

THE MEDIATION EFFECT OF CLIENTS' SATISFACTION BETWEEN AUDIT QUALITY AND AUDITOR RETENTION OF SMALL AND MEDIUM ENTERPRISES (SMES)

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Abstract: *Audit quality has been widely researched and the literatures have proven the quality of auditor-sourced services is of paramount importance to client management in deciding whether to continue with auditor services. The audit firm should be concerned in delivering high quality services through competencies and independence, as these two factors are used as proxies for audit quality based on the social exchange theory. Besides that, client satisfaction on services plays vital roles for the client's decision to retain or appoint new audit firm. Therefore, the purpose of this study is to explore the relationship between audit quality and auditor retention of Small and Medium Enterprises (SMEs) in Sabah. Additionally, the study also examined whether satisfaction has a role as mediator between the audit quality and auditor retention. The study applied a quantitative analysis of which at least 100 questionnaires were distributed to the SMEs and only 70 were useable and finalized. We deployed SPSS version 21 to conduct descriptive and regression analysis. Our findings indicated that clients' decision to retain auditor services depended upon auditor's competencies but less depended on auditors' independence. Additionally, when the study put forward satisfaction to mediate the relationship between competence, independence and auditor retention, it is revealed that satisfaction has full mediation effect on clients' satisfaction towards auditor retention but partially mediated independence and auditor retention. This study is significance as it is one of the earlier studies in Malaysia, particularly in Sabah, that has provided insight on the clients' (SMEs) intention for auditor retention from the perspective of customer satisfaction towards audit service quality. Therefore, the findings could be relied upon by audit firms to enhance its' audit services based on competencies and independence which leads towards clients' satisfactions and auditor retention.*

Keywords: *Audit Quality, Clients' Satisfaction, Auditor Retention, SMEs, Social Exchange Theory.*

Introduction

External auditors play a vital role in the protection of financial users by ensuring the effectiveness of organizational management. They also face challenges in maintaining and safeguarding their professional reputations. Therefore, audit firms should be concerned in providing high quality services to gain retention from their existing clients an extended period and at the same time, continue to attract new clients. By delivering high quality services to their clients, it will maximize client satisfaction and leads to customer retention (Pandit, 1999; Ismail, Haron, Ibrahim and Isa, 2006; Morton and Scott, 2007; Duff, 2009).

The social exchange theory (SET) is suitable in explaining the relationship between auditor and their client (Herda and Lavelle, 2013) since SET is viewed as the obligation for both of parties to gives and to get a return. In this study, SET focuses on the client's perception towards auditor in delivering high quality services and confidence with the service quality in the future based on satisfactory and consistency of past performance (Barnes, 2007; Tribault and Kelly, 1959).

Previous studies indicated three elements that are important in maintaining the services performance of a company which are service quality, satisfaction and customer retention (Mohamad Sabri, 2014; Inamullah, 2012; Lin and Wu, 2011; Ismail *et al.*, 2006). Audit quality has an effect on the retention and extension of the existing auditor's service (Morton and Scott, 2007). The audit firms' needs to ensure their auditor are competent and independent in providing high audit quality to their clients (Dunakhir, 2016; Fontaine, Letaifa and Herda, 2013; Suyuno, 2012).

Clients will continue to employ audit services for a longer time from their existing external auditor when they are satisfied with the overall quality of services (Ismail *et al.*, 2006, Mohamad Sabri, 2014; Mohamad Sabri and Ramely, 2015). This is due to satisfaction as one of the crucial factors for clients to decide whether to stay or switch their existing auditor (Mohamad Sabri, 2014; Fontaine *et al.*, 2013). The client's audit firm is considered satisfied with the services can be seen through the period length of the audit firms are in the service (Mohamad Sabri, 2014; Ismail *et al.*, 2006).

Therefore, retention is considered as a main concern for practitioners due to its significant impact towards the improvement in firm performance, especially in term of sales and profitability (Odunlami, 2015). Audit firms also faced similar issues related to retention, which can negatively influence audit performance, audit quality and auditor and professional reputations. As a result, audit firms tend to focus more on improving the overall quality of services, as well as maintaining the technical effectiveness (Duff, 2009) in order to gain retention from their clients.

