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Tribalism and Perceived Auditor Independence: A Research Opportunity in the Arab World

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Abstract: This study discusses a phenomenon prevalent in the Arab culture namely tribalism and its possible effect on auditor independence. It provides insight into collective societies, specifically tribal ones where the individual takes care of his group's interests in what is considered as permanent loyalty to the group, often attributed to a collectivistic society. Owing to its widespread existence, it may threaten auditor's independence, especially when both auditor and client come from one tribe or two affiliated tribes.

Key words: Auditor independence, culture, tribalism, Arab countries, tribes

INTRODUCTION

Independent auditors obtain evidence enabling them to know whether the information in the financial reports is accurate. Upon doing so, they report to the users of the financial statements through the expression of their opinion of the company's financial position, operational results and changes in financial position and whether or not the statements are according to generally accepted accounting standards. Although, the company's management might have an interest in falsifying reports of performance or misrepresenting, an independent auditor's report is assumed to provide an unbiased and credible information of the firm's financial position (Kumar and Sharma, 2005).

According to agency theory, the problem lies in the fact that principals do not trust managers to provide reliable and relevant information. As a consequence, the role of auditor in this situation is very important to increase the credibility and validity of financial information in order to protect the other parties' interest. However, auditors face another type of conflict of interest which may reduce their independence namely the self conflict of auditor's interest (Goldman and Barlev, 1974). This may lead to decreased credibility of financial information.

Therefore, auditor independence is a concept critical to financial statement users as they largely depend on the external auditor's opinions. Hence, without auditor independence from clients' management, the former's opinion becomes useless (Mautz and Sharaf, 1961). Auditor independence is the source of financial reporting integrity as it ensures that the financial statements certified by the auditor can be depended on by the investors who are considered the main axis of commerce and the state's economic growth (Fearnley *et al*., 2002), moreover, the credibility of the statements hinges on the individual's perception of auditor independence. This is why, it is deemed as the core of the auditing profession.

The collapse of major corporations including Enron, Worldcom, Parmalat and Health South Corporation in the earlier years of the millennium has been debated upon by both academics and regulators alike. In this context, prior researchers took the basic reason behind the collapse into consideration which was the damage of credibility and validity of financial statements and the oversight of the primary aim of audit functions (Cullinan, 2004).

The above cited companies collapsed in developed countries that are characterized by auditing competence and independence. This collapse worsened the Western economies' experience of a severe financial crisis in 2008 brought about by banking failures. The state eventually had to intervene to rescue collapsing financial institutions.

A study dedicated to the examination of financial reports in relation to the collapse was conducted by Sikka (2009). He revealed that while strong regulations and standards exist in the Western countries, there is considerable lack of auditor independence. This was supported by the banks' acknowledgement of the unqualified audit opinions on their annual reports before they went bankrupt. For example in the US, the Lehman Brothers, Citigroup, U.S. Bankcorp, Washington Mutual,

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Thornburg Mortgage in the UK Abbey National, Alliance and Leicester, Barclays, Royal Bank of Scotland, Northern Rock, Lloyds TSB Bank in France, Banks of Dexia; in Holland, Fortis, ING Bank in Iceland, Landsbanki, Kaupthing Bank; in Switzerland, the UBS Bank and finally in Germany, the Hypo Real Estate Bank. These banks all suffered the same fate. Given the situation in the developed countries where auditor independence is lacking, one can surmise that the situation in the developing countries along with least developed countries would be even worse.

Threats to independence arise from a variety of activities and relationships (e.g., family and business relationships) and may emerge in a wide array of circumstances. Providing non audit services to audit client has the potential to create a strong relationship between auditor and his client. Thus, it is essential to identify potential threats that represent risk sources of auditor independence (PCAOB, 2003).

A number of regulatory frameworks of auditor independence such as IFAC (2005) revealed that UK and Australia adopted a principle based approach to auditor independence. This approach is based on identifying threats to auditor independence and safeguards which can be applied to minimize risks. These regulatory frameworks determine five main threats (risks) in Code of Ethics for Professional Accountants (June 2005) that may impair auditor independence. These threats are:

- Self-interest threats that occur as a result of financial interests or other interests
- Self-review threats that occur when judgment needs to be evaluated by the auditor as he is responsible for this judgment (auditor re-evaluating his work)
- Advocacy threats that occur when auditor promotes opinion to the point that may compromise objectivity
- Familiarity threats that occur when close relationship as the auditor may be sympathetic to the others' interests
- Intimidation threats that occur when auditor is threatened from acting objectively by threats

Moreover, IFAC, Code of Ethics mentioned safeguards that may eliminate or reduce threats: safeguards that come from professional regulation and legislation (experience requirements, requirements of professional development, regulations of corporate governance, standards of profession, disciplinary procedures and professional monitoring, external review by third party of the reports) and safeguards that come from work environment. Safeguards vary depending on the circumstances of work environment (e.g., policies of monitoring quality control of engagements).

Threats towards auditor independence along with its safeguards are all associated to the technical factors, environmental factors and regulation (Wolnizer, 1987). One or more of the above factors may seem to adversely impact auditor independence. Consequently, this may lead to stakeholders' perception of the compromise of the financial statements integrity. Hence, independence in appearance as well as in fact is needed to achieve auditor independence. As such, the IFAC Code of Ethics stressed the importance of both independence of appearance and fact.

