such adaptations taking into account the Maltese market expectations. On its part, Paper CG-4 pointed out common cases of non-compliance to the Code, this confirming, again in line with Baldacchino (2011), the particular need in this small state environment for important regulation to become compulsory.

6.1.5 Secrecy issues

As for the *tendency towards secrecy, with respect to EA*, INTRO-1 pointed out the increased emphasis on secrecy in this small state, with both auditors and their clients going to great pains to overcome the difficulty of keeping information secret or at least unclear in an environment where business transactions are often carried out by persons who already know each other. Furthermore, Paper AUD-2 indicated that, unlike literature findings related to larger countries referred to earlier, in such a context, the predominance of the personal working relationships in auditor-change decisions over economic considerations was implying that such increased emphasis on secrecy was even more important. Additionally, Paper AUD-3 found that Maltese auditors were aware of their lack of transparency but found it possibly beneficial, helping them to continue being perceived favourably by jurors. Yet, as stated by Pany (1992), in view of the importance of jurors in litigation cases against US auditors, this may ultimately change with an increase in such cases. Interestingly, these are still relatively few to date.

As for the *tendency towards secrecy, with respect to CG*, Paper CG-2 found company concerns in such a small environment towards confidentiality breaches by competitors: this was hampering the introduction of internal audit benchmarking, putting into question both the awareness and relevance of ethical codes used elsewhere in Europe such as the European Benchmarking Code of Conduct (EFQM, 2001). Additionally, Paper CG-4 found that, despite MLEs being expected to "comply-or-explain" adherence to the Code, listed companies were rarely justifying non-compliance with valid or sufficient explanations, this further indicating their tendency against transparency and raising further serious doubts as to whether a Code not enforced by law could be effective in Malta. Furthermore, Paper CG-5 found that, on their part, and, contrary to the views of outside parties such as financial analysts, most listed entities gave no priority to having more disclosures and commonly seemed to accept these only if and when compelled to do so. This extended to listed entities the original Paper INTRO-1 argument about auditors that their position "is not exactly that of a champion of the public interest" (Chapter 2, Section 6). Within this small state, there seems as yet to be little, if any, price being paid by either party for retaining secrecy.

6.1.6 Small business units

As for *small business units*, this sub-theme was limited to the EA part of the papers. Paper INTRO-1 pointed out, in line with Francalanza (1988), that such units with their particular internal control problems were predominant within such a small country. In line with previous literature in Malta and the UK (Baldacchino, 1992a; Keasey and Watson, 1993), Paper AUD-1 found that the audits of small owner-managed companies were perceived by auditors and their clients as having a positive influence on management and staff, besides also having relevance to outside third parties. Additionally, Paper AUD-2 found that, besides various other factors identified elsewhere in the literature as contributing to auditor-change decisions (Beattie and Fearnley, 1995; Woo and Koh, 2001), a further characteristic in the case of small companies was that in client retention the audit fee level may override quality considerations such as auditor reputation. Furthermore, Paper AUD-4 contrasted the higher qualification rate in the smaller-sized company scenario in Malta with the rates in other studies elsewhere (Soltani, 2000; Ball *et al.,* 1979; Chan and Walter, 1996) which focused only on public and listed companies. In addition, Paper AUD-7 found that audit staff seemed even more prone to take shortcuts and justify resorting in AQR acts in such audits, such findings confirming an earlier study by Willett and Page, 1996 in the UK.

6.1.7 Other small state issues

As for *other issues, insofar as these relate to EA*, in 1992 Paper INTR0-1 argued that in Malta, unlike in larger countries, user pressures to improve audit quality was probably wanting, with the then current studies (Galea St John, 1990 and Magri, 1991) indicating that audit reporting was adding little or no credibility particularly to small company financial statements in the eyes of their main users, the banks and the Inland Revenue Department. However, audit-derived credibility seemed to have somewhat improved over the years, because, as already stated (Section 6.1.6), Paper AUD-1 in 2003 found that the small statutory audit was being perceived as relevant to outside third parties. In addition, Paper AUD-6 confirmed the audit fee deficiencies, noted earlier by Baldacchino *et al.* (2014a), in large companies with government involvement, where the desired prestige of a sizeable public sector audit was often best being bought out by a cheap fee.

As for *other issues, insofar as these relate to CG*, these involved other issues emanating from the smallness of the state of Malta. Paper CG-2 pointed out that despite the evident need emphasised in the literature (Camp,1989; McNamee,1995) for relevant benchmarking partners, these were are rarely, if at all, available in Malta, this rendering difficult the attainment of meaningful inter-company comparisons. Furthermore, Paper CG-3 referred to limitations in the number of experts available and the resulting lack of independence of the institutions, with the common prevalence of hat-changing, a practice also raised earlier in Baldacchino (2011) and a common source of COIs. Finally, Paper CG-5 referred to the size limitations of the MSE, which were inhibiting possible progress such as the application of an adequate CGI standard.

6.2 Paper relevance to the wider small state literature

Evidently, the major small state characteristics listed in Sub-section 3.2 - in particular the limited human and institutional capacity, the lack of readily available information, and the need to ensure the appropriate regulations - do contribute to the specific issues overviewed in the preceding Sub-section, among which: the independence and size limitations of EA/CG institutions and the defaults in their disciplinary follow-ups; the increased corporate pressures towards non-disclosure; a regulatory framework with long outstanding measures and in need of adaptation of its imported elements and the additional difficulties of business units which, although small and disputably auditable, are still statutorily audited.

Additionally, the preceding Sub-section has shown how - as referred to earlier in small state networking (Sub-sections 3.3 and 3.4) - this specific environment impinges further on the exercise of EA and CG, with particular significance of, *inter alia*, behavioural issues such as working relationships with clients; the heavy resistance towards initiating change; the increased professional COIs threatening professional independence and related issues such as the possibly adverse effects of engaging in large companies with government involvement.

Interestingly, most of the above small state sub-theme insights are probably also relevant to related business disciplines such as banking and investment services, insurance, and business management. Sub-theme relevance may also probably be extended to economics, national governance, and education, these being the major existing fields in small state literature, as stated already in Section 3.2. Insofar as these insights are relevant, professional education in each of the fields will probably have to cater for the resulting implications, such as for the need to ensure that, beyond the traditional core competence skills, students are highly drilled in communication competencies and related soft skills. In this connection, it is hoped that this portfolio prompts separate studies by researchers in these fields.

7. Follow-up research

As already stated, the papers included in the portfolio are a selection of my papers published by December, 2016. In 2017, in addition to some co-authored papers related to Maltese accountancy but not directly related to the papers in the portfolio (Baldacchino *et al.*, 2017a; Baldacchino *et al*, 2017e; Baldacchino *et al*., 2017f), the following research studies have been published or are in progress:

- A paper (Baldacchino *et al.*, 2017c) following up Papers AUD-2 and AUD-5, This further analyzes the two major behavioural factors in client-initiated auditor changes referred to in the two portfolio papers.

- Two papers following up Paper CG-3 on co-operatives. These are:

  - A paper (Baldacchino *et al*. 2017b) assessing incentive and monitoring schemes in the CG of Maltese co-operatives. This is a revised version of a paper which I presented at the 5th OFEL Annual Conference, Dubrovnik in April, 2017.
  - A paper (Baldacchino *et al.* 2017d) which analyses the alternatives in updating the Maltese co-operative regulatory framework. This paper is expected to have particular impact in addition to that of Paper CG3 on the Maltese co-operative movement.

- Furthermore, current papers in progress involve:

  - an examination of the role of the Nomination Committee within Maltese listed companies.
  - the accountancy-related regulatory framework of Maltese voluntary organisations.

- Additionally, following up on Papers CG-4, 5 and 6, two further research studies, are planned to be initiated in 2018:

  - the influence of family relationships in the CG of Maltese public interest
  - cases of non-compliance to the Maltese CG Code.

8. Concluding remarks

Since the early nineteen eighties, Malta has invested heavily in the accountancy profession, particularly by the provision of publicly sponsored professional accountancy and related business courses at its national University. These efforts have been targeted at rendering the upcoming generations of accountants and auditors and those in charge of CG a core part of the "highly educated workforce" described by the World Bank (2017) as already referred to in Commentary Section 3.2.

On my own part, as past member and current Chairman of the Maltese Accountancy Board, I have been contributing to the development of the profession by my continued influence on the oversight and regulation of Maltese accountants and auditors, ensuring appropriate investigative and disciplinary measures in addition to the regular inspections of auditing practices. My varied non-executive director experiences were also useful in this respect.

Furthermore, and as already referred to briefly in Commentary Section 2, in my capacity as Head of the Department of Accountancy, University of Malta, I have been chiefly responsible in the past decade for the continuous reform of the education of University-related professional accountants. This involved, *inter alia*, upgrading the professional course to postgraduate level, introducing additional study units (e.g. risk management, financial services law) beyond the traditional core ones, as well as launching a number of accounting electives. Such reforms have been aimed at ensuring that graduate accountants – who once they pass their University course do not have to sit for more examinations in order to obtain their Maltese CPA warrants – have more versatility and responsiveness to the increasing demands of the flourishing Maltese financial centre. Simultaneously, emphasis has been placed on the publication of refereed research papers by the Department of Accountancy, mostly on my part. Such papers, a selection of which is in this portfolio, have also been found relevant in the teaching of advanced EA and CG in professional and Continuing Professional Education courses run by the Department. Furthermore, many papers, such as those referred to in Commentary Section 7, have already given rise to further research studies while a number have also been well cited. In addition, as already described in Commentary Section 2, other papers (such as Paper CG-3) have to date also had their own particular practical impact in Malta.

Beyond the practical recommendations in the papers themselves, I urge the main players interested in the profession, which besides the Accountancy Board include the audit firms, the Malta Institute of Accountants, and those in charge of CG in the larger companies to continue, together with the Department of Accountancy, University of Malta, to seek the optimal ways of tackling the complexities and drawbacks of EA and CG by business professionals practising within the context of Malta and similar small states. A major step to be recommended in this direction is the setting up of a Research Foundation in small state accountancy, aimed at bringing together representatives of the interested parties to ensure optimal progress by mutual dialogue and the pooling of resources.

Finally, sustained educational investment, stronger legal systems and well-developed financial sectors will all have their significant part to play in Malta's future development. On my part, I look forward to continuing, in the foreseeable future, to advance to the interested parties further practical recommendations to be derived particularly from the ongoing empirical studies referred to in Commentary Section 7 and beyond. In my view, the recipe for professional success remains a balanced mix of theory and practice.

References: Baldacchino P.J., Regulatory and Other

Baldacchino, P.J.

Azzopardi, J. and Baldacchino, P.J. (2009). The concept of materiality and attitudes towards threshold disclosure among Maltese audit practitioners. *Bank of Valletta Review,* Autumn: 40.

Baldacchino, P.J. (1992a). The auditor-management relationship in a microstate perspective, MPhil Thesis, Loughborough University Business School, Loughborough University, Loughborough.

Baldacchino, P.J. (1992b) [INTRO-1]. Problems of the accountancy profession in a microstate: A Maltese viewpoint**.** *Bank of Valletta Review*, 6 (Autumn): 29-34. Earlier version at the International Conference on Islands and Small States, Foundation of International Studies, University of Malta, Malta, 23-25 May,1991.

Baldacchino, P.J. (2007) [CG-1]. An EU-inspired corporate governance statement for Maltese listed companies: Boon or scourge? In: *Civil Society Report Business Ethics and Religious Values in the European Union and Malta - for a Moral Playing Field,* Xuereb, P.G.(ed). European Documentation and Research Centre, University of Malta, Malta: 161-167.

Baldacchino, P.J. (2011). Accountancy in Malta - some insights from recent research*. Presentation at the Accountancy CPE Seminar Session,* University Residence, Lija, Malta, 3 March.

Baldacchino, P.J. (2013). On bossing the boss. Presentation at the 1st International OFEL Conference on Corporate Governance, Dubrovnik, Croatia, April 12.

Baldacchino, P.J. and Borg, J. (2014) [AUD-6]. An analysis of the development of audit fees in Malta. *The IUP Journal of Accounting Research and Audit Practices*, April, XIII (2): 27- 52.

Baldacchino, P.J. and Bugeja, J. (2012) [CG-3]. Conflicts of interest in Maltese cooperatives and their financial implications. *Bank of Valletta Review,* 46 (Autumn): 1-16.

Baldacchino, P.J. and Cardona, C., (2011) [AUD-5]. Factors influencing first-time external audit selection in Malta. *The IUP Journal of Accounting Research and Audit Practices,* x (2): 45-69.

Baldacchino, P.J. and Higson, A.H. (1993). The auditor-management relationship in a microstate (Malta): Communication barriers. Working Paper 22, Loughborough University Business School Research Series, Loughborough, U.K.

Baldacchino, P.J. and Vella, A. (2014). Recent mergers and acquisitions in Malta. *The IUP Journal of Applied Finance,* 20(1): 5-22.

Baldacchino, P.J., Attard, M. and Cassar, F. (2014a). Factors influencing audit fees in Malta. *Bank of Valletta Review*, 48 (Spring): 27-40. Earlier version at the European Accounting Association 36th Annual Congress, Paris 6-8 May, 2013.

Baldacchino, P.J., Baldacchino, J., Bezzina, F. and Tipurić, D. (2015) [CG-5]. Assessing the applicability of a corporate governance index in Maltese listed entities. *International Journal of Transitions and Innovation Systems,* 4 (1/2): 43-60. Earlier version at the 3rd OFEL International Conference on Governance, Management and Entrpreneurship, Dubrovnik, Croatia 17-18 April, 2015.

Baldacchino, P.J., Bezzina, F., Tabone N. and Vassallo, J.P. (2014b). Financial audit report modifications in Malta. *European Journal of Economics and Management,* 1 (1): 91-108: https://bib.irb.hr/datoteka/EJEM_2014_Vol.1_No.1.pdf [3rd January, 2017. Earlier version at the 2nd OFEL International Conference on Governance, Management and Entrpreneurship, Dubrovnik, Croatia 4-5 April, 2014.

Baldacchino, P.J., Camilleri, A., Cutajar, I., Grima, S. and Bezzina, F. (2016a) [CG-6]. The participation of the small shareholder in the annual general meeting. *European Journal of Economics and Management,* 3(2): 7-28: http://www.ejemjournal.com/EJEM2016 Vol.3 No.2.pdf [3 January, 2017]. Earlier version at the 4th OFEL International Conference on Governance, Management and Entrpreneurship, Dubrovnik, Croatia 15-16 April, 2016.

Baldacchino , P.J., Grech , L., Farrugia, K., Tabone, N. (2016b). An analysis of audit report lags in Maltese companies. In: *Contemporary Studies in Economic and Financial Analysis*. Grima S., Bezzina F, Romānova, I., Rupeika Apoga, R. (Eds). Emerald Group Publishing Limited, 98:161-182.

Baldacchino, P.J., Pule, D., Tabone, N., and Agius, N. (2016c). Recent weaknesses by a supreme audit institution: An analysis. In: Contemporary *Issues in Bank Financial Management. Case Studies in Economic and Financial Analysis*. Grima S. and Bezzina, F. (Eds). Emerald Group Publishing Limited : London, U.K.: 97: 133-156.

Baldacchino, P.J., Tabone N., Bezzina, F. and Agius, J. (2016d) [AUD-7]. Investigating the impact of organisational culture and audit personnel characteristics on dysfunctional audit behaviour. *The IUP Journal of Accounting Research and Audit Practices*, Xv (3):34-63. Earlier version at the European Accounting Association Conference, Glasgow 28-30 April, 2015.

Baldacchino, P.J. and Bartolo, C., (2017a]. The role of the Maltese Public Accounts Committee in public finance, *Journal of Accounting, Finance and Auditing Studies,* Oct 3(4):53-91.

Baldacchino, P.J., Camilleri, C., Grima, S. and Bezzina, F. (2017b). Assessing incentive and monitoring schemes in the corporate governance of Maltese cooperatives. *European Research Studies Journal* , 20(3A): 179-197. Earlier version at the 5th OFEL International Conference on Governance, Management and Entrepreneurship, CIRU, Dubrovnik, Croatia, 7-8 April, 2017.

Baldacchino, P.J., Caruana, R. Grima S. and Bezzina, F.H. (2017c). Selected behavioural factors in client-initiated auditor changes: The client-auditor perspectives. *European Research Studies Journal*, 20 (2):14-44. Earlier version at the International Conference on Applied Business and Economics (ICABE), EconomiX, University of Paris Ouest – Nanterre La Défense, Paris, Sep 1-2, 2016.

Baldacchino, P.J., Falzon M., and Grima S. (2017d). The co-operative regulatory framework in a small state: Reviewing the alternatives. *Journal of Accounting, Finance and Auditing Studies,* March 3(2): 16-43 .

Baldacchino, P.J., Farrugia, M.L., and Grima, S. (2017e). The applicability of the social enterprise in a small state: The case of Malta. *European Journal of Economics and Management*: 4(1): 7-34. Earlier version at the 5th OFEL International Conference on Governance, Management and Entrepreneurship, CIRU, Dubrovnik, Croatia 7-8 April.

Baldacchino, P.J., Tabone, N., and Demanuele, R. (2017f). Materiality disclosures in statutory auditing: A Maltese perspective. *Journal of Accounting, Finance and Auditing Studies*: 3(2):116-157.

Balzan, L. and Baldacchino, P.J. (2007) [CG-2]. Benchmarking in Maltese internal audit units. *Benchmarking - An International Journal,* 14(6): 750-767.

Bezzina, F., Baldacchino, P.J. and Azzopardi, J.R. (2014) [CG-4]. The corporate governance relationship between the board and management in Maltese listed companies. In *Rethinking Corporate Governance*. Tipurić, D., Raguž, V. and Podrug, N. (eds). Pearson, UK: 1-15. Earlier version at the 1st OFEL International Conference on Corporate Governance, Dubrovnik, Croatia 12 April, 2013.

Desira, J. and Baldacchino , P.J. (2005) [AUD-3]. Jurors' and self-perceptions of the statutory auditors in Malta. *Managerial Auditing Journal,* 20(7): 691-706.

Farrugia, K.J., and Baldacchino, P.J. (2005) [AUD-4]. Qualified audit opinions in Malta. *Managerial Auditing Journal*, 20(8): 823-844.

Magri, J. and Baldacchino P.J. (2004) [AUD-2]. Factors contributing to auditor change decisions in Malta. *Managerial Auditing Journal,* 19(7): 956-968.

Tabone, N. and Baldacchino, P.J. (2003) [AUD-1]. The statutory audit of owner - managed companies in Malta. *Managerial Auditing Journal,* 18(5): 387-98.

Zammit, S and Baldacchino, P.J. (2012). Two auditors: One public client *International Journal of Government Auditing,* April 39: 2: 14-18.

Regulatory

Accountancy Profession Act - Malta, 1979. Chapter 281 of the laws of Malta.

Cadbury, A. (1992). *The financial aspects of corporate governance: A report of the committee on corporate governance* [Cadbury Report]. London: Gee and Co.

Central Co-operative Fund Regulations - Malta, 2016. L.N 244 under Chapter 422 of the laws of Malta.

Committee on Basic Auditing Concepts (1973). *A Statement of Basic Auditing Concepts.* American Accounting Association: Sarasota Fl.

Companies Act - Malta, 1995. Chapter 386 of the laws of Malta.

Cooperative Societies Act - Malta, 2001. Chapter 442 of the laws of Malta.

European Commission (COM) (2011). Green Paper – The EU corporate governance framework. 5th April, 164 final – Brussels.

European Benchmarking Code of Conduct (EFQM) (2001): www.efqm.org/benchmarking/downloads/The%20European%20Benchmarking%20Code%20of%20Conduct.pdf [2 January,2006].

International Organisation of Securities Commissions (IOSCO) (2004). *Code of Conduct fundamentals for Credit Rating Agencies*, OICV-IOSCO, Madrid,Spain.

Listing Authority, (2017). Full Listing Rules: https://www.mfsa.com.mt/pages/viewcontent.aspx?id=267 [1January,2017].

Malta Financial Services Authority (MFSA) (2017). Code of Principles of Good Corporate Governance for Listed Entities: http://www.mfsa.com.mt/pages/viewcontent.aspx?id=365 [1 January, 2017].

Malta Institute of Accountants (1992*).* Code of Ethics, MIA: Malta.

Other

Abulizz, S.M., Sherer, M.J. and Essex Univ., Colchester (United Kingdom). Dept. of Accounting and Financial Management, 1990*. Qualified Audit Reports: Company Size and Auditor Evidence from the UK.* University of Essex, Department of Accounting and Financial Management.

Addams, H.L. and Davis, B. (1994). Privately held companies report reasons for selecting and switching auditors. *The CPA Journal*, 64(8): 38.

Association of British Insurers (2013). Improving Corporate Governance and Shareholder Engagement: https://www.abi.org.uk/~/media/Files/Documents/Publications [1Nov, 2014].

Audit Report (2002a). Disagreement about accounting treatment. Jan, 109:3-4.

Australian Institute of Company Directors (2016). What is corporate governance?: http://www.companydirectors.com.au/director-resource-centre/governance-and-director-issues/corporate-governance [23 Feb 2017].

Baldacchino, G. (2009). Governance in small places: The unleashing of asymmetric federalism. In *Remote Control: Governance Lessons for and from Small, Insular and Remote Regions*. Baldacchino G., Felt L. and Greenwood R. (eds.), St John’s NL, Newfoundland: Iser Press: 114-134.

Ball, R, Walker, G. and Whittred, G.P. (1979). Audit qualifications and share prices. *Abacus*, 15: 23-34.

Beattie, V.A. and Feamley, S. (1995). The importance of audit firm characteristics and the drivers of auditor change in UK listed companies. *Accounting and Business Research,* 25 (100): 227-39.

Bedingfield, J.P. and Loeb, S.E. (1974). Auditor changes - examination. *Journal of Accountancy*, 137 (3): 66-69.

Boissevain, J. (1974) *Friends of Friends Networks, Manipulators and Coalitions* Basil Blackwell , Oxford.

Briguglio, L. (2016). *Small States and the European Union - Economic Perspective*. Taylor and Francis Ltd, Routledge, London.

Brown, D. (2008). Conflict of Interest. *Governance Matters.* May: http://www.coopscanada.coop/assets/firefly/files/files/GovMatArchives/GM17_May08.pdf [25 August 2010].

Burgoon, J.K., Bonito, J.A., Ramirez, A., Dunbar, N.E., Kam, K. and Fischer, J. (2002). Testing the interactivity principle: Effects of mediation, propinquity, and verbal and nonverbal modalities in interpersonal interaction. *Journal of communication*, 52(3): 657-677.

Camp, R.C. (1989). *Benchmarking: The Search for Best Practices that Lead to Superior Performance*, ASQC Quality Press, Milwaukee, WI.

Campbell, T. and Houghton , K.A. (2005). *Ethics and Auditing*. ANU: E-Press: http/ /epress.anu.edu.au/ethics auditing/frames.php [22 September, 2010].

Casapinta, L. S., (1987). Accountants Propose 'Two Key Steps' in Tax Reform Process. *The Times (Malta),* 2 October: 16.

Chan, Y.K. and Walter, T.S. (1996). Qualified audit reports and costly contracting. *Asia Pacific Journal of Management,* 13(3): 37-63

Commonwealth Secretariat (2014). Small states and the commonwealth: Strengthening resilience for sustainable development: http://thecommonwealth.org/sites/default/files/events/documents/P743_commonwealthmallstates150814_FINAL CE_ammend.pdf [18 April, 2017].

Commonwealth Secretariat (2017a). The commonwealth member countries: http://thecommonwealth.org/member-countries [18 April, 2017].

Commonwealth Secretariat (2017b). Small states/the commonwealth: http:// thecommonwealth.org/small-states [18 Apr. 2017].

Cook, S. (1995). *Practical Benchmarking: A Manager's Guide to Creating a Competitive Advantage.* Kogan Page, London.

Creswell, J.W., Clark, V.L.P. (2011). *Designing and combining mixed methods research.* Sage Publications , California.

Cross, R., Nohria N. and Parker, A. (2002). Six myths about informal networks - and how to overcome them. *MIT Sloan Management Review* (Spring): 67-75.

DeBattista, A. (2015).Themes for an EU presidency*. Times of Malta*, 27 August:40.

English, J. (1978). Abolish the mandatory audit for the family company. *Accountancy,* May: 64-5.

Ertimur, Y., Ferri, F. and Stubben, S.R. (2010). Board of directors' responsiveness to shareholders: Evidence from shareholder proposals. *Journal of Corporate Finance*, 16(1): 53-72.

Francalanza, C.A, (1988). Setting accounting standards for Malta*. International Journal of Accounting* : 168-178.

Galea St. John, A. (1990). The small audit report - local usage and perception. B. A. (Hons) dissertation, Department of Accountancy, University of Malta .

Glass Lewis & Co. (2006). Mum's the word: http:// www.soxfirst.com/50226711/Auditor7o20Turnover.pdf [14 October, 2007].

Grimminger. A. and Di Benedetta. P. (2013). *Raising the bar on corporate governance: A study of eight stock exchange indices:* http://www.ifc.org/wps/wcm/connect/a6724900400acal3af3aff23ff966f85/Raising_the_ ar_o n_CG.pdf?MOD = AJPERES [18 September 2013.

Harlow, K. (2016). Role of an external auditor in corporate governance. *Chron:* http://work.chron.com/role-external-auditor-corporate governance27754.html [2 January, 2017].

Herman, E.S. (1981). *Corporate Control, Corporate Power.* Cambridge: Cambridge University Press, 98:1.

Hofstetter, K. (2005*). One size does not fit all - corporate governance for controlled companies. NCJ Int'L. &Com. Reg. 31: 597*: http://dxdoLorg/10-2139/ssrn.802705 [12 June, 2012].

Iacobucci, D. and Nordhielm, C. (2000). Creative benchmarking. *Harvard Business Review*, 78(3): 24-25. Com Section 5.3

Jones, M.E. (1985). Small companies: the need to re-assess the statutory audit requirement. *The Accountant's Magazine*, January: 31-3.

Karagiorgos, T., Dragolas G., Gotzamanis, E. and Tampakoudis, I. (2010). Internal auditing as an effective tool for corporate governance. *Journal of Business Management*, 2(1): 15-23.

Kadushin, C. (2012). *Understanding social networks: Theories, concepts, and findings*. Oxford: Oxford University Press.

Keasey, K. and Watson, R. (1993). *Small firm management: ownership, finance finance and performance*, Blackwell, Oxford.

Keasey, K., Thompson, S., and Wright, M. (1997). *Corporate governance economic, management and financial issues*, Oxford University Press, Oxford .

Khanchel, I. (2007). Corporate governance: measurement and determinant analysis. *Managerial Auditing Journal,* 22(8): 740-760.

Lafarre, A. (2014). *Shareholder activism at European AGMs: voting turnout and behaviour of (small) shareholders*. Master's thesis Ondernemingsrecht, Tilburg University.

Lazarsfeld, P.F. and Merton, R.K. (1954). Friendship as a social process: a substantive and methodological analysis. *Freedom and control in modern society*, 18(1): 18-66**.**

Magee, R. P. and Tseng, M.C. (1990). Audit pricing and independence. *The Accounting Review,* 65(2): 315-336.

Magri, J. (1991). *The introduction of compilation and review services in Malta*. B.A. (Hons) Dissertation, Department of Accountancy, University of Malta.

Mayo, P. (2013). *Education in Small States - Global Imperatives, Regional Initiatives and Local Dilemmas*. Routledge, London.

McKinsey (2004). *Mckinsey global survey of business executives:* www.mckinsevquarterly.com [11 December, 2006]**.**

McNamee, D. (1995). Management control concepts: benchmarking and internal auditing: www.mc2consulting.com/bmsteps.htm [3 November,2006].

Merriam-Webster (2017). *Merriam-Webster.com*. Social networking (n.d): https://www.merriam-webster.com/dictionary/social%20networking [18 Apr. 2017].

Moody, J. and White, D.R., 2003. Structural cohesion and embeddedness: A hierarchical concept of social groups. *American Sociological Review*, Feb.

Nor, M. (2011). Auditor stress: Antecedents and relationships to audit quality. Doctoral thesis, Edith Cowan University, Western Australia:(1):103-127.

Olear, G.(2008). Avoiding conflicts of interest. *The Cooperator*: http://cooperator.com/articles/1618/l/Avoiding-Conflicts-oflnterest/Pagel.html [12 December, 2010].

Otley, D.T. and Pierce B.J. (1996). Auditor time budget pressure: consequences a and antecedents. *Accounting, Auditing & Accountability Journal*, 9(1): 31-58.

Pandya, H. (2013). Corporate governance: Role of auditor and auditing committee. *1PASJ International Journal of Management,* July, 1(2): 1-7.

Pany, K. (1992). Expectations of the audit function. The CPA Journal, LXIII (8): 58-9.

Porter, B., Simon, J. and Hatherly, D (2014). *Principles of External Auditing*. Wiley Publishers, London**.**

Robson, C (2011*).* *Real World Research*, Wiley Publishers.

Sarkar, J., Sarkar, S. and Sen, K. (2012). Corporate governance index for large listed companies in India. *Indian Accounting Review,* 16(1): 1-18.

Standard and Poor's (2004). *Standard & Poor's corporate governance scores and evaluations: criteria, methodology and definitions*, Standard & Poor's Governance Services. New York, USA.

Saunders, M., Lewis ,P., and Thornhill, A. (2007). *Research Methods for Business Students,* Pearson Education Ltd.

Scott, J. (2012). *Social Network Analysis*. Sage.

Soltani, B. (2000). Some empirical evidence to support the relationship between audit reports and stock prices - the French case. *International Journal of Auditing*, 4 (3): 269-91.

Svanberg, J*, &* Öhman P*.* (*2013*). Auditors' time pressure: does ethical culture support audit quality? *Managerial Auditing Journal*, 28(7): 572-591.

White, D.R. and Harary, F., (2001). The cohesiveness of blocks in social networks: node connectivity and conditional density. *Sociological Methodology*. Jan 1: 305-359.

Willett, C. and Page, M. (1996). A survey of time budget pressure and irregular auditing practices among newly qualified UK chartered accountants. *British Accounting Review*, 28(2): 101-120.

Woo, E.S. and Koh, H.C. (2001). Factors associated with auditor change: A Singapore study. *Accounting and Business Research*, 31(2): 133-144.

World Bank (2016). Small states. 5 Oct: http://www.worldbank.org/en/country/smallstates [18 Apr. 2017]

CHAPTER 2: INTRODUCTORY PAPER

Problems of the Accountancy Profession in a Microstate: A Maltese Viewpoint [INTRO-1]

Baldacchino, P.J[1].

Bank of Valletta Review

No. 6, Autumn Issue, 1992, pp. 29-34

This paper is a revised version of a paper with the same title presented at the International Conference on Islands and Small States held by the Foundation of International Studies, University of Malta on 23-25 May, 1991.

[1] Lecturer in Accountancy and Finance at the University of Malta

Problems of the Accountancy Profession in a Microstate: A Maltese Viewpoint

Baldacchino, P.J.

University of Malta, Malta

The Maltese accountancy profession has the bulk of its current accounting practices and regulatory framework modelled on the British ones, and this is probably also the case of professions in several other ex-colonies. Because of this, Maltese accountancy leaders seem sufficiently aware of many of the issues being debated at the moment in the United Kingdom. Yet, as far as is known, the profession has not to date focused its attention on other issues which may be even more relevant than the above: those arising from the very smallness of this island-state. This paper therefore selects and exposes some of the latter issues. Hopefully, these will also be of interest to other microstates.

Keywords*: Malta, accountancy profession, state smallness*

1. Introduction

This paper gives a brief look at some of the effects of a microstate environment on a particular profession, namely accountancy, in Malta.

The Maltese accountancy profession has the bulk of its current accounting practices and regulatory framework modelled on the British ones, and this is probably also the case of professions in several other ex-colonies. Because of this, Maltese accountancy leaders seem sufficiently aware of many of the issues being debated at the moment in the United Kingdom.

Yet, as far as is known, the profession has not to date focused its attention on other issues which may be even more relevant than the above: those arising from the very smallness of this island-state, with a population of around 350 thousand and a current accountancy profession of 486 warrant holders (Malta Government Gazette, 1992).

This paper therefore selects and exposes some of the latter issues. Hopefully, these will also be of interest to other microstates and their study, which, as Hein (1989) put it "may require in many ways an entirely different approach to problems of social, environmental, political and economic management" (p.18).

2. Close relationships

External auditing is a main service provided by the accountancy profession, and, as is the case in all other countries, the accountancy profession enjoys a monopoly in providing it to local companies. However, in a microstate, the problem is that auditors and their clients come from the same, small community, and that there is a much higher chance of their being related. Anyone who knows that I am auditing my mother-in-law's limited liability company will probably hardly trust me in giving an independent view - and whether or not I remain on good terms with her!

Maltese law does, in fact, prohibit such close relationships for public and private companies. However, contrary to what many take for granted, it does not do this for the bulk of companies, the private exempt ones, which, as at 31 December, 1989, were 87 per cent of all registered companies required to have an audit (Registrar of Partnerships,1989).

Indeed auditors have recently been required by a new Institute Code of Ethics "to ensure that an independent approach to any assignment is not endangered as a consequence of any personal or family relationship" (Malta Institute of Accountants, 1992, Para 8.6). Yet, it may be very difficult for users to be aware of the possible conflicts of interest, where, for example, an auditor is giving his opinion on the accounts of a close relative bearing a different surname.

Moreover, concerning the wider question of friends, it is a fact that living in a micro island-state you do come to know and associate with most people in your particular sphere of life. Therefore, it is far easier and more common to find someone with whom you play squash or tennis outside office hours coming to audit your work. Questions arise, like: How far are personal and professional relationships to mix in practice? Where will a line be drawn - that is, at what point will it be unsuitable for your friend to accept or continue a professional engagement? Approaching such cases seems for practitioners more a matter of exercising professional integrity and trust than one of having and abiding with detailed regulations.

While such problems may interest the seventeen Maltese audit firms, they become particularly challenging for many of the sixty-one local sole audit practitioners (Accountancy Board, 1990). They cannot pass on the audit to another partner in their firm and their client portfolio is not that varied to enable them to resign without drastic effects on their personal incomes.

3. The small size of business units

Another characteristic of this microstate is that most of the local business units are small in size (Briguglio, 1992). For example, as at 31 December, 1989, about 75% of the 8,800 registered companies had a share capital of less than Lm5,000 (Registrar of Commercial Partnerships, 1989). Available statistics also show that the vast majority of private sector firms in Malta employ less than 10 persons (Annual Abstract of Statistics). As stated by Francalanza (1988), it is perhaps to be expected that, in such a small country, most of the local business units would tend to be small.

The problem of the accountancy profession is that, in small concerns, it is much more difficult to check that financial statements give a true and fair view. In small concerns, the employees are few, a single manager often dominates them and such a manager is more often than not the owner of the enterprise. As a result, nobody from outside the company can check what the management is really doing, as it is in full control of the situation. Therefore traditional auditing techniques like examining mark-ups and ratios of the income and expenditure items can fail to reveal omissions from the records such as cash purchases and cash sales. Given the large size of the local black economy, auditors' concern is more understandable.

4. Few users and trust in the accounting product

In such a small country users found in larger economies like the United Kingdom, such as, for example, creditors, employees and investment analysts do not seem powerful or interested enough to make regular use of audited financial statements. The users who are really important appear to be the banks and the Inland Revenue Department.

However, while both the latter users require audited financial statements for their own purposes, they have both amply shown that they do not place full trust in the audit report. For example, in 1987, 24 out of 25 interviewed managers of one of the main local banks stated that in their opinion small company audited accounts were primarily produced *"for the Inland Revenue",* implying that such accounts often understated profit for tax purposes and therefore did not really portray a true and fair position (Saliba, 1987). A plausible reason for this situation was that probably, at least until the 1989 revision of the highest tax bracket from 60% to 35%, taxation seemed excessive. So one might say, at least up to then, that the tax law seemed contrary to a consensus of behaviour, and as De Bono, 1985 aptly put it, "where a law is contrary to a consensus of behaviour then it tends to lose its moral base."

In other words, in 1987 fiscal morality was probably low. However, the point is that there is as yet no definite evidence that fiscal morality has indeed improved, or that tax evaders will not continue to try their luck despite the mentioned tax upheaval.

This gives further support to research carried out in late 1990 by two accountancy students, Galea St John and Magri, where nine out of fifteen bankers showed their cynicism on the audit report of small companies, which, in their view, added little or no credibility at all to the financial statements (Galea St John, 1990 and Magri, 1991). One may therefore conclude that banks are still diffident of the audited accounts of many such companies.

The same scepticism as regards the audit report is also evident among tax assessors. Three out of a sample of five company assessors, also interviewed in the above-mentioned related studies, believed that little or no credibility is added to the accounts by the audit report. It seems that a clear audit report will often not by itself reduce the chance of a tax investigation.

5. Discipline and the catch 22 situation

Both banks and the Inland Revenue would surely like more reliably audited financial reports. Ironically, however, both are barred by their statutory requirements of secrecy from lodging complaints against offending accountants and auditors. For both it looks a question of heads you win, tails I lose.

The local Institute of Accountants, on the other hand, claims that "without such channels of information, the Institute's investigative and disciplinary machinery is blunted" (Casapinta, 1987, p.16).

The Institute's efforts to ensure its members behave in accordance with a code of ethics is probably its most difficult function as it depends on complaints against members usually by other members. To make matters worse, as stated by Bonello (1987), a Maltese partner in one of the "Big Six" international audit firms: "the perception of members as to what constitutes unprofessionalism has more leeway in Malta than, perhaps, in countries with a less young profession" (p.3).

The ethical rules of larger countries in a more advanced phase of accounting development, such as the U.K. and the U.S.A. are probably not therefore to be adopted wholesale. In the same vein, as stated by Darmanin (1990), even the adoption of international standards may not be a right step in accounting development, as the problem may be rooted in the attitudes inherent in the profession within the country itself.

6. The secrecy dilemma

In such a small country, many go to great pains to keep information secret or at least unclear. For example, all private exempt companies - as mentioned above 87% of all local companies in 1989 - do not lodge accounts at all at the Registrar of Partnerships, and therefore the public has no information at all on their performance. One may therefore ask what price these companies are paying for the privilege of having limited liability.

In addition, local auditors cannot normally divulge information to the public authorities of the commission of irregularities unless specifically required by law. Therefore, as long as accounts show a true and fair picture of the company's financial situation, no sensible auditor will release information on, say, infringements of the Exchange Control Act or evasion of customs duty. His position is not exactly that of a champion of the public interest.

7. Concluding note

This paper has delved into some of the main problems of the accountancy profession in a developing microstate. Hopefully, it will generate thought and discussion on the extent to which similar issues recur in other similar small states. Common issues, after all, may call for common solutions.

References

Regulatory

Malta Institute of Accountants (MIA) (1992*).* Code of Ethics, Malta Institute of Accountants, Malta.

Other

Accountancy Board (1990). Unpublished compiled lists, 30 November, Malta.

Bonello, J. L. (1987). Auditing in Malta - key issues facing the profession. *COPE News,* COPE, Malta: 3.

Briguglio, L., (1992). Small business in Malta and their chances of survival following EC membership. *The Times (Malta),* 30 January.

Casapinta, L. S. (1987). Accountants propose two key steps in tax reform process, *The Times Malta),* 2 October: 16.

Central Office of Statistics (1989*). Annual Abstract of Statistics*. Malta.

Darmanin, D. (1990). Modelling the phases of accounting development*. Bank of Valletta Review*, Autumn 2: 39-50.

De Bono, E. (1985). *Conflicts, A Better Way To Resolve Them*. Harrap Ltd: London.

Francalanza, C.A. (1988). Setting accounting standards for Malta*. International Journal of Accounting*: 168-178.

Galea St. John, A. (1990). The small audit report - local usage and perception. B.A.(Hons) dissertation, Department of Accountancy, University of Malta, Malta.

Hein, P. (1989). The study of microstates . In *Economic Development of Small Countries - Problems, Strategies and Policies.* Kaminarides J., Briguglio L. and Hoogendong, H (eds). Netherlands: Eburon Publishers: 16-29.

Magri, J. (1991). The introduction of compilation and review services in Malta. B.A. (Hons) dissertation, Department of Accountancy, University of Malta, Malta.

Malta Government Gazette (1992). Lists of accountancy warrant holders. Notices 30 and 31,14 January: 155-158.

Registrar of Commercial Partnerships (1992). Unpublished Statistics, Malta: Department of Trade, Malta.

Saliba, E. (1987). The Banks' Role in Small Business Finance with Particular Reference to Malta. BA (Hons) dissertation, Department of Accountancy, University of Malta, Malta.

PART 1: EXTERNAL AUDITING PAPERS

CHAPTER 3

The Statutory Audit of Owner-managed Companies in Malta [AUD-1]

Tabone, N[1]. and Baldacchino, P.J.[1]

Managerial Auditing Journal

Vol 18, Issue 5, 2003, pp.387-398

[1]Department of Accountancy, University of Malta

The Statutory Audit of Owner-managed Companies in Malta

Tabone, N., and Baldacchino, P.J.

University of Malta, Malta

Historically, as a former British colony, Malta has had its accounting and auditing practices highly influenced by UK regulation. However, in the last decade, departures have steadily been occurring from a UK-based regulatory framework to one increasingly influenced both by international standards and European Union requirements. One such departure relates to the retention of the statutory audit requirement for all Maltese companies, despite its earlier abolishment for small companies in the UK. This study evaluates the relevance of a mandatory annual statutory audit requirement for owner-managed companies as perceived by two interest groups: the owner-manager and the auditor. It also considers possible alternatives to such a requirement. Results indicate that for Maltese owner-managed companies, the statutory audit fulfils two important roles: it bears relevance to outside third parties, and it has a positive effect on the owner-manager and staff.

Keywords: *audit, company law, Malta, small firms, auditors*

1. Introduction

Malta and the UK share a number of common ties: historical milestones, language, business contacts, international relations and tourist influxes. These close links also extend to accounting and auditing practices. For many years, Malta has had its accounting and auditing practices highly influenced by UK regulation. However, in the last decade, Malta has sought to establish itself as a hub of financial services in the Mediterranean region and a series of financial services legislation has been enacted with the objective of supporting Malta's evolving role within the international sphere. Departures have steadily been occurring from a UK-based regulatory framework to one increasingly influenced both by international standards and European Union requirements. One such departure relates to the retention of the statutory audit requirement for all Maltese companies, despite its earlier abolishment for small companies in the UK.

Malta is a tiny island in the middle of the Mediterranean Sea, 60 miles to the south of Sicily. It has a population of 390,000 and its economy is principally based on the manufacture of commodities for export, tourism and the provision of financial services. The number of Maltese registered companies marginally exceeds 30,000, yet only about half of them may be considered to be active companies. A predominant characteristic in the corporate governance structure of these companies is that the directors are also the ultimate beneficial owners of the company. Ownership and control are typically vested in the same persons and consequently these companies are referred to as "owner-managed companies" (De Gabriele, 2001; Doublet, 1999; Mangion, 2001). At present, the Maltese Companies Act 1995 imposes a statutory audit requirement for the financial statements of all companies, irrespective of their size, capital structure or business activity. The statutory audit is to be conducted by an independent auditor in accordance with International Standards on Auditing. However, in the budget speech for 2002, the Minister of Finance indicated that audit exemptions for small companies would be introduced in company legislation with the objective of reducing compliance costs for such companies.

The purpose of this study is to survey local owner-managers and auditors on the relevance of a mandatory annual statutory audit requirement for owner-managed companies and on possible alternatives to such a requirement. Where the ultimate beneficial owners are also the directors of a company, a statutory audit would seem superfluous as far as its main purpose - shareholder protection - is concerned. Shareholders, having an intimate knowledge of the business affairs and having access to all information on a daily basis, would be in a position to know the true financial state of affairs of the company as a consequence of the decisions taken in their capacity as directors. The prevalence of owner-managed companies in Malta makes a study on the relevance of the statutory audit requirement a relevant issue to investigate.

Our findings indicate that in the context of owner-managed companies, the statutory audit fulfils two important roles. First, it is relevant to outside third parties who have no direct ownership interest in the company but who nonetheless contribute to the viability of the enterprise. Second, it has a positive effect on the owner-manager and staff.

The rest of this paper is divided into four main sections. The first section summarizes the relevant literature on the relevance of the statutory audit for owner-managed companies. The second section discusses the methodology used in the study. The third section presents the results and implications. Finally, the concluding section summarises the findings and presents the limitations of the study.

2. Literature review

2.1 Economic size, ownership-management and audit relevance

The conventional focus when evaluating the need for a statutory audit requirement is the economic size of the company. In company legislation, quantitative criteria based on turnover, net assets and/or number of employees are often used to distinguish between "small" and "large" companies. The criteria adopted understandably differ from one country to another, mainly because operational definitions are linked to the specific level of development of the country and to the particular purpose for which the definition is formulated. In the UK, a company is exempted from a statutory audit requirement if it qualifies as a small company in accordance with the UK Companies Act 1985, its turnover does not exceed £1 million and its balance sheet total for that year does not exceed £1.4 million. In Malta, at present, there are no audit exemption thresholds. The financial statements of all companies are subject to a full scope audit conducted in accordance with International Standards on Auditing. However, the Maltese Companies Act 1995 limits the disclosure requirements for small companies, allowing them to file an abridged set of financial statements at the Registry of Companies. In the imminent future, audit exemptions for private companies are to be introduced in the Maltese company legislative framework and such exemptions are to be based on the economic size of the companies.

A classification based on economic size is, however, rather too limiting in scope. A study on the need for a mandatory annual statutory audit requirement for all companies must necessarily consider other indicators, primarily the ownership-management structure of the companies.

The concept of ownership-management is more stable over time and less sensitive to economic pressures and other external influences than that of economic size. It focuses on the two main organs concerned with the statutory audit of financial statements: the board of directors, which is responsible for the preparation of a set of financial statements which give a true and fair view of the company's state of affairs, and the shareholders, who are the primary stakeholder group for whom the statutory audit is legally intended. This concept is used in this study to evaluate the relevance of a statutory audit requirement from the perspectives of the owner-manager and the auditor.

This study defines an owner-managed company as a limited liability company incorporated under the Maltese Companies Act 1995 where the ultimate beneficial owners are *de facto* controlling the company in their capacity as directors. This definition is not meant to be a rigid legalistic definition. The objective of this definition is to encapsulate all companies whose ultimate beneficial owners are, in substance, controlling the company. The definition therefore also covers situations where a shareholder or a group of shareholders are directors of a company and own the vast majority of the shares, with their spouses and/or descendants holding the few remaining shares.

2.2 The auditing function in owner-managed companies

According to Andersen *et al* (1993, as cited in Koh and Woo, 2001), in line with the agency theory (Jensen and Meckling, 1976), information asymmetry and the demand for monitoring are among the reasons for undertaking external audits. Where there is a separation of ownership and control, the principal is willing to incur a financial cost to monitor the activities of the agent. The agent is responsible for producing most of the financial information required by the principal. This information is seen to be of doubtful objectivity in view of the presence of natural or deliberate bias caused by the existence of a conflict of interest (Kent and Sherer, 1983). It is therefore in the principal's interest to have the truth and fairness of the financial statements testified by an independent auditor. In addition, the agent may view the audit as a device to assert the quality of the information provided to the principal. Within the context of a limited liability company, the information provided by the agent is not exclusively used by the principal - other stakeholders may also place reliance on this information. The auditor is therefore seen as fulfilling an insurance role. The auditor's independent opinion adds credibility to the financial statements prepared by the agent and it provides third parties with reasonable assurance on the truth and fairness of the financial statements. The auditor may also fulfil a behavioural role, acting as an influence on the directors, management and staff. The auditor may assist the directors in maintaining a company's reporting standards and grant the directors access to financial expertise to improve their existing systems and controls.

However, with respect to owner-managed companies, the applicability of some of these roles appears to be questionable. In an owner-managed company, ownership and management of the company's assets are vested in the same persons. Thus, the question arises as to whether a mandatory annual statutory audit requirement is justified in such circumstances, where the auditor is merely reporting information already known to the same person acting in a different role.

English (1978, p. 5) questions the *raison d'être* of the statutory audit for owner- managed companies by arguing that where shareholders are also directors, the statutory audit only serves "to tell Mr and Mrs A (as shareholders) that they, Mr and Mrs A (as directors) have not misled or cheated them". A similar argument is used by the Institute of Chartered Accountants in Australia, which argues that the statutory audit may be a time-consuming, unnecessary and onerous expense for many "mum and dad" type companies which have very few shareholders. As these shareholders would not only own the company but also manage it, the benefits of an audit are questionable since shareholders would essentially be reporting to themselves (ICAA, 1995 as cited in Baxter and Pragasam, 1998). English (1978) argues that the time spent on the statutory audit could be utilized more fruitfully for credibility reviews and future cash flow planning. Jones (1985) puts forward his view on the need for the auditing profession to direct its energies into developing more relevant business services. A similar line of thought is used by Wills (1999), who argues that whilst the form of the statutory audit essentially remains the same from one year to another, the needs of owner-managers vary continuously. Thus, the government should no longer prescribe a statutory audit, but allow owner-managers to choose the assurance service most appropriate to them (Singleton-Green, 1995).

A counter argument to the above is that the annual audit improves the reliability and usefulness of the financial information available to shareholder-directors (Keasey and Watson, 1993). The lack of specialised accounting expertise in owner-managed companies, particularly in view of the ever-increasing complexity of business transactions and accounting standards, means that the "housekeeping" and "discipline" imposed on the staff and management by the annual audit requirement is essential for the provision of reliable and consistent financial information (Gunter, 2000; Keasey *et al.,* 1988). Moreover, without the statutory audit, the door may be opened wide for unqualified auditors to wreak havoc in the books of owner-managed companies (Laine, 1998).

The existence of an accountability relationship must not be limited to the principals having an ownership stake in the company. The manner in which a company is managed will affect other parties who have no direct ownership interest (such as creditors, bankers and tax authorities) but who nonetheless contribute to the viability of the organisation. Realism, rather than the provisions of the law, dictates that shareholders are not the only group of people to whom the company, as managed by the directors, should be accountable (Kent and Sherer, 1983). Thus, the concept of accountability, and the use of the statutory audit to enforce it, is applicable to all sets of participants associated with a company, and not just to the shareholders. Although the statutory audit may not directly address all the conflicting objectives of the various stakeholders, it is still perceived as a means of ensuring that the financial statements produced are reasonable. The audit function may also place constraints, in the interests of stakeholders, upon the actions of the owner- managers, in the knowledge that their financial transactions will be subject to scrutiny by an independent third party.

With respect to Maltese companies, Baldacchino (1992) interviewed local auditors and managers, and found that both parties mostly perceived the audit function as important because of its positive influence on management and staff. In small companies, this behavioural role of the auditor was appreciated, but with ownership-management and no outside loan financing, audits were in question as to their cost-benefit.

2.3 Alternatives to the statutory audit requirement

Shaw (1978) argues that the only alternative to a mandatory audit is "no audit". A similar attitude is adopted by Davison (1980, p. 42) who states that "surely, the proper alternative is no audit at all". According to Shaw (1978), if company legislation is to be amended, then any changes should be directed at exempting companies from an audit requirement rather than introducing a new form of assurance service. The adoption of audit deregulation may, however, open the floodgates for adverse selection, where the very companies that may benefit most from, or mostly need, the statutory audit may opt for an exemption (Langard, 1999, as cited in Seow, 2001). Furthermore, audit deregulation may have an impact on the auditing profession in the sense that small audit practitioners may no longer be in a position to train audit staff, leading to the creation of an oligopoly of audit service providers (ACCA, 2000).

An independent professional review has been suggested as a lighter, less costly form of assurance service suitable for owner- managed companies (Stewart, 2000). A review engagement is different from an audit in the scope of work undertaken (Auditing Practices Board, 2000). Still, reviews have been criticised by Davison (1980) on the grounds that if the public interest does not require the law to impose a full audit on small companies, then there is no justification for imposing a review requirement on such companies. Moreover, a review may not be sufficiently distanced from an audit by the users, such that it may further widen the audit expectation gap (Page,1991).

Others have suggested that the statutory audit *per se* is a valuable exercise which only needs to be modified. Hatherley (1992) introduces the concept of reporting to "committed" stakeholders - that is, stakeholders who effectively have a long-term interest in the company. The body of shareholders would no longer remain the addressee of the audit report; instead, the report would be addressed to committed stakeholder groups. These may include bankers, creditors, or loan providers, who may not be in a position to withdraw facilities without causing that company severe financial distress. By reporting to a body of committed stakeholders, the auditor in an owner-managed company would no longer be working in a vacuum.

3. Research methodology

3.1 Research instruments

A questionnaire containing 29 statements was used in the survey. Respondents were asked to indicate on a six-point Likert-scale their position *vis-a-vis* each statement. In the rating scale, respondents could choose from strongly/moderately/slightly disagree or agree, represented by numbers 1 to 6. The questionnaire was divided into five sections.

The first section focused on the relevance of the statutory audit for owner-managed companies. The second section considered the introduction of audit exemptions, while the third section delved into possible alternatives to the mandatory audit requirement. The fourth section covered the overall perspective of the respondents. Finally, the last section sought to collect demographic data on the respondents.

Respondents were asked to accede to a follow-up interview. The objective of these interviews was to enable the respondents to express their views openly where debatable issues arose, thus better bringing to light the perceptions of the two respondent groups. A semi-structured interview was conducted with the first ten respondents from each group who had acceded to the request.

3.2 Sample selection and response rates

A mail survey was carried out amongst a random sample of owner-managers in each of 150 owner-managed companies satisfying the definition adopted for the purposes of this study, and 150 certified public accountants and auditors (CPAA's). The sample of companies was selected from the list of companies available at the Registry of Companies while the sample of auditors was selected from the list of warrant holders published by the Accountancy Board.

By the cut-off date, which was scheduled as five weeks after despatch of the questionnaires, 118 valid responses were received: 39 responses from owner - managers (26 per cent response rate) and 79 responses from auditors (53 per cent response rate). The majority of owner-managers (56 per cent) were not professionally qualified in any business-related area. Most owner-managers (92 per cent) indicated that their company was a first-generation company. On the other hand, the majority of responses from the auditor respondent group were derived from audit partners (54 per cent). The other responses originated from sole practitioners (33 per cent) and warrant holders working in industry (13 per cent).

4. Results and implications

4.1 Relevance of the statutory audit

Table 1 presents the mean responses and standard deviations of the two respondent groups with respect to the statements focusing on the relevance of the statutory audit requirement for owner-managed companies. It also gives the results of the Mann-Whitney test for significant differences between the responses of owner-managers and those of auditors. The merits of the statutory audit are segregated from its criticisms. The results are presented in descending order, based on the average means of the two groups.

The two respondent groups were distinctly in agreement with respect to the relevance of the statutory audit to other stakeholders. This was also evident in the interview sessions. All the owner-managers interviewed supported this statement. One owner-manager described the audited financial statements as the key to obtaining bank finance. Another owner-manager suggested that the annual audit satisfied bankers and tax authorities that the books of account were maintained to a sufficiently high standard. The auditors interviewed were more concerned with the added credibility associated with an audited set of financial statements.

Both respondent groups agreed that the statutory audit improved the reliability of the financial statements of owner-managed companies. They also considered the role of the auditor as important in view of the ever-increasing complexity of business transactions and accounting standards. Statistically significant differences were, however, noted with respect to these two statements. The majority of the owner-managers interviewed were convinced that the financial statements prepared by their accountant were reliable, and that their accountant or financial controller was adequately versatile with changing accounting standards. One owner-manager commented that his auditor never traced any material misstatements in the financial statements and that this proved that his financial statements were reliable enough.

Both respondent groups perceived the annual audit as imposing a sense of financial discipline on the owner-manager and staff. However, there was a statistically significant difference in their responses. One of the auditors interviewed described the statutory audit as a vital check for owner-managed companies, since

Table1
Relevance of the statutory audit

	OM Cos		CPAAs		
	Mean	**St Dev**	**Mean**	**St dev**	***p*-value**
Section 1					
The annual audit is necessary since It is relevant to other stakeholders, such as creditors, tax authorities and bankers	5.4872	0.6833	5.4557	0.9309	0.7352
The annual audit is useful improving the reliability of the financial statements of owner-managed companies	4.9231	1.1094	5.3418	0.8303	0.0413*
The role of the auditor is important in view of the ever-Increasing complexity of business transactions and accounting standards	4.9231	1.0854	5.2278	1.1541	0.0393*
The annual audit imposes discipline on the management and staff of owner-managed companies	4.4103	1.4818	5.0506	1.1536	0.0137*
The annual audit Is useful in the detection of material fraud and error	4.0000	1.4327	4.7342	1.1060	0.0056*
The auditor may provide better specialist advice in other non-audit areas at a lower cost than external third party consultants	3.9487	1.5381	4.4051	1.1931	0.1604
The needs of owner-managers change from one year to another, but the form of the audit essentially stays the same, year in, year out	4.4103	1.3518	3.5696	1.4994	0.0058*
There Is little dialogue between the auditor and the owner-manager once the annual audit is finalised	4.5897	1.4090	3.3671	1.5457	0.0001*
The statutory audit merely confirms to the owner-manager what he already knows about the company	4.2308	1.4772	3.2025	1.5139	0.0010*
The statutory audit only looks at history; it adds nothing new	3.8462	1.5481	3.3165	1.4636	0.0666
Generally, owner-manager analyses carefully report prepared by auditor	3.6667	1.5275	3.0127	1.4455	0.0291*
The benefits of an audit could be obtained outside the legal-relationship	3.4872	1.2747	2.9620	1.6521	0.0662
In owner-managed companies, shareholders are relatively well Informed on the state of affairs of the company and so the statutory audit is not needed	3.5128	1.6839	2.5063	1.518	0.0016*
The statutory audit requirement is only a means of providing Income for the auditing profession	3.5641	1.7136	1.6582	1.1863	0.0000*

Note: * Significantly different between owner-managers and auditors at p < = 0.05

such companies were often characterised by the existence of a dominant owner-manager.

The most significant difference in the perceptions of the two respondent groups concerned the issue of fraud and error. Both respondent groups agreed that the statutory audit was useful in the detection of fraud and error resulting in material misstatements in the financial statements. However, owner-managers expressed a lower level of agreement with the statement than the auditors did.

4.2 Criticisms of the statutory audit .

One statistically significant difference concerned the statement dealing with the poor communication between the owner-manager and auditor once the statutory audit was finalised. Owner-managers agreed with this statement whilst auditors expressed mixed feelings.

Owner-managers agreed with the statement that the form of the annual audit did not change in line with changes and developments in their company. They also agreed that for owner-managed companies, the statutory audit only confirmed to them what they already knew about the company. Auditors appeared to have a neutral opinion with regard to these two statements.

Both respondent groups did not appear to have a definite view on whether the statutory audit added anything new. This was also apparent in the interview sessions, where six owner-managers argued that the statutory audit was too historic and that it was not conducted at the right time. One owner-manager argued that it was important to look at the past to budget for the future. Another owner-manager believed that the audit formalized the past performance of the company and that it provided an independent confirmation that one had achieved one's targets. On the other hand, the interviewed auditors acknowledged the historical nature of the audit. However, the vast majority believed that the audit was valuable to the owner-manager. A common line of thought amongst auditors was that the auditor's advice on internal controls, tax planning and other related financial issues significantly added value to the owner-manager. Another auditor suggested that in owner-managed companies, the audit was very important for those shareholder-directors who were non-executive directors. As companies entered new generations, the complete alignment between ownership and directorship may be lost and so the relevance of the statutory audit will increase. In line with this argument, auditors disagreed that the statutory audit was not needed in owner-managed companies simply because ownership and control were vested in the same persons. Owner-managers expressed a neutral opinion on this matter.

Auditors believed that the owner-managers did not read and analyse carefully the contents of the audit report. Owner-managers appeared to have mixed feelings on this issue. Another statement in the questionnaire focused on the possibility of obtaining the benefits of the audit outside the legal requirement, and therefore without the need for the mandatory provision of the law. Auditors disagreed with this statement, while owner-managers were less decided in this regard.

A contentious issue related to whether the statutory audit requirement was only a means of supporting the large amount of statutorily-mandated revenue for the auditing profession. Auditors were strongly in disagreement with this issue, while owner-managers expressed a neutral view. This resulted in the highest significant difference in this section of the questionnaire.

4.3 No statutory audit

Table 2 presents the mean responses of the two respondent groups with respect to the statements concerned with audit deregulation. The results are presented in descending order, based on the average means of the two groups.

Both respondent groups agreed that auditors would prefer to retain the mandatory annual audit requirement for owner-managed companies, and in this respect, no statistically significant difference arose. Statistically significant differences were noted in all the other statements set. Both respondent groups agreed that, with audit exemption, the companies mostly in need of an audit would be the ones to opt for an exemption. One owner-manager was, however, critical of this statement, arguing that one should not generalize since there were companies which genuinely did not consider the audit to be relevant to their needs.

Owner-managers expressed a neutral view on the financial burden associated with the annual audit exercise. On the other hand, auditors did not perceive the audit as a significant burden for owner-managed companies. In the in-depth interviews, owner-managers commented that in a highly competitive business environment, the audit fee was a costly overhead and that companies would certainly be thankful for any measures which reduced compliance costs. The majority of the auditors interviewed disagreed with audit exemptions. One auditor remarked that, in Malta, the current audit fee levels were very low when compared to other countries and were not therefore a significant burden on these companies. Another auditor remarked that the introduction of audit exemption demanded a professional and mature commercial environment, and that the Maltese business environment had still not reached that stage of development. Two auditors were in favour of audit exemptions on the grounds that, for owner-managed companies, an audit exercise was often difficult to undertake in view of the inherent internal control limitations and the dominance of the owner-manager.

Owner-managers expressed a neutral opinion on their preference regarding the criteria on which audit exemption should be based. Auditors disagreed with the use of ownership-management as a criterion. In the interview sessions, four owner-managers supported ownership-management exemption on the basis that it was more relevant; four owner-managers were in favour of economic size since it better reflected the impact of the company on the whole economy; the other two owner-managers stated categorically that audit exemptions should not be introduced. The majority of auditors preferred economic size as a basis for exemption, although three auditors suggested that it should be based on a combination of both.

Table 2
No statutory audit

	OM Cos		CPAAs		
	Mean	**St Dev**	**Mean**	**St dev**	***p*-value**
Section 2					
Auditors would prefer to retain the mandatory audit requirement for owner-managed companies	4.9231	1.4214	4.5949	1.5319	0.2440
With no statutory audit, the companies that mostly need an audit may be the ones to opt for an exemption	4.1282	1.6088	4.9747	1.3105	0.0034*
The annual audit is a financial burden, a workload and a time-consuming exercise for owner-managers and their staff	3.5385	1.5191	2.3544	1.3871	0.0001*
Audit exemption should be based on the ownership-management structure, rather than on economic size (turnover, net assets or number of employees)	3.5897	1.5341	2.2025	1.5391	0.0000*
With audit exemption, the funds previously used for audit will now be used for better future cash flow planning and budgeting	2.8974	1.5860	1.7848	1.1510	0.0001*

Note: * Significantly different between owner-managers and auditors at p < = 0.05

Auditors were convinced that, with audit exemption, the funds previously used to cover the audit fee would not be utilised for better cash-flow planning and budgeting. Owner-managers also disagreed with this statement, though to a lesser extent. In the interview sessions, eight owner-managers indicated that they would simply re-allocate the funds to the finance department or distribute them to employees to keep them motivated.

4.4 Alternatives to the statutory audit requirement

Table 3 presents the results of the responses to the statements concerned with possible alternatives to the statutory audit requirement.

Table 3
Alternatives to the statutory audit requirement

	OM Cos		CPAAs		
	Mean	**St Dev**	**Mean**	**St dev**	**p-value**
Section 3					
For owner-managed companies, a user-centred audit methodology should be developed; i.e. the audit should be tailored to suit the needs of the owner-managers	4.6667	1.5447	4.0759	1.6777	0.0406*
The audit report should not be a standard report which Is far too familiar	3.4615	1.6197	2.7468	1.5728	0.0232*
In owner-managed companies, the audit report should be addressed to other users to enforce the accountability relationship	3.3590	1.5473	2.7722	1.7755	0.0602
Owner-managers should be granted the option to choose whether to have their financial statements audited or not	3.7949	1.7944	2.0886	1.5291	0.0000*
An independent professional review (IPR) is a lighter, less costly form of assurance service that Is suitable for owner-managed companies	3.3333	1.5949	2.519	1.4924	0.0075*

Note: * Significantly different between owner-managers and auditors at p < = 0.05

Four out of the five statements set obtained responses from the two respondent groups which were statistically different. One statistical difference related to the user-centred methodology to be used in the annual audit exercise. Both respondent groups agreed that the audit approach should be tailored to suit the needs of owner-managers. Owner-managers were, however, more in agreement with this statement than the auditors

The auditors interviewed were in favour of a standardized audit report on the grounds that standardization promoted clarity, consistency and comparability. Owner-managers were more critical of the audit report, describing it as a stereotyped report, an inflexible report and a report which remained the same, year in, year out, except for a change in the date. These views were also reflected in the responses to the mail survey, resulting in a statistically significant difference.

Auditors disagreed that the audit report should be addressed to other users to enforce the accountability relationship. Owner-managers were undecided on this issue. In the interview sessions, nine auditors rejected this idea, arguing that it would lead to catastrophic increases in audit fees and that it would mean a lot in terms of auditor's liability.

Owner-managers expressed a neutral view on whether they should be granted the option to choose whether to have their financial statements audited or not. Auditors disagreed with this option. In the interviews, owner-managers were in favour of the option, describing it as democratic and fair. On the other hand, auditors were less enthusiastic about this alternative: eight auditors were against such an option, while two auditors were in favour, provided adequate protection was afforded to minority shareholders.

Another statistically significant difference related to the responses given to the statement which focused on the use of independent professional reviews. Auditors disagreed with the concept of a review and this was also apparent in the interviews, where seven auditors expressed their disagreement with the use of reviews as an alternative to an audit. Owner-managers were more interested in the use of reviews, provided it was acceptable to the banks and tax department. Two owner-managers were, however, completely against reviews on the grounds that they were irrelevant to them, as much as an audit was.

4.5 Overall perspective

The results of the final section of the questionnaire are presented in Table 4.

Table 4
Overall perspective

	OM Cos		CPAAs		
	Mean	**St Dev**	**Mean**	**St dev**	**p-value**
Section 4					
A statutory audit requirement is justifiable on the grounds of safeguarding societal interests	4.6923	1.0798	4.8608	1.3562	0.1559
The annual audit is only undertaken because it is required by statute	4.4359	1.3138	4.4810	1.2285	0.8507
A legal requirement for an audit of all companies is justifiable	3.9231	1.6284	4.5570	1.6621	0.0155*
Owner-managed companies would prefer to abolish the mandatory audit requirement	4.0769	1.5284	4.2911	1.4246	0.5073
On the whole, the benefits of the annual audit for owner-managed companies exceed the costs associated with it	3.6667	1.4204	4.3418	1.5012	0.0154

Note: * Significantly different between owner-managers and auditors at p < = 0.05

The final section of the questionnaire summarised the overall views of the two respondent groups. Both owner-managers and auditors agreed that the statutory audit requirement safeguarded societal interests. More auditors than owner-managers were in favour of a mandatory audit for all companies, and in fact, a statistically significant difference arose in this respect.

Both respondent groups agreed that owner-managers would prefer to abolish the mandatory audit requirement. In line with this view, both auditors and owner-managers acknowledged that the annual audit was only undertaken because it was required by statute. No statistical differences were noted for these two statements. A statistically significant difference arose with respect to the statement comparing the benefits and the costs associated with the audit exercise. Auditors agreed that the benefits exceeded the costs associated with the audit, while owner-managers were more sceptical about this.

5. Discussion of findings

The prevailing alignment between ownership and management in the vast majority of Maltese limited liability companies may bring into question the need for a mandatory annual statutory audit requirement for such companies. It is clear from our findings, however, that the statutory audit of local owner-managed companies fulfils two major roles. The more important role of the statutory audit is that it bears relevance to outside third parties who may have a direct interest in the owner-managed company. The second role of the statutory audit emanates from the positive effect of the audit process on the owner-manager and staff.

5.1 Relevance to outside parties

There is clear agreement that the statutory audit requirement is necessary since it is relevant to third parties, such as bankers, trade creditors and tax authorities. The statutory audit improves the reliability of the financial statements prepared by the owner-manager. The independent audit opinion expressed in the auditor's report adds credibility to the financial statements. This added credibility is particularly relevant when audited financial statements are used as a basis for dealings with bankers, suppliers, leasing companies and government agencies. The role of the external auditor is also useful in tackling the increasingly complex business transactions and the onerous requirements of the financial reporting framework. These factors render the statutory audit relevant to those outside stakeholders who may not have an ownership interest in the owner-managed company but who nonetheless directly support its existence and viability. Our findings present the insurance role - the protection of third-party interests - as a major role of the statutory audit in the Maltese context.

5.2 Positive effect on owner-manager and staff

The statutory audit process has a positive effect on the owner-manager and staff, not so much by detecting material fraud and error contained in the financial statements, but by imposing financial discipline and providing specialist advice in other non-audit areas.

The statutory audit promotes a sense of financial discipline in the way owner-managers and their staff conduct their business activities and in the manner in which accounting records are maintained. It therefore serves as a psychological deterrent factor and an added independent check on the owner-managed company. It is in the Interest of third parties, particularly unsecured creditors, and of society in general, for the operations of a limited liability company to be conducted in an orderly manner and kept under scrutiny. Although local owner-managers may puritanically argue that it is in their own Interest to be financially disciplined, the statutory audit still serves as a useful external influence on the behaviour of the owner-manager and staff.

The statutory audit may grant the owner-manager access to the financial expertise necessary to improve the company's systems and operations. The auditor acquires a detailed understanding of the organizational and control characteristics of the owner-managed company from the conduct of recurring statutory audits. The auditor also benefits from a specialist exposure to a wide range of companies in various industries and may therefore utilise this expertise to ask relevant questions which those involved in the day-to-day activities of the owner-managed company may fail to put forward. The auditor may act as an independent person on whom to bounce off constructive ideas with the aim of improving the efficiency and effectiveness of the operations of the owner-managed company. This advice needs not be restricted to financial matters, but may also extend to operational and governance matters. These influences tie in well with the behavioural role - the influence on management and staff - of the statutory audit.

It is evident from our findings, however, that local owner-managers expect a higher degree of added value from the auditors' services. For local owner-managed companies, monitoring the agency relationship between shareholders and directors is not considered a relevant function of the statutory audit since this merely confirms what owner-managers already know about the company from their direct involvement in its day-to-day operations. There also appears to be a poor dialogue between the owner-manager and the auditor once the annual audit is finalised. Moreover, local auditors may be adopting a rigid procedural methodology in the conduct of the audit, thus ignoring the individual needs and characteristics of the owner-managed company. There is agreement that a proactive attitude is required in the conduct of the audit, where the auditor provides strategic advice on the future development of the company. This would introduce the auditor to a new, challenging role in the corporate governance of owner-managed limited liability companies.

Such demands by owner-managers on the audit function may, however, put into question the fundamental notions of independence and objectivity upon which the conduct of a statutory audit is based. A continuous dialogue with the auditor beyond the present generally accepted levels and the involvement of the external auditor in strategic planning issues would narrow the distance between the audit function and the management function. This may question, if not in fact but certainly in appearance, the independence of the auditor and would therefore limit the credibility offered by the auditor's opinion in the interest of third parties.

5.3 Overall perceptions of owner-managers and auditors

The overall picture which emerges from this study is that local auditors attach more significance to the roles of the statutory audit than owner-managers do. This is evident from the differences in the responses to the statements set. The auditors' mean responses are invariably higher with respect to the merits of the statutory audit and lower with respect to its criticisms. This discrepancy may be justified on the grounds of the auditors' professional understanding of the importance of their role in the local commercial and business environment. There may also be an element of self-interest, self-worth or pride which auditors associate with the functions which they perform. Furthermore, local owner-managers may lack the professional accounting and auditing background necessary to appreciate the positive effects of the statutory audit process. Auditors need to take these considerations into account in their interactions with the owner-managers.

5.4 Possible alternatives to the statutory audit requirement

The ownership-management structure of local owner-managed companies may strengthen the case for abolishing the statutory audit requirement, particularly in view of the general trend in various countries to relieve such companies from costly bureaucratic burdens. However, the introduction of an audit exemption regime is based on a natural evolution of the economy and it demands a professional and mature business environment. In Malta, audit exemptions may not be conducive to a higher level of corporate governance and accountability, particularly in view of the intrinsic lax culture inherent in many local owner-managed companies. Restricting surveillance and curtailing accountability is unlikely to stimulate economic activity in the interest of the local commercial community and the general public. In addition, the statutory audit adds value to the owner-managed company through the auditor's advice on internal controls, cash-flow planning and tax planning. This advice may be forfeited in case of a complete abolition of the statutory audit since local owner-managers are unlikely to voluntarily engage an external auditor unless this is required by lenders, particularly bankers.

Local owner-managers appear to be more enthusiastic about changes to the current *modus operandi*. Owner-managers express their wish of reducing business compliance costs. At the same time, owner-managers acknowledge that a statutory audit requirement is justifiable on the grounds of safeguarding societal interests. Other, lighter forms of assurance services, such as independent professional reviews, are still new to the local business community and thus, owner-managers are still undecided about their relevance and applicability in the local context. The alternative of granting a voluntary option to owner-managers has not featured as a solution to the issue. This may indicate that whilst owner-managers wish to reduce compliance costs for their own company, they would still prefer to have the financial statements of their trade contacts duly surveilled by an annual audit, in their own interest and in the interest of society in general.

A user-centred methodology is required in the audit of an owner-managed company. This involves tailoring the audit process to suit the nature and individual characteristics of the company. Based on the results of the audit procedures undertaken, the auditor can fulfil an advisory role by providing recommendations in the management letter which add value to the owner-manager and justify the audit fee charged. Unfortunately, in view of the ever-increasing compliance requirements and the economics of audit engagements, local auditors may no longer be in a position to dedicate sufficient time to these important "by-products" of the statutory audit. This is where the local auditing profession seems to need to concentrate its efforts and resources: ensuring that the added value associated with the statutory audit process is delivered to the owner-manager in fact and in appearance, such that the owner-manager will actually be the one to actively and voluntarily seek the auditor's services.

6. Summary and conclusions

In the context of an owner-managed company, the statutory audit cannot be seen as monitoring the traditional agency relationship between the shareholders and directors since no such relationship exists. If this function were to be the only function fulfilled by the statutory audit, then the audit of owner-managed companies would indeed be irrelevant and unnecessary. However, there are other roles fulfilled by the statutory audit which render it an important exercise for all interested parties.

The study concludes that in the context of local owner-managed companies, the statutory audit fulfils two important roles. It is relevant to outside third parties who have no direct ownership interest in the company but who nonetheless contribute to the viability of the enterprise. Furthermore, the statutory audit has a positive effect on the owner-manager and staff - it imposes financial discipline on the owner-managed company, it has a psychological deterrent effect against errors and other irregularities, and it also grants the owner-manager access to financial expertise. These roles are to be taken into consideration before any alternative to the statutory audit requirement is introduced in the Maltese legislative framework.