However, audit firms experienced difficulty in ensuring their client satisfaction and repurchase intentions, due to auditor might failure to provide better audit quality services or commit a lot of error in delivering services (Mohamad Sabri, 2014; Ismail *et al.*, 2006). Therefore, in order to gain retention from clients, audit firms should consider which strategic plan can be used to satisfy their clients. This is due to auditor retention depending on the extent of the relationship between audit quality and satisfaction. Numerous past researchers have identified satisfaction as a mediator effects between customer loyalty/retention and service quality (El-Adly, 2018; Mohd Sabri, 2014; Ismail *et al.*, 2006).

The problems of auditor retention can be viewed from the perspective of SMEs' intention towards their existing auditor. Due to lack of managerial capabilities, skills and expertise in SMEs, so they need auditor to provide financial assistance. This is to guarantee SMEs complied with legal requirement and achieve competitive advantages. Additionally, SMEs are considered as one of the main GDP contributions and backbone of the economic growth in Sabah. Sabah's SMEs is essential as the state with the highest contribution to job opportunities. Besides that, Commission companies of Malaysia (CCM) had required that, financial statement by all companies should be audited before submitted to CCM for each financial year (Companies Act, 2016).

Based on the preliminary study, there are high numbers of SMEs companies in Sabah that are still using services from their existing auditor for more than nine years. Moreover, SMEs were chosen as the respondents, since SMEs is categorized as companies with high percentage in retaining their existing auditor for longer tenure and utilise non-audit services in the same audit firm (Mohamad Sabri and Ramely, 2015; Mohamad Sabri, 2014; Haron, Yahya, Ismail and Lee, 2012). Based on Mohamad Sabri (2014) and Ismail *et al.* (2006), this resulted showed that SMEs are satisfied with their current audit firms and gives empirical judgement on client satisfaction toward audit quality received.

Although related studies have been conducted in Malaysia (Mohamad Sabri, 2010; Ismail *et al.*, 2006), but replication of study in different context such as SMEs in Sabah should be undertaken. Thus, more research should be carried out to identify the relevant information based on client's decisions and SMEs are suitable as it enable to narrow down diversity of studies and facilitated data collection. Due to lack of the empirical study in these areas particularly in the Malaysian SME's, especially in Sabah, the topic of this paper will present a comparable issue between Sabah and other Malaysian states, and overall in Malaysia. Therefore, the purpose of this study is to explore the relationship between audit quality and auditor retention amongst Small and Medium Enterprises (SMEs) in Sabah. Additionally, the study also examines whether satisfaction has a role as mediator between the audit quality and auditor retention. This study is significant as it is borrow marketing theory which is social exchange theory to exploring the relationship between audit quality, satisfaction and auditor retention.

Literature Review

Auditor Retention

Retention is defined as customer repurchases the same product or used services from the same firm for a longer period (Ang and Buttle, 2006; Sirdeshmuh, Singh and Sabol, 2002; Bowen and Chen, 2001). The definition of auditor retention was adopted from the definition of retention and is defined as intention of audit firm's client to stay for another year (Pandit, 1999: 176). Auditor retention is essential for organizational survival and it was explain using social exchange theory (Gerpott, Rams and Schindler, 2001). It is supported from previous study that, social exchange theory is suitable in illustrating the relationship between audit firms and its client (Yi and Gong, 2009).

There have been multiple studies that scrutinised client perception of audit quality, satisfaction and auditor retention (Ismail *et al.*, 2006; Butcher Harrison and Ross, 2013; Mohamad Sabri, 2014). Satisfaction is an important player in enhancing retention. It can be proven from marketing literature; customer satisfaction was strongly significant and positively associated with customer retention (Odunlami, 2015; Inamullah, 2012; Lin and Wu, 2011). This result is consistent with study from professional services firms, found a highly significant relationship

between satisfaction and auditor retention (Mohd Sabri, 2014; Trasorras, Weinstein and Abratt, 2009; Ismail *et al.*, 2006).

Moreover, previous researchers also studied on the relationship between audit quality and auditor retention. The result indicated that there was a positive and significant relationship between audit quality and auditor retention (Butcher *et al.*, 2013; Morton and Scott, 2007; Pandit, 1999, DeAngelo, 1981). This is due to, providing high audit quality can influence on the intention or decision for auditor retention (Morton and Scott, 2007). Competence and independence are the most significant variables of audit quality that can influence the future of the incumbent auditor (Kiant, 2013; DeAngelo, 1981).