In this regard, several studies addressed the issue of auditor independence and its resolution. Prior studies dedicated to this examination can be divided into survey studies and archival studies. The former approach used primary data and concentrated on the perceptions of financial report users while the latter used secondary data. Both set of approaches examined the factors that may influence auditor independence including economic dependence, non-audit services, competition, flexibility of accounting standards, auditor size, director control, auditor tenure, business and personal relationships, the financial position of the client, auditor change, audit committee, tenure regulation, audit risk, regulation of auditor change, financial relationship disclosure and company type. These factors have long been examined by prior studies and the present ones in several developed as well as developing countries. For instance, they were examined in New Zealand by Gul (1989) in the UK by Beattie *et al.* (1999) in Malaysia by Abu Bakar *et al.* (2005) in Australia by Ye *et al.* (2011) in Saudi Arabia by Hudaib and Haniffa (2009) in Bahrain by Al-Ajmi and Saudagaran (2011) and in Indonesia by Irmawan *et al.* (2013).

COMMON CHARACTERISTICS IN ARAB COUNTRIES

Many countries around the world share common factors (e.g., in their markets, religion and culture) that may influence auditor independence (Wolnizer, 1987; Cohen *et al.*, 1992). All Arab countries share the same language, religion and culture and they have similar attributes with some differences (Fattouh and El-Katiri, 2012). The Arab world is culturally rich, complex and diverse. It includes twenty two countries in the precise geographical area which constitutes the Arab world. These countries include Algeria, Bahrain, Djbouti, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libya, Mauritania, Morocco, Oman, Palestinian Territories, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tunisia, United Arab Emirates and Yemen.

The prevailing religion in the Arab world has played a significant and influential part in shaping society and culture in the region. Islam is the official religion in the Arab world and it influences every facet of life. Laws, education, day-to-day routines, clothes and even conversations are significantly influenced by Islam. Islam emphasizes on behaviors like generosity, respect and modesty that majority of the people in the Arab world practice.

Furthermore, Arabic is one the major languages of the world. It is spoken by >370 million Arab people and it is the official languages of majority of Arab countries. In addition, Arabic is the language of the Muslim Holy Book, the Qur'an. It is a language of Islamic religious significance to hundreds of millions of Muslim people throughout the world, both Arab and non-Arab.

Moreover, Arabs and Westerners have entirely different culture. Family coupled with tribal connections is what Arab social structure is built on. Both family and tribe significantly influence the individual's values and behavior and they provide financial and emotional support to tribal members. Accordingly, family is very important and family honor is greatly protected. Loyalty between family and tribe is carried over to business where it is common for companies to be managed by family and at the same time, employ individuals from the same family/tribe. In this regard, the tribe refers to a group of persons forming a community and claiming descent from a common ancestor.

The role of tribalism is often overlooked in many business and economic researches in Western countries and many developed and developing countries. However, the situation is different in Arab countries where the tribe plays a main role in politics and social life (Corstange, 2008). Therefore, this phenomenon provided the main motivation for the present study to discuss auditor independence in the context of the emerging Arab world market, characterized by tribal culture that entails the greatest sense of loyalty toward other members in tribe. This cultural characteristic of the Arab countries in the Arab world and the significance of kinship as well as personal relationships are distinct to this region (Hudaib and Haniffa, 2009). Hence, examining the phenomenon in this context is crucial because auditor independence is not just a technical concept but also a cultural one (Wolnizer, 1987). According to Cohen *et al.* (1992), both cultural values and socio-economic conditions prevailing in a specific environment will impact individual's perception and behavior.

ARAB TRIBAL CULTURE AND THE IMPACT ON AUDITOR INDEPENDENCE

Prior studies examined various personal links to auditor independence. Specifically, Hussey and Lan (2001) studied the UK finance directors' perceptions concerning auditor independence in light of professional, distant professional, amicable professional and personal friendship aspects. They revealed that the finance directors knew that the nature of their personal relationship with their auditors would affect the perceptions of auditor independence by third parties. According to them, it would appear that finance directors enjoying a good personal relationship with their auditors are aware that this relationship would adversely affect the third party's perceptions.

In related studies, Dykxhoorn and Sinning (1981) and Lavin (1976) noted the effect of family and business relations upon auditor independence in the context of Germany. Dykxhoorn and Sinning (1981) showed that family and business relations between auditor and auditee appeared not to adversely affect the perceptions of financial users toward auditor independence. On the other hand, Lavin (1976) noted that business relationships negatively affected the perceptions of auditor independence significantly despite the respondents lack of concern of family relations in situations where an audit has a sibling or relative employed at the higher ranks of the company as long as the partner is not directly involved in the audit this finding is consistent with that of Cheung and Hay (2004) in the context of New Zealand.

The same notion was contended by Islam *et al.* (2005) who stated that auditor independence may be compromised by the personal relationship between auditor and auditee and the auditor's relationship with an individual connected to the firm. This relationship may be deemed as close relationship with the auditor (e.g., the auditor's immediate family, a partner, a spouse or an individual personally close to the person for reasons aside from business or private informal obligation, contract or indebtedness).

Similarly, Irmawan *et al.* (2013) examined family relationship's impact on perceived auditor independence in Indonesia, specifically in terms of Javanese culture. The loyalty in