The study also concludes that local auditors are sceptical about the appropriateness of alternatives to the mandatory annual statutory audit requirement. On the other hand, owner-managers are more open to changes to this requirement. At the same time, owner-managers are well aware of the need of the statutory audit to safeguard the interests of third parties, particularly bankers and tax authorities, and to enable them to conduct their operations in the form of a limited liability company.

The results of our study are subject to the following limitations. Responses were received from a limited number of owner-managers and auditors, and so the responses may not be totally representative of the population. The study is also limited to the viewpoints of the owner-manager and the auditor. The perspective of local users of audited financial statements is valuable for a comprehensive evaluation of the subject matter, and consequently we recommend this aspect as an area for further study to future researchers

References

Regulatory

Auditing Practices Board (2000). *The Proposed "Independent Professional Review Review" of the Financial Statements of Small Companies,* May.

Other

Association of Chartered Certified Accountants (ACCA) (2000). *The Statutory Audit Requirement for Smaller Companies - ACCA Response to the DTI' s Consultation Paper:* www.acca.co.uk/resources/technical/documents/stat-auditrequirements.htm [30 June 2001].

Andersen, D., Francis, J.R. and Stokes, D.J. (1993). Auditing, directorships and the demand for monitoring. *Journal of Accountancy and Public Policy,* 12 (Winter): 353-75

Baldacchino, P.J. (1992). The auditor-management relationship in a microstate perspective, MPhil thesis, Loughborough University Business School, Loughborough University, Loughborough.

Baxter, P. and Pragasam, J. (1998). Australian proprietary companies' demand for external auditing. *Australian Accounting Review*, May: 67-72.

Davison, I.H. (1980). Small companies - why a review is not the answer. *Accountancy,* March: 42-46.

De Gabriele, L. (2001). Towards the 21st century corporate culture for Malta. *The Accountant (Malta)*, September: 48-53.

Doublet, A. (1999). Special considerations in the application of International Standards on Auditing to the audit of small companies. *The Accountant (Malta),* January: 13-16.

English, J. (1978). Abolish the mandatory audit for the 'family company". *Accountancy,* May: 64-5.

Gunter, A. (2000). Audits plaudits. *Accountancy*, June: 75-6.

Hatherley, D. (1992). Can auditing work without a break with tradition? *Accountancy*, September: 85.

ICAA, Institute of Chartered Accountants of Australia (1995). Mum and Dad companies lose under new audit rules*. ICAA Queensland Bulletin*, October, Institute of Chartered Accountants in Australia: 14.

Jensen, M. and Meckling, W. (1976). Theory of the firm: managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics*, October: 305-60.

Jones, M.E. (1985). Small companies: the need to re-assess the statutory audit requirement. *The Accountant's Magazine*, January: 31-3.

Keasey, K. and Watson, R. (1993). *Small Firm Management: Ownership, Finance and Performance*, Blackwell, Oxford.

Keasey, K., Watson, R. and Wynarczyk, P. (1988). The small company audit qualification: a preliminary investigation. *Accounting and Business Research,* 18(72): 323-33.

Kent, D. and Sherer, M. (1983), *Auditing and Accountability*. Pitman, London.

Koh, H.C. and Woo, E. (2001). The auditor manager-expectation gap in auditing. *Managerial Auditing Journal,* 16(31): 76-88.

Laine, C. (1998). Helping members in business. *Accountancy*, January: 80.

Langard, P. (1999). A damaging grand gesture. *Accountancy Age*: June.

Mangion, G. (2001). Company audits: good value for money. *The Times Business (Malta)*, 26 July: 7.

Page, M.J. (1991). The auditor and the smaller company. In *Current Issues in Auditing*, Sherer, M. and Turley, S. (Eds). PCP: 275-86.

Seow, J.L. (2001).The demand for the UK small company audit - an agency perspective. *International Small Business Journal*, 19:2, January-March: 61-79.

Shaw, J. (1978). Why a review simply won't do. *Accountancy*, March: 79-81.

Singleton-Green, B. (1995). Time to abolish the big company audit? *Accountancy,* April: 76-7.

Stewart, D. (2000). Independent review: so what happens now? *Accountancy,* May: 148-9.

Wills, M. (1999). Adding it up just right. *Accountancy*, August: 48.

CHAPTER 4

Factors Contributing to Auditor Change Decisions in Malta [AUD-2]

Magri, J[1]. and Baldacchino, P.J.[1]

Managerial Auditing Journal

Vol 19, Issue 7, 2004 pp. 956-968

[1]University of Malta, Malta

Factors Contributing to Auditor Change Decisions in Malta

Magri, J. and Baldacchino, P.J.

University of Malta, Malta

Auditor changes are not alarmingly high in Malta but have been rising of late and the driving forces in this regard could be particular to a small-island state. This paper seeks to elicit the perceptions of behavioural, economic or other factors that influence auditor-client realignments in Malta. It does this mostly by a mail questionnaire responded to by 97 Maltese companies. Such findings were complemented by 15 interviews with companies that actually changed their auditor. The study concludes primarily that behavioural forces provide the principal motivators of auditor changes in Malta. Deterioration in the working relationship with the auditor and lack of accessibility feature as foremost concerns. Economic forces, albeit being important triggers of auditor changes, come only secondary in importance. Underlying this, there is evidence of differences in the attitudes of clients and non-clients of Big 4 audit firms as well as between small and. large companies.

Keywords : *Malta, auditors, auditing, employee turnover*

1. Introduction

As a tiny island state, with a population of around 400,000, Malta is heavily characterised by close interweaving personal relationships. Exchanges of information are affected amongst people who know each other. Therefore, confidentiality is even more difficult to maintain than in larger countries (Baldacchino,1992). Applying this scenario to the business environment, the concepts of checking and trust probably assume an increasingly important role in Malta, with the auditing function bearing magnified responsibilities towards the Maltese community. An auditor is clearly more prone to forsaking the fundamental principles of independence in an environment like that prevailing on a small island, where a predominant characteristic remains the strength of the behavioural relations between parties. The independent attitude, assumed integral to the exercise of the auditing profession, probably finds tougher barriers in such close-knit communities and these opposing forces generally affect issues, such as that regarding auditor changes, in particular ways, perhaps showing interesting contrasts when compared to the same phenomena in larger countries.

This paper deals with the factors leading to client-initiated auditor changes in Malta. Internationally, the concern of the profession and also of regulators with respect to client-induced auditor changes is not a novelty. They can be traced back to the recession in the eighties where the profession ended up with excess supply on the market and both opinion shopping by companies and aggressive fee negotiations became frequent. In response, auditors started to consolidate their positions through mergers and competitive pressures led to a shift in auditing focus from detailed examinations of systems transactions to high-risk areas and analytical reviews (Beattie and Fearnley,1998a,b). This environment was jeopardizing independence and there was general acknowledgment of the negative consequences which are triggered as a result of auditor-client realignments. Voluntary auditor changes could actually undermine the profession's credibility, in turn damaging the business sentiment in a country.

A study of such voluntary auditor changes in Malta was ,therefore, felt opportune in particular following the implementation of the more extreme audit disclosure requirements of the Companies Act 1995. This has led to the possibility of a more rigorous compilation of data by the regulatory authorities. In fact, statistics consulted through preliminary research for this paper pointed towards an increasing number of Maltese companies going through such auditor changes, although their frequency seemed to remain relatively low, possibly due to the environment outlined earlier. Therefore, the need became clearer to ascertain the nature of the factors that were increasingly inducing such changes to examine whether they provoked similar concerns. More generally, such a study could provide some insight into the different workings of the profession in small island states. Indeed, this paper sets out to identify such factors, both individually and under their diverse economic, behavioural and other characteristics.

In contrast to foreign conclusions, the results indicate that the factors that would induce most auditor changes are behavioural, rather than economic in nature and there is an evident demarcation between the attitudes of companies which are clients of Big 4 audit firms and those which are not. The paper is organized as follows. The following section reviews the relevant literature on the subject. The next section details the results and provides an in-depth discussion on the relevant findings and the final section summarises these findings and analyses any limitations met in conducting the study.

2. Literature review

The nature of factors that trigger auditor changes could be behavioural, economic or perhaps a mixture of the two. Literature tends to find mixed evidence of the importance of each category of factors within the auditor-change process. Beattie and Fearnley (1998a,b) allege that while behavioural factors are dominant when it comes to selecting an auditor, purely economic factors are the more significant drivers of change.

Various authors contend that one economic factor, the audit fee, is the most frequently cited reason for changing auditors, supporting the concern that exists regarding price-cutting in the auditing profession (Beattie and Fearnley,1995; Bedingfield and Loeb,1974; Woo and Koh, 2001). Fees precipitate change more often when they exceed "acceptable tolerance limits". Otherwise companies find that it is not worth going through a costly auditor change process as a reaction to a slight fee increase.

A major candidate of auditor changes is audit quality, which concerns the ability of the auditor to detect problems and breaches in the accounting system. Menon and Williams (1991) contend that quality serves as an important differentiating audit attribute and is heavily reliant on the perceived credibility that certain auditors bring to their engagements, based on their reputation. Audit quality incorporates components such as the size of the audit firm in question, its name brand, independence practices and level of expertise. When the management of a company has its incentives closely aligned with those of the owners of the company, there is reduced need for the attributes which differentiate one audit firm from another in terms of quality. This is so because agency costs are minimal and no extra effort needs to be taken in making management credible to potential investors. On the contrary, there are positive relationships between increased agency costs and auditor switching, with company owners always seeking the services of "better quality" auditors such that the monitoring of management's stewardship would be more effective (DeFond,1992). Indeed, auditor changes occur more frequently by companies employing non-Big 4 audit firms. Having more resources to provide a certain level of service, the larger audit firms are synonymous with better quality (Woo and Koh, 2001).

A highly sensitive issue concerns the qualification of the audit opinion. The belief that auditor switches are often effected to defy the main purpose of external audit may be unfounded (Knapp and Elikai,1988). Beattie and Fearnley (1995, 1998a, b) found that information suppression by management is the less common cause of auditor changes in the UK. The instances where qualified audit opinions may actually trigger auditor changes can be traced to cases where the qualification arose due to some matter of fundamental importance. Otherwise, it is not evident that companies shop around for a clean audit opinion (Woo and Koh, 2001). It is rather evident when qualified opinions are triggered by the conservative and all-too stringent treatment of auditing standards provokes auditor switching by companies (Krishnan, 1994). Despite these views, a very comprehensive study conducted by Krishnan *et al.* (1996) tested a two-way causation hypothesis between audit opinion and auditor switching and found evidence that audit opinion influences switching while switching also influences the opinion. Their arguments are upheld vigorously by two separate studies (Lennox, 2000, Lennox and Pratt, 2003) which found that when companies receive qualified audit opinions they are more likely to switch auditors, with such switching further increasing the probability of getting a better audit opinion. It is also becoming increasingly apparent post Enron that, as stated by Lennox and Pratt (2003), "companies do successfully engage in opinion shopping, swapping auditors to suit their narrow self-interest" (p.78). Smith (1986) further evidenced the successful elimination of "subject to" qualified audit reports by switching auditors. Successor auditor reports seem to fail to identify certain circumstances that could have effectively led to the qualification by the predecessor auditor in the first place. Obviously, the author contends that, in certain instances, a genuine difference of opinion could be the pertinent issue. A study focusing on auditor-client relationships in Malta also identified the phenomenon of auditor switching as being rather common on the island, with management tending to exercise a lot of influence on companies' owners to engineer an auditor change following a qualification or even the threat of one.

These reactions were found to be more common when the qualifications carried tax implications (Baldacchino,1992).

Disagreements over accounting principles could effectively trigger auditor changes. Income-decreasing accounting choices targeted towards minimising litigation risk by the auditor often characterise the last year with a predecessor auditor, while such discretionary accruals lose importance immediately in the first year of appointment of the new auditor (DeFond and Subramanyam,1998). However, according to Whisenant and Sankaraguruswamy (2000a,b,c), accounting disagreements account for only a minimal percentage of client-initiated auditor changes. This view supports earlier evidence by Beattie and Fearnley (1998a,b).

Multivariate studies have shown an association between the incumbent auditors' level of industry specialisation and longevity on the engagement with auditor changes. These auditor-related variables tend to have a net positive effect on clients' decision to retain their present auditor (Williams, 1988). In addition to such auditor-related issues, there are strong views that candidate determinants also include client-related variables. Johnson and Lies (1990) focus on clients' internal structures to support their argument. Williams (1988) acknowledges that when a client decides to change its financing channels, its investment portfolio or even its operating characteristics, it will move along the auditor's cost curve because the latter would then have to familiarise himself with the new environment of the client's business. This shift could mean a loss in the audit firm's competitive advantage with respect to that client, thus inducing a change in auditor. Indeed, factors relating to "structural changes" are major determinants of auditor changes (Whisenant and Sankaraguruswamy, 2000a, b, c).

A highly influential client-related variable is reputation influences. When a client perceives that, for some reason, he is receiving a tarnished reputation, one way to confront the issue would be to seek the services of a new auditor in the hope that management's faith in the monitoring of financial statements would be restored (Williams, 1988).

Other purely economic factors contribute towards auditor-change decisions. Companies often feel more comfortable if their auditors are approved by, and have a good relationship with, their bankers (Beattie and Feamley, 1998a,b). Moreover, when companies grow and exhibit a need for auditors who possess more technical competence, auditor realignments take place, often in favour of larger audit firms that are capable of offering a better-quality service (Beattie and Feamley,1995, 1998a, b; Whisenant and Sankaraguruswamy, 2000a, b, c; Woo and Koh, 2001).

The incidence and impact of qualitative behavioural factors have become increasingly deterministic in auditor-change decisions. Although the major determinants of auditor changes remain purely economic factors, other factors such as poor working relationships with the audit staff, personality clashes between company management and the audit staff and inaccessibility of the audit partner may also trigger switching moves (Addams and Davis,1994).

Other factors cited related to dissatisfaction with changes in the audit partners and with what they regarded as lack of consideration in setting meeting places and schedules, with the auditors always trying to make things comfortable for themselves (Beattie and Feamley, 1998a, b).

Beattie and Feamley (1998a,b) conducted an exhaustive study about auditor changes and the tendering process. Their findings impinge on the importance of characteristics, which are of a hybrid nature, in the auditor-client relationship. They found that nearly half of the reasons cited for change related to audit staff quality issues, with a major factor being that of excessive staff turnover within the audit firm they employed.

Other possible contributors of change have been identified as being changes in the company's top management (Woo and Koh, 2001), and the use of inexperienced audit staff. In addition to changes in management composition. Woo and Koh (2001) also identified a lower diffusion of ownership, having defined this as the level of common stock held by the largest single shareholder, as a major determinant of auditor changes.

3. Research methodology

3.1 Research instruments

The main research tool adopted was a mail questionnaire. This was divided into three sections. The first section sought to extract any relevant respondent company demographics. The second section featured a list of 27 statements, 25 of which put the respondents into situations that could arise independently of each other, in their relationship with their present auditors. Respondents were asked to place themselves on an attitude continuum, running from very important, fairly important, slightly important to not-at-all important, represented by numbers 1-4, respectively, according to how much they believed the particular situation would affect them in an eventual decision to change their auditor. The third section sought to establish whether any respondent companies had changed auditor and the reasons triggering such changes, if any.

In addition, these findings were complemented by comments received from 15 companies that had actually filed a change in auditor with the Registrar of Companies at the Malta Financial Services Authority between 1998 and 2002. The interviewees were the first to both appear in the records made available by the Malta Financial Services Authority, and to accept to be interviewed. They were asked to give their viewpoints as to why their company had effected such a change in auditor.

3.2 Sample selection and empirical data collection

A random sample of 250 companies was selected for the purposes of this study. It was categorised into three company size brackets, these being: small, defined as companies having 10-49 employees; medium, having 50-249 employees and large, having 250+ employees. This sample was extracted from the business registry list at the National Statistics Office, featuring all 1,562 active companies employing more than ten employees as at the date of the study.

The questionnaires were mailed out and the responses were duly inputted into a coding frame that yielded a two-way matrix of variables versus respondents. These results were then subjected to a statistical analysis using the SPSS package, version 10.0 for Windows.

3.3 Response rates and participant demographics

Valid responses from 97 companies were received by the cut-off date set, representing a response rate of 40 per cent.

Most (55/97 or 57 per cent) of the respondent companies had Big 4 firms as auditors, while the rest (42/97 or 43 per cent) engaged other auditors. Respondents were 41/97 (42 per cent) in the 10-49 employment bracket, 19 of which had changed auditor; 30/97 (31 per cent) in the 50-249 employment bracket, eight of which had changed auditor and 26/97 (27 per cent) in the 250 + employment bracket, nine of which had changed auditor. Most of the auditor-changing respondent companies were therefore in the smallest employment bracket (19/36 or 53 per cent).

4. Research findings

Table 1 presents the auditor-change factors tackled in this study, in the descending order of importance, according to the rating total given by respondent companies. It identifies factors such as behavioural, economic or other, the latter comprising a mixture of the two. The test statistics (*p*-values) obtained from the analysis with respect to the difference in responses in relation to company sizes and type of auditor engaged by the surveyed companies are also presented.

The most important factors presented by the survey were both behavioural and possibly related. These were the deterioration of the relationship between client and auditor and the auditor being rarely accessible. Interestingly, these findings stood irrespective of company size or type of auditor.

In the interviews, some small company interviewees referred to this actual deterioration in the working relationship as having taken place in their case when their auditor was a Big 4 firm. One such director referred to being treated as a stranger and not even known by name.

> "I was too small fry for them and I decided there and then to change auditors and go to a non-Big 4 firm."

However, clearly lack of attention was not attributable to Big 4 firms dealing with small companies. Another interviewee, this time of a medium-sized company, switched from a non-Big 4 firm to a Big 4 one with the hope of acquiring a better accessibility with the new auditor.

On the other hand, the third most important factor in inducing auditor-change decisions was an economic one. Should an auditor lack reporting timeliness, taking a long time to submit reports to clients and more importantly to the regulatory authorities, this would adversely affect the relationship with his client, increasing the probability of a severance in the relationship. In this context it was pointed out by some interviewees that auditor timeliness was important particularly because of the possibility of the imposition of fines by the regulator.

The next ranked factor, which was neither purely economic nor behavioural, related to the use of inexperienced audit staff in the completion of an audit. The analysis showed a significant difference in response to this factor among

Table 1. Ranking of factors contributing to auditor-change decisions

Ranking [Rating total]	**Factor category**	**Factor**	**Test statistics (*p*-values) in relation to: Company size**	**Test statistics (*p*-values) in relation to: Type of Auditor**
1. [116]	Behavioural	The working relationship with the auditor deteriorates substantially	0.331	0.330
1. [116]	Behavioural	The auditor is rarely accessible	0.606	0.400
3. [126]	Economic	The auditor lacks reporting timeliness and often takes too long to submit final reports to the client and to the regulatory authorities	0.735	0.197
4. [143]	Other	The auditor makes use of inexperienced audit staff to complete work on the audit	0.356	0.039*
5. [179]	Economic	The company has its operations spread over a number of countries. The directors feel the need to have an auditor with a global reach in terms of good contacts with foreign audit firms that have offices in the same countries as the company's operations	0.088	0.207
6. [181]	Economic	The company grows and the directors feel the need to have a more technically competent auditor	0.386	0.078
7. [186]	Economic	The client notices a difference in the conduct of the audit; the engagement is mostly done at auditor's offices and audit staff rarely visit client's premises	0.454	0.446

Table 1
(Continued/ 2)

Ranking [Rating Total]	**Factor Category**	**Factor**	**Test statistics (*p*-values) in relation to: Company Size**	**Test statistics (*p*-values) in relation to: Type of Auditor**
8. [191]	Economic	The client notices that the auditor is spending less time on his audit	0.901	0.295
9. [193]	Economic	The auditor informs the client that he will raise the audit fee above the current level or above the level that would have been pre-negotiated with the client, which latter increase the client finds acceptable	0.034*	0.029*
10. [201]	Economic	The auditor, despite being the reasonable sort, will have to qualify his audit opinion. The client disagrees because he has a different opinion over various technical accounting matters. They are both right in their arguments	0.861	0.772
11. [202]	Economic	The client becomes aware of other auditors who have more specialized knowledge of the industry in which the client company operates	0.454	0.442
12. [205]	Economic	The client disagrees with the auditor over accounting issues	0.641	0.436

Table 1
(Continued/3)

Ranking [Rating total]	Factor category	Factor	Test statistics (*p*-values) in relation to: Company Size	Test statistics (*p*-values) in relation to: Type of auditor
12. [205]	Economic	The client disagrees over the audit opinion; the auditor says he will qualify his audit opinion; he will do so because he is too conservative and follows auditing standards very strictly. The client is aware that there are more reasonable auditors who would not qualify their opinion under similar circumstances	0.087	0.509
14. [210]	Economic	The client becomes aware that his auditor does not have a very good relationship with the client's bankers	0.122	0.758
15. [213]	Economic	The company faces a merger with another company. The move necessitates the provision of audit services by a group auditor	0.332	0.013*
16. [217]	Behavioural	There are evident personality clashes between key management in company and present auditor	0.095	0.811
17.[218]	Economic	The audit fee client is charged is relatively low, but auditor highly inflates the charges on other non-audit services he offers the client, such as corporate financial advice	0.895	0.105
18[226]	Other	The audit firm has a high turnover of audit staff	0.192	0.362

Table 1
(Continued/4)

Ranking [Rating total]	**Factor category**	**Factor**	**Test statistics (*p*-values) in relation to: Company Size**	**Test statistics (*p*-values) in relation to: Type of Auditor**
19. [228]	Other	The company undergoes changes in senior management in the finance function. The directors are aware that the new management does not get on well with the present auditor	0.091	0.126
19. [228]	Economic	The client is of the opinion that the audit fee he is currently charged is too high. However, the auditor makes it very clear they will not negotiate lower fee	0.046*	0.017*
21. [231]	Behavioural	Within the audit firm the client engages, there is a change in the audit partner who normally takes responsibility for the engagement	0.001*	0.003*
22.[242]	Economic	Client feels need to have a Big 4 audit firm because he believes that name is synonymous with better quality of reporting	0.000*	0.000*
23. [245]	Economic	The client is aware that his major competitor company also engages his auditor	0.130	0.331
24.[253]	Economic	The auditor carries out the audit at the end of the financial year and does no interim audits	0.069	0.153
25.[263]	Behavioural	Audit firm client engages at present merges with another firm	0.866	0.374

Note: *Company size and/or type of auditor significantly affect the attitude towards the auditor-change factor concerned at $p < = 0.05$

respondent companies depending on whether their auditor was a Big 4 firm or not. In the case of companies with Big 4 auditors, the importance awarded to this factor was significantly higher.

Some interviewees also referred to the factor of inexperienced staff. They explained that this was particularly relevant in the case of Big 4 auditors because of the continuously higher turnover of staff such firms underwent. One interviewee claimed that his company had switched from a Big 4 to a non-Big 4 firm because repeatedly every year completely new audit staff was assigned to his company and needed to be "shown the ropes".

The issue of company expansion has evident consequences upon auditor retention by clients. The next two factors, purely economic, both related to this, regard the need to have an auditor with a global reach and the need to have a more technically competent auditor in view of company growth. Divergent views between the larger companies, these being clients of Big 4 audit firms in their majority and the smaller companies were evident in relation to both factors.

Two other quality-related issues, in addition to the third ranked factor of timeliness referred to earlier, were referred to by the next two ranking factors: where the visits by the auditor to the client companies are rare and where the client notices that the auditor is spending less time on the audit.

Surprisingly, it was at this point, according to the survey, that the first fee-related factor, that of the auditor raising the fee level above the acceptable pre-negotiated one, was considered. The second fee-related factor – that of the auditor wanting to retain his current high fee – was even much lower in the ranking list (19th). For both factors, significant differences of company size and type of auditor were found. Large companies clearly gave both factors less importance than medium and small ones. In addition, companies with Big 4 auditors also gave significantly less importance to these factors. Moreover, the only three interviewed companies that had changed auditor because of the fee level were all, in fact, small. According to one of them the Big 4 status of his auditors was not worth the price asked: "I decided not to pay for the sake of the name".

Next in the ranking list (10th) came a factor related to the sensitive issue of opinion shopping. This was the eventuality when a disagreement over the audit opinion arises between the client and auditor where, despite the auditor being the reasonable type, the client fully believes that his own arguments hold and will not accept a qualification. Another aspect of opinion shopping was tackled through a related factor, this being the circumstance where a client does not accept a qualification owing to his belief that the auditor is not reasonable but is in fact conservative in applying auditing standards. No significant differences were noted in the responses overly given by the companies surveyed to these two factors.

Following the above analysis, respondents ranked a number of economic factors towards the middle of the list. Apart from the factor relating to the audit fee level, ranking 19th, which was referred to previously, none of the other factors exhibited significant differences in responses according to company sizes and type of auditor engaged by the respondents. Such factors included situations where clients become aware of auditors with more specialised knowledge of the industry in which they operate, where disagreements over accounting issues arise and where the client becomes aware that the auditor and the banker do not share mutual respect. On an island where the bank is sought continuously and is often the sole provider of financial support to companies, a mid-ranking for this latter factor proved rather surprising. Even the behavioural factor relating to personality clashes between key management in the company and the auditor emerged as a less important contributor of auditor-change decisions in Malta.

Where a client is aware that his audit fee is in actual fact being subsidised by other non-audit services s/he would not consider it as an overly important trigger for an auditor-change process. This situation ranked among the factors towards the lesser rankings of the list (17th). Such was the case with the next ranked factors relating to the audit firm having a high turnover of audit staff and the possibility that new senior management in the finance function of a company does not get on well with the present auditor. These factors, which are neither purely behavioural nor economic in nature, do not seem overly important as motivators of auditor changes.

Although not regarded by companies as an important contributor to auditor-change decisions, the behavioural factor where the person who usually assumes responsibility for a client's engagement changes exhibited noticeable, statistically significant divergencies in responses. The larger companies attributed less importance to this factor than did the smaller companies. Moreover, companies that engage non-Big 4 audit firms viewed the issue as being of more importance in inducing an auditor change than did the companies that are clients of Big 4 firms. These findings were complemented by the comments of one interviewee of a medium-sized company. He stated that his company changed its auditor because the incumbent had severed his relationship with one audit firm and they wanted to retain him as their auditor. To this effect they followed him to the new firm he joined.

Another three economic factors ranked next. Each of these factors cannot be regarded as an evident contributor to auditor-change decisions in Malta. However, there were some significant results.

One such factor is the perceived reputation of the Big 4 audit firms and thus the importance of assuming them as auditors. The need to have a Big 4 audit firm triggered significantly different views between the smaller and the larger companies. Smaller companies believed that this need would never compel them to change auditor whilst only a small minority of the larger firms would not give any importance to this need. Moreover, companies which are not clients of Big 4 audit firms awarded this factor less importance.

Another factor which, however, did not exhibit statistically significant results regarded the instance where clients become aware that their major competitors also engage their auditor. A small company among those interviewed reported that this factor provided the main impetus for its change in auditor. The company was the fruit of a demerger between two companies following clashes between proprietors. In view of the circumstances, it was decided that they would not retain the previous auditor simply because they could not afford to have their major competitors know anything about them.

A behavioural factor, directly related to the audit firm, tailed the ranking list The eventuality that the audit firm the client engages merges with another firm did not seem to affect the clients' decisions whether to retain their present auditors or not.

5. Discussion of findings

Behavioural concerns in the auditor-client relationship emerged as the dominant forces in Malta which could effectively trigger voluntary auditor changes. Irrespective of the size of companies and even of the type of auditor they would be engaging, a deterioration in the working relationship as well as accessibility to their auditor are important determinants of auditor-retention decisions.

Most likely, it is the fostering of a sound relationship with top company management which makes the major difference. Companies do not attach much importance to how middle management and other staff get on with the auditors. However, a less than stable relationship between senior management and auditors emerged in this study as the primary inducer of auditor changes in Malta.

Auditor accessibility as a primary motivator of auditor switching suggests that what clients expect from their auditors goes well beyond the mere rendering of annual attestation services. The expectation of management is for it to build a relationship with their auditors. The latter are expected to be responsive to queries without delay and to be available to provide their advice on the operations of the company which may concern matters apart from those related to the statutory audit.

The emphasis attributed to these behavioural factors indicates that underlying statutory audit services in Malta are personal relationships that play a major role in affecting auditor-change decisions. This is further evidenced by the finding that situations like the merging of audit firms do not particularly affect client companies. Perhaps these do not represent real threats to personal relationships that have been established already.

However, auditor-client relationships are still perceived somewhat in significantly different ways by small and large companies. Small companies tend to foster relationships with the auditor on a personal level. In contrast, large companies seem to be identifying their relationship more with the audit firm. In fact, small companies were found to be more prone to changing their auditors should the person normally assuming responsibility for the audit engagement changes. Therefore, their relationship seems to stand on a more "personal" level, while that of large companies takes on a more "corporate" form: they do not seem to view a personal change in the audit engagement partner as effectively jeopardising this all-important relationship.

Unlike studies to date in other countries already referred to (e.g. UK and Singapore), economic factors have been found here to be secondary in importance. Nevertheless, irrespective of size or type of auditor engaged, particular importance was attached to quality-related economic concerns such as reporting timeliness and the frequency of visits to client premises. Such issues affect companies' decisions as to whether to retain their auditors, irrespective of size or type of auditor engaged.

However, the way two other economic factors were ranked - reputation and audit fees - betrayed further differences between the different types of companies. Large and Big 4 associated companies tend significantly more to prefer to engage auditors with a reputation, probably as this is perceived to enhance their own standing in the eyes of the business community. On the other hand, other companies place much more importance to the level of audit fees, and issues related to disagreements over such a level tend to drive them more towards effecting auditor changes. Therefore, large and Big 4 associated companies are willing to pay an image-building premium, which other companies consider to be unaffordably expensive.

With respect to other factors leading to auditor changes, even here the large and Big 4 companies face a different scenario from the small ones. This is indicated particularly by their reaction to the possibility of facing inexperienced audit staff. The former, large type lead to a change in auditor. On the other hand, the smaller ones do not seem to face many problems in this direction. It could be that with small practitioners and non-Big 4 audit firms, despite having fewer members of staff, their staff turnover (even in Malta) is not as high and consequently not as disruptive as in the case of the Big 4 audit firms. Staff turnover definitely inconveniences client companies, with client staff having to spend more time to help in the introduction of the changing fieldwork. Auditors and clients might also be concerned about getting their practical share of quality and value for money. On the other hand, the concern of the smaller companies might be more that of maintaining a personal relationship with the auditor himself and audit staff turnover is probably rarely an issue.

Some of the salient characteristics emerging from this study help to explain the higher frequency of auditor changes in small companies. The major trigger of such changes could probably be traced to company growth. Changes in the circumstances of small company operations often lead to their expansion, thus triggering off the need for increased competence and expertise relating to financial matters. As a result the services of large audit firms may come to be preferred since the latter are often seen to be better equipped to handle growth and the ensuing specialized demands. At this point, small companies tend to seek the services of large audit firms since the latter possess the necessary resources to aid them in the pursuit of growth and to meet their more specialized demands.

In addition, the importance attached to the level of fees by small companies, taken together with the lack of importance which they attach to having a reputable audit firm, also point to the likelihood of higher frequency of auditor changes in their case. Small firms are probably more willing to substitute a decent fee level for a reputable image. Finally, the one-to-one personal type of relationship which small companies seem to prefer is also probably playing its part in increasing their auditor-change frequency.

6. Summary and conclusions

It can be concluded that while the culture of auditor changes is not so much ingrained within the business community in Malta, it exhibits characteristics which are very particular to this island state. Most definitely behavioural forces in the auditor-client relationship are pivotal when it comes to taking decisions regarding auditor retention.

Behavioural concerns feature across the whole spectrum of companies in Malta. Nevertheless, small companies tend to view these behavioural forces as attributes of a one-to-one relationship with their auditors. It would be blunt to say that they want their auditor to become their best friend, but actually it is the perception that they impart. Such close-knit relationships have to be safeguarded for the benefit of the small company community in Malta, which constitutes most companies on the island, and also have to be closely guarded and carefully monitored to preserve the profession's loyalty to independent issues.

Economic and other factors, despite being forces of auditor changes, tend to assume a role also albeit being secondary in importance. Particular economic concerns featuring predominantly within the ambit of small companies relate to fee issues and to the willingness of such companies to forsake quality and reputation for a more affordable fee. Large companies award more importance to actual audit-related factors when it comes to auditor-retention decisions. Therefore, they attribute due attention to quality levels and to the reputational aspects of their relationship with their auditors.

Understanding such intricacies will help give new insight to the auditing profession on the island. By carefully monitoring the factors inducing auditor changes, practitioners will become more aware of deficiencies in their relationship with their clients and this hopefully also helps in avoiding loss of clients. Moreover, regulators and supervisory authorities within the Maltese financial industry may also better elucidate the reasons behind such changes, thereby enhancing the credibility of the financial sector and the standing of the island as a reputable financial jurisdiction.

The results of this study are subject to a number of limitations. This study focuses primarily on the identification of factors that contribute to *voluntary* auditor-change decisions. However, auditor resignations are also prevalent in Malta. The viewpoints of professional practitioners themselves, whilst also being of utmost interest, do not form part of the material in this research paper.

This study is also directed towards companies which employ ten or more employees. A consideration of micro-sized enterprises employing fewer employees would have unnecessarily inflated the population under study. A realistic assessment of the situation of smaller companies in Malta will probably point to an informal and unique relationship with the auditor, justifying a study on its own.

References

Regulatory

Companies Act - Malta, 1995. Chapter 386 of the Laws of Malta

Other

Addams, H.L. and Davis, B. (1994). Privately held companies report reasons for selecting and switching auditors. *The CPA Journal*, 64(8): 38.

Baldacchino, P.J. (1992). The auditor-management relationship in a microstate perspective. MPhil thesis, Loughborough University Business School, Loughborough University, Loughborough.

Beattie, V.A. and Feamley, S. (1995). The importance of audit firm characteristics and the drivers of auditor change in UK listed companies. *Accounting and Business Research,* 25 (100): 227-39.

Beattie, V.A. and Feamley, S. (1998a). Auditor changes and tendering - UK interview evidence. *Accounting, Auditing and Accountability Journal*,11(1): 72-98.

Beattie, V.A. and Feamley, S. (1998b). Audit market competition: auditor changes and the impact of tendering. *British Accounting Review*, 30(3): 261-89.

Bedingfield, J.P. and Loeb, S.E. (1974). Auditor changes - an examination. *Journal of Accountancy*,137(3): 66-9.

DeFond, M.L. (1992). The association between changes in client firm agency costs and auditor switching. *Auditing: A Journal of Practice and Theory* 11(1): 16-31.

DeFond, M.L. and Subramanyam, K.R. (1998). Auditor changes and discretionary accruals. *Journal of Accounting and Economics*, 25(1): 35-67.

Johnson, W.B. and Lies, T. (1990). The market for audit services: Evidence from voluntary auditor changes. *Journal of Accounting and economics*, 12(1-3): 281-308.

Knapp, M.C. and Elikai, F. (1988). Auditor changes: a note on the policy implications of recent analytical and empirical research. *Journal of Accounting, Auditing and Finance*, 3(1): 78-86.

Krishnan, J. (1994). Auditor switching and conservatism. *Accounting Review*, 69(1): 200-15.

Krishnan, J., Krishnan, J. and Stephens, R.G. (1996). The simultaneous relation between auditor switching and audit opinion: an empirical analysis. *Accounting and Business Research*, 26(3): 224-36.

Lennox, C. (2000). Do companies successfully engage in opinion shopping? Evidence from the UK. J*ournal of Accounting and Economics*, 29(3): 321-37.

Lennox, C. and Pratt, K. (2003). *Opinion shopping and the role of audit committees when audit firms are dismissed: The US experience*. Edinburgh: Institute of Chartered Accountants of Scotland.

Menon, K. and Williams, D.D. (1991). Auditor credibility and initial public offerings. *Accounting Review*, 66(2): 313-332.

Smith, D.B. (1986). Auditor subject to opinions, disclaimers, and auditor changes. *Auditing: A Journal of Practice and Theory*, 6(1): 95-108.

Whisenant, S. and Sankaraguruswamy, S. (2000a). Evidence on the auditor and client relationship: what can be learned from reasons reported by by managers for changing auditors. Working paper (September 2000c). Georgetown University:

http://papers2.ssrn.com/sol3/search [17 July 2002].

Whisenant, J.S. and Sankaraguruswamy, S. (2000b). Evidence on whether disclosures by managers about auditor-client friction are related to changes within and across quality levels. Working paper (September 2000c). Georgetown University:
http://papers2.ssrn.com/sol3/*search* [17 July 2002].

Whisenant, J.S. and Sankaraguruswamy, S. (2000c). Evidence on whether disclosures by managers about auditor-client friction are related to changes in either quality levels or size (for lateral-quality level realignment). Working paper (September 2000c). Georgetown University:
http://papers2.ssrn. com/paper.taf?ABSTRACTJD = 244228 [17 July 2002].

Williams, D.D., (1988). The potential determinants of auditor change. *Journal of Business Finance & Accounting*, 15(2): 243-261.

Woo, E.S. and Koh, H.C., (2001). Factors associated with auditor changes: a Singapore study. *Accounting and Business Research*, 31 (2): 133-44

CHAPTER 5

Jurors' and Self-perceptions of the Statutory Auditors in Malta

[AUD-3]

Desira, J[1]. and Baldacchino, P.J.[1]

Managerial Auditing Journal

Vol 20, Issue 7, 2005, pp. 691-706

.

[1]University of Malta, Malta

Jurors' and Self-perceptions of the Statutory Auditors in Malta

Desira, J. and Baldacchino, P.J.

University of Malta, Malta

The objective of this paper is to find out and compare perceptions of the audit profession by jurors with those of auditors themselves in the small island-state of Malta. The objective is achieved by considering auditor responsibility, the reliability of audited financial statements and the decision usefulness of audited financial statements. A mail questionnaire was responded to by 56 auditors and 18 jurors, with the latter response being complemented by a further 100 jurors responding to the questionnaire when delivered by hand. The study finds substantial divergences in the perceptions of the two respondent groups, particularly in the areas of fraud detection, responsibility for the internal control structure of a company, maintenance of accounting records, and actual work performed by an auditor. In addition, a particular trend in Malta is the high regard with which both respondent groups held the audit profession. Limitations included the size of the sample of potential jurors taken when compared with the actual potential juror population of Malta, and the original low mail response rate from the jurors group. Given the increase in recent years of the number of litigation cases against auditors and the particular need for the profession to restore public confidence in it, it is imperative for auditors to become more aware of how public perceptions differ from theirs.

Keywords : *auditors, perception, Malta, auditing*

1. Introduction

Given the recent collapse of large companies such as Enron and Parmalat, the cases of litigation against auditors are increasing. Since the general public forms the juror pool, the primary factor in determining the outcome of any litigation against the auditor is the mindset of the jurors who sit in judgment during cases of litigation, and represent the mindset of the general public itself. There exists the possibility of the existence of a divergence in perception as to the auditors' role, as well as differences in general attitudes towards auditing. It is therefore becoming increasingly important to know more about any gaps, where existent, so that the auditor would be in a position to better present his/her case in a court of law.

In a study conducted by Bates (1989) in the UK, it was found that the general public was not very familiar with the auditing profession. Fewer than one in ten claimed that they knew at least a fair amount about auditing. The results showed that the majority believed that an auditor was responsible for detecting fraud of all kinds whilst three in five held the belief that the auditor was responsible for actively searching for fraud. Pany (1992) conducted a similar study in the US to determine how jurors, representing the general public, perceived the audit function. From the data collected, Pany concluded that a gap existed. Jurors expected more from the auditor than the auditors believed they should provide. Such results have implications on any auditor-defendants during cases of litigation.

In Malta, the Maltese Companies Act 1995 (the 1995 Act) is clear as to what should be the end result of an audit. The auditor is responsible for drawing up a report, being a manifestation of his/her opinion on the financial statements of the company. The 1995 act specifically states (Section 179) that the report represents the auditors' opinion as to whether the annual accounts are in accordance with the relevant legislation and show a true and fair view. With reference to the work to be performed when drawing up the report, the 1995 act requires an auditor to perform any tests, which enable him/her to determine that proper records have been kept. This means that the auditor is not required by law to go through all the data. If sufficient confidence on the accounting information can be obtained from a sample of the data, the auditor could take that sample as the basis of his/her evidence.

One should note that Section 176(1) of the Companies Act 1995 gives the responsibility for a company's financial statements to the directors. The board of directors approves and signs the financial statements to be presented at the annual general meeting.

From a Maltese law perspective, the role of the auditor is to draw up an audit report giving his/her opinion as to the truth and fairness of a company's financial statements, whilst going through as much evidence as he/she deems fit in order to have a basis for the opinion given.

The purpose of this study is to determine whether there is any divergence of perceptions between Maltese jurors and external auditors. This includes the consideration of any possible effects of Malta being an island on such divergences. The objectives are to find out and compare how jurors perceived the audit profession with what the auditors themselves perceived. This is achieved by considering auditor responsibility, the reliability of audited financial statements, and the decision usefulness of audited financial statements.

The remainder of this paper is divided into four main sections. The first section presents relevant literature to highlight the role and function of the auditor. This is made by reference to the act, International Standards on Auditing, as well as findings of prior research related to the study. The second section discusses the methodology used in the study. The results of the study are presented in the third section. The fourth section consists of the limitations encountered during the conduct of the study and presents a conclusion and summary of findings.

2. Literature review

2.1 The expectations gap

Before one can determine whether there exists a difference in perception regarding the Maltese auditor, one should have an understanding of the components of the expectations gap. The expectations gap may be divided into two components: the requirements gap and the feasibility gap.

The requirements gap is due to a gap between the auditors' actual standard of performance and the performance required of them by the public. This gap can be further subdivided into the performance gap and the standards gap. The performance gap occurs due to a difference between the actual standard of performance and the standard of performance determined by reference to professional standards and statutes. The standards gap can be defined as the difference between the standard of performance as determined by reference to professional standards and statutes, and the public's required standard of performance.

The feasibility gap refers to the gap between the public's required standard of performance and various public expectations. For example, believing that auditors are responsible for the preparation of financial statements falls within the feasibility gap.

The expectations gap was often seen as the result of the public not understanding the function and nature of auditing, as well as having unreasonable expectations. Educating the public, typically through the audit report, became important. D.M. Nally, chairman of PricewaterhouseCoopers (PwC), announced in March 2003 that the firm was working to close the expectation gap by delivering a high-quality audit. This was to be achieved by auditors going beyond standards. For example, auditors should expand the requirements to include audit procedures to detect significant fraud. PwC aimed to go beyond the traditional corporate reporting model, with the aim of providing more access to information that was subject to audit procedures and to enhance the transparency and completeness of disclosures. Hatherly *et al.* (1991) examined whether an expansion of the audit report could shift the perception of the user. The results showed that the expanded report changed reader perception. Such an expanded report had a halo effect by giving a sense of well-being that influenced other dimensions not directly addressed by the expanded wording of the report. Although not reducing the expectation gap per se, it was suggested that the auditing profession should address this issue by using expanded reports to dampen expectations. Schelluch (1996) found corroborative evidence, in that the expectation gap detected in prior research studies appeared to have been reduced over time by introducing the long-form audit report.

Another point of view was that the expectation gap was considered a result of the time lag between new demands on the profession and actually adjusting to them. For example, research done by Ernst & Young in the US in 2002 suggested that over 35 per cent of all investment decisions made by fund managers were made on non-financial performance factors. The public was requesting a wider assurance function to cover not just the financial factors, but the entire scorecard of an organisation. This assurance had yet to be given.

2.2 The auditor's role as defined by jurors

The Australian Educational Research Pty Ltd (2003) believed that many members of the public expected that:

- auditors should accept prime responsibility for the financial statements. They should "certify" financial statements;
- a "clean" opinion guaranteed the accuracy of financial statements, and that auditors performed a 100 per cent check of the accounting data; and
- auditors should give early warning about the possibility of business failure; and
- audits were supposed to detect fraud.

In a study conducted in the UK by Bates (1989), it emerged that the general public was not very familiar with the auditing profession. Fewer than one in ten (10 per cent) claimed to know at least a fair amount about auditing. Two in five (40 per cent) had no idea what proportion of a company's financial transactions an auditor generally checked. A total of 27 per cent believed that auditors generally check over 90 per cent of a company's transactions. Three quarters (75 per cent) believed that it was an auditor's responsibility to detect frauds of all kinds and three in five (60 per cent) believed it was an auditor's responsibility to actively search for fraud.

Hanks (1992), a senior researcher for the Consumers' Association in the UK, said that it was of vital importance to improve the public's understanding of the present role of auditors. As an example Hanks cited how small investors relied on the auditors' report. Such investors usually felt misapprehensive of the status of the report, the nature of audited financial statements, the type and extent of work undertaken, as well as the level of assurance provided by auditors. It was a common misconception of the general public to believe that an unqualified auditors' report implied that the figures were absolutely accurate or that there was no fraud and/or irregularity

2.3 The auditor's role as defined by professional standards

International Standard on Auditing (ISA) 200 states that the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework (IFAC, 2003b). The standard further states that although an unqualified opinion to the financial statements enhances the credibility of the financial statements, the public cannot assume that the report was anything but an opinion on the financial statements. For instance, from an auditor's report, one cannot deduce the future viability of the entity or whether management was being effective in how it conducted the affairs of the entity. An audit is designed to provide reasonable assurance that the financial statements are free of material misstatement, resulting in the auditor being responsible for forming and expressing an opinion on these statements. ISA 200 gives the management of the entity responsibility for preparing and presenting the financial statements.

In respect of fraud and error, ISA 240 states that an audit conducted in accordance with the International Standards on Auditing is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement. The audit may act as a deterrent, but the auditor is not, and cannot, be held responsible for the prevention of fraud and error (IFAC, 2003c).

Regarding auditor responsibilities, the Code of Ethics issued by the International Federation of Accountants - IFAC (2003a) holds the same view. The code states that the aim of an audit engagement should be to provide a high level of assurance that the financial statements are free from material misstatement.

Although the standards guiding the profession define the auditor's role, members of the profession believed that the public expected otherwise of them. The terms "reasonable expectation" and "material misstatements" play a large part in the gap between the expectations of the public and that of the auditors. For example, when considering fraud, detection by the auditor of material misstatements can be difficult or even highly unlikely. Foulds (1998) explained that the current business environment made detection always more difficult. Commerce was becoming increasingly international with transactions spanning several jurisdictions. Technological change had resulted in the "paperless office". According to Foulds such developments had made the potential for cover-ups enormous. On the other hand, Foulds believed that the public still held the auditor responsible for finding all misstatements, irrespective of the efficiency effect of such a task on the audit process.

When asked whether the general public had an accurate definition of what the auditors' role was, James E. Copeland Jr, CEO of Deloitte & Touche, said that there was a vast misunderstanding and expectations gap between what was possible for auditors to do and what the public believed they should do (Heffes, 2002). He asserted that it was not a question of what auditors were actually doing, but whether it was even possible to meet the public's expectations. He believed that it was not possible for auditors to meet the public's expectations. Copeland suggested that the business press had a responsibility to help in educating the public about the limitations of even a well-performed audit. Flint (1988) said that the public's expectation of auditors was important. The audit performs a social function owing to investigations and reporting on achievement by means of standards or criteria of accountability set by society. Flint believed that an auditor should interpret the meaning dynamically, and thus the expectation, of the audit requirement. In the same document, Lee stated that the role of an auditor could be determined from a mix of legally and professionally prescribed standards of auditor behaviour within a framework of changing public expectations.

When defining the auditors' role, there seems to be a difference of opinion within the auditing profession itself. This phenomenon could be the result of a lack of transparency. Although audits enhance the transparency of companies to interested parties, the audit process and findings themselves are not transparent.

2.4 The effect of divergences between perceptions

The Cohen Commission (1978) considered whether a gap existed between what the public expected or needed and what auditors could and should reasonably be expected to accomplish. The commission found that users generally had reasonable expectations of auditors' abilities and the assurances they could give. The gap was more a result of the professions' failure to react and evolve rapidly enough to keep pace with the changing environment. This resulted in legislation trying to diminish the expectation gap. The European Commission's (EC) green paper (COM, 1996) arrived to the conclusion that any definition of the statutory audit should consider the needs and the expectations of users to the extent that they were reasonable, as well as the ability of the statutory auditor to respond to those needs and expectations. Without the existence of a common definition of the statutory audit in the EU, a damaging gap might be created.

The problem areas included detecting and preventing fraud and error, warning of business failure, guaranteeing the accuracy of the accounting content of verified financial statements, and judging the efficiency and adequacy of corporate operations and management.

Pany (1992) found that US jurors had a large expectation gap towards the audit profession. Owing to the jurors' importance in determining the outcome of any litigation against auditors, this was a worrying proposition. The presence of a performance gap meant that professionals needed to conform to statutory requirements. These standards should not create a standards gap themselves. The standards had to anticipate the feasible demands of society, as handed down in common law decisions. If jurors did not have adequate standards to act as guidelines, incorrect judgments would be passed. The feasibility gap could influence the jury's decision. Society could be placing unrealistic demands for accountability. The jury could not have the required education in auditing to realise that the existing professional standards were adequate from an auditor's point of view.

Best *et al*. (2001) found a similar expectations gap in Singapore. This phenomenon was particularly apparent when considering the level and nature of the auditor's responsibilities.

3. Research methodology

3.1 Research instrument

In view of the large population involved, a mailed questionnaire was considered to be the most appropriate research tool. The questionnaire consisted of two sections. The first section collected background data on the survey participant, mainly whether he/she had prior accounting knowledge and experience and his/her current occupation. This data was then used to determine any possible effect on juror perception. The second section contained 21 semantic differential belief statements. These statements helped measure three factors:

(1) Auditor responsibility.
(2) Reliability of audited financial statements.
(3) Decision usefulness of financial statements.

These three factors helped create the perception of the Maltese auditor from both the jurors' and auditors' points of view.

The questionnaire consisted of adjectival statements marked by seven-point Likert scales. Respondents had to choose a number from the scale that identified their level of agreement with the statement. Statements 1-10 related to auditor responsibility, statements 11-17 to the reliability of the audited financial statements and statements 18-21 related to the decision usefulness of financial statements.

After the 21 statements, the questionnaire provided enough space for any comments the survey participant could have.

The same questionnaire was sent to both auditors and jurors. The purpose of this was to ensure comparability of replies.

3.2 Sample selection and response rates

The electoral register was utilised to create a random sample of 100 potential jurors who were mailed the questionnaire. To take into consideration the exempt groups, these being members of parliament, police and the armed forces, any person falling within the exempt categories was disregarded during the sample creation stage. A further 100 questionnaires were delivered by hand on two specific dates from City Gate, Valletta.

To maintain the same tolerance levels for the two groups' replies, a sample of 100 warranted Maltese auditors was chosen. The latest warrant holder list as provided by the Accountancy Board (n.d), the Maltese accountancy profession regulator, was used to obtain the addresses of a random number of auditors, either sole practitioners or working with an audit firm, to be able to mail them the questionnaire.

The two participant groups had considerably different response rates. For the jurors, a response rate of 18 per cent was achieved. Together with the 100 questionnaires delivered by hand there were a total of 118 valid questionnaires. In the case of the auditors, the response rate was of 56 per cent.

4. Results and implications

4.1 Juror group demographics

From the valid responses received, seven major occupational categories were determined. These categories are listed in Table 1. The remaining professions were included in the miscellaneous group so as to facilitate data analysis. The variety of occupations meant that respondents came from different backgrounds, minimising the risk of bias in respondent perceptions.

The respondents' occupational experience was spread over a range of years. A total of 25 per cent of respondents had been in their current occupation for one to five years, with the remaining 75 per cent being spread over the 6 to 10,11 to 15 and over 16 year brackets respectively.

The years of experience within an occupation served as an indication of the approximate age of the respondents. The results showed that the sample was indicative of most age groups found within the Maltese society who might be called upon to serve as jurors.

When asked whether they had any accounting qualifications, 19 per cent said that they had either ordinary level, intermediate level, advanced level or another higher qualification. Although imparting to their holders an introductory understanding of accountancy, such qualifications do not necessarily mean that their holders know enough about the auditor's role.

Respondents with accounting qualifications were not expected to rate statements in a significantly different way from participants with no accounting qualification. This was supported by means of cross-tabulation by utilizing the Chi-squared test. Only when ranking the statement of whether the audited financial statements were useful for making decisions did qualifications have a statistically significant influence on the result. Regarding accounting experience, nearly 18 per cent of the survey participants said that they had some sort of experience.

Table 1

Occupation of juror group participants

Subject group	Responses received
Clerk	10
Housewife	8
Managing director	5
Secretary	4
Student	8
Teacher	4
Technician	4
Miscellaneous	75
Total	118

Out of the 21 respondents with accounting experience, around 66 per cent had ten years or less experience and only a minority (29 per cent) had any formal accounting qualification. Owing to the low proportion of respondents with accounting qualifications and experience, there could have been a lack of understanding of the actual financial statements, thereby increasing any possible divergence in the perception of the Maltese auditor between jurors and auditors.

4.2 Auditor group demographics

The auditor group participants came from a variety of positions within audit firms and also included sole practitioners. Table 2 shows the frequency of each position. The sample was representative of various positions within the audit firm. Apart from this, nearly 20 per cent were sole practitioners. Owing to the variety in work positions, the perception of the Maltese auditor derived from the answers was representative of the Maltese auditor population. Regarding the respondents' experience within their current grade, nearly 60 per cent had one to five years experience, 14 per cent had six to ten years, 10 per cent had 11 to 15 years, whilst 16 per cent had over 16 years experience. The high percentage of respondents from the one-to-five year experience bracket probably mirrored the situation of the auditing profession in Malta. In recent years, a larger number of people entered the auditing profession than was the case in prior years. However, it was found that the respondent's experience in his/her current grade did not seem to have a major impact on his/her answer.

The participants were from a variety of educational backgrounds. These consisted of either a university degree, primarily bachelor of accountancy [Hons] (35.71 per cent) or its predecessor BA [Hons] in accountancy (17.86 per cent), Malta Institute of Accountants qualification (3.57 per cent) or an ACCA qualification (42.86 per cent).

Table 2

Position of auditor group participants

Occupation	Responses received
Audit manager	3
Auditor	29
Consultant	2
Partner	8
Sole-practitioner	11
Senior auditor	1
Senior manager	2
Total	56

In view of such a variety in educational background one could consider negligible any potential bias within the auditors' perceptions created by the participants' prior educational experience.

All auditors within the sample said that they had prior accounting experience. This experience varied along the same categories as for experience in their grade, with most having up to five years accounting experience. Auditors were clearly very well informed about the uses of the financial statements and were in a better position to consider the questionnaire statements from an auditing point of view rather than let themselves be sidetracked due to accounting issues. Therefore, any possible divergences with the perceptions of the juror group became more apparent.

4.3 Perceptions on auditor responsibility

After performing the Mann-Whitney U-test to check for statistical differences between the respondent groups' means, it emerged that jurors and auditors had both similar as well as different perceptions of what constituted an auditor's responsibility (Table 3).

4.3.1 Perception differences.

The two respondent groups had six major differences in perceptions regarding auditor responsibility. The largest (p = 0) of these was that jurors perceived the auditor as responsible for maintaining a client's accounting records. It was interesting to note that jurors agreed that management should be responsible for producing an entity's financial statements, but that these would be drawn up from accounting records maintained by the same auditor who audited the financial statements. Auditors strongly disagreed with this statement. The Code of Ethics issued by the International Federation of Accountants (IFAC, 2003a) states that auditors have an obligation to identify potential threats to independence and take appropriate action to eliminate them. If the auditor maintains the accounting records, such a threat would have been created. Such juror perception could be due to the fact that, although the Code of Ethics states otherwise, some sole practitioners in Malta do maintain such records for their client. Owing to the small

Table 3

Auditor responsibility statements

	Jurors		Auditors		
Auditor responsibility	**Mean**	**St Dev**	**Mean**	**St dev**	**p-value**
The auditor is responsible for maintaining accounting records.	4.46	2.26	1.07	0.32	0.000*
The auditor is responsible for detecting all fraud	4.82	1.92	1.63	1.18	0.000*
The auditor is not responsible for preventing fraud	3.64	2.09	5.61	1.95	0.000*
The auditor is responsible for the security of the internal control structure of the company	4.14	2.06	1.84	1.52	0.000*
The auditor is responsible for checking every client transaction	3.40	2.08	1.39	0.85	0.000*
The auditor does not have a say in the selection of audit procedures	3.61	2.08	1.55	1.23	0.000*
Management has responsibility for producing the financial statements	5.27	1.95	6.21	1.82	0.000*
The auditor is responsible for giving a guarantee of the long-term survival of the company	3.75	1.94	1.57	1.25	0.000*
The auditor is unbiased and impartial	5.62	1.55	6.29	1.26	0.002*
The auditor performs his duties efficiently and effectively	5.75	1.33	6.07	1.41	0.047*

Note: *Mean values significantly differ from one another at $p < 0.05$; Std Dev. means standard deviation

size of most Maltese companies, such an arrangement is more than welcome, even at the expense of possibly compromising the auditor's independence.

An area with considerable differences in perceptions between the two groups was that of fraud. Jurors perceived the auditor as responsible both for detection as well as for prevention of fraud. Such a perception could be due to the presentation and form of the actual auditor's report. This indicates that the auditor is reasonably sure that the accounts are free of material misstatements and show a true and fair view. If the auditor does not give any further indication of what a material misstatement involves, the reader may easily believe that the accounts are free from fraud. The natural conclusion would be that the auditor is responsible for detecting and preventing fraud. This was in fact indicated in this study. All jurors, apart from managing directors, perceived the auditor as having responsibility for preventing and detecting fraud. Managing directors, who in their line of work probably have to deal with auditors, knew that the auditor was not responsible for fraud; their replies conformed with those made by the auditor group. The indications were that the reason for such a perception gap was lack of communication.

Another gap (p = 0) was detected regarding the auditor's responsibility for the security of a company's internal control structure. Jurors perceived an auditor as having such a responsibility. This could be due to a possible lack of clarity when conveying the actual scope of an audit. Jurors believed that an auditor would go through a client's control structure as a normal procedure of an audit and would have responsibility for its security. Auditors strongly disagreed with this notion. They are backed by International Standard on Auditing 400: Risk Assessment and Internal Control (IFAC, 2003d), which states that an auditor should only be concerned with functions within the internal control structure relevant to the financial statements. The auditor would obtain an understanding of such a system and determine its limitations. No responsibility is placed upon the auditor by the standard. Within the juror group, students and managing directors did not place any responsibility on the auditor. In the case of students this could have been due to the higher probability that they had been exposed to auditing in their tertiary studies. Regarding the managing directors, owing to their work, they knew that internal controls were their responsibility and not the auditor's.

A considerable difference ($p = 0$) was found regarding the use of sampling and selection of audit procedures. Although jurors knew that an auditor does not check every client transaction and that he/she has a say in the selection of audit procedures, the mean had a central tendency, especially for the second statement. This could be an indication that respondents did not have enough knowledge on the issue and centred on the mid-point of the Likert scale. Jurors did not have a clear indication of whether or not an auditor checks every client transaction. In fact 31 per cent believed that he/she does check every client transaction. These misconceptions on the actual audit could be indicative of a larger problem. The audit profession did not give enough indications of what work was actually performed. Owing to such a lack of transparency within the auditor's work, a difference was detected between what jurors perceived an audit involves and what auditors perceived themselves as doing.

4.3.2 Perception similarities

In the remaining four differential belief statements, although the means of the two respondent groups were statistically different, both groups held the same belief. The difference was on the strength of their belief.

Jurors and auditors both agreed that the financial statements were management's responsibility. The Companies Act 1995 placed responsibility for the financial statements with the directors of a company. Owing to the highly reported company failures of the last few years, the general public has become more aware of management's responsibility for the financial statements. Linked with this was that neither of the groups believed that the auditor should be responsible for giving a guarantee of a company's long-term survival. A case in point was a recent insolvency of Price Club, a Maltese supermarket group. Even though the auditors found no problems with the audited financial statements, the company still ended up filing for liquidation. Similar cases may have shown the reality to the public: auditors do not have the capacity to provide a guarantee for a company's long-term survival.

Both jurors and auditors themselves had a high regard of the audit profession in Malta. Such a perception could have been the result of the high esteem professional people enjoy with the Maltese population at large. Both groups considered auditors unbiased and impartial. If this juror perception were compared with the belief that an auditor is responsible for maintaining accounting records, it may seem contradictory. It may be that jurors could not be aware of the actual definition of auditor independence or of its implications.

4.4 Perceptions on audited financial statements

The two groups' perceptions on audited financial statements provided further insight as to any other functions the Maltese auditor was perceived to be performing.

4.4.1 Audited financial statement reliability

There was considerable divergence between juror and auditor perceptions regarding the issue of audited financial statement reliability (Table 4). Jurors tended to give more reliability and accuracy to audited financial statements that a competent auditor would have found too difficult to achieve.

An example where jurors gave more accuracy and reliability to audited financial statements was when asked about fraud. Jurors perceived audited financial statements as an indication that a company was free from fraud. Auditors strongly disagreed with such a statement, as they felt responsible and able to find only fraud that causes material misstatement in the financial statements. This statistically large (p = 0) difference in perceptions could have been the result of a lack of understanding of what an auditor actually does. As previously mentioned, there was the impression of a lack of transparency in audit procedures that could be giving the public the wrong impression of what work is entailed within an audit. In fact, whilst jurors felt that the extent of work performed by an auditor was clearly communicated,

Table 4

Financial statement reliability statements

	Jurors		**Auditors**		
Financial statement reliability	**Mean**	**St Dev**	**Mean**	**St dev**	**p-value**
The company is free from fraud	4.11	1.94	2.45	1.59	0.000*
The extent of audit work performed is clearly communicated	5.44	1.31	3.88	1.89	0.000*
The financial statements give a true and fair view	5.85	1.25	6.39	1.12	0.000*
The auditor does not agree with the accounting policies used in the financial statements	3.25	1.76	1.71	1.3	0.000*
The current standards of audit practice give a clear guidance to auditors	5.32	1.25	5.71	1.09	0.032
Users can have absolute assurance that the financial statements contain no material misstatements	4.56	1.69	3.75	2.36	0.062
The extent of assurance given by the auditor is clearly indicated	5.24	1.45	5.43	1.7	0.100

Note: *Mean values significantly differ from one another at $p < 0.05$; Std Dev. means standard deviation

auditors themselves considered such disclosure as inadequate. This could have been the result of insufficient disclosure within the auditor's report. Such findings were highlighted within the Cohen Commission (1978), which found several deficiencies within the auditor's report, especially relating to the actual work performed by an auditor, which often confused users of financial statements.

Jurors and auditors had no significant difference in their responses to the next three reliability statements. Although the respondent groups' means were statistically different, the two groups had the same opinion. They both agreed that audited financial statements show a true and fair view. Both groups were also in concurrence regarding the issue of auditor agreement with the accounting policies used within audited financial statements. The only difference was the strength with which the two groups agreed. Whilst auditors strongly disagreed that they would not be in agreement with the accounting policies, jurors disagreed only slightly. Again, this might have been the result of a lack of in-depth knowledge of what is implied within audited financial statements, as the replies made by the managing directorswere very similar to those made by the auditor group. Both groups considered current standards of audit practice as giving clear guidance to auditors. In the case of jurors, this follows their trend of having a positive attitude towards the audit profession as a whole. Whenever they were asked a question directly related to the audit profession, they adopted a positive attitude in their answer.

Jurors believed that, from the audited financial statements, they could have absolute assurance that the financial statements contained no material misstatements. Auditors disagreed with this, as most commented one could have a reasonable, not an absolute, assurance. In fact, within the auditor's report auditors would say that from the work performed one could have reasonable assurance that the financial statements are free from material misstatement. This was a difference in the perceived assurance given. This difference becomes more serious when comparing what participants replied as to the auditor's communication of the extent of assurance given. Both jurors and auditors agreed that the extent of assurance given was clearly communicated. Since the assurance given was considered as clearly communicated, the implication was that jurors believed that, through such communication, the auditor was saying that one could have absolute, not reasonable, assurance that audited financial statements contained no material misstatements.

4.4.2 Decision usefulness of audited financial statements

These statements had the least statistical differences. Such an occurrence could be due to the public's widespread exposure to audited financial statements as contrasted to an auditor's report (Table 5). A statistical difference ($p = 0$) was found

Table 5
Decision usefulness of financial statements

	Jurors		Auditors		
	Mean	**St Dev**	**Mean**	**St dev**	**p-value**
The audited financial statements show that the company is well managed	4.93	1.61	2.91	1.50	0.000*
The audit profession adjusts quickly to new demands by clients	4.50	1.62	4.18	1.54	0.233
The audited financial statements do not give enough indications of the company's performance	3.47	1.88	3.68	1.69	0.344
The audited financial statements are not useful for making decisions	3.03	1.85	3.11	1.51	0.413

Note: *Mean values significantly differ from one another at $p < 0.05$; Std Dev. means standard deviation

in the perceptions towards how useful audited financial statements are when considering whether an entity was well managed. Auditors strongly disagreed with the statements. Jurors slightly agreed that management performance could be determined by analysing audited financial statements. Again, this follows a positive trend adopted by the public. More reliance was placed on audited financial statements, probably as they perceived that no other indicators were available for use to assess management. As the financial statements showed a true and fair view and the public considered them free of all fraud and misstatement, it was no surprise that in their view the financial statements should show that the company is well managed.

Jurors and auditors both perceived the audit profession as adjusting quickly to new demands made by clients. As already highlighted, the jurors' answer to this statement continues their positive perception trend towards the Maltese auditor.

From the answers, the Maltese public holds the Maltese auditor in high regard even if in certain cases they had a wrong perception of what his/her work actually involves. The auditor group itself had a high regard of the Maltese audit profession and the work performed.

Both groups agreed that audited financial statements give indications on a company's performance. Although some auditors commented that other indicators might need to be considered in order to grasp the overall picture, they still felt that the audited financial statements were the main indicator of performance. Linked to this was the perception that audited financial statements were considered useful for making decisions.

5. Limitations

A limitation encountered was the size of the sample of potential jurors taken when compared to the actual potential juror population of Malta. Considering the valid questionnaires for both groups, with 95 per cent confidence interval, one can calculate the findings' maximum error as being 9 per cent for the jurors' group and 13 per cent for the auditors' group.

Another limitation was the low response rate from the jurors' group. If none of the questionnaires were delivered by hand and assuming the same rate, there would have been only between 36 and 40 valid questionnaires.

It was also noted that some statements had some central tendency within the replies. This could have been due to the respondents not understanding the statement and selecting a mid-point on the Likert scale - a phenomenon that could have probably been avoided by providing a "do not know" option beyond the Likert scale.

6. Summary and conclusion

Various writers found a perception gap between auditors and the general public on the perceived roles of the external auditor. In Malta, both jurors and auditors had similarities and divergences in perceptions in various areas. Starting with the similarities, the audit profession is held in high regard in Malta, being considered as performing its role efficiently and effectively in an unbiased and impartial manner. Current standards of audit practice were considered as giving clear guidance to auditors and the assurance given by the auditor in the audited financial statements was considered as clearly communicated. Both groups considered audited financial statements as showing a true and fair view, as giving an indication of company performance and as being useful for decision-making. Jurors and auditors also agreed that a company's management should be held responsible for the financial statements.

The differences in perceptions between the two groups related mainly to the auditor's responsibility for various issues, ranging from fraud, to the security of a company's internal control structure. A major perception gap was found in the area of prevention and detection of fraud and material misstatements. Jurors gave responsibility to the auditor in both prevention and detection of fraud in a company, and at the same time considered audited financial statements as giving absolute assurance that they contained no misstatements. There was a discrepancy in the perceived audit work done. Jurors perceived an auditor as responsible for maintaining a company's accounting records and for ensuring the security of an entity's internal control structure. This gap was considered the result of a lack of communication of the audit work performed, as further evidenced by jurors not being sure whether an auditor uses sampling and if the auditor or the client selected audit procedures. It emerged that there was not enough transparency in audit procedures. Although auditors knew this, the general public was under the false impression that an auditor gave enough communication of the work performed. The study also indicated that in Malta the audit profession was regarded in a very positive light when compared with the perception elsewhere. Both jurors as well as auditors themselves held this positive view.

The final discrepancy in perceptions was that jurors considered audited financial statements as an indication of management performance.

References

Regulatory

Cohen Commission (1978). The Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations. *Manuel F. Cohen, Chairman. New York, NY: AICPA*.

European Commission (COM) (1996). The role, the position and the liability of the statutory auditor within the European Union. Green paper, Brussels.

International Federation of Accountants (IFAC) (2003a). *Handbook of International Auditing, Assurance, and Ethics Pronouncements.* International Federation of Accountants, New York, NY.

International Federation of Accountants (IFAC) (2003b). Objective and general general principles governing an audit of financial statements. *International Standard on Auditing 200,* International Federation of Accountants, New York, NY.

International Federation of Accountants (IFAC) (2003c). The auditor's responsibility to consider fraud and error in an audit of financial statements. *International Standard on Auditing 240*, International Federation of Accountants, New York, NY.

International Federation of Accountants (IFAC) (2003d). Risk assessments and internal control. *International Standard on Auditing 400,* International Federation of Accountants, New York, NY.

Other

Australian Educational Research (2003*).* Activity-based risk evaluation model of auditing: glossary of auditing terms: www.abrama.net/abrama/expect_gap_g.html [14 August 2003].

Bates, B. (1989). Knowledge and opinions of audits among the general public. Report by Market and Opinion Research International Ltd (MORI) on behalf of KPMG Peat Marwick McLintock, London.

Best, P.J., Buckby, S. and Tan, C., (2001). Evidence of the audit expectation gap in Singapore. *Managerial Auditing Journal*, 16(3): 134-144.

Flint, D. (1988). *Philosophy principles of auditing: an introduction.* Macmillan Education.

Foulds, M. (1998). Fraud and the role of the auditors. *Accounting and Business*: 38-40.

Hanks, J., (1992). The expectations gap – the consumer angle. *Journal of Accountancy*, February: 33.

Hatherly, D., Innes, J. and Brown, T., 1991. The expanded audit report - An empirical investigation. *Accounting and Business Research*, 21(84): 311-319.

Heffes, E.M. (2002). The future of corporate reporting: from the top. (Financial Reporting). *Financial Executive*, 18(9): 54-57.

Pany, K. (1992). Expectations of the audit function*. The CPA Journal*: LXIII (8): : 58-9.

Schelluch, P., 1996. Long-form audit report messages: further implications for the audit expectation gap. *Accounting Research Journal*, 9(1) : 48-55.

Further reading

Accountancy Board (n.d). *Code of Ethics for Accountants*, Ministry of Finance, Valletta.

Anderson, J.C., Jennings, M.M.,Lowe, D.J. and Reckers, P.M. (1997). The The mitigation of hindsight bias in judges' evaluation of auditor decisions. *Auditing A Journal of Practice and Theory,* 16(2): *20.*

Audit Practices Board (1991). Proposals for an expanded auditors' report. *Accountancy*, November: 125-7.

Companies Act - Malta, 1995. Chapter 386 of the Laws of Malta.

Dewing, I.P. (2001). Bridging the expectations gap. *Accountancy*, July: 9 8.

Dewing, I.P. (2002). UK fund managers, audit regulation and the new accountancy foundation: towards a narrowing of the audit expectations gap? *Managerial Auditing Journal*, 17(9): 537-45.

Ernst & Young (2002). The role of auditors. *Professional Banker*, September: www.icfai.org/icpe/study@icfai/octoberl/9_oct.htm [14 August 2003].

Ezzell, W.F. (2002). AICPA chair tells how to restore profession. *SmartPros Editorial Staff*: www.accounting.smartpros.com/x6816.xml [5 September 2003].

Frank, K.E. (2001). The expectations gap: perceptual differences between auditors. jurors and students. *Managerial Auditing Journal*, 16 (3): 145-9.

Frank, K.E., Hanson, R.K., Lowe, D.J. and Smith, J.K. (2001). CPA's perceptions of the emerging multidisciplinary accounting/legal practice. *Accounting Horizons. 15*(1), pp.35-48.

Goodman, L. (2002). International research implications for academicians and standard setters ongoing concern reporting: evidence from the United States: www. pbfea2002.ntu.edu.sg/papers/6078.pdf [5 August 2003].

Hrdlicka, G. (2002). Survey: damaged perception of accounting profession not likely to change. *SmartPros Editorial Staff:* www.accounting.smartpros.com/x36059.xml [15 September 2003].

International Federation of Accountants (IFAC) (2003). The auditor's report on financial statements. *International Standard on Auditing 700*, International Federation of Accountants, New York, NY.

Jenkins, G. (1999). The auditor as an advocate for the clients: perceptions of the auditor-client relationship. *Journal of Applied Business Research*, 15 (2): 73-8.

Johnson, E.N., Jordan Lowe, D. and Reckers, P.M. (2000). A new culture? Evidence of support for diversity in public accounting performance evaluation judgments. In *Advances in Behavioural Research*: 13-35. Emerald Group Publishing Limited.

Lawson, G. (2002). Caveat auditor: the rise of accountants' liability. *Centre for Legal Policy*: www.manhattan-institute.org/html/cjm_16.html [14 September 2003].

Loft, A. (2000). Expectations gap: www.auditexpectationsgap.ntu.edu.sg/papers/6200.pdf [16 August 2003].

Lowe, D.J. and Reckers, P.M. (1994).The effects of hindsight bias on jurors' evaluations of auditor decisions. *Decision Sciences*, 25(3): 401-426.

Market and Opinion Research International (MORI) (2003). Stakeholders' views on the future of auditing: www.mori.com/pubinfo/mac-stakeholders-views.shtml [16 August 2003].

Nally, D.M. (2003). PwC poised to close profession's expectation gap. *SmartPros Editorial Staff:* www.accounting.smartpros.com/x37474.xml [10 September 2003].

Porter, B. (2000*). Principles of External Auditing*. 4th ed., John Wiley & Sons, London.

Power, M. (2001). *The Audit Society: Rituals of Verification*. 4th ed., Oxford University Press, Oxford.

Strawser, R.H. (2001). *The New Auditor's Report: Will it Close the Expectations Gap in Communications?* Texas A&M University, College Station, TX.

Tabone, N. and Baldacchino, P.J. (2003). The statutory audit of owner-managed companies in Malta. *Managerial Auditing Journal*, 18(5): 387-398.

Thorpe, J. (2003), The role of auditors: www.icfai.org/icpe/study"icfai/octoberl/9_oct.html [6 October 2003].

Zelin, A. (2003). *Sampling and Tolerances*. Market and Opinion Research International, London.

CHAPTER 6

Qualified Audit Opinions in Malta
[AUD-4]

Farrugia, K.J[1] and Baldacchino, P.J.[1]

Managerial Auditing Journal

Vol. 20, Issue 8, 2005, pp. 823-843

[1]Department of Accountancy, Faculty of Economics, Management and Accountancy, University of Malta.

Qualified Audit Opinions in Malta

Farrugia, K.J. and Baldacchino, P.J.