In conclusion, preceding studies have identified that audit quality and customer satisfaction has substantial relationship with auditor retention (Mohamad Sabri, 2014; Ismail *et al.*, 2006). Therefore, improvement in audit quality and higher level of customer satisfaction leads to auditor retention and the following hypotheses are presented:

- H₁: There is a significant and positive relationship between satisfaction with auditor retention.
- H₂: There is a significant and positive relationship between audit quality with auditor retention.
- H_{2a}: There is significant and positive relationship between competence with auditor retention.
- H_{2b}: There is significant and positive relationship between independence with auditor retention.

Audit Quality

Audit quality has become the centre of attention, for being an interesting subject, and has been defined from various perspectives. The most discussed and commonly used definitions by many researchers in describing audit quality, comprises of competence (the technical quality on probability of auditor to uncover the breach or misstatement) and independence (professionalism behaviour of the auditor to report the breach or misstatement found) (DeAngelo, 1981; Moizer, 1997; Herrbach, 2001; Sulaiman, 2011). Based on empirical research, it is noted that audit quality was evaluated based two type of measure; direct and indirect measure (Arezo, 2011). The example of direct measures are financial reporting compliance, quality control review, bankruptcy, SEC performance, while indirect measure is related to behavioural perspective such as service quality and technical quality (i.e. reputation, independence, competence and experience).

There are existing studies on satisfaction which proven that service quality is essential in providing customer satisfaction. Providing high audit quality can relatively affect client satisfaction, and there is significant relationship between audit quality and client satisfaction (Ismail *et al.*, 2006; Morton and Scott, 2007; Butcher *et al.*, 2013). Competence is a proxy in measuring audit quality and is defined as the knowledge (education, expertise, skills and experience), as well as having ethical behaviour in conducting audit (Asmara, 2016; Usman, 2016; Arens, Elder and Beasley, 2014).

The most important audit quality dimension for auditors is capability, which is part of competence factor (Dunakhir, 2016). Therefore, competence was significant and positively associated with customer satisfaction (Moghavvemi, Lee and Lee, 2018; Iskandar, Rahmat and Ismail, 2010). Contrary, study from Reheul, Canegham and Verbruggen (2015) found that competence was positively related on selecting new audit firms rather than to satisfy their

clients. This study was supported from McKnight and Wright (2011) indicated that competence is the least distinguishing factor in measuring auditor's performance.

Another attributes of audit quality measurement is independence. Independence is defined as the basis of reporting a discovered breach and divided into two categories namely independence in appearance and independence in fact (DeAngelo, 1981; Fearnley, Beattie and Brandt, 2005). Previous studies demonstrated empirical evidence that independence influences audit quality (Octavia and Widodo, 2015; Suyuno, 2012). Quick and Schmidt (2018) brought attention to only one study from Dopuch, King and Schwartz (2017) was investigated the effect of auditor retention on auditor independence and observed that audit firm rotation either alone or jointly with auditor retention, increase auditor independence. However, it contradicts with their result, which perceived auditor independence does not have a significant effect on rotation and retention. However, study from Iskandar *et al.* (2010) found that client satisfaction is significantly and positively related to audit firm independence. Therefore, the following hypotheses are presented:

- H₃: There is a significant and positive relationship between audit quality with satisfaction.
- H_{3a}: There is significant and positive relationship between competence with satisfaction.
- H_{3b}: There is significant and positive relationship between independence with satisfaction.

Satisfaction

Satisfaction is described as an immediate reaction of emotion of a person on the specific time or point of determination (Giese and Cote, 2002). Satisfaction occurs when a company has the ability to predict and anticipate based on what customer's desire from their services in order to fulfil client's want, need or goal (Hansemark and Albinsson, 2004; Kotler, 2000; MacInnis, 2001). Previous studies have found that a mediator affects satisfaction to auditor retention and audit quality (Parasuraman, Berry and Zeithaml, 1990; Ismail *et al.*, 2006; Mohamad Sabri, 2014). Additionally, social exchange theory explain that, when auditor provides high audit quality will leads to customer satisfaction and in return the client will continue to purchased services from the existing auditor for the longer period (Herda and Lavelle, 2013). Thus, the following hypothesis is presented:

- H₄: The interrelationship between audit quality and auditor retention is affected by the mediating variable of satisfaction.