University of Malta

This paper has the objective of identifying the different types of qualifications in auditor's reports of companies in Malta, the extent of multiple and repeated qualifications in such reports and any significant relationships between such main types of qualifications and firm-specific variables. The study in this small Mediterranean island is designed to investigate the auditor's reports of 419 companies in the period 1997/2000. This is also complemented by an analysis of 12 interviews held with audit partners in different practices. Results show that 19.9 per cent of sampled companies had a qualified auditor's report. The most common type of qualification was that of limitation-on-scope found in small companies and issued by non-Big Four audit firms. Small companies were also prone to going concern qualifications in view of their more common net liability situations. Disagreement-with-management qualifications were found to be more likely in larger companies and to be mostly issued by Big Four audit firms. The methodology adopted by the study may also be used in similar future studies in other small states and further research could possibly be undertaken on the motivation behind the issuance of such qualifications. The study concludes that Maltese companies, which are as yet all required to be audited irrespective of size, have an apparently high rate of audit qualifications and also that the auditor's reports of non-Big Four audit firms are often deficient or even incompatible with the wording of the International Standards on Auditing.

Keywords: *Malta, audit reports, auditing standards*

1. Introduction

As is the case in many other countries, the Maltese external auditor is required by company law to examine the financial statements of companies and to express an opinion thereon, whether they are prepared in all material respects according to an identified financial reporting framework. In compliance with the Maltese Companies Act enacted in 1995, such a framework is based on the International Financial Reporting Standards issued by the International Accounting Standards Board and the auditor's opinion is drawn up in accordance with the International Standards on Auditing issued by the International Federation of Accountants. The Act imposes the filing of the auditor's opinion with the Registry of Companies together with the respective financial statements for companies registered under this Act, independent of their size and whether public or private. The auditor's opinion is expressed in an auditor's report and is normally in a brief and standard form. An opinion is issued without a modification when the auditor has sufficient evidence to support the disclosures and amounts in the financial statements. Otherwise, a modified audit report is issued. Modifications may be of two types. The first type, not the subject of this paper, relates to matters not affecting the auditor's opinion and requires the inclusion of an emphasis-of-matter paragraph. The second type concerns matters which do affect the auditor's opinion.

The rest of this paper relates to the latter type of modification. It was only with the coming into force of the Maltese Companies Act that all locally registered companies were obliged to file their financial statements with the Registry of Companies. In addition, such research could easily be undertaken following the enactment of this Act since access to auditors' reports in the financial statements of locally registered companies became available electronically. This type of study has identified the main types of qualified audit opinions issued by Maltese auditors between 1997 and 2000 and the extent of multiple and repeated qualifications during the same period. It will also examine any significant relationships between such main types of qualifications obtained and firm-specific variables consisting of the type of company and industry, the net asset value, the size of the company and its auditor, and the company's issued share capital.

The paper is organised into four main sections. The first summarises the relevant literature. The second section discusses the methodology used in the study. The third section then presents the results and implications of the study. The final section summarises the findings and the limitations of the study.

2. Literature review

International Standard on Auditing or ISA 700 (International Federation of Accountants or IF AC, 2001) gives three categories of matters that affect an auditor's opinion. The first category is the qualified opinion, which has two generic grounds for qualification, one being circumstances leading to a limitation on the scope of the auditor's work and the other being circumstances leading to disagreement-with-management. In both cases, the auditor's opinion states that the financial statements give a true and fair view of the company's situation, except for the matter/s leading to the qualification. The second category is the disclaimer of opinion, which arises when the effects of the limitation are so material and pervasive to the financial statements that, as a whole, they could be misleading. The third category is the adverse opinion expressed on matters in financial statements which are so material and pervasive that the auditor concludes that they are seriously misleading.

The same standard also specifies that a material matter regarding a going concern problem needs to be disclosed in an emphasis-of-matter paragraph. In addition, ISA 570 (IFAC, 1999) deals with the reporting of going concern issues, and lists three instances in which an auditor is to express a qualification. The first instance relates to financial statements not including adequate disclosure about a going concern problem. In such a case, the auditor's report is to be qualified, preferably including a reference to the material uncertainty casting doubt on the company's going concern. The second instance is where, in the auditor's judgement, the company cannot continue as a going concern and yet the financial statements have been prepared on the basis that it can. Here, an adverse opinion is to be expressed in the auditor's report. The final instance refers to a limitation-on-scope qualification where management is unwilling to make or extend its assessment of the entity's ability to continue as a going concern.

It is to be noted that up to the coming into force of the Maltese Companies Act 1995, most auditors drafted their detailed audit report wording in line with UK auditing practices. Research undertaken by Hopkins (1995) examined a sample of 1,000 auditor's reports in the UK for qualifications in December 1983 and again in December 1994. He found that the qualification rate had gone down from 34.8 to 3.8 per cent during the period. Yet, such a decrease was mostly related to both the abolishment between the two dates of the small company audit qualification and to the exclusion of small companies' opinion from the 1994 sample following their exemption from the annual statutory audit requirement. Another divergence between the two dates was the marked reduction in the need for a qualification due to disagreement with management. This indicated more management compliance with the UK auditing standards over the years. There was also a shift in reporting an audit report modification due to a going concern uncertainty in the intervening period, since fundamental uncertainty ceased to be a matter of qualification, and auditors started disclosing going concern uncertainties faced by their clients by way of an emphasis-of-matter paragraph. Another indication of the low recent rate of qualifications in auditor's reports in the UK was illustrated by- Company Reporting (2001). This revealed that less than 1 percent of the 392 companies which were listed in its database and which published their financial statements during the period April 2000-2001 had an audit report qualification. This could be contrasted with earlier findings in the UK: Firth (1978) had found that 247 out of a total of 3,000 (8 per cent) stock exchange quoted companies in the UK had a qualification between 1974 and 1975. Clearly, fewer qualifications are being issued in the UK in recent years. The UK journal the Audit Report (2002a, b, c, d,and e) attributed this to two main factors. The first was the beneficial impact of SAS 600 (The Auditing Practices Board, 1993) and its later additions, which elaborated more on the circumstances leading to a qualification and how the auditor's report was to be worded in such circumstances. The second reason was the movement towards audit exemption for more companies which has already been referred to above. It was also found that limitation-on-scope qualifications were still prevalent in the UK during 2002 and a number of these were either deficient, issued without sufficient clarity or grounds for qualification or even not in accordance with SAS 600. In fact, a small number were still modelled on the old UK standards (CCAB, 1980), such as using the "subject to" verdict. Finally, the journal referred to deficiencies in the use of the going concern qualification. This included a lack of clarity in wording this qualification, the unnecessary inclusion of the qualification and its confusion with the limitation-on-scope one.

Various studies on the impact of qualified opinions have been carried out in a number of other countries. However, most of these studies limited their population to qualifications found in listed companies only. In France, between 1986 and 1995, Soltani (2000) identified 543 auditor's reports of companies (6.4 per cent) containing a qualification, mostly related to disagreement on non-conformity with accounting principles and on the calculation of provisions and also to scope limitations, respectively. Similar findings were reported in Australia where Ball *et al.* (1979) found a number of qualifications for reasons that included disagreement on depreciation on buildings, valuation of shares and other assets and provisions and also limitation-on-scope qualifications. Additionally, in Australia, Wines (1994) looked at 100 auditor's reports for the years 1980-1989 and came up with an average qualification rate of around 22.8 per cent. Furthermore, in the US, research by Butler *et al.* (2004) found that since the introduction of SAS 58 (American Institute of Certified Public Accountants, 1988) in the US in 1988, the average qualification rate had decreased from 12.9 per cent between 1980 and

1987 to 0.65 per cent between 1988 and 1999, but there was also a marked increase in unqualified opinions including an emphasis-of-matter paragraph in the auditor's report. In Singapore, Chan and Walter (1996) found that between 1973 and 1985, a company listed on the Shanghai Stock Exchange had a 9 per cent probability of receiving a qualification with the most common circumstances leading to a qualification being asset and liability valuation, going concern and non-compliance with accounting standards.

A number of studies already referred to also dealt with multiple and repeated qualifications. For example, Ball *et al.* (1979) found 15.4 per cent of qualified auditor's reports with multiple qualifications and 13.8 per cent of such reports were repeated for two subsequent years, and 0.9 per cent of them also repeated for three subsequent years. Yet in France (Soltani, 2000), the figures for repeated qualifications were considerably higher with 51.9 per cent repeated for two subsequent years and 20.4 per cent repeated for more than two subsequent years. In addition, when the 543 companies were categorised into the types of qualifications obtained, the highest percentage (26.5 per cent) had a multiple qualification in their auditor's report. In Singapore, Chan and Walter (1996) found that 62.3 per cent of the auditor's reports between 1973 and 1985 were repeated and also that out of first time qualified auditor's reports, 5.8 per cent had a multiple qualification. In the UK, Firth (1978) observed that once a firm received a qualification for two consecutive years, there was a fair chance that the audit report would be qualified the year after and this was proved by his findings where 70 per cent of firms having a qualified auditor's report between 1972 and 1974, again received a qualification for a third time in the period 1974-1975.

In Malta, Mugliette (1987) found 13 qualified auditor's reports out of a sample of 100 private non-exempt companies during 1985. Qualifications included the small company qualification, followed by limitation-on-scope qualifications due to restricted internal control procedures or an inadequate system over stock control and recording or even uncertainty on financial statement items such as debtor's values, investments and current liabilities. Disagreement-with-management qualifications were quite rare. Baldacchino (1992) interviewed 20 managers and 20 auditors and found that the small company qualification was still highly prevalent. Since this qualification was not specific regarding the issues involved, it was considered to have little if any practical effect and consequently management was much less sensitive to it than to qualifications referring to such specific control weaknesses.

Given the apparent need for qualifications in small companies in Malta, one may argue for the exemption of such companies from the statutory audit requirement, as has been done earlier in several other countries. Yet, Tabone and Baldacchino (2003) confirmed the perceived importance of the small company audit to outside third parties and its deterrent value on management and staff. If removed, the small company audit would therefore need replacement by an appropriate alternative.

With respect to the firm-specific variable of whether the company was small or not and its relationship to qualifications, Keasey *et al.* (1988) examined 180 small companies from the UK Companies House for the three years 1980-1982 and found that a total of 114 auditor's reports (21 per cent) incurred the small company qualification. Most of these auditor's reports belonged to companies which were audited by a large audit practice, had a secured loan, declining earnings, large audit lags and also had few non-director shareholdings. Furthermore, once the auditor expressed such a qualification, it would be more likely that this would appear again in the following year's auditor's report. A UK study was carried out by Abulizz *et al.* (1990) on a sample of 542 companies which had qualified audit opinions between 1978/1979 and 1981/1982 and of which 52.9 per cent were small. The study found that in total, large and medium companies received proportionately more qualifications than small ones. Small companies were more prone to receive adverse opinions, disclaimer of opinions and going concern qualifications. Medium-sized companies incurred disagreement-with-management qualifications on facts, amounts and the level of disclosure in financial statements, while large companies tended to incur qualifications on disagreement as to valuations in financial statements and non-audit of a subsidiary. This was contrasted with findings in other studies. For example, Warren (1975, 1980) and Chow and Rice (1982) found that, among listed companies, the larger ones reported fewer qualifications than those of a smaller size.

With respect to the firm-specific variable of size of audit firm as it relates to qualifications, research in the US research by Butler *et al* (2004) found that companies with a Big Five audit firm as auditor had a higher frequency of receiving an unqualified audit opinion. Abulizz *et al.* (1990) found concurring results that Big Eight audit firms were more likely to issue serious qualifications while other audit firms qualified on the less serious matters. Moreover, in this regard, the Audit Report (2002a) commented that auditor's reports compiled by the larger audit firms tended to be less faulty since they afforded a technical department which gave advice on the ongoing changes in audit reporting. On the other hand, smaller practices often paid less attention to the detail and explanations of qualifications in their auditor's report and even though the standardised recommended wording had been changed, they tended to persist in copying a similar auditor's report as had been issued the year before.

3. Methodology

For the purpose of this study, companies in Malta were classified in the same manner as in the Maltese Registry of Companies, i.e. private non-exempt, private exempt, international trading non-exempt and international trading exempt [Note 1]. International trading companies are normal trading companies except that they are precluded from trading in Malta. There were 9,776 companies active at 1 January 1997, the beginning of the four-year period under study. A sample of 565 companies was selected using the random sampling technique; these consisted of 3 public, 121 private, 385 private exempt, 36 international trading non-exempt and 20 international trading exempt companies. Results obtained from this sample can be inferred onto the whole population at a percentage error rate of 3.8 per cent. Of these, 146 were not considered further because they either did not file any financial statements during the four-year period (86), or did not file financial statements for more than two years (60), bringing down the number of companies actually taken into account to 419 companies. Out of these, 124 companies were found with at least one qualification during the four years. Information with respect to companies with a qualification and relating to the required firm-specific variables already referred to was collected manually. It is to be noted that the type of industry variable is based in accordance with the statistical classification of economic activities required by the European Union [Note 2]. Another variable was the size of the company, which categorized all companies in the sample as either small or non-small. In line with the Maltese Companies Act (Section 185), a company was classified as "small" if balance sheet total is less than Lml.l million (approx. Euro 2.69 million), turnover less than Lm200,000 (approx. Euro 490,000) and the average number of employees during the accounting period was not more than 50. The information was then statistically analysed through the data package, BMDP Release 7.

The above findings were complemented by an additional 12 semi-structured interviews with Maltese audit partners, four out of each of the Big Four audit firms, other audit firms and sole practitioners. All Big Four audit firms had clients in the sample company population with a qualified auditor's report. The other eight interviewees were selected out of both those having clients found featuring as qualified in the companies sampled for study (two other audit firms and two sole practitioners), and out of others not having such clients (two other audit firms and two sole practitioners), the latter being selected randomly from the Malta Business Directory (Debono, 2002).

A number of questions on the issues investigated in this paper were compiled and asked to the 12 interviewees (Appendix). The interview also included a case study (Figure 3) seeking to find out how the respondents would draft an auditor's report of a small company with a lack of internal controls and proper records. Respondent replies are analysed in the following section together with the analysis of the qualified auditor's reports already referred to above.

4. Results and implications

4.1 Types of qualifications

Audit opinions over the four-year period 1997/2000 of the 419 companies making up the sample population are shown in Figure 1. It is noted that a minority averaging 11.9 per cent of the audit opinions were classified as neither qualified nor unqualified, since the financial statements of these companies were either not filed for up to two financial years (6.8 per cent) or consisted of an emphasis-of-matter paragraph (5.1 per cent). Lack of filing was particularly noticeable in 1997, since it was the first year in which every company, independent of size, had to file the statutory annual financial statements. Out of 1,676 auditor's reports for the period, 1,143 (68.2 per cent) were unqualified with the remaining 333 (19.9 per cent) having a qualification.

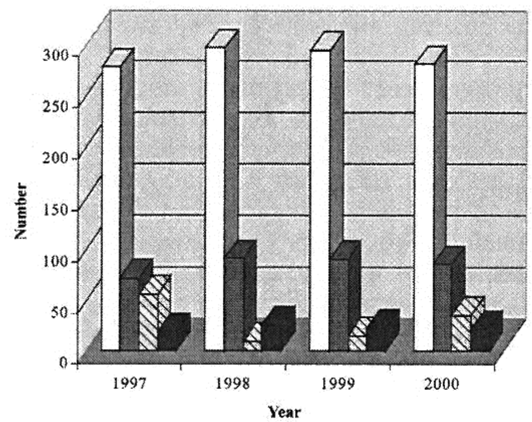
Further analysis by year and type of company of the average qualification rate for the period is summarised in Table 1. It can be seen that most qualifications relate to private exempt companies and international trading ones. Public companies were omitted from further study since their auditor's reports contained no qualified opinions. Additionally, it may be noted from Table 1 that no material fluctuations in audit report qualifications occurred from year to year with the exception of an increase of 20 qualified opinions from 1997 to 1998 in the private-exempt company category.

In the interviews complementing the above findings, respondents stated that for the periods under review, they had issued a qualified auditor's report to a number of their clients. However, their estimates of the average qualification rates fluctuated highly between those given by respondents in Big Four audit firms who gave the average rate as 5 per cent and those in other audit firms and sole practitioners who both gave an average rate of around 20 per cent. Some of the latter also added that the probable reason for their high rate of qualification was that the majority of their clients were private exempt companies.

The 333 qualified audit reports referred to earlier belonged to 124 different companies. Interestingly, 19 of these companies (15.3 per cent) had changed their auditor up to the end of the period and most (17/19) of those that changed were private-exempt companies. However, no association could be noted between change in auditor and removal of qualification. In fact, it was noted that only one of these companies which changed their auditor obtained a clean auditor's report in the first subsequent report issued by the new auditor. On the contrary, five of these companies obtained their qualification only after changing to a new auditor.

Figure 1: **Audit opinions from the sample population**

Panel A



Panel B

	Year Ending				Four Year Period	
Opinion Type	*1997*	*1998*	*1999*	*2000*	**Total**	**Type Avg %age**
☐ Unqualified	276	295	293	279	**1,143**	**68.2**
▩ Qualified	70	90	89	84	**333**	**19.9**
▨ No 1-2 years financial statements	55	9	15	35	**114**	**6.8**
■ Emphasis of Matter	18	25	22	21	**86**	**5.1**
Total	419	419	419	419	**1,676**	**100**

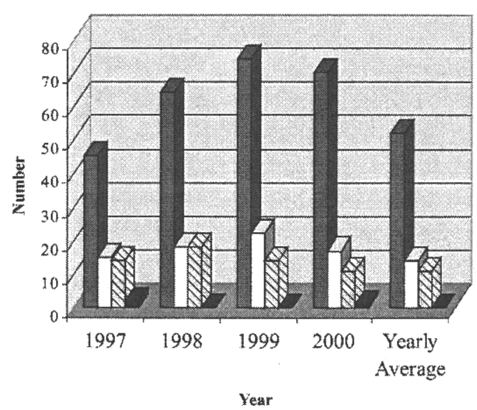
Table 1
1997 – 2000 qualified audit reports by year and by type of company

Type of company	Total number of companies sampled	Companies with qualified opinion for the years 1997	1998	1999	2000	Four-year average number of qualifications	Average four-year qualification rate (percentage)
Private exempt	*289*	56	76	76	68	*69.0*	*23.9*
ITC exempt	*15*	3	2	3	3	*2.8*	*18.3*
ITC non- exempt	*29*	2	4	4	5	*3.8*	*12.9*
Private non-exempt	*83*	9	8	6	8	*7.8*	*9.3*
Public	*3*	0	0	0	0	*0.0*	*0.0*
Total per year	***419***	***70***	***90***	***89***	***84***	***83.3***	***19.9***

Figure 2 segregates qualified auditor's opinions found during the period into four of the different types of qualifications as referred to by ISA 700 namely: limitation on scope, going concern, disagreement with management and disclaimer of opinion. The adverse opinion type was omitted as no resort to it was made. One notes here that the numbers shown in Figure 2 refer to qualifications for the period - a total of 386 for the four years and not to the number of qualified auditor's reports already given as 333. The difference consists in 53 other qualifications found in the auditor's report containing multiple qualifications. It can be immediately seen that limitation-on-scope qualifications outnumbered the other types of qualifications taken together and even showed an increase over the four-year

Figure 2: **1997-2000 qualified opinion types**

Panel A



Panel B

	Companies with Qualified Opinions for the year				Yearly Average	%age of Qualified Audit Opinions
	1997	*1998*	*1999*	*2000*		
Limitation on Scope	45	64	74	70	**63.3**	**65.5**
Going Concern	15	18	22	17	**18.0**	**18.7**
Disagreement with Management	15	18	14	11	**14.5**	**15.0**
Disclaimer of Opinion	2	0	0	1	**0.8**	**0.8**
Total	77	100	110	99	**96.5**	**100**

period. The different types, together with the extent of repeated and multiple qualifications will now be further analysed.

4.2 Limitation-on-scope qualifications

As one may compute from Figure 2 panel B, out of a total of 386 qualifications for 1997/2000, 253 (65.5 per cent) were due to limitations on the scope of the work of the auditor. Such qualifications were mostly found on their own (202/253) but there were instances (51/253) where they formed part of multiple qualifications. As to the latter, there were 19 multiple qualifications due to limitations-on-scope faced by the auditor in more than one area, while the remaining limitation-on-scope qualifications were found together with some other type of qualification (18 with going concern and 14 with disagreement-with-management). Table 2 analyses the 253 qualifications into four groups being, small company qualifications, non-specific limitations, specific limitations and other.

One notices that the most frequent limitation-on-scope qualification was the small company one, still modelled on the Type Six UK original one (CCAB, 1980), despite that the latter was abolished by the Audit Practices Committee way back in 1989. Understandably, this qualification was prevalent in private and international trading exempt companies, most of which are also probably classified as small. The next most common qualification was the non-specific limitation on scope. Local auditors issued such a qualification in those cases where they had no practical audit techniques to enable them to issue a clean opinion, but still failed either to mention the specific area/s which could not be so verified or to quantify the effect of such a qualification on the financial statements. This type of limitation-on-scope qualification with a generic wording featured mostly in private companies, both exempt and non-exempt. As is also the case with the previously mentioned Type Six qualification, this was still being issued in breach of the requirement of ISA 700 that, in the case of an audit opinion other than unqualified, the reasons leading to a qualification are to be mentioned in the auditor's report and that where

Table 2
1997 – 2000 number of audit reports limitation-on-scope qualifications

Year	Small company qualification	Non-specific limitation	Specific limitation	Other	Total number of qualifications
1997	14	11	14	6	45
1998	29	16	14	5	64
1999	25	21	21	7	74
2000	18	25	20	7	70
Total	86	73	69	25	253
Group percentage of four year total	34.0	28.9	27.3	9.8	

Note: Total number of companies samples was 419 for each of the four years

possible the effects on financial statements of non-compliance with IFRS's are to be quantified. Another limitation-on-scope qualification was the specific one, where auditors were unable to carry out the desired auditing procedures mainly owing to deficiencies in the internal control system, lack of proper accounting for cash sales, non-attendance for stock-take and lack of confirmations of other balance sheet items such as debtors and allocation of costs to contacts. Qualifications of this type were generally found in international trading companies, where they occurred because the auditor could not verify material balances of branches outside the country which directly affected the financial statements. Other types of limitation-on-scope qualifications were few and related to lack of proper books of accounts and opening balances limitations.

In the interviews, most of the respondents (10/12) stated that the major type of qualification given to their clients was limitation on scope. The circumstances leading to such a qualification were similar to those already referred to above, namely, the small size of the companies they audited. Small size rendered impracticable any reliance on the internal control system and verification could only be performed through detailed tests. Problems encountered while conducting such tests were often related to the sales figures since most of the transactions were on a cash basis. This resulted in an unsatisfactory audit trail. Similarly, auditors found it difficult to verify the amounts due by their clients and in a number of companies this often led to qualification. In some cases, a limitation-on-scope situation arose where, despite the stock figure being material, management did not perform the yearly stock-take.

Interviewees were also presented with a case study involving a small company as shown in Figure 3. In this company, the auditor could not perform all audit procedures owing to various deficiencies in the internal control and accounting systems. They were asked about the type of opinion which they would issue in such a case. Big Four audit firms qualified such a case study with either a specific limitation-on-scope qualification or with an outright disclaimer of opinion. On the other hand other audit firms were split between the non-specific limitation-on-scope qualifications and the Type Six ones, while most sole practitioners selected the Type Six qualifications.

4.3 Going concern qualifications

Figure 2 panel B, shows that this was the next most issued type of qualification, making up 18.7 per cent of total qualifications during the four-year period. Out of the 72 companies with a going concern qualification in their auditor's report, 52 had this qualification on its own, while the remaining 20 had a multiple qualification (18 with a limitation-on-scope and two with disagreement-with-management qualification). As already seen, ISA 570 lists the circumstances for issuing qualified or modified auditor's reports owing to going concern uncertainties, and recommends the wording to be used by the auditor in these instances. Yet, as shown in Table 3, only 4.2 per cent of the qualifications complied with this ISA. Those qualifications which did not comply with this ISA are categorised in the table either as still in accordance with an old UK Model (CCAB, 1985) or as being qualified despite having an emphasis-of-matter situation or ambiguous wording.

Figure 3: Case study presented to interviewees

One of your clients is a relatively small-sized importing company, generating annual turnover of around Lm 100,000 (approx. Euro .245,000), employing two individuals and with the owner-manager keeping the accounting records himself. At the end of the year you are required to carry out the audit. The company does not have a proper accounting system since items are just listed on a cashbook and there are no appropriate systems of controls. The audit procedures you have performed did not provide satisfactory comfort. Can you outline the type of audit opinion you would issue to this client?

Table 3
1997 – 2000 number of audit reports with going concern qualifications

Year	Ambiguous wording	Qualified "except for" emphasis-of-matter situations	1985 UK guideline model	ISA compliant	Total number of qualifications
1997	7	5	2	1	15
1998	9	4	4	1	18
1999	12	4	5	1	22
2000	13	1	3	0	17
Total	*41*	*14*	*14*	*3*	*72*
Group percentage of four year total	*57.0*	*19.4*	*19.4*	*4.2*	

Note: Total number of companies samples was 419 for each of the four years

The first group of reports (19.4 per cent of the going concern qualifications) modelled on the old UK Auditing Guidelines were qualified on the basis of uncertainty. However, in the UK, this standard was abolished in 1994 and replaced by SAS 130 (The Auditing Practices Board, 1994), which removed the need for qualifying on such a basis. In this situation, compliance with ISA 570 would have entailed an unqualified report with an emphasis-of-matter paragraph. Interestingly, all qualifications in this group were made by sole practitioners and this implied that they were not up to date with current standards. The second group (19.4 per cent of the going concern qualifications) ambiguously qualified "except for" despite using the wording of an unqualified auditor's report including an emphasis-of-matter paragraph, as recommended by ISA 570. This group of qualifications was again mostly the prerogative of sole practitioners although one other audit firm also committed such ambiguity. The third and largest group of qualifications not complying with the ISA involved various ambiguous wordings which ostensively followed no particular standard or model. Most of these auditor's reports explained the reason/s for qualification in just one sentence such as "the financial statements have been prepared on a going concern basis, which assumes the company's support of the company's bankers and directors". Apart from being short when compared with the examples included in the IFAC standards, it does not provide adequate information about qualifications to the reader. In other cases, though the explanatory paragraph of the auditor's report elaborated more on the matter/s leading to the qualification, yet the wording used was not compatible with that recommended by any particular standard. The ambiguities were committed by different types of auditors but in no case by any Big Four audit firm.

Two of the interviewees, who were also sole practitioners, confirmed that they would qualify a situation which according to ISA 570 was an emphasis-of-matter one. This involved the specific fundamentally uncertain situation where liabilities exceeded assets at the end-of-year balance sheet.

4.4 Disagreement-with-management qualifications

The third type of qualification, making up 15 per cent of total qualifications was related to disagreement with the treatment or disclosures of matters in the financial statements. This type of qualification was found on its own in 42 companies, and was included as a multiple qualification in 16 companies (14 of which with a limitation-on-scope and two with a going concern qualification). This type of qualification was sub-divided into three categories. The most common (25/58) was that where the auditor disagreed with management as to the non-preparation of consolidated financial statements by the parent company. It is to be noted that, although companies with direct shareholding in each other were required by IFRS's to prepare consolidated financial statements, yet they could still remain exempt under the Maltese Companies Act if the group satisfied a number of criteria as listed in the Act. As a result, not all auditors were treating this situation uniformly. A few cases were found of such a situation where auditors did not qualify but merely inserted a note in the auditor's report of the parent company referring to the IFRS/Maltese law inconsistency and that on the basis of the law consolidated financial statements had not been prepared. In these cases, a note describing details was also added to the financial statements. The second category (20/58) was that of disagreement due to inappropriate accounting treatment and departure from IFRS's, with the majority of disagreements being due to a lack of a professional valuation of property. The third category (13/58) was disagreement as to facts and/or amounts in the financial statements, mainly in view of the fact that management did not provide for depreciation on property and fixed assets. Most of the qualifications in the last two categories were found in auditor's reports of private non-exempt companies. This was probably because these were commonly much larger than the exempt companies and could afford to employ separately from their auditor their own professional accountant, one who could easily hold different viewpoints that were different from those of the auditor on the appropriate accounting treatment of items in the financial statements.

As to interviewees, these were divided on the audit report treatment of the first category referred to above, which is that relating to the lack of preparation of consolidated financial statements. On the one hand, partners in three Big Four audit firms and one from the other audit firms declared that they would qualify their auditor's report. On the other hand, another Big Four audit firm respondent as well as three from other audit firms stated that they would not qualify but merely add a note in the auditor's report. Sole practitioners did not take a stand on this matter because, as they stated, they had not yet encountered such a situation. Overall the need became clear for more consistency between the law and the IFRS's. With respect to the other categories of disagreement-with-management qualifications, respondents confirmed that these were more common in the private non-exempt companies. In this context, a Big Four audit firm partner commented that the larger clients were more prone to disagreement-with-management qualifications in view of the complexity of their business. In his view this was in contrast to the smaller less complex businesses, which were more prone to limitation-on-scope qualifications. A sole practitioner added that such matters of disagreement were mostly encountered by the Big Four audit firms and other audit firms. In his experience, sole practitioners preferred to iron out any disagreements with directors before the financial statements were signed by them.

4.5 Disclaimers of opinion

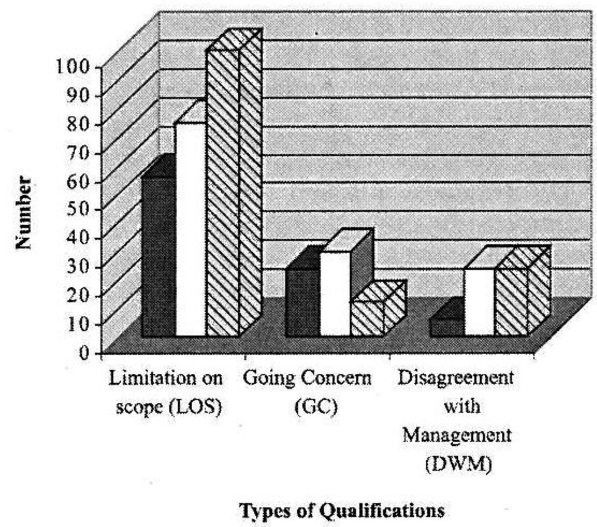
Only three disclaimers of opinion were found in the period 1997/2000. Two were expressed in the auditor's report of a company whose auditors could not perform audit procedures on a number of financial statement items and the other in a company with a seriously impaired going concern in addition to the non-provision for depreciation by directors. The rarity of these qualifications was also confirmed in the interviews where most (9/12) remembered only a few cases of such a qualification in their whole career, while the others (3/12) could not remember ever issuing such a qualification. A Big Four audit partner stated that his firm had mostly issued disclaimers in the first year audit of small companies because the required changes were only carried out in subsequent years.

4.6 Multiple and repeated qualifications

The frequency of multiple and also of repeated qualifications with respect to the types of qualifications identified above was also separately considered. Out of the 124 companies with a qualification, there were 98 whose auditor's reports (79 per cent) contained a qualification repeated at least once. Out of a total of 386 qualifications found during the period, only 35 were found to have been issued for one year only. Figure 4 breaks down the remaining 351 repeated qualifications during the period. Of these, 86 consisted of 43 qualifications repeated for the following year only, 129 consisted of 43 qualifications repeated for the two subsequent years and 136 consisted of 34 qualifications repeated for all three

Figure 4: **Companies with audit qualification repetitions**

Panel A



Panel B

Qualifications repeated for:	*Type of Qualification as above*			Total	
	LOS	*GC*	*DWM*		
Following year only	56	24	6	**86**	*(43 * 2)*
Two subsequent years	75	30	24	**129**	*(43 * 3)*
Three subsequent years	100	12	24	**136**	*(34* 4)*
Total	231	66	54	**351**	*120*

subsequent years. In terms of the number of qualifications, it can be noted that limitation-on-scope qualifications outnumbered the other types. As has already been seen, most such qualifications related to private exempt companies, which seemed to be either unable or unwilling to improve on their internal control or financial reporting limitations. Going concern qualifications were the next type involving repetitions. Interestingly, in this type of qualification repetitions rarely extended beyond two subsequent years, an indication that matters often changed radically for better or for worse after this period. On the contrary, the disagreement-with-management types mostly continued to be repeated beyond the following year.

Interviewees differed as to the extent of repetition. All respondents claimed to have issued repeated qualifications during the period under review. Yet, Big Four audit firm respondents stated that these were not significant in their case. However, in the experience of other audit firms and of sole practitioners, a clear majority of the qualified auditor's reports in any financial year contained the same qualification as that issued the year before. Respondents from other audit firms and sole practitioners agreed with the above findings that limitation-on-scope qualifications, more than other types, were subject to probable repetition for a number of years especially if they belonged to private exempt companies. In the opinion of a sole practitioner, "it would be too costly for small-sized companies to introduce proper accounting records and/or systems of internal control and therefore a repeated qualification is accepted by management". Another sole practitioner gave as his motivation to issuing repeated qualifications, his continued uncertainty in assessing the going concern status of his clients; a number of these had been facing a net liability situation for a number of years but management had opted not to cease trading. As the liquidity position had never improved, his report had remained qualified for going concern. Two Big Four audit firm respondents stated that most of the disagreement-with-management qualifications were repeated beyond the following year because the management of the respective client companies generally retained its controversial disagreement with respect to its accounting policies.

It was found that 14 per cent (53/386) of the qualifications were multiple. The most common were the private exempt company multiple qualifications (38/53). The latter were due to either a limitation-on-scope on more than one financial statement item (19/38) or the combination of a limitation-on-scope and a going concern qualification (14/38) or a limitation-on-scope with disagreement-with-management qualification (3/38), or, finally, disagreement-with-management with a going concern qualification (2/38). International trading companies also faced multiple qualifications (11/53) due to the non-preparation of consolidated financial statements together with a limitation-on-scope qualification. Private non-exempt companies had the next most multiple qualifications (4/53) and the circumstances were due to a combination of a limitation-on-scope and a going concern qualification faced by the auditor.

A number of auditor's reports incurred multiple repeated qualifications. These were mostly common in private exempt companies since, as already mentioned, their management was often unwilling to implement measures to remedy the deficiencies mentioned in the qualified auditor's report. More than half of the private exempt companies, with a multiple qualification as described in the previous paragraph, had the same qualified auditor's report repeated beyond the year following the first. A small number of international trading companies also faced repeated multiple qualifications. In their case, nothing could be done by management to avoid the qualification since, at the time of study, the issue of exemptions given by the Companies Act with respect to group financial statements had not yet been resolved. In addition, as the activities of such companies were performed outside Malta, the auditor could face a limitation-on-scope on his work as the required audit tests could not be carried out.

As to interviewee comments with respect to multiple qualifications, these differed between those of audit partners and those of sole practitioners. For audit firms, multiple qualifications were rare. On the other hand, the situation was different for sole practitioners who often reported on the financial statements of private exempt companies where such a situation was deemed to be more common.

4.7 Qualifications and firm-specific variables

The second part of the research consisted in identifying any associations among the three classifications of qualified audit opinions (limitation on scope, going concern and disagreement with management) and the selected data variables, using the chi-squared test, for each of the four years 1997/2000. No association was found between the auditor's opinions and two of the variables, i.e. whether the company was small or not and the issued share capital of the company.

In another test, a significant relationship (p = 0.0000 for all the four years) was found between the disagreement type of qualification and the type of company for the whole period under study. Qualifications of this type were mostly prevalent in international trading companies, followed by private non-exempt companies.

Another significant relationship over all four years was found between auditor's qualifications and the type of industry (1997: p = 0.0051, 1998: p = 0.0024, 1999: p = 0.0022, 2000: p = 0.0024). It was found that, particularly over the period under study, disagreement-with-management qualifications were mostly common in companies in the import, wholesale and retail business and this was followed by the financial intermediation sector. The high relative percentage of companies with a disagreement-with-management qualification falling within these two industries and the results of the chi-squared test pointed out that if the auditor disagreed with the company's accountant on financial statement issues it was probably a company operating within these two sectors. As for limitation-on-scope qualifications, the test was only significant for 1998, and no relationship was identified for going concern qualifications throughout the four years. Therefore, no evidence was found establishing any significant relationship between these two qualification types and the type of industry. The final test checked whether there was any association between the net asset values of companies which received qualified audit reports and the type of qualification obtained. Net asset values were grouped into four categories, namely those values between Lm0 - Lml0,000 (Euro 0 - approx. Euro 24,500), those above Lml0,000 for both positive and negative figures. Over the four-year period such an association was found significant only for the going concern type of qualification (1997: p = 0.0057; 1998: p = 0.0004; 1999: p = 0.0066; 2000: p = 0.0003). Interestingly, companies with a going concern qualification had a negative net asset value for at least one of the years in which they had such qualification.

Use was also made of the chi-squared test to identify a relationship between companies with a repeated qualified auditor's report and firm-specific variables. A relationship (p = 0.0121) was found between the repeated qualification and the type of company. The results showed that a qualification in private exempt companies and international trading non-exempt companies had a significantly higher chance of being a repeated one. Significance was also identified between repeated qualifications and whether the company was small or not (p = 0.0204). In this regard, exempt companies, which also satisfied the criteria for classification as small companies referred to earlier, had a higher probability of obtaining a repeated qualification than those which did not satisfy such criteria.

4.8 The auditor and qualifications

Finally the research investigated the association between qualified opinions and the type of audit firm voicing such opinion. The chi-squared test was used to identify a relationship between the type of qualification and the size of the audit firm expressing it. A highly significant relationship was found for the four-year period

(1997: $p = 0.0022$; 1998: $p = 0.0001$; 1999: $p = 0.0000$; 2000: $p = 0.0000$) between disagreement-with-management qualifications and the type of auditor. Such a highly significant association was due to the fact that most of disagreement-with-management qualifications (45/58) were expressed by a Big Four audit firm, with a minimal amount expressed by other audit firms and sole practitioners. Less highly significant results were found for the association between limitation-on-scope qualifications and the type of auditor (1998: $p = 0.0122$; 1999: $p = 0.0102$; 2000: $p = 0.027$) since the test was significant for only three years. Over the four years, most of the limitation-on-scope qualifications were issued by sole practitioners, followed by other audit firms, with a small percentage issued by the Big Four audit firms. No relationship was found between the going concern qualification and the type of auditor issuing it.

4.9 Implications

At 19.9 per cent, the four-year average rate of qualifications appears at first high. Yet, one needs to take into account that the scope of the study went beyond public companies and covered all the different types of Maltese registered companies. It also included small companies which in Malta are all subject to the statutory audit. Indeed, private exempt companies, most of which are defined as small, had the highest qualification rate out of all the four types of companies. As one may note, these findings contrast with those found in the UK by Abulizz *et al.* (1990) but are in line with other studies elsewhere such as those of Chow and Rice (1983) and Warren (1975, 1980). Furthermore, the qualification rate found in this study would probably have been much higher had all the companies in the sample population filed their financial statements for the period under study. In this respect there is clearly a pressing need to impose tougher penalties for non-filing than at present.

Given the smaller-sized company scenario, the large predominance of limitation-on-scope qualifications is probably not surprising. As already seen, similar results were obtained in UK by Hopkins (1995) when analysing a sample of

1,000 audit reports, such results contrasting with other studies elsewhere focusing only on public and listed companies (Soltani, 2000; Ball *et al.*, 1979; Chan and Walter, 1996) where most qualifications were found to be disagreement with management. It is clearly disquieting to see that, in this study, the majority of limitation-on-scope qualifications were not specific ones and often deficient by today's standards. Therefore, they probably resulted in few, if any, practical pressures on management to carry out the needed changes. In addition, it was found that limitation-on-scope opinions in Malta qualifications were mainly issued by sole practitioners and to a lesser extent by other audit firms. This implies that a number of auditors within these categories are less proactive than others and continue to issue qualifications based on outdated standards. These findings agree with similar comments referred to earlier that were expressed in the UK by the Audit Report (2002a).

Findings both from the sampled companies and from the semi-structured interviews pointed to the persistent use of the outdated Type Six qualification on the islands as a reporting practice resorted to mostly by sole practitioners but also by other audit firms. Therefore, even in Malta's case, the presence is felt of the inherent problems in small audits, this underlining the urgency of settling the long standing debate of whether to abolish Malta's statutory small audit requirement on the same lines as in other countries and/or perhaps introduce an alternative exercise as suggested earlier. In addition 90 per cent of the qualified opinions were also found in the auditor's reports of companies defined as small.

Deficiencies were also clearly portrayed by the going concern qualifications. The majority of such qualifications were not adhering to the use of the wording recommended by IFAC and were even failing to give a clear explanation for the given qualification. Action needs to be taken to tackle the ambiguity and overuse of such qualifications. The relationship identified between the going concern qualification and the negative net asset value of the company with a qualification further proves that this type of qualification is resorted to when the company is merely going through a difficult financial situation. As already stated, in these cases ISAs recommend the inclusion of an emphasis-of-matter paragraph in the auditor's report and not a qualification. In this regard, the profession needs to emphasise how it may help to see that sole practitioners and, to a lower extent, other audit firms, report more in line with current auditing standards.

Findings from the study also indicated a relationship between disagreement-with-management qualifications and Big Four audit firms. Such results are also consistent with findings in the UK by Abulizz *et al.* (1990). It can be seen that other audit firms and sole practitioners are finding it more difficult to qualify auditor's reports for disagreement with management. This is an area which definitely calls for further research, as it may imply issues of lack of independence, or even that particularly in the case of sole practitioners, there is no effective second opinion on the part of the auditor given that both accounting and reporting are effected by the same person, especially in companies which do not afford a qualified accountant.

Although the number of repeated qualifications found in this study appears high, yet similar studies elsewhere also reported high percentages (Ball *et al,* 1990; Soltani, 2000; Chan and Walter, 1996; Firth, 1978). Yet, interestingly it appears that in Malta the highest percentage of repeated qualifications are those recurring for more than three subsequent years. Analysing them by the type of qualification it was found that limitation-on-scope qualifications were mostly repeated. This substantiates further the need to bring to an end deficient and non-specific qualifications as it confirms that such qualifications are not making management feel pressured to implement the required measures in order to change the auditor's report to unqualified in future years. This paper found that around 14 per cent of the audit qualifications were multiple, such a percentage being similar to those found in other studies (Ball *et al*., 1990; Soltani, 2000; Chan and Walter, 1996). Yet, further analysis revealed that multiple qualifications due to limitation on the scope of the auditor's work outnumbered the other types. Again, the incidence of this qualification in almost all reports containing multiple qualifications indicates that its presence might in itself be symptomatic of there being a higher chance of having some other qualification.

Finally, it is clear that even in Malta the Big Four audit firms issue less qualified auditor's reports. Again this is in line with similar research effected elsewhere (Butler *et al*., 2004; Abulizz *et al*., 1990).

5. Summary and conclusions

This study has attempted to analyse the type of qualified audit opinions in Malta between 1997 and 2000. It has also studied the extent of multiple and repeated qualifications in the same period and found significant relationships between such main types of qualifications and firm-specific variables.

Despite the limited geographical size of the Maltese islands, the average qualification rate for the four years was 19.9 per cent, the majority of which emanated from private exempt companies. The majority of qualifications in this type of companies were due to limitation on scope of the auditor's work or to going concern issues. The small size of such companies rendered impossible any reliance on internal controls and, where no proper accounting records were kept, the auditor's task was even made more difficult. In addition, most of the repeated and multiple qualifications identified in the study, originated from auditor's reports of small companies. It can be concluded that the profession needs to delve more deeply into the auditor's reports issued by other audit firms and sole practitioners as the way in which such reports are drafted frequently makes them deficient or even incompatible with the recommended wording of the ISA's. Moreover, the high qualification rate among small companies extends the debate on whether such companies should be exempted from the full scope audit. As to disagreement-with-management qualifications, these feature more in larger companies. Perhaps factors such as inter-practitioner competition and the fact that auditors may also be personally employed in small companies may be impeding the small company auditor from disagreeing with management in the same manner as his larger company counterpart. Finally, it is concluded that the type of qualification is associated with the size of audit firms, whereby disagreement-with-management qualifications are mostly issued by Big Four audit firms, while limitation-on-scope qualifications tend to be issued by sole practitioners and other audit firms.

The study faced a number of limitations. The four-year period on which the research was based was the first in which all companies falling under the Companies Act (1995) irrespective of whether they were exempt or not, started also to file their financial statements. Therefore, findings could not be meaningfully compared to earlier periods. It is, therefore, recommended that the period under study is compared with periods of subsequent years as and when the information becomes available. This was the first extensive research known to be undertaken in Malta specifically investigating qualified audit opinions in recent years. The methodology undertaken in this study could serve as the basis for studies in other small states which could look into the types of qualified audit opinions issued, and into what motivates the issuance of such qualifications. Further studies could also investigate the extent of non-compliance by the auditing profession in respect of whether the recommended wording is that allowed by either their local legislation or auditing standards in force. Hopefully, the situation will be increasingly one of continual improvement.

Notes

1. Private companies and international trading companies become exempt on condition that they have no more than 50 debenture holders and that nobody corporate is a shareholder.

2. This is known as the *Nomenclature statistique des activités économiques dans la Communauté européenne.*

References

Regulatory

American Institute of Certified Public Accountants (1988). *Reports on Audited Financial Statements*, Statement on Auditing Standards, No. 58 AICPA. New York, NY.

Companies Act - Malta, 1995. Chapter 386 of the laws of Malta.

International Federation of Accountants (IFAC) (1999). *Going Concern*. International Standard on Auditing No. 570, IFAC, New York, NY.

International Federation of Accountants (IFAC) (2001). *The Auditor's Report on Financial Statements*. International Standard on Auditing No. 700, IFAC, New York, NY.

The Auditing Practices Board (1993). *The Auditor's Report on Financial Statements.* Statement of Auditing Standards No. 600. The Accountancy Foundation, London.

The Auditing Practices Board (1994). *The Going Concern Basis in Financial Statements.* Statement of Auditing Standards No. 130.

The Consultative Committee of Accounting Bodies (CCAB) (1980). *Audit Report Examples*, Audit Guideline S501. CCAB, London.

The Consultative Committee of Accounting Bodies (CCAB) (1985). *The Auditor's Considerations in Respect of Going Concern.* Audit Guideline S410. CCAB, London.

Other

Abulizz, S.M., Sherer, M.J. and Essex Univ., Colchester (United Kingdom). Dept. of Accounting and Financial Management,(1990). Qualified Audit Reports: Company Size and Auditor : Evidence from the UK. Department of Accounting Financial Management, University of Essex.

Audit Report (2002a). Disagreement about accounting treatment. January,109:3- 4

Audit Report (2002a). Audit Report (2002b). Limitation on scope. January,109: 4-8.

Audit Report (2002c). Going concern. February, 110: 2-8.

Audit Report (2002d). Post balance sheet events. September, 117: 2-8.

Audit Report (2002e). Reliance on others. October, 118:2-8.

Baldacchino, P.J. (1992a). The auditor-management relationship in a microstate perspective. MPhil thesis, Loughborough University Business School, Loughborough University, Loughborough.

Ball. R, Walker, G. and Whittred, G.P. (1979). Audit qualifications and share prices. *Abacus*, 15: 23-34.

Butler, M., Leone, A.J. and Willenborg, M. (2004). An empirical analysis of auditor reporting and its association with abnormal accruals. *Journal of Accounting and Economics*, *37*(2), pp.139-165.

Chan, Y.K. and Walter, T.S. (1996). Qualified audit reports and costly contracting, *Asia Pacific Journal of Management,* 13 (3): 37-63.

Chow, C.W. and Rice, S.J. (1982). Qualified audit opinions and auditor switching. *The Accounting Review,* April: 326-35.

Company Reporting (2001). Auditor's reports and opinions. No. 131: 3-8.

Debono, G. (2002). *The Malta Business Directory*, 1-4.

Firth, M. (1978). Qualified audit reports: their impact on investment decisions decisions. *Accounting Review*, 53 (3): 642-650.

Hopkins, L. (1995). *The Audit Report*. Butterworth and Co. (Publishers) Ltd, London.

Keasey, K., Watson, R. and Wynarczyk, P. (1988). The small company audit audit qualification: a preliminary investigation. *Accounting and Business Research*, 18 (72): 323-33.

Mugliette, B. (1987). The audit report, an analysis of opinion with particular reference to Malta. BA (Hons.) Accountancy dissertation, University of Malta, Malta.

Soltani, B. (2000). Some empirical evidence to support the relationship between audit reports and stock prices - the French case. *International Journal of Auditing,* 4 (3): 269-91.

Tabone, N. and Baldacchino, P.J. (2003). The statutory audit of owner-managed companies in Malta. *Managerial Auditing Journal,* 18(5): 387-398.

Warren, C.S. (1975). Uniformity of auditing standards, *Journal of Accounting Research*, Spring: 162-76,

Warren, C.S. (1980). Uniformity of auditing standards. *Journal of Accounting Research*, Spring: 312-24.

Wines, G. (1994). Auditor independence, audit qualifications and the provision of non-audit services: a note. *Accounting and Finance*, 34 (1): 75-86.

Appendix.

Auditor interview schedule

(1) In your experience, what percentage of your audit reports contained qualifications during 1997/2000?

(2) Of the types of qualifications below, which was the most commonly issued between 1997 and 2000?

- limitation-on-scope;
- going concern;
- disagreement-with-management;
- disclaimer; and
- adverse.

(3) In what circumstances have you faced limitations on the scope of your audit?

(4) If a client's balance sheet total liabilities exceed total assets, would this effect your auditor's report, and if so, how?

(5) In case you perform group audits which are exempt from preparing consolidated accounts due to the Maltese Companies Act, how does this affect your auditor's report?

(6) In your experience, what are the main disagreements with management leading to qualified opinions?

(7) In case you issued a disclaimer or adverse opinion, what were your reasons?

(8) During 1997/2000, did you ever need to repeat qualifications in subsequent years? If so, which types?

(9) During 1997/2000, how frequent did you find the occurrence of multiple qualifications ?

CHAPTER 7

Factors Influencing First-Time External Auditor Selection in Malta [AUD-5]

Baldacchino, P.J.[1] and Cardona, C.[2]

The lUP Journal of Accounting Research & Audit Practices

Vol. X, **Issue 2**, 2011, pp. 45-69

[1] Head, Department of Accountancy, Faculty of Economics, Management and Accountancy, University of Malta, Msida, Malta.

E-mail: peter.j.baldacchino@um.edu.mt

[2] Senior Audit Associate, PwC, Malta

Factors influencing First-Time External Auditor Selection in Malta

Baldacchino, P.J. and Cardona, C.

University of Malta, Malta and PwC Malta

This paper attempts to shed some light on the factors - behavioural, economic and others - that influence a client's selection of an external auditor in Malta. A comparison is also made between the clients' perceptions and the views expressed by auditors themselves. This study shows that relationships exist between a number of client characteristics and the size of the audit practice appointed. Responses from both auditors and audit clients indicate that Maltese clients value factors of a behavioural nature more than those of an economic one. The study implies that auditors need to strive to understand their clients' businesses and industries if they are to provide timely and relevant advice and services, deliver the levels of quality that their clients have come to demand from the profession, and even exceed their clients' expectations. The paper therefore provides external auditors with important insights into those factors influencing their selection.

Keywords*: auditor selection, Malta, external auditing*

1. Introduction

In Malta, the Companies Act, 1995 requires that all companies carry out a statutory audit of their financial statements irrespective of their size, capital structure or business activity (Tabone and Baldacchino, 2003). This requirement has resulted in the need to select and appoint a statutory auditor within each and every company incorporated in Malta, and its sister island Gozo.

External auditor selection is the process of choosing from among the various audit firms and sole practitioners capable of performing the statutory audit as required by Maltese Law. In order to select between different auditors, many factors need to be considered by the client, with these being determined during the initial stages of the external auditor selection process. The importance of a good external auditor selection process stems from the concept of the asymmetrical distribution of information amongst a company's stakeholders. Information asymmetry exists when one party possesses information that another party lacks (Gaa, 2005, p.1).

1.1 Responsibility for auditor selection

High profile scandals have served as instigators for change throughout the corporate world, also leading to a change in the way the companies appoint their external auditors. In America, the Sarbanes-Oxley Act was signed into law on July 30, 2002. One of the changes implemented under Provision 301 of this legislation was that the selection of external auditors no longer remained the competence of a company's management, with the responsibility for doing so being shifted directly to the audit committee and board of directors. This act is designed to address the concern that, if management selects the auditor, it will choose the auditor based on the likelihood of receiving a 'clean' audit opinion rather than on the auditor's competence (Keating *et al*., 2003). As Crouch (2004) writes, permitting senior management to have sole control over external auditor selection and retention is like the fox guarding the hen's house.

The Eighth Directive, or what commentators are labelling, Europe's equivalent to the Sarbanes-Oxley Act, has also been enacted on the island. Amongst other provisions, the Directive requires that, "in a public interest entity, the proposal of the administrative or supervisory body for the appointment of a statutory auditor or audit firm shall be based on a recommendation made by the audit committee "(Art 41, Para.3).

As regards the actual appointment of the statutory auditors, in Malta it is only the first company auditor that can be appointed by management. During a company's first Annual General Meeting shareholders are given the power to confirm an auditor's appointment, or otherwise.

In 1995, Beattie and Fearnley wrote that at the time it was generally agreed that no comprehensive, well-specified theory of auditor selection existed. While these authors have since conducted and published research in the field, based on studies in the UK, existing research into external auditor selection in Malta dates back over a decade to a study carried out by Galdes in 1994. The purpose of this present study is to shed some light on the current trends influencing external auditor selection within the small Mediterranean island-state of Malta. The paper commences with an overview of relevant literature, following which the findings emanating from the responses to two mail questionnaires, received from 68 companies and 33 auditors respectively, are presented and discussed. Finally, the conclusion is offered.

2. Literature review

In its corporate governance toolkit, PriceWaterhouseCoopers or PwC states that while auditor independence is a "key issue to be addressed", yet there are "no set rules" in auditor selection. Irrespective of how selection is made, it is important to "determine at the outset what attributes are required of the external auditor to ensure the selection process is sufficiently robust" (PwC, 2005, Section 4.1)

2.1 Behavioural versus economic factors

Beattie and Fearnley (1998) claim that extant theory of auditor choice is grounded in economic theory. They posit that a void in theory arises from the failure to incorporate behavioural factors into research carried out in this area. In 2004, Magri and Baldacchino incorporated both behavioural and economic aspects in their study on the factors leading to auditor change in Malta. The study confirms the importance of behavioural factors, finding that the top two factors leading to a change of auditor were behavioural. The authors found that, while foreign studies on auditor change decisions cite economic factors as being predominant, Maltese companies attribute importance to both behavioural and economic factors.

2.2 Main factors influencing auditor choice

2.2.1 Audit fees

Audit fees vary from one engagement to another but, according to Turpen (1995), much of the variability of these fees can be explained by client attributes associated with audit effort and audit risk. The complexity of the audit is therefore a main component in the determination of the audit fee. In their study into auditor choice and change, Beattie and Fearnley (1998) find that fees are the most frequently cited factor influencing the selection of a new auditor. Nevertheless, research shows that auditors have a tendency to purposely discount their fees during the first and subsequent initial years of an audit (Turpen, 1995; and Simons, 2011) so as to attract clients. When choosing an auditor, clients should therefore be aware of the risk of low-balling, a practice whereby an auditor charges a fee that is lower than the costs incurred to carry out an audit; this may imply that, as the auditor establishes a steady relationship with his client, fees are likely to rise.

Literature is nevertheless inconsistent about the idea that audit fees are the topmost factor considered when choosing an auditor (e.g. Addams and Davis, 1994; Glass Lewis & Co., 2006). The fall in importance of seeking a low audit fee could be the result of a change in corporate culture following a string of high profile accounting scandals. In Krell (2006), Mark Heimbouch, CFO at Jackson Hewitt, referred to how auditing has increasingly moved from being a commodity to a question of quality and value as well as a vital component of corporate governance.

Rather than looking at which auditor can provide their company with the lowest-cost audit, Monks (2007) says that clients become less sensitive to fees once they are able to see the value in a service. He claims that professionals must spend time getting to know their clients better and hence gain an understanding of their needs, tailoring their services so as to be able to provide clients with the value of service they desire. Addams and Davis (1994, p.38) find that "fees are not the primary reason for obtaining or retaining a client... meeting client needs is the overwhelming issue".

2.2.2 Auditor's expertise

As international standards and legislation develop further, bringing about increasingly complex accounting rules, auditors need to possess highly specific skills in order to continue to provide the level of service expected of them (Krell, 2006). Section 4.1 of Part A of the Maltese Code of Ethics for Warrant Holders (Accountancy Board, 2004, p.3) requires that warrant holders "maintain professional knowledge and skill at the level required to ensure that clients... receive competent professional service".

Clients expect their audit partners and engagement staff to be technically competent, as the results of a study on the importance of audit firm characteristics by Beattie and Fearnley (1995) suggest. Addams and Davis (1994) find that, linked to technical expertise, clients also demand that their auditor has a certain level of experience within the industry that they operate in.

Sukhraj (2007, p.1) reports Ken Lever, Financial Reporting Committee Chairman of the Hundred Group of Finance Directors, as saying that, "the growth in complexity of reporting is leading to a greater reliance by audit firms on their technical departments that apply 'rules' to a set of facts without necessarily having a deep knowledge of the circumstances or business context" and that, "the profession is increasingly moving toward a more combative relationship with companies which discourages cooperation which ultimately could have an indirect impact on the quality of the audit.

2.2.3 Quality of service and auditor size

As with any other purchase, clients also look at the quality of the service they will receive when selecting a potential auditor. The concept of audit quality is often associated with the joint probability of an auditor both discovering and reporting a breach (DeAngelo, 1981). Given the inherent difficulty in finding a measure for audit quality, the author finds that auditor size may be used as a proxy for quality. The reasoning is that the larger the audit firm (and therefore its fee income), the more it stands to lose in terms of clients and fees in the event that it incurs a loss of reputation due to a mistake on its part. A larger audit firm will therefore employ more rigorous techniques aimed at identifying fraud or other misconduct in order to safeguard its reputation. Taken literally, DeAngelo's argument suggests that a cardinal ordering of auditor size can be used to proxy for audit quality (Francis and Wilson, 1988).

The collapse of Arthur Andersen, coupled with a string of mergers within the audit market, has left only four truly global firms. This has brought about increased debate – amongst those who think that audit quality is commensurate with the size of the audit firm – about the level of auditor choice available to companies (e.g.

Oxera Report, 2006), as well as discussions on whether a Big 4 audit necessarily provides better quality. In Hawkes (2006, p.1), Steve Maslin, Head of Assurance at Grant Thornton, is reported as saying, "I am tired of the sustained campaign by the Big Four that they provide better audits than anyone else. We have taken over audits from the Big Four firms and found problems in the accounts."

What seems to be emerging from this ongoing debate is that non-Big 4 firms provide quality audits too and that companies should not look for quality solely from Big 4 firms but rather, that they should choose an auditor that can deliver the level of quality they desire, regardless of whether the auditor is a Big 4 firm or not.

2.2.4 Location of the auditor

Stokes (1992) argues that the geographical proximity of the auditor is relevant since it permits a flexible and timely response to client needs. Nevertheless, Galdes (1994) suggests that this argument may not apply to a microstate like Malta where, given its size, it is easy for an auditor to reach almost any part of the island. Galdes found that when selecting an auditor in Malta, location ranked as the least important out of nine factors. Literature is therefore, inconsistent about the true level of importance given to the auditor's location when selecting an auditor, at least with respect to Malta.

2.2.5 Relationship between Client and Auditor

While economic factors play a pivotal role in the selection process, companies are placing increasing weight on more qualitative, behavioural factors when making their choices. Addams and Davis (1994) find that CEOs place considerable importance on the relationship established between the audit firm's key personnel and the client's decision makers during the course of the auditor-evaluation process. Research on auditor change decisions in Malta by Magri and Baldacchino (2004) finds supporting evidence of the importance of the relationship between client and auditor. Maltese companies ranked 'a substantial deterioration in this relationship' as being the foremost reason leading to a change in auditor.

Literature seems to indicate that clients do not want to feel as though their auditor's only contact with them is during the annual audit. Kriss Bush, CFO of Jump TV, is quoted by Krell (2006, p.1), saying that, "some auditing partners are managing their relationships with client companies strictly by the book, and those relationships tend to lack chemistry..."

Investing in good client-auditor relations can be of long-term benefit to a firm and help increase client loyalty (Kuenzel and Krolikowska, 2007). The authors claim that a good relationship helps to retain clients for longer, thus improving the auditor's profitability. In order to foster commitment, Kuenzel and Krolikowska advise audit partners and staff to take advantage of both formal and informal situations to pass on knowledge that is of value to the client. This supports the view that clients are not solely interested in their auditor fulfilling the requirements of a statutory audit, but demand more in terms of value-added services.

2.2.6 Non-audit services

Auditors are known to provide other services to businesses apart from auditing, including the provision of advisory and taxation services. Seattle and Fearnley (1995) and Addams and Davis (1994) find that the ability to provide non-audit services ranked amongst the top half of those factors influencing auditor selection.

Based on all the factors outlined, client-auditor alignments can be viewed as the minimum cost match between client needs and auditor services (Seattle and Fearnley, 1995). The authors claim that a significant change in either the client or auditor's characteristics may result in realignment between a client and his auditor if the other party is unwilling or unable to accommodate this change.

3. Research methodology

3.1 Research instrument

The main research tool adopted was the postal questionnaire. This was chosen both because of the ability to send it to a large sample at once as well as allowing respondents the ability to remain anonymous in their response. Two questionnaires were designed for the purpose of this study – one which was mailed to companies and the other to auditors in public practice.

The questionnaires were divided into three main sections. The first section sought to collect information relating to the respondent company or audit firm. The second section related to auditor choice. Respondents were asked to rate the level of importance attributed to each of 23 factors thought to influence the selection of an auditor using a 7-point Likert scale ranging from Very Unimportant (1), Neutral (4) to Very Important (7). The third and final section sought to extract respondent demographics.

Similar questionnaires were sent to companies and auditors, the purpose being to ensure comparability of replies.

3.2 Sample selection and response rates

After piloting the research instrument with a client and an external auditor, mail surveys were carried out amongst a random sample of 330 Maltese companies registered after October 2004 but before February 2006. This not only ensured that the companies had been in operation long enough to have chosen their external auditor, but also that this choice had not been made too long before the date of the study.

Previous studies in Malta indicated a higher response rate amongst practising auditors and consequently a random sample of 70 practising auditors was selected from a warrant holder list provided by the Malta institute of Accountants. Given the nature of the study, qualified auditors working in business were excluded from the sample so as to elicit responses solely from warrant holders in public practice.

By the cut-off date, scheduled five weeks after the mail-out of questionnaires, valid responses from 68 companies and 33 auditors were received, representing response rates of 20.6% and 47.1% respectively. The majority of companies that responded employed nine or less employees (66.2% of respondents), with a minority employing 50 or more (5.9% of respondents). With respect to auditors, sole practitioners represented the largest segment of respondents (42.4% of respondents), followed by members of non-Big 4 firms and Big 4 firms (30.3% and 27.3% of respondents, respectively).

The data collected were subject to analysis using SPSS. The most frequently used test is the chi-squared test, which is able to indicate whether two variables are significantly related or not. If the *p*-value lies below 0.05 the hypothesis that the two variables are related is accepted. This indicates that the result can be generalized, as it is not attributable to chance. If however the value is greater than 0.05, the hypothesis can be rejected.

4. Research findings

The findings presented are based upon the tests conducted on the 68 valid responses, received from the postal survey carried out among individuals involved in the selection of an auditor within newly-registered companies. Comparative findings, which were derived from the tests performed on the 33 responses received from auditors, are also presented where relevant.

4.1 The bearing of an organization's characteristics over the auditor the type of auditor engaged

From the analysis performed, it resulted that certain characteristics of a company can have an influence over the type of auditor chosen. As evidenced in Table 1, companies employing between 0-9 employees are more likely to make use of a sole practitioner. Conversely, companies that employ more than 50 employees are more likely to make use of a Big 4 firm. Given the *p*-value (0.023) obtained, it can be concluded that there is a significant association between the number of persons employed by a company and the type of auditor appointed. This result may be generalized because it is not attributable to chance.

Table 1: Cross-Tabulation - Type of Auditor Appointed Versus Number of Persons Employed by the Company

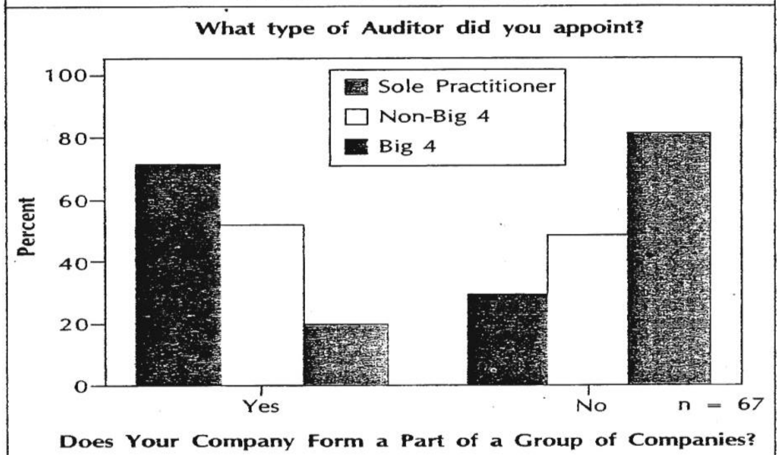
			What type of Auditor did you appoint?			
			Big 4	**Non-Big 4**	**Sole Practitioner**	**Total**
How many employees does the company employ?	**0-9**	Count	5	17	23	45
		Percentage	35.7	63.0	85.2	66.2
	10-49	Count	6	9	4	19
		Percentage	42.9	33.3	14.8	27.9
	50-249	Count	2	1	0	3
		Percentage	14.3	3.7	0.0	4.4
	250 +	Count	1	0	0	1
		Percentage	7.1	0.0	0.0	1.5
	Total	**Count**	**14**	**27**	**27**	**68**
		Percentage	**100.0**	**100.0**	**100.0**	**100.0**

Note: Sample Population - Companies.

When company respondents were asked whether their company formed a part of a group of companies or not, 43.3% replied affirmatively, with the remaining 56.7% saying that their company did not form a part of a group.

As seen from Figure 1, companies that are part of a group are more likely to appoint a Big 4 auditor, while sole practitioners are more likely (*p:* 0.003) to be chosen by those companies that do not form a part of a group of companies.

Figure 1: Chart Showing the Type of Auditor Appointed According to Whether a Company Forms a Part of a Group or Not



Note: Sample Population – Companies.

4.2 Being or intending to become listed on a stock exchange

4.2.1 The clients' perspective

In the survey sent to companies, respondents were asked to indicate whether their company was, or intended to become, listed on a stock exchange at the time the auditor was chosen. The majority responded negatively, with just 6% of valid responses claiming that their company was, or intended to become, listed at the time when the auditor was chosen. Nevertheless, when these responses were cross-tabulated against the type of auditor chosen, it was found that there exists a significant association (*p*: 0.000) between the type of auditor appointed and whether a company is, or intends to become, listed on a stock exchange or not. From the analysis, it was seen that while all three types of auditors were selected to perform audit engagements for non-listed companies, companies that are, or intend to become, listed on a stock exchange are more likely to appoint one of the Big 4 firms.

Respondents were also asked whether their company was, in fact, listed at the time of this study. When these responses were cross-tabulated with the type of auditor appointed, similar associations (p: 0.020) to those described above were obtained.

4.2.2 The auditors' opinion

In the questionnaire sent to auditors, respondents were asked to indicate what type of auditor a company is likely to choose when it is, or intends to become, listed on a stock exchange. From the valid responses received, 91.2% indicated that a Big 4 firm would be chosen, with the remaining 8.8% indicating that a non-Big 4 firm would be appointed. Furthermore, it is interesting to note that respondents from across all three types of audit practices showed consensus that a Big 4 firm is most likely to be appointed.

4.3 Matters relating to the external auditor selection process

4.3.1 Meeting the auditor prior to appointment

Respondents were asked to indicate whether they held a meeting with a prospective audit or prior to making their choice as to who to appoint. The absolute majority responded that they had indeed held a meeting with at least one auditor. However, 13.8% responded that they did not meet anyone prior to making their decision. Furthermore, when asked to indicate whether they have changed their first company auditor, 35.3% of respondents answered with assent. It is interesting to note that from the analysis performed, the results show that companies holding a meeting with more than one auditor seem more likely to change their auditor than those that either did not meet anyone, or else only met a single auditor prior to appointing the auditor. The p-value (0.001) obtained suggests that this association is not attributable to chance.

4.3.2 Explanation and provision of non-audit services to audit clients

In the survey sent to companies, respondents were asked to indicate whether their auditor explained what services, other than auditing, were offered by the firm, prior to his appointment. Of the valid responses received, 71.6% were affirmative while the remaining 28.4% said that their auditor had not. Furthermore, respondents were also asked to indicate whether their auditor was presently providing any non-audit services to the company such as tax, accountancy or advisory services.

From the analysis it became evident that those companies receiving an explanation from their auditor about non-audit services are more likely to actually engage their auditor in the provision of such services. Since the *p*-value (0.022) does not exceed the 0.05 level of significance, we can accept that there exists a significant association between the explanation of non-audit services by an auditor and the eventual provision of such services to the audit client.

4.4 Audit quality

In an attempt to determine whether individuals equate an audit firm's size with a particular level of audit quality, respondents were asked to rate their level of agreement with the following statement: The larger the audit firm, the better the audit quality.

4.4.1 The clients' perspective

The mean rating score (2.96) indicated that respondents from companies felt that they 'slightly disagreed' with the statement presented above. Nevertheless, it is evident from Table 2 that companies that are, or intend to become, listed on the stock exchange are more likely to agree with this statement (mean: 5.25) compared to companies that are not listed (mean: 2.81). Given that the p-value (0.028) is less than the 0.05 level of significance, this association can be generalized because it is not attributable to chance.

Table 2: Audit Quality - Mean Rating Scores Attributed to the Statement Relating to Audit Quality by Companies that were, or Intended to Become, Listed on the Stock Exchange or Not							
		The larger the audit firm, the better the audit quality					
		N	**Mean Rating**	**Std. Deviation**	**Std. Error**	**95% Confidence Interval for Mean**	
						Lower Bound	**Upper Bound**
Were you listed (or did you intend to become listed) on a stock exchange when choosing your auditor?	Yes	4	5.25	2.062	1.031	1.97	7.00
	No	64	2.81	1.582	0.198	2.42	3.21
	Total	**68**	**2.96**	**1.697**	**0.206**	**2.55**	**3.37**
Note: Rating Score: 1 >= Strongly Disagree; 4 = Neutral; 7 =; Strongly Agree; and Sample Population: Companies.							

A significantly different rating was also given to the statement depending on the type of auditor appointed by the respondents. As Table 3 illustrates, respondents who appoint a Big 4 firm tend to agree more (mean: 4.43) with this statement than those who appoint a sole practitioner (mean: 2.59) or a non-Big 4 firm (mean:2.56). The *p*-value (0.017) suggests that this result may be generalized and is not attributable to chance.

4.4.2 The auditors' opinion

Responses from auditors resulted in a mean rating score (3.78) that also tended toward disagreement with the statement. Nevertheless, Big 4 audit firms tend to agree with this statement more than the smaller firms. The *p*-value (0.017) implies that this result is not attributable to chance and can therefore be generalized to the population of auditors.

Table 3: Audit Quality - Mean Rating Scores Attributed to the Statement Relating to Audit Quality by Companies that Appointed Different Types of Auditors

		The larger the audit firm, the better the audit quality					
		N	**Mean Rating**	**Std. Deviation**	**Std. Error**	**95% Confidence Interval for Mean**	
						Lower Bound	**Upper Bound**
What type of auditor did you appoint ?	Big 4	14	4.43	2.174	0.581	3.17	5.68,
	Sole Practitioner	27	2.59	1.338	0.257	2.06	3.12
	Non-Big 4	27	2.56	1.340	0.258	2.03	3.09
	Total	**68**	**2.96**	**1.697**	**0.206**	**2.55**	**3.37**

Note: Rating Score: 1 = Strongly Disagree; 4 = Neutral; 7 =; Strongly Agree; and Sample Population: Companies.

4.5 Auditor choice: mean rating scores attributed by clients and auditors

In order to determine the importance attributed to a number of influential factors when selecting a company's first external auditor, respondents were asked to provide a rating, ranging from very unimportant (1) to very important (7) to each of the 23 factors presented to them. Tables 4 and 5 list these factors in descending order of importance based on the mean computed for the respective samples. Each factor was classified as being 'behavioural' or 'economic' in nature. Factors that did not clearly pertain to either of the categories were classified as ‘other’ factors.

The clients' perspective is presented in Table 4, and the auditors' opinion is presented in Table 5.

4.5.1 A comparison of client and auditor responses

In order to establish whether the ranking order elicited by clients and auditors, in Tables 4 and 5 respectively, are indeed similar, the Spearman correlation coefficient was computed. The coefficient obtained (0.884) indicates a very strong positive relationship between the ranking orders elicited by the two groups of respondents. Given that the *p*-value (0.000) is less than the 0.05 level of significance, this result is not attributable to chance.

These findings imply that auditors are strongly aware of the importance attributed by clients to the 23 factors. Figure 2 illustrates the responses further.

Table 4: Factors Influencing External Auditor Selection Ranked According to the Mean Rating Scores Attributed by Individuals Involved in the Choice of Their Company's First Auditor

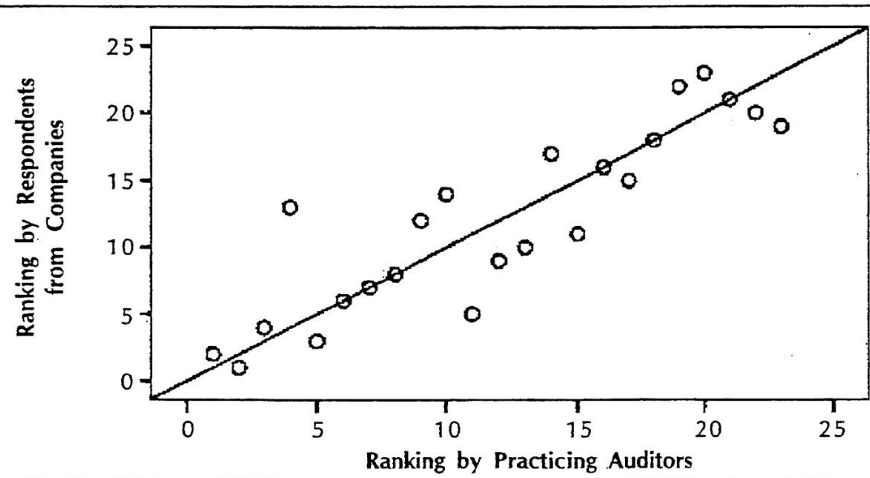
Ranking by Companies [Ranking by Auditors*]	Factors Influencing External Auditor Selection	Category	*N*	Mean Rating	Std. Deviation
1 [2]	Quality of Service	Economic	68	6.32	1.190
2 [1] ,	Availability of the auditor when needed	Behavioural	67	6.13	1.347
3 [5]	The work proposed by the auditor meets the client's expectations	Economic	68	5.99	l .333
4 [3]	Establishing a long-term relationship with auditor	Behavioural	68	5.91	1.346
5 [11]	Ability of the client to develop a good working relationship with the auditor or audit team	Behavioural	68	5.81	1.479
6 [6]	Auditor's understanding of the client's business	Economic	68	5.69	1.595

	Table 4 continued				
Ranking by Companies [Ranking by Auditors*]	**Factors Influencing External Auditor Selection**	**Category**	**N**	**Mean Rating**	**Std. Deviation**
7 [7]	Provision of a value-for-money audit	Economic	68	5.62	1.404
8 [8]	Auditor's experience within the client's industry	Economic	68	5.51	1.540
9 [12]	Personality of the auditor	Behavioural	68	5.38	1.812
10 [13]	Recommendation(s) made about the auditor	Behavioural	68	5.31	1.623
11 [15]	Independence of the auditor	Behavioural	68	5.28	1.819
12 [9]	Provision of tax services	Economic	68	5.16	1.742
13 [4]	Audit fee	Economic	68	4.91	1.777
14 [10]	Provision of advisory services	Economic	68	4.87	1.946
15 [17]	Provision of accounting services	Economic	68	4.63	2.014
16 [16]	Size of auditor's practice	Economic	68	4.15	1.595
17 [14]	The fee charged for other non-audit services	Economic	68	4.03	1.853
18 [18]	That the auditor does not perform the audit of the client's competitor(s)	Economic	68	3.96	2.147
19 [23]	That the audit firm selected was a non-Big 4 firm	Other	68	3.38	2.165
20 [22]	Proximity of the auditor's office/s to client's office/s	Economic	68	3.31	2.039
21 [21]	That the auditor selected was a sole practitioner	Other	68	3.18	1.969
22 [19]	Global presence of the audit firm	Economic	68	3.10	1.830
23 [20]	That the audit firm selected was a Big 4 firm	Other	67	2.66	2.049
Note: * Vide Table 5; Rating Score: 1 = Very Unimportant; 4 = Neutral; 7 = Very Important; and Sample Population: Companies.					

Table 5: Factors Influencing External Auditor Selection Ranked According to the Mean Rating Scores Attributed by Auditors					
Ranking by Auditors [Ranking by Companies*]	**Factors Influencing External Auditor Selection**	**Category**	***N***	**Mean Rating**	**Std. Deviation**
1 [2]	Availability of the auditor when needed	Behavioural	33	6.27	1.069
2 [1]	Quality of Service	Economic	33	6.06	0.788
3 [4]	Establishing a long-term relationship with the auditor	Behavioural	33	5.94	0.933
4 [13]	Audit fee	Economic	33	5.94	1.197
5 [3]	The work proposed by the auditor meets the client's expectations	Economic	33	5.85	1.034
6 [6]	Auditor's understanding of the client's business	Economic	33	5.82	0.950
7 [17]	Provision of a value-for-money audit	Economic	33	5.73	1.069
8 [8]	Auditor's experience within client's industry	Economic	33	5.73	1.069
9 [12]	Provision of tax services	Economic	33	5.55	1.148
10 [14]	Provision of advisory services	Economic	33	5.39	1.059
11 [5]	Ability of the client to develop a good working relationship with the auditor or audit team	Behavioural	33	5.39	0.966
12 [9]	Personality of the auditor	Behavioural	33	5.30	1.015
13 [10]	Recommendation(s) made about the auditor	Behavioural	33	5.30	1.159
14 [17]	The fee charged for other non-audit services	Economic	33	4.76	1.300
15 [11]	Auditor independence	Behavioural	33	4.67	1.594
16 [16]	The size of the auditor's practice	Economic	33	4.36	1.270
17 [15]	Provision of accounting services	Economic	33	4.24	1.521
18 [18]	That the auditor does not perform the audit of the client's competitor(s)	Economic	33	4.24	1.714
19 [22]	Global presence of the audit firm	Economic	33	3.97	1.510

	Table 5 Continued				
Ranking by Auditors [Ranking by Companies*	**Factors Influencing External Auditor Selection**	**Category**	**N**	**Mean Rating**	**Std. Deviation**
20 [23]	That the audit firm selected was a Big 4 firm	Other	33	3.76	1.437
21 [21]	That the auditor selected was a sole practitioner	Other	33	3.55	1.277
22 [20]	Proximity of auditor's office/s to client's office/s	Economic	33	3.39	1.478
23 [19]	That the audit firm selected was a non-Big 4 firm	Other	33	3.30	1.237
Note: *Vide Table 4; Rating Score: 1 = Very Unimportant; 4 = Neutral; 7 - Very Important; and Sample Population: Auditors.					

Figure 2: Scatter Plot Illustrating the Ranking Scores Attributed by Clients and Auditors to Each of the 23 Factors



Note: Every point represents a factor influencing external auditor selection; and Sample Population: Companies and Auditors.

4.6 Selecting the three most important factors

In addition to providing a rating of 1 to 7, respondents were asked to consider the list of 23 factors, select the three most important factors taken into consideration when choosing their auditor, and write them in descending order of importance. Tables 6 and 7 rank the factors mentioned as most important, second most important and third most important, as listed by clients and auditors respectively. The clients' perspective is presented in Table 6, and the auditors' opinion is presented in Table 7.

Table 6: Top Three Factors Influencing External Auditor Selection Cited by Respondents Responsible for Appointing the Auditor Within Their Company

Ranking by Companies	Factors Influencing External Auditor Selection	Individual Ranking Frequency*				Factor Ranking from Table 4**
		Most Important	Second Most Important	Third Most Important	Total^	
1	Quality of Service	11^{1}	17^{1}	4^{4}	32	4
2	Availability of the auditor when needed	8^{2}	1^{11}	17^{1}	26	2
3	Audit Fee	3^{7}	11^{2}	11^{2}	25	13
4	Auditor's understanding of the client's business	8^{2}	8^{3}	3^{5}	19	6
5	Establishing a long-term relationship with the auditor	3^{7}	6^{4}	5^{3}	14	4

Note: * Superscripts indicate the rank of factors within each of the top three slots (thus, for example, three respondents cited 'audit fee' as the most important factor when choosing their auditor and this was the seventh most frequently cited such reason); ^ Factors are shown in decreasing frequency of total citations across the three top slots; ** The factor ranking provided in the rightmost column is shown for comparison purposes only and is reproduced from the rankings obtained in Table 4; and Sample Population: Companies.

Table 7: Top Three Factors Influencing a Client's External Auditor Selection process as Cited by Practising Auditors

Ranking by Companies	Factors Influencing External Auditor Selection	Individual Ranking Frequency*				Factor Ranking from Table 5**
		Most Import ant	Second Most Important	Third Most Important	Total^	
1	Audit Fee	10^{1}	17^{1}	4^{4}	22	4
2	Availability of the auditor when needed	3^{3}	5^{2}	6^{1}	14	1
3	Establishing a long-term relationship with the auditor	3^{3}	5^{2}	2^{3}	10	3
4	Quality of Service	3^{3}	2^{5}	2^{3}	7	2
5	Auditor's experience within client's industry	4^{2}	1^{9}	1^{9}	6	8

Note: * Superscripts indicate the rank of factors within each top three slots (thus, for example, five respondents cited 'establishing a long-term relationship with the auditor' as the second most important factor when choosing their auditor and this was the second most frequently cited such reason); ^Factors are shown in decreasing frequency of total citations across the three top slots; ** The factor ranking provided in the rightmost column is shown for comparison purposes only and is reproduced from the rankings obtained in Table 5; and Sample Population: Auditors.

4.7 The importance of economic and behavioural factors

4.7.1 The clients' perspective

It is evident from the mean rating scores obtained that behavioural factors are slightly more important to clients when choosing their auditors, with three out of the top five factors being behavioural. The mean ratings shown in Table 8 confirm this finding, with behavioural factors obtaining a higher overall mean rating score than the other two categories. The *p*-value (0.000) obtained suggests that this result is not attributable to chance and can be generalized.

Table 8: Overall Mean Rating Scores Attributed by Clients to Behavioural, Economic and Other Factors					
	Mean Rating	**Stf. Deviation**	**Std. Error**	**95% Confidence Interval for Mean**	
				Lower Bound	**Upper Bound**
Behavioural Factors	5.66	1.586	0.079	5.51	5.82
Economic Factors	4.82	1.962	0.064	4.69	4.94
Other Factors	3.07	2.075	0.146	2.79	3.36
Note: Rating Score: 1 = Very Unimportant, 4 = Neutral, 7 = Very Important; and Sample Population: Companies.					

4.7.2 The auditors' opinion

As shown in Table 9, responses from auditors echo those elicited from companies, with the former attributing more importance to behavioural factors than economic ones. Given the *p*-value (0.000) obtained, this occurrence is not attributable to chance and can be generalized to the population of auditors.

Table 9: Overall Mean Rating Scores Attributed by Auditors to Behavioural, Economic and Other Factors					
	Mean Rating	**Std. Deviation**	**Std. Error**	**95% Confidence Interval for Mean**	
				Lower Bound	**Upper Bound**
Behavioural Factors	5.48	1.241	0.088	5.31	5.65
Economic Factors	5.07	1.494	0.070	4.94	5.21
Other Factors	3.54	1.320	0.113	3.27	3.80
Note: Rating Score: 1 = Very Unimportant, 4 = Neutral, 7 = Very Important; and Sample Population: Companies.					

4.8 Relationships between respondent characteristics and mean rating scores

In addition to being asked to rate the importance attributed to influential factors, clients were also asked to provide information pertaining to themselves as well as to the company they form part of. From the analysis performed on this data, a number of statistically relevant relationships were identified between the rating scores attributed and respondent characteristics.

4.8.1 Location of the company

Respondents were asked to specify on which island their audit is held, in order to establish where the main activities of the company are carried out. The majority (92.6%) responded that their audit is held in Malta with the remainder being held in Gozo. As shown in Table 10, significant differences exist between the mean rating scores attributed to the below-mentioned factors depending on whether a company's audit takes place in Malta or Gozo.

Respondents from Gozo attributed more importance to each of the three factors listed in Table 10, compared to respondents from Malta. The largest difference in mean rating scores between the two categories of respondents was with respect to 'the proximity of the auditor's office{s) to the respondents' office(s)'. Respondents from Malta felt that this factor was 'slightly unimportant' (mean: 3.13), whereas their Gozitan counterparts thought that their prospective auditor's location was 'important' (mean: 5.60) when considering whom to appoint. As illustrated by the *p*-values obtained in Table 10, the relationships are not attributable to chance and can therefore be generalized to the population of clients in Malta and Gozo respectively.

Table 10: Mean Rating Scores Attributed to Factors Influencing External Auditor Selection, Depending on the Location of the Client

Factors Influencing External Auditor Selection	Where is your Audit held?	*N*	Mean Rating	Std. Deviation	Std. Error	95% Confidence Interval for Mean		*p*-Value
						Lower Bound	Upper Bound	
That the auditor does not perform the audit of the client's competitor(s)	Malta	63	3.81	2.093	0.264	3.28	4.34	0,043
	Gozo	5	5.80	2.168	0.970	3.11	7.00	
	Total	**68**	**3.96**	**2.147**	**0.260**	**3.44**	**4.48**	
Proximity of the auditor's office(s) to the client's office(s)	Malta	63	3.13	1.896	0.239	2.65	3.60	0.031
	Gozo	5	5.60	2.608	1.166	2.36	7.00	
	Total	**68**	**3.31**	**2.039**	**0.247**	**2.82**	**3.80**	
Provision of tax services	Malta	63	5.05	1.755	0.221	4.61	5.49	0.024
	Gozo	5	6.60	0.548	0.245	5.92	7.00	
	Total	**68**	**5.16**	**1.742**	**0.211**	**4.74**	**5.58**	

Note: Rating Score: 1 = Very Unimportant, 4 = Neutral, 7 = Very Important; and Sample Population: Companies.

4.8.2 Type of audit firm selected

Respondents were asked to specify the type of auditor chosen to perform their company's audit. As shown in Table 11, a relationship exists between the response to the aforementioned question and the importance attributed to the factors listed in the said table. Respondents that ultimately chose a Big 4 firm attributed more importance to an "auditor's level of industry experience" as well as to an '"auditor's global presence". Given the *p*-values obtained, the relationships identified in the Table 11 are not attributable to chance.

Table 11: Mean Rating Scores Attributed to Factors Influencing External Auditor Selection, Depending on the Type of Auditor Appointed

Factors Influencing External Auditor Selection	What type of Auditor did you appoint?	*N*	Mean Rating	Std. Deviation	Std. Error	95% Confidence Interval for Mean		*p*-Value
						Lower Bound	Upper Bound	
Auditor's experience within the client's industry	Big 4	14	6.21	1.578	0.422	5.30	7.00	0.027
	Non-Big 4	27	5.30	1.436	0.276	4.73	5.86	
	Sole Practitioner	27	5.37	1.573	0.303	4.75	5.99	
	Total	**68**	**5.51**	**1.540**	**0.187**	**5.14**	**5.89**	
Global presence of the audit firm	Big 4	14	4.57	1.742	0.465	3.57	5.58	0.003
	Non-Big 4	27	3.00	1.776	0.342	2.30	3.70	
	Sole Practitioner	27	2.44	1.528	0.294	1.84	3.05	
	Total	**68**	**3.10**	**1.830**	**0.222**	**2.66**	**3.55**	

Note: Rating Score: 1 = Very Unimportant, 4 = Neutral, 7 = Very Important; and Sample Population: Companies.

4.8.3 Intention to be listed on a stock exchange

Individuals involved in the choice of their company's auditor were asked whether their company was, or intended to become, listed on the stock exchange at the time when their auditor was chosen. Based on the results presented in Table 12, a number of relationships were identified between the listing status of companies and the mean attributed to certain factors influencing external auditor selection. Respondents from companies that were, or intended to become, listed, in fact attributed greater importance to each of the five factors in Table 12.

Table 12: Mean Rating Scores Attributed to Factors Influencing External Auditor Selection, Depending on Whether a Company is (or Intends to Become) Listed on the Stock Exchange or not

Factors Influencing External Auditor Selection	Were you listed (or did you intend to become listed) on a stock exchange when choosing your auditor?	*N*	Mean Rating	Std. Deviation	Std. Error	95% Confidence Interval for Mean		*p*-Value
						Lower Bound	Upper Bound	
Auditor's experience within the client's industry	Yes	4	7.00	0.000	0.000	7.00	7.00	0.011
	No	64	5.42	1.541	0.193	5.04	5.81	
	Total	**68**	**5.51**	**1.540**	**0.187**	**5.14**	**5.89**	
Ability to develop a good working relationshi p with the auditor or audit team	Yes	4	7.00	0.000	0.000	7.00	7.00	0.032
	No	64	5.73	1.493	0.187	5.36	6.11	
	Total	**68**	**5.81**	**1.479**	**0.179**	**5.45**	**6.17**	
The size of the auditor's practice	Yes	4	6.00	0.000	0.000	6.00	6.00	0.009
	No	64	4.03	1.573	0.197	3.64	4.42	
	Total	**68**	**4.15**	**1.595**	**0.193**	**3.76**	**4.53**	
That the audit form selected was a Big 4 audit firm	Yes	4	5.50	1.732	0.866	2.74	7.00	0.012
	No	63	2.48	1.942	0.245	1.99	2.97	
	Total	**67**	**2.66**	**2.049**	**0.250**	**2.16**	**3.16**	
Global presence of the audit firm	Yes	4	5.50	1.000	0.500	3.91	7.00	0.012
	No	64	2.95	1.768	0.221	2.51	3.39	
	Total	**68**	**3.10**	**1.830**	**0.222**	**2.66**	**3.55**	

Note: Rating Score: 1 = Very Unimportant, 4 = Neutral, 7 = Very Important; and Sample Population: Companies.

The mean rating scores differed the most with respect to 'whether the audit firm selected 'was a Big 4 audit firm' or not, as well as the 'global presence of the audit firm'. It seems that compared to a company that is not listed on a stock exchange, a company that is, or intends to become listed, is likely to give more importance to these factors when choosing its prospective auditor. Furthermore, the *p*-values obtained suggest that the relationships presented in Table 12 are not attributable to chance.

4.8.4 Forming part of a group of companies

Clients were also asked whether their company forms a part of a group or not. As exhibited in Table 13, a relationship exists between the mean rating scores attributed to the two factors mentioned, and whether a company forms a part of a group of companies or not.

It seems that companies that indeed form a part of a group attribute lesser importance to their prospective auditor's ability to provide "accounting" and "advisory" services, compared to those companies that do not form a part of a group. The *p*-value obtained suggests that this result is not attributable to chance and can therefore, be generalized to the entire population of companies.

Table 13: Mean Rating Scores Attributed to Factors Influencing External Auditor Selection, Depending on Whether a Company forms Part of a Group of Companies or not

Factors Influencing External Auditor Selection	Does your company form part of a group of companies?	*N*	Mean Rating	Std. Deviation	Std. Error	95% Confidence Interval for Mean		*p*-Value
						Lower Bound	Upper Bound	
Provision of Accounting services	No	38	5.29	1.659	0.269	4.74	5.83	0.006
	Yes	29	3.90	2.110	0.392	3.09	4.70	
	Total	**67**	**4.69**	**1.979**	**0.242**	**4.20**	**5.17**	
Provision of advisory services	No	38	5.32	1.694	0.275	4.76	5.87	0.040
	Yes	29	4.24	2.132	0.396	3.43	5.05	
	Total	**67**	**4.85**	**1.956**	**0.239**	**4.37**	**5.33**	

Note: Rating Score: 1 = Very Unimportant, 4 = Neutral, 7 = Very Important; and Sample Population: Companies.

4.8.5 Respondents' levels of accounting knowledge

The questionnaire sent to companies also sought to establish the level of accounting knowledge of respondents.

As shown in Table 14, the level of accounting knowledge seems to have an effect over the level of importance ascribed to the ability of a prospective auditor to provide 'accounting' and 'advisory' services.

Clients that are not as knowledgeable in accounting seem to attribute greater importance to the provision of both accounting and advisory services. Conversely, individuals who have studied accounts up to a diploma or university level are neutral as to their auditor's ability to provide these services

. Table 14: Mean Rating Scores Attributed to Factors Influencing External Auditor Selection, Depending on the Respondent's Level of Accounting Knowledge

Factors Influencing External Auditor Selection	What is your Level of Accounting Knowledge?	*N*	Mean Rating	Std. Deviation	Std. Error	95% Confidence Interval for Mean Lower Bound	95% Confidence Interval for Mean Upper Bound	*p*-Value
Provision of Accounting services	None	5	5.60	2.074	0.927	3.03	7.00	0.000
	Basic Level	28	5.64	1.420	0.268	5.09	6.19	
	Advanced Level	5	6.00	0.000	0.000	6.00	6.00	
	Diploma/ University Level	11	4.18	1.834	0.553	2.95	5.41	
	Professional Level	17	2.59	1.543	0.374	1.79	3.38	
	Total	**66**	**4.64**	**1.997**	**0.246**	**4.15**	**5.13**	
Provision of advisory services	None	5	5.80	2.T68	0.970	3.11	7.00	0.000
	Basic Level	28	5.75	1.351	0.255	5.23	6.27	
	Advanced Level	5	6.00	0.000	0.000	6.00	6.00	
	Diploma/ University Level	11	4.18	1.537	0.464	3.15	5.21	
	Professional Level	17	3.29	2.085	0.506	2.22	4.37	
	Total	**66**	**4.88**	**1.926**	**0.237**	**4.41**	**5.35**	

Note: Rating Score: 1 = Very Unimportant, 4 = Neutral, 7 = Very Important; and Sample Population: Companies.

Furthermore respondents possessing a professional level of accounting knowledge claim that they view these factors as 'slightly unimportant' to them when selecting an auditor. The *p*-values obtained suggest that these findings are not attributable to chance and can thus be generalized to the population of respondents.

5. Discussion on findings

With a multitude of auditors to choose from, Maltese and Gozitan companies alike, without a doubt, had to develop a set of criteria against which they can assess and make a final selection as to whom they would appoint as their auditor. This section discusses the major findings that have emanated from the study, outlining those decisive factors upon which individuals ultimately decide whom to appoint.

5.1 What influences a client's decision? The quality dilemma

Clients evaluate their prospective auditors primarily on the 'quality of service' that can be offered to them. Nevertheless, when asked whether they associate the size of the auditor with a particular level of quality, as postulated by DeAngelo (1981), companies generally disagreed, leading to the question of how is quality indeed assessed and measured in the Maltese Islands? If 'quality' is of such fundamental importance to clients then there must surely be a way of measuring it.

5.1.1 Availability of the auditor

A possible measure of quality could be the 'availability of the auditor' once appointed. Companies expect their auditor to be on hand when needed and not only meet the management once a year, during the annual audit. An auditor should therefore strive to build a strong, long- term business relationship with his client, offering invaluable advice and support that goes beyond his clients' expectations. This could provide the level of quality that companies seem to have come to presume from their auditor.

5.1.2 Size of the audit practice

In the case of Small and Medium-sized Enterprises (SMEs), a larger audit firm does not imply better quality. This is possibly a result of their experience with larger firms who at times view SMEs as being too small, consequently not dedicating enough time, attention or senior personnel to these clients.

On the other hand, the size of an audit practice can be an indication of quality amongst some clients such as those that are thinking of going public. Such clients believe the larger size of an auditor to be commensurate to better quality, possibly implying that to these businesses a larger audit firm is able to bring a better reputation to their company through brand awareness and the global presence of their audit firm. Listed companies almost exclusively opt for a Big 4 audit, suggesting that as Maltese companies and the Maltese stock exchange continue to grow and mature, the demand for the services of Big 4 firms may likewise expand.

5.2 Relationships or economics: what do clients prefer?

Magri and Baldacchino (2004) had established that while earlier foreign studies cite economic factors as being prevalent with respect to auditor change, in Malta importance was being attributed to both economic and behavioural factors. The results of the present study go a step further, indicating that when choosing an auditor, clients tend to place more weight on behavioural factors compared to those of economic nature. This confirms the suggestions made to auditors by Kuenzel and Krolikowska (2007), investing in good client-auditor relations and taking every opportunity to pass on advice can be of long-term benefit to a firm, and help increase client loyalty. It seems that, other than fulfilling statutory requirements, clients in Malta seek to establish a personal relationship with their auditor, partner or audit team. This bias toward behavioural factors may arise due to the fact that Malta is a mini-state in which importance is given to familiarity and acquaintances.

5.3 Evaluating the audit fee

Beattie and Fearnley (1998) found that the 'audit fee' is usually the most frequently cited factor influencing auditor choice. However, the present study found that this was not reflected in the Maltese scenario. Clients give much less importance to the fee when choosing their first auditor, ranking this below factors such as the 'personality of an auditor' and an 'auditor's independence'. Nevertheless, auditors seem to have the impression that their clients give noticeably more importance to the audit fee, possibly suggesting that during negotiations with their auditors, clients place more weight on the audit fee than they are willing to admit.

Another possible explanation to this ostensible inconsistency is that, while clients have a number of expectations from their auditor, including "quality of service", "availability", "proposed work", "understanding of the business and industry" and the "provision of non-audit services", if their auditor fails to meet these expectations, they will cite the audit fee as being too high.

5.4 Across the channel

Clients in Gozo, Malta's sister-island, feel that an 'auditor's location' is more important to them compared to their counterparts in Malta. Gozitans also feel that they are uncomfortable appointing an auditor who also 'audits their competitors', this possibly being a characteristic of a limited market with only a few players within each segment. Companies operating in such an environment may become extra vigilant in trying to prevent their competitors from gaining information about their operations. This may imply that a company in Gozo has a limited choice of auditors if it wants to avoid those auditors that audit its competitors, while at the same time appointing an auditor that is located close to its place of operation. This quest for auditor independence may further imply that there exists a market for Maltese auditors in Gozo. However, auditors and audit firms should become aware that if they intend to win clients on Malta's smaller sister-island, they must consider how to appear more accessible, possibly opening an office on the island, or visiting clients more regularly.

5.5 Comparing perceptions

Upon comparing the responses elicited from both clients and auditors, it was established that similarities indeed existed, with some responses being identical to prospective clients are looking for in an auditor. One can only hope that, other than merely being aware of what influences clients when selecting their auditor, practitioners will actually strive to provide their customers with what they desire.

6. Conclusion

Perhaps one of the main conclusions of this study is that the all-important factor influencing external auditor selection is the 'quality of service' that the client expects his auditor to provide once appointed. Coupled with the overall importance attributed to factors of 'behavioural' nature, this may imply that clients in Malta look for more than just the lowest audit fee that they can find. In addition it was also observed that quality is not determined by the size of the audit firm, but possibly by "the availability of an auditor" and the ability to develop a "long-term working relationship with an auditor".

The study also determined that while clients did not rank the audit fee as one of the topmost influential factors, the fee was indeed one of the most frequently cited issues when clients were asked to mention the three most important factors influencing their choice of auditor. It may be inferred from this apparent inconsistency that when clients mention that the fee *per se* has influenced their decision, it may actually be that other – perhaps unquantifiable – factors really influenced their choice of auditor.

In general it was also noted that auditors possess a fairly accurate understanding of what clients value most when appointing their prospective auditors. Nevertheless, despite the similarities, it was interesting to observe that, in the auditors' opinion, clients give considerably more importance to the audit fee when selecting their auditor.

The discussion and conclusion emanating from the study imply that auditors need to strive to provide value throughout the course of the statutory audit. Clients are not only interested in an auditor's technical knowledge, but would like to choose an auditor who they believe will give them time and build a strong working relationship with client management.

The results of our study are subject to the following limitations. Responses were received from a limited number of clients and auditors. Keeping this in mind, wherever the chi-squared test was performed, only significant relationships (with a *p*-value <0.05) have been presented. Further research is necessary to verify the validity of the results of this paper to other countries by replicating this research with other companies and auditors in other economies, particularly island-states.

References

Regulatory

Accountancy Board (2004). Ministry of Finance, Government of Malta. Code of Ethics for Warrant Holders, Malta.

Companies Act - Malta, 1995. Chapter 386 of the laws of Malta.

Eighth Directive (2006), EU Directive 2006/43/EC of the European Parliament and of the Council.

Sarbanes, P. (2002). Sarbanes-Oxley Act, 2002. In *The Public Company Accounting Reform and Investor Protection Act. Washington DC: US Congress.*

Other

Addams, H.L. and Davis, B. (1994). Privately held companies report reasons for selecting and switching auditors. *The CPA Journal*, *64*(8):38.

Beattie, V. and 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. and Fearnley, S.(1998). Audit market competition: auditor changes and the impact of tendering. *The British Accounting Review*, 30 (3): 261-289.

Crouch, T. (2004). Seven-year auditor rotation: http://www.auditnet.org/articles/TC%2OSeven%20Year%20Auditor%20 Rotation. htm [21 April, 2007].

DeAngelo, L. E. (1981). Auditor size and audit quality. *Journal of Accounting and Economics*, December: 183-199.

Francis, J.R. and Wilson, E.R. (1988). Auditor changes: A joint test of theories relating to agency costs and auditor differentiation. *Accounting Review*: 663-682.

Gaa, J.C. (2005). Accounting ethics. In Werhane, P. H. and Freeman, R.E. (eds). *Business Ethics, The Blackwell Encyclopaedia of Management* : 1-7, Blackwell Publishing, Maiden, MA.

Galdes, J. (1994). The selection of statutory auditors: an analysis of Maltese and foreign practices. B. Accountancy (Hons) dissertation, Department of Accountancy, University of Malta.

Glass Lewis & Co. (2006). Mum's the word: http:// www.soxfirst.com/50226711/Auditor7o20Turnover.pdf. [14 October, 2007].

Hawkes, A. (2006). Big Four and beyond: Is bigger better?: http://www.accountancyage.com/accountancyage/analysis/2T71153/bigger-better. [8 August , 2007].

Keating, E.K., Fischer, M., Gordon, T. and Greenlee, J. (2003). The relation between auditor selection and adverse audit findings: examination of nonprofits subject to the Single Audit Act. In *ARNOVA Conference(January)*.

Krell, E (2006). The New Dynamics of Auditor Selection. *Business Finance*, November: 18.

Kuenzel, S. and Krolikowska, E., 2007. Client loyalty: play the loyalty card *Accountancy Age*: http://vww.accountancyage.com/accountancyage/features/2188173/client-loyalty-play-loyalty [21 October , 2007].

Magri, J. and Baldacchino, P.J., 2004. Factors contributing to auditor-change decisions in Malta. *Managerial Auditing Journal*, 19(7): 956-968.

Monks, J. (2007). True Value of Your Services Because You're Worth it . *Best Practice Magazine :* https://www.thepacepartners.com/the-true-value-of-your-services-because-youre-worth-it [18 October, 2007].

Oxera, C.L. (2006), Competition and choice in the UK audit market: http://www.frc.org. uk/documents/pagemanager/frcCompetition %2 Oand %20choice %20in%20the%20UK%20audit%20market.pdf. [1September, 2006].

PriceWaterhouseCoopers (2005) (PwC). Corporate Governance toolkit for small and medium enterprises, PwC Australia.

Simons, D., 2011. Lowballing and learning effects. *Betriebswirtschaftliche Forschung und Praxis: BFuP*, 63 (2): 160-179.

Stokes, D. B. (1992). The market for audit services: Evidence from audit firm mergers. Paper presented at the Annual Conference of the American Association, USA.

Sukhraj. P. (2007). Hundred group: auditors are too combative. *Accountancy Age:* http://vwvw.accountancyage.com/accountancyage/news/2201M18/hundred-groupslams- auditors [18 October, 2007].

Tabone, N. and Baldacchino, P.J., (2003). The statutory audit of owner-managed companies in Malta. *Managerial Auditing Journal*, 18 (5): 387-398.

Turpen, R.A. (1995). Audit fees - What research tells us. *The CPA Journal*, 65(1): 54.

CHAPTER 8

An Analysis of the Development of Audit Fees in Malta

[AUD 6]

Baldacchino, P.J.[1] and Borg, J.[2]

The IUP Journal of Accounting Research and Audit Practices

Vol X111, Issue 2, 2014, pp. 27-52

[1] Head and Senior Lecturer, Department of Accountancy, Faculty of Economics, Management and Accountancy, University of Malta.

E-mail: peter.j.baldacchino@um.edu.mt

[2] Associate, Malta Institute of Accountants and A/Lecturer, University of Malta

An Analysis of the Development of Audit Fees in Malta

Baldacchino, P.J. and Borg, J.

University of Malta, Malta

This paper seeks to assess the development of the pricing of statutory audits in Malta over time, with a view of changes in its determinants, the Global Financial Crisis (GFC) and other potentially significant events. The findings reveal that there seems to be a general difficulty in realigning the audit fee in response to variations in its drivers, with a degree of price rigidity or stickiness being attributed to elements of imperfect competition and imperfect information in the market. The study also suggests the prevalence of implicit contracts between audit firms other than the Big 4 and their audit clients in order to mitigate the increase in audit fees expected since the recent GFC from 2008. Such behaviour needs to be studied more deeply to understand its persuasiveness across other microstates.

Keywords*: audit fees, external auditing, Malta*

1. Introduction

Every limited liability company incorporated in Malta is required by law to appoint a qualified independent auditor registered with the local accountancy board, with the remuneration thereof being defined rather unclearly in the Companies Act (Cap. 386 of the Laws of Malta) as including 'sums paid in respect of expenses'.

The audit fee constitutes one of the audit engagement's terms that, as per ISA 210 (IFAC, 2009a), must be agreed to by the auditor and management (or those charged with governance). In so far as its estimation is concerned, Dickins *et al*. (2008) argue that it is not only an art, but also a science. In fact, a number of researchers have opted to scientifically examine the correlation between different variables and the pricing of audits, especially since the seminal work of Simunic (1980).

Moreover, Hay *et al*. (2006) have interestingly put forward a meta-analysis of audit fee models, which indicates that the significance of such variables can change overtime. To this end, Raluca (2011) has identified the recent Global Financial Crisis (GFC) from 2008 as an important breaking point for the behaviour of the audit fee.

This study contributes to the existing stream of research by somewhat complementing the work by Baldacchino *et al*. (2013). In fact, while Baldacchino *et al*. (2013) have been the first to empirically analyze the factors influencing the pricing of external audit services in the Maltese environment, the main objective of this longitudinal study is to arrive at evidence on trends or developments in such audit fees and the impact of their determinants overtime.

Understanding whether the influence of such determinants has changed over time should help auditors answer questions like whether they have been able to align the engagement fee with the client risk involved, perhaps instituting revisions to their processes for setting audit fees as a result. Meanwhile, the management can be made aware of how shifts in the company can lead to either an increase or a decrease in the audit fee charged. Furthermore, it will be interesting to see whether, especially with a view of the financial turbulence during the end of the last decade, the external auditor's/compensation is exhibiting some general upward or downward pattern.

The present research aims to assess the stability or otherwise of the audit fee in the Maltese environment and its development in relation to changes in its drivers over the period under examination by asking the following research questions:

- How have audit fees in Malta reacted to movements in their determinants between 2004 and 2011?
- What trends are being exhibited by the audit fee in the Maltese environment during the period under study?
- What relevance, if any, have the GFC and other events had on the prices charged in the Maltese audit market?

The paper is structured as follows: after a brief introduction of the topic at hand, an assessment is made of the literature tackling audit fees and their development over time. Subsequently, the method adopted for obtaining the relevant data is described, the results of which are then presented and analyzed with a view of the literature in the field. This is followed by a summary of the most relevant facts, together with the concluding remarks, limitations encountered and recommendations.

2. Literature review

2.1 Audit fee determinants

Numerous studies have been carried out worldwide over the past 30 years to investigate which factors influence the pricing of external audit services, and this by providing empirical evidence on the relationship between the audit fee charged and the attributes of the companies audited. Pioneering in this regard has been the seminal paper by Simunic, dating back to 1980.

Such models are based on historical research of a cross-sectional nature, relying on data drawn from a short period of time (like a single year) and modelling the audit fee as a function of a number of independent variables. The main audit fee determinants are largely auditee size, complexity and risk. However, these are usually accompanied by parameters for the size of the auditor and a host of other factors used more or less sporadically accordingly.

2.1.1 Client size

Client size is included as one of the audit fee determinants across virtually all published literature (Hay *et al*., 2006), with the natural log of the auditee's total assets typically used as a proxy (Al-Harshani, 2008). A significant positive association is expected *a priori*, consistent with the hypothesis that, *ceteris paribus*, the larger the client, the greater the workload to complete the audit and the greater will be the price charged (Zhang and Myrteza, 1996).

Meanwhile, Chan *et al.* (1993) contend that turnover should be used to measure size, especially where the audit approach is not based on the balance sheet as traditionally is the case, even though this has problems too in terms of the effect of corporate policy, capital intensity and varying definitions thereof (Naser *et al*., 2007).

2.1.2 Client complexity

Hay *et al.* (2006, p.169) state that "the empirical evidence strongly supports a positive relationship between complexity and audit fees". Eighty-two of the studies analyzed by these authors include the number of subsidiaries as a surrogate, in line with the conjecture that auditing many branches is associated with embarking on additional work (Ho and Ng, 1996) and a more resource-consuming audit (Hackenbrack and Knechel,1997), for which a higher price should be charged.

2.1.3 Risk

Simunic (1980) penned that the pricing of audit services is not only a function of the cost of performing the audit (including a normal return), but a premium is also added by audit firms to compensate themselves for potential losses. However, Jubb *et al*. (1996) argue that multivariate audit fee modelling should employ different measures recognizing different components of this concept of 'risk'.

2.1.4 Other contributing factors

Auditor size

Different studies ask whether the type of auditor affects the audit fee, with a variety of answers being obtained after relying on a dichotomous variable to distinguish between large and small audit firms. On the one hand, consider the findings of Langendijk (1997), evidencing that large audit firms do not charge significantly higher prices in the Netherlands. However, Palmrose (1986) argues that some kind of mark-up is requested by auditors of a large size as a signal of greater quality, with Shapiro (1983) evidencing a premium that "provides a flow of profits that compensate the seller for the resources expended in building up the reputation" (p. 678).

The so-called Big 4 are perceived by auditees on the demand side to be more able in the delivery of the audit itself due to such aspects as their international coverage (Oxera Consulting, 2006), for example, explaining the estimates of Chen and Hsu (2009), who indicate an average audit fee premium of 15.6%.

Company status

A public limited company is charged an audit fee that is significantly higher than that charged to its private counterpart (Clatworthy and Peel, 2007), with listed entities requiring greater audit work (Langendijk, 1997). Such surcharge in the case of public enterprises may be reflecting the additional experience required by the auditor to ensure compliance with specific rules and regulations (Dickins et al., 2008).

Initial audit engagements

Ho and Ng (1996) expect an increase in the audit fee justifying the additional costs incurred in an initial audit engagement, say as auditors will spend time familiarizing themselves with the client's operations and accounting systems. This is in addition to the notion envisaged by Van (2010) that a new client relationship poses a prime inherent risk for audit firms, resulting in a higher price being charged.

On the other hand, note that DeAngelo (1981) presents a model predicting what is known as 'low-balling', or the alleged tendency for the auditor to charge a lower price for new audits with a view to recovering any losses in subsequent years (Simon and Francis,1988).

Same as predictions in the theoretical literature, empirical evidence is mixed with respect to low-balling. For instance, whereas Sankaraguruswamy *et al*. (2012) find substantial increases for the second audit year, Craswell and Francis (1999) report fee discounting only when the initial audit in question involves an upgrade in audit quality. Furthermore, new clients have been found by Niemi (2002) to pay higher fees.

2.1.5 Maltese-specific factors

The findings of Baldacchino *et al*. (2013) indicate that companies owned by foreigners tend to pay higher audit fees than those owned by the locals in Malta.

Cognizance should also be taken of another Malta-specific factor as per Baldacchino *et al*. (2013), stating that relatively lower fees are charged to entities under government ownership. This differential can be explained by the idea put forward by Rubin (1988) that the public sector involves a divergence from the private sector even in terms of the procedures surrounding the auditing contracting process.

2.2 Audit fee movement over time

Despite the audit market being studied extensively in both developed countries (like the US, the UK and Australia) and emerging economies (like Hong Kong, Malaysia and Jordan), academic literature contains very little by way of systematic analysis of the long-term behaviour of audit fees paid to external auditors.

2.2.1 Trends in audit fee from the 1980s

The findings of Carson *et al.* (2003) suggest a 'mature' audit market in Australia since, in real terms, audit fees have been relatively stable over the period of 16 years between 1984 and 1999. Parallels can be drawn with the evidence of Menon and Williams (2001) using the US Securities and Exchange Commission (SEC) filings, finding that audit fees remained flat in the 1990s.

The more recent panel dataset by Oxera Consulting (2006) for the UK evidences an average increase of 11.7% per annum between 1995 and 2004, with a faster growth rate registered as from 2000. This is consistent with the analysis of 496 of the S&P 500 companies by Ciesielski and Weirich (2006), finding a 103% increase in total audit and related fees during the period 2001-2004. More specifically, using median results, Markelevich *et al.* (2005) quote a rise in audit fees of approximately 80% from $239,000 in 2000 to $430,000 in 2003.

This upward trend is somewhat confirmed by Audit Analytics (2011) data, showing that accelerated filers with the SEC witnessed a rise in audit fees as a percentage of the revenue earned between 2002 and 2009. On the contrary, Waresul and Hasan (2012) document declining audit fees after adjusting for inflation in Bangladesh between 1990 and 2003. The authors note how such a phenomenon can have long-term implications as it might drive talented individuals away from the profession.

2.2.2 Audit fee stickiness and price rigidities

Price changes have been found to be less frequent for services than for goods by Bils and Klenow (2004), despite their failing to specifically include the statutory audit in their analysis. However, using data for the US firms, Zhang *et al.* (2011) identify such rigidity for audit fees too, in the sense that they do not immediately or fully adjust to changes in their determinants as predicted by a standard audit fee model. This is because such traditional models are implicitly based on the assumption of a frictionless auditing market, with Ferguson *et al.* (2005) also discussing how both imperfect competition and imperfect information contribute to this sluggishness.

Note that the study by Ferguson *et al.* (2005) attributes the considerable difference in the explanatory power between levels and first differences specifications of the audit fee to the presence of pricing frictions in the auditing market. Evidencing such difference in explanatory power is the model developed by Ghosh and Lustgarten (2006), yielding an R^2 of almost 77% when estimated at levels and approximately 12% in first differences form.

Delving deeper into the matter, Carson *et al.* (2003) find only changes in the client size and non-audit fee variables as significantly accounting for variations in the price charged per annum, thus appearing to reject the notion of sensitivity to the likes of changes in the client's complexity and risk over time.

2.3 The global financial crisis

The GFC has reignited interest in the profile of the auditing profession as a whole (ACCA, 2011). For example, one can refer to literature dealing with how the extent of modifications, auditor turnover and auditor resignation has changed in recent years (Chen and Zhang, 2012).

Furthermore, Raluca (2011) identifies the GFC as a breaking point for the behaviour of the audit fee over time, comparable to the Savings and Loan Crisis in the US during the 1980s (Doogar *et al*., 2012). In fact, Chen and Zhang (2012) find the significantly higher audit fee charged during the post-financial crisis period as an indication of a higher audit workload.

The GFC has caused a change in auditor behaviour in response to a higher risk being perceived in an environment largely characterized by financially distressed clients (Xu *et al.*, 2011). More specifically, Mautz and Sharaf (1961) argue that auditors increase their professional skepticism and audit effort in similar situations.

On the other hand, Ettredge *et al.* (2011) find that as much as 49.6% of the sampled clients have managed to exert fee pressure on their auditor and obtained concessions to relieve some of the economic hardship with the recession. Therefore, despite changes in their clients' characteristics (such as increased size, complexity and other audit cost drivers), auditors seem not to have responded by increasing their audit work and the resultant audit fee as expected.

2.4 Other potentially significant events

The extant foreign literature suggests that certain unique or one-off developments may have a considerable impact on the audit fee charged from one year to another by having a direct bearing on the world of auditing.

2.4.1 New auditing standards and other regulatory influences

Menon and Williams (2001) note a significant increase in audit fees in 1988, when the Auditing Standards Board issued the so-called 'expectation gap' standards. Wong (2009) also states that the change in the regulatory environment has been the most significant for the development of audit fees in Australia in the 2000s.

Hard facts point out to a rise in audit and related fees of as much as 41% in 2004 alone (Ciesielski and Weirich, 2006). Similarly, Audit Analytics (2011) reports a 45.52% increase in the average amount of audit fees paid by SEC accelerated filers per $1 million in revenue between 2003 and 2004. As confirmed by Pandit and Rubenfield (2010), this major spike is attributed to a large extent to be in compliance with Section 404 of SOX, specifically mandating auditors to attest that the client's control system is functioning adequately.

2.4.2 Changing competitive dynamics of the auditing industry

Maher *et al.* (1992) report a decrease in real audit fees between 1977 and 1981, when the auditing profession apparently increased competition in the market for independent audit services by removing restrictions. Meanwhile, the 1998 merger between PriceWaterhouse and Coopers & Lybrand affected market concentration as measured by the Herfindahl-Hirschman index, leading to a price increase in the audit market (Oxera Consulting, 2006).

On the other hand, Pong (2004) concludes that as the dominance of few large firms increased, the market actually experienced a 9.7% decrease in inflation-adjusted audit fees between 1991 and 1995, rather than higher charges.

2.4.3 Audit technology and productivity improvements

Once productivity in auditing improves (such as through the use of audit software), audit effort and the resultant fee charged should fall, as confirmed by Wong (2009).

More specifically, Menon and Williams (2001) opine that integrating technology into the audit process leads to a more structured approach, which in turn should result in increased cost-effectiveness as per the findings of Gist (1994).

2.4.4 Looking into the future

Note that as there is expected to be a growing demand for more regular reporting in the future (ACCA, 2011), more work will be done by the auditor, possibly being translated into higher prices.

It is also worth considering the possible impact on audit fees of the measures proposed by the Green Paper of the European Commission (COM, 2010) with the aim of providing for the improvement of the profession. These include joint audits, with Andre *et al.* (2013) finding significantly higher audit fees where this is a mandatory requirement.

3. Data and methodology

3.1 Research design

On the basis of its *raison d'être*, this study employs a mixed approach. In fact, a dynamic model of audit fees largely involving first differences is combined with a series of semi-structured interviews involving open-ended questions. Such respective quantitative and qualitative methods are viewed as complementary, in line with the notion of triangulation.

Rather than a levels specification as per the study conducted locally by Baldacchino *et al.* (2013) and much of the international research dealing with audit fees, changes analysis is used here to examine directly whether variations in the audit fee from one year to another are brought about by changes in its determinants. Definitions of the potential determinants of inter-company audit fee changes are given in Appendix 1. Hence, inferring the temporal development in audit fees from cross-sectional differences is avoided (Ghosh and Lustgarten, 2006). Using first differences also has the advantage of naturally controlling for the impact of correlated omitted variable bias, which typically arises when estimating a cross-sectional regression (Haw *et al*., 2012).

More specifically, proxies have been taken for the determinants of the auditor's remuneration discussed in the preceding section, with first differences being calculated where necessary. The model was revisited after conducting preliminary semi-structured interviews, when the paramount importance of considering the lagged values within the Maltese context immediately emerged.

In fact, 10 interviews with audit partners from Big 4 and other audit firms supplement results from the model as practitioners share with the researcher their knowledge and experience of the development of the auditing market in Malta. Broad and non-directional questions have been asked, "starting with words like 'what' and 'how' to encourage descriptions by the respondents revolving around the objective and research questions of this study.

3.2 Data collection

Publicly available data is used, in line with prior audit fee studies, following the manual perusal of the financial statements submitted by the sampled companies since such information is not readily available in a database.

Official lists of public and private limited liability companies in Malta have been obtained from the Registry of Companies as per Figure 1. The relevant number of active companies excludes shipping companies (which are not required to file a copy of their annual accounts with the Registrar of Companies).

Note that this empirical study manages to take into consideration a time period spanning over the eight years between 2004 and 2011 by making use of

Figure 1: Population of Public and Private Limited Companies in Malta

Total number of companies as on November 1, 2012:

58,069

⇩

Active companies registered until December 31, 2011:

29,530

⇩

Active companies registered until December 31, 2003:

13,047

panel data, with the same cross-sectional entity being repeatedly surveyed over the years under scrutiny. Thus, the model findings are based upon a sample of 880 firm-years relating to 110 individual and unique active companies in Malta during the period that has been chosen with significance being tested at 0.05 level.

4. Results and discussion

4.1 Determinants of changes in audit fee

4.1.1 What drives a change in audit fees from one year to another?

Two coefficients were found to be statistically significant at 95% confidence level, with their significance values given in Table 1.

Furthermore, as expected *a priori*, the identified relationships are positive as evidenced by the β coefficients in Table 2. Therefore, it seems that changes in the audit client's asset base and number of subsidiaries (surrogating for the auditee's size and complexity respectively) contribute with a one-period lag to explaining the change in the engagement fee. This can be explained by reference to the changing investment in resources for the auditing process (Simunic, 1980).

Table 1: Results of Tests of Between-Subject Effects					
	Type III Sum of Square	**df**	**Mean Square**	***F*-Value**	**Sig.**
LAGChgLNA SSETS	0.766	1	0.766	6.402	0.012
LAGChgSUB	11	1	0.874	7.308	0.007

Table 2: Parameter Estimates						
	B	**Std. Error**	***t*-Value**	**Sig.**	**95% of Confidence Interval**	
					Lower Bound	**Upper Bound**
LAGChgLNASSETS	0.088	0.035	2.530	0.012	0.020	0.155
LAGChgSUBS	0.052	0.019	2.703	0.007	0.014	0.091

Logically, it follows that an increase in the audit client's size should be accompanied by expanding effort on the audit, say as more individual items will need to be scrutinized to give the same level of assurance on the population (Simunic, 1980), as mentioned by audit partners interviewed: "If the sheer amount of what you have to audit were to increase, this would be more-or-less matched with an increase in the number of hours allotted to that engagement."

Similarly, Hackenbrack and Knechel (1997) argue that audits of complex entities consume more labour resources, explaining the positive relationship between complexity and audit fees that has been empirically noted. In fact, practitioners have pointed out that a revision upwards of the audit fee is also likely to be necessary when the audit client "implements a new computerized system" or "automates its processes", in which case specialists in the field will need to be relied upon.

Another auditee-specific factor, which has emerged from the semi-structured interviews, is "how organized that audit client is". Due to the integrity of internal controls and the quality of internal documentation being questionable, the auditor will have "to dig deeper" before reaching an objective. This affects the time spent on the job and can lead to cost overruns having a bearing on the price charged for the following year's audit engagement.

4.1.2 How stable is the audit fee in relation to changes in its determinants?

Blinder (1991) finds how there is a lag ranging from three to four months for price adjustments following significant demand or cost shocks. In parallel, changes in auditee size and complexity have here been found to contribute with an annual lag to explaining audit fee changes. This is opposed to the case with the standard audit fee models that, being built on a static framework, assume full price changes within a single period.

This notion of a one-period delay to intra-company audit fee changes is also supported by the finding that challenges encountered during the audit *vis-ά-vis* the auditee's system are "taken into account when quoting the price for the following engagement". Therefore, in line with the international findings of Zhang *et al*. (2011) and Ferguson *et al*. (2005), it seems that audit fees in Malta do not seem to respond instantaneously to the forces of demand and supply.

Furthermore, given that we cannot generalize with 95% confidence about the significance of the other coefficients from the dynamic audit fee model attempted, it appears that auditors in the Maltese environment are unable to institute price changes for audit engagements in response to variations in certain auditee characteristics and other factors like risk (Full results of dynamic model of audit fees are presented in Appendix 2). This can lead to courses of action like putting in less auditing effort, which perhaps compromises audit quality.

4.1.3 What relevance do the Maltese-specific factors have when it comes to changing audit fees?

Foreign ownership

Businesses coming in from abroad are used for paying larger sums of money for professional services and, in the words of the interviewees, they seem to be "more willing and able to pay a higher price" for the statutory audit.

Audit services tend to be loss-leaders that open the door to more lucrative non-audit services like consultancy. However, foreign-owned entities "are perhaps the best audit clients to have, because they are very likely to be profitable in themselves".

Foreign firms "typically accept changes more easily" when the audit partner feels that an increase is due as they are accustomed to paying more as audit fees abroad. However, this discrepancy is not the only reason, because international companies with overseas shareholding have been described as "appreciating more what goes into an audit" and "being pretty favourably impressed with the quality of our work".

Therefore, not only are foreign-owned firms typically charged more than their local counterparts (Baldacchino *et al*., 2013), but audit fees seem to be less sticky here. This promises an advantage so much so that a possible strategic avenue is envisaged with an auditor focusing solely on a portfolio of international audit clients, even though there would be little room for manoeuvre here if the audit fees were to be negotiated at the group level.

Government involvement

From the interviews, it has emerged how value-for-money is a very important consideration where significant government involvement is concerned. For example, it has been mentioned how parliamentary questions might come into play to expose the audit fee being charged, so "the cheapest-is-best attitude is favoured".

Notwithstanding that, audit partners have highlighted how state-owned enterprises are gradually moving away from the mere lowest bid rule, with certain recent tenders that are including different specifications (in terms of experience and so on), which serve as criteria to be met for the statutory audit to be provided.

Note that, on the contrary, a number of audit partners have expressed how their audit firms do not bid for audits of state-owned auditees, usually involving hourly rates that are "lower than that paid to the maid". Furthermore, interviewees have described it as being "something very sad" that government tenders typically have a clause stipulating that the cheapest auditor will be chosen.

Therefore, the degree of price-competitiveness is somewhat less in the case of companies that are in the hands of the public, in the sense that there is more openness to a warranted change in audit fees. This can be attributed to the idea that the traditional private audit client attaches a value to the relationship and sense of mutual trust built with the auditor, and will not easily replace such auditor with a less expensive one.

4.2 Recent trends in the audit fee

4.2.1 What brings about this rigidity of audit fees in the Maltese environment?

The descriptive statistics given in Table 3 show that the mean change in audit fees for the sample of companies chosen was approximately 11.6%. However, the median result is reported to be 0%, suggesting that changes in the pricing of statutory audits are generally not very high.

Table 3: Descriptive Statistics					
	Mean	**Median**	**SD**	**Minimum**	**Maximum**
ChgAUDFEE	0.116	0	0.349	-0.688	4
LAGChgLNASSETS	0.038	0.021	0.456	-6.496	3.464
LAGChgSUBS	0.04	0	0.699	-4	10

In fact, from the distribution of the actual changes in the audit fee as per the sample taken into consideration, we immediately spot a considerably large spike around the level of 0, as shown in the histogram presented in Figure 2.

Delving deeper into the matter, a relatively high incidence of no actual audit fee change in the sample taken into consideration can be noted from Table 4.

This suggests an element of sluggishness in audit fees, which can be attributed to frictions in the auditing market brought about by the following issues:

Imperfect competition

Explicit contracts: From the interviews, it emerged how contracts can be explicitly entered into for the provision of statutory audit services that fix a price even for a period of five years, for example. This can lead to problems, because one would not be able to change the quoted audit fee even if more work than expected were to be subsequently envisaged.

Figure 2: Distribution of Actual Audit Fee Changes

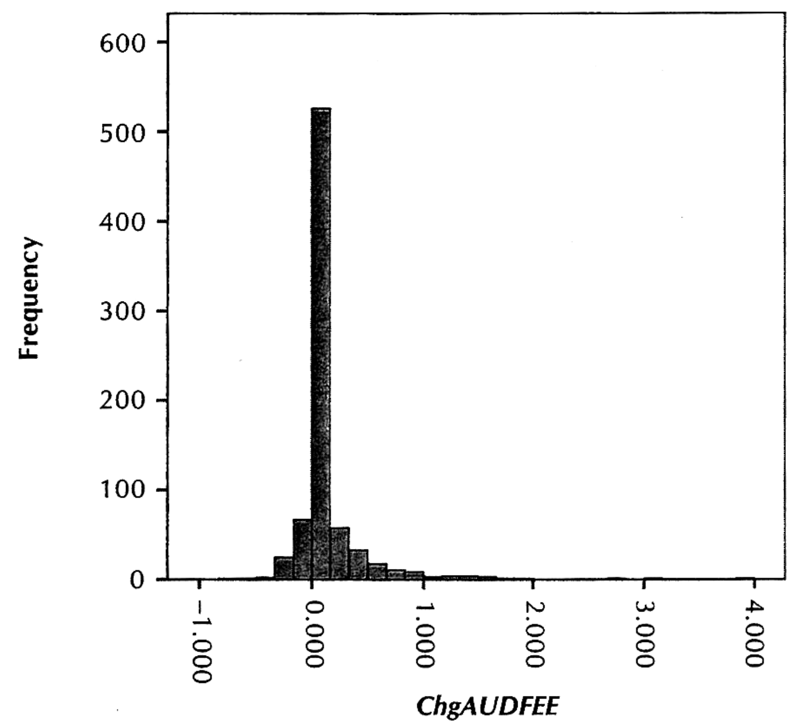


Table 4: Incidence of Zero Change		
Year	**Incidence of Zero Change**	
2005	75	68.182%
2006	50	45.455%
2007	48	43.636%
2008	21	19.091%
2009	47	42.727%
2010	54	49.091%
2011	56	50.909%
Total	**351**	**45.584%**

Non-audit services: Audit partners have stressed how "profit margins on audits are always declining", especially where audit clients are local firms. Therefore, it makes business sense to consider the role of the audit in getting a foot in the door for other more profitable services like consulting and tax advisory, as envisaged by Adelopo (2009), thus making competition in the auditing world less than perfect.

Imperfect information

*Coordination failure**:*** Since information in the auditing environment seems to be less than perfect, auditors will hesitate before spurring a rise in prices until they are more certain that any change in the auditee's business is not temporary, or until competitors move first (Ball and Romer, 1991).

Commodity mentality: Especially, indigenous audit clients in Malta prefer not to spend any more money than necessary on this intangible, without appreciating its value in terms of the comfort and order that it tends to bring about. Audit partners expressed how "a culture has been ingrained" over time, with the audit being seen merely as "a compliance cost". This is opposed to the case where foreign-owned companies are concerned, as discussed earlier.

4.2.2 How are audit fees moving in Malta?

Table 5 has been compiled to compare and contrast the recent movements of the audit fee in terms of market prices and inflation-adjusted dimensions, with calculations for the annual rate of change, the inflation index constructed and the mean audit fee in real terms being based on the nominal mean audit fee for 2004 of €5,778.

Literature dealing with initial audit engagements (e.g. DeAngelo, 1981; and Ho and Ng, 1996) points out that first year audits are theoretically more costly to perform. From this, it can be deduced that a recurring audit allows cost savings to be derived as the auditor is automatically more familiar with the auditee. However, the upward trend in audit fees for the companies in question may indicate that these possible 'learning curve' benefits are not being shared with the audit client in the form of lower prices in Malta.

Such quantitative results (Table 5) show a consistent upward movement in the audit fee between 2004 and 2011, and these can be coupled with one of the findings from the qualitative interviews that "revision downwards of an audit fee is not very common". With the exception of the final year under scrutiny, this

Table 5: Mean Audit Fees and Inflation

Year	Mean Audit Fee (€) (Nominal/Market Price)	Rate of Change (%)	12-Month Average Rate (%)	Inflation Index Y 2004 = 100	Mean Audit Fee (€) (Real/Constant 2004 Prices)
2005	6,154	6.507	3.01	103.01	5,974
2006	7,532	22.392	2.77	105.86	7,115
2007	8,727	15.866	1.25	107.19	8,143
2008	9,779	12.055	4.26	111.75	8,751
2009	11,273	15.278	2.09	114.09	9,881
2010	12,180	8.046	1.51	115.81	10,517
2011	12,510	2.709	2.72	118.96	10,516

Note: Authors' workings are supplemented by the 12-month moving average of the Retail Price Index (RPI) by the National Statistics Office (NSO) in Malta. Note that the relative figures for December each year have been used, since virtually all of the sampled companies have a financial year ending on December 31.

trend is confirmed even after controlling for increases in the price level, as shown in the multiple line chart presented in Figure 3.

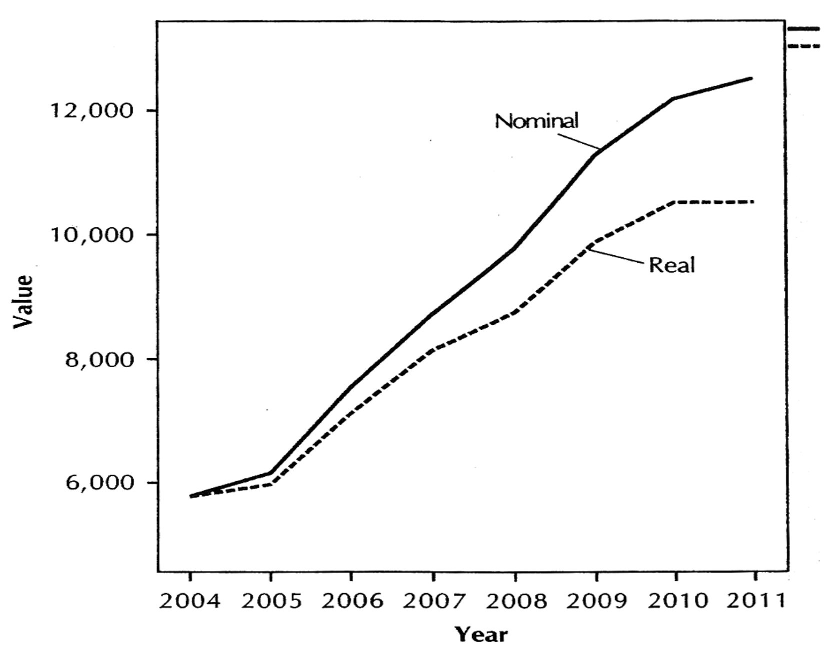
Audit quality concerns

Studies show that downward movements in the audit fee are smaller and slower than upward ones (Ferguson *et al*, 2005; and Zhang *et al*, 2011). In fact, both Shapiro (1983) and Palmrose (1986) imply that a higher price signals greater quality, so the auditee might not really request an audit fee decrease even when the expected audit costs fall (Ferguson *et al*., 2005).

Euro changeover in 2008

The euro changeover in Malta in 2008 should have given an impetus for such upward audit fee movement, in line with statistical evidence showing that such a happening leads to price developments in certain sectors (Ehrmann, 2006). In fact, Table 4 has illustrated how the incidence of zero audit fee change fell to a minimum of 19% between 2007 and 2008.

Figure 3: Nominal and Real Mean Audit Fees (in €)



Inflation

The importance of considering inflation is evidenced by the likes of Maher *et al.* (1992) as they went a step further and actually restated audit fee figures using the relevant Consumer Price Index. This appears to be applicable also to Malta as interviewees have talked about there being "almost a standard increase" in audit fees due to inflation from one year to another. However, the movement of statutory audit prices should continue to be monitored closely in the future since a tapering off of the real audit fee, even though it appears to have risen in nominal terms, has been noted in Table 5 between 2010 and 2011. Building on the arguments given by Waresul and Hasan (2012), as auditors pocket less all the time, this makes it more difficult to devote resources for investment that is essential to deliver high quality audits.

4.3 Global financial crisis and other events

4.3.1 How has audit fee setting been affected by the global financial crisis?

Table 6 shows the mean pre-crisis and post-crisis audit fee. The paired-samples t-test was resorted to in order to investigate whether the mean difference in the audit fee charged before and after the recent GFC as from 2008 is statistically significant, with the test hypotheses being posited as follows:

H_0: There is no significant difference between the mean post-crisis and pre-crisis fee.

H_a: There is a significant difference between the mean post-crisis and pre-crisis fee.

Table 6: Post-Crisis and Pre-Crisis Mean Audit Fees (in €)

	Mean Audit Fees	
	Post-Crisis	**Pre-Crisis**
Nominal/Market Prices	11,436	7,048
Real/Constant 2004 Prices	9,916	6,752

Tables 7 and 8 show that the probability is not greater than 0.05, thus the null hypothesis can be rejected, implying that the difference between the relative mean audit fees shown cannot really be attributed to chance.

Table 7 Results of Paired Samples Test (Mean Audit Fees at Nominal/Market Prices)

	Paired Differences			95% Confidence Interval of the Difference				
	Mean	**SD**	**Std. Error Mean**	**Lower**	**Upper**	***t*-Value**	**df**	**Sig. (2-Tailed)**
Pair 1 PostCrisis-PreCrisis	4.3879709E3	1.3885274E4	13239089E3	1.7640265E3	7.0119153E3	3.314	109	0.001

Table 8 Results of Paired Samples Test (Mean Audit Fees at Real/Constant Prices)

	Paired Differences			95% Confidence Interval of the Difference				
	Mean	**SD**	**Std. Error Mean**	**Lower**	**Upper**	***t*-Value**	**df**	**Sig. (2-Tailed)**
Pair 1 PostCrisis-PreCrisis	3.1642257E3	1.1581306E4	1.0946996E3	994.5667633	5.3338847E3	2.890	109	0.005

Audit partners from the Big 4 explained how "the recession brought more work on going concern and more reviews of projections", with such issues as impairment implying "more input from the top people". Given that the auditor was from a Big 4 audit firm in almost 81% of the observations in the sample (711 firm-years out of 880), this can serve to explain the statistically significant difference between the mean post-crisis and pre-crisis audit fee.

On the other hand, interviewees from other audit firms expressed another possible reaction of audit fee setting as from 2008, which can be effectively summed up using this analogy: "If a ship were to be sinking, you would do your utmost to salvage it."

In some instances, such audit partners seem to have intervened themselves in revising the audit fee downwards, with the prospect of strengthening ties with the auditee and reaping the benefits as the situation improves in the long run.

In fact, auditors other than the Big 4 expressed how it would have been an ill-advised course of action, if they were to have raised the price charged. Thus, they seem to have had to temporarily absorb the impact of the maintenance or augmentation of the scale of their work in the face of an increased audit risk as "increased cost consciousness" featured on the audit clients' agenda. This can be explained in terms of the 'invisible handshake' characterization by Okun (1980), as opposed to the market being cleared through the working of an 'invisible hand'.

Neo-Keynesians highlight the importance of implicit understanding between participants when market conditions are tight in order to avoid price increases (Blinder *et al*., 1998), supporting the contention that such a relationship with the customer drives price sluggishness.

However, authorities have expressed their fear that auditors may be tempted to cut corners on audit quality by curtailing required audit effort in the light of the fee pressure exerted by auditees facing financial challenges during such times when every entity feels the pinch (PCAOB, 2010).

Moreover, important implications for auditor independence can stem from the pricing of the statutory audit (Magee and Tseng, 1990). Therefore, especially in such cases where the auditor practically shares the economic pain accompanying the recession by agreeing to audit fee reductions, the interests of stakeholders other than merely the audit client *per se* need to be kept in mind.

4.3.2 What impact have new standards and regulations had on audit fees?

There is a strong case for arguing that changes in the overarching regulatory framework can trigger higher prices for the statutory audit, as evidenced in the international literature (e.g. Menon and Williams, 2001; Wong, 2009; and Audit Analytics, 2011). For example, in this regard, an audit partner has highlighted the implications of the revised ISA 600, imposing more onerous requirements in relation to the group audit.

Furthermore, even accounting rules can considerably alter the scope of an audit as they are revisited: "They all boil down to changes in the audit work to be carried out."

At the end of the day, auditors cannot consider themselves not to constitute a business enterprise, and a couple of respondents stated how they explicitly ask the auditee for an audit fee increase expected as a result of such changes. However, the majority of the audit firms in question opined that "the increases in audit fees have not been adequate, with the result that we" ended up suffering the difference". This can be due to the auditee being, at the end of the day, interested in the end-result of the statutory audit (irrespective of what has gone into the process), possibly having serious negative repercussions on audit quality.

4.3.3 How is competition affecting statutory audit pricing?

Audit partners have expressed how "there is a very high level of competition" in the Maltese auditing environment, which can explain why no double-digit rate of change has been registered in the mean audit fee charged to the sampled companies for the years 2010 and 2011.

In terms of the quantity of audit clients, "more firms are coming in from abroad, so the market is growing". As noted by the interviewees from the Big 4, this has provided an excellent opportunity for the medium-sized players to grow and, "especially in the last 2 or 3 years, we have started seeing some movements from Big 4 to lower than Big 4."

Such audit partners also expressed how they face stiff competition from smaller audit firms as they are perhaps seen more as a "trusted advisor" by their clients. Not being "audit-centric" has been deemed to make it easier "to build a base" upon which to get across audit fee increases when necessary.

4.3.4 What is the future of audit fees?

Note that the situation of audit fees is evolving all the time, so different avenues can be pursued to shed light on the direction in which the pricing of statutory audits can move in the future.

IT improvements

Rather than being reflected in lower audit fees as hypothesized by Menon and Williams (2001), advancements in audit technology have been mentioned by interviewees to be crucial in order to compensate for the extra auditing effort to be put in following the implementation of new standards and regulations. Not computerizing more and more of the work involved implies that "you will be wasting a lot of precious time", so it is advisable that auditors use Computer-Assisted Audit Techniques (CAATs) that make them more efficient.

Growth in internal auditing

As hypothesized by Gerrard *et al*. (1994), increased internal audit effectiveness may play a part in mitigating the rise in external audit fees as it strengthens accountability within organizations. In fact, the availability and extent of reliance on the internal auditor's work is one of the considerations mentioned by ISA 300

(IFAC, 2009b) in establishing the overall audit strategy, because duplication of effort can be reduced (Morrill and Morrill, 2003).

The potential impact of the EC Green Paper on audit policy

Interviewees mentioned how the EC proposals can "change the status quo" and have a considerable effect on audit fees. In fact, audit partners have expressed how "joint audits might push up the price" in line with the findings of Andre' *et al*. (2013), as pointed out earlier, whereas the mandatory rotation of audit firms can drive it down.

The role of rising labour costs

Interviewees expressed how audit fees in Malta are "unrealistically low" when compared to those abroad, sometimes being described as "absolutely obscene". To their knowledge, this comparison has remained "fairly stable over the years". However, notable is the danger viewed by a number of audit partners that "we might become the victims of our own success". As Malta continues to enjoy this prosperous period in financial services, businesses from abroad in the hedge funds, remote gaming and similar markets affect the industry negatively by "paying over-the-top salaries to professionals". Therefore, audit firms have to bear increasing internal costs as they counteract in order not to fall behind, eventually being translated into higher prices charged.

5. Conclusion

This longitudinal study embarked on a bid to understand the stability or otherwise of the pricing of statutory audits in a microstate over time, with Malta as a reference point. Therefore, the intertemporal development of audit fees is examined with a view of changes in their determinants, the GFC and other potentially significant events.

Changes in auditee size and complexity have been found to be significant when explaining the change in the audit fee, albeit with a one-period lag, together with how organized the auditee is. However, research findings point out that the assumption of frictionless audit markets implied in standard audit fee models should be rejected. In fact, there seems to be a general difficulty in realigning the audit fee in response to variations in its determinants over time.

Thus, the research community is here made aware that audit fees in Malta seem to exhibit a degree of price rigidity or stickiness, attributed to elements of imperfect competition and imperfect information in the market. Notwithstanding that, it appears that there is more openness to a warranted increase in audit fees where companies are foreign-owned or not in the hands of the government concerned.

Moreover, evidence of a statistically significant increase in audit fees since 2008 has been found. However, at the same time, a prevalence of implicit contracts between audit firms other than the Big 4 and their audit clients in order to mitigate this increase is suggested. Such behaviour needs to be studied more deeply to understand its pervasiveness across other microstates.

5.1 Recommendations

5.1.1 A "value pricing" approach

As opposed to the traditional "time-based billing" method, this study suggests invoicing audit clients on the basis of the external value created thereto. Changing the pricing culture by shifting away from a focus on the internal costs of generating the service can align the interests of the auditor and the auditee, making it easier for auditors to institute audit fee changes where auditees' expectations are met.

5.1.2 Partners with special focus on business development

Specific partners should be in charge of identifying new business opportunities for the audit firm and nurturing the relationship with existing clients. Such a person ought to have the right attitude towards the job and adequate communication skills, making it easier to sit down with the auditee and arrive at a rational basis upon which to increase the price of the statutory audit.

The pricing of statutory audits depends on negotiation, categorically, so the auditor should actively strive to enhance the audit experience and foster a sort of "working relationship" with the audit client. This is bound to change the currently predominant perspective that audits are there "just for the signature at the end of the audit report".

5.2 Limitations

This study discusses changes in audit fees in Malta without delving into the firm-specific rates per hour charged for the time spent by staff and partners on the engagement, the structure of which is likely to be considered highly confidential by providers of such professional services. Furthermore, no data has been collected for the smallest of companies in Malta, which are allowed by the Companies Act to file only abridged accounts that do not reveal certain information.

References

Regulatory

Companies Act - Malta, 1995. Chapter 386 of the laws of Malta.

International Federation of Accountants (IFAC) (2009a). *ISA 210 Agreeing the Terms of Audit Engagements,* New York.

International Federation of Accountants (IFAC) (2009b). *ISA 300 Planning an Audit of Financial Statements,* New York.

Other

Association of Chartered Certified Accountants (ACCA) (2011). Audit under fire: a review of the post-financial crisis inquiries: http://www.accagiobal.com/content/dam/acca/giobai/PDF-technicai/audit-publications/ poi-af-auf.pdf [16 October 16, 2012].

Adelopo, I. (2009). Modelling issues in the relationship between audit and non-audit fees. *Journal of Applied Accounting Research*, 10(2) : 96-108.

Al-Harshani, M.O., (2008). The pricing of audit services: evidence from Kuwait. *Managerial Auditing Journal*, 23(7) : 685-696.

Andre, P., Broye, G., Pong, C. and Schatt A (2013). Are joint audits associated with higher audit fees?: http:7/papers.ssrn.com/soi3/papers.cfm?abstract_id = 2039001. [11 March, 2013]

Analytics, A. (2011). Audit fees and non-audit fees: An eight year trend: http://www.auditanaiytics.com/0000/custom-reports.php [7 August,2012].

Baldacchino P. J., Attard, M. and Cassar, F. (2013). Evidence of determinants of audit pricing from Malta. Paper Presented at EAA Annual Congress 2013. Paris, France, May 6-8.

Ball, L. and Romer, D. (1991). Sticky prices as coordination failure. *The American Economic Review*, 81(3): 539-552.

Bils, M and Klenow, P. J. (2004). Some evidence on the importance of sticky prices. *Journal of Political Economy*, 112 (5): 947-985.

Blinder, A.S. (1991). *Why are prices sticky? Preliminary results from an interview study* (No. w3646). National Bureau of Economic Research.

Blinder, A., Canetti, E.R., Lebow, D.E. and Rudd, J.B. (1998). *Asking about prices: prices: A new approach to understanding price stickiness*. Russell Sage Foundation, New York.

Carson, E., Simnett, R., Soo, B. and Wright, A.M. (2003). A longitudinal investigation of the audit and non-audit services fee markets (1984 - 1999*)*. Working paper, University of New South Wales, Sydney.

Chan, P., Ezzamel, M. and Gwilliam, D. (1993). Determinants of audit fees for quoted UK companies. *Journal of Business Finance and Accounting*, 20(6): 765-786.

Chen, H. and Zhang, M. (2012). Audit Reaction on Financial Crisis: http://www.aabri.com/SA12Manuscripts/SA12116.p_df. [4 October, 2012].

Chen, Y.S. and Hsu, J. (2009). Auditor size, auditor quality, and auditor fee premiums: Further evidence from the public accounting profession: http://papers.ssrn.com/sol3/papers.cfm?abstract_id = 1325049.[12 November 2012].

Ciesielski, J.T. and Weirich, T.R. (2006). Ups and downs of audit fees since the Sarbanes-Oxley Act. *The CPA Journal*, 76 (10): 28.

Clatworthy, M.A. and Peel, M.J. (2007). The effect of corporate status on external audit fees: Evidence from the UK. *Journal of Business Finance and Accounting,* 34(1-2): 169-201..

Craswell, A.T. and Francis, J.R. (1999). Pricing initial audit engagements: A test of competing theories. *The Accounting Review*, 74 (2): 201-216.

DeAngelo, L.E. (1981). Auditor independence, low balling, and disclosure regulation. *Journal of accounting and Economics*, 3(2): 113-127..

Dickins, D.E., Higgs, J.L. and Skantz, T.R. (2008). Estimating audit fees post-SOX. *Current Issues in Auditing*, 2(1): A9-A18.

Doogar, R., Rowe, S. and Sivadasan, P. (2012). Asleep at the wheel (again)? Bank audits during the financial crisis: http://papers.ssrn.com/sol3/papers. cfm?abstract_id = 1982234. Retrieved on [16 October 16, 2012].

Ehrmann, M. (2006). Rational inattention, inflation developments and perceptions after the euro cash changeover. ECB Working Paper Series No.588.

Ettredge M, Li C and Emeigh E (2011). Fee pressure and audit quality: http://papers.ssrn.com/sol3/papers.cfm?abstract_id = 1903860. September, 2012]

European Commission (COM) (2010). *Green paper: Audit policy: lessons from the crisis*. Publications Office of the European Union.

Ferguson, A., Lennox, C. and Taylor, S. (2005). Audit fee rigidities in the presence of market frictions: Evidence and explanations. Working paper, Hong Kong University of Science and Technology and University of New South Wales..

Gerrard, I., Houghton, K. and Woodliff, D. (1994). Audit fees: The effects of auditee, auditor and industry differences. *Managerial Auditing Journal*, 9(7): 3-11.

Ghosh, A. and Lustgarten, S. (2006). Pricing of initial audit engagements by large and small audit firms. *Contemporary Accounting Research*, 23(2): 333-368.

Gist, W.E. (1994). Empirical evidence on the effect of audit structure on audit pricing. *Auditing: A Journal of Practice and Theory*, 13(2): 25-40.