Theoretical Framework

The theoretical framework postulates the relationship between audit quality, satisfaction and audit firm retention. Based on the social exchange theory, satisfaction can acts as a mediator of audit quality towards audit firm retention (Herda and Lavelle, 2013; Yi and Gong, 2009). Figure 1 shows the conceptual structure of the study by illustrates the following basic sequence audit quality leads to satisfaction, which in turns leads to audit firm retention.

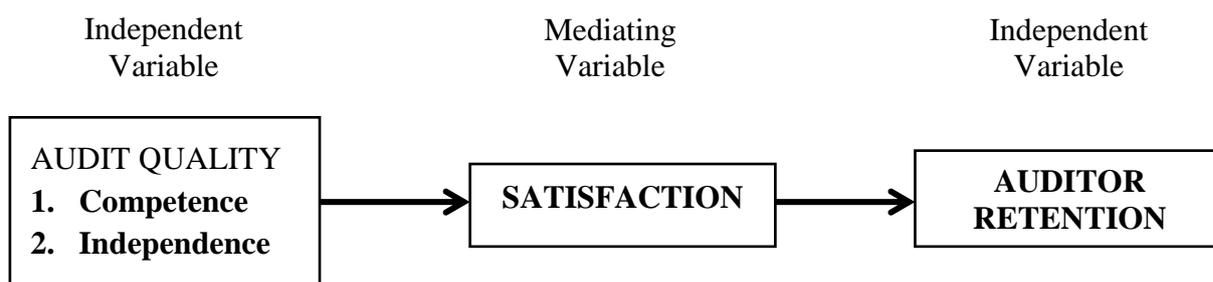


Figure 1: Theoretical Framework

Sources: Herda and Lavelle, 2013; Yi and Gong, 2009; Homan, 1958.

Methodology of the Paper

A cross-sectional survey study based on the deductive research approach was conducted using a pre-tested questionnaire in the East of Malaysia, namely Sabah. The aim of this study was to assess the relationships between audit quality, satisfaction and auditor retention among SMEs companies in Sabah using regression analysis. The sample of the study were drawn from a population of SMEs companies with annual sales turnover below RM20 million. The data were collected through self-administrative, email and online questionnaire. The questionnaire consisted of four sections, which comprised of (i) demographic of respondents, (ii) client experienced with the audit service from their existing audit firm, (iii) respondent feedback whether they are satisfied or not with the current services offered by firms and could it lead to auditor retention. Lastly in section four, preferred intention to retain or switch their existing auditor was chosen as the dependent variable to reflect the dichotomous nature of the decision.

Table 1: Questionnaire Design and Measurement

Variable	Items	Source	Measurement
Competence	6	Butcher <i>et al.</i> (2013); Morton and Scott (2007) and Duff (2002)	Five-point Likert Scale
Independence	5	Morton and Scott (2007)	Five-point Likert Scale
Satisfaction	4	Eggert and Ulaga (2002); Taylor and Baker (1994); Taylor and Baker (1994) and Bitner (1990)	Seven-point Likert Scale
Auditor Retention	5	Butcher <i>et al.</i> (2013) and Eggert and Ulaga (2002)	Seven-point Likert Scale

Table 1 showed the questionnaire design and measurement used in this study. Both descriptive and inferential statistical analyses were carried out using SPSS Statistic 21. Descriptive statistical analysis was used to summarise the results of respondents while inferential statistics was utilised to test the relationship. This research ensured that the particulars of respondents were anonymous so that the data collected would not be traced back to them.

Finding and Discussion

Description of Sample

A total of 70 respondents participated in this study and the information about demographic profile of companies and respondents are presented below.

Table 2: Demographic Profile of Companies and Respondents

Demographic Variables	Frequency	Percentage
Respondent Designation		
Director and Manager	40	57.1
Account and Finance Manager	16	22.9
Account Assistance and Clerk	5	7.1
Internal Auditor	9	12.9
Year of Company Operation		
0-5 years	14	20.0
6-10 years	21	30.0
11-15 years	17	24.3
16-20 years	5	7.1
More than 21 years	13	18.6
Year of using Existing Auditor		
0-5 years	25	35.7
6-10 years	24	34.3
11-15 years	11	15.7
16-20 years	5	7.1
More than 21 years	5	7.1

Table 2 shows that most of the respondents are directors and managers of company which is 40 respondents, followed by account and finance manager at 16 respondents, internal auditors is 9 respondents and only 5 respondents are account assistants and clerks. Next, the table shows the profile of company, which is the period of company operation and year of company using services from their existing auditor. Most of respondents came from companies that already have been operating between 6-10 years which is 21 respondents. While, the highest respondents that represents company that using services for existing auditor ranging between 0-5 years which is 25 respondents.