Hackenbrack, K. and Knechel, W.R. (1997). Resource allocation decisions in audit engagements. *Contemporary Accounting Research*, 14(3): 481-499.

Haw, I-M., Yu, V. and Zhang, X. (2012). Analyst following and perceived audit risk: Evidence from Audit Fees in China: http://papers.ssrn.com/sol3/papers. cfm?abstract id = 1985840. [13 December, 2012].

Hay, D.C., Knechel, W.R. and Wong, N. (2006). Audit fees: A meta-analysis of the effect of supply and demand attributes. *Contemporary Accounting Research*, *23*(1):141-191.

Ho, S.W. and NG, P.P. (1996). The determinants of audit fees in Hong Kong: An empirical study. *Asian Review of Accounting*, 4(2): 32-50.

Jubb, C.A., Houghton, K.A. and Butterworth, S. (1996). Audit fee determinants: The plural nature of risk. *Managerial Auditing Journal*, 11(3): 25-40.

Langendijk, H. (1997). The market for audit services in the Netherlands. *European Accounting Review*, 6(2): 253-264.

Magee, R. P. and Tseng, M.C. (1990). Audit pricing and independence. *The Accounting Review,* 65 (2): 315-336.

Maher, M.W., Tiessen, P., Colson, R. and Broman, A.J. (1992). Competition and audit fees. *Accounting Review*:199-211.

Markelevich, A., Barragato, C.A. and Hoitash, R. (2005). The nature and disclosure of fees paid to auditors. *The CPA Journal* : 6-10..

Mautz, R.K. and Sharaf, H.A. (1961). *The Philosophy of Auditing*. American Accounting Association. Monograph No. 6. Sarasota, FL: American Accounting Association.

Menon, K. and Williams, D. D. (2001). Long-term trends in audit fees. *Auditing: A Journal of Practice and Theory*, 20 (1):115-136.

Morrill, C. and Morrill, J. (2003). Internal auditors and the external audit: A transaction cost perspective. *Managerial Auditing Journal*, 18(6) : 490-504.

Naser, K., Abdullhameed, H. and Nuseibeh, R. (2007). Determinants of audit fees: empirical evidence from an emerging economy. *Scientific Journal of Administrative Development,* 5 : 84-116.

National Statistics Office - Malta (n.d.). Index of Inflation: http://www.nso.gov.mt/site/page.aspx?pageid = 152. [11 March,2013]

Niemi, L. (2002). Do firms pay for audit risk? Evidence on risk premiums in audit fees After direct control for audit effort. *International Journal of Auditing*, 6(1): 37-51.

Okun A M (1980). The invisible handshake and the inflationary process. *Challenge*, 22 (6): 5-12.

Onwuegbuzie, A.J. and Leech, N.L. (2006). Linking research questions to mixed methods data analysis procedures . *The Qualitative Report*, 11(3): 474-498.

Oxera Consulting (2006). Competition and choice in the UK audit market: http://www.bis.gov.uk/files/file28529.pdf. [7 August 7, 2012].

Palmrose, Z.V. (1986). Audit fees and auditor size: Further evidence. *Journal of Accounting Research*: 24 (1), Spring: 97-110.

Pandit, G.M. and Rubenfield, A. (2010). Has Sarbanes-Oxley Act curtailed the growth in auditor compensation or just changed its composition? A look at more recent evidence. *International Journal of Disclosure and Governance*, 8 (1): 31- 42.

Public Company Accounting Oversight Board (PCAOB) (2010). *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis*. PCAOB Release No. 2010-006.

Pike, R. and Neale, B. (2009). *Corporate Finance and Investment: Decisions and Strategies.* Pearson Education Limited, Essex.

Pong, C.K. (2004). A descriptive analysis of audit price changes in the UK 1991-95. *European Accounting Review*, 13(1) : 161-178.

Raluca, I.P.O., (2011). Audit fee econometrical models: An overview of the auditing research literature. *Annales Universitatis Apulensis: Series Oeconomica,* 13(2): 378-386.

Rubin, M. A. (1988). Municipal audit fee determinants. *The Accounting Review*, 63(2): 219-236.

Sankaraguruswamy, S., Whisenant, S. and Willenborg, M.(2012). Pricing and quality of initial audit engagements: http://mays.tamu.edu/media/documents/2012/ 03/08/SWWMarch5.pdf. [16 October,2012].

Shapiro, C. (1983). Premiums for high quality products as returns to reputations. *The Quarterly Journal of Economics*, 98 (4): 659-680.

Simon, D. T. and Francis, J. R. (1988). The effects of auditor change on audit fees: tests of price cutting and price recovery. *The Accounting Review*, 63 (2) : 255-269.

Simunic, D. A. (1980). The pricing of audit services: theory and evidence. *Journal of Accounting Research,* 18 (1), Spring:161-190.

Van Caneghem, T. (2010). Audit pricing and the Big 4 fee premium: Evidence from Belgium. *Managerial Auditing Journal*, 25 (2):122-139.

Waresul, Karim A .K.M. and Hasan, T. (2012). The market for audit services in Bangladesh. *Journal of Accounting in Emerging Economies*, 2(1): 50-66.

Wong, S. (2009). Audit pricing in Australia in 2000s. *International Review of Business Research Papers*, 5 (3): 82-89.

Xu, Y., Carson, E., Fargher, N. and Jiang ,L. (2011). Auditor responses to changes in business risk: the impact of the global financial crisis on auditors' behaviour in Australia: http://www.afaanz.org/openconf/20_11/modules/request.php9module_= oc_proceedings&action=view.php&a=Accept+as_ + Paper&id=61. [October 28, 2012].

Zhang, M. W. and Myrteza, S. (1996). The determinants of audit fees: Australian perspective. *Asian Review of Accounting*, 4 (1): 81-97.

Zhang, Z., De Villiers, C. and Hay, D. (2011). Audit fee stickiness: http:// www.afaanz.org/openconf/2011/modules/request.php?module = oc_proceedings& action = view.php& a = Accept + as + Forum&id = 84.[7 August , 2012

APPENDIX 1

Definition of Potential Determinants of Inter-Company Audit Fee Changes

A univariate general linear model has been developed, involving a combination of covariates and fixed factors in a bid to explain the dependent variable , such variables defined as follows:

ChgAUDFEE: The percentage change in audit fees (disclosed in the notes to the accounts) from one year to another, expressed in decimal form.

ChgLNASSETS: The change in the natural logarithm of total assets (as shown in the balance sheet) from one year to another, being a measure of changing auditee size.

ChgLNREVENUE: The change in the natural logarithm of total revenue (as shown in the income statement) from one year to another, being another measure of changing auditee size.

ChgSUBS: The change in the number of subsidiary undertakings (disclosed in the notes to the accounts) from one year to another, being a measure of changing auditee complexity.

ChgDELAY: The change in the audit report lag (defined as the number of calendar days between the financial year end and the date of the auditor's report) from one year to another, being a measure of changing audit risk.

ChgGEARING: The change in the gearing ratio (defined as total liabilities divided by total assets) from one year to another, being a measure of changing financial risk. Note that "American gearing" is used here in accordance with Pike and Neale (2009).

ChgROCE: The change in the return on capital employed (defined as the ratio of Profit after tax to total equity) from one year to another, being a measure of changing operating risk.

LOSS: An indicator variable that equals '1' where profit after tax is negative and '0' otherwise.

LOSS_NoLOSS: An indicator variable that equals '1' where a company changes from a negative to a positive profit after tax figure being registered and '0' otherwise.

NoLOSS_LOSS: An indicator variable that equals '1' where a company changes from a positive to a negative profit after tax figure being registered and '0' otherwise.

MOD_NonMOD: An indicator variable that equals '1' where a company is issued a clean audit report following a previous modified audit report and '0' otherwise.

NonMOD_MOD: An indicator variable that equals '1' where a company is issued a modified audit report following a previous clean audit report and '0' otherwise.

NEWAUDITOR: An indicator variable that equals '1' where the external auditor is not the same as for the previous year and '0' otherwise.

AUDITORTYPE: An indicator variable that equals '1' where the external auditor is coming form a Big 4 audit firm and '0' otherwise.

COMPANY: An indicator variable that equals '2' for a public limited company and '0' for a private limited company.

APPENDIX 2

Full Results of Dynamic Model of Audit Fees

The full results obtained from the dynamic model of audit fees attempted using PASW (SPSS) are shown in the following table:

Dependent Variable: ChgAUDFEE

	Type III Sum of Squares	**Df**	**Mean Square**	***F*-Value**	**Sig.**
Corrected Model	3.282#	14	0.234	1.960	0.019
Intercept	0.004	1	0.004	0.037	0.848
LAGChgLNASSETS	0.766	1	0.766	6.402	0.012
LAGCHgLNREVENUE	0.060	1	0.060	0.503	0.478
LAGChgSUBS	0.874	1	0.874	7.308	0.007
LAGChgDELAY	0.011	1	0.011	0.093	0.760
LAGChgGEARING	O.400	1	0.400	3.346	0.068
LAGChgROCE	0.012	1	0.012	0.098	0.755
LAGLOSS	0.122	1	0.122	1.017	0.314
LAGLOSS_NoLOSS	0.017	1	0.017	0.142	0.706
LAGNoLOSS_LOSS	0.038	1	0.038	0.318	0.573
LAGMOD_NonMOD	0.210	1	0.210	1.759	0.185
LAGnonMOD_MOD	0.073	1	0.073	0.608	0.436
LAGNEWAUDITOR	0.027	1	0.027	0.230	0.632
AUDITORTYPE	0.369	1	0.369	3.088	0.079
COMPANY	0.076	1	0.076	0.631	0.427
Error	77.150	645	0.120		
Total	89.287	660			
Corrected Total	80.432	659			

Note: # R^2 =0.041 Adjusted R^2 = 0.020

APPENDIX 2 (Cont)

Dependent Variable: chgAUDFEE

	B	Std. Error	*t*-Value	Sig.	95% of Confidence Interval	
					Lower Bound	Upper Bound
Intercept	-0.046	0.130	-0.357	0.721	-0.301	0.209
LAGChgLNASSETS	0.088	0.035	2.530	0.012	0.020	0.155
LAGChgLNREVENUE	0.023	0.032	0.709	0.478	-0.040	0.085
LAGChgSUBS	0.052	0.019	2.703	0.007	0.014	0.091
LAGChgDELAY	-3.451E-5	0.000	-0.305	0.760	0.000	0.000
LAGChgGEARING	-0.001	0.001	1.829	0.068	-9.365E-5	0.003
LAGChgROCE	-0.001	0.003	-0.312	0.755	-0.006	0.004
[LAGLOSS=0]	0.039	0.038	1.009	0.314	-0.037	0.114
[LAGLOSS=1]	0[a]	-	-	-	-	-
[LAGLOSS_NoLOSS=0*]*	0.017	0.045	0.377	0.706	-0.071	0.105
[LAGLOSS_NoLOSS=1*]*	0[a]	-	-	-	-	-
[LAGNoLOSS_LOSS=0*]*	-0.030	0.053	-0.564	0.573	-0.134	0.074
[LAGNoLOSS_LOSS=1*]*	0[a]	-	-	-	-	-
[LAGMOD_NonMOD=0*]*	0.090	0.068	1.326	0.185	-0.043	0.224
[LAGMOD_NonMOD=1*]*	0[a]	-	-	-	-	-
[LAGNonMOD_MOD=0]	0.058	0.075	0.779	0.436	-0.089	0.205
[LAGNonMOD_MOD=1]	0[a]	-	-	-	-	-
[LAGNEWAUDITOR=0]	0.031	0.064	0.479	0.632	-0.095	0.156
[LAGNEWAUDITOR=1]	0[a]	-	-	-	-	-
[*AUDITORTYPE=0*]	-0.062	0.035	-1.757	0.079	-0.131	0.007
[*AUDITORTYPE*=1]	0[a]	-	-	-	-	-
[COMPANY=0]	-0.028g	-0.035	-0.795	0.427	-0.096	0.041
[COMPANY=1	0[a]	-	-	-	-	-

CHAPTER 9

Organizational Culture, Personnel Characteristics and Dysfunctional Audit Behaviour

[AUD-7]

Baldacchino, P.J[1]., Tabone, N[1]., Agius, J[2]. and Bezzina, F[1].

The IUP Journal of Accounting Research and Audit Practices

Vol XV, Issue 3, 2016, pp. 34-63

This paper is a revised and expanded version of a paper entitled "Investigating the Impact of Organisational Culture and Audit Personnel Characteristics on Dysfunctional Audit Behaviour" presented at the European Accounting Association Conference, Glasgow 28-30 April, 2015.

[1] Head, Department of Accountancy, Faculty of Economics, Management and Accountancy, University of Malta, Msida, Malta and is the corresponding author. E-mail: peter.j.baldacchino@um.edu.mt

[2] Lecturer, Department of Accountancy, Faculty of Economics, Management and Accountancy, University of Malta, Msida, Malta.
E-mail: norbert.tabone@um.edu.mt

[3] Audit Senior, KPMG Malta, Portico Building, Marina Street, Pieta, Malta. E-mail: justineagius@gmail.com

[4] Associate Professor, Department of Management, Faculty of Economics, Management and Accountancy, University of Malta, Msida, Malta, MSD 2080.
E-mail: frank.bezzina@um.edu.mt

Organizational Culture, Personnel Characteristics and Dysfunctional Audit Behaviour

Baldacchino, P.J[1]., Tabone, N[1]., Agius, J[2]. and Bezzina, F[1].

[1]University of Malta, Malta and [2]KPMG Malta

This paper analyses the incidence and impact of dysfunctional audit behaviour (DAB) within audit firms. It investigates the impact of organisational culture and individual audit personnel characteristics on the acceptance of dysfunctional practices among audit staff. A mixed methods approach is employed. A questionnaire is distributed among the audit personnel of forty audit firms in the European island-state of Malta. This is complemented by eight semi-structured interviews with audit partners from different firms. The perceived reinforcement of underreporting of chargeable time, inappropriate behaviours by superiors and the individual's locus of control are found to be significant predictors of the acceptance of dysfunctional practices. The study also indicates that audit experience leads to a reduction of such behaviour and that Big Four auditors are less accepting of dysfunctional practices than those in smaller firms. Furthermore, *the organisational culture within audit firms and an individual's perception of control exhibit significant influence on the acceptance of dysfunctional practices. The study thus seeks to help in enhancing audit quality by raising awareness on the impact of dysfunctional practices and sheds new light on factors contributing to such behaviour and thus seeks to help by indicating ways to enhance audit quality.*

Keywords: *dysfunctional audit behaviour, organizational culture, personnel characteristics*

1. Introduction

Auditor behaviour received increased attention following recent audit failures and increased litigation against audit firms. A lack of due diligence and professional scepticism in conducting audit engagements has led to auditors not discovering significant financial frauds. Audit firms are often blamed for not predicting business failures and this has negatively impacted the reputation of the auditing profession (Copeland, 2005). Studies have shown that the quality of audits is threatened by audit personnel's negligent behaviour and poor performance, often referred to as Dysfunctional Audit Behaviour (DAB). This may lead to the auditor's inability to identify material misstatements in the financial statements being audited (Nor, 2011).

A common causal factor of DAB among numerous studies is the presence of time budget pressures within audit firms (Gundry & Liyanarachchi, 2007). These may negatively influence the auditor's own actions by tempting him/her to take shortcuts, this threatening audit quality. However, since time budgets are essential features in the effective planning of audit engagements, other studies have sought to identify factors that contribute to auditors acting dysfunctionally, rather than functionally, to such pressures (Donnelly *et al.*, 2003; Morris, 2009; Paino *et al*., 2012). Consequently, the aim of this study, based in Malta, is to examine the impact of aspects of audit firm culture and individual auditor characteristics on the acceptance of DAB among audit personnel, thus extending prior research in the area.

As for firm culture, audit firm governance in particular has various implications for audit quality (Jenkins *et al.*, 2008). Leaders, through their actions, set the tone of the company and influence the behaviour of its employees. The study investigates the impact of such culture on DAB acceptance by looking at the perceived reinforcement by superiors of under-reporting of time, and also their behaviour through their own engagement in DAB and inappropriate requests made to audit personnel.

The individual characteristics of auditors may also help shape audit behaviour. As stated by Herrbach (2005, p.390), audit firms are “a collection of individuals with different needs, goals and interests.” The audit environment may be interpreted in different ways depending on the individual, leading to conflicting behaviours within a single firm. This study sheds light on the influence of three specific individual characteristics on the acceptance of DAB: an individual’s locus of control, performance and turnover intentions.

Understanding the impact of these aspects on the behaviour of audit personnel should better guide audit firms in enhancing audit quality. In fact, the International Audit and Assurance Standards Board (IAASB, 2013,p.19) identified, among others, “the values, ethics and attitudes of auditors, which in turn, are influenced by the culture prevailing within the audit firm” as inputs that shape the quality of audits.

The study adopts a mixed methodology approach, unlike most related prior studies which have employed a quantitative research one (Donnelly *et al.,* 2003; Paino *et al.,* 2012; Svanberg and Öhman, 2013). Interviews were accordingly conducted with selected audit partners to gain further insights on the findings of the questionnaire.

The rest of the paper is structured as follows. The following section evaluates relevant literature, followed by a description of the research methodology adopted in the study. The findings of the study are presented and discussed subsequently, followed by the conclusion that also forwards some recommendations while acknowledging the limitations.

2. Literature review

Audit quality has received increased focus following recent corporate scandals such as those of Enron, Worldcom and Parmalat. Copeland (2005) argued that these ethical failures have led to a loss of trust in the capital markets and stained reputations for most people working in the capital markets, even those who were not at fault. The need for high quality audits has been recommended to prevent a repetition of such events in the global economy, as well as to restore confidence in the markets and the auditing profession (Kingori, 2003). DeAngelo (1981,p.186) defines audit quality as "the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach". It is also commonly defined relative to the close conformity of the audit with applicable auditing standards (Watkins *et al.*, 2004).

More recently, the IAASB (2013,p.10) embarked on a project to create a framework for audit quality that "describes the input and output factors that contribute to audit quality at the engagement, audit firm and national levels". This consultation paper places emphasis on input factors that foster audit quality which include, amongst others, auditors that display appropriate values, ethics and attitudes. This framework encourages audit firms to seek new ways of improving audit quality in their particular environments.

2.1 Dysfunctional audit behaviour

Herrbach (2001) described an agency problem within auditing between the owners of the audit firm - the partners (principals) and the audit personnel (agents). The audit partner issuing the audit opinion is involved in the performance of the audit in all stages but may not be present in the preparation of all audit documentation. This may tempt individual audit staff, facing time budget pressures, to participate in various dysfunctional acts which may not be in the best interest of the audit firm (Herrbach, 2001).

Time budget pressures are a result of a firm allocating insufficient hours for staff to finish individual tasks and procedures. Auditors react to time budget pressures in one of two ways. One is to act functionally by working additional hours and charging all hours to the client; increasing the time budget or finding more efficient audit techniques (Otley & Pierce, 1996a; Svanberg and Öhman, 2013). The alternative is to engage in DAB by taking shortcuts and thereby compromising audit quality. This occurs during the auditor's execution of work in completing auditing tasks and is defined as undesirable acts performed by auditors that may directly or indirectly reduce audit quality (Kelley & Margheim, 1990; Nor, 2011). Of the two ways, DAB may erroneously be considered by staff to be more in the interest of the firm, probably more so in the more recent post-crisis audit market, which has been found to be characterised by high competition and sticky audit fees (Baldacchino and Borg, 2014). Thus, audit firms are forced to absorb additional costs, and to focus on cost reduction. Yet, dysfunctional behaviour which is intentionally taken up by audit personnel may reduce the quality of audit evidence obtained and increase the risk that an inappropriate audit opinion is issued, to the detriment of financial statements users (Coram *et al*., 2008).

The main types of DAB mentioned in prior studies are underreporting of time and Premature Sign-Off (PMSO) of audit steps. The latter type is an Audit Quality Reduction (AQR) Act, defined as an audit procedure poorly carried out (Herrbach, 2001). Such an act "poses a direct threat to the reliability of audit records which form the basis of the audit opinion" (Otley & Pierce, 1996a, p.35).

2.1.1 Under-reporting of chargeable time (URT)

In this form of DAB, personnel react to audit pressure by completing the necessary audit procedures in their own time without reporting actual hours (Rhode, 1978).

Such under-reporting is often viewed as unethical since it involves providing false information and presumably violates audit firms' policies and ethical standards (Buchman and Tracy, 1982; Kingori, 2003).

URT has been found to indirectly impact audit quality. Since time budgets of future audit engagements are frequently based on budgets of present engagements, URT may lead to understated and unrealistic budgets (Agoglia *et al*., 2011). In future engagements, audit personnel may feel pressured to work in the budgeted time and may decide to take shortcuts and engage in AQR acts (Akers & Eaton, 2003). It is also thought to impair personnel evaluations and client billing (Lightner *et al*., 1982 and Agoglia *et al.*, 2011).

URT has been known to be an issue present in the auditing profession for decades. Rhode (1978) noted that 55% of American Certified Public Accountants (CPAs) participating in his study admitted to engaging in under-reporting of chargeable time. A high incidence of under-reporting of chargeable time was also noted in recent studies (Morris, 2009; Svanberg and Öhman, 2013; Zakaria *et al*., 2013). Morris (2009) posited that URT is frequently viewed as essential in auditing and remains accepted in the profession even though it may lead to a reduction in quality in future audits.

2.1.2 Premature sign-off (PMSO)

Rhode (1978) found that approximately 60% of CPAs had engaged in PMSO, or signing off a necessary audit step (not covered by an additional audit step) without having completed it or noted the omission of procedures. Otley & Pierce (1996b) found that only 40% of responding Irish senior auditors indicated to never engaging in PMSO. They concluded that this behaviour weakens a firm's control system and seriously threatens audit quality. In contrast, Nor (2011) found that only 24.8% of audit personnel among Malaysian audit firms admitted to never engaging in such an act. PMSO may also create adverse legal consequences to the audit firm and team members (Kelley & Margheim, 1990). Studies in the US (Kelley and Margheim, 1990; Malone and Roberts, 1996) observed that PMSO was the least commonly resorted to act of the AQR acts examined. This finding is supported by Coram et al. (2008) who found that, being fraudulent, false sign-off is perceived to face the most severe consequences by audit staff.

2.2 Organisational culture

Organisational culture has been viewed as the very essence of an audit firm, serving as a means of controlling undesirable employee behaviour (Jenkins *et al*., 2008). An organisation's culture is moulded through leaders' actions such as how they allocate resources, what behaviour they reward, and how they recruit, select and promote subordinates (Schein, 2004). Through such actions, they set the norms and values, and influence the behaviour at the workplace positively or negatively. The effect of organisational culture on auditors' acceptance of DAB is examined focusing on two aspects: the perceived reinforcement of under-reporting of chargeable time and superiors' dysfunctional behaviour.

2.2.1 Perceived reinforcement of under-reporting of chargeable time .

Priorities and goals are set through what leaders consistently pay attention to, reward and stress (Schein, 2004). If a firm signals to its employees that unethical behaviour is punishable and ethical behaviour rewarded, employees will be encouraged to behave ethically (Svanberg and Öhman, 2013). Rhode (1978) outlined that the ability to meet time budgets is perceived by audit personnel as important for advancement. In view of a competitive culture within the firm, the emphasis to remain within budgeted time may lessen the importance of quality, encouraging dysfunctional practices.

According to Akers and Eaton (2003), respondents engaging in URT perceive that such an act leads to job satisfaction, advancement and a sense of accomplishment. In addition, Agoglia *et al.* (2011) found that audit managers were more likely to give high evaluations to known under-reporters than to staff who accurately reported exceeding the budget when the manager had the desire to retain the client. They also concluded that managers preferred recruiting known under-reporters on future audit engagements. On the basis of the above, one would expect to find that the reinforcement of URT within audit firms leads to a higher acceptance of DAB.

2.2.2 Superiors' dysfunctional behaviour

Leaders are probably a main influence on organisational culture since they determine the organisational tone: employees learn what behaviour is expected from them by noting superior behaviour (Schein, 2004). Audit firms usually adopt a clear hierarchical structure having different managerial levels, with the audit partner at the top followed by managers and seniors (Herrbach, 2001). If an audit manager is commonly known to engage in DAB, then this would send a clear message to staff that such behaviour is acceptable (Nor, 2011), this creating a dysfunctional culture. Therefore, superiors set the example. Belkaoui and Pikur (1987) found supervisors to be the most important source of appraisal and feedback to seniors regarding acceptable performance, with immediate supervisors having more influence on subordinate behaviour than the firm as a whole.

Studies have shown that URT was significantly influenced by whether superiors requested or were perceived to approve such behaviour among senior auditors (Lightner *et al*., 1982; and Taylor *et al*., 2012).

When a supervisor asks a subordinate to engage in URT, stress is created, impacting the latter's behaviour. Such stress is caused by compliance, conformity and obedience pressures emerging from the supervisor's request (Akers and Eaton, 2003). The effect of inappropriate supervisor requests depends on the subordinates' assessment of the cost and benefit consequences of their response. Audit personnel may give precedence to securing a favourable evaluation over the risk of getting caught (Lord & DeZoort, 2001).

Otley and Pierce (1996b) found that only 37% of respondents had never either been requested or encouraged to engage in URT by managers and such management prompting was more likely effected through implicit encouragement than explicit request.

2.3 Individual characteristics

The evaluation of what drives auditors to engage in DAB requires an analysis beyond their behaviour related to their work. It is relevant to explore individual factors leading to differences in audit personnel's acceptance of DAB. Identifying the characteristics of audit team members affecting their reactions to pressures is vital in understanding auditor behaviour. We will now overview the relationship between the acceptance of DAB and the (i) locus of control, (ii) self-rated employee performance and (iii) turnover intentions of audit personnel.

2.3.1 Locus of control

Events leading to rewards or reinforcements are perceived differently by individuals. One difference is attributed to whether an individual perceives such rewards as contingent to one's own behaviour or to forces independent of one's actions (Rotter, 1966). In fact, individuals may be divided into two: internals, who believe that rewards are a direct result of their actions and externals, who believe that rewards or reinforcement follow little action from oneself but are mainly contingent to an external force such as powerful others, luck or chance (Rotter, 1966).

Externals tend to feel powerless since they see outcomes as governed by forces beyond their control and consider planning futile. Such individuals may make use of manipulation or deception as an attempt to exert some form of control on the perceived hostile environment which does not value hard work (Gable & Dangello, 1994). Solar & Bruehl (1971) stated that externals may feel that, so as to acquire the reinforcements required for survival, they have to manipulate others. In an audit environment, manipulation or deception would be reflected by the incidence of DAB and the sacrificing of audit quality (Donnelly *et a*l., 2003). It is therefore expected that an auditor with an external locus of control will be more willing to engage in dysfunctional practices. This positive association was found to be significant among audit personnel in the US (Donnelly *et al.,* 2003) and in Malaysia (Paino *et al*., 2012).

2.3.2 Employee performance

DAB is often employed by audit team members to manipulate the performance measure and distort any true performance indicator (Donnelly *et al.*, 2003). Such behaviour is expected to take place where individuals see themselves as performing below expected levels. In their effort to survive and obtain the required reinforcements, they may be more accepting of manipulation and deception (Solar & Bruehl, 1971). This becomes essential for them where they cannot meet organisational or individual goals through their own efforts (Donnelly *et al.*, 2003). Therefore, audit personnel with a low opinion of their own performance exhibit a higher acceptance of DAB (Donnelly *et al.*, 2003; and Nor, 2011). However, Paino *et al.* (2012) found a significant and positive relationship between employee performance and DAB acceptance and argued that such a positive relationship could reflect audit team members' attempts to retain their high performance.

2.3.3 Turnover intentions

This is a term that refers to the intention to disassociate oneself from the firm (Ameen *et al.,* 1995). Audit firms are known to face high turnover rates characterised by auditors staying with a firm for three to four years until a level of expertise is gained (Herrbach, 2001). Being part of the nature of the auditing profession, job burnout, time budget pressures and long working hours play a significant role in contributing to high turnover rates within audit firms (Herda and Lavelle, 2012).

Malone and Roberts (1996) stated that when audit staff members intend to resign in the near future, they may be more willing to engage in DAB since they would be less worried about possible termination if caught. In addition, audit personnel with high turnover intentions may be less afraid of the potential adverse effects of DAB on their performance appraisal and promotion (Donnelly *et al*., 2003). Studies conducted in the US (Donnelly *et al*., 2003) and China (Yuen *et al*., 2013) found positive and significant relationships between turnover intentions and the acceptance of DAB. On the contrary, it may be argued that committed employees may be more willing to engage in DAB in order to enhance their performance evaluations and chances of promotion. In fact, *Paino et al*. (2012) found a negative and significant relationship between turnover intentions and the acceptance of DAB in Malaysia. Hence, one wonders whether this relationship is in fact context specific or, rather, a case of an odd chance fluctuation.

3. Objectives

As stated earlier, this study investigates the impact of aspects of audit firm culture and individual auditor characteristics on the acceptance of DAB among audit personnel. Analysis of the impact is built up by three research questions:

1. How do audit personnel respond to tight budgets and to what extent do they engage in quality reduction acts?

2. What are their attitudes towards the under-reporting of time? More specifically:

   - Is under-reporting of time perceived as unethical by personnel, and, if so, does perception vary as a function of demographic variables?

   - Are personnel willing to report significant mistakes made during their audits, and, if so, does this willingness vary as a function of demographic variables?

   - Is under-reporting of time punishable by audit firms, and, if so, does punishment incidence vary by firm type?

- Does under-reporting of time lead to benefits and, if so, how important are these benefits and does the overall level of benefits vary as a function of demographic variables?

3. Can aspects of organisational culture and individual/firm characteristics significantly predict dysfunctional audit behaviour acceptance among such audit personnel?

This empirical study adopts a mixed methods approach. The sampling design, the build-up of the research instruments and participation as well as the data analysis procedures are now expounded.

4. Data and methodology

4.1 Population and sampling

The target population of the study consists of all the 702 audit personnel in the 40 registered Maltese audit firms as listed on the website of the Malta Accountancy Board as at 23rd September 2013. For this population size to be reached, the partners responsible for HR within these firms were contacted and kindly asked to disclose the total number of audit personnel in their respective firms. They were then asked to support the study by forwarding an e-mail containing information about our questionnaire and a hyperlink to an online questionnaire to their audit personnel. They were assured that the responses provided were strictly confidential and that the data gathered would be used for research purposes only. In addition, a signed supervisor consent form was enclosed with the e-mail for authenticity purposes.

4.2 Research instruments and participants

4.2.1 Questionniare

A structured questionnaire was purposely designed for the present study using the *Kwiksurveys* online software tool. This questionnaire contained four sections – Section A on dysfunctional audit behaviour (incidence and acceptance of dysfunctional audit behaviour), Section B on organisational culture (perceived reinforcement of under-reporting of time, superiors' engagement in dysfunctional audit behaviour), Section C on individual factors (locus of control, employee performance, turnover intentions) and Section D on demographic information on the respondent's background (gender, audit experience, job position, firm type). Audit partners were requested to skip Section B since this inquired about the behaviour of one's superior. Table 1 specifies the number of items pertaining to each construct used in the questionnaire and the source(s) from which each construct was adopted.

All the Cronbach alpha coefficients exhibited in Table 1 exceeded 0.7, indicating that all the construct measures were internally consistent. Apart from these measures, the questionnaire included five items on the response of audit personnel to tight budgets adopted from Kelley & Seller (1982) and Otley & Pierce (1996b). These items, however, produced a low Cronbach alpha coefficient of 0.104 and attempts to eliminate particular items to improve overall internal consistency proved futile. These items will therefore be examined separately and will not be combined into a single scale.

Respondents were requested to indicate their level of agreement with the five-point Likert-type questions ranging from 'strongly disagree to strongly agree' or from 'never to always'. Apart from the Likert-type statements, respondents were also asked to answer on a dichotomous scale (No *vs.* Yes) each of the following: "Under-reporting of time is 'unethical", "Under-reporting of time is punishable at my place of work", and "If I realise I have made a significant mistake during an audit, I would definitely report it".

Between September 20th and November 5th of 2013, 278 completed questionnaires were received but 26 of these had to be discarded because they contained missing information. This resulted in a net sample of 252 (35.8% response rate). Assuming 95% confidence in the estimate, that 50% of the sample will have the specified attribute (worst scenario for categorical variables) and a

Table 1: Constructs - Sources used, Number of Items and Cronbach's Alpha Coefficients

Construct	**Adopted from**	**No of items**	**Cronbach α**
DAB incidence	Kelley & Margheim (1990), Otley and Pierce (1995)	5	0.850
DAB acceptance	Donnelly *et al* . (2003)	12	0.855
PR of URT	Lightner *et al.* (1982); Akers and Eaton (2003)	8	0.876
SE in DAB	Lightner *et al.* (1982); Otley & Pierce (1996b)	6	0.830
LOC	Spector (1988)	16	0.804
EP	Donnelly *et al.* (2003)	7	0.833
TI	Donnelly *et al.* (2003)	3	0.822

Note: DAB = Dysfunctional Audit Behaviour, PR = Perceived Reinforcement, URT = under-reporting of time, SE = Superior’s Engagement, LOC = Locus of Control, EP = Employee Performance, TI = Turnover Intentions.

sample size of 252, the resulting margin of error is 4.95% (Lenth, 2012). As this margin of error is within the ± 5% margin, it can be tolerated (DeVaus, 2002). The single largest groups were female (50.4%), audit seniors (52.0%), employed by Big Four Firms (54.0%), and had five to nine years of auditing experience. A more detailed summary of the demographic characteristics of the respondents is presented in Table 2.

Table 2: Respondent Characteristics

Demographic Characteristic	**Category**	**Frequency**	**Percentage**
Gender	Male	125	49.6
	Female	127	50.4
Audit Experience	0-1 year	58	23.0
	2-4 years	62	24.6
	5-9 years	94	37.3
	10+ years	38	15.1
Firm Type	Big Four	136	54.0
	Non Big Four	115	46.0
Job Level	Audit Junior	49	19.4
	Manager	45	17.9
	Audit Senior	131	52.0
	Partner	27	10.7

4.2.2 Interviews

The objective of conducting interviews was to gain a better understanding of the attitude towards dysfunctional audit behaviour within Maltese audit firms and the organizational factors influencing such behaviour. Non-standardised semi-structured interviews were held with eight audit partners, one from each Big Four firm and four with audit partners selected at random from the smaller audit firms. Such interviews follow a pre-established interview schedule but allow the researcher to freely change the order of the questions and to probe further by asking additional questions (Kajornboon, 2005). The sample size chosen falls within the recommended sample size interval for interviews (Kvale & Brinkmann, 2009), particularly when considering a homogeneous population (Guest *et al.*, 2006), in order to reach data saturation and validity. The interview schedule developed was based on a preliminary analysis of the responses gathered from the questionnaire by November 5, 2013. This analysis enabled the interviews to delve into the key findings of the questionnaire. The interview schedule was sub-divided into three sections and each question was carefully designed to promote objectivity and exclude any personal biases.

Initial contact was made by way of an e-mail sent to selected audit partners inviting them to participate in the research study. The e-mail provided the audit partners with the interview schedule. Interviews were subsequently held with the 8 audit partners at their respective audit firms. The interviews, which were conducted between November 2013 and January 2014, lasted around 40 minutes each. Permission was granted from the interviewees to audio record the meetings which were consequently transcribed to facilitate analysis. To ensure anonymity and confidentiality, we assured the participants that no names will be disclosed.

4.2.3 Data analysis procedures

To answer the research questions, we used descriptive statistics; the mean and standard deviation were used with interval/ratio scales, the median and the interquartile range was used with ordinal scales while counts and percentages were used with nominal scales. To rank items on the basis of mean ranks, the Friedman test was used and in the presence of an overall significant difference, the Wilcoxon test as post-hoc test was used to examine pair-wise differences. The Bonferroni correction was applied to counteract for the problem of multiple comparisons among sub-groups inflating the Type 1 error (Miller, 1991). In determining whether a variable could be predicted by a set of independent variables (predictors), stepwise multiple regression was used when the independent variable used the interval/ratio scale of measurement, binary logistic regression being used when the dependent variable was binary/dichotomous and qualitative. Finally, in determining whether an association existed between categorical variables, cross-tabulations accompanied with the Chi-squared test were generated. All the above statistical analysis was conducted in the SPSS V20 software package.

5. Results

Once the interviews were transcribed, content analysis was used to identify themes or patterns in the text. This facilitated the interpretation of the findings that emerged from the question.

5.1 How do the audit personnel respond to tight budgets and to what extent do audit personnel engage in quality reduction acts?

As to how audit personnel respond to tight budgets, all audit personnel participating in our study reported that they engaged in some kind of response in relation to tight budgets. A Friedman test revealed that the mean ranks of the responses pertaining to the five statements outlined in Table 3 differed significantly from each other ($\chi^2(4) = 287.16$, $p < 0.001$). A series of Wilcoxon tests (with significance set at $p \leq 0.005$ after applying a Bonferroni correction) revealed the statement that was rated most highly was - "working harder but charging all time appropriately". This was followed by"requesting and obtaining a budget increase", the "under-reporting of time by working on personal time", "shifting time to non-chargeable items", and "reducing the quality of audit work to meet budget" respectively. More detailed statistical output is presented in Table 3.

In the interviews, most of the audit partners (6/8) stated that the time budget in the previous year was usually taken as the basis for setting the current year's budget, with the budget being adjusted accordingly for past efficiencies and/or inefficiencies. Furthermore, half the interviewees (4/8) suggested that less time was allocated for subsequent audits since one had more experience with the client. All audit partners (8/8) agreed that staff members should speak up when they perceive a particular time budget for a task to be unattainable and should discuss it with their manager. Half of them (4/8) stated that they expected audit team members to work overtime to meet the budgets since "the reality is that there is so

Table 3: Response to Tight Budgets - Descriptive Statistics and Rank Ordering

Statement*	**Reported to some Extent*****	**Median (IQR)**	**Mean Rank**	**Wilcoxon Test** (Post-Hoc) Summary**
Work harder but charge all time properly	97.8%	4 (3-4)	4.23	A
Request and obtain a budget increase	85.3%	3 (3-4)	3.46	B
Underreport time by working on personal time	83.2%	3 (2-3)	2.93	C
Shift time to non-chargeable items	68.5%	2 (2-3)	2.59	D
Reduce the quality of audit work to meet budget	45.1%	1 (1-2)	1.79	E

Note: N = 252; *Scales are ordinal and range from 1 (never) to 5 (always); **different letters signify statistically significant differences after applying Bonferroni correction, with sig. set at p ≤ 0.005; ***All excluding strongly disagree

much work to be done in the busy season." In addition, two audit partners *(2/8)* admitted that they intentionally under-allocated hours in the budget and assumed staff would work beyond an eight-hour day.

As to the extent to which audit personnel engage in quality reduction acts, the mean of the responses pertaining to the five items eliciting incidence of dysfunctional audit behaviour acts outlined in Table 4 was relatively low (M = 1.63, SD = 0.60). In fact, only 16.8% of the respondents reported that they did not engage in any one of these five quality reduction acts during the previous year, albeit those who did, did so to a low extent. The responses to these five statements differed significantly from each other in mean ranks ($\chi^2(4) = 104.32$, $p < 0.001$). Acceptance of weak client explanations was rated highest, and this was followed by a reduction in the amount of work performed on an audit step below what they considered reasonable, failure to reach an accounting principle, a superficial review of client documents, and the signing off on an audit step without completing the work or noting the omission/PMSO. A summary of statistical output is exhibited in Table 4.

Table 4: Audit Quality Reduction Acts - Descriptive Statistics and Rank Ordering

Statement*	**Reported to some Extent*** **	**Median (IQR)**	**Mean Rank**	**Wilcoxon Test** (Post-Hoc) Summary**
Accepted weak client explanations	68.5%	2 (1-2)	3.59	A
Reduced amount of work performed on an audit step below what you considered reasonable	49.5%	1 (1-2)	3.15	B
Failed to research an accounting principle	49.5%	1 (1-2)	3.01	B, C
Made superficial reviews of documents	41.8%	1 (1-2)	2.85	C
Signed off an audit step without completing the work or noting the omission/PMSO	26.1%	1 (1-2)	2.40	D

Note: N = 252; *Scales are ordinal and range from 1 (never) to 5 (always); **different letters signify statistically significant differences after applying Bonferroni correction, with sig. set at $p \leq 0.005$; ***All excluding strongly disagree.

In the interviews, the Big Four audit partners unanimously stated that they were not aware of AQR acts within their firms and that serious repercussions would arise for such behaviour. PMSO was seen as the most serious act by all the Big Four audit partners since it gave “a false sense of security that the work was done.” A common concern among all the Big Four audit partners was that certain individuals did not demonstrate sufficient professional scepticism and had lost the natural ″curiosity" that was essential in the auditing profession.

Moreover, a non-Big Four audit partner affirmed that certain audit clients were too small and did not really need to be audited, especially the owner-managed ones. Unlike in other European countries, these firms were still required by Maltese regulation to present a set of audited financial statements. In such cases, where the client did not show interest in the audit and the audit fee was low, the audit staff might take shortcuts since the work was “boring” and the audit was “something we know nobody wants”.

All audit partners (8/8) agreed that each AQR act was detrimental to audit quality, drawing towards a less robust audit opinion. One Big Four audit partner highlighted the impact of AQRs on future audits since, once accepted, they would also spread to other audit engagements. Despite knowing about the risks such behaviours posed, all audit partners (8/8) seemed confident that, through their review systems in some cases involving four-level exercises, any such shortcuts were being picked up.

5.2 What are the attitudes of employees towards under-reporting of time?

5.2.1 Do audit personnel perceive the under-reporting of time as unethical? If so, does this perception vary as a function of demographic variables?

The majority of the audit personnel (74.5%) acknowledged that under-reporting of time is unethical. Binary logistic regression revealed that when the four demographic variables (gender, audit experience, firm type and job position) were entered on Step 1, none of them could adequately distinguish between those acknowledging that under-reporting of time is unethical and those who do not. A summary of the binary logistic regression output is presented in Table 5.

Table 5: Variables in the Binary Logistic Regression Equation

(Perception of Under-Reporting of Time)

		B	**S.E.**	**Wald**	**Df**	**Sig.**	**Exp(B)**
Step 1[a]	Gender(1)	-.137	.367	.139	1	.709	.872
	Firm Type(1)	-.343	.386	.789	1	.374	.709
	Job Position	-.513	.234	4.816	1	.028	.599
	Audit Experience	.422	.216	3.818	1	.051	1.526
	Constant	1.650	.666	6.132	1	.013	5.206

Note: [a] Variable(s) entered on step 1: gender, firm type, job position, audit experience.

5.2.2 Are audit personnel willing to report significant mistakes made during an audit? If so, does this willingness vary as a function of demographic variables?

The vast majority of audit personnel (94.6%) reported that they generally report a significant mistake during an audit. Binary logistic regression revealed that none of the four demographic variables could adequately distinguish between those who are willing to report a significant mistake during an audit and those who are unwilling (Table 6).

Table 6. Variables in the Binary Logistic Regression Equation

(Reporting significant mistakes during an audit)

		B	S.E.	Wald	Df	Sig.	Exp(B)
Step 1[a]	Gender(1)	.858	.739	1.345	1	.246	2.357
	Firm Type(1)	-.038	.762	.003	1	.960	.963
	Job Position	.148	.392	.143	1	.705	1.160
	Audit Experience	.837	.458	3.338	1	.068	2.309
	Constant	.454	.983	.213	1	.644	1.575

Note: [a] Variable(s) entered on step 1: gender, firm type, job position, audit experience.

5.2.3 Is under-reporting punishable by audit firms? If so, does the punishment incidence vary by firm type?

Only 34.8% of the respondents reported that URT is punishable by their firm. A chi-squared test revealed that there was no significant association (χ^2 = 1.87, p = 0.171) between punishment for URT (No *vs* Yes) and firm type (Big Four *vs* Non-Big Four).

In the interviews, all audit partners (8/8) stated that URT was against their firm's policy and that they encouraged their staff to report all chargeable hours, including overtime. Most of them (7/8) affirmed that under-reporting of time defeated the scope of knowing the costs of audit engagements for the firm. A Big Four audit partner (1/8) pointed out the importance of gathering the correct data about the time spent on an audit because "that is the only way we are able to renegotiate the fees going forward". Sometimes, an audit client may be "disorganized" and that could explain why audit team members worked late.

Most audit partners (6/8) acknowledged that they were aware of URT in their firms. Big Four partners (4/8) stated that they frequently reminded staff of the importance of charging all productive time. In one case, a Big Four audit partner $_{(1/8)}$ described that they had introduced a policy whereby audit staff members get paid for overtime, and so "there is an incentive for them to charge." Most audit partners interviewed (7/8) stated that, when they become aware of an audit team member who has resorted to URT, s/he would not be reprimanded but rather called to be reminded that s/he should report all chargeable hours. A Big Four audit partner $_{(1/8)}$ argued that:

> "We do not penalise someone with such a commitment to us simply because s/he refused to put down the hours. His/her bonus will not be affected by this."

Moreover, two of the audit partners (2/8) in smaller firms claimed that URT compensated for the time wasted during the day browsing the internet, checking emails and phone chatting. Most interviewees (6/8) did not believe that URT could impact audit quality, one declaring that "as long as you work the hours, it's irrelevant for audit quality whether or not you report them". With regards to URT, a Big Four audit partner (1/8) stated that:

> "You have to break that mould. There has to come a time when personnel state the amount of time they actually spent and then the firm will have to see how it is going to handle this."

Once the hours really being put in an audit are identified, the audit fee would be adjusted accordingly. However, another Big Four audit partner (1/8) argued that if his audit firm addressed this issue while other firms in the market did not, its quoted fees, being based on the really higher number of hours, would result higher, and thus it would lose clients. This audit partner stated that in their case they had to "struggle to get acceptable efficiencies on engagements."

5.2.4 Does under-reporting of time lead to benefits? If so, how important are these benefits?

The responses to statements outlined in Table 7 differed significantly from each other with respect to their mean ranks ($\chi^2(7) = 102.32$, $p < 0.001$). Summary statistics revealed that URT very often leads to (i) more interesting and challenging assignments, (ii) superiors believing that they are as competent or even more competent than their peers, and (iii) promotion and advancement; but sometimes it leads to (i) a better periodic evaluation, (ii) higher job security, (iii) a feeling that they are as competent as their peers, (iv) a feeling of accomplishment and (v) more job satisfaction. A summary of the statistical output is presented in Table 7.

5.2.5 Can aspects of organisational culture and individual/firm characteristics significantly predict DAB acceptance among audit personnel?

In the preliminary analysis, we examined zero-order correlations between DAB acceptance and the independent variables used in the regression model.

Table 7. Under-reporting of Time Benefits: Descriptive Statistics and Rank Ordering

Under-reporting of time leads to: *	Reported to some Extent	Median (IQR)	Mean Rank	Wilcoxon Test** (Post-hoc) Summary
- more interesting and challenging jobs	94.5%	4 (3-4)	4.23	A
- superiors believing that they are as competent or even more competent than their peers	93.5%	4 (3-4)	3.46	A
- promotion and advancement	94.2%	4 (2-4)	2.93	A
- better periodic evaluation	91.6%	3 (2-4)	4.79	A,B
- higher job security	91.6%	3 (2-4)	1.79	B,C
- feeling as competent as peers	87.1%	3 (2-4)	1.79	B,C
- a sense of accomplishment	90.3%	3 (2-4)	1.79	C, D
- more job satisfaction	84.5%	3 (2-4)	1.79	D

Note: N = 252; *Scales are ordinal and range from 1 (never) to 5 (always); **different letters signify statistically significant differences after applying Bonferroni correction, with sig. set at $p \leq 0.00178$.

This revealed that DAB acceptance was significantly correlated with:

(i) the two organisational culture characteristics, namely perceived reinforcement of URT (r = 0.402, p < 0.001) and superior requests/engagement (r = 0.280, p < 0.001); and

(ii) three of the seven individual/firm characteristics, namely locus of control (r = 0.312, p < 0.001), turnover intentions (r = 0.168, p = 0.008) and audit experience (r = -0.162, p = 0.010).

DAB acceptance was not significantly associated with gender (r = 0.059, p = 0.348), job status (r = 0.069, p = 0.273), employee performance (r = -0.035, p = 0.581), and firm type (r = -0.110, p = 0.082).

Stepwise multiple regression was then used to determine which of these nine independent variables emerged as significant predictors of DAB acceptance. Perceived reinforcement of URT was entered in Step 1 ($F_{1,222}$ = 42.57, p < 0.001, R^2 = 0.16), supervisor engagement/requests in Step 2 ($F_{2,221}$ = 27.40, p < 0.001, R^2 = 0.20), audit experience in Step 3 ($F_{3,220}$ = 21.06, p < 0.001, R^2 = 0.22), firm type in Step 4 ($F_{4,219}$ = 18.40, p < 0.001, R^2 = 0.25) and locus of control in Step 5 ($F_{5,218}$ = 16.71, p < 0.001, R^2 = 0.28). The regression coefficients are exhibited in Table 8.

Table 8. Regression Coefficients Table (Step 5)[a]

	Unstandardized Coefficients		Standardized Coefficients	T	Sig.	Collinearity Statistics	
	B	Std. Error	Beta			Tolerance	VIF
(Constant)	1.067	.188		5.685	.000		
Perceived Reinforcement of URT	.212	.054	.251	3.955	.000	.825	1.213
Supervisor engagement/requests	.198	.060	.210	3.323	.001	.834	1.199
Audit experience	-.142	.043	-.196	-3.335	.001	.957	1.045
Firm type	-.259	.083	-.191	-3.137	.002	.893	1.120
Locus of Control	.249	.090	.176	2.778	.006	.830	1.205

Note: [a] Dependent Variable: DAB Acceptance

Table 8 shows that the DAB acceptance increases as reinforcement of under-reporting of time increases, supervisory engagement/requests increase, locus of control increases, and audit experience decreases. Additionally, DAB acceptance is less likely to occur from Big Four audit personnel.

There was no statistical evidence that the error terms were positively auto correlated since the Durbin Watson statistics (d =1.953) was close to 2 and greater than Savin and White's (1977) upper cut-off value ($dU_{0.05}$ = 1.82 for $k = 5$). The Variance Inflation factors (VIFs) were all close to 1 implying that there were no issues concerning multicollinearity (Field, 2009).

Although firm type was not significantly correlated with DAB acceptance, it emerged as a significant predictor of DAB acceptance. This means that 'firm type' is a suppressor variable and its inclusion helps to reduce the error variance in the other predictors and explain better the variability in DAB acceptance - the criterion variable (Bezzina & Saunders, 2014).

In the interviews, all audit partners *(8/8)* admitted that attainment of time budgets was one of the factors considered in the evaluation and promotion process of audit staff. A Big Four audit partner argued: "It is expected that you achieve your time budget because it is assumed that time budgets are reasonably set." However, emphasis was made that various other factors were considered in the evaluation process of staff including discussions about each of the staff members with managers, feedback reports and the quality, knowledge and experience placed in the audit file.

Similarly, audit managers were selected on the basis of a number of criteria including experience, knowledge, commitment to the firm and being in possession of the right competencies. Two of the Big Four audit partners *(2/8)* stated that managers strived to look efficient since they felt responsible for the budget and might be afraid of facing the audit partner with a "budget that has gone wrong." It became clear from the interviews that supervisors were selected because they were trustworthy and it was not tolerated that they, or even their superiors engaged in or requested others to engage in DAB. A Big Four partner *(1/8)* commented: "I'd hate to think we have that situation."

6. Discussion

6.1 Time budget pressures in the performance of statutory audit engagements

The findings provide evidence of the presence of time budget pressures among audit firms under study. Results indicate that respondents were almost as inclined to engage in URT as to request a budget increase in response to tight budgets, although in other studies elsewhere {e.g. Otley & Pierce (1996b) and Zakaria *et al.* (2013)} audit staff were even more inclined to engage in URT. Maltese audit partners do expect audit staff to work beyond regular hours to meet time budgets and this may dishearten audit personnel from requesting budget increases, particularly if such requests were rejected by audit managers or partners in the past.

URT distorts the measures of cost and profitability on an audit, and impairs audit fee renegotiations on future ones. URT also conceals the fact that audit staff worked beyond reported hours owing to disorganisation in the client's accounting record-keeping. Although contingent fees are not permitted, the audit fee which is generally agreed upon in advance at the start of the audit should include scope for variation so as to take account of unexpected factors in the work. Therefore, URT may also be imposing a constraint on revenue growth and restricting the revenue earned both on current and future audit engagements.

Given that prior year time budgets are used to plan future time budgets, these are also inaccurately set if URT is present within the audit firm. This leads to tighter time budgets for audit staff which may impact the quality of work by increasing the incidence of AQR acts, as noted by Atkers and Eaton (2003) and Agoglia *et al.*

(2011). Moreover, purposely allocating fewer hours on an audit engagement to enhance profitability may further perpetuate the pressures from time budgets.

Our findings indicate that AQR acts are not widespread among the surveyed audit personnel, with most of them being performed only rarely by respondents. Yet, even such limited acts can pose a direct threat to the reputation of an audit firm and to audit quality.

6.2 Audit firms perceived as reinforcing URT

Although the majority of respondents agreed that URT is unethical, it was only 16.8% of the same respondents that stated that they never engaged in URT. This percentage compares to 5% and 12% of Malaysian and Swedish audit firms as reported in Nor (2011) and Svanberg and Öhman (2013) respectively. A substantial number of audit personnel may therefore be going against their own ethical beliefs. For this reason, the perceived reinforcement obtained from URT must be of considerable value. Our findings show that audit staff members consider that URT leads to various rewards associated with the staff evaluation process, where the attainment of time budgets would typically be one of the main factors considered. Our findings therefore support in this respect those of Akers & Eaton (2003) and Agoglia, *et al.* (2011).

The perceived reinforcement of URT has been found to be a significant predictor of DAB acceptance. If URT is perceived to be tacitly rewarded within an audit firm, an environment is created where audit personnel are willing to act against their ethical beliefs and are more accepting of further dysfunctional practices. Despite URT being against firm policy, the lack of disciplinary action taken against under-reporters may be sending a mixed signal to audit personnel. Instead of deterring such behaviour, audit firms may be seen as rewarding the use of URT which, in turn, leads to a higher acceptance of dysfunctional practices.

Two reasons emerge why URT may not be subject to sanctions within audit firms in Malta despite the known repercussions associated with it: first, that URT is perceived as having no severe impact and, secondly, that URT is perceived as helping to maintain audit fee levels. Despite being aware of URT within their firm, most partners do not really consider that it is a pervasive problem – in fact, in their view, some URT may even be compensating for the unproductive hours spent by staff during the day, this resulting in more realistic reported hours. Anyway, the immediate costs of URT are borne by audit staff themselves through foregone pay or leave, and current audit fee levels are therefore not affected.

6.3 Superiors engaging in dysfunctional behaviour

Audit partner/ manager trust is fundamental. Although audit partners expressed confidence that their managers were trustworthy, the findings show that inappropriate behaviour among superiors is not uncommon. It was only 41.3% of respondents who stated that their superior never engaged in PMSO. Therefore, the incidence of PMSO among superiors as reported by respondents was much higher than the respondents' own reported engagement in such a practice. This is quite concerning.

PMSO compromises audit quality and provides a false sense of assurance. Furthermore, individuals who resort to PMSO must do so in the belief that they will not be caught. Audit personnel admitted to being subject to implicit requests from their superiors to underreport time whilst implicit requests to PMSO were less common. Similar to Otley & Pierce (1996b), explicit requests occurred far less frequently than implicit ones. The findings also illustrate that audit superiors within Big Four firms are more likely to engage in or request others to underreport time than those from smaller audit firms. Given that time budgets are perceived as more unattainable in Big Four firms, superiors may be more inclined to underreport time in order to appear efficient. The hierarchical structure of Big Four firms could also be contributing to such an attitude.

The importance of budget attainability attached by superiors to their own performance evaluations may in turn be motivating the wrong type of personnel behaviour. Superiors' dysfunctional behaviour induces the adoption of similar practices among subordinates since their superiors are their main source of performance feedback. In fact, performance evaluations of audit staff often include discussions with managers and the evaluation of feedback reports. As a result, audit team members are likely to work hard to please their superiors, even if that implies engaging in dysfunctional practices.

6.4 External locus of control – a DAB predictor

External LOC was found to be a significant predictor of DAB acceptance. Therefore, individuals with an external LOC are more accepting of DAB than individuals with an internal LOC. These results are consistent with the studies by Donnelly *et al.* (2003), and Paino *et al.* (2012) referred to earlier. These findings also complement those of Solar & Bruehl (1971), and Gable & Dangello (1994), where externals were found to be more willing to resort to manipulation to obtain the reinforcements required to survive.

Audit firms need to ensure that hard work is rewarded and appreciated through frequent reinforcement practices, supporting the recommendation of the IAASB (2014) for creating a culture where audit quality is valued. On the other hand, reinforcing inappropriate or unethical practices like URT is unfair towards hardworking audit personnel who do not engage in similar practices. In particular, for personnel with an external LOC, this will lead to a perception of a hostile working environment.

6.5 Experience and DAB acceptance

Our findings suggest that more experienced audit staff exhibit lower levels of DAB acceptance than less experienced personnel (as also evidenced in Nor, 2011). A range of factors could explain such occurrence. For example, the various efforts undertaken by audit firms to enhance audit quality may be having the desired effect on audit staff. This includes training whereby audit personnel are reminded of the importance of every step involved in an audit engagement including the proper documenting and reporting of audit work. Moreover, experienced personnel are often more mature and may be more appreciative of audit work and more conscious of the consequences of dysfunctional behaviour.

6.6 Big Four - better behaviour?

Although audit personnel within Big Four firms perceived budgets to be more unreasonable than their non-Big Four counterparts, our findings suggest that Big Four audit staff are inherently less accepting of DAB. This finding was also expressed in studies by Margheim and Pany (1986) and Nor (2011). This study puts forward two main arguments that advance support to this finding:

(i) better control mechanisms - Big Four firms are known to display a highly competitive internal environment characterised by high pressures and robust internal controls, and therefore incorporate internal support mechanisms to mitigate the possible consequences on audit quality. Furthermore, Big Four firms may have more extensive reviews and effective quality control procedures passed down from their foreign network firms; and

(ii) tedious work associated with small audit clients – the Maltese Companies Act, 1995 requires all companies incorporated in Malta to be subject to a statutory audit (other than very small private entities which meet the requirements listed under Article 185 (1) (b) of the Companies Act). Small audit clients, such as owner-managed companies, are usually associated with low audit fees and the work carried out on such audit engagements would most likely be routine and uninteresting. Audit personnel within small audit firms face such circumstances more often and hence may be more prone to take shortcuts and justify resorting to AQR acts (as evidenced in a UK study by Willett and Page, 1996).

7. Conclusion

This study has sought to shed light on the impact of aspects of audit firm culture and individual auditor characteristics on the acceptance of DAB among audit firms based in Malta. It concludes that audit firm culture exhibits significant influence on such acceptance by audit personnel. This relates in particular to the perceived reinforcement of underreporting of chargeable time and inappropriate behaviours by superiors. As for individual auditor characteristics, an individual's perception of control in his/her work has also been found to be a significant predictor of such acceptance. Results also indicate that audit experience leads to a reduction of such behaviour and that audit Big Four personnel seem to be less accepting of dysfunctional practices than those in smaller firms.

Further indications of the study are that, while not being a widespread problem, DAB is an important issue for audit firms. URT is a widely resorted act among audit personnel, possibly causing increasingly tight time budgets for subsequent audit periods. The high URT incidence is likely caused by the mixed signals given by audit firms to their staff. Despite being against firm policy, there appears to be a lack of disciplinary measures taken towards known under-reporters. Consequently, the belief that audit firms reward under-reporters is revealed to lead to a higher DAB acceptance among audit personnel. Furthermore, while not common, the mere presence of AQR acts such as the acceptance of weak client explanations and the superficial review of client documents is serious for audit firms as it increases the risk that a material misstatement is not detected during the conduct of an audit engagement and it directly impacts the reputation risk of the firm.

We recommend further research into the reasons for the higher acceptance of DAB within smaller audit firms, although a possible justification for this has been put forward in this study. Furthermore, it is hoped that, as part of their effort to enhance quality, audit firms step up their action to respond to the various causes of DAB among audit personnel that have been uncovered. Firms need to ensure that they are clearly communicating internally the adverse effects of such DAB to their audit personnel. In particular, an unambiguous message needs to be sent regularly that URT is not acceptable and that there are other more important factors apart from attaining time budgets that are given due consideration in the staff appraisal process. Beyond discouraging DAB, this should positively help existing personnel understand the importance of providing high quality audits. In addition, we recommend that more attention be focused on the quality, attitudes and intentions (such as apparent locus of control and expected durability) of staff upon recruitment, given the significance of each individual's attitudes on the firm's audit quality.

The results of our study are subject to the limitations encountered in its scope and conduct. The study only analyses the relationship of DAB with aspects of firm culture and selected individual characteristics. Other potential factors contributing to the acceptance of DAB among audit personnel have therefore been excluded. Furthermore, the incidence of DAB was measured using self-reported measures in the questionnaire. Given that these questions were of a sensitive nature, the respondents may have understated their engagement in such practices. Finally, the perspectives of audit clients and ex-audit personnel are probably valuable for a comprehensive evaluation of the subject matter, and we believe that this is an interesting avenue for further research.

References

Regulatory

Companies Act - Malta,1995. Cap. 386 of the Laws of Malta: http://www.mfsa.com.mt/pages/viewcontent.aspx?id=231 [20 March, 2014]

International Auditing and Assurance Standards Board (2013). *A Framework for Audit Quality: Consultation Paper.* [pdf] New York: International Federation of Accountants: http://www.ifac.org/sites/default/files/publications/files/A%20Framework%20for%20Audit%20Quality.pdf [10 July, 2013].

Other

Accountancy Board, Malta, 2013. *Registered Audit Firms and Principals*: https://secure3.gov.mt/accountancyboard/Registers/RegisteredAuditFirmsPrincipals.aspx [23r September,2013].

Agoglia, C.P., Hatfield, R.C. and Lambert, T.A. (2011). When do audit managers prefer staff to underreport time? In *International Symposium on Audit Research* :1-32.

Akers, M.D., & Eaton, T.V. (2003). Under-reporting of chargeable time: The impact of gender and characteristics of under-reporters. *Journal of Managerial Issues,* 15(1): 82-96.

Ameen, E.C., Jackson, C., Pasewark, W.R. & Strawser, J.R. (1995). An empirical investigation of the antecedents and consequences of job insecurity on the turnover intentions of academic accountants. *Issues in Accounting Education,*10(1): 65-82.

Baldacchino P.J & Borg J. (2014) An analysis of the development of audit fees in Malta. *The IUP Journal of Accounting Research and Audit Practices,* 13 (2): 27-52.

Belkaoui, A. & Picur, R.D., (1987). Sources of Feedback in a CPA Firm. *Journal of Business Finance & Accounting,* 14(2):175-186.

Bezzina, F. & Saunders, M.N.K. (2014). The pervasiveness and implications of statistical misconceptions among academics with a special interest in business research methods. *Electronic Journal of Business Research Methods*, 12(2): 29-42: www.ejbrm.com [13 September, 2014]

Buchman, T.A. & Tracy, J.A. (1982). Obtaining responses to sensitive questions: Conventional questionnaire versus randomized response technique. *Journal of Accounting Research,* 20(1): 263-271.

Copeland, J.E., Jr. (2005). Ethics as an imperative. *Accounting Horizons*, 19(1): 35-43.

Coram, P., Glavovic, A., Ng, J. and Woodliff, D.R. (2008). The moral intensity of reduced audit quality acts. *Auditing: A Journal of Practice and Theory,* 27(1): 127-149.

DeAngelo, L.E. (1981). Auditor size and auditor quality. *Journal of Accounting and Economics*, 3(3):183-199.

DeVaus, D.A. (2002) *Surveys in Social Research* (5th ed.). London: Routledge.

Donnelly, D.P., Quirin, J.J. and O'Bryan, D. (2003). Auditor acceptance of dysfunctional audit behaviour: an explanatory model using auditors' personal characteristics. *Behavioural Research in Accounting,*15 (1):87-110.

Field, A. (2009). Discovering Statistics Using SPSS. London, Sage.

Gable, M. & Dangello, F. (1994). Locus of control, Machiavellianism, and managerial job performance. *The Journal of Psychology,* 128(5): 599-608.

Guest, G., Bruce, A. & Johnson, L. (2006). How many interviews are enough? An experiment with data saturation and validity. *Field Methods*, 18(1): 59-82.

Gundry, L.C. & Liyanarachchi, G.A. (2007). Time budget pressure, auditors' personality type, and the incidence of reduced audit quality practices. *Pacific Accounting Review,* 9 (2): 125-152.

Herda, D.N. & Lavelle, J.J. (2012). The auditor-audit firm relationship and its effect on burnout and turnover intention. *Accounting Horizons*, 26(4): 707 -723.

Herrbach, O. (2001). Audit quality, auditor behaviour and the psychological contract. *European Accounting Review,* 10(4): 787-802.

Herrbach, O. (2005). The art of compromise? The individual and organisational legitimacy of "irregular auditing". *Accounting, Auditing and Accountability Journal*, 18(3): 390-409.

Jenkins J.G., Deis, D.R., Bedard, J.C and Curtis, M.B. (2008). Accounting firm culture and governance: A Research Synthesis. *Behavioural Research in Accounting*, 20(1): 45-74.

Kajornboon, A. B. (2005). Using interviews as research instruments. *E-Journal for Research Teachers* , 2(1):1-9: http://www.culi.chula.ac.th/e-Journal/bod/Annabel.pdf [12th November 2013].

Kelley, T. and Margheim, L. (1990). The impact of time budget pressure, personality, and leadership variables on dysfunctional auditor behaviour. *Auditing - A Journal of Practice and Theory,*9(2): 21-42

Kelley, T. & Seller, R. E. (1982). Auditor stress and time budgets.*The CPA Journal, (pre-1986),* 52(000012), December: 24-34.

Kingori, J.L. (2003). *The reduction of dysfunctional audit practices through the the amplification of ethical obligation*. Ph.D. Southern Illinois University at Carbondale.

Kvale, S and Brinkmann, S. (2009). *Learning the craft of qualitative research interviewing*. Thousand Oaks: Sage Publications.

Lenth, R. (2012) *Java applets for power and sample size* [Computer Software]: http://homepage.stat.uiowa.edu/~rlenth/Power [12 November].

Lightner, S.M., Adams, S.J. & Lightner, K.M. (1982). The influence of situational, ethical and expectancy theory variables on accountants' underreporting behaviour. *Auditing: A Journal of Practice and Theory,* 2(1): 1-12.

Lord, A. T. and DeZoort, F.T. (2001). The impact of commitment and moral reasoning on auditors' responses to social influence pressure. *Accounting, Organizations and Society,* 26(3): 215-235.

Malone, C.F. and Roberts, R.W. (1996). Factors associated with the incidence of reduced audit quality behaviours. *Auditing: A Journal of Practice and Theory,* 15(2): 49-64.

Margheim, L. and Pany, K. (1986). Quality control, premature sign off and under-reporting of time: Some empirical findings. *Auditing: A Journal of Practice and Theory*, 5 (2): 50-63.

Miller, R.G. (1991). *Simultaneous Statistical Inference*. New York: Spinger-Verlag.

Morris, J.T. (2009). The impact of authentic leadership and ethical organizational culture on auditor behaviour. Doctoral thesis, University of San Diego.

Nor, M. (2011). Auditor stress: Antecedents and relationships to audit quality, Doctoral thesis, Edith Cowan University, Western Australia.

Otley, D.T. & Pierce B.J. (1996a). Auditor time budget pressure: Consequences and antecedents. *Accounting, Auditing & Accountability Journal*, 9(1): 31-58.

Otley, D.T. & Pierce, B.J. (1996b). The operation of control systems in large audit firms. *Auditing: A Journal of Practice and Theory,*15(2): 65-84.

Paino, H., Smith, M. and Ismail, Z. (2012). Auditor acceptance of dysfunctional behaviour: An explanatory model using Individual factors. *Journal of Applied Accounting Research,* 13(1): 37-55.

Rhode, J.G., (1978). Survey on the influence of selected aspects of the auditor's work environment on professional performance of certified public accountants. Issued as *The Independent Auditor's Work Environment: A Survey. Research Study No: 4 New York, NY: AICPA*.

Rotter, J.B. (1966). Generalized expectancies for internal versus external control of reinforcement. *Psychological Monographs: General and Applied ,*80(1): 169-214.

Savin, N. E. & White, K. J. (1977). The Durbin-Watson test for serial correlation with extreme sample sizes or many regressors. *Econometrica, Journal of the Econometric Society,* 5(8):1989 -1996.

Schein, E.H. (2004). *Organizational Culture and Leadership,* 3rd Ed, San Francisco: Wiley and Sons.

Solar, D. & Bruehl, D. (1971). Machiavellianism and locus of control: Two conceptions of interpersonal power. *Psychological Reports*, 29(3) :1079 - 1082.

Spector, P.E. (1988). Development of the work locus of control scale. *Journal of Occupational and Organizational Psychology*, 61(4): 335-340.

Svanberg, J, and Öhman P. (2013). Auditors' time pressure: Does ethical culture support audit quality? *Managerial Auditing Journal*, 28 (7): 572-591.

Taylor, E.Z., Curtis, M.B. and Chui, L. (2012). Staff auditors' observations of questionable peer behaviour. *The CPA Journal*, 82(6): 66-71.

Watkins, A.L., Hillison, W. and Morecroft, S.E. (2004). Audit quality: A synthesis of theory and empirical evidence. *Journal of Accounting Literature*, 23: 153-193.

Willett, C. and Page, M. (1996). A survey of time budget pressure and irregular auditing practices among newly qualified UK chartered accountants. *The British Accounting Review*, 28(2):101-120.

Yuen D.C, Law P., Lu, C. and Guan, J. (2013). Dysfunctional auditing behaviour: Empirical evidence on auditors' behaviour in Macau. *International Journal of Accounting and Information Management*, 21 (3): 209-222.

Zakaria, N.B., Yahya, N. and Salleh, K. (2013). Dysfunctional behaviour among auditors: The application of occupational theory. *Journal of Basic and Applied Scientific Research*, 3(9): 495-503

Appendix

Questionnaire

Section A: Dysfunctional Audit Behaviour

1. In response to tight budgets, how often do you?

N = Never R = Rarely S = Sometimes O = Often A = Always	**N**	**R**	**S**	**O**	**A**
1.1 Work harder but charge all time properly.					
1.2 Under-report time by working on personal time.					
1.3 Reduce the quality of audit work to meet meet budget.					
1.4 Request and obtain a budget increase.					
1.5 Shift time to non-chargeable items.					

2. To what extent do you agree about acting in any of the following manners when conducting an audit engagement over the past year?

SD = Strongly Disagree D = Disagree N = Neutral A = Agree SA = Strongly Agree	**SD**	**D**	**N**	**A**	**SD**
2.1 Accepted weak client explanations.					
2.2 Made superficial reviews of client documents.					
2.3 Failed to research an accounting principle.					
2.4 Reduced the amount of work performed on an audit step below what you considered reasonable.					
2.5 Signed off on an audit step without Completing the work or noting the omission/PMSO.					

3. I would be more accepting of auditors signing off a required audit step without finishing the work or noting the omission if:

3.1 They believe the audit step will not find anything wrong if completed.					
3.2 On previous audits there were no problems with this part of the client's systems/records.					
3.3 Audit supervisor shows strong concern over the time it's taking to complete the audit step and is putting pressure onto getting it done.					
3.4 They believe the audit step is unnecessary.					

Appendix (Cont/2)

4. I would be more accepting of auditors under-reporting time if:					
SD = Strongly Disagree D = Disagree N = Neutral A = Agree SA = Strongly Agree	**SD**	**D**	**N**	**A**	**SD**
4.1 It improves their chances for promotion and advancement.					
4.2 It improves their performance evaluation.					
4.3 It is suggested by their immediate supervisor.					
4.4 Others under-report their time and it is necessary to compete with them.					

5. I would be more accepting of auditors altering/replacing audit procedures if:					
5.1 They believe the original audit procedure was unnecessary.					
5.2 On previous audits there were no problems problems with this part of the client's systems/records.					
5.3 They do not believe the procedure would find anything wrong.					
5.4 They are under a lot of time pressure to complete the audit.					

6. Please read each of the following statements carefully and then specify the extent of your disagreement/agreement with each item accordingly.					
6.1 Under-reporting of time is unethical.					
6.2 Under-reporting of time is punishable at my place of work.					
6.3 If I realized I have made a significant mistake during an audit, I would definitely report it.					

Appendix (Cont/3)

Section B : Organizational Culture
If you are a partner in an audit firm, please ignore this section and move to Section C.

7. What is the likelihood that underreporting of time leads to:					
VU = Very Unlikely U = Unlikely N = Neutral L = Likely VL = Very Likely	**VU**	**U**	**N**	**L**	**VL**
7.1 Better periodic evaluations.					
7.2 Superiors thinking that you are as competent or even more competent than your peers.					
7.3 Higher job security.					
7.4 Promotion and advancement.					
7.5 Subsequent assignments to more interesting and challenging jobs.					
7.6 Feeling as competent as your peers.					
7.7 Feeling of accomplishment.					
7.8 Feeling of job satisfaction					

8. How often does your superior engage in the following activities?					
N = Never R = Rarely S = Sometimes O = Often A = Always	**N**	**R**	**S**	**O**	**A**
8.1 Underreporting of time.					
8.2 Signing off a required audit step without finishing the work or noting the omission.					

9. How often does your superior request you to underreport time?					
9.1 Implicitly					
9.2 Explicitly					

10. How often does your superior request you to sign off a required audit step without finishing the work or noting the omission?					
10.1 Implicitly					
10.2 Explicitly					

Appendix (Cont/4)

Section C : Individual Characteristics					
11. Please read each of the following statements carefully and then specify the extent of your disagreement/agreement with each item accordingly:					
SD = Strongly Disagree D = Disagree N = Neutral A = Agree SA = Strongly Agree	**SD**	**D**	**N**	**A**	**SD**
*11.1 A job is what you make it.					
*11.2 On most jobs, people can pretty much accomplish whatever they set out to accomplish.					
*11.3 If you know what you want out of a job, you can find a job that gives that to you.					
*11.4 If employees are unhappy with a decision made by their boss, they should do something about it.					
11.5 Getting the job you want is mostly a matter of luck.					
11.6 Making money is primarily a matter of good fortune.					
*11.7 Most people are capable of doing their jobs well if they make an effort.					
11.8 In order to get a really good job you need to have family members or friends in high places.					
11.9 Promotions are usually a matter of good fortune.					
11.10 When it comes to landing a really good job, whom you know is more important than what you know.					
11.11 Promotions are given to employees who perform well on the job.					
11.12 To make a lot of money you have to know the right people.					
11.13 It takes a lot of luck to be an outstanding employee in most jobs.					
*11.14 People who perform their job well generally get well rewarded.					
*11.15 Most employees have more influence on their supervisors than they think.					
*11.16 The main difference between people who make a lot of money and people who make less money is luck.					

Appendix (Cont/5)

12. How would you self-rate your performance?					
WBA = Well Below BA = Below Average A = Average AA= Above Average WAA = Well Above Average	**WBA**	**BA**	**A**	**AA**	**WAA**
12.1 My performance with regard to planning (i.e. determining goals and budgeting).					
12.2 My performance with regard to investigating (i.e. collecting and preparing information, financial reports, inventories).					
12.3 My performance with regard to coordinating (i.e. exchanging information, arranging meetings and giving advice).					
12.4 My performance with regard to supervising (i.e. directing, leading, counselling and training subordinates).					
12.5 My performance with regard to staffing (i.e. employment interviewing and recruiting)					
12.6 My performance with regard to representing (i.e. promoting the firm's interests).					
12 .7 Overall performance					

13. Please read each of the following statements carefully and then specify the extent of your disagreement/agreement with each time accordingly.					
SD = Strongly Disagree D = Disagree N = Neutral A = Agree SA = Strongly Agree	**SD**	**D**	**N**	**A**	**SD**
*13.1 I plan to remain with my current firm until I retire.					
*13.2 I plan to remain with my current firm for at least two more years.					
*13.3 I plan to remain with my current firm for at least five more years.					
Note: * These statements were reverse scored.					

Appendix (Cont/6)

Section D: Demographics

This section elicits demographic information about you and your firm and is for the purpose of statistical analysis only. All answers are strictly confidential and anonymous.

14. Gender31

☐ Male ☐ Female

13. Years of audit experience ____--

14. Job position

☐ Partner ☐ Manager ☐ Senior ☐ Junior

15. Firm type

☐ Big Four Firm ☐ Other

Thank you for your contribution.

PART 2: CORPORATE GOVERNANCE PAPERS

CHAPTER 10

An EU-Inspired Corporate Governance Statement for Maltese Listed Companies – Boon or Scourge?

[CG-1]

Baldacchino, P.J.

In: Civil Society Report Business Ethics and Religious Values in the European Union and Malta - for a Moral Playing Field, P.G Xuereb (ed), European Documentation and Research Centre, University of Malta, Malta. ISBN 978-99909-6-44-9

First Edition, 2007, pp.161-167

An EU-Inspired Corporate Governance Statement for Maltese Listed Companies – Boon or Scourge?

[CG-1]

Baldacchino, P.J.
University of Malta, Malta

A largely ignored but important doubt lingers with the advent of the myriad of corporate governance laws, rules, standards and codes: are the overall implications of such a regime, if any, being appropriately weighed? This paper debates some such implications and their significance on Maltese listed companies by considering one particular proposed corporate governance change by the European Union Commission: the statutory inclusion in its Proposed Amending Directive Com (2004) 725 of a Corporate Governance Statement in the Annual Report of listed companies.

Keywords: *corporate governance, corporate governance statement, European Directive*

1. Introduction

The traditional definition of corporate governance is that of "the system by which companies are directed and controlled" (Cadbury,1992: Section 2.5). Indeed, corporate governance is concerned with the interaction of a company's management, board of directors and stakeholders in ensuring the fairness of such a system. It needs hardly be said that corporate governance systems needed reform in the past decades for the sake of protecting the various stakeholders. For example, neither the USA nor the European Union could envy each other in the light of recent major corporate scandals such as Enron and Parmalat. Crises stimulate the search for new and more rigorous methods of surveillance and control (Moran,1986). As would therefore be expected, both legislators and regulatory bodies have been increasingly involved in the tightening up of the global legislative regulatory framework.

Perhaps the strongest evidence of this was, in the U.S.A, the Sarbanes-Oxley Act of 2002 which, according to the opening of the Act itself, was enacted "to protect investors by improving the accuracy and reliability of corporate disclosures" (Sarbanes, 2002). In a comparable manner, in the European. Union, the 8th Directive on Company Law was finally implemented in 2006 further to the Commission's 2003 Action Plan for Modernising Company Law and Corporate Governance at EU Level (COM, 2003). Among other changes, the 8th Directive mandates audit committees for listed companies and includes fundamental changes around the relations of the board directors with the auditors.

Indeed, several other new rules, accounting and auditing standards and improvements have by now taken hold in many countries: it is good news for investors that boards of directors are becoming increasingly independent, audit committees are acting with newly found scepticism and autonomy and chief executive officers are assuming greater responsibility for financial reporting

(Deloitte and Touche, 2006). After all, a much-quoted survey of investor perceptions indicates that investors are willing to pay more for a company that is well governed and that the quality of corporate governance standards ranks alongside financial performance and other factors when deciding whether to invest in a company (Mckinsey, 2004).

In this vein, and even beyond legislation, most countries have developed their code of recommendations in this area - witness, for example, the many recent corporate governance codes listed by the European Corporate Governance Institute on its website (ECGI, 2006), including that of Malta introduced in 2001, revised in 2005 and intended to be adopted by issuers of listed securities.

Since 2001 the Malta Financial Services Authority (MFSA) listing rules have encouraged such issuers to 'endeavour to adopt' the principles of the "Code of Good Corporate Governance". The Rules require issuers to include in the Annual Report a statement, verified by the auditors, with regard to the effective measures they have taken to ensure compliance with the Code. Therefore, although the whole Code as such is not obligatory, listed companies in effect would already best adopt the "comply-or-explain" principle of explaining from which parts of the Code they depart, if they do so, and their reasons.

Yet a largely ignored but important doubt lingers with the advent of the myriad of this and further corporate governance laws, rules, standards and codes: are the overall implications of such a regime, if any, being appropriately weighed? This paper debates some such implications and their significance on Maltese listed companies by considering one particular proposed corporate governance change by the European Union Commission: the statutory inclusion in its Proposed Amending Directive of a Corporate Governance Statement in the Annual Report of listed companies (COM, 2004)

2. The proposed new corporate governance statement

The Amending Directive proposes a Corporate Governance Statement which not only requires the application of the 'comply-or-explain' principle already referred to above to a specified code of corporate governance, but also a number of other disclosure requirements. The main such requirements are:

- the disclosure of the operation of the shareholder meeting and its key powers,
- a description of shareholders' rights and how they can be exercised, as well as the composition and operation of the board of directors and its committees, and
- the disclosure of the companies' internal control and risk management systems.

With regard to the first two disclosure requirements above regarding shareholders and board of directors, these should still create no significant changes with respect to Maltese listed companies: the descriptions will mostly involve disclosing what is already required in Maltese company law, in itself EU-compliant. However, there are major issues to consider even in Malta if the Commission were to move ahead with the third disclosure requirement of the companies' internal control and risk management systems. In this respect, even according to the Explanatory Memorandum of the proposed directive itself (COM, 2004 ,Section 2c), consultation has already shown that stakeholders disagree as to the need to go further than the application of the "comply-or-explain" principle. In fact, "while business was reluctant to go further other stakeholders favoured additional disclosure, in particular information about the risk management system applied by listed companies".

3. Disclosing to everybody in the dark?

A main issue here is that unless benchmarks are first agreed and established as to what is expected to be disclosed, such disclosures will probably be meaningless and mostly wasteful of resources as little, if any, inter-company comparisons or even inter-period comparisons may be carried out. Both phrases "internal control" and "risk management systems" are wide-ranging and umbrella ones. Internal controls involve so many aspects of the organisation - among others, its plans, lines of reporting, delegation of authority, segregation of duties, physical security aspects, management and supervision, the internal audit, personnel policies and the overall control environment. Similarly, risk management systems also permeate almost everywhere: there are business, financial, physical, managerial, legal, foreign exchange and several other types of risks to manage.

If serious enough, sub-committees of listed company boards of directors such as audit and risk management committees need in fact to be continuously occupied with both controls and risks. Yet, one may ask what - with this increased requirement - the "other stakeholders" are really after, because the exercise may unwittingly result in another public relations showcase showing the acceptable law-abiding face of their companies. How worthwhile is it for such boards to engage further financial and legal consultants at considerable cost to venture out politically correct information? While Annual Reports are increasingly thick and glossy, they are also probably being read less. Additionally, given the differing tastes of the various stakeholders, there will invariably be variances as to which items to disclose and also as to the desired level of detail - too commonly virtually impossible to satisfy. Can this merely lead to expensive information overload?

Even from the management's perspective, this may be an example of a questionable add-on to the contrasting demands which are continuously being made on them both for more accountability and for more value by stakeholders in search of an ever-bigger piece of the corporate cake. After all, over the years, in addition to many more demands on boards of directors, traditional watchdogs have been highly empowered while others freshly installed, all in the name of corporate governance: the external auditors with their tightened international auditing standards, the internal auditors with their more strategic role, the varying regulators with their pressing and expensive demands, in many instances even three or more of them such as industry, listing and company ones, government authorities at the various levels - local, central and European all armed with new compulsory legislation. In allocating scarce resources in a tough, cost-cutting and dynamic environment, the "boss" or chief executive officer already finds it difficult as it is to strike a successful balance between delivering a good bottom line and coping with these elements of the regulatory framework.

In particular, stakeholders remote from the boardroom may too easily underestimate the significance of this. Requiring companies to disclose more and more on what they are doing will not necessarily make their operations more understandable. If one is not careful enough, companies may substantially be made to churn much more paperwork than before, but stakeholders given only a false sense of security.

This is not to say that the march of modern corporate governance needs to stop. The scrutiny of the governance and control being exercised at the top is a process that is to go on: new and better ways may be thus found for exercising reasonable checks and balances such as preventing anyone from having unfettered powers of discretion, distinguishing between possibly conflicting roles even beyond chairman and chief executive, and improving on the existing relationships of Boards of Directors and the different types and sizes of shareholders, and even making directors and chief executives more generally accountable. But before promulgating new rules, the regulating authorities need to undertake serious impact assessments of such regulations taking into reasonable account the major stakeholders involved. A lesson to Europe in this context was the largely unforeseen cost to many American companies of implementing the above-mentioned Sarbanes-Oxley Act in the USA (Sarbanes, 2002). While benefits were clearly reaped, the stricter regime has also resulted in consultancy and audit shooting up dramatically, at least in the initial years. As a result, controversies still rage as to how far it is cost-beneficial both to the companies and to their stakeholders.

More specifically to this corporate governance statement requirement, the demand for more information to be made public can have its benefits if the sender knows clearly what to give and the receiver what to expect. This would entail spelling out specific details of the benchmarking standards. In working these out, the regulators would need also to consider and as far as possible take into account the potential pitfalls emanating from the attitudes of the parties involved as such attitudes may effectively inhibit the transmission of meaningful information. For example, senders may be too intent on protecting their interests and may be shrewd or resourceful enough to be able to filter the information in that interest. On the other hand, the major "stakeholders" could easily include inquisitive and potentially manipulative competitors, lethargic shareholders interested only in their dividend cheques, potential short-termist investors trying to speculate on the market, financial advisors with too many hats or conflicts of interest (particularly in a small island-state) and even some journalists with their political agenda on how to interpret company communications. While definitely one cannot solve all issues resulting from such attitudes, yet their consideration would definitely influence the type of information to be asked for.

4. Giving less but what is needed

Perhaps an even better alternative is to re-examine the need for the corporate governance statement to go beyond the "comply-or-explain" principle. If one borrows the concept from auditing, the typical established statutory audit report addressed to company shareholders does not in any way venture information unless there is the need for qualification or emphasis - and the approach seems to have worked. One reason for this is that the accompanying statutory financial statements are already heavily and increasingly regulated as to what to contain or not. One may therefore either decide not to ask for more disclosure with respect to corporate governance, or if more information is to be required, reserve it to the major changes that have occurred in controls or risks during the year. However, this information could also be incorporated with the other statements or reports in the Annual Report, such as in the directors' report. In any case, one perhaps needs best to avoid general descriptions of systems: what if you were made to listen to the whole story of what happens in your car controls by your mechanic every morning before starting off? In reality, you are only interested if anything is wrong.

Furthermore, inasmuch as a car mechanic will best point out car trouble, it is not the company but an independent specialist who will probably be best equipped to make – rather than merely verify aspects - of the statement. Rather than a financial auditor, perhaps it would be best to engage a management specialist for the purpose. Thus, if independent Board of Director sub-committees are functioning in a company, the chairman of, say, the Risk Management Committee may be required to present the risk management aspect in a report to the AGM, while the chairman of the Audit Committee will present the internal control aspects.

5. A question of priorities

Perhaps, the pertinent question is even more fundamental: is the current emphasis on information disclosure the best approach to ensure progress in corporate governance? Could it be that regulatory priorities need re-shuffling? After all, irrespective of the regulatory framework in force, it is invariably dependent for its success or failure on the persons involved. Before regulating the flow of information, it could be much better to think of tightening up the present regulation of the persons involved in the process. For this, one perhaps needs to re-visit the corporate governance *modus operandi* taken for granted over the years. For instance, with respect to the minimum qualifications required of directors: should candidates for board directorships in non-financial listed companies continue to be considered fit and proper for the position despite their having no background in ethics, law and finance, and/or business education in general? Are shareholding interests and financial backing to remain enough in practice to secure appointment to the boards of such companies? Furthermore, on being appointed to this position, should a short introductory familiarization course, if held at all, suffice?

In addition, with respect to the statutory term of appointment of directors: given that they are in charge of long-term strategies for their companies, is it wise to appoint them every annual general meeting? Why not have their appointment for a non-renewable but reasonable number of years such as five to seven years? In this manner, one would promote the long-term vision and continuity at the top which are necessary for many corporate governance matters. Why should directors care about minimizing risks if the weight of such risks will become apparent only beyond the term of office - next year or even after? Moreover, although a profit retention policy may be needed for a company's long-term financial survival, how can directors refrain from recommending that extra dividend demanded by shareholders once they are completely dependent on such shareholders for imminent re-election?

6. Conclusion

In conclusion, the proposed corporate governance statement disclosure requirement cannot be described as a scourge, but it is not a boon either. It could easily be like driving a car repeatedly around a roundabout - a fuel-consuming exercise without going anywhere. To continue on the car analogy, it is also useless to try to stop cars from overspeeding, but then fail to insist on a proper driver's licence. In the area of corporate governance, we may need not only to slow down and not over-regulate, but, probably even more importantly, to insist with a sense of urgency on a proper licence for the corporate drivers in charge.

References

Regulatory

Cadbury, A. (1992). *The financial aspects of corporate governance: A report of the committee on corporate governance* [Cadbury Report]. London:Gee & Co.

Commission of the European Communities (COM) (2003). *Communication from the Commission to the Council and the European Parliament: modernising company law and enhancing corporate governance in the European Union - A plan to move forward. 284 final. Brussels.*

Commission of the European Communities (COM) (2004). *Proposal for a Directive of the European Parliament and of the Council amending Council Directives 78/660/EEC and 83/349/EEC : The annual accounts of certain types of companies and consolidated accounts*. 725 final. Brussels.

European Corporate Governance Institute (ECGI) (2006). *Corporate Governance Codes in Various Countries:* www.ecRi.org/codes/all codes []12 December, 2006].

Sarbanes, P. (2002). Sarbanes-Oxley Act, 2002. In *The Public Company Accounting Reform and Investor Protection Act.* Washington DC: U.S. Congress.

Other

Deloitte & Touche (2006) *Deloitte's Point of View - Sarbanes-Oxley Compliance- A Bridge to Excellence:* www.deloitte.com/dtt/research [10 October, 2006].

McKinsey (2004). *Mckinsey Global Survey of Business Executives* : www.mckinsevquarterly.com [11th December, 2006]

Moran, M (1986). *The Politics of Banking*. London, Macmillan

CHAPTER 11

Benchmarking in Maltese Internal Audit Units

[CG-2]

Baldacchino, P.J.[1] and Balzan, L.[1]

Benchmarking - An International Journal

Vol 14, Issue 6, 2007, pp. 750-767

[1]Department of Accountancy, Faculty of Economics, Management and Accountancy, University of Malta.

Benchmarking in Maltese Internal Audit Units

Balzan, L. and Baldacchino, P.J.

University of Malta, Malta

The organisation-wide drive towards total quality management (TQM) and the call for sound corporate governance require that Maltese internal audit (IA) units benchmark their operations as a first step towards the critical evaluation of their processes and the management of change. The purpose of this paper is to determine the awareness of this process in Maltese lA units, its perceived major benefits and limitations and also major barriers in its implementation. The objective of this study is achieved through a series of semi-structured interviews with 12 Maltese lA executives representing most Maltese lA units. This study concludes that Maltese lA executives have a weak grasp of the benchmarking process and that current lA evaluation techniques are mere rudimentary comparisons, essentially backward and inward-looking in nature. Maltese lA executives appreciate the benefits of benchmarking as an effective lA quality tool but are divided as to its limitations. In addition, there are organisational and cultural barriers preventing them from attaining its potential benefits. In addition to the analysis of major obstacles to the implementation and development of this TQM tool in a European ministate, this study points to possible regulatory and organisational changes for future improvements.

Keywords: *internal auditing, benchmarking, Malta, total quality management*

1. Introduction

Even though the number of internal audit (IA) units is limited in a small island like Malta, such units are not insulated from the general shift in orientation away from traditional assurance towards consulting and value-added services of IA. One of the pressures pushing IA in this direction is the entry of accounting firms into IA. This is inducing IA units to safeguard their professional status by reviewing the quality of their operations (Dittenhofer, 2001b) and expanding their role into operational and managerial audit (Guoming,1997). Internal knowledge makes IA a helpful ally in the early detection (Xiangdong,1997) and solution (Bencini, 2003) of modern business problems. Ultimately, the status of IA is determined by its value (Xiangdong,1997).

A number of researchers, such as Flesher and Zanzig (2000), found evidence that some audit customers do not recognise the value of IA, and may even restrict the internal auditor's role to internal control evaluation over traditional areas such as accounting and finance. Indeed, unless IA moves into value-added activities, the IA function risks being perceived as an overhead, and even worse, being outsourced (Liu *et al.*,1997). The new operational and consulting orientation of IA elicits the question of whether IA units are sufficiently equipped with resources and expertise to fulfil their role as consultants (Nagy and Cenker, 2002).

In addition, the string of debacles that followed the Enron scandal in the USA, including the Worldcom, Adelphia and Parmalat cases, reminded managers, board members and other stakeholders of the need to focus on internal controls. Cadbury (1992) attributed failures of quoted companies to control failures. In the USA, a report by the Committee of Sponsoring Organisations of the Treadway Commission (COSO, 1992) had also reinforced and re-emphasised the proactive role of IA in establishing and maintaining an effective and efficient internal control system. IA is the principal mechanism through which the board of directors and management monitor the quality of internal controls. Such a proactive role of IA also allows external auditors to place reliance on the work of IA and to reduce the extent of external audit work (IFAC, 2003). IA quality also takes on a new dimension in today's competitive environment, by ensuring that internal controls are strong enough in times when business risk is augmented by organisation-wide change (Liu *et al.*,1997).

As corporate conduct deficiencies call for corrective action, the IA function is being driven to participate in the organisation-wide quality revolution labelled total quality management (TQM): "Under the TQM concept, internal auditors are viewed as part of the management team, helping others work towards achieving long-term, overall welfare of the organisation" (Rezaee,1996, p. 320). The auditing profession is no longer insulated from the worldwide phenomenon of consumer empowerment. It needs to focus on customer needs and to provide services that customers value (Cooper, 2003). IA units that want to withstand the pressures acting on modem IA must learn to love change. Change drives continuous improvement, which is the underlying philosophy of TQM. In order to counter such challenges, opportunities and pressures acting on the IA function, internal auditors need to become conversant with the theoretical and practical aspects of TQM techniques (Hawkes and Adams,1995). A study by Rand (1994) revealed weak familiarity with, and low usage of, TQM techniques by a majority of the surveyed IA managers. However, Vinten (1996) states that the IA function in general is willing to adopt such modern management concepts. For example, in the UK, an attribute standard of the Institute of Internal Auditors (IIA, 2004a, para.1300) requires chief IA executives to "develop and maintain a quality assurance and improvement program that covers all aspects of the intemal audit activity and continuously monitors its effectiveness."

A major modern TQM approach to IA performance evaluation is benchmarking, which may be defined as: "the process of continuously measuring and comparing one's business processes against comparable processes in leading organisations to obtain information that will help the organisation identify and implement improvements" (Andersen and Pettersen, 1996, p.4). Benchmarking is what Peters (1989, p. 229) calls"creative swiping" - learning other companies' best practices and doing new things or doing old things in a new way. As one of the most effective business strategies that is working for organisations of all sizes in all industries, benchmarking "has the potential to propel quantum improvement in internal auditing" (Julien,1993).

This paper sets out to determine the awareness of this process in Maltese IA units, its perceived major benefits and problems and also major barriers in its implementation. The results indicate that Maltese IA executives are only poorly aware of the benchmarking concept and that current IA evaluation techniques are mere rudimentary comparisons, essentially backward and inward-looking in nature. Maltese IA executives appreciate the benefits of benchmarking as an effective IA quality tool but are divided as to its limitations. In addition, there are organisational and cultural barriers keeping them out of reach of its potential benefits.

The paper is organised as follows. The next section reviews the relevant literature on the area and is followed by a section that discusses the methodology used in the study. The following two sections present the results and implications. The final section presents a summary and conclusion of the findings and limitations of the study.

2. Literature overview

2.1 Alternative IA quality evaluation techniques

Before examining in some detail the benchmarking approach, it is appropriate to take a preliminary look at two alternative IA quality evaluation techniques found in the literature, namely standard-based performance evaluation and results examination.

One of the objectives of the IA quality program required by the IIA is to "provide assurance that the internal audit activity is in conformity with the Standards and the Code of Ethics" (IIA, 2004a, para. 1300). Cangemi and Singleton (2003) developed a four-step IA evaluation program, based on compliance with department, corporate and professional IA standards. This evaluation program involves making a summarised review of all IA assignments using a quality assurance checklist, a detailed review by seniors of randomly selected assignments, an annual self-assessment conducted by the quality assurance coordinator and a tri-annual external review. However, Dittenhofer (2001a) opines that IA performance evaluation based on IA standard compliance allows for the possibility of conforming to operational standards without being productive. This cannot be afforded in times when quality is being continuously redefined through innovation rather than a fixed standard:

> "Clinging to tradition, many of us still over-emphasise the element of compliance. This limits the potential of audit to deliver value-for-money and will continue to do so until we broaden our scope." (Peters,1992, p.16).

Dittenhofer (2001a) considers it more appropriate to focus on aspects that relate more closely to the intended outcome of the IA process. He advocates the use of "results examination" where IA effectiveness can be ascertained by looking at whether the auditor has found the auditee's actions to be successful in achieving its goals and objectives. According to Dittenhofer, results examination involves identifying the auditee's objectives, establishing the criteria that could signify their achievement or otherwise, and using the established criteria to determine whether and to what degree the auditee's actions have resulted in the achievement of objectives. Although this approach is more results-oriented, its success depends on the measurability and subjectivity of the criteria chosen.

2.2 IA benchmarking

In any case, IA quality evaluation may be approached through benchmarking. The Andersen and Pattersen (1996) definition of this approach has already been referred to in the introduction and shows that the approach may be divided into five elements: it is a process, that is, a structured, systematic and continuous exercise; it requires measurement and comparison of processes; it involves comparisons of like with like; it entails an external perspective; and it should result in the implementation of identified potential improvements.

Camp (1989) of Rank Xerox, the pioneer of benchmarking, further developed benchmarking into four stages, namely planning, analysis, integration and action.

2.2.1 Planning

Planning starts off with the commissioning of a team supported by sponsor who has authority and stature in the organisation to drive the exercise and support the findings (Camp,1989; Cook,1995; McNamee,1995). Camp (1989) divides the planning stage into three steps. The first of these steps is to identify the activity to be benchmarked and the quantitative and qualitative measures to be used (Camp,1989; Cook,1995; McNamee,1995). The second step is to identify the benchmarking partner (Camp, 1989; McNamee,1995). A prerequisite of effective benchmarking is the availability of participation from reliable information resources (Babachicos,1999). Four routes may generally be taken to establish benchmarking partners, namely, benchmarking with organisations in related industries, best practice benchmarking, internal benchmarking and external competitive benchmarking. With respect to the latter. Cook (1995) proposed a direct relationship between the degree of such external propensity and the potential for improvement. Finally, one should establish the appropriate means of collecting internal and external data, who will be involved in data collection (Camp,1989; McNamee,1995), the aggregation level of the data (Cook,1995; McNamee,1995) and the number of benchmarking partners required (Cook,1995). The collection of data should be well planned (Brown *et al.*1994) and based on the principles of a relevant benchmarking code of conduct to ensure that benchmarking efforts are not derailed over a breach of etiquette (McNamee,1995)

2.2.2 Analysis .

This involves the interpretation of information as a basis for action and implementation. According to Camp (1989) this involves two steps, namely the establishment of the performance gap and the projection of future performance. In the first place, one should quantify and determine the reasons for the current gap between the company and benchmarking partner. This will "inject energy into the program as the size of the problem - and the opportunity - comes into view" (Peters, 1989, p. 74). Ratios and formulae make lA performance evaluation more visible, but unless such data is standardised, comparative analysis would not be workable. Babachicos (1999) proposes the development of a benchmarking survey to provide each participating lA executive with a data source for comparison, based on a confidentiality agreement. One such survey is the Annual Report of the Global Auditing Information Network (GAIN) organised by the Institute of Internal Auditors (USA) (IIA, 2004b).

However, it is important not to reduce the problem to metrics (McNamee, 1995). One must step back and look for things the numbers are not telling us. Examples of performance indicators to measure qualitative issues are: employee absenteeism or the number of suggestions made to a suggestion scheme in order to gauge motivation; the number of layers in a department and the frequency of gathering and acting on feedback by management to monitor management; and the number and types of complaints to determine customer satisfaction (Cook,1995). Cangemi and Singleton (2003) propose the use of the balanced scorecard system to combine qualitative and quantitative lA performance measures.

The second step in the analysis stage is to project future performance, that is, estimate, over an agreed time frame, the change in performance of the company and the benchmarking company in order to assess if the gap is going to grow or decrease (Camp,1989; McNamee,1995).

2.2.3 Integration

Integration involves two further steps. The first is the effective communication of findings and establishment of goals to eliminate the performance gap (Camp,1989; McNamee,1995). The second is the development of action plans to achieve the established goals. Discussions with IA staff, possibly forming quality circles (Zettie, 2002), give staff the opportunity to identify better procedures (Babachicos,1999) and to prioritise areas of change through cost-benefit analysis and other techniques (Cook,1995). Even a small change could be the start of a journey to significant improvement (Babachicos,1999).

2.2.4 Action

Finally, action should be taken to implement the plans, report and reassess the benchmarks. The first step is to implement the actions, plans and strategies. This involves good project planning and management (Camp,1989). Two-way communication, management support, a coaching leadership style and the use of readily understandable language are ways of overcoming resistance, which generally manifests itself at this stage (Cook,1995). The second step is to assess and report the results of the action plans (Camp,1989). Finally, one will reassess or recalibrate benchmarks on a regular and systematic basis and maintain good links with the benchmarking partners (Camp,1989). Cook (1995) even suggests the formation of benchmarking consortia where representatives of the companies involved meet on a regular basis to share information and experiences.

2.3 The benefits and limitations of IA benchmarking

The benchmarking philosophy is in line with Ishikawa's (1990) concept of "forward looking quality" or Kano *et al.* (1996) "attractive quality" where "learning as much as possible from individual examples of failures and success" (Kondo, 2002, p.301) is preferred to traditional statistical techniques.

The external perspective of benchmarking provides a "helicopter vision" (Cook, 1995, p.30) that not only prevents complacency, but also accelerates and manages change. It is a versatile tool that highlights value gaps and pinpoints areas in which potential and necessity for improvement exists, sets performance goals, and generates an understanding of world class performance (Cook,1995).

Benchmarking is also helpful in setting up, retaining and maintaining an IA department, by helping to overcome the lack of documentation on such a strategic process (Liu *et al.,*1997).

Kondo (2002) also suggests that activities that bring out human qualities, such as creativity and innovation, in the quest for quality improvement, stimulate employees' satisfaction and desire to work.

On the other hand, benchmarking has been criticised for requiring a large investment in time, labour and capital (Blakeman, 2002) and for drawing companies towards imitation and homogeneity (Campbell *et al.,* 2000). It has also been argued that it lacks predictive power. At best, it provides a snapshot view of the present but provides no clues to future know-how (Campbell *et al*., 2000). Others argue that it gives only limited information about how to correct shortfalls, and creates difficulties in selecting the indicators to be used (Benchmarking PLUS, 2004).

3. Research methodology

3.1 Research instruments

The small size of the population involved facilitated the adoption of the personal semi-structured interview. Personal interviews enable direct communication in a two-way conversation, where the interviewer may probe for a clearer or more comprehensive explanation if the respondents' answers are unclear or brief. The interviewer may also provide feedback in clarifying any questions respondents may have about the instructions or questions. Moreover, the presence of an interviewer generally increases the percentage of people who are willing to complete the interview, especially in cases such as this, where the questionnaire was somewhat long. The interview schedule was divided into two sections. The first stage of the interview consisted of 16 questions that sought to establish the extent of familiarity with benchmarking in an IA context, whether respondents had ever considered conducting the exercise, its implementation and the nature of benchmarking practices adopted. A mixture of five-point Likert scale and open-ended questions were used in this section. The use of open-ended questions was deemed to be more appropriate to this exploratory study since the range of responses was not known. Also, respondents are free to answer with whatever is uppermost in their thinking, to provide useful insight into current IA benchmarking practices.

Both interviewees that benchmarked formally and those that benchmarked informally were required to pass on to the second section of the interview schedule. The first three questions were aimed at obtaining an understanding of the respondents' awareness of benchmarking, its benefits and problems. Five-point Likert scales were used in these three questions. All respondents, except those claiming to be performing formal benchmarking, were required to answer the final three questions of the interview, the objective of which was to determine the extent to which interviewees were willing to adopt benchmarking as defined to them and the barriers which they expected if they were to implement the process. A mixture of multiple choice questions and five-point Likert scales was employed here.

The final part of the interview was aimed at obtaining a number of respondent characteristics, which information was checked with other data gathered in the interview in order to ascertain any meaningful relationships.

3.2 Sample selection and response rates

The sample consisted of one group of 18 Maltese IA executives representing the whole known population of Maltese IA units based on a list compiled in two earlier studies by Galea (2004) and Attard (2004). After further research another two organisations were added to this list. The small population of 20 can be explained by the fact that mostly it is the larger public companies which have as yet adopted the IA function in this small island-state. Respondents for the research questions were the executives of Maltese IA units as these were specifically required to deploy an IA quality assurance and improvement program by the IIA (2004a,b). The interview proceedings were recorded and a transcript prepared after each interview. Quantifiable data, such as five-point Likert scale ratings, were inputted and analysed by Microsoft Excel. The sections of the interview were analysed by means of formulae, tables and graphs.

Out of the 20 potential interviewees, 12 participated in the interview. Out of the non-participants, two IA executive posts were vacant, while the remaining six were not available to participate in the study.

4. Results of the study

4.1 Awareness of IA benchmarking

The first part of the interview schedule was aimed at establishing the awareness of benchmarking in Maltese IA units. Out of the 12 participants, 11 had come across the term "benchmarking" in relation to IA, eight of whom had considered performing the benchmarking exercise. Of these seven had actually implemented it. Most IA executives (4/7) were performing the exercise themselves. Others (2/7) stated that the whole IA unit was involved in benchmarking, mainly because of the small size (one to five employees) of the IA team and the fact that benchmarking was intrinsic to the IA exercise. The remaining IA executives (1/7) had a benchmarking team. On average respondents were indifferent to the importance of the role of a sponsor to drive the benchmarking project and support the findings. However, they still agreed that planning the benchmarking exercise was important.

4.2. IA benchmarking practices

Respondents who claimed to be benchmarking informally (4/7) based the selection of area to benchmark on the capability of the process or activity of being benchmarked, judgement based on past performance coupled with personal experience, and the risk associated with particular activities or processes.

Interviewees who claimed to be benchmarking formally (3/7) based their selection on the awareness of current best practices (through training and professional reading), IA standards requirements, the risks associated with particular activities or processes, activities selected by the global holding company, and processes or activities measured in a benchmarking survey.

Three common performance indicators emerged amongst interviewees. Most (4/7) used control reliance factors (that is, scores assigned to measure risk in various areas) monitored internally over time. Others (2/7) measured IA productivity in terms of the proportion of total available man-hours allocated to productive activities monitored internally over time, while a few (1/7) monitored the timeliness of the audit report internally over time.

Other performance indicators were the percentage of recommendations implemented and training *per capita*, both monitored internally over time, and other relevant performance indicators reported in an international benchmarking survey.

None of the interviewees considered evaluating IA staff motivation through the benchmarking exercise. A few (2/7) used customer satisfaction surveys to seek feedback from auditees on issues such as the timeliness, clarity and conciseness of the audit report and whether IA objectives were clearly stated. Performance ratings were benchmarked internally over time. While some had plans to develop a customer satisfaction survey in the future, others stated that issues of organisational culture had to be addressed prior to moving towards the appropriate IA set-up. An alternative to the customer satisfaction survey was the close-out meeting where, as one interviewee explained, IA findings and performance are discussed in a meeting with auditees at the end of every audit.

None of the interviewees had formal procedures for the selection of benchmarking partners. Some (3/7) benchmarked with members of their own group of companies. The choice was justified on the grounds that, being a member of a foreign group of companies, it was natural for them to seek to benefit from a foreign perspective when information was so easily accessible. Others (3/7) claimed to be benchmarking informally and internally over time. The reasons advanced by the latter respondents included lack of co-operation between Maltese internal auditors, problems of comparability with similar foreign organisations due to differences in the environment in which the organisations operate, lack of permission (for competitive reasons) to share IA performance information, lack of local competition against which to benchmark and the need to ensure that procedures and controls are well in place prior to benchmarking externally. One respondent (1/7) claimed that IA performance information was obtained from a combination of foreign benchmarking partners (organisations within the same industry and best practice organisations in unrelated industries) through a global benchmarking survey.

Only two IA executives made use of benchmarking surveys and the type used by each was different. The first type was a quality assurance and improvement survey administered by the head of the IA group of companies on the basis of results of internal self-assessment (performed every two years) between members of the group in different countries and external reviews (performed every five years). The other type of survey was an international survey of the GAIN administered by the IIA (USA), available for a fee. Such a survey therefore had a wider external perspective and its choice was attributed to the fact that no direct local competitors existed, in consequence of the quasi-monopoly status of the group in question. It was described by the respondent to be an open and advanced form of IA benchmarking which fostered sharing of IA performance data amongst IA units in different industries and countries.

The users of both types of surveys claimed there were problems of comparability and interpretation of data owing to differences in the size of organisations and their business environment as most were based in different environmental, social, political and cultural contexts. None of the other interviewees were aware of the GAIN and similar surveys, although they stated that they would be interested in administering similar surveys when the nature of such surveys was described to them.

None of the respondents were members of a benchmarking consortium. The respondents of the banking and finance sector pointed out that a joint audit forum had been set up by the Malta Bankers' Association, for the discussion of relevant IA issues. However, no IA performance data was exchanged during such meetings.

In general, the ethical dimension of IA benchmarking was neglected, with none of the interviewees being aware of the European benchmarking code of conduct (EFQM, 2001).

Most IA units (5/7) identified their performance gap by conducting an annual or semi-annual review to assess whether IA department objectives were met. A few (2/7) compared results of IA department performance against survey results and compiled a report of quantitative performance gaps.

None of the interviewees had an organised approach for developing action plans to close or increase the identified performance gaps. Two interviewees claimed that decisions for action to be taken on reported performance results were made by top management and communicated to the IA department. Most of the interviewees (5/7) did not have organised procedures for prioritising areas of improvement. Others (2/7) based their prioritisation on the risk ratings of the areas benchmarked.

None of the interviewees who benchmarked informally had procedures to ensure their benchmarks were up-to-date. On the other hand, different ways of keeping benchmarks updated were identified amongst the interviewees that performed benchmarking on a formal basis, namely regular updating of the IA standards and procedures by the group's parent, annual subscription to a global benchmarking survey and pressure exerted by the internal auditors on the IIA to update (in line with developments in current environmental conditions and IA needs) the standards against which IA performance was evaluated.

4.3 Factors promoting IA quality

Factors promoting the need to improve IA quality were rated by the seven respondents who claimed to be benchmarking, as shown in Table 1.

While Maltese IA executives agreed that the increased emphasis on IC quality is relevant in pushing quality upwards in the IA units' agenda, they disagreed that the threat of outsourcing is a factor promoting IA quality. In this context, opinions were mixed about the relevance of pressure to motivate IA staff through creative activities such as benchmarking and of dissatisfaction with the existing IA expectations gap.

Table 1
Factors promoting the need for higher IA quality

The need for higher IA quality arises owing to:	Mean (n = 7)	SD
The general increased emphasis on the quality of IC	4.00	0.58
Pressure to motivate IA staff through creative activities such as benchmarking	3.14	1.07
Dissatisfaction with the existing IA expectations gap	3.00	0.58
The threat of outsourcing the IA function	1.43	0.53

Notes: 1 - completely irrelevant; 5 - highly relevant

Respondents also added additional factors considered to be creating the need for higher IA quality such as the role for IA as a change agent within the organisation and the participation of IA in project implementation throughout the organisation, the need to ensure monitoring of IA by the regulator and credibility in the eyes of both external auditors and the regulator, which credibility influences the continuity of operations especially in the banking and finance sector.

4.4 The benefits and limitations of IA benchmarking

The attributes of benchmarking as an effective IA quality improvement tool and the perceived limitations of benchmarking were rated by the seven respondents who claimed to be benchmarking, as shown in Tables 2 and 3 below.

IA executives agreed that benchmarking has various attributes as an IA quality tool. One perceived attribute was that it highlights value gaps and pinpoints areas in which potential and necessity for improvement exist. However, they were indifferent as to the role of benchmarking in accelerating and managing change, mainly because of the difficulty of changing organisational culture.

Mixed views were shown with respect to the resources required for

Table 2
Benefits of benchmarking as carried out

The attributes of benchmarking as an effective IA quality improvement tool are that it	Mean (*n* = 7)	SD
Highlights value gaps and pinpoints areas in which potential and necessity for improvement exist	4.14	0.38
Generates an understanding of world class performance	4.00	1.00
Is versatile and applicable to a wide range of areas	3.71	1.11
Facilitates the setting of performance goals	3.57	0.79
Creates an external perspective	3.57	0.98
Accelerates and manages change	3.00	0.58

Notes: 1 - completely irrelevant; 5 - highly relevant

Table 3
Limitations of IA benchmarking as carried out

Benchmarking	Mean (*n* = 7)	SD
Requires large investment in time, labour and capital	3.00	1.73
Gives limited information on how to correct performance shortfalls	2.57	1.13
Draws companies towards imitation and homogeneity	2.43	0.53
Involves difficulties of identification of performance indicators	2.43	1.62
Lacks predictive power	1.86	1.07

Notes: 1 - completely irrelevant; 5 - highly relevant

.

benchmarking. Some claimed that the exercise required a lot of time to set up, filter relevant information and keep the data updated, while others argued that costs could be reduced if information resources were pooled. IA executives disagreed that benchmarking lacks predictive power, with some adding that past experience coupled with knowledge of the industry is one way of predicting future performance.

4.5 The future of IA benchmarking

A good number (4/9) of the IA executives who were unaware of, or had not considered adopting or had even chosen not to implement IA benchmarking or that only adopted it at the informal level, thought it to be a good idea for the future. Some of these, mainly from government-owned entities in the maritime industry, deemed IA benchmarking to be a useful exercise once other more important IA issues were addressed. They claimed that while the IA function was still evolving in the relevant entities, organisational culture was slowing down the process. One IA executive claimed that:

> "... the IA function is evolving in hiccups because of the fire-fighting nature of problem solving and the lack of support from the Board for innovative management techniques such as IA benchmarking."

Others (2/9), all from the banking and finance sector, had formal benchmarking as part of the IA audit strategy. The remaining respondents (3/9) had different points of view. One interviewee (an outsourced internal auditor) explained that, although benchmarking had important benefits to offer in the management of change, none of his clients had ever requested the service. An in-house IA executive claimed that in the industry in question "formal benchmarking is adequate but not available" because of competition and confidentiality issues. The remaining interviewee (an outsourced internal auditor) considered benchmarking a "refinement of IA" and stated that full-scale benchmarking would only be useful after ensuring the appropriate procedures and controls were in place and operating effectively.

As benchmarking partners, some of these IA executives (3/9) would opt for organisations in related industries in the future. Two of these considered both Maltese and non-Maltese partners while the remaining interviewee opted for only Maltese partners, given the unique Maltese operating environment. Others (3/9) would also opt for Maltese and non-Maltese partners but identified as acceptable to them organisations in both related and unrelated industries and, particularly, best practice organisations irrespective of industry, as well as direct competitors within the same industry. A few (2/9) opted only for competitors in their own industry. One of these considered only non-Maltese competitors, given that there were no direct Maltese incumbents in the field, while the other interviewee considered both Maltese and non-Maltese competitors. One respondent opted only for best practice organisations in unrelated industries, claiming that "management is management - it's the same everywhere irrespective of whether you're managing people, risk ... anything." None of the interviewees considered adopting internal performance comparisons in the future.

As can be seen in Table 4, most such interviewees considered a lack of adequate benchmarking partners to be the main barrier they expected to encounter in performing the benchmarking exercise. This was mainly due to a perceived lack of cooperation from other IA executives in the same industry or because of a lack of direct competitors given a quasi-monopoly status. Response to expected barriers relating to a lack of human resources, high compliance costs, reluctance to disclose information and forfeiting market share to competitors was mixed. With respect to reluctance to disclose information, response was particularly varied – while some considered the sharing of IA performance information a positive opportunity, others expressed concern for confidentiality. However, on average, the other problems of benchmarking did not seem to worry the respondents. However, interviewees pointed to barriers additional to the above which they expected to encounter in adopting benchmarking. These were problems of comparability of information, the need to address more important problems in the organisation and in the IA set-up before finding the time for benchmarking, a lack of support from top management and an incompatible organisational culture.

Table 4
Barriers to introducing formal IA benchmarking

Problems expected in introducing benchmarking are	Mean (n = 9)	SD
A lack of adequate partners	4.13	1.13
A lack of human resources	2.88	1.36
High compliance costs	2.75	1.17
Reluctance to disclose information	2.75	1.98
Forfeiting market share to competitors	2.63	1.41

Notes: 1 - completely irrelevant; 5 - highly relevant

5. Discussion of findings

5.1 The types of benchmarking

5.1.1 Risk-based results examination

It is clear that most of the IA executives claiming to be performing benchmarking on an informal basis monitor risk ratings of their auditees internally over time and deduce the performance of the IA function from the extent to which risk has been mitigated at the auditee level. The inference of IA performance from the degree of auditee objective-achievement is close to what Dittenhofer (2001a) called "results examination." However, being risk-based, this practice lacks the logic of Dittenhofer's theory, since the inherent part of total risk is uncontrollable by the IA function and is subject to change, possibly distorting IA performance inference and rendering it meaningless. This practice also lacks the external perspective required in benchmarking. A look at the profile of the relevant respondents reveals that while IA units consider an external perspective to be problematic owing to the sensitive nature of IC and risk information, all of these respondents are public listed companies. This implies that, since most financial information is publicly available, it may easily be possible for them to share IA performance information, other than IC and risk information, without impinging on the confidentiality issue.

5.1.2 Standard-based performance evaluation

Where benchmarking was considered on a formal basis, the indications are that such formal comparison of current standards is made against European or international standards, these being either IA standards established by the IIA or quality standards and procedures established by foreign holding companies.

The control element is highly evident in this form of performance evaluation, where standards are an instrument of ensuring uniform quality. Yet, the concept of benchmarking is incompatible with standardisation - it is rather about learning to embrace change first and then trying to improve. Moreover, as stated by Dittenhofer (2001a), standard-based IA performance evaluation allows for the possibility of conforming to operational standards without being productive. This could limit the potential of IA to deliver value for money (Peters, 1992).

An interesting observation is that for this category of respondents confidentiality is of relatively little concern. This may be helped by the fact that standards are common to all members of the group, thus leading them to place less emphasis on competition. Yet, problems are encountered in the comparison and interpretation of IA performance data because of the different cultural, regulatory and environmental settings in which the different members of the group operate. This raises the argument in favour of benchmarking with Maltese competitors, where available, or with competitors established in countries with the same economic and environmental fabric similar to that of Malta.

5.1.3 Survey-based benchmarking

It has been seen that benchmarking surveys are being used only rarely, and this is unfortunate as such an approach may have a greater potential for significant improvements because of its wider perspective. However, even here it has been seen that there may easily remain considerable difficulties in interpreting survey results if the participants are based in different environmental, social, political and cultural contexts such as in global surveys.

Perhaps, rather than thinking of global benchmarking, it would be better to organise a national consortium for Maltese IA executives where IA performance information can be exchanged between IA representatives. Eventually, this effort may be extended to include European partners operating in a similar regulatory, economic and cultural environment. Although this would not eliminate comparability problems, it would be an additional opportunity to learn from a broader external dimension.

Once such a national IA benchmarking consortium is set in motion and a mutual understanding of what is expected of the exercise is obtained, including the choice of performance indicators, benchmarking efforts may be organised in survey format to accompany less frequent consortia meetings. Participants would thus be in a position to regularly benefit from the feedback given by the results of such surveys.

This could also lead to the setting up of a benchmarking award recognising benchmarking excellence. Such an award could serve as a platform for those excelling to disseminate their knowledge and to help in the further improvement of IA units.

5.2 The awareness of IA benchmarking

As seen earlier, benchmarking involves five elements: it is a process and requires the measurement and comparison of processes, comparison of like with like, an external perspective and the implementation of identified potential improvements.

However, current IA performance evaluation practices in Malta portray a different picture. Rather than considering benchmarking as a process, in the sense of a structured, systematic and continuous exercise, Maltese IA units perform benchmarking in an unstructured manner on an annual or semi-annual basis. None of the IA units focus on the comparison of how tasks are actually performed. Instead they focus on quantitative performance measures, which not only present problems of comparability across organisations, but also lack the qualitative dimension necessary for breakthrough improvements. Unfortunately, most IA units have not yet removed their blinkers - they compare their quality with their own performance in preceding time periods, and thus fail to exploit the direct relationship proposed by Cook (1995) between the degree of external propensity and the potential for improvement.

Notwithstanding the high percentage of Maltese IA executives who came across the benchmarking concept in an IA context and are implementing some form of IA performance evaluation, most Maltese IA units therefore demonstrate a weak grasp of the benchmarking concept and a limited scope of its application. Current IA performance evaluation practices are mostly mere rudimentary comparisons, incompatible with the benchmarking concept, and this leaves Maltese IA units out of reach of its potential benefits.

5.3 Benefits, limitations and barriers in Maltese IA benchmarking

The importance of IA quality evaluation and improvement in Malta is mainly driven by the increased emphasis on IC quality. Against this background, IA executives appreciate the value of benchmarking and attribute the emergence of benchmarking as an effective IA TQM tool to its benefits. Most that are not performing benchmarking seem willing to implement its concept someday, although only a few seem prepared to do this in the foreseeable future. The problems identified by Maltese IA executives seem not to be so much those inherent in the nature of benchmarking itself. In fact, major limitations, as referred to in the literature, seem to be ignored or at the least met with mixed views by IA practitioners already embracing the concept. For example, the limitation of the investment required in time, labour and capital was met with such mixed views. Neither seems the failure to embrace the benchmarking concept to be primarily due to the poor grasp of it as already mentioned.

The major issue seems rather to be that of the perceived barriers of an organisational and cultural nature in the implementation of benchmarking. Such barriers may perhaps best be re-classified as five, namely an under-developed IA function, the controlling versus value-adding dilemma in the IA unit, a lack of awareness of the ethical dimension, a lack of Maltese benchmarking partners and network, and an incompatible organisational culture.

In the first place, most respondents consider IA to be a luxury in view of its current under-developed stage. In this context, as one respondent commented, benchmarking is seen as a "refinement of IA," which may be addressed only when such IA function reaches a more developed stage. At this stage the objectives of the average IA function probably remain hazy, with, for example, some of the IA executives also being directly responsible for risk management. One would therefore expect to find too many divergences in IA practices hampering meaningful benchmarking. However, an appropriate step in the direction towards a more level playing field and common grounds of comparison is the clarification within organisations of the objectives of the IA function.

The IA dilemma of how far to move away from mere controlling and towards adding value is also another benchmarking barrier. While some IA units seem to be shifting towards such orientation, others seem to want to remain firmly control-oriented. One such indication of this is that currently there are very few IA units that make use of customer satisfaction surveys, although some do have plans to use them. In addition, when asked to identify factors which they considered to be promoting the need for IA quality, some interviewees made control-oriented comments (e.g. the need to ensure monitoring of IA performance by the regulator), while others made value-oriented comments (e.g. the role of IA as a change agent and the participation of IA in project implementation throughout the organisation).

Another barrier is the insufficient ethical awareness. IA executives are concerned that benchmarking will reveal confidential information to competitors. These inhibitions are the result of a general lack of regard to the ethical dimension of the exercise and the lack of awareness of an acceptable code of conduct such as the European Benchmarking Code of Conduct (EFQM, 2001). Adopting the latter would help to ensure that confidentiality is not breached, and thus facilitate the exchange of IA performance data.

A further issue is the lack of Maltese benchmarking partners and network. Most organisations having an IA function often lack same-scale competitors owing to their relatively large size. However, as stated in the literature, there are arguments in favour of benchmarking with units outside one's industry (Iacobucci and Nordhielm, 2000) and units in organisations of a different size. As one interviewee put it, "at the end of the day, IA is the same everywhere, whether it is in a manufacturing company, a service provider or a financial institution." The use of international IA benchmarking surveys such as GAIN (IIA, 2004b) would help in overcoming the lack of Maltese benchmarking partners. However, the immediate use of such surveys would still present problems of comparability in view of the various differences already referred to earlier. An alternative way out is to start looking at ways of establishing a Maltese IA benchmarking structure which permits the confidential exchange of standardised IA performance data. This may first best be effected in the banking sector where there is already an established IA forum for IA executives to meet regularly to discuss IA issues. As yet IA benchmarking is not part of their agenda, probably because of the different sizes of Maltese banks. However, it is important to keep in mind that IA benchmarking is not only about comparing quantitative data which, by nature, is susceptible to distortion due to size differences. It also involves the comparison of IA processes, and therefore remains worthwhile for consideration in the agenda.

A final important barrier is the incompatible organisational culture. While in some organisations IA benchmarking has been adopted to align the IA function with the rest of the organisation's effort towards TQM, in other organisations IA executives face serious barriers in performing the exercise because of a general complacency within the organisation. In some cases, especially the government-owned organisations, this complacency starts from the topmost levels of the organisation, and works against the need to accept the notion of change before seeking to improve. Unless there is an organisation-wide willingness and top management support to set the proper tone for change, the benchmarking efforts of IA executives will be futile. As one respondent commented "one can take the management horse to the water, but one cannot make it drink."

Probably, in order to set up an appropriate foundation for IA benchmarking, one needs to promote the IA function and its role through a more rigorous regulatory framework Making an effective, full-time IA function a mandatory requirement for Maltese listed companies could be a first step in this direction helping to induce the early adoption of the necessary IA culture. This may perhaps also be followed in due course by the development and maintenance of a mandatory IA quality assurance and improvement program.

Finally, a benchmarking award that recognises benchmarking excellence would provide a platform for those excellent examples to disseminate their knowledge and further the improvement of IA units.

5.4 Limitations of the study

A limitation in carrying out this study, to be taken into account particularly if one is to compare these results to those that may be found in other countries, is the small number of respondents on which the study was necessarily based given the limited number of Maltese IA units. In addition, although the interview schedule was sent one week in advance to all participants, the extent to which they prepared for the interview could have varied considerably, this possibly resulting in inconsistencies in the quality of replies.

6. Summary and conclusions

This study set out to establish the awareness of benchmarking in Maltese IA units and to determine the need for, benefits of and barriers in the performance of this exercise. This objective was achieved through a series of interviews with 12 Maltese IA executives representing the majority of Maltese IA units.

This study concludes that Maltese IA executives have a weak grasp of the benchmarking process and that current IA evaluation techniques are mere rudimentary comparisons, essentially backward and inward-looking in nature. Maltese IA executives appreciate the benefits of benchmarking as an effective IA quality tool but are divided as to its limitations. In addition, there are organisational and cultural barriers preventing them from attaining its potential benefits.

It can also be concluded that although benchmarking awareness is weak and that the technique is as yet little used, there is a general willingness to adopt the benchmarking concept in the future. If Maltese IA executives want to protect their professional status and start being perceived as value-adding agents, they need to expend more effort to become more organised and to ward off cultural complacency by mutual learning and going outside their IA box

Hopefully, it will not be too long before benchmarking overcomes its barriers in Malta and becomes a normal IA practice, thus establishing another milestone to a rapidly evolving profession.

References

Regulatory

European Benchmarking Code of Conduct (EFQM) 2001 :
www.efqm.org/benchmarking/downloads/The%20European%20Benchmarking%20Code%20of%20Conduct.pdf [2 January, 2006]

Institute of Internal Auditors (IIA) (2004a). International standards for the professional practice of internal auditing: www.theiia.org/iia/index.cfmPdoc_id = 1595 [30 August,2005].

International Federation of Accountants (IFAC) (2003). Considering the work of internal audit. *International Standard on Auditing 610,* IF AC, New York.

Other

Attard,J.(2004). The changing strategic role of internal auditing with particular reference to Malta. B.Accountancy (Hons) dissertation. Department of Accountancy, University of Malta, Malta

Babachicos, P.F. (1999). Comment*. Managerial Auditing journal*, 14(8) : 380-386.

Benchmarking PLUS (2004). Performance benchmarking:
www. benchmarkingplus.com.au/performance % 20bmarking.htm

Bencini, J. (2003). Interview with Eugenio Privitelli. *The Accountant (Malta*), April: 33-37.

Bjorn, A. and Pettersen, P.G. (1996). *The Benchmarking Handbook: Step-by-Step Instructions,* Chapman & Hall, London.

Blakeman, J. (2002). Benchmarking: Definitions and overview. *Centre for Urban:*
www.uwm.edu/ Dept/CUTS/bench/bm-desc.htm [14 August 2005]

Brown, M.G., Hitchcock, D.E. and Willard, M.L. (1994), *Why TQM Fails and What to Do about It.* Irwin Professional Publishing, Chicago, IL.

Camp, R.C. (1989). Benchmarking: The search for industry best practices that lead to superior performance. In *Benchmarking: The search for industry best practices that lead to superior performance*. ASQC/Quality Resources, Milwaukee,WI.

Campbell, C.P., White, G. and Babidge, L. (2000). *Benchmarking Educational Websites: EdNA Online*. Education. au Limited: www.educationalau.edu.au/research/benchmarking/complete.pdf [18 August, 2005]

Cangemi, M.P. and Singleton, T. (2003). *Managing the Audit Function: A Corporate Audit Department Procedures Guide,* 3rd ed., Wiley, Hoboken, NJ.

Cadbury, A. (1992). *The financial aspects of corporate governance: A report of the committee on corporate governance*. London: Gee and Co.

Cook, S. (1995). *Practical Benchmarking: A Manager's Guide to Creating a Competitive Advantage,* Kogan Page, London.

Cooper, B. (2003). The accountant of the future. *The Accountant (Malta)*, July: 54-6.

Committee of Sponsoring Organizations of the Treadway Commission (COSO) (1992). *Internal Control-integrated Framework*: 1-4, Coopers and Lybrand New York, NY.

Dittenhofer, M. (2001a). Internal auditing effectiveness: An expansion of present methods. *Managerial Auditing Journal*, 16(8): 443-450.

Dittenhofer, M. (2001b). Reengineering the internal auditing organisation. *Managerial Auditing Journal,*16(8): 458-68.

Flesher, D.L. and Zanzig, J.S. (2000). Management accountants express a desire for change in the functioning of internal audit. *Managerial Auditing Journal*, 15(7): 331-337.

Galea, V. (2004). Internal audit reporting in selected Maltese companies: An evaluation. B.Accountancy (Hons) dissertation, Department of Accountancy University of Malta, Msida.

Guoming, B. (1997). The development trend and prospects of internal auditing. *Managerial Auditing Journal*, 12(4/5): 243-6.

Hawkes, L.C. and Adams, M.B. (1995). Total quality management and the internal internal audit: Empirical evidence. *Managerial Auditing Journal*, 10(1): 31-36.

Iacobucci, D. and Nordhielm, C. (2000). Creative benchmarking. *Harvard Business Review*, 78(3): 24-25.

Institute of Internal Auditors (IIA)(2004b). Global auditing information network (GAIN): www.gain2.org/Sample.pdf [30 August 2005].

Ishikawa, K. (1990), *Introduction to Quality Control,* 3A Corporation, *Tokyo.*

Julien, F.W. (1993). The power of benchmarking. *Internal Auditor*, 50(4): 22-28.

Kano, N., Seraku, N., Takahashi, F. and Tsuji, S. (1996). Attractive quality and must-be quality. *The Best on Quality*, 7(10): 105.

Kondo,Y. (2002). Quality is the centre of integrated management . *Managerial Auditing Journal,*17(6): 298-303.

Liu, J., Seng Woo, H.S. and Boakye-Bonsu, V. (1997). Developing internal auditing procedures in UK organisations using a benchmarking approach. *Managerial Auditing Journal*, 12(9): 464-78.

McNamee, D. (1995), Management control concepts: Benchmarking and internal auditing: www.mc2consulting.com/bmsteps.htm [3 November 2005].

Nagy, A.L. and Cenker, W.J. (2002). An assessment of the newly defined internal audit function. *Managerial Auditing Journal*, 17(3):130-137.

Peters, B. (1992). The quality revolution. *Internal Auditing*, December: 16-18.

Peters, T. (1989*), Thriving on Chaos: Handbook for a Management Revolution*. Pan Books, London.

Rand, R.S. (1994). Samurai audit manager's readiness for TQM*.* *Internal Auditing*, 9(3): 23-31.

Rezaee, Z. (1996). Improving the quality of internal audit functions through total quality management. *Managerial Auditing Journal*, 11(1): 30-34.

Vinten, G. (1996), Editorial. *Managerial Auditing Journal*, 11(1): 4-5.

Xiangdong, W. (1997). Development trends and future prospects of internal audit. *Managerial Auditing Journal,* 12(4/5) : 200-204.

Zettie, S. (2002). The quality circle approach to knowledge management. *Managerial Auditing Journal,* 17(6): 317-321.

Further reading

American Institute of Certified Public Accountants (1996) . The Elliot Report, AICPA Special Committee on Assurance Services. USA.

Bou-Raad, G. (2000). Internal auditors and a value-added approach: The new business regime. *Managerial Auditing Journal*, 15(4): 182-6.

Dale, B. and Bunney, H. (1999). *Total Quality Management Blueprint*, Blackwell Publishers Ltd, Oxford.

Dalli, A. (2001). The introduction of benchmarking in Malta: Benefits and local limitations. B.Accountancy (Hons) dissertation, Department of Accountancy, University of Malta, Msida.

Grayson, J. (1992). Benchmarking and best practices: www.apqc.org/portal/apqc/ site/generic;jsessionid = DJ2YVDODLVK.. ./overview.jhtm [15 October 2006]

International Benchmarking Clearing House (IBC) (1992) . Pamphlet, APQC.

Institute of Internal Auditors (IIA) (1995). *Impact of a control assessment approach upon the role and practice of internal auditing*. IIA, London.

Institute of Internal Auditors (IIA) (2000). *Internal auditing: Adding value across the Board*, IIA, London.

Imai, M. (1986). *Kaizen: The Key to Japan's Competitive Success*. McGraw-Hill Publishing Company.

Kennesaw State University Corporate Governance Centre (2002) . *21st century governance and financial reporting principle*s. Kennesaw State University Corporate Governance Centre:
http://ksumail.kennesaw.edu/ ~ dhermans/principl.htm

Powers, V.J. (1997) Selecting a benchmarking partner: Five tips for success. *Quality Digest:*
www. qualitydigest.com/oct9//html/benchmk.html [16 October,2005]

Ratliff, R.L. Wallace, W.A., Sumners, G.E., McFarland, W.G. and Loebbecke, J.K. (1996). *Internal Auditing: Principles and Techniques*, 2nd ed. Institute of Internal Auditors, Altamonte Springs, FL.

Rezaee, Z. (1995). What the COSO report means for internal auditors. *Managerial Auditing Journal,*10 (6): 5-9.

Warwick, D.P. and Lininger, C.A. (1975). The *Sample Survey: Theory and Practice*, McGraw-Hill, New York, NY.

CHAPTER 12

Conflicts of Interest in the Governance of Maltese Co-operatives and their Financial Implications

[CG-3]

Baldacchino, P.J[1]. and Bugeja, J.[2]

Bank of Valletta Review

No. 46, Autumn 2012, pp. 1-16

[1]Peter J Baldacchino is Head of the Department of Accountancy at the Faculty of Economics, Management and Accountancy at the University of Malta

[2]Ms Jeanelle Bugeja is at present employed in auditing at PwC (Malta) and is a professional accountancy graduate at the University of Malta

Conflicts of Interest in the Governance of Maltese Co-operatives and their Financial Implications

Baldacchino, P.J. and Bugeja, J.

University of Malta and PricewaterhouseCoopers (Malta)

The main objective of this paper is to ascertain the major conflicts of interest faced in the governance of the Maltese co-operative movement consisting of three governing institutions and individual co-operatives, as well as the financial implications of such conflicts. Results from personal semi-structured interviews point to a lack of awareness on the deeper meaning of what constitutes a conflict of interest. Furthermore, no clear delineation of roles among the three institutions is as yet present. With respect to co-operatives, results reveal that the majority of conflicts of interest surface within committees of management owing to varying personal/entity interests and the overlapping roles of directorship and management. In the authors' view, at the co-operative level, the need arises for the development of a general Code of Ethics and for better training for those in charge of governance, as well as for skill gap analysis and the formalization of their relevant policies. On the other hand, at the institutional level, the need beckons for general restructuring, including revisions to the appointment system of the respective governing bodies.

Keywords: *conflicts of interest, governance, Maltese co-operatives, co-operative finance*

1. Introduction

Co-operatives were one of the early structures formed with the specific aim of assisting groups of workers that have an entrepreneurial spirit to achieve their aims. In fact, according to Luccock (n.d.), "No one can whistle a symphony. It takes an orchestra to play it" . The International Co-operative Alliance, the organisation that represents co-operatives and the co-operative movement worldwide, defines a co-operative as "an autonomous association of persons united voluntarily to meet their common economic, social and cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise." (ICA,1995, p.1). Thus co-operatives are distinct from other forms of public or private organisations in that they are democratic structures owned and controlled by their members, whereby each person has one vote. Furthermore, members are guided by a set of seven principles that enable them to put their co-operative and ethical values into practice.

The main objective of this paper is to ascertain the major conflicts of interest faced in the governance of the Maltese co-operative movement consisting of three governing institutions and individual co-operatives, as well as the financial implications of such conflicts. The analysis is based on semi-structured interviews held between October 2010 and March 2011 with 9 representatives of the three institutional bodies - the Co-operatives Board, Koperattivi Malta and the Central Co-operative Fund - as well as with members of the committees of management or professional management of 22 Maltese co-operatives willing to participate in the study out of a total of 52 existing at the time of study. The analysis must therefore be interpreted within the limitations of such response, with the overall position being noted as prevailing as at 31st March 2011. Yet, in this latter context, no significant changes to such position were noted by the authors up to 15 May, 2012.

2. The corporate governance of co-operatives

Within the Maltese co-operative framework, one finds various hierarchical levels in its governance. With respect to the three above-mentioned governing institutional bodies:

- The role of the Co-operatives Board is to "register, monitor and exercise supervision over co-operative societies and ensure that they operate in full compliance with the provisions of the Co-operative Societies Act" (CSA, 2001, Art. 3[1]). Moreover, the Co-operatives Board is to assist and give advice to the Minister responsible on all co-operative aspects. The Board is appointed by the Minister and is composed of the Chairman, Secretary and between 2 to 6 other members.

- Koperattivi Malta (KM) is a non-political organisation set up by the CSA 2001 and it must "have at least absolute majority of all primary co-operatives societies" registered with it as members (CSA, 2001, Art 106 [a]). However, registration with KM is not compulsory. Its Council is made up of a maximum of 9 individuals elected from the member co-operatives. The roles of President, Secretary and Treasurer are then selected from the elected individuals. Its main role is to assist co-operative societies in Malta and to represent and promote the Maltese co-operative movement, both locally and internationally. It also has to provide a variety of services to member co-operatives, including education and training.

- The Central Co-operative Fund (CCF) is imposed by Art 91 of the CSA 2001 and is to be used to promote co-operative education, training and research, and for the general development of the Maltese societies in every aspect of the economy and society. Those co-operatives whose annual audited financial statements show a surplus contribute to the fund to the extent of 5% of such surplus. The CCF committee is obliged to exercise a high degree of diligence in administering the funds under its responsibility

(Government of Malta, 2002). Such a board is composed of 7 members: 2 members elected from the Co-operatives Board, 1 member from Koperattivi Malta and the rest are selected from Maltese co-operatives.

Individual co-operatives are categorised into five sectors, namely: producers, workers, consumers, social co-operatives and public sector co-operatives. Within each co-operative, the hierarchical levels are the Supervisory Board (optional), the Committee of Management (COMM), Professional Management and Members/Employees.

Members of the COMM are users, owners and controllers of the society and the COMM is vested with the conduct and management of the affairs and business of the co-operative (CSA, 2001). On the other hand, the function of the Supervisory Board is to ensure that co-operative affairs are conducted in accordance with the provisions of the Act, the Statute and the resolutions and decisions adopted at the general meetings. From the replies of respondents, it emerged that the majority of co- operatives have opted to do away with the Supervisory Board and adopted instead a single-tier system of corporate governance with the COMM managing the whole affairs of the society.

In some co-operatives, the COMM may appoint a person or persons as full-time professional manager/s responsible for implementing strategies approved by the COMM.

The COMM approves all members that are admitted in a society. Munkner (1982) describes the position of a member as having a dual capacity - as a member of the co-operative group, and as user of the services and facilities of the co-operative. A member has the right to one vote in the AGM, irrespective of the number of shares paid. Apart from members working in a co-operative, there can be both voluntary as well as paid employees engaged by the COMM. Even though employees do not have a voting right, it is their duty to abide by the society's principles and values and work towards common goals.

3. Conflicts of interest defined

For the purpose of this paper, a working definition of conflict of interest (COI) is the following:

> "A conflict of interest arises when the personal or professional interests of a member who is authorised to take decisions have the potential to be at odds with corporate and societal values." (Brown, 2008, amended).

In situations involving a group of people, conflicts of interest (COIs) are common, and can hardly be avoided. In fact, from the study, the perception of the majority of respondents is that while in general everybody states that they try to avoid conflicts of interest, the reality is different in that one accepts them "as part of human nature". Yet, all this is tied up with the "individual's moral values and ethics". Overall, personal interests and financial gains were identified as the most common sources of conflicts.

In reality, conflicts of interest can be mainly categorised into pecuniary and non-pecuniary interests (OECD, 2003). Pecuniary interests involve an actual or potential financial gain that may arise from a member who has decision-making power, including improved employment or post-employment prospects, gifts or hospitality, financial rewards and business referrals. Non-pecuniary interests do not have a direct financial component, but still have financial implications, and may arise from personal or family relationships or involvement in social or cultural activities. A COI may also be looked at it in simpler terms as it is generally a situation in which someone in a position of trust has competing professional or personal interests that strongly colour one's perceptions, making the individual incapable of taking decisions objectively.

4. Risks of conflicts of interest

Conflicts of interest carry a number of risks, including that board members may be held liable if prudent management of an organisation's resources is not exercised. Higuera (1996) mentioned that a 1974 court decision in the USA, known as "The Sibley Hospital Case: Trustees and their loyalty to the Institution" confirmed that board members can be held legally liable for COIs because they constitute a breach of fiduciary responsibility. Olear (2008) states that nothing undermines a community's faith in their leadership faster than impropriety and self-dealing amongst the board and management team.

According to Brown (2008), if COIs are not dealt with, risks can go beyond financial penalties and remedies. The lasting effect of ignoring COIs is reputational. Individuals on the governing body could be tainted with the ethical aspects of the matter, and both personal and corporate reputations could be ruined for a lasting period of time.

5. Should conflicts of interest be regulated?

According to Campbell and Houghton (2005), ethical behaviour does not simply mean conforming to legal and professional rules, but is indeed a culture of 'doing the right thing'. However, it is inevitable that individuals are faced with ethical decisions and COIs. Thus it is fundamental that both internal and external regulatory frameworks and measures are engrained in the culture of co-operatives.

In an ideal scenario, COIs should be avoided at all costs. Since within any community enterprise certain COIs are inevitable, one needs to know how to deal with them in a constructive manner. Both extremes of a complete regulatory framework, or complete self-regulation, are considered to be inappropriate. The majority of respondents stressed that a general Code of Ethics (COE), with a set of rules, needs to be established. Regulation cannot cover every possible situation, yet it would serve as a solid base for the identification and minimisation of instances of COIs. The way in which such a COE is to be drafted needs to leave enough space for self-regulation. Such a COE will also best form part of the CSA 2001, in order to strengthen regulation in this respect, since there is only one clause regulating such an important matter.

More tools within all levels of the co-operative movement need to be developed for the appropriate management of COIs. Disclosure policies need to be drawn up consisting of a detailed questionnaire or statement, with a regular review and update. Full and accurate prior disclosure, followed by abstention from decision making on matters in which conflicts may potentially exist, will probably be the best practice. Decisive action should always be taken on the merits of each case even if this entails suing for damages in serious cases. Whilst such structures may initially be costly to implement, their contribution to the financial stability of the system should in the long-term outweigh costs, promoting informed decisions within a stronger framework – this also eventually leading to the strengthening of liquidity, profitability and investment.

6. The financial implications

When a co-operative experiences any type of COI, proper corporate governance may be seriously undermined if this is not dealt with appropriately, with negative consequences on the financial stability of the society. While varying financial implications are involved in any business activity, COIs clearly tend to give rise to strategic and operational activities which result in adverse financial ones as indicated in Table 1 below. In this context, the study indicates that individual awareness of such financial effects of a COI, such as unprofitability, risky business and arrangements with third parties of low credibility often comes about when these have actually been realised.

Table 1

Financial Implications of Strategic and

Operational Activities Resulting from COI's

Strategic Activities	• Inefficient use of time, resources and money
	• Erroneous decisions on short and long-term capital investments
	• Biased decisions taken
	• Negative impact of agreed strategies and objectives
	• Undermining of effective internal controls
Operational Activities	• Questionable business ventures with third parties of low credibility
	• Trading in markets which do not allow profitable return on investment
	• High risk of insider trading
	• Engaging in risky business agreements that can have serious repercussions on the operational viability of the co-operatives if the venture fails
	• Loss of contracts due to negative reputation
	• Pricing frauds
	• Proper tendering systems not observed with potential risk of not benefitting from the most advantageous offers or services
	• Excessive consultancy fees

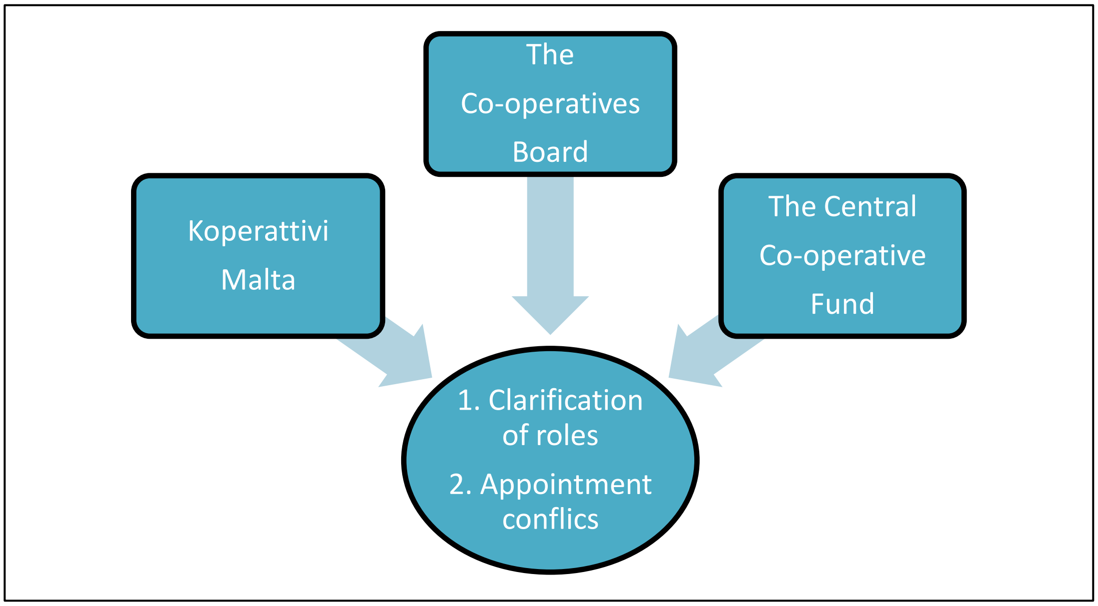
7. Towards a better institutional framework

Through this study, the main issues identified as needing specific intervention in the three institutions are highlighted in Figure 1 below. As shown, analysis revealed that the current roles of these institutions are not clearly defined and that the current appointment system of the board/councils is also leading to real and perceived COIs, sometimes leading also to resource wastage and inter-institutional disputes.

Figure 1

Issues Identified as Possibly Leading to

Institutional Conflicts of Interest



Individual co-operatives need to look up to the three institutional bodies in order to function properly and prosper. If the relationship amongst the institutions is not strong and appropriate, co-operatives tend to perceive them negatively and thus also to be adversely affected. In all communities, the strength lies in their leadership and the intra-relationships governing them.

One consideration is whether the Co-operatives Board is to retain its current structure and regulatory role, or transform itself into a co-operative authority with stricter monitoring powers and a more active role in the development of new legislation and policies. Such transformation would result in the regulator being in a better position to inspect and ensure compliance with co-operative regulation and principles, and hence to utilise better the full powers already provided in the current legislation.

As for the relevance and adequacy of the appointment systems, the Board clearly needs wider representation of the various parties concerned in the movement. The fact that Board members are appointed by the responsible Minister, with the majority having to pass through a steep learning curve each time that there is a Ministerial change, has been considered a great disadvantage. Probably, a more balanced and stable alternative would be to have equal representation of government, KM and individual co-operatives, together with an Opposition member.

On the other hand, Koperattivi Malta (KM) is one of the contributors to this lack of clarity in roles, as it has no specific roles entrenched within the Co-operative Societies Act 2001. Furthermore, the current nomination process to the AGM and consequently to council needs to be looked into. Nominating individuals on the basis of two delegates per co-operative may not be entirely just. Probably, a wider and more direct representation could be achieved leading to better awareness, understanding and acceptance. One way may be having delegates nominated directly and separately by all co-operative members in each sector, with the number of nominations being proportionate to the total number of members in each sector. Wider representation would hopefully lead to more enthusiasm on the nomination process to the council itself. It is important that emphasis is placed on the independence of council members, particularly in the context of ongoing business relationships, as these will be perceived negatively owing to possible COI implications. However, this will not necessarily preclude a council member from being a "supplier of services" provided that a scrupulously independent tendering process is conducted.

With respect to the Central Co-operative Fund (CCF), the appointment of its Board, with potential concurrent membership of both the KM and the CCF, can evidently cause uneasiness within the institutional bodies, as well as with co-operatives *vis-à-vis* the institutions.