Assessment of Variables

In testing the validity of questionnaire, this study used exploratory factor analysis to measure whether the concept or questionnaire for each dimensions emerge or not. The principle component factors (PCA) was employed to analyse all the variables with Promax rotation on data received from 70 respondents. In addition, the Kaiser-Meyer-Olkin (KMO) measured the sampling adequacy, which determines if the responses given with the sample are adequate or not and it should be close than 0.5 for a satisfactory factor analysis to proceed. The result of KMO as suggested that sample was factorable (KMO = 0.589).

Reliability was used to test consistency and stability, and Cronbach's alpha (α) represented how well the items are correlated with one another (Bajpai and Bajpai, 2014). We used the criteria of Cronbach's alpha for establishing the internal consistency reliability: Excellent ($\alpha > 0.9$), Good ($0.7 < \alpha < 0.9$), Acceptable ($0.6 < \alpha < 0.7$), Poor ($0.5 < \alpha < 0.6$), Unacceptable ($\alpha < 0.5$) (Cronbach and Shavelson, 2004). The result showed that the Cronbach's alpha (α) value ranging from 0.6 to 0.955 has fulfilled the minimum requirement of level reliability as suggested by Cronbach and Shavelson, (2004).

Regression Analysis and Hypotheses Result

Table 3: Regression Result of Satisfaction and Auditor Retention

Independence Variable	coefficient	t-value	sig	Remark
Satisfaction	1.078	8.756	0.000**	Supported
R ²	0.530			
Adjusted R ²	0.523			
F-statistic	76.661			
Sig. F	0.000			

Notes: **significant at 0.05 level, ***significant at 0.01, *significant level 0.10.

Table 3 exhibits the regression result for satisfaction and auditor retention. The result showed that the t-statistic for satisfaction ($t = 8.756$, $p = 0.000$) are positive and significant, while the value of Adjusted R square of 0.523 or 52.3% was significant at 0.000 levels. This result indicated that satisfaction had a greater impact on auditor retention and consistent with previous studies from Odunlami (2015), Innamullah (2012) and Lin and Wu (2011) found that customer satisfaction and customer retention have strong significant and positive relationship. Therefore, Hypothesis H₁ is accepted and concluded that satisfaction affects auditor retention.

Table 4: Regression Result of Competence, Independence and Auditor Retention

Independence Variable	coefficient	t-value	sig	Remark
Competence	0.356	2.076	0.042**	Supported
Independence	0.143	0.721	0.473*	Not Supported
R ²	0.137			
Adjusted R ²	0.111			
F-statistic	5.308			
Sig. F	0.007			

Notes: **significant at 0.05 level, ***significant at 0.01, *significant level 0.10.

The table 4 displays that the regression results for competence, independence and auditor retention. The result showed that the t-statistic for competence ($t = 2.076$, $p = 0.042$) are positive and significant. The hypothesis H_{2a} is accepted have similar result from Butcher *et al.* (2013), in which competence has a greater impact on perceptions of audit service quality for retainers. While, the independence result ($t = 0.721$, $p = 0.473$) reported has positive relationship but not significance, hence hypothesis H_{2b} is not accepted. This result is consistent with study from Butcher *et al.* (2013) found that independence does not have significant relationship with auditor retention. This is due to independence only influence on initial selection of auditor or in decision to change audit firms (Reheul *et al.*, Butcher *et al.*, 2013).

Table 5: Regression Result of Competence, Independence and Satisfaction

Independence Variable	coefficient	t-value	sig	Remark
Competence	0.436	4.068	0.000***	Supported
Independence	-0.047	-0.383	0.703*	Not Supported
R ²	0.260			
Adjusted R ²	0.238			
F-statistic	11.793			
Sig. F	0.000			

Notes: **significant at 0.05 level, ***significant at 0.01, *significant level 0.10.