The principal consideration is the perceived COI arising from the fact that the majority of individuals on the CCF board are also allowed to form part of the KM Council. As a result, the same individuals may wear different hats for different occasions, such as with their dual role in the presentation and approval of projects. This may easily be perceived as not conducive to the optimal allocation of funds. Of course, this does not mean that the CCF board membership would necessarily exclude a member or two sitting concurrently on the KM Council. Such representation may be important for informed decisions to continue to be made. However such person/s, if any, cannot be allowed to participate in conflicting situations such as project presentation and approval. Funds approved by the CCF are also to be monitored by the CCF within a stricter regulatory framework. For example, quarterly reviews may be established whereby financial performance is evaluated against the budgets with corrective action being required immediately when the latter are not being achieved.

In deciding on the future of the CCF, a number of alternatives are proposed in order to ensure the elimination of COIs. This involves changing the present set-up by way of KM/CCF amalgamation, or by the introduction of a Board of Trustees composed mostly of independent members. Probably, the latter alternative involving trustees would be a superior alternative because while leading to less bureaucracy, KM/CCF amalgamation would necessitate a formula to cater equitably for the financing of non-KM member entities, unless KM membership first becomes compulsory for all Maltese co-operatives.

8. Coordinating the entities into a better framework

The clarification and differentiation of the major roles of the three institutions, including the elimination of any present overlapping need to be emphasised for them to achieve the strength necessitated by the movement. It has already been proposed that the regulatory role would be better under the responsibility of a co-operative authority with wider powers and representation of the various stakeholders.

This authority may be ultimately responsible for a fund trust run by five trustees appointed by the authority in agreement with KM. A legal requirement will be imposed, whereby all trust members would be unrelated and independent from any dealings within the co-operative movement and at least three would be professionals with sufficient expertise in commercial banking and, possibly, co-operatives, such as commercial lawyers, accountants and bankers. The chairman would be chosen by the trust members from amongst these professionals. The co-operative authority might also elect an internal audit unit to monitor the approval and usage of the CCF funds. Fund trustees need to have their own executive team working independently from that of the authority.

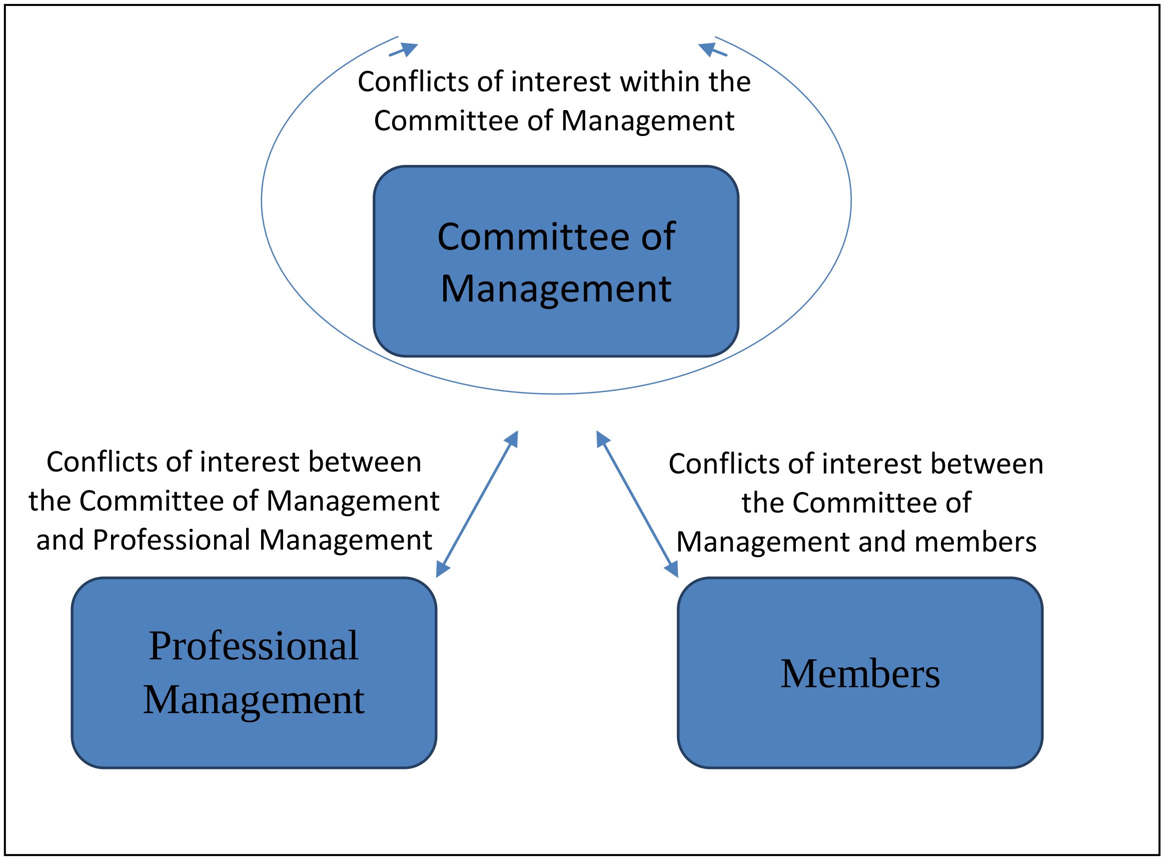
On the other hand, as the statutory arm of the co-operative movement, KM would also be statutorily regulated with possible changes to the system of election to council as referred to earlier. It would have its own support unit composed of, say, a lawyer, accountant, and professional consultant/s - such as industrial psychologist and /or other relevant professional. This could provide services to all KM-affiliated co-operatives and their members, while also being open to non-affiliated co-operatives at a charge. Services would typically include feasibility studies for new projects, management, skills and social audits. Hopefully, such changes would contribute to better and more independent monitoring, more operational effectiveness, and meaningful investment appraisals.

9. Conflicts of interest within individual co-operatives

Figure 2 identifies the three areas in which such COIs within individual co-operatives will now be discussed.

Figure 2

Conflicts of Interest within Individual Co-operatives



9.1 Conflicts of interest within the committee of management

The original Co-operative Societies Act 1974 allocated specific managerial roles and authorities to the COMM based on the requirement of a two-tier system of corporate governance with a supervisory board responsible for the direction of the co-operative. However, since this board was made non-mandatory by the CSA 2001, most co-operatives have functioned with a COMM only, performing also the function of the higher board.

Given also the common absence of a manager, this committee is also trying to balance the dual responsibilities of providing long term direction and the day-today management of the business. This paves the way for possible COIs owing to unclear direction/management roles, at times creating internal conflicts and even squabbles that lead to negative consequences on the finances of the co-operative. The Act needs therefore to be amended to clarify the role of a committee of management now performing the function of a mixed board of directors. This may lead, for example, to the creation of audit committees.

Furthermore, currently, the law does not specify any qualifications required by members to form part of the COMM. As membership of the co-operative society is a legal requirement for election to the COMM, there is a strong possibility of a skills gap being created with the COMM. This may necessitate the employment of a manager to support such skills, which may involve significant costs.

The issue may be tackled in various ways. Compulsory membership of the co-operative for election to the COMM in the CSA 2001 may be removed. Furthermore, the appointment of a manager may be made compulsory for co-operatives of a certain size. Finally, regular skill gap analysis may be carried out by the proposed support unit of KM and either specific training given to fill the resulting gaps or co-option to the committee of one or two professionals could be permitted by law to supplement such committee.

9.2 Conflicts of interest between the committee of management and professional management

Findings indicated that COIs may arise when professional managers take over the management of the co-operative: they may abuse of their discretionary position to give priority to their financial and personal interest. Of course, this is not invariably so: ethical managers may bring innumerable advantages, with better informed decisions in the relevant field, whilst in the process contributing to a better informed and coherent committee.

In most situations, professional managers participate in COMMs but have no voting rights. One may consider the possibility of responsibilizing such managers by requiring them to form part of the COMM, with direct voting rights to exercise in the final decision-making process. In considering the statutory option to dilute the committee of management with non-co-operative members such as managers or, as previously suggested, with relevant professionals, the danger of there being too many non-members who may be detached from the interests of members must also be kept in mind. For this reason, the majority of COMM seats probably still need to be retained for co-operative members.

9.3 Conflicts of interest between the committee of management and members

The principal COI in this area mainly emerged between the short and long- term interests of the members in deciding on fund distribution. The vision of well-intentioned management may focus on securing the continued existence of the co-operative, while members may press for the immediate distribution of surpluses. Energies are thus wasted in directing resources into areas that are not synchronized with the business, management and financial strategies of the co-operative, this having clear negative consequences. In co-operatives, such a conflict is particularly prevalent in view of the statutory ineligibility of members to have prior-year surpluses distributed to them. The removal of this restriction, while controversial, would incentivise members to have co-operative surpluses invested for future growth. Of course other possible solutions may be studied.

10. Conclusion

Overall, most COI's at all levels are subtle and discreet and the study revealed that they are not being easily identified or handled once they surface. Furthermore, both institutions and co-operatives generally perceive COIs limitedly in situations of direct pecuniary gain and insufficient emphasis is as yet given to other deeper instances which may ultimately have even wider financial and corporate governance implications.

It is also clear that conflicts of interest tend to be a clear symptom of inadequate corporate governance. Mitigating the existence of COIs will help develop the capacity and capability of the governing bodies to be more effective, minimise the substantial negative financial implications associated with them and enable the individual co-operatives to address better stakeholder expectations.

Institutions have an important role to play and their sole mission needs to be directed towards promoting co-operative principles and values. Once such inspirational values are seriously reinforced amongst members, the concern related to COIs will be substantially minimised. Such values should even inspire others to form part of the co-operative community and, as Saint-Exupery (n.d.) stated:

> "If you want to build a ship, don't drum up people together to collect wood and don't assign them tasks and work, but rather teach them to long for the endless immensity of the sea."

References

Regulatory

Cooperative Societies Act - Malta (CSA), 2001. Chapter 442 of the laws of Malta

Government of Malta (2002). Legal notice 108 of 2002: http://www.doi.gov.mt/EN/legalnotices/2002 [6 Sept 2010].

Other

Brown, D. (2008). Conflict of interest. *Governance matters.* Canadian Cooperative Association. May: http://www.coopscanada.coop/assets/firefly/files/files/GovMatArchives/GM17_May08.pdf [25 August 2010].

Campbell, T. and Houghton , K.A. (2005). *Ethics and auditing*. ANU: E-Press: http/ /epress.anu.edu.au/ethics auditing/frames.php [22 September 2010].

Higuera, J. J. (1996) An ounce of oversight: http://www.cof.org/files/Documents/Family_Foundations/Trustee-Orientation/An-Ounce-of-Oversight.pdf [14 Nov.2010].

International Cooperative Alliance (ICA) (1995). Statement on the co-operative identity: http ://www.ica.coop/coop/principles.html [14 September 2010]

Luccock, H.E. (n.d.). Quotes.net. STANDS4 LLC : http://www.quotes.net/15280 [5 January, 2011]

Munkner, H.H. (1982). *Ten lectures on co-operative law*. Friedrich-Ebert- Stiftung.

Organization of Economic Co-operation and Development (OECD) (2003). Managing conflict of interest in the public service. Guidelines and country experiences: http://www.oecd.org/dataoecd/13/22/2957360.pdf [14 November 2010].

Olear, G. (2008). Avoiding conflicts of interest. *The Cooperator*, 1 May : http://cooperator.com/articles/1618/l/Avoiding-Conflicts-ofInterest/Pagel.html [12 December, 2010].

Saint-Exupery, A. (n.d). Brainy quote.com: http://www . brainyquote.com/quotes /quotes/a/antoinedesl 2126. html [7 December, 2010]

CHAPTER 13

The Corporate Governance Relationship between the Board and Management in Maltese Listed Companies

[CG-4]

Bezzina, F.H.[1], Baldacchino, P.J.[1], and Azzopardi J.R.[2]

In: Rethinking Corporate Governance,
Darko,T., Raguž, R.V. and Podrug, N. (eds),
Universities of Zagreb and Dubrovnik, Croatia, Pearson
ISBN 978-1-78273-686-8

First Edition, 2014, pp 1-15

This paper is a revised and expanded version of a paper with the same title presented by second author at 1st OFEL International Conference on Corporate Governance, CIRU, University of Zagreb held at Dubrovnik, Croatia on 12th April, 2013.

[1] Faculty of Economics, Management and Accountancy (FEMA), University of Malta, Malta

[2] Chief Executive Officer, University of Malta Group of Companies

The Corporate Governance Relationship between the Board and Management in Maltese Listed Companies

Bezzina, F.H.[1], Baldacchino, P.J.[1], and Azzopardi J.R.[2]

[1]University of Malta and [2]University of Malta Group of Companies

This study focuses on the board/management relationship aspect of Corporate Governance (CG) in Maltese public listed companies. It examines the level of adherence to the CG regulatory framework, the role of management and its interaction with directors and shareholders, and the locus of corporate control by inspecting the Annual Reports of all companies (N = 20) with shares listed on the Malta Stock Exchange as at December 31, 2010. The findings reveal weak areas of governance relating to the performance evaluation of the board, the disclosure of director and senior executive remuneration, the level of explanations being provided for non-compliance with the Code and the attention being devoted to shareholder communication and corporate social responsibility. Recent amendments to the framework have diluted the impact of some measures that were introduced earlier, but this merely resulted in the accommodation of on-going practices, as highlighted by lengthy and multiple directorships and their negative implications on the board's independence from management. Owner control is predominant with major shareholding blocks dominating boardrooms and management. Finally, the companies investigated bear the hallmarks of a small island economy, with their governance exacerbated by the reluctance or inability of shareholders to exercise their voting rights and powers of control, and by poor practices as yet left unchecked by the level of regulatory supervision. The study provides five recommendations on how incongruences within the CG framework could be addressed to improve the CG performance of Maltese public listed companies and concludes by providing some interesting suggestions for further research.

Keywords: *corporate governance, CEO, directors, Maltese companies, management*

1. Introduction

Corporate Governance (CG) has been defined as "the system by which business corporations are directed and controlled" (OECD, 1999). The CG structure specifies the distribution of rights and responsibilities among different participants in the corporation, and spells out the rules and procedures for making decisions on corporate affairs (OECD, 2004). It is mainly concerned with the mitigation of conflicts of interests (real, potential or apparent) between managers and stakeholders (Cadbury,1992) and in promoting corporate fairness, transparency and accountability (Wolfensohn, 1999). CG developed mostly in response to large-scale financial meltdowns of powerful corporations such as Enron or WorldCom in the United States (U.S.) or the Guinness and Robert Maxwell scandals in the United Kingdom (U.K.), since CG weaknesses were a causal factor in, or at least aggravated the financial crisis (Ball, 2010). The consequences of poor CG have far-reaching effects and undermine the effectiveness of the global anticorruption campaign in an era of globalization (Wu, 2005).

This study is based in Malta and focuses on the CG relationship between the board of directors and management of Maltese public listed companies. Malta is a small island state situated in the centre of the Mediterranean. It has a population of 412,970 and an area of just over 316 km2 (NSO, 2010). It is a full member of the European Union (EU) forms part of the Eurozone. Due to limited natural resources, Malta's economy is highly dependent on foreign trade, manufacturing, tourism and financial services (Falzon, 2011). The system of government resembles that of Great Britain, since Malta was a British Crown Colony between 1800 and 1964 and its CG system is generally one-tier.

Since the European Commission in 2003 decided that it would leave CG issues to be dealt with by the member states at the national level and saw no need for a separate code of European CG, conducting studies at the national level has become essential in ensuring a strong CG across the various EU member states.

This study specifically delves into the CG implications of the board/management relationship of listed companies in Malta's economic, political and legal contest; a new angle of CG that has not yet been dealt with in previous studies conducted within the Maltese contest. Although CG can be applied to any form of governance of companies, listed or otherwise, we restrict the term to the need for investor protection in public limited companies, since these represent the largest commercial entities and the most economically important. This study attempts to (a) assess the level of adherence of public listed companies to the current CG regulatory framework, (b) examine the role of management and its interaction with directors and stakeholders and (c) investigate the locus of corporate control in Maltese listed companies. In the light of the findings that emerge, the study will provide a series of recommendations aimed at addressing weak areas of the CG so that the regulatory framework becomes more effective in enabling Maltese public listed companies deliver their intended strategy, and to ensure that markets and consumers are further protected.

2. Literature review

2.1 International development of corporate governance

Historically, one can trace the origins of CG to the concerns about the separation of ownership and control with the advent of limited companies. Unlike smaller private companies, where directors often own the majority of shares, listed public companies are normally expected to have a clearer demarcation between directors and shareholders. Over time, the latter had come to be seen as a group unconcerned with controlling management and interested only in returns on their investments in the form of dividends and capital growth. Yet, this might be a mistaken view since different shareholders have different needs, interests and perspectives on corporate ethics and social responsibility (Stout, 2012). Gradually, the U.S. and the U.K. experienced an increase in the number of institutional investors such as insurance companies and pension funds, holding significant stakes in public listed companies (Mallin, 2007). However, despite their considerable holdings/powers, fund managers were more likely to sell off their investment upon signs of any problems in the companies rather than attempt to control management. The corporate collapses prompted governments and regulators to realise that the effective control of directors/management was not being done by shareholders and that more effective control mechanisms were needed. The response varied across countries which adopted different approaches to enhance CG. In the U.S., the Sarbanes-Oxley Act was passed in July 2002 seeking to protect investors by improving the accuracy of corporate disclosure and reporting procedures and increasing corporate openness. In the UK, a number of reports were prepared for the Stock Exchange in the 1990's. These include the 1992 Cadbury Committee's report on the Financial Aspects of CG, which recommended that boards of public companies should comply with a code of best practice as a condition for continued listing and that listed companies include a Statement of Compliance with the Code in their Annual Reports. The report also recommended that independent non-executive directors should be appointed to the boards of listed companies and that the appointment of all executive directors should be vetted by a Nominations Committee made up of the non-executive directors. Unless approved by an Annual General Meeting, non-executive directors were not to be offered service contracts for more than three years and the remuneration packages were to be agreed by the Remuneration Committee made up mainly of non-executive directors. A similarly structured Audit Committee was to be established to oversee the company's finances and interact with external auditors. Finally, the same person could not act as Chairman and CEO. Other reports followed which built on the recommendations of the Cadbury Report (Cadbury,1992). These include:

a) The Greenbury Committee report (Greenbury,1995), which recommended that a Remuneration Committee takes into consideration the interests of both shareholders and directors when determining directors' remuneration. Executive directors' service contacts were not to provide notice periods exceeding one year and the Remuneration Committee was to include a report in the annual accounts and placed before shareholders. Today, compliance with this report is a prerequisite for companies to be listed since it has been incorporated in the Stock Exchange Listing Rules (Listing Authority - Malta, 2012).

b) The Hampel Committee report (Hampel,1998), which concluded that directors should be provided with more information and trained as to their responsibilities. At least one-third of the board should be made up of non-executive directors, the majority of which should be independent. All companies should have a Nominations Committee for recommending new board appointments with directors obliged to seek re-election every three years. Directors' contacts were not to exceed 12 months. The Hampel Report led to "The Combined Code", published in June 1998 by the London Stock Exchange as a general code of good practice. It did not have the force of law but non-compliance could lead to fines and non-listing

c) The Turnbull report (ICAEW, 1999) concluded that the board should be responsible for the evaluation of likely risks facing the company, putting into place safeguards and controls to reduce likelihood of these risks and making a transparent annual assessment of risk.

d) The main thrust of the Higgs report (Higgs, 2003), which led to a revised Combined Code (FRC, 2003), was collective board responsibility with a preference towards the UK unitary system of board structure and a greater role for the non-executive directors.

e) Sir Robert Smith's report on audit committees (Smith, 2003) dealt with the role and responsibilities of Audit Committees and reinforced the independence of the auditor and raised the standard of CG in British Companies.

Today, the governance regulatory framework for companies around the world is a combination of legislation, case laws and codes of practice. Whilst company law provides for a number of statutory duties of directors, the bulk of what is regarded as CG is contained in codes of best practice, which Gower and Davies (2003) describe as "soft law" in that they constitute "only a disclosure obligation" (pp. 322-323).

In 2003, the European Commission decided that it would leave CG issues to be dealt with by the member states at the national level and saw no need for a separate code of European CG. However, fundamental issues were dealt with through Directives and the "European Union Corporate Governance Forum" was set up in 2004 to co-ordinate CG efforts across member states. In July 2011, the mandate of the Forum expired and the Commission had to consider how best to involve experts in future developments in CG, in the light of responses to the April 2011 Green Paper (COM, 2011). On 12 December, 2012, the European Commission communicated an action plan entitled "European company law and corporate governance" outlining how to modernise and enhance the current framework (COM, 2012a). The scope was to enhance transparency between companies and investors, to encourage long-term shareholder engagement and to improve the framework or cross-border operation of companies. A process of codification of most company law directives is also included with the action plan.

2.2 The Companies Act - Malta (1995): directors' duties

The Companies Act - Malta (1995) sets out the general duties of directors. Directors are bound to act honestly and in good faith in the best interest of the company. They are obliged to promote the well-being of the company, to be responsible for the general governance of the company, the proper administration and management of the company, and the supervision of officers. They also have the duty to exercise the powers they have for the purpose for which the powers were conferred and shall not misuse such powers. The Companies Act also places a duty of competence on any director (Article 316 [4]), since s/he director is obliged to exercise the degree of care, diligence and skill and must be a "reasonably diligent person" having "knowledge, skill and experience". This is in line with the argument that there is no such thing as a passive director who leaves all management functions to others without question (Keay, 2007). Although the Companies Act (1995) allows for corporate directors, the Listing Rules (Listing Authority - Malta, 2012) only allow individual persons to be appointed directors in listed companies. This makes sense in view of the notion of personal liability. The Act gives the Board of Directors broad discretionary powers (Article 137[3]) but requires them to place before shareholders the financial statements which must be audited and reported by external auditors appointed by the general meeting and by having the directors' performance scrutinized in the annual general meeting. Shareholders have also the power to remove and appoint directors, to pass resolutions and to intervene directly in the management of the company.

2.3 The development of corporate governance in Malta

In Malta, the development of CG was influenced mainly by its development in other countries, mainly the U.K., and by OECD Principles of Corporate Governance (OECD, 1999, 2004). In 2001, a working group set up by the Malta Stock Exchange, which was made up of a mixture of local Exchange officials and industry experts, produced a report containing a draft entitled "Code of Principles of Good Corporate Governance". This Code aimed at giving directors a guide to effective CG through a number of basic principles. The Code was suggested for adherence by listed companies but it was emphasized that the principles were equally advisable and advantageous for any other company. Although the proposed Code was not mandatory, listed companies would be obliged to make a Statement of Compliance at least once a year and to include it in the Annual Report. Auditors were requested to comment on the disclosure made by the company in this regard. With some modifications, the Code was included in the Listing Rules as non-mandatory (Listing Authority - Malta, 2012). However, the Statement of

Compliance and the auditors' verification thereof were made mandatory. The Code was revised in 2005 by the Malta Financial Services Authority (MFSA). The Audit Committee was made obligatory and companies had to comply with the Code or else they had to explain why they did not comply with it in the Annual Report. Further revisions followed, after guidelines were laid down by the OECD. Today, the Code (as revised on 16 November, 2010) is also annexed to the Listing Rules (MFSA, 2010; Listing Authority - Malta , 2012).

The non-mandatory principles of the Code are aimed at enhancing the legal, institutional and regulatory framework for good governance in the local corporate sector and are meant to complement the provisions in the Companies Act (1995). The revised Code, however, turned down the requirements for a minimum number of Board meetings, the disclosure of individual directors' remuneration and the performance appraisal of individual directors. We believe that the diluted measures in the revised Code are more in line with on-going practices and although this will result in better adherence to the revised Code, it also implies a lowering of CG standards. A number of inconsistencies and contradictions between corporate law and the various CG instruments in force have also been highlighted by Muscat (2007). These include: (a) allowing the roles of Chairman and CEO to be combined provided an explanation is provided to the market and company stakeholders; (b) empowering the Board to award executive contracts to non-executive directors when under Maltese law the power to appoint directors rests with the shareholders; and (c) the Code addresses shareholders directly and urges their participation in the Annual General Meeting and in the election of directors, and further urges them to continue to hold directors accountable – despite the fact that the Code mainly addresses directors and management.

The Corporate Governance Guidelines for Public Interest Companies (MFSA, 2006) are generally referred to as "The Guidelines". A public interest company is defined as one whose operations affect a substantial sector of society and which acts in communal interest. Since public interest companies may include regulated companies, Muscat (2007) argued that the Guidelines could apply to a listed company. However, it is unlikely that this was the intention of the MFSA since listed companies are already expected to comply with their Code. The Guidelines are non-mandatory and very closely based on the principles of the Code but no Statement of Compliance and auditors' verification thereon is required. However, public interest companies are urged to adopt them and to highlight this fact in their Annual Reports.

Predating both the Code and the Guidelines is the Code of Ethics for Board Directors in the Public Sector (Cabinet Office - Malta, 1994) and generally referred to as the "Code of Ethics". It applies, amongst others, to Government-appointed directors of companies in which the Government has a shareholding interest as well as to those persons appointed by the Government to the governing bodies of other organisations. The Code of Ethics sets out the following values as the fundamental pillars for the ethical conduct of directors: integrity, honesty, loyalty to the public interest, fairness, conscientiousness, and compassion. It states that directors are to ensure that they are fully aware of the provisions of the said Code and that they practise full adherence to it without fail.

2.4 Corporate board structure in Malta

In Malta, the corporate board structure follows the Anglo-American model of the unitary board. This model emphasises the interests of shareholders and relies on a single tier of board of directors generally composed of non-executive directors selected by shareholders. The role of the non-executive director needs to be clearly defined and distinguished from that of the executive. In the U.K., the CEO does not serve as chairman of the board while in the U.S. this dual role is the norm even though many have reservations on this owing to the negative impact on CG (Bowen, 2008). The Anglo-American model contrasts with the Continental model which also recognises the interests of stakeholders (Douma and Schreuder, 2013) and relies on a two-tier of Board of Directors. The Executive (or Management) Board is composed of company executives who are responsible for running the day-to-day operations and providing the general direction of the company. The non-executive directors (or Supervisory Board) represent shareholders and employees and have the authority to appoint and dismiss executive board members, to determine their remuneration and to approve major business decisions. In Malta, although the corporate board structure follows the Anglo-American model, the majority of corporate funding is provided by banks, a characteristic of the continental two-tier Board of Directors. Moreover, the incidence of the majority shareholdings in Maltese listed companies is very high.

2.5 Roles of the CEO and the Chairman – dual or separate?

The CEO's job responsibilities can vary from organization to organization, depending on the needs of the organization and the corporate board structure. Russell (2009) argues that the relationship between a Board and the CEO can make or break an organization. She adds that the distinct roles within the organizational structure need to be respected. The Board is mainly responsible for 'governing' while the CEO is mainly responsible for 'managing'; yet they must work in partnership to fulfil the management needs and goals of the organization.

In the CG literature, there is an increased insistence that the role of Chairman and CEO should be separate, although this is less pronounced in the US. According to the stewardship theory, the dual role can establish strong, unambiguous leadership, and shareholder interests are maximized by the shared incumbency; however according to the agency theory, duality results in the promotion of CEO entrenchment by reducing board monitoring effectiveness (Donaldson and Davis, 1991; Finkelstein and D'Aveni, 1994). Using a contingency framework, Filkenstein and D'Aveni (1994) found that "board vigilance was positively associated with CEO duality"; however duality was less common when "CEOs had high informal power and when firm performance was high" (p. 1079).

Desai *et al.* (2003) found that CEO duality affects performance negatively and that there is an important interaction effect between outside board monitoring and CEO duality. In a study with family-controlled public firms, Braun and Sharma (2007) found that duality did not affect firm performance; however, when family ownership is low, separating the roles is beneficial in terms of shareholder returns and a useful governance control as the risk of family entrenchment increases.

2.6 Corporate control in corporations

A common notion that prevails in all definitions of CG is that of control of the company and corporate management in particular (Hofstetter, 2005). Shareholders are expected to lose effective control with the total delegation of the management of the business to a specialised management team (or Board of Directors). Moreover, with larger corporate size comes a greater share of ownership, a reduction in the power of the shareholders and the strengthening of managerial authority (legally meaning the Board of Directors). However, according to Berle and Means (1991), this is not always so clear since control can take different forms: majority control, complete ownership, control through legal device, minority control and management control. Control may not rest wholly on considerations of quantitative levels of shareholding as it may also be exercised even with a small number of shares. In large public companies with widely dispersed shareholding, no shareholder is in a position to exercise effective control through the formal decision-making process of the Annual General Meeting. Shareholders find no worth in evaluating proposals presented at the Annual General Meeting as they generally lack capability, incentive and power to monitor the actions of management. The institutional investors are more likely to have these resources and to exercise a semblance of control. The "Report on the Working Group on Corporate Governance" (Malta Stock Exchange, 2001) recognised the importance of institutional investors and stated that "their actions or inactions with respect to companies in which they invest can influence small shareholders' attitudes, and therefore the attitude of the market, towards those companies".

In his ground-breaking book, Herman (1981) reassessed the phenomenon of managerialism and criticized Berle and Means (1932) that their position on control was unsophisticated. He contrasted the power of managers with those of other interest groups and argued that the ultimate corporate power of large corporations lies with the managers, with shareholders, bankers and government having limited effect on the autonomy of management. Management's "strategic position" within the company (high executive office, directorship, high committee positions) is the basis of its control over the company. Herman (1981) argued that even in the presence of significant management power, the Board will still have its latent legal powers which only come to the forefront and are enforced on management when things go terribly wrong, financially and operationally. The Board, as well as shareholders in the general meeting, have the power to intervene and remove the management. However, even in such circumstances, it will not be easy to displace the management given its control over the information with regard to non-executive directors, its influence over Board members and the general fear of disruption and conflict by the directors themselves. An obvious threat to management control would be a strong and truly independent Board of Directors. Most of the inquisitiveness and challenging of management is expected to come from independently-minded, non-executive directors. However, Herman (1981) argued that it is widely accepted that (a) outside directors are not invited to join the boards of major corporations to "run" the firms or to decide on basic policy, (b) outside directors are usually passive and do what management wants them to do; and (c) management wants boards to carry out limited functions, principally advising in areas of competence, solidifying relationships with important external constituencies, assuring the outside world by their presence that the organisation is in good hands, and providing a standby facility for emergency use in times of crisis.

Although Herman's empirical and thoughtful thinking increased our understanding of the phenomenon of managerialism, Pettet (2005) argued that the "agency problem", which arises from the separation of ownership from control, within the corporate environment raises questions on the legitimacy of corporate power. As a result, the fundamental question that arises in CG is whether there are sufficient controls, legal or otherwise, on the Board to ensure that managerial powers are exercised not only for the benefit of shareholders (a CG debate) but also for a wider range of people beyond these and creditors (a social responsibility debate). Perhaps, the most plausible solution to date to the question, "What should be the objective of public corporations?" is found in Keay's entity maximisation and sustainability model (Keay, 2008, 2011). In this theory, Keay urges directors to maximise the market value of the corporation (an independent legal entity), to sustain it in the long term, and to pursue the development of the corporation's position, whilst taking into account the investments made by various shareholders and other stakeholders.

3. Method

The main aim of this study is to assess the relationship between the board of directors and management and the implications of this relationship on the CG of Maltese listed companies. More specifically, the objectives of this study are:

a) to evaluate the general level of adherence to the codes of CG;
b) to assess the role of the CEO and management vis-a-vis that of the board of directors;
c) to investigate the locus of corporate control in Malta and its impact on CG.

It was decided to limit the study specifically to companies having equity listed on the Malta Stock Exchange and to exclude any collective investment schemes. This resulted in 20 companies which are listed in the Appendix together with the company websites from which the Annual Reports and financial statements as at December 31, 2010, were retrieved.

Empirical data collection came mainly from the Annual Reports of these 20 companies with listed equity, including their compliance statements on the adherence to the Code and explanations for non-compliance. This source was chosen because it reflects the official position and statement of the company concerned with regards to the CG strategy. This approach obviated the need of sending a survey to the various companies with an uncertain response outcome. The data analysis consisted of summarising the information obtained from the review of the Annual Reports of these listed companies. The findings are presented and discussed later in the paper. Moreover, the authors drew from these findings and from personal experiences in top management and/or director roles within listed companies to provide suggestions on how the current Maltese CG framework may be enhanced.

4. Results and discussion

4.1 Adherence to the Code

The analysis of adherence to the Code focused on various aspects of the Code which were grouped into the following 10 categories:

1) The position of the Chairman and the CEO should be occupied by different individuals and, in exceptional circumstances, the company should provide an explanation to the market and to its shareholders through a company announcement (MFSA, 2010, Section 2.1). After reviewing the Annual Reports of 2010 for the 20 listed companies, we found that 18 companies (or 90%) abide with the Code. In one company, the same individual occupied the positions of a Chairman and CEO simultaneously and the explanation given was "in view of the particular circumstances of the company", which is clearly an insufficient explanation. In another company, the Chairman was also an executive director and both the Chairman and the CEO were significant shareholders; this is not in accordance with the Code which emphasizes that

the Chairman should meet certain independence criteria from the executive (MFSA, 2010, Section 2.3)

2) The Board should appoint a committee that is chaired by a non-executive director in order to carry out a performance evaluation of its role, committees and individual directors (MFSA, 2010, Section 7.1). Only three of the 20 listed companies (15%) perform an evaluation exercise of the Board as requested by the Code. From the remaining 17 companies, six (30%) do some sort of evaluation but do not have a specific committee for this purpose and the remaining 11 (55%) do not conduct an evaluation. Recently, the Maltese Government's response to the EU Green Paper (COM, 2011) stated that public listed companies should be encouraged to conduct a regular external independent assessment (e.g. every three years) and such an assessment should not be made by auditors. Given that the evaluation of the Board's performance emerges as one of the weakest aspects of governance in listed companies, we suggest that this requirement is made mandatory in the Code. We believe that it would also give shareholders a basis for better decision-making.

3) The Remuneration Committee composed of non-executive directors (with no financial interest other than shareholders in the company, one of whom is independent and acts as chairman) devises the appropriate packages needed to attract, retain and motivate directors as well as senior executives with the right qualities and skills to manage the company (MFSA, 2010, Section 8.2). Out of the 20 companies investigated, 11 (55%) perform the function of the Remuneration Committee as required by the Code. As to the remaining 9 companies, four (20%) perform the function with some divergence and the other five companies (25%) neither have a Remuneration Committee nor do they perform the required functions; with only one company providing sufficient justification for non-adherence.

4) The Code requires the Remuneration Committee to disclose the total emoluments of directors and senior executives, and to split this total into the following four sections: 'fixed remuneration', 'variable remuneration', 'share options' and 'others' (MFSA, 2010, Section 8.6.4). All the 20 companies reviewed (100%) disclose the directors' emoluments and 16 of these (80%) split this aggregate into separate components. However, only five companies (25%) disclose the aggregate emoluments of senior executives, with only one (5%) splitting the components by type of emolument, as required by the Code.

5) The Board should account fully to shareholders and ensure that the company communicates effectively with the market. It should also engage institutional investors and market intermediaries in meaningful dialogue (Principle 9). Our study revealed that all 20 companies (100%) utilise the normal official channels for communicating with shareholders. These include the Annual General Meeting (AGM), Annual Report and Financial Statements, the published interim results, company announcements to the market and the investor section on their website. However, only seven companies (35%) claim to hold direct meetings with institutional investors and stockbrokers (mostly to coincide with the AGM or other events that materially affect the company) and only three (15%) report having an official internal structure or officer specifically responsible for shareholder relations.

6) listed companies are expected to act as corporate citizens in the community and to conduct specific corporate social responsibility (CSR) initiatives (Section 12.3). In the Annual Reports, only 12 companies (60%) mentioned specific CSR initiatives which they conducted (philantropic causes, environmental protection, heritage, health, arts, culture and sports) while the other eight companies (40%) only reiterated their commitment without going into specifics or else did not acknowledge any CSR obligations. It is clear that

the CSR concept is still in its infancy in Malta and remains an unfamiliar notion to a relatively large segment of Maltese public listed companies.

7) The responsibilities of the Board include the setting up of an Audit Committee in terms of the Listing Rules – a mandatory requirement (Listing Authority - Malta, 2012, S5.117). In all companies, the Audit Committee was exclusively made up of directors, with the majority being non-executive, and chaired by a non - executive director. All companies except one (95%) met at least four times a year. Although all companies had an independent member whom they deemed as competent in accounting/auditing, this competence was not necessarily backed up by a qualification, with seven companies (35%) basing competence on experience rather than a professional qualification in the discipline. The analysis of reports provided evidence of long-term directorships and this brings up questions on the effective independence of such non-executive directors from management when serving on such an important governance committee. Two companies (10%) had their Chairman also occupying the role of Chairman of the Audit Committee. Although this is not prohibited by the Code, it is not allowed in the U.S. and maybe it is time to consider adopting the U.S. position the Code.

8) As regards the attendance of directors in Board meetings, the Code requires listed companies to report to the Annual General Meeting on the attendance to the Board meetings by directors (Section 5.4). One particular company failed to report on individual attendances to Board meetings, giving only an overall attendance of 83% for 2010 and stating that "the quality of contributions was more relevant than physical attendance". Is this an excuse to camouflage unsatisfactory attendance of some directors – especially directors representing important equity holdings?

9) The majority of divergences from the Code were not supported by valid or sufficient explanations. For instance, most listed companies which failed to conduct a performance evaluation of their Board simply claimed that their Board's performance was already under scrutiny of the shareholders. It is common knowledge that shareholders do not exercise effective control of Boards; this reasoning does not distinguish listed companies, where the need for stronger CG is mostly felt, from the rest. When individual emoluments of directors were not disclosed, either the explanations provided were vague (e.g. "we opted for aggregate disclosure") or else no explanation was attempted. It is clear that the level of explanations provided by Maltese listed companies in cases of non-compliance is insufficient and this could be attributed to the fact that there is no particular regulatory or auditing supervision on this aspect. This does not mean, however, that there is no effective regulatory role on CG since the MFSA does intervene in listed companies albeit discreetly, and more resolutely so, possibly even exercising sanctions in the case of licensed listed entities. In response to an EU Green paper (COM, 2011), the Maltese government agreed that monitoring bodies should be authorised to check the informative quality of explanations in the CG statements and to require companies to complete the explanations where necessary. It also recommended independent reports to be issued on the findings of these bodies.

10) As regards tenure, independence, multi-directorships and conflicts of interest, the Annual Reports provide evidence of directors who have been in office for 12,15, 18 and 19 years, and who form part or even chair the Audit Committee or the Remuneration Committee, and yet they continue to be considered as independent. Four companies have directors holding an appreciable amount of other mandates (concurrent directorships). It is doubtful how much time and effort such directors can dedicate to Board meetings and participate in various Board sub-committees. One company has

been noted to allow directors appointed by shareholders not to disclose an existing or potential conflict of interest, arising from a conflict between the company and the appointing shareholder, and even to participate in related discussions in the Board "provided they act honesty, in good faith, and always in the best interests of the company". However, the Code demands full disclosure of any conflict of interest and only then should the Board decide whether the director may participate or otherwise in the relevant discussion (Section 11.2).

4.2 The role of CEO and the management team in a governance relationship with the Board

In our analysis, only one company (5%) had a person occupying the dual role of Chairman and CEO. In 11 companies (55%), the CEO was part of the Board as an executive director, and of these, only one CEO was not a significant shareholder or did not previously work for a major shareholder. Out of the remaining 8 CEO directorships (40%), four CEOs were personally material shareholders, with three of these (15%) having a *de facto* controlling interest. These different scenarios present different shades of CEO and management influence of the Board, shareholders and stakeholders.

The Code recommends a mixed Board with an emphasis on independent non-executive directors to safeguard the independence of the Board from management influence and capture (MFSA, 2010, Section 3.2). Such influence will also depend on the dynamism or otherwise of the Board, on whether there exists an Executive Committee or even more, on whether the Executive Committee includes Board member participation. The combination of a small Board, no Executive Committee and a dominant CEO is bound to raise serious CG issues. In fact, 67% of the smaller Boards not exceeding six members, amongst which were three of the four information technology companies, did not have an Executive Committee. Such companies have been found to share the following common characteristics: CEOs who were at the same time executive directors, significant shareholders as well as technical experts whom the business did not afford to do without, this rendering them with unfettered powers of discretion in the company. Common symptoms of this situation are depressed share prices, no dividends and the non-disclosure of managerial remuneration packages. On the other hand, 75% of the larger companies and Boards typically had an Executive Committee which would invariably include executive directors and senior management. Questions arise when the Executive Committee is active and the Board relatively dormant. Is the Board being kept informed of the business progress? Is there disenfranchisement of the non-executive directors not forming part of the Executive Committee? It was found that some listed companies, amongst which some of the largest, had a functioning Executive Committee yet only held a few Board meetings during the year. A Board reduced to mere formality presents the danger of an increase in managerial control and/or majority shareholder dominance and interference.

4.3 The locus of corporate control

Major or substantial shareholders dominated most boards and management teams in Maltese listed companies with equity listed on the Malta Stock Exchange. In fact, out of the 20 companies investigated, nine (45%) had major shareholders with an excess of 50% interest and six other companies (30%) had smaller substantial shareholders owning between 30% and 50% of the company's share capital. Out of a total number of 146 board directors, 49 (33.5%) were directly appointed by significant shareholders and these were found in 13 different companies (65%). Notably also, while the other directors were elected at the Annual General Meeting (AGM), only 23 of them (15.8%) were found to be non-executive directors.

Another aspect reflecting corporate control relates to the proxy forms and their use in the AGM. In three of the largest companies quoted on the Malta Stock Exchange, the format of this form for use at the AGM differs significantly from the specimen proxy form in the Companies Act (1995) as well as that shown in the Companies' Articles of Association. It is often evident from such format that management has an interest in influencing as much as possible the outcome of shareholder voting – and this not only with respect to the election of directors. One particular company was quite forthright in this sense with the first option presented on the form being to appoint the Chairman of the AGM as the proxy and onus being placed on the shareholder to cross out this option for the other options to be considered. As a result, the protection of minority shareholders may be perceived as a material CG concern in these companies: in most cases, such Chairman preference results in undue managerial influence on the Board – and ultimately to the effective control of the major or substantial shareholder. Moreover, the proxy voting procedure itself may in various ways be open to manipulation by the listed companies such that major/substantial shareholders, or alternatively management, are easily placed in the unfairly privileged position to obtain control beyond their respective proportional holding or mandate. This is particularly relevant given also the commonly known inertia of small shareholders in participating in the AGM, this resulting in many such shareholders not exercising their voting rights. In addition to this, while the Code seeks to responsibilize institutional investors to act as a guiding light for other shareholders by making considered use of their votes, nothing prevents the institutional investors themselves from occasionally passing over proxy votes without specific voting instructions to the company Chairman particularly if so requested by him/her – this sealing the unfair domination of major shareholder and management.

5. Conclusion

5.1 Summary of major findings and limitations of the study

This study has identified various aspects of non-adherence by Maltese public listed companies to the current CG regulatory framework. The weakest aspects relate to a lack of professional evaluation of the Board's performance, the restricted disclosure of senior executives' remuneration packages, and a general insufficiency in the reasons disclosed for non-adherence to the Code. Other governance areas of concern are the low priority given by companies to shareholder relations and to CSR. In Malta, any influence of the management team mostly emanates from the direct link to the major shareholders (in some cases being the CEO's themselves). This may be due to the relatively small size of the island, the predominance of majority shareholders in public listed companies and the high percentage of directly appointed directors and management officials. The study determined that the dominant form of corporate control is exercised by the majority shareholders and this control is sometimes extended even beyond their proportional shareholding held through such means as manipulation of proxy measures exercised by listed companies before and during AGM's (particularly with respect to the election of directors).

However, some limitations to the above findings must be noted Firstly, there are some aspects in the Code that came into effect in 2011 (e.g., the establishment of a Nominations Committee) that could not be incorporated in this study when analysing the adherence to the Code based on the 2010 Annual Reports. Secondly, the findings and implications of this study, which is based in Malta, might not necessarily lend themselves to generalisation over other contexts, since different countries have unique economic, political and legal contexts.

5.2 Recommendations

In the light of the findings that emerged, recommendations are proposed as follows.

5.2.1 The need for harmonisation and integration

There are incongruendes and conflicts within the CG framework which need to be addressed. A harmonised and integration process of the various elements of the CG framework needs to be embarked upon. Moreover, the non-mandatory nature of the Code allows too much flexibility and options for the market players. We suggest that the framework is revised to increase the shareholders' confidence in the governance and control systems within Maltese listed companies.

5.2.2 Proposed changes to the CG framework

The proper disclosure of reasons for non-adherence with the CG framework calls for more involvement by the Regulator. Although adherence to the Code is discretionary, careful and comprehensive explanations for its non-adherence are to be made mandatory. Certain other measures recommended in the Code need to be made mandatory, given their importance and the fact that they are seldom being implemented. These include the following: (a) the Board's performance evaluation was not included in the revised Code and should be reinstated; to counteract for the sensitivity and difficulty of such an exercise, we recommend that companies are urged by the Code to involve external expert evaluators when deemed necessary to facilitate the process, (b) the current recommendation for aggregate disclosure of remuneration packages of directors and senior executives should be made mandatory so that shareholders benefit from improved transparency, particularly when their investments are not yielding the expected return; (c) in line with many countries around the world, including the U.S., when Maltese companies are listed, Company Chairman / CEO duality as well as Company Chairman / Audit Committee Chairman duality should not be permitted; (d) the independence criteria for tenure of directorships in listed companies should be shortened from 12 years, or, at least, a reduced time threshold could be applied to non-executive directors serving on Audit or Remuneration Committees; (e) the concurrent mandates held by directors of listed companies need to be limited to reflect the required amount of time and effort (in hours) depending on the size and complexity of the company; (f) the Board should acknowledge the importance of having diversity within it including gender; in this regard, the European Commission (COM, 2012b) has recently adopted gender quotas which would see women represent 40 per cent of non-executive Board member positions in public companies by 2018, with countries having the power to impose sanctions on firms that do not abide to this directive at the national level (Robinson, 2012).

5.2.3 Board activity minimum threshold

The Code proposes a minimum annual threshold of Board meetings for listed companies and that larger companies consider setting up an Executive Committee to help in the task of monitoring management. Where such a committee is set up, it would be appropriate to include adequate Board representation in the form of non-executive directors. The Code should urge the Board representatives to help in the setting up of clear terms of reference for the Executive Committee and to establish definite and periodic reporting lines to the whole Board.

5.2.4 Responsibilizing shareholder voting

The CG regulatory framework needs to introduce incentives to encourage shareholders to exercise their voting rights. In particular, the institutional investors are to be incentivised to make considered use of their votes for other shareholders to note and possibly follow. We recommend that institutional investors are obliged to disclose their voting strategy with proxies entrusted to them while shareholders of listed companies are not to be allowed to give their proxy vote without specific voting instructions.

5.2.5 More effective directors

Apart from induction training for directors of listed companies, we recommend that directors also undergo continuous personal development programmes throughout their tenure. Ideally, the training should include both technical and ethical modules. We also recommend that listed companies develop internal codes of conduct in line with CG principles for their directors and executives.

5.3 Suggestions for further research

During the course of this study, some interesting avenues for further research emerged. We suggest that an assessment of the strength of CG in different corporate scenarios is conducted particularly in (a) subsidiary companies with group executive management officials forming part of the Board of Directors; and (b) public listed companies with residual government interest and listed companies with foreign interest. It would be interesting to: (a) analyse how institutional investors may better live up to the expectations of the Code in serving as a guiding light to all shareholders; (b) to evaluate the effectiveness of the competent authorities in monitoring CG in listed companies; and (c) to investigate the role of auditors in reviewing CG in listed companies and their reporting scope. Finally, since Maltese companies are considered to be small by international standards, the question remains whether the CG framework is too draconian for compliance by Maltese companies. In fact, the Green paper on the EU CG Framework (COM, 2011) acknowledges that codes in some member states reflect company size and structure or contain provisions tailored to smaller companies. However, while the Maltese Government agreed that measures should take into account the size of listed companies on the basis of capitalisation, it did not approve for the establishment of a differentiated regime for SMEs as proposed in the Green paper. We believe that the possibility of introducing a differentiated CG regime for SMEs needs to be investigated further before any strong conclusions may be drawn.

5.4 Concluding note

Companies must understand the importance of adapting, strengthening and innovating their CG practices if they intend to remain competitive and to prosper in a changing world. Adherence to the CG regulatory framework should not be seen as the price for listing but rather as the means for achieving higher quality levels of performance for the benefit of all stakeholders. Furthermore, whilst CG is meant to become a corporate culture, this is hardly ever achieved solely through self-regulation and conviction. Changes therefore need to be made by the public authorities concerned to render CG more effective – an exercise which as Baldacchino (2007) emphasised will best be promoted by enhancing the quality rather than increasing the quantity of regulation.

Acknowledgements

All authors contributed equally to this paper.

References

Regulatory

Cabinet Office - Malta (1994). Code of ethics for board directors in the public sector. Malta: OPM.

Cadbury, A. (1992*). The financial aspects of corporate governance: A report of the committee on corporate governance* [Cadbury Report]. London: Gee and Co.

Companies Act - Malta, 1995. Chapter 386 of the laws of Malta.

European Commission (COM) (2011). Green Paper – The EU corporate governance framework. 5th April, 164 final – Brussels.

European Commission (COM) (2012a). Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions.

European Commission (COM) (2012b). Women on boards: Commission proposes 40% objective .Ref IP/12/1205 , November 11: http://europa.eu/rapid/press- release IP-l 2-1205_en.htm [11 November, 2012]

Financial Reporting Council (FRC) (2003). The combined code on corporate governance. London: FRC

Greenbury, R., 1995. *Directors' remuneration: Report of a study group chaired by Sir Richard Greenbury* .London: Gee Publishing.

Hampel, R. (1998). *Committee on corporate governance: Final report. London:* Gee Publishing.

Listing Authority - Malta (2012). Listing Rules: http://www.mfsa.com.mt/Files/LegislationRegulatiori/regulation/listingAuthorit}T/Listing /o20Rules%20 30.07.2012.pdf.[12 September, 2012].

Malta Financial Services Authority (MFSA) (2010). Code of Principles of Good Corporate Governance for Listed Entities: http://www.mfsa.com.mt/pages/viewcontent.aspx?id=365 [12 September, 2012].

Malta Financial Services Authority (2006). Corporate governance guidelines for public interest companies: http://www.mfsa.com.rnt/FHes/publications/Corporate%20Governance/FINAL0/o20and0/o20LAST%20 \TERSION%20-%20CG%20Guidelines%20for%20Public%20Interest%20C%E2%80%A6.pdf [12 November,2012].

Malta Stock Exchange (2001). Report of the working group on corporate governance: http://www.borzamalta.com.mt [12 June, 2012]

Organisation for Economic Cooperation and Development (OECD) (1999). *OECD Principles of Corporate Governa*nce. Paris: OECD Publishing.

Organisation for Economic Cooperation and Development (OECD) (2004). *OECD Principles of Corporate Governance*. Paris: OECD Publishing.

Higgs, D. (2003). *Review of the Rule and Effectiveness of Non-executive Directors*. London: DTI.

Institute of Chartered Accountants in England and Wales (ICAEW) (1999). *Internal Control - Guidance for Directors on the Combined Code* [Thurnbull Report]. London: ICAEW.

Sarbanes, P. (2002). Sarbanes-Oxley Act, 2002. In *The Public Company Accounting Reform and Investor Protection Act. Washington DC: US Congress*.

Smith, R. (2003). *Audit Committees Combined Code Guidance [Smith Report*]. London Financial Reporting Council.

Other

Baldacchino, P.J. (2007) [CG-1]. An EU-inspired corporate governance statement for Maltese listed companies: Boon or scourge? In: *Civil Society Report Business Ethics and Religious Values in the European Union and Malta - for a Moral Playing Field,* Xuereb, P.G.(ed). European Documentation and Research Centre, University of Malta, Malta: 161-167.

Ball, I. (2010). From conformance to performance: Linking governance, strategy and sustainability. In: *UNCTAD: Corporate Governance in the Wake of the Financial Crisis: Selected International View*. New York and Geneva: United Nations: Ch 7: 138-159

Berle, A.A. and Means, G.G.C. (1991). *The Modern Corporation and Private Property*. New Brunswick: Transaction Publishers..

Bowen, W.G. (2008). *The Board Book: An Insider's Guide for Directors and Trustees.* New York: W.W. Norton and Company Ltd.

Braun, M. and Sharma, A. (2007). Should the CEO also be chair of the board? An empirical examination of family-controlled public firms. *Family Business Review*, 20(2): 111-126.

Desai, A., Kroll, M. and Wright, P. (2003). CEO duality, board monitoring, and acquisition performance: A test of competing theories. *Journal of Business Strategies*, 20 (2):137-156.

Donaldson, L. and Davis, J.H. (1991). Stewardship theory or agency theory: CEO governance and shareholder returns. *Australian Journal of Management*, 16 (1): 49-64.

Douma, S. and Schreuder, H. (2013). *Economic Approaches to Organisations*. London: Pearson.

Falzon, J. (2011). An analysis of the productive sectors of the Maltese economy: A comparison with EU member states. In *Presentation held at The Malta Institute of Management National Economic Forum,* Malta, May*:* http://wwwjmaltamanagement.com/wp- content/uploads/2011 / 0 5 / executive summary2.pdf [June 2, 2012].

Filkenstein, S. and D' Aveni, R.A. (1994). CEO duality as a double-edged sword: How boards of directors balance entrenchment avoidance and unity of command. *The Academy of Management Journal*,37 (5):1079-1108.

Ganado and Associates (2011). Submission in response to the EC green paper on the EU corporate governance framework, 18 July: http: // ec-europa _eu/internal_ market/consultations / 2011 / corporate-governance - framework/individual - replies /ganado en.pdf [11 December, 2012].

Gower, L.C.B. and Davies, P. (2003). *The Principles of Modern Company Law.* London: Sweet and Maxwell.

Herman, E.S. (1981). *Corporate Control, Corporate Power.* Cambridge: Cambridge University Press, 98:1

Hofstetter, K. (2005*). One size does not fit all - corporate governance for controlled companies. NCJ Int'L. &Com. Reg. 31: 597*: http://dxdoLorg/10-2139/ssrn.802705 [12 June, 2012].

Keay, A. (2007). *Company Directors' Responsibilities to Creditors*. Oxon: Routledge-Cavendish, Mar 12.

Keay, A. (2008). Ascertaining the corporate objective: An entity maximisation and sustainability Model. *The Modern Law Review*, 71 (5): 663-698.

Keay, A. (2011). *The Corporate Objective* . Edward Elgar Publishing.

Mallin, C. (2007). The role of institutional investors in corporate governance. In: *Corporate Governance*, Mallin, C. (ed). Oxford: Oxford University Press: Ch 6: 80-100.

Muscat, A. (2007). *Principles of Maltese Company Law*. Malta: University Press.

NSO (2010). *Demographic Review 2009*. Malta: National Statistics Office.

Pettet, B.G. (2005). *Company Law*. Harlow: Pearson Education.

Robinson, F. (2012). Commission approves gender proposal. *The Wall Street Journal,* November 14: http://online.wsj.com/article/SB10001424127887324556304578118383366062000 -html [15 November,2012]

Russell, C. (2009). Clearly defining the roles of Board and CEO. *Third Sector Magazine,* April: 39.

Stout, L.A. (2012). The problem of corporate purpose. *Issues in Governance Studies,* 48:1-14.

Wolfensohn, J. (1999). Corporate governance is about promoting corporate fairness, transparency and accountability. *Financial Times*, 21st June.

Wu, X. (2005). Corporate governance and corruption: A cross-country analysis. *Governance: An International Journal of Policy, Administration, and Institutions*, 18 (2):151-170.

APPENDIX

List of Maltese Companies with Listed Equity (Excluding Collective Schemes) and Website from where the Annual Statements and Financial Reports 2010 were retrieved.

6pm Holdings p.l.c. Available at www.6pmplc.com.

Bank of Valletta plc. Available at www.bov.com.

Crimsonwing, p.l.c. Available at www.crimsonwing.com.

FIMBank p.l.c. Available at www.fimbank.com.

Global Capital, p.l.c. Available at www.globalcapital.com.mt

GO p.l.c. Available at www.go.com.mt

Grand Harbour Marina p.l.c. Available at: www.ghm.com.mt

HSBC Bank Malta p.l.c. Available at www.hsbc.com.mt.

International Hotel Investments p.l.c Available at www.ihiplc.com.

Island Hotels Group Holdings p.l.c . Available at www.islandhotels.com.

Lombard Bank Malta p.l.c. Available at wwwlombardmalta.com.

Loqus Holdings p.l.c . Available at: www.datatrak.it.

Malta International Airport p.l.c. Available at www.maltairportcom.

MaltaPost p.l.c . Available at www.maltapostcom.

Medserv p.l.c . Available at wuw.medservmaita.com.

Middlesea Insurance p.l.c . Available at www.middlesea.com.

MIDI p.l.c Available at www.midimalta.com.

Plaza Centres p.l.c . Available at www.plaza-shopping.com.

RS2 Software p.l.c . Available at www.rs2.com.

Simonds Farsons Cisk p.l.c Available at www.farsons.com.

CHAPTER 14

Assessing the Applicability of a Corporate Governance Index in Maltese Listed Entities

[CG-5]

Baldacchino, P.J.*[1], Baldacchino, J.[2], Bezzina[3], F.H. and Tipurić, D.

International Journal of Transitions and Innovation Systems

Vol 4, Issues 1/2, 2015, pp. 43 - 64

This paper is a revised and expanded version of a paper entitled "Assessing the Applicability of a corporate governance index in Maltese listed entities' presented at the 3rd International OFEL Conference on Governance, Management and Entrepreneurship, Dubrovnik , Croatia, 17-18 April 2015.

*Corresponding Author

[1] Head, Department of Accountancy, Faculty of Economics, Management and Accountancy, University of Malta, Malta

[2] Audit Associate, Ernst & Young (Malta), Malta

[3] Head, Department of Management, University of Malta, Malta

[4] Head, Department of Organisation and Management, University of Zagreb, Croatia

Assessing the applicability of a corporate governance index in Maltese listed entities

Baldacchino, P.J.[1], Baldacchino, J.[2], Bezzina, F.L.[1] and Tipurić, D.[3]

[1]University of Malta, [2] Ernst & Young (Malta) and [3]University of Zagreb

This paper sets out to establish to what extent, if any, a corporate governance index (CGI) is suitable and applicable to Maltese listed entities (MLEs). Two sets of semi-structured interviews were held with seven financial analysts and 13 MLEs. This was followed by a CGI survey sent to the same MLEs previously interviewed and an analysis of their Annual Reports for the three-year period 2011-2013. A CGI model purposely designed for the present study was then tested on two MLEs. Findings show that corporate governance in Malta is not given appropriate importance by MLEs. Yet respondents agreed to CGI introduction in order to improve current CG practices. The study goes on to assess the impact, benefits and limitations of such a CGI in Malta and provides feasible recommendations which may help towards the consolidation of corporate governance in MLEs.

Keywords: *corporate governance, corporate governance index, CGI, attributes, listed entities, financial analysts, Malta*

1. Introduction

Several recent corporate collapses, such as Arthur Andersen and Parmalat, were the result of bad corporate governance (CG) and one direct consequence of this is that, as time went by, CG has become increasingly important (Khanchel, 2007). Various CG definitions exist but they usually refer to "the system by which companies are directed and controlled" (Cadbury,1992, p.15). CG has been promoted with the aid of codes that encouraged public companies to have a proper CG structure (ECGI, 2006). The Maltese Code of Good Corporate Governance for Listed Entities (the Code) was introduced in 2001, with revisions in 2005 and 2011 (MFSA, 2011). In its latest revision, the "comply or explain" type of code together with the "non-compliance section" became mandatory. Since then, Maltese listed entities (MLEs) have had to provide reasonable explanations for non-compliance with any particular principle or provision in the Code (Bezzina *et al*., 2012). Notably, in the case of Malta, there is no legal obligation for listed entities to disclose in their Annual Report the assurance that reflects CG quality. This is clarified by the auditors themselves as in the report they explicitly state that they are not required to perform any additional work as regards CG effectiveness. However, such a position has certain limitations, as it is a very simplistic requirement based on simple disclosures (Gower and Davies, 2003). CG codes have been looking too generous for companies in just answering 'yes' or 'no' and giving explanations, where such explanations frequently lack certain details (Medland, 2013).

As a result, various countries have felt the need to depart from the code of best practice by taking "a quantitative evaluation approach" (Strenger, 2004, p.11) and providing a measurement capable of showing the quality level of CG whilst simultaneously reflecting its efficiency and effectiveness. This is usually referred to as a corporate governance index (CGI), being an independent opinion based on transparent measures and a standardised analytical process assisting interested parties in clearly analysing relevant characteristics of good CG (Standard and

Poor's, 2004; Strenger, 2004). Bhagat *et al.* (2008) referred to the CGI as a standard with the aim to benchmark an entity's governance characteristics against what is considered to be best practice by its provider. In response to this, a number of organisations have been offering CGIs so as to reflect governance quality and performance of listed companies (Schnyder, 2012).

Every country has its own approach to constructing the CGI by tackling different governance areas that include particular governance attributes. Given that in Malta there is as yet no such index, this study examines whether such an index is applicable and useful to Maltese investors. Malta is a small island state situated in the centre of the Mediterranean and has only 21 companies with listed equity (excluding collective schemes). A Maltese CGI may equip investors to answer questions concerning governance performance through a more efficient and effective process. Thus, the objective of this paper is to establish the extent to which, if in any way, a CGI is suitable and applicable to Maltese listed companies (MLEs). For this purpose, it will:

1 assess the needs and attitudes towards CG measurement in MLEs and determine the entity that may be responsible for providing and assessing the CGI in Malta.

2 ascertain the construction of an MLE index including its attributes and its benchmarking.

3 test our constructed CGI on two MLEs by assessing its impact, benefits and limitations.

The paper will conclude by providing particular recommendations, particularly which of the CGI models being proposed may help towards the consolidation of CG in MLEs.

2. Literature review

2.1 The CGI provision

CGIs were introduced by parties interested in the field of CG. Normally, such CGIs were specifically built to cater for the needs of a particular market. Two examples of academically constructed CGIs are the LLSV index which caters for 49 countries and the G-index, both built to be used in the USA (La Porta *et al.,* 1998; Gompers *et a*l., 2003). As time went by, commercial CGIs were becoming an established product of most credit-rating agencies while new specific governance-rating agencies were then purposely born for providing this service (Balling *et al.,* 2005). Unlike academic providers, commercial CGI providers had the ability to look beyond country borders and thus derive more meaningful comparisons in governance practice (Aguilera and Desender, 2012). Moreover, such providers were better equipped in the market especially owing to their ability to easily access company records (Schnyder, 2012).

Yet, a study conducted by the Stanford Law and Business Faculty in California showed that commercial CGI's are not as credible as they seem (Snyder, 2009). Daines *et al.* (2010, p.46) also argued that such CGIs "have either limited or no success in predicting firm performance or other outcomes to shareholders". Although usually based on the same publicly disclosed information, differently constructed CGIs were found to be little correlated and differing considerably (Daines *et al*. 2010). Moreover, Snyder (2009) found serious negative correlations in CGI results provided by rating agencies, with better performance being achieved by weak CG. Such conflicting results were due to either different CGI construction methods being used or to measurement errors being incurred (Daines *et al*., 2010; Snyder, 2009). Furthermore, Schnyder (2012, p.5) argued that rating agencies usually use "the kitchen-sink-approach to index construction" by including many index elements of limited use rather than focusing on the important ones, this resulting in a score misrepresenting the entity's governance performance. Additionally, conflicts of interest and independence between CGI providers and assessors required high attention so as not to get results compromised (IOSCO, 2004).

Three world-renowned CGI providers are Institutional Shareholder Services (ISS), Governance Metrics International (GMI) and S&P's. The former two are governance rating agencies founded in 2002 and 2000 respectively and the latter was founded in 2002 with a new CGI department.

2.2 The CGI model

In their CG Score paper, Standard and Poor's (2004) argued that different countries and companies require specific CGI models owing to market need differentials. Various studies also acknowledged the fact that a number of constructed CGIs are based entirely on their respective national CG codes (Grimminger and Di Benedetta, 2013; Khiari *et al*., 2007; Spanos *et al.,* 2006). If a CGI is based exclusively on the CG code, the index strength will be equal to the strength of the code itself, implying that if such code is being deficient in certain criteria, so will the CGI (Grimminger and Di Benedetta, 2013). Additionally, Khanchel (2007) as well as Martynova and Renneboog (2010) highlighted that CGIs based on national codes might quickly turn obsolete because CG codes are usually left outdated with respect to current market changes. It was thus determined that the elements of the index should go beyond this, leaving the CGI open to adjustments – reflecting, say, more international aspects rendering it more globally convergent (Martynova and Renneboog, 2010; Grimminger and Di Benedetta, 2013). A case in point was the initiative taken by the ISS (2014) to construct a new CGI with the aim "to compare companies within global portfolios using a single index" [Brown, (2004), p.3].

Six most common governance areas emerging from various academic and commercial CGIs are board of director structure, director remuneration, ownership structure, shareholder rights, audit committee and process and transparency and disclosure. We note below a selection of attributes under each area indicating why each is so important for the construction of the CGI.

a. Board structure: a bigger board reduces likelihood of inactivity and delays (Kim *et al*., 2010); the higher the presence of non-executive directors, the better the results (Khanchel, 2007); the presence of a non-executive majority with a non-executive chairman ensures higher independence (Bezzina *et al*., 2012); frequency of meetings is an important determinant of effectiveness (Albert-Roulhac, 2008; ISS, 2014); the more experienced the board, the more effective (Kim *et al.* 2010); CEO/Chairman duality might lead to abuse of power (Sarkar *et al.,* 2012); and a CEO serving more than one company could dedicate less attention (Piatt and Piatt, 2012).
b. Director remuneration: the more appropriate the remuneration committee and its policies, the more probable the attractiveness and adequacy of remuneration (Listing Authority - Malta, 2013); performance-based remuneration could promote higher director's incentives (Mallin, 2004); and fixed/variable segregation of remuneration could result in more verifiability (Bezzina *et al*., 2012; Barrett *et al*., 2004).
c. Ownership structure: institutional shareholders lead to agency cost minimisation and pressure for better director decisions (Bezzina *et al*., 2012; Sarkar *et al.*, 2012); minority shareholder safeguards could minimise expropriation problems (Guedes and Loureiro, 2007; Standard and Poor's, 2004); and director or employee shareholding could promote goal congruence (Noamene and Hassairi, 2012).
d. Shareholder rights: fairness requires one-share-one-vote adoption (Martynova and Renneboog, 2010); proxy rights could lead to higher AGM participation (Listing Authority - Malta, 2013); adequate AGM attendance could depend on timely notification (Listing Authority - Malta 2013); an appropriate shareholding threshold to call an AGM

encourages shareholder activism (Listing Authority-Malta, 2013); shareholder representation could highlight shareholder's say (Listing Authority – Malta, 2013); and dividend policy disclosure would help regularise returns and diminish problems (Standard and Poor's, 2004).

e. Audit committee (AC) and process: non-executive directors on the AC are a means towards more independence (Mallin, 2004); adequacy of meeting frequency and attendance is important for the proper function of the AC (Listing Authority Malta 2013); the shorter the lifespan, the more independent is the AC (Mallin, 2004); internal auditing could improve internal controls (Spencer Pickett, 2011); predetermined auditor rotation could enhance audit independence (Sarkar *et al.,* 2012); and non-audit services by the statutory auditor could compromise independence (Sarkar *et a*l., 2012).

f. Transparency and disclosure: International Financial Reporting Standard (IFRS) adherence and timeliness would ensure true and fair financial statements (Standard and Poor's, 2004); proper board remuneration disclosure could lead to higher transparency (Bezzina *et al*., 2012); sufficient non-financial information promotes information on company's prospects (Standard and Poor's, 2004); up-to-date online information enhances understanding (Listing Authority - Malta, 2013); the risk of excessive information could be minimised with proper data safeguards (Choi and Sami, 2012); and access to relevant company data including trends and targets reflects higher transparency (Standard and Poor's, 2004).

2.3 CGI construction and presentation considerations

When selecting attributes, one has to be careful not to omit important ones (Balling *et al.* 2005) as this would contribute to an index bias (Schnyder, 2012). Selection is not easy to perform as the choice of areas and attributes is highly subjective, resulting in a common construction limitation (Mostafa, 2012).

Furthermore, Balling *et al.* (2005) attributed the considerable variation in the selection of attributes from one CGI to another to the lack of theoretical basis in the identification of the governance criteria. Indeed, Schnyder (2012) concluded that a simpler index has more predictive power, being less complex and subjective. Another debate in this respect concerned the use of weightings. In a weighted CGI, the selection of weightings was found to be crucial as it was very subjective and difficult where such selection depended on the judgment of the rating provider (Spanos *et al.*, 2006). Balling *et al.* (2005) stated that when weightings are applied, information is used better. Indeed, the use of weightings seems to be more beneficial, reflecting the importance of certain governance areas in the light of "public accountability and transparency" (Mostafa, 2012, p.11). Conversely, Sarkar *et al.* (2012) argued that equal weightings have the advantage of avoiding complexity and bias as all attributes are treated equally. Both the selection of attributes and the choice of weightings could therefore hinder CGI comparability between countries and companies (Khiari *et al.*, 2007).

Nonetheless, an appropriate CGI benchmark should be constructed for a selected number of companies through various information sources (Mostafa, 2012). This should be a guide for companies to target for and operate around (Khanchel, 2007). Typically, benchmark information would be that publicly available, mainly from Annual Reports, company websites, stock exchanges, press releases and company prospectuses (Barrett *et al.*, 2004; Grimminger and Di Benedetta, 2013). The advantage of using such information was more transparency and comparability among entities in view of its easier verifiability (Spanos *et al.*, 2006). In contrast, Ramlal (2009) highlighted those studies using surveys with company personnel as a source of information. Indeed, Hodgson *et al.* (2011) found that both questionnaires and public information were in use. However, according to Ananchotikul (2008), the survey method on its own is unreliable as there is a higher risk of having biased or poor responses.

As for presentation, the CGI is either a percentage score – with 100% indicating sublime governance practice (Strenger, 2004) – or in a ranking scale ranging between 'X' and 'Y' representing very poor and excellent governance performance in their extremes. As for location of disclosure, Mostafa (2012) stated that the Annual Report should be the ideal place because it was the most suitable medium to contain all relevant information in one place – rendering its use highly reliable.

However, some prefer to disclose only up to a certain level of detail regarding CGI criteria and methodologies used (Grimminger and Di Benedetta, 2013). Moreover, it was found that when the index criteria and methodology are disclosed by the rating provider, accessibility was very limited. Companies were also found to avoid disclosing low rating scores in order to avoid a bad press (Brown, 2004). Such avoidance was found to affect the degree of usage of the CGI (Stren ger, 2004). The more information is disclosed, the more meaning could be attained from the CGI (Grimminger and Di Benedetta, 2013).

2.4 The perception and influence of a CGI

A CGI affects the way directors and stakeholders look at CG. On the one hand, if it indicates problems, such an index will quickly lead to director action (Hermanson, 2004), and so it incentivises them to perform better (Khanchel, 2007), making the organization more attractive (Daines *et al.*, 2010). On the other hand, a CGI promotes transparency and stakeholder awareness about the expected director performance (Hermanson, 2004), enhancing confidence that "the business is well managed and will continue to be profitable" (Mallin, 2004, p.1). Consequently, an index would be convenient for investors in picking the best governed entities (Sarkar *et al.*, 2012), helping in manoeuvring investment decisions in promising markets, and avoiding high risk companies (Grimminger and Di Benedetta, 2013; Khanchel, 2007).

Durnev and Kim (2005) verified that company valuation is sensitive to its CGI: companies that achieved a higher governance score tended to be valued higher, particularly in large dynamic markets or in those with a poor legal framework. A slight increase in the CGI score would reflect into a short-run positive share price effect (Durnev and Kim, 2005; Walker, 2013). Additionally, within a weak legal system, there is more investor appreciation of the CGI as clearly not everyone would be on equal footing and a higher CGI would possibly enable better access to capital and growth opportunities (Grimminger and Di Benedetta, 2013).

Yet, a company's CGI should not be used on its own but complemented by other factors, including the verification of the corporate strengths and weaknesses to help it develop the ideal network within which to operate (Khanchel, 2007). Additionally, Sarkar *et al.* (2012) claimed that the market should be left alone in dictating the pace for companies to carry out governance improvements at the appropriate time, this implying that a CGI should not be legally imposed.

3. Method

As stated earlier, the main objectives of this paper are to construct a CGI for Malta and to establish the extent to which, if in any way, our CGI is suitable and applicable to MLEs. The MLEs targeted were 21 and included only those entities capable of issuing share capital on the stock exchange and hence those entities that provided only debt securities were excluded. The major Maltese financial services firms involved in dealing and advising on local securities were approached to give their views on the subject.

Empirical data came from three sources: semi-structured interviews, the Annual Reports of listed companies and the CGI survey. For the semi-structured interviews, we targeted all 21 MLEs but eight of them did not grant us permission to interview one member of the Board of Directors (the Board), resulting in 13 interviews. Similar interviews were also conducted with seven financial advisors/analysts in different financial services firms in Malta. The questionnaire comprised six sections and 25 questions; Section 1 focused on the needs and attitudes towards CG measurements, Section 2 on the CGI provider and assessor, Section 3 on the CGI model. Section 4 on the CGI presentation and disclosure, Section 5 on the impact of the CGI and Section 6 on concluding considerations. This source was chosen as it provided more opportunities for flexible and informal interactions and probing was used to provide more detailed explanations in the responses. The second source was the 2011-2013 Annual Reports, where we conducted an analysis of the 13 MLEs, including online company data of the MSE listed entities, with specific reference to the "CG Statement of Compliance". This information was necessary to test current adherence to the Code. The 2013 Annual Reports were also used for both the construction of the CGI benchmark and CGI test. Finally, the third source involved a CGI survey that required MLE representatives (MLE reps) to react to 33 CG attributes in the four selected areas.

The data recording and analysis consisted of first transcribing and summarising each interview. For the selection of attributes, a reduction process identified by Mostafa (2012) was used as to verify their importance. This consisted of an ascending rating scale of 1 to 3 where '1' represented low importance, '2' fair importance and '3' high importance. Then the data obtained through Annual Reports and CGI survey was analysed through the use of "retained measures" being: numerical measurements (absolute or percentage numbers 0-100); 'yes' or 'no' measurements (1 = positive , 0.5 = both and 0 = negative); and Likert-type measurements ranging from 1 = lowest to 10 = highest.

For setting the CGI benchmark, measures of central tendency (median) and spread (minimum and maximum) were calculated for each attribute. The median attribute scores were then normalised using the following formula: (median - minimum) / (maximum - minimum), thus bringing the resulting scores between 0 and 1. Furthermore, CG area weightings were applied to the total attribute score of each area by the multiplication of the average applicable CGI weightings for Malta as found in Appendix 1. This contributed to a weighted sub-index for each CG area. The CGI final benchmark score for each MLE was then determined by adding all the weighted sub-indices to attain a final CGI of 100%. The CGI as compiled above was applied for Company X (CoX) and Company Y (CoY) using the actual company data for 2013, then compared with the CGI benchmark to determine the CG position of each company.

4. Findings and discussion

4.1 Needs and attitudes towards CG measures in Malta

The analysis revealed different views between MLE reps and analysts towards CG practices. MLE reps foresaw no added benefit in such reporting - they may be adhering to the Code simply because they are forced to do so by the listing rules. Reconfirming this was the lack of detail and soundness of certain non-compliance explanations observed in the CG Statement of Compliance of the participating 13 MLEs. These mainly related to shareholder conflicts, the absence of the Nominations Committee and the lack of board performance evaluation. On the contrary, analysts found proper CG reporting as an indication of better accountability and transparency, highlighting the impending need to address the several CG defaults of MLEs. These included the lack of transparency of board members, a lack of communication on board meeting outcomes and conflicts of interest.

MLE rep attitude therefore indicated resistance to CG progress. Going for better disclosures was not a priority for nine of them, who referred to the need for simpler statements or for competition issues as the grounds for their stance. Nonetheless, both groups declared that they were not against a CGI as such as they saw it as an opportunity to improve CG. The main concern of MLE reps was that the effectiveness of such a CGI could be easily hampered by the inadequate size of the Maltese Stock Exchange, with companies in varying industries, this implying that no standard CGI could be suitable to all companies. Moreover, three MLE reps pointed out that, prior to CGI application, the market needed to be made aware and knowledgeable about the index, particularly because stakeholder acceptance to it was as yet questionable. Some MLE reps also feared that a CGI might be overrated by their investors, to the detriment of other factors such as future financial prospects.

Respondents indicated the need for the CGI to be constructed in Malta but to be modelled on international practices. In this respect, 7 MLE reps and all analysts believed that Malta should opt for an index which has already been tried and tested abroad, but tweaked to fit the Maltese environment.

4.2 The CGI provider and assessor in Malta

The MFSA, as regulator, was seen as the body best placed to be involved in the different steps of the CGI implementation: for constructing or appointing the body responsible for constructing, and also for assessing, the index. Two financial analysts pointed out that, as a body already experienced in the local sector, the MFSA would not only fit such a role but also be cost efficient; also that for such a structure to succeed, it is to be composed of separate in-house committees or segregated departments within the MFSA, each being independently responsible for the different CGI stages so as to keep each stage autonomous. However, most interviewees indicated the need to consider also the alternative of appointing a private CGI provider, subject to the continuous monitoring of the regulator. A dilemma in fact remained as to whether to opt for a foreign credit-rating agency rather than the MFSA in the provision and assessment of the CGI. While credit-rating agencies may be more reputable in providing rating, the MFSA benefits from its specialised expertise in CG. Three analysts emphasised that the assessor needed to be free from any fear of potential liability resulting from any consequent adverse effect on company share performance, and that, as a government agency, the MFSA would therefore be stronger for this function. Additionally, three other financial analysts referred to the possible risk of manipulation in the case of a foreign-rating agency being appointed: other rating agencies may try to enter the market to compete, with fees being possibly manipulated for the sake of client engagement.

Furthermore, six MLE representatives and one analyst favoured the possibility of making the CGI a self-assessment exercise as is done with the current Statement of Compliance. However, with self-assessment, both real and apparent independence are threatened unless this exercise is also reliably reviewed. Indeed, index review is considered by respondents to be beneficial in any case, even if the MFSA is chosen to perform the functions of the CGI: in the latter situation, the dilemma only remains whether one should opt for the statutory auditor or else for another reviewer, perhaps a CG specialist.

However, independently of which bodies are ultimately involved, the MFSA as regulator is to remain a watchdog over the entire CGI framework as this will facilitate any required sanctions for misconduct.

4.3 The Maltese CGI playing field

The Code could be the departing point of the CGI. If this option is taken up, initial costs are minimised. Yet, respondents preferred a CGI to be based on an international model like the OECD (2004) one as this is a more comprehensive model benefitting from a harmonised CGI – one capable of including most international developments and minimising the number of unaddressed issues. Nonetheless, index modifications were still considered necessary in order to make the CGI more flexible to meet current changes. Yet, those opting for the adoption of the Maltese Code pointed out that such adjustments may be costly and confusing to the local market.

The next step in construction concerns the selection of governance areas and attributes. Such selection was left to the respondents and it emerged that the four most important CG areas to be included in the CGI for Malta were: board of director structure, transparency and disclosure, audit committee and process, and shareholder rights. With respect to such areas, the respective attributes were then selected with the aid of the ascending l-to-3 rating scale referred to earlier. The least-rated attributes were then eliminated so that that only 65% of the original ones were retained. Appendix 2 lists these selected attributes under the respective governance area. Thus, with the inclusion of four governance areas and the limited number of attributes in each area, the CGI was meant to be easier to adopt. Governance areas were also weighted according to respondent preferences (Appendix 1) so that the relative importance of each selected area would be taken into account. However, in order to retain index simplicity, the selected attributes were retained with equal weighting (Sarkar *et al.*, 2012).

Some interviewees (two MLE reps and one analyst) highlighted that most information should be obtained from the public domain for the sake of transparency, thus also facilitating its verification. Accordingly, wherever possible, in the construction of the CGI benchmark for MLEs from derived sources, referencing was only made to non-public information when such information was not available. Yet, using such mixed sources of information had its clear advantages, providing the necessary insights and explanations.

The relevance of the CGI probably depends mostly on the CGI benchmark. The mathematical reliability of such a benchmark and its capacity to distinguish between acceptable and inacceptable practices are crucial. In this case, simple descriptive statistics was used based on three types of retained measures, as already referred to in Section 3. The absolute benchmark and the normalised benchmark figures are shown near each attribute in Appendix 2. Each normalised attribute was assigned a score of 1 reflecting best practice that is expected from each attribute. In this respect, an argument relates to the relevance of the average benchmark figures in reflecting best practice. The average may be a clear pointer to the norms in those particular attributes, though not necessarily to best practice. However, the law may allow a different value to the attribute. A relevant example here is the "time to file financial statements with the regulatory body". The law (Listing Authority - Malta, 2013) allows 120 days as maximum while the benchmark being adopted is 87 days. Probably, the law is materially out of sync with current practice rather than the benchmarks not being in themselves best practice.

4.4 The CGI preview

Most respondents (9 MLE reps and 7 analysts) were in favour of the disclosure of a sub-index score for each CG area. This was found to contribute to the support of the final CGI result by the specification of the different areas. Final scores in isolation may easily be misleading and will make sense provided that investors do actually note sub-index scores. Furthermore, CGI users are probably not so sensitive to the type of CGI scores selected – whether a percentage or a scale – as, irrespective of the type, the major question remains whether such scores are high or low. Response was in fact inconclusive in this regard. Therefore, while percentage scores were adopted in this study, the parties involved with the CGI might still need to delve more into the matter.

CGI criteria and methodology were found to depend on the market size, the market need for this information and the scope of the CGI itself. Six MLE reps and six analysts agreed to disclose both CGI criteria and methodology as this may help improve CGI analysis. Yet, as two MLE reps emphasised, when taking into account the size of the Maltese market, it may be unnecessary for MLEs to disclose the CGI methodology as this would probably be common to all listed companies. Nonetheless, this possibility may not eliminate particular disclosures owing to, say, changes in the size and nature of companies.

Regarding CGI access, respondents agreed that a CGI should be publicly disclosed given that such companies are PIEs and most information sources are public. Yet, it is shareholders and their analysts who are probably most interested in the CGI. This clearly makes the Annual Report a possible medium in which CGI results are disclosed, with the advantage of information being easily retrievable. However, the online disclosure of the CGI on its own or in an alternative location was also agreed to so as to attract more attention to it. Moreover, most respondents (9 MLE reps and 6 analysts) were after a compulsory CGI so as to ensure universal MLE adoption.

4.5 The possible CGI influences in Malta

With the exception of one MLE rep, all respondents agreed that the CGI would leave great impact on the CG Statement of Compliance as it will boost shareholder interest in it. Yet, the CGI remains mostly relevant for the majority shareholders, who are probably following developments in this area in any case. Moreover, the CGI was seen to be positively correlated with both company reputation and gearing. Better CGI scores are seen as an indication of good directorship, rendering suppliers of capital increasingly confident in doing business with an MLE. Regarding the CGI impact on MLE share prices, most respondents commented that the CGI level reflects investment soundness – thus affecting share price changes and probably also the cost of capital. However, two analysts claimed that such price impact is not that possible in Malta given the slow trading activity in most listed shares.

Yet, irrespective of such impacts, 10 MLE reps agreed that cost would be a major issue for MLEs in adopting the CGI. They already have enough compliance obligations, and the CGI obligations may be seen as comparable to those of another audit. Conversely, the others argued that costs will not be an issue if the CGI is simple and compliance to it remains very similar to that of the Maltese

Code. Nonetheless, doubt clearly lingered, particularly among most MLE's, as to whether it was worthwhile investing in a CGI involving new compliance costs.

Furthermore, as for index applicability, analysts indicated that the CGI could prove to be useful also to entities listing in debt securities only. At a later stage, one may therefore consider introducing the CGI for adoption by such companies.

4.6 CGI test application on two MLEs

The CGI was then tested on two approximately equally-sized listed companies within the same industry. Table C1 in Appendix 3 illustrates such testing on two MLEs with respect to the Board Structure area. The following summarises the results found per area.

4.6.1 Board structure index

Both companies were rewarded with benchmark scores for separating the roles of the Chairman and CEO. However, none received any scores as the CEOs and the Chairpersons served on other boards.

For the other attributes in this area, different scores were attained. In both companies, Board size composition exceeded the benchmark and as a result the CGI gave an excess credit. Company Y (CoY) was abiding with the accepted mix of directors and achieved the benchmark scores. However, Company X (CoX) was entirely composed of non-executive directors. For this attribute, the CGI awarded CoX a score greater than "1", reflecting the incentive to have a totally independent board. Furthermore, both companies were penalised for the lack of directors' experience – in both cases this was below the benchmark (six and ten years respectively).

More significant differences were observed in the number of board meetings and the percentage attendance. CoX was rewarded for holding 24 meetings while

CoY was penalised for holding only four meetings. Moreover, CoX board members attended 79% of such meetings whereas CoY's registered attendance stood at 92%, results indicating that both companies needed improvement.

4.6.2 Transparency and disclosure index

Full benchmark scores were assigned to both entities in disclosing proper accounting standards and policies, in presenting remuneration disclosures including a remuneration report and for handling sensitive information. Conversely, no scores were received by either company as they did not permit shareholder access to company records.

The CGI of both companies were equally affected by their disclosure efficiency, tested through the time they usually take (120 days each) to file financial statements with the regulator. CoY was assigned full benchmark scores for sufficiently disclosing non-financial information and for the frequent update of its website. On the other hand, CoX received a lower score as it was less forthcoming about such disclosures and updating its website. Furthermore, CoY was disclosing performance benchmarks together with trends and targets to stakeholders, while CoX was not doing so. As a result, CoY was accredited with twice the score of CoX, the sub-index indicating that CoY was stronger in its transparency and disclosures.

4.6.3 Audit committee and process index

The structure of both audit committees was as required by the listing rules (Listing Authority - Malta, 2013), consisting of three members, all non-executive directors. Such Audit Committee members attended all 2013 meetings. Moreover, the audit reports of both companies in the previous 10 years were unqualified and both had an internal auditor. For such attributes, both companies received the benchmark scores. However, they had not performed auditor rotation in the previous ten years and therefore lost the relevant scores. They also lost further scores for engaging the statutory auditor for non-audit services.

CoY received the benchmark scores for conducting the monthly monitoring and review of internal procedures, while CoX was awarded twice the standard credits for performing such functions twice monthly. Furthermore, CoY determined the life span of an Audit Committee cycle which was that of one year. CoX did not establish this and was therefore not awarded with any score for such attribute. As for Audit Committee meetings, CoX had held nine meetings as against the four meetings held by CoY. This was the main attribute that inflated this sub-index for CoX.

4.6.4 Shareholder rights index

Both entities achieved almost similar sub-index results in this area where most attributes received full scores. Indeed, both companies attained benchmark scores for four attributes, namely: "Adoption of the one-share-one-vote principle", "AGM shareholder attending records kept", "dividend policy in place and disclosed" and "proxy arrangements in place and disclosed". Moreover, unlike CoX, CoY also gained the full scores by having an internal shareholder representative. Differences from the benchmark were noted in the other attributes. Both entities notify shareholders 21 days before an AGM in accordance with the law. Moreover, shareholders may call an AGM if they possess a 10% threshold, which is lower than the 19% legally required. Both companies varied in their scores from the benchmark for these two attributes.

These results were then weighted with the average applicable CGI weightings presented in Appendix 1 to achieve the sub-index results which ultimately contributed to the final CGIs. Such CGIs were of 91.87% for CoX and 80.12% for CoY (see Table C2 in Appendix 3. CoX outperforms CoY in the Board Structure and Audit Committee and Process, while CoY outperforms CoX in

Transparency and Disclosure and Shareholder Rights, Thus, the CGI user may not only conclude that, as per the overall index, CoX is somewhat superior to CoY in CG practice, but perhaps even more significantly that, as per the sub-indices, while CoX tends to be more compliance-oriented, CoY tends to be more shareholder-oriented.

4.7 CGI benefits and limitations

Benefits and limitations of adopting a CGI in Malta emerged as follows.

4.7.1 Benefits

One benefit is that the CGI challenges the Board towards improving CG practices. In this connection, four MLE reps noted that this challenge would probably lead to enhanced Boardroom professionalism. Furthermore, with the CGI, directors will probably become more accountable to the annual general meeting. More transparency and responsiveness to shareholder queries will be expected, this rendering the general meetings more meaningful, with proceedings going seriously beyond bottom-line figures. In other words, the CGI could help minimise the prevailing asymmetry of information in this fundamental principal/agent relationship. Additionally, the CGI is cost-beneficial. Its construction exercise is simple enough, and also relatively inexpensive. Furthermore, quantifying a CG deficiency against a benchmark renders it easier and quicker to notice, monitor and correct.

4.7.2 Limitations

A limitation in the application of the CGI, as pointed out by three analysts, is the attitude towards change in Maltese businesses: given their small-island state culture, businesses have a strong tendency to resist change at initiation stage. In referring to the resistance to change with respect to CG, Baldacchino (2011) highlighted the "cold-hot phenomenon", a stronger resistance at initiation stage though a much weaker resistance at later stages. Resistance may be even more pronounced in this case of a new measure to be presented to an already overcrowded regulatory regime. In applying CGI, another issue which may arise when companies differ in size and industry is that such companies may have different needs. The proposed CGI benchmarks assume that companies are circa the same size and industry and such benchmarks are somewhat ineffective if this is not so. This implies that these benchmarks are most reliable either in intrafirm comparisons or limitedly in interfirm comparisons with companies of the same size and industry.

A further limitation relates to the relevance of the selected attributes and the weightings being applied. The perceptions of what is important may change both by person and over time and are often difficult to substantiate objectively. This leads to a somewhat subjective selection where certain companies may be judged on not-so-relevant attributes, with more useful others being ignored. Related to this, the interpretation of CGI scores may easily be misleading. A higher score may reflect superlative practice in that attribute, meaning extra credits for the company. Yet, excessive attribute scores may not necessarily reflect proper practices. Indeed, companies may be tempted to improve their index position by overdoing in attributes which do not result in extra corporate benefits and even to the detriment of significant priorities. This might actually result in a disservice to CGI users. Moreover, index reliability is hard to check if the score is based on information that is not all publicly available. The less transparency in the information being transmitted, the greater will be the possibility of manipulation, particularly by those responsible for the CG of the company, themselves already used to the mechanics of the index.

5. Conclusions

The findings of this study suggest that a simple and cost-effective CGI may be implemented that is suitable and applicable for MLEs. The need for simplicity calls for few yet highly significant areas and attributes, relevant area weightings and an unsophisticated but reliable mathematical model as a benchmark. In addition, for the CGI to be cost effective, its provider and assessor will probably best be a centralised and experienced body such as the MFSA, provided that proper safeguards are taken for the complete segregation of CGI provision and assessment even within the same body and for the MLE assessments to be reviewed by a specialist in CG. Such CGI is an initiative towards higher director accountability. Yet, before its introduction, a promotion drive needs to be undertaken to increase shareholder CG awareness, possibly led by the financial services regulator itself so as to minimise market misinterpretations and counter the expected initial resistance. Additionally, the following recommendations need to be considered to consolidate the adoption of such as CGI:

- *Developing a menu of CGIs applicable to entities both listing in equity and debt securities*: the one-size-fits-all assumption is to be ultimately addressed by having industry-specific CGIs possibly taking into account also the varying sizes and complexities of companies. This could be achieved by having a menu of CGI standards based on the same structure but containing different measurement criteria in line with the characteristics of specific companies. The scope of the CGI can be further enlarged in the future by including also entities listing only in debt securities. As more companies adopt CGIs, their use becomes increasingly useful for comparative purposes.
- *Adopting the Code of Good Corporate Governance as a basis for the CGI:* by adopting the Code as the basis of best current CG practices, the CGI benchmark for score rewards and penalties may be quickly understood and become more easily acceptable to all parties.
- *Tying up CGI benchmarking to the regulatory framework:* the CGI benchmark needs to be kept in line with the regulatory framework. Regular revisions to both will be essential in order to ensure that they remain appropriately consistent with each other, thus preventing any unnecessary confusion.

- *Incentivising the market to adopt the CGI by promoting more CG awareness and education:* MLE stakeholders need to be made more aware of CG issues. Therefore, the relevant bodies have to work harder on the education of market players to render them more knowledgeable of CG developments.

Following this study, further research could examine the CGI from the shareholders' perspective in order to extract their needs and preferences in the construction of the Index. Given that this study highlights the possibility of making the CGI a self-assessment exercise, it would be also relevant to investigate the feasibility of such an option. Finally, a related interesting area relates to the CGI review. While this has already been somewhat referred to earlier, further research may, for example, help to identify and assess the nature and role of the reviewers suitable for such an exercise.

To conclude, we believe that the CGI is a significant CG practice that, once introduced, calls for continuous attention and reflection as it may easily become a powerful means for aligning corporate stakeholders towards a major common goal: that of improving the CG performance of the company.

References

Regulatory

Cadbury, A. (1992). *The financial aspects of corporate governance: A report of the committee on corporate governance* [Cadbury Report]. London: Gee& Co.

International Organisation of Securities Commissions (IOSCO) (2004). *Code of Conduct fundamentals for Credit Rating Agencies*, OICV-IOSCO, Madrid, Spain.

Organisation for Economic Cooperation and Development (OECD) (2004). *OECD Principles of Corporate Governance*. Paris: OECD Publishing.

Listing Authority - Malta (2013). Full Listing Rules: http://www.mfsa.com.mt/pages/viewcontent.aspx?id=267 (accessed 28 August 2013).

Malta Financial Services Authority (MFSA) (2011). Code of principles of good corporate governance for listed entities: http://www.mfsa.com.mt/pages/viewcontent.aspx?id 365 [28 August, 2013).

Other

Aguilera, R.V. and Desender, K.A. (2012). Challenges in the measuring of comparative corporate governance: A review of the main indices. In *West Meets East: Building Theoretical Bridges (Research Methodology in Strategy and Management*. Emerald Group Publishing Limited Bradford, England, 8: 289-322.

Albert-Roulhac, C. (2008). Corporate governance in Europe: Raising the bar. *Business Strategy Series*, 9(6): 287-290.

Ananchotikul, N. (2008). Does foreign direct investment really improve corporate governance? Evidence from Thailand. *Bank of Thailand Paper* DP/03/08: http://www.bot.or.th/Thai/EconomicConditions/Semina/MonthlyWorkshop/MonthlyWorkshop/June5 I_CGpaperNasha.pdf [20 July 2013].

Baldacchino, P.J. (2011). Accountancy in Malta - some insights from recent research. *Presentation at the Accountancy CPE Seminar Session,* University Residence, Lija, Malta, 3 March.

Balling, M., Holm, C. and Poulsen, T. (2005). Corporate governance ratings as a means to reduce asymmetric information. *Financial Reporting Research Group Working Paper Series,* Aarhus School of Business: http://papers.ssni.com/sol3/papers.cfm?abstract_id=847524 (accessed 22 August, 2013).

Barrett , A., Todd. P. and Schlaudecker. C. (2004). *Corporate Governance Ratings*. Towers Perrin, Stamform, USA.

Bezzina, F., Baldacchino, P.J. and Azzopardi, J.R. (2014). The corporate governance relationship between the board and management in Maltese listed companies. In *Rethinking Corporate Governance*. Tipurić, D., Raguž, V. and Podrug, N. (eds). Pearson, UK: 1-15.

Bhagat, S., Bolton, B. and Romano, R. (2008). The promise and peril of corporate governance indices. *Columbia Law Review*, 108(8): 1803-1882.

Brown. M.S. (2004) *The Ratings Game: Corporate Governance Ratings and Why You Should Care,* The Global White Page Boardroom Adviser Series, USA.

Choi, J.J. and Sami, H. (2012). Corporate transparency from the global perspective: A conceptual overview. In *Transparency and Governance in a Global World*, Emerald Group Publishing Limited, 13:3-7.

Daines. R., Gow, I. and Larcker, D. (2010). Rating the ratings: How good are commercial governance ratings? *Journal of Financial Economics*, 98(3): 439 - 61.

Durnev. A. and Kim. H. (2005). To steal or not to steal: firm attributes, legal environment, and valuation. *The Journal of Finance,*60 (3): 1461-1493.

European Corporate Governance Institute (ECGI) (2006). Corporate governance in various countries:
http://www.ecgi.org/codes/all_codes.php[13 July, 2013].

Gompers, P., Ishii, J. and Metrick, A. (2003). Corporate governance and equity prices. The Quarterly Journal of Economics, 118 (1): 107-115.

Gower, L. and Davies, P. (2003). *The Principles of Modern Company Law*. Sweet & Maxwell, London.

Grimminger, A. and Di Benedetta, P. (2013). *Raising the Bar on Corporate Governance: A Study of Eight Stock Exchanges Indices:*
http://www.ifc.org/wps/wcm/connect/a6724900400acal3af3aff23ff966f85/Raising_the_ bar_o n_CG.pdf?MOD = AJPERES [18 September, 2013].

Guedes. J. and Loureiro, G. (2007). Controlling vs. minority shareholders: Is there expropriation? An empirical analysis of the stock price performance of European companies. *CESifo GDIC Report*, 5(1):16-21.

Hermanson, D. (2004). Corporate governance ratings: Good or bad? *Internal Auditing, Accounting and Tax*,19(6): 37-40.

Hodgson. A. Lhaopadchan, S. and Buakes, S. (2011). How informative is the Thai corporate governance index? A financial approach. *International Journal of Accounting and Information Managemen*t,19(1): 53-79.

Institutional Shareholder Services (ISS) (2014). *ISS Governance Quick Score 2.0. Overview and Updates*. Institutional, Shareholder Services Inc., USA.

Khanchel I. (2007). Corporate governance: Measurement and determinant analysis. *Managerial Auditing Journal.* Vol. 22, 8: 740-760.

Khiari, W., Karaa, A. and Omri, A. (2007). Corporate governance efficiency: an indexing approach using the stochastic frontier analysis. *Corporate Governance*, 7(2): 148-161.

Kim. K., Nofsinger, J. and Mohr. D. (2010*).* *Corporate Governance*. 3rd ed. Prentice Hall, USA.

La Porta R., Lopez-de-Silanes, F., Schleifer, A. and Vishny, R. (1998). Law and finance. *Journal of Political Economy,* 106(6): 1113-1155.

Mallin, C. (2004). *Corporate Governance*. Oxford University Press, Oxford.

Martynova, M. & Renneboog, L.D.R. (2010). A corporate governance index: convergence and diversity of national corporate governance regulations. *Tilburg Finance Centre,* Discussion Paper : 2010-17.

Medland. D. (2013). *Raising the bar with a new corporate governance index*: http://www.forbes.eom/sites/dinamedland/2013/10/06/raising-the-bar-with a-new corporate- governance-index [13 November 2013].

Mostafa, K. (2012). A disclosure index to measure the extent of corporate governance reporting by UAE listed corporations. *Journal of Financial Reporting and Accounting*. 10(1): 4-33.

Noamene, T. and Hassairi, S. (2012). Representation of employee shareholders in the board: Issues and economic consequences. *International Business Research*, 5 (12): 212-222.

Piatt, H. and Piatt, M. (2012). Corporate board attribute and bankruptcy*. Journal of Business Research*, 65 (8): 1139-1143.

Ramlal, V. (2009*). A framework for the Construction of a Corporate Governance Index for Trinidad & Tobago.* Salises,UW1, St Augustine: http://sta.uwi.edu/conferences/09/salises/documents/V%20ramlal.pdf [10 September, 2013].

Sarkar, J., Sarkar, S. and Sen, K. (2012). Corporate governance index for large listed companies in India. *Indian Accounting Review,* 16(1): 1-18.

Schnyder, G., 2012. Measuring corporate governance: lessons from the "Bundles Approach"*. Centre for Business Research, King's College, University of Cambridge*. Working Paper 438.

Snyder. B. (2009*).* How good are commercial corporate governance ratings? *Stanford Graduate School of Business:* http://vvww.gsb.stanford.edu/news/research/Iarkercorpgov.html [November, 2013).

Spanos. L., Tsipouri. L. and Xanthakis, M. (2006). Corporate governance rating in a small open capital market: Methodology and application in the Greek market. *lUP Journal of Corporate and University of Athens.* Economics Working Paper. Telangana, India.

Spencer Pickett, K. (2011). *The Essential Guide to Internal Auditing*. 2nd ed. Wiley. Chichester, West Sussex.

Standard and Poor's (2004) *Standard & Poor's Corporate Governance Scores and Evaluations: Criteria, Methodology and Definitions*. Standard & Poor's Governance Services. New York USA.

Strenger, C. (2004). The corporate governance scorecard: a tool for the implementation of corporate governance*. Corporate Governance: An International Review*, 12(1): 11-15.

Walker, S. (2013). Corporate Governance: Its effect on share price. In *RIBM Doctoral Symposium*, Manchester Metropolitan University:1-20.

Appendix 1

Table A1 shows the relative CGI reapportioned weightings in four CG areas across each type of respondent and overall. Such weightings were based on the proportion of ticks for each area after eliminating the three least weighted areas.

Table A1 Average applicable CGI weighting per area

Respondents	*Structure of board of directors*	*Transparency and disclosure*	*Audit committee and audit process*	*Shareholder Rights*
MLEs	28.31%	23.66%	27.30%	20.73%
Financial analysts	28.13%	28.95%	21.97%	20.95%
Average applicable CGI weighting	*28.22%*	*26.31%*	*24.64%*	*20.84%*

Appendix 2

Tables B1 to B4 list the attributes selected under each corresponding governance area. For benchmark calculations, the following steps were used:

a data was collected from Annual Reports of MLEs and interviews

b attributes were quantified

c descriptive statistics comprising the median, minimum and maximum scores were computed

d the median was used as the attribute benchmark

e the median attribute score was normalised using the following formula: (median - minimum)/(maximum - minimum)

Table B1 The selected attributes for the CGI in MLEs including their benchmark: governance area – BOARD STRUCTURE

Attributes	*Benchmark scores*	*Normalised benchmark*
Board size	7	0.50
Percentage of non-executive directors on board	80	0.60
Number of board meetings held annually	9	0.24
Percentage of board meetings attended by non-executive directors	100	1.00
Average years of experience as directors at this or in another company	15	0.47
Avoidance of Chairman and CEO duality	1	1.00
Chairman and/or CEO not serving on another board	1	1.00

Table B2 The selected attributes for the CGI in MLEs including their benchmark: governance area –TRANPARENCY AND DISCLOSURE

Attributes	*Benchmark scores*	*Normalised benchmark*
Sufficient disclosure of accounting standards and policies used	1	1.00
Time to file financial statements with the regulatory body	87	0.56
Board remuneration disclosure including Remuneration report	1	1.00
Disclosure of specific performance benchmarks	1	1.00
Updated company website	10	1.00
Sufficient level of non-financial information disclosed	10	1.00
Access to company records for shareholders	1	1.00
Procedures for the handling of sensitive Information	1	1.00
Disclosure of trends and targets to stakeholders	1	1.00

Table B3 The selected attributes for the CGI in MLEs including their benchmark: governance area – AUDIT COMMITTEES AND PROCESS

Attributes	*Benchmark scores*	*Normalised benchmark*
Audit committee size	3	0.50
Percentage of non-executive directors on audit committee	90	0.67
Number of audit committee meetings held annually	5	0.33
Percentage of audit committee meetings attended by its members	100	1.00
Life span of an audit committee cycle (in years)	1.6	0.27
Internal auditor availability	1	1.00
Non-audit services not currently provided by the current statutory auditor	1	1.00
Auditor changes in the past ten years	1	1.00
Annual frequency of monitoring and review of internal procedures	12	0.48
Unqualified audit opinion in the last ten years	1	1.00

Table B4 The selected attributes for the CGI in MLEs including their benchmark: governance area – SHAREHOLDER RIGHTS

Attributes	*Benchmark scores*	*Normalised benchmark*
Availability of shareholder director or officer	1	1.00
Adoption of the one-share-one-vote principle	1	1.00
Days of notice before AGM	25	0.15
AGM shareholder attending records kept	1	1.00
Dividend policy in place and disclosed	1	1.00
Proxy arrangements in place and disclosed	1	1.00
Current threshold of shareholding to call an AGM	19	0.20

Appendix 3

Table C1 illustrates the application of part of the CGI model on two MLEs while Table C2 shows the sub-indices and overall CGIs for the two MLEs.

Table C1 Testing the CGI for Company X and Company Y in the one governance area

Structure of board of directors	*Benchmark*		*CoX*		*CoY*	
	N	*S*	*ND*	*SS**	*ND*	*SS**
Board size	0.50	1.00	0.83	1.66	0.83	1.66
Percentage of non-executive directors onboard	0.60	1.00	1.00	1.67	0.60	1.00
Number of board meetings held annually	0.24	1.00	1.00	4.20	0.00	0.00
Percentage of board meetings attended by non-executive directors	1.00	1.00	0.00	0.00	0.62	0.62
Average years of experience as directors at this or in another company	0.47	1.00	0.00	0.00	0.21	0.44
Avoidance of Chairman and CEO duality	1.00	1.00	1.00	1.00	1.00	1.00
Chairman and/or CEO not serving on another board	1.00	1.00	0.00	0.00	0.00	0.00
Total score for area		7.00		8.54		4.73
Total score as a percentage of benchmark		100		121.93		67.57
Area Weight		28.22		28.22		28.22
Structure of board sub index {%)		*28.22*		*34.43*		*19.07*

Notes: N = normalised benchmark, S = score awarded for benchmark: ND = normalized data for company; SS = score awarded to company = ND/N; *Some discrepancies are present in decimal numbers as original data were rounded to 2 d.p. to avoid clutter.

Table C2 Sub-indices and overall CGIs for Company X and Company Y

Sub-index	*Benchmark (%)*	*CoX (%)*	*CoY (%)*
Structure of board of directors	28.22	34.43	19.07
Transparency and disclosure	26.31	16.46	24.40
Audit committee and audit process	24.64	26.09	18.79
Shareholder rights	20.84	14.89	17.86

CHAPTER 15

The Participation of the Small Shareholder in the Annual General Meeting:

A Reflection of Good Corporate Governance?

[CG-6]

Baldacchino, P.J[1]., Camilleri, A.[1], Cutajar, I.[1], Grima, S[1]. and Bezzina, F[1].

European Journal of Economics and Management

Vol 3, Issue 2, 2016, pp 7-28

.

This paper is a revised and expanded version of a paper with same title presented at the 4th OFEL International Conference on Corporate Governance, CIRU, University of Zagreb, held at Dubrovnik, Croatia 15-16 April, 2016.

Corresponding Author: *peter.j.baldacchino@um.edu.mt* (Peter J. Baldacchino)

[1] Faculty of Economics, Management and Accountancy, University of Malta

The Participation of the Small Shareholder in the Annual General Meeting:

A Reflection of Good Corporate Governance?

Baldacchino, P.J., Camilleri, A., Cutajar, I., Grima, S., Bezzina, F.H.

University of Malta, Malta

This paper analyses the level of small shareholder (SS) participation in the Annual General Meeting (AGM), assessing how this reflects upon the corporate governance of listed entities. It focuses on SS attendance, voting and proposals (excluding those of institutional and majority shareholders), improving SS participation and the significance of such AGM proceedings to listed company corporate governance. Empirical mixed methodology research is carried out in a Maltese listed company (MLC) setting by means of semi-structured interviews with seventeen MLC secretaries, five stockbrokers, an online questionnaire responded by fifty-four shareholders in different MLCs, as well as the analysis of company notices and documentation relating to the AGM. Results indicate that SS participation is weak. Attendance is poor, and is often spurred both by legitimate factors such as information on current financial performance and by questionable ones such as refreshments served and venue. Shareholders seem uncomfortable in asking management formal questions and even in voting by show of hands, and therefore opt for informal interaction with management and for voting by poll, the latter often rendering attendance fruitless and even unnecessary by permitting proxies. As for proposals, they could induce management's later action despite seldom, if ever, being approved, but their submission is rare and mostly frivolous, commonly hampered by a lack of financial knowledge. The study concludes that the current level of SS participation does not render the AGM a tool reflecting good corporate governance, as it does not keep in balance the interests of this shareholder with those of other stakeholders. For the sake of better direction and control, and, in particular, for more transparency and accountability, the AGM has to be less stage-managed, as well as more interactive and engaging towards such shareholder. This calls for increased management commitment, particularly towards more investor education and guidance.

Keywords: *annual general meeting, corporate governance, small shareholder, shareholder participation, Maltese listed companies*.

1. Introduction

The term "corporate governance" has been defined as the system by which companies are directed and controlled (Cadbury,1992). Corporate governance is mainly concerned with providing structures through which objectives are set, performance is monitored and rights and responsibilities are adequately allocated among different participants in the corporation (OECD, 1999; OECD, 2004).

From a narrow perspective, corporate governance is limited to the relationship between the company and its shareholders (Solomon, 2010). In a wider context, corporate governance may be considered as a set of relationships between a company's management, its board, its shareholders and other stakeholders (OECD, 1999). While academics have defined corporate governance from varying perspectives, the existence of conflicts arising from the separation of ownership and control is a predominant feature. Discussions on corporate governance have concentrated on the relations between the directors and managers of companies and other parties, in particular focusing on the role of corporate governance to protect and advance the interest of shareholders through appointing and monitoring capable management (Walker, 2009).

The Annual General Meeting (AGM) represents one of the corporate governance instruments intended to assist shareholders in holding the directors of a company accountable, thus limiting the possibility of expropriation of shareholders by managers (La Porta *et al.*, 2003). It has been the interest of various scholars to evaluate the importance of the physical meeting of shareholders on entities' corporate governance. While AGMs aim to serve as a means of overseeing the actions and decisions of companies (OECD, 2004), studies have shown that AGMs can be seen as redundant in terms of effectively exercising the agent-principal relationships (Apostolides and Boden, 2005).

Proponents of proposals that AGMs contribute little to effective corporate governance have justified their conclusions by arguing that due to little or no opportunity to influence the company's strategy, private shareholders prefer to exit rather than use their voice in AGMs (Apostolides and Boden, 2005). Nonetheless, while dominant investors have alternative routes by which to exercise governance (Strätling, 2003), small shareholders largely depend on AGMs to exercise their shareholder rights (Van der Elst, 2013).

The market instability brought about by corporate scandals such as Enron, WorldCom and Parmalat, followed by the financial crises in 2008, have led shareholders to demand more information and become more active (Ertimur *et al.,* 2010; Gillan and Starks, 2000; Jensen and Meckling, 1976). The primary focus of activist shareholders is to put pressure on companies to continue enhancing their corporate governance practices, this with the aim of improving the companies' performance and achieving higher returns on investment. In April 2014, the European Commission submitted a proposal on tackling corporate governance shortcomings relating to European listed companies with the aim of enhancing shareholders' rights where necessary to ensure that shareholders are more engaged (COM, 2014).

This empirical study is based in Malta, a small member state of the European Union (EU). In view of the AGM's importance to small shareholders, this paper analyses the level of small shareholder participation in the AGM of Maltese listed companies. This paper aims to analyse small shareholder attendance at AGMs, evaluate their voting rights, including their strength and effectiveness as well as examine and assess shareholder proposals put as resolutions on the agenda of the AGM. In the light of the emerged results, the paper will provide recommendations addressing the weaknesses identified among AGMs of listed companies, particularly identifying means by which small shareholders' participation at the AGM could be increased.

2. Literature review

The AGM is an integral part of a company's corporate governance system as it provides the opportunity to shareholders to exercise their ownership rights, including the opportunity to direct any questions to the Board (The Association of British Insurers, 2013). Strätling (2003) identified that AGMs serve to provide three principal functions. Firstly, AGMs aim at informing shareholders about the company's financial performance and important management decisions. Secondly, AGMs enable companies to obtain the shareholders' consent for decisions that the board of directors has no discretion to take. Thirdly, AGMs support a forum for discussion between directors and shareholders about past performances and future business policies.

Similar to other jurisdictions, Maltese company law grants rights to shareholders at the AGM. In particular, Maltese listing rules provide each shareholder, including a proxy holder, with the right to attend the AGM and ask questions related to the items on the agenda and to have such questions answered by directors or by a competent person as the directors may delegate (Laws of Malta, 1995 and Listing Authority - Malta, 2014). Moreover, such listing rules allow shareholders, holding a minimum of 5% of the issued share capital, to table resolutions at the AGM.

2.1 Small shareholders' attendance at the AGM

Shareholder democracy can be achieved through increased participation by investors at the AGM (Van der Schee, 2011). Various scholars have determined that there may be a number of factors influencing shareholder participation. Empirical research by Strätling (2003) and Apostolides and Boden (2005: 61) showed that participation tends to increase when the company is in financial difficulties, with the latter stating, "*the more salient the current issues, the greater* *the AGM attendance*". Similarly, Kathurima (2011) claimed that the main determinants for shareholders' attendance at meetings depend on the agenda of the meeting and the need to enquire on the company's performance.

Numerous researchers have analysed in great detail the real significance of the AGM, particularly to different classes of investors. Van der Elst (2013) and Bottomley (2003) maintained that the AGM has become less important to large shareholders as, in practice, the company often communicates with institutional shareholders outside the AGM, for example through conferences or one-on-ones. While one-on-ones and other activism behind closed doors are targeted towards large and often institutional investors, the AGM is aimed at all shareholders, including individual and small shareholders (Van der Elst, 2013). This implies that small shareholders largely rely on AGMs to exercise their shareholder rights (Lafarre, 2014).

Recently, participation at AGMs has been increasing through technological breakthroughs (Weil, Gotshal and Manges LLP, 2002). As a measure to increase participation at AGMs, the EU Commission advocates that Member States should focus more on reducing participation barriers so that shareholders could engage in cross-border voting more easily (COM, 2014).

2.2 Minority shareholder voting

Voting is an important tool, as up to a certain extent, it enables shareholders to influence corporate governance (Yermack, 2010). According to Macey (2008), it is presumed that more and better voting rights to shareholders would further improve corporate performance and accountability. Shareholders commonly vote on directors' elections, executive compensation, fundamental corporate changes, amendments and the sale of most or all corporate assets. These rights are subject to change by contractual provisions. Furthermore, they are subject to legal precincts in various aspects. Notwithstanding the importance of shareholder voting at the AGM, various scholars have discussed whether voting indeed serves the purposes assigned to it by corporate law (Lafarre, 2014).

Low attendance rates and absenteeism of shareholders at the AGM is a widely debated topic in corporate governance literature (Van der Schee, 2011). As proclaimed by economic theory, the ownership structure of the company highly influences voting turnouts (Van der Elst, 2011). In a widely dispersed ownership structure, the voting outcome will be the same irrespective of whether a small (individual) shareholder participates in the AGM (Lafarre, 2014). In this respect, by holding large voting blocks and being able to influence voting results, large shareholders tend to have more motives to participate in AGMs than small shareholders (Van der Elst, 2011).

The voting procedure can have an effect on the nature and quality of the general meeting (Apostolides, 2010). Shareholder voting models have evolved over time from one-share-one vote to a variety of voting structures, some favouring small or individual shareholders and others enhancing the control of large shareholders (Dunlavy, 2006; Pistor *et al.,* 2003). According to Apostolides (2010), a poll by ballot is one of the safest methods for directors, as the majority of proxy votes on resolutions would be carried in favour of the Board. This view supports Hampel (1998) who argued that a show of hand is riskier and more transparent, as small shareholders can still register an interesting majority against the Board.

Maltese company law provides that a resolution put to vote shall be decided "*on a show of hands unless a poll is demanded"* (Companies Act, 1995, First Schedule, Reg 41). Such voting is "*a method of dealing with non-contentious matters expeditiously and inexpensively*" (Companies and Securities Advisory Committee, 2010, Para 4.108). The study of Bottomley (2003) analysed the voting tool adopted for approval of agenda items, whereby most of which were decided by show of hands, except for the election of directors and the fixing of their remuneration.

2.3 Minority shareholder proposals

Shareholder-initiated proposals have become an integral part of corporate governance and performance control. Shareholder proposals are a means of mitigating agency problems and thus, advocating shareholder participation (Bebchuk, 2005).

Shareholder proposals are powerful and beneficial to both investors and companies. Investors are able to communicate their concerns to the Board of Directors, while companies get an opportunity to gain insights of shareholders' interests and concerns over particular matters (British Columbia Investment Management Corporation, 2010). Nevertheless, various scholars such as Bebchuk (2005) and De Jong *et al.* (2006) have generally considered shareholder proposals to be a relatively weak disciplinary mechanism whereby activist small shareholders exert little influence on management.

A recent study conducted on Maltese listed companies by Bezzina *et al.* (2014) revealed that the ownership concentration of such companies influenced the effectiveness of the exercise of rights in controlling decisions. In companies with a widely dispersed shareholding, shareholders were regarded as less powerful and hence were unable to exercise effective control through their participation at the AGM (Bezzina *et al.,* 2014).

Empirical literature shows that proposal submissions do not really act as an agency control device as often management and institutional activists negotiate between themselves behind the scenes or pursue their own serving agendas (Bainbridge, 2006; Anabtawi, 2006; Crespi and Renneboog, 2010). Similarly, Ertimur *et al.* (2010) argued that as shareholder proposals are presented well ahead of the AGM, the Board could evaluate them, obtain management's opinion, hear from large shareholders and eventually determine whether to implement them or put them for shareholders' vote. Some scholars claimed that the non-binding nature of shareholder proposals yield no control benefits (Prevost and Rao, 2000; Gillan and Starks, 2000). However, various others scholars asserted that albeit their non-binding nature, submitted proposals can exert pressure on the firm being subject to the proposal. Studies show that proposals attaining the majority vote are likely to be implemented (Bizjak and Marquette, 1998; Martin and Thomas, 1999; Ertimur *et al*., 2010; Thomas and Cotter, 2007). Evidently, shareholders target proposals to certain companies more than others, and there may be various contributing factors for this. Shareholders tend to become aware and more active especially when the company does not operate up to their expectations. Early studies proclaimed that proposals submitted tend to be substantially targeted to underperforming companies (Karpoff *et al.,* 1996; Martin and Thomas, 1999). According to Cziraki *et al.* (2010), voting outcomes were strongest for proposals seeking changes to the Board, thereby indicating major governance concerns.

Findings by Gordon and Pound (1993) showed that shareholder proposals are likely to gain more votes during the firm's worsening economic performance period, this similarly indicating a potential quality problem with present management. Maug and Rydqyst (2001) explained that investors are wary in respect of governance issues where the benevolence of managers' judgement is less plausible. Nonetheless, the pass rates of investors' proposals are low while approvals of managements' proposals are high (Maug and Rydqyst, 2001). The study of Gillan and Starks (2000) showed that proposals sponsored by active individual investors receive significantly fewer votes than proposals sponsored by institutional investors or coordinated groups of investors.

2.4 Improving participation

The increasing desire to improve participation at AGMs has led various researchers to identify ways how regulations can be improved. Common proposals were to allow for technology advances, with the aim of making AGM practices more effective. One of the recommendations put forward by the Australian CAMAC (2012), was to embrace technology in the conduct of meetings and thereby, doing away with proxy voting and mandating direct voting without having to attend in person. Amey and Mozley (2012) stated that such an Internet voting system represents a highly efficient way of increasing participation in shareholders' meetings, doing away with physical presence and thereby saving time, costs and inconvenience of travelling while assuring effective communication. Similarly, Gonzalez *et al.* (2014) highlighted the importance of innovative voting procedures by enabling foreign and other shareholders to vote in real time without having to travel. Gonzalez *et al.* (2014) further advocated a public counting, this allowing for more transparency.

Good governance is achieved through continuous improvement. As circumstances change, companies have to seek ways to keep advancing in the worldwide corporate governance and implement the best practices for the benefit of the company, its shareholders and all other stakeholders (IFC, 2009).

3. Methodology

The findings and analysis of this study were supported by both secondary and primary data sources. Secondary data sources consisted of company notices in relation to notices of the AGM, Annual Reports and other documents published by company secretaries. This data was used to substantiate primary data sources.

A mixed methodology was adopted. Data was mainly collected through twenty-two semi-structured interviews. Seventeen interviews were held with company secretaries, aimed at ascertaining the level of shareholders' participation in their respective companies. The other five interviews were held with stockbrokers dealing with shares of the same companies. The latter's views were found relevant in view of interactions with small shareholders and their independence.

Therefore, two semi-structured interview schedules were designed: one for company secretaries and another for Maltese stockbrokers. The interview schedules consisted of both open-and close-ended questions, with the latter involving either categorical questions or five-point Likert-type items, signifying the respondents' level of agreement to a number of statements (from 1 = "strongly agree" to 5 = "strongly disagree").

Obtaining small shareholders' views was also essential to the study. Since the online address details of such shareholders were unavailable, the Malta Association of Small Shareholders was contacted and an on-line questionnaire was sent through their intermediation to those members of whom they had on-line details. Fifty-four shareholders, being the majority of such members, responded to this questionnaire. Descriptive statistics were used to summarise the item responses. To determine whether the responses differed across the three groups (MLCs, shareholders and stockbrokers), the Chi-squared test was used with nominal scales while the Kruskal Wallis test was used for ordinal scales.

4. Analysis of results

4.1 Small shareholders' participation at the AGM

In evaluating small shareholder participation in Malta, it was first essential to obtain an understanding of the shareholding structure of listed companies. As per Maltese Listing Rules (Listing Authority - Malta, 2014), shareholders in such companies are allowed to raise resolutions at the AGM when having a minimum of 5% of the company's issued share capital. An analysis of the shareholding structure of the listed companies interviewed showed that, on average, 72.41% of the companies' issued share capital was held by shareholders holding more than 5% of the issued share capital.

While not all shareholders may table resolution at the AGM, they have the right to ask questions. When the 17 Maltese listed company representatives (MLCs) were asked about the level of shareholder participation, 64.7% claimed that it was quite low. Furthermore, 23.5% added that shareholders tend to feel more comfortable approaching the Board informally before, during and after the AGM rather than raising questions at the formal meeting.

As for the shareholders (N = 54), only 37.0% reported that they were active at least to some extent. Most shareholders (57.4%) also indicated that they did not feel comfortable asking questions at the AGM, the majority of these (51.6%) preferring to ask questions before/after the meeting, with the remaining respondents feeling uncomfortable to ask any questions.

The three respondent groups were provided with two statements that, as revealed by the literature, show the reality of AGMs. These two statements were: (i) "AGMs are truly an occasion where small shareholders exercise their rights"; and (ii) "Large shareholders tend to have more motives to participate in AGMs as they are more able to influence the voting turnout". With regards to the first statement, the Kruskal Wallis test revealed that the three groups varied significantly with respect to mean ranks ($p = 0.03$); MLCs agreed to the statement (Median (Md) = 4), while small shareholders and stockbrokers were undecided (Md = 3). However, with respect to the second statement, there was no significant difference in mean ranks ($p = 0.46$); all groups agreed (Md = 4) that large shareholders tend to have more motives to participate as they can have a greater influence on the voting turnout.

Shareholder participation in the AGM will now be assessed in more detail in the next four sections: small shareholder attendance, their voting, their proposals and how to improve their participation. The analysis will then delve into the significance of the AGM to the corporate governance of listed companies.

4.2 Small shareholder attendance at the AGM

The number of shareholders eligible to attend the most recent AGM and the actual attendance figures for each listed company were obtained from the 17 MLC's. The attendance of the shareholders was found poor: 13 companies had an average attendance below 20%, with two between 20-40%, and only the remaining two beyond 80%.

The shareholders were asked to indicate and justify their attendance levels at AGMs during the last five years. Results showed that the majority of the 54 respondents (38.9%) indicated that they had attended from four to six AGMs. Most respondents (94.4%) also stated that when attending they had done so to get informed about their company's performance and to exercise their voting rights. A few (13.0%) had not attended AGMs at all because they were unable to influence the voting result.

The important determinants of shareholders' attendance that emerged among all 76 respondents were "current financial performance" (Md = 4) and "refreshments served" (Md = 4). The agenda, venue and duration of the AGM were neither important not unimportant (Md =3). Kruskal Wallis tests revealed that only "agenda of the meeting" differed significantly in mean ranks across groups (p = 0.05), with brokers seeing this factor as important (Md = 4) and shareholders and MLC's as neither important nor unimportant (Md = 3).

4.3 Small shareholder voting

4.3.1 Voting rights emanating from local laws and EU directives

Each and every shareholder has various rights emanating from the regulatory framework. The three independent respondent groups were asked to rate the strength of such shareholders' rights. The level of agreement differed considerably across mean ranks ($p < 0.01$), whereby companies rated shareholders' rights as strong (Md = 4), while small shareholders and stockbrokers considered rights to be rather weak to moderate (Md = 2). One of the five independent local stockbrokers commented that MLCs tend to adopt a "box-ticking exercise", whereas another claimed that the revision of the existing Shareholder Rights Directive (COM, 2014) would continue to improve such rights.

Whether institutional shareholders are privileged and have more power over minority shareholders is debatable. Out of the five stockbrokers interviewed, two agreed that institutional shareholders are more powerful than the minority shareholders because they have a greater say owing to the weighting of their shares. The remaining three stockbrokers stated that institutional and majority shareholders are more privileged because they have access to more information and are in a better position to analyse that information.

Greater shareholder participation may be achieved by encouraging investors to exercise their voting rights. In order to achieve this, two out of five stockbrokers emphasised the importance of increasing education among investors, claiming that "Maltese investors lack investment knowledge". Three stockbrokers agreed that the corporate governance framework should introduce incentives that encourage investors to exercise their voting rights.

4.3.2 Shareholder voting method

Voting at Maltese AGMs takes place either by show of hands or by poll. Evidently, the 17 listed companies investigated tend to adopt the show of hands method for most of the resolutions (58.8%) rather than the poll because it is easier and less costly.

When the MLCs were asked to give their opinion on the level of transparency of the two methods, over half of them (52.9%) stated that voting by poll is more transparent because it accurately provides the exact number of shareholder votes. They added that when voting takes place by show of hands, the votes of the investors could still not be easily determined and their respective amounts of shares are also disregarded. However, some other MLCs (17.6%) stated that the show of hands is more transparent because resolutions are approved visibly and publicly. The rest of MLCs (29.4%) claimed that both voting methods may be regarded as transparent.

Given that MLCs indicated that voting by show of hands is a common voting method by most listed companies, small shareholders were asked to indicate their preferred voting method. Interestingly, the majority of the 54 small shareholders indicated that they prefer to vote by ballot for resolutions (57.4%). Others indicated that they favour show of hands (24.1%) or they have no preference for any particular voting method (18.5%).

4.4 Proposals from small shareholders

Shareholder participation can be analysed further from the aspect of the proposals put forward by shareholders. Most of the 17 MLCs (88.2%) found it difficult to recall any shareholder proposals made, this being indicative of the lack of shareholder participation. Nearly all MLCs (94.1%) stated that their companies mostly receive enquiries rather than proposals. Most (88.2%) commented that shareholders are interested in dividends or offers given by the company.

For certain MLCs (29.4%), an appreciable number of proposals emanate from substantial and majority shareholders, often also forming part of the Board, rather than small ones. According to the majority of MLCs (58.8%), proposals made by such majority shareholders are always discussed at Board level and implemented. However, most MLC's (58.8%) also claimed that once any proposal is received from minority shareholders, it is invariably evaluated by management and, if deemed *"valid",* it is forwarded to the Board for further consideration. Yet, only one of the 17 MLCs stated that the Board had referred such proposals by small shareholders to the AGM, and this over the preceding five years' period. Furthermore, no such referred proposal originating from small shareholders had in fact resulted in acceptance at the AGM. Notwithstanding this, the MLC noted that such proposals had resulted in the company holding further discussions with the representatives of the small shareholders in question in an effort to take the proposals on board in managing the company. On their part, all five stockbrokers also confirmed that, notwithstanding the fact that shareholders' proposals may not be approved and thus not influence the outcome of the AGM, they might still have an impact on future decisions. However, they added that the reluctance of small shareholders to put forward such proposals could be due to the fact that they did not wish to be or to be seen to be "frivolous". Most of the stockbrokers (60.0%) pointed out that the major determinant of such proposals was the level of investor education in financial matters. They emphasised that, in fact, at present small shareholders are not adequately equipped to support or otherwise the Board in its decision making. In their view, the participation of small shareholders is still primarily held back by the latter's common lack of financial knowledge. One of the stockbrokers even highlighted the free-rider problem, whereby individual small shareholders do not bother to know more, and simply decide to rely rather on the initiatives of a few other investors for any proposals to be made.

Both MLCs and stockbrokers were also asked whether proposals from small shareholders can be considered as weak owing to the lack of influence that such shareholders can exert on management. Only 3 out of 17 MLCs (17.6%) agreed that shareholder proposals are weak because of this. In contrast, three out of five

(60.0%) of stockbrokers agreed that, besides the question of influence of the lack of financial knowledge referred to earlier, small shareholder proposals are also weak because of their minimal or no influence which they could exert on management. Yet, the two stockbrokers in disagreement stated that the weaknesses in shareholder proposals were little related to the influence which shareholders could exert.

4.5 Improving participation

As for matters that may improve shareholder participation, the majority of the 17 MLCs (64.7%) agreed that an e-voting system would facilitate the counting process. However, they were concerned about the ability of shareholders to use electronic systems. The rest of the MLCs stated that they did not feel it necessary to adopt an e-voting system.

A similar question asked stockbrokers to give their opinion about the adequacy of the voting system currently adopted by MLCs. All five stockbrokers stated that the voting system was adequate. However, most (80.0%) added that the voting system could be improved by technology as this renders the system less costly and also leads to more precise results than the show of hands.

When asked about the adequacy of the voting process for approval of resolutions, MLCs agreed more strongly than brokers and shareholders ($p < 0.01$). Yet, when respondents were required to rate whether technology can aid in the voting process at AGMs to improve transparency, all three groups agreed (Md = 4) and the difference across groups was not statistically significant ($p = 0.66$).

Despite such consensus, both stockbrokers and MLCs agreed more strongly than shareholders that a virtual meeting is not a full substitute for a physical meeting ($p = 0.04$).

4.6 The significance of the AGM in the corporate governance of MLCs

The AGM is a tool reflecting good corporate governance and thus, transparency and accountability. MLCs, stockbrokers and shareholders indicated the extent to which these two principles are reflected at AGMs. As for transparency, MLCs reported this to a higher extent (Md = 5) than stockbrokers and shareholders (Md = 3), and this difference was statistically significant ($p<0.01$). As for accountability, again MLCs reported this to a higher extent (Md = 5) than stockbrokers (Md = 4) and shareholders (Md = 3), and this difference was statistically significant ($p<0.01$).

Two stockbrokers raised several comments about the importance of the AGM in providing information and regular updates to shareholders, particularly in view of the separation of control that exists between management and shareholders. A broker claimed that “a strong forum addresses information asymmetry”. Similarly, one stockbroker commented that the presentation of information at the AGM as well as disclosures should be clear and useful to shareholders in making their investment decisions.

When asked whether directors are accountable to shareholders at the AGM, stockbrokers disagreed that the AGM is effective with respect to such accountability (Md = 2). One broker commented that the Chairman of a few of the listed companies in Malta is as yet also the CEO, with a duality that in practice “runs the show”. He further argued that directors are less likely to be accountable to shareholders given that normally they do not even address shareholders at the AGM.

Stockbrokers and MLCs strongly agreed (Md = 5) that the AGM allows shareholders sufficient time to ask questions to the Board, while shareholders agreed to a lower extent (Md = 4), with this difference reaching statistical significance ($p<0.01$). As regards to the statements presented to respondents that (i) the AGM provides information to shareholders on the company’s operation and (ii) generates a discussion between directors and shareholders, stockbrokers and

MLCs strongly agreed (Md = 5) while shareholders agreed (Md = 4), with the Kruskal Wallis tests reaching statistical significance at $p < 0.01$.

MLCs and small shareholders were also asked whether the main purposes of the AGM are being attained in Maltese AGMs. A significantly higher proportion ($p < 0.01$ using exact test, since some cells had expected counts less than 5) of MLCs (76.5%) and stock brokers (80.0%) than shareholders (22.2%) stated that these purposes are being attained, this again pointing to the relatively more positive attitude towards the AGM being taken by MLCs as in contrast to the small shareholders.

5. Discussion

Given the weak participation of small shareholders in the AGM, two moot points emerge: firstly, what makes it so weak and secondly, given such weakness, whether the meeting is an adequate reflection of good corporate governance.

5.1 Participation by small shareholders – What makes it weak?

Results showed that the majority of small shareholders did not consider themselves as active participants in the AGM. Research findings identified various factors contributing to weak small shareholder participation.

5.1.1 Poor attendance

Results showed that the attendance of shareholders at AGMs of the interviewed MLCs was poor when compared with the total number of shareholders in their respective listed companies. This was also apparent in international AGMs as research by Strätling (2003) and Hodges *et al*.(2004) also showed poor attendance at the AGM. Results revealed that small shareholders were passive investors who felt demotivated to attend AGMs owing to their inability to influence the voting turnout.

In conformity with the view of Apostolides and Boden (2005) and Kathurima (2011), research findings showed that prominent agenda issues as well as the company's performance tend to be the factors that mostly motivate shareholders to attend. Results also indicated that refreshments offered by companies could have a significant impact on shareholders' attendance at AGMs. The provision of refreshments seems to be highly valued by small investors, for whom such events serve as an outing. Findings showed that small shareholders regard these as an informal setting in which to ask and discuss questions with the directors – questions which they lack the confidence to place in the formal meeting.

5.1.2 A box-ticking exercise

In contrast to MLCs responses, stockbrokers and small shareholders regarded shareholder's rights to be rather weak. Results have shown that small shareholders prefer to vote by ballot as they feel uncomfortable showing hands, especially where they are investors in more than one company and directors may be up for election in different companies. Much of this may be attributable to the fact that, in the context of a small country, shareholders and directors are more likely to know each other.

Results have also shown that small shareholders were reluctant to ask questions during the AGM and therefore, when attending the AGM they would only participate by ticking the boxes on the ballot. Like all other shareholders, small shareholders have the right to vote and ask questions at the AGM. However, brokers acknowledged that institutional and majority shareholders have access to more information than small shareholders, giving them better ability to raise queries and analyse information. This leads one to question whether the rights of small shareholders are in fact strong enough to address their participation passivity at AGMs. Both stockbrokers and small shareholders argued that shareholders' rights could be improved in this regard. The new European-wide directive (COM, 2007) which addresses the key principles of accountability and transparency, is another milestone in shareholders' rights. As proclaimed by ACCA (2015:5), "Recent global developments in corporate governance include a new focus on the implementation and the quality of response rather than simple box ticking".

5.1.3 Rare and weak proposals hampered by a lack of financial knowledge

Proposals forwarded by shareholders at the AGM are both rare and weak, and there may be a number of factors contributing to this. One clearly emerging factor is the poor financial background of small investors rendering them unaware of the risks which they are exposed to and hardly capable of making informed financial decisions, even hindering them to the extent that they do not understand the AGM agenda. The strong indications, particularly as given by stockbrokers, are that this directly contributes to shareholders being less likely to put forward AGM proposals and also to the probability that even when they do so, these are in fact not taken seriously. For shareholder proposals to make any impact, they commonly have to be backed by sound financial knowledge. More education to this effect is therefore imperative if one is to have valid and increased shareholder proposals. As perceived to date, it is as yet justifiable to consider proposals as a weak disciplinary mechanism, as claimed by Bebchuk (2006). Yet, while there are diverging views on the power of such proposals, for the small shareholder these clearly have the potential of being a main participation ingredient facilitating a better balance among the corporate players.

MLCs do currently endeavour to increase investors' financial skills through a few investor education programmes and conferences held jointly with the Malta Association of Small Shareholders. Additionally, media and stockbrokers do provide educational investment material on their website. Yet, evidently, more needs to be done with the specific aim to overcome shareholder apathy towards reading and learning such skills. Furthermore, for the longer term, new investor generations may be introduced earlier to the fundamental aspects of finance and stock market dynamics. As ultimate aim, the necessary background is to be provided, rendering it more difficult for small shareholders to have their resolutions by-passed, as such, proposals will then have the real potential of sending significant messages to their company, even if not approved at the AGM itself. After all, it is in the interest of the company itself that the small shareholders do not continue to rely on institutional investors or a few active retail shareholders to speak up and try to bring change on their behalf.

Of course, the lower the level of investor knowledge, the greater the need for the MLCs also to ensure that general communication with them is clear and effective. Therefore, on their part, directors and others in contact with investors are also to ensure that their communication skills are sharp and may themselves have to undergo regular training, including induction courses and professional development programmes.

5.2 The AGM: enough for good corporate governance?

5.2.1 A forum for director/shareholder interaction?

In the light of the weak participation by small shareholders at the AGM, one asks whether the functions of the AGM as defined by Strätling (2003) are being applied for the sake of good corporate governance, particularly in supporting a forum for discussion between directors and shareholders both about past performance and future business prospects.

Directors are to hold themselves accountable to shareholders, and this is hardly, if at all, possible without shareholder participation and involvement. Accountability cannot be served merely with the CEO's or Chairman's speech, and the rest of the directors being uninvolved and silent for most of the meeting. As this seems to be commonly occurring, the inference is that AGMs are stage-managed and not serving as a platform for shareholders to exercise their ownership rights, including that of deriving from the directors the appropriate information concerning their stewardship. For this climate to be dispelled, time is to be allowed not only for genuine questions but also for the transmission of all needed information, such as the profile of all candidates, old and new, presenting themselves for director election. As for the transfer of information on the company's financial performance, it is important that the information provided during the AGM is not too technical for investors to understand. Such transmission has to be clear, simple and concise and, insofar as is possible, complete. This would help to transform the AGM from mostly being, as at present, a set of procedures for having management-backed resolutions rubber-stamped, focusing on the fulfilment of the financial reporting legal requirements to one with meaningful and potentially far-reaching interactive discussions. Such transformation is a *sine qua non* if the small shareholders' interest to attend and participate in the AGM is to be rekindled and for the AGM to become a more significant reflection of corporate governance than at present.

5.2.2 Exploiting technology – A way forward ***?***

The study points to a general need to exploit technology further to improve the AGM. This includes the use of electronic voting as long as shareholders are adept at using the new systems. In addition, more webcasting of the AGMs would permit those shareholders unable to attend to follow the meeting and thus with the opportunity of being kept informed as well. Technological devices could be used to increase shareholder engagement in decision-making. Listed companies could invest in an electronic polling system whereby the shareholder can select a simple 'yes' or 'no'. Such a polling system can become a simple and effective means for shareholders to convey their opinion, and for management to take more account of shareholders' opinions. This again brings to the fore the importance of shareholder education in bringing about change.

6. Conclusion

In summary, this study indicates that the level of small shareholder participation at AGMs of listed companies is low, with poor shareholder attendance being a major factor leading to this. Yet, even when attending, small shareholders do not feel confident in raising questions or bringing forth proposals during the AGM, and this is mainly due to limited meaningful information being transmitted to them, this being commonly aggravated by their lack of financial knowledge. The resulting inability of the AGM to create an effective forum for discussion between directors and shareholders casts serious doubt on whether the AGM actually reflects good corporate governance, as it does not keep in balance the interests of the small shareholder with those of the other stakeholders, including themselves, management and major shareholders.

For the sake of better direction and control, and, in particular, for more transparency and accountability, the study recommends that directors strive more towards ensuring that AGMs are not stage-managed, going beyond the simple routines of gathering votes and formal approval of resolutions towards serious interaction between themselves, management and all shareholders, possibly involving better use of technology. On their part, in order to effect fruitfully such interaction, small shareholders have to combat their passivity and attain a stronger sense of ownership in their company. For most of them, a main way towards effecting this is to stop relying on institutional or main shareholders to speak up and bring change. As a pre-requisite for this, they need to commit themselves towards acquiring the minimum level of financial knowledge. For this purpose, the study recommends that they participate much more in educational activities, particularly, though not only, those that may be tailor-made for them by company management.

The study has its limitations. In their response to what occurs at the AGM, MLCs may have been somewhat influenced by what their company expects to be occurring. Furthermore, the proportion of small shareholders responding to the questionnaire was relatively low, being largely limited by on–line accessibility. Following this study, further research may therefore attempt to place added focus on the perspectives of small shareholders themselves, such as by securing direct listed company support, such as listed company authorisations to attend the various AGMs and thus establishing face-to-face contact with such shareholders.

To conclude, Baldacchino *et al*. (2015) envisage the creation of a corporate governance index as a powerful means to align all corporate stakeholders towards a major common goal – that of improving the corporate governance performance of the company. Clearly, enabling a more meaningful participation for the small shareholder in the AGM should be an important preliminary step in the process ofachieving such stakeholder alignment towards corporate governance improvement.

References

Regulatory

Companies Act - Malta, 1995. Chapter 386 of the laws of Malta.

European Commission (COM) (2007). Directive 2007/36/EC of the European Parliament and of the Council on the exercise of certain rights of shareholders in listed companies.

European Commission (COM) (2014). Proposal for a Directive of the European Parliament and of the Council amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement and Directive 2013/34/EU as regards certain elements of the corporate governance statement, COM(2014) 213 final.

Listing Authority - Malta (2014). Listing Rules: https://www.mfsa.com.mt/pages/viewcontent.aspx?id=267 [24 September, 2014].

Organisation for Economic Cooperation and Development (OECD) (1999). *OECD Principles of Corporate Governa*nce. Paris: OECD Publishing.

Organisation for Economic Cooperation and Development (OECD) (2004). *OECD Principles of Corporate Governance*. Paris: OECD Publishing.

Other

Association of Chartered Certified Accountants (ACCA) (2015). *ACCA's position on the European Commission's proposal for a revised shareholder rights directive*. London, Feb**:** http://www.accaglobal.com/content/dam/acca/global/PDF [12 March 2015] .

Amey, J.H. and Mozley E.D. (2012). Online shareholder participation in AGMs*. HLS Forum on Corporate Governance and Financial Regulation:* http://blogs.law.harvard.edu/corpgov/2012/07/19/online-shareholder-participation-in-annual-meetings [15 November, 2104].

Anabtawi, I. (2006). Some skepticism about increasing shareholder power *UCLA Law Review,* 53(3): 561-600.

Apostolides, N. (2010). Exercising corporate governance at the annual general meeting . *Corporate Governance: The International Journal of Business in Society ,* 10 (2): 140-149.

Apostolides, N. and Boden, R. (2005). Cedric the pig: Annual general meetings and corporate governance in the UK . *Social Responsibility Journal,* 1(1): 53-62.

Association of British Insurers (2013). *Improving corporate governance and shareholder engagement:* https://www.abi.org.uk/~/media/Files/Documents/Publications [1 November, 2013].

Australian Corporations and Markets Advisory Committee (CAMAC) (2012) .*The AGM and Shareholder Engagement.* Australian Government Discussion Paper : http://www.camac.gov.au/camac/camac.nsf/byheadline/pdfdiscussion+papers/$file/agm.pdf [15 October,2015].

Bainbridge, S. (2006). The case for limited shareholder voting rights. *UCLA Law Review: 53*: 601-636.

Baldacchino, P.J., Baldacchino, J., Bezzina, F. and Tipurić, D. (2015). Assessing the applicability of a corporate governance index in Maltese listed entities*. International Journal of Transitions and Innovation Systems,* 4 (1/2): 43-60.

Bebchuk, L.A. (2005). The case for increasing shareholder power. *Harvard Law Review*, 118 (3): 833-914.

Bezzina, F., Baldacchino, P.J. and Azzopardi, J.R. (2014) [CG-4]. The corporate governance relationship between the board and management in Maltese listed companies. In *Rethinking Corporate Governance*. Tipurić, D., Raguž, V. and Podrug, N. (eds). Pearson, UK: 1-15.

Bizjak, J.M. and Marquette, C.J. (1998). Are shareholder proposals all bark and no bite? Evidence from shareholder resolutions to rescind poison pills. *Journal of Financial and Quantitative Analysis,* 33: 499-521.

Bottomley, S. (2003). *The role of shareholders' meetings in improving corporate governance*. Centre for Commercial Law, Faculty of Law, Australian National University, Canberra..

British Columbia Investment Management Corporation (2010). *Corporate Governance Principles and Proxy Voting Guidelines:* http://www.bcimc.com/publications/pdf/responsibleinvesting/corporategovernanceprinciplesproxyvotingguidelines.pdf [20 September, 2014].

Cadbury, A. (1992). *The financial aspects of corporate governance: A report of the committee on corporate governance* [Cadbury Report]. London: Gee & Co.

Companies and Securities Advisory Committee. (2010). *Shareholder Participation in the Modern Listed Public Company: Final Report* . Sydney: Companies and Securities Advisory Committee.

Crespi, R. and Renneboog, L., (2010). Is (institutional) shareholder activism new? Evidence from UK shareholder coalitions in the pre-Cadbury era. *Corporate Governance: An International Review*, 18(4) : 274-295..

Cziraki, P., Renneboog, L. and Szilagyi, P.G. (2010). Shareholder activism through proxy proposals: The European perspective. *European Financial Management,* 16(5): 738-777.

De Jong, A., Mertens, G., and Roosenboom, P. (2006). Shareholders' voting at general meetings: Evidence from the Netherlands. *Journal of Management and Governance*, 10(4): 353–380.

Dunlavy, C.A. (2006). Social conceptions of the corporation: Insights from the history of shareholder voting rights. *Washington and Lee Law Review, 63:* 1347-1388.

Ertimur, Y., Ferri, F. and Stubben, S.R. (2010). Board of directors' responsiveness to shareholders: Evidence from shareholder proposals. *Journal of Corporate Finance*, 16(1): 53-72. .

Gillan, S.L. and Starks, L.T. (2000). Corporate governance proposals and shareholder activism: The role of institutional investors. *Journal of Financial Economics,* 57(*2):* 275-305.

González, G.P., Guzman, A., Prada, F. and Trujillo, M. (2014). Annual general meetings: A waste of time or effective corporate governance bodies?: http://papers.ssrn.com/sol3/papers.cfm?abstractid=2395053 [15 Oct, 2014].

Gordon, L.A. and Pound, J. (1993). Information, ownership structure, and shareholder voting: Evidence from shareholder-sponsored corporate governance proposals. *Journal of Finance,* 48(2): 697-718.

Hampel, R. (1998). *Committee on Corporate Governance: Final Report. London:* Gee Publishing.

Hodges, R., Macniven, L. and Mellett, H. (2004). Governance of UK NHS trusts:the the annual general meeting. *Corporate Governance: An International Review,* 12(3): 343-52.

International Finance Corporation (IFC) (2009). *Stakeholder engagement and the Board: Integrating best governance practices:* http://www.ifc.org/wps/wcm/connect/19017b8048a7e667a667e76060ad5911/FINAL%2Bfocus8_5.pdf?MOD=AJPERES[22 September,2014].

Jensen, M.C. and Meckling, W.H. (1976). Theory of the firm: Managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics,* 3(4): 305-360.

Karpoff, J.M., Malatesta, P.H. and Walkling, R.A. (1996). Corporate governance and shareholder initiatives: Empirical evidence. *Journal of Financial Economics,* 42: 365–395.

Kathurima, K. (2011). *The Effectiveness of Annual General Meetings for Retirement Benefits Schemes.* Retirement Benefits Authority: http://www.rba.go.ke/publications/research-papers/category/1-research-reports-2010-2011?download=161%3Athe-effectiveness-of-annual-general-meetings-for-retirement-benefits-schemes [29 August, 2014].

Lafarre, A. (2014). Shareholder activism at European AGMs: Voting turnout and behaviour of (small) shareholders. Master's thesis Ondernemingsrecht, Tilburg University.

La Porta, R.L., Lopez-de-Silanes, F., Shleifer, A. and Vishny, R. (2000). Investor protection and corporate governance. *Journal of Financial Economics*, 58: 3-27.

Macey, J.R. (2008). *Corporate Governance: Promises Kept, Promises Broken.* Princeton: Princeton University Press.

Martin, K.J. and Thomas, R.S. (1999). The effect of shareholder proposals on executive compensation. *University of Cincinnati Law Review,* 67:1021-081.

Maug, E. and Rydqvist, K. (2001). What is the function of the shareholder meeting? Evidence from the U.S. proxy voting process. Working Paper, Humboldt University.

Pistor, K., Keinan, Y., Kleinheisterkamp, J. and West, M.D. (2003). The evolution of corporate law: A cross-country comparison. *Journal of International Economic Law*, 23(4): 791-871.

Prevost, A.K. and Rao, R.P. (2000). Of what value are shareholder proposals sponsored by public pension funds? *Journal of Business,* 73(2): 177–204.

Solomon, J. (2010). *Corporate Governance and Accountability*. Chichester: John Wiley & Sons Ltd.

Strätling, R. (2003). General Meetings: A dispensable tool for corporate governance of listed companies? *Corporate Governance: An International Review,* 11(1): 74-82.

Thomas, R.S. and Cotter, J.F.(2007). Shareholder proposals in the new millennium: Shareholder support, board response, and market reaction. *Journal of Corporate Finance*, 13(2): 368-391.

Van der Elst, C.F. (2011). Revisiting Shareholder Activism at AGMs: Voting determinants of large and small shareholders. *European Corporate Governance Institute (ECGI*), Finance Working Paper 311: 2.

Van der Elst, C.F. (2013). Shareholders as stewards: Evidence from Belgian General Meetings. Working Paper, Tilburg Law School: http://ssrn.com/abstract=2270938[22 September,2014].

Van der Schee, P.A. (2011). Regulation of Issuers and Investor protection in the US and Malta. *Boom Juridische Uitgevers: The Hague*: 137-138.

Walker, D. (2009). A review of corporate governance in UK banks and other financial industry entities: Final recommendations. http://webarchive.nationalarchives.gov.uk/+/http:/www.hmtreasury.gov.uk/d/walker_review_261109.pdf [6 November, 2015].

Weil, Gotshal and Manges LLP (2002). *Comparative study of corporate governance codes relevant to the European Union and its member states, on behalf of the European Commission*. Internal Market Directorate General, Brussels: http://ec.europa.eu/internal_market/company/docs/corpgov/corp-gov-codes-rpt-part1_en.pdf [3 October,2014].

Yermack, D. (2010). Shareholder voting and corporate governance*. Annual Review of Financial Economics,* 2(1)*:* 103-125.