Based on the above table, the result indicated that the relationship between competence and satisfaction were positively and significantly associated ($t = 4.068$, $p = 0.000$). A statistical significant ($F\text{-value} = 11.79$; $p = 0.000$) was determined. The hypothesis H_{3a} is accepted, mirroring similar result from Iskandar *et al.* (2010), whereby competency is a vital determinant of audit quality and has significant effect on client satisfaction. While relationship between independence and satisfaction was found not to be significant and negatively relationship ($t = -0.383$, $p = 0.703$). According to result from demographics' respondents, it was indicated that the company might not view independence as an important element of audit quality for satisfaction, since most of them are using the services from their existing auditor for more than five years. Based on Sarbanes-Oley Act 2002 (SOX) required rotation for auditor at least one every five years and Malaysia does not have mandatory audit firm rotation requirement (Malaysian Institute of Accountant, 2011, pp.82-83). Therefore, H_2 is accepted. The value of Adjusted R square of 0.238 or 23.8% was significant at 0.001 levels. Overall, this study concluded that audit quality affects satisfaction and H_3 is supported.

Hypothesis 4 was tested using multiple regression analysis to obtain the result of IV (competence and independence) on the DV (auditor retention) that was tested on a continue scale. Consequently, this study utilized satisfaction as mediator to test whether this variable gives significant effect of audit quality to auditor retention. According to previous studies by Baron and Kenny (1986) and Ramayah, Ignatius and Aafaqi (2005), the results in the present study can be categorized to be partial or full mediate depending on few circumstances:

1. Full mediation – when at the end of results is no longer significant
2. Partial mediation – when at the end of result shows still significant but the value of (β) or significant decreased.

Table 6: Hierarchical Regression Result of Service Quality, Satisfaction and Auditor Retention

Independent variable	Dependent Variable (Auditor Retention)				Result
	Without mediating variable		With mediating variable		
	Coefficient β	t	Coefficient B	t	
Competence	0.356	2.076*	-0.122	-0.870*	Full Mediation
Independence	0.143	0.721*	0.195	1.340*	
Satisfaction			1.097	7.651***	Partial Mediation
R ²	0.137		0.543		
Adjusted R ²	0.111		0.522		
F-statistic	5.308		26.088		
Prob. F-statistic	0.007		0.000		

Notes: **significant at 0.05 level, ***significant at 0.01, *significant level 0.10.

The table 6 presents the hierarchical regression result of service quality, satisfaction and auditor retention that used to understand more on the mediator effect. In this study, satisfaction can be seen as fully mediates between competence and auditor retention, while satisfaction is partial mediates between independence and auditor retention. These results are consistent with existing prior research from Mohamad Sabri (2014) and Ismail et al. (2006), which it showed

that satisfaction mediates the relationship between audit quality and auditor retention. Hence, hypothesis H4 is supported.

Conclusion, Limitation and Future Research

The purpose of this study was to explore the relationship between audit quality and auditor retention amongst Small and Medium Enterprises (SMEs) in Sabah. Additionally, the study also examined whether satisfaction plays a role as a mediator between audit quality and audit retention. The findings in this study indicated that competence has a significant effect on satisfaction and auditor retention. Independence was found to be not significant. It was also discovered that satisfaction is a key element in enhancing auditor retention. Thus, satisfied audit client (SMEs) is important in developing auditor retention. Satisfaction was also observed to mediate the relationship of competence and auditor retention. Thus, the results indicated that improving client's perceptions on audit quality can effectively increase satisfaction levels and leads to audit firm retention.

A limitation of our study is that only two independent variables were chosen for this study. There are other determinants in audit quality that can lead to satisfaction and auditor retention. Another limitation is that, like prior studies, this study is cross-sectional and relies on self-collected data gathered by closed ended survey questionnaire and is, therefore, subjected to the normal limitations. Future research could use alternative theoretical models and other variable such as experience and service quality to measures of audit quality. Besides that, open ended questionnaires are recommended to be included in the future researchers' survey or using different methods, such as face-to-face interview with respondents.

The lack of adequate research in this particular area warrants further examination, as future studies will be fruitful in understanding the association between audit quality, satisfaction and auditor retention. This study's results have implications for audit firms in practice, since it has provided direct evidence of clients' (SMEs) decisions on audit firm is related to specific attributes of audit service quality, especially audit competence. This result can be used for audit firm as a guide in designing an effective retention strategy in retaining their clients and attract new potential clients.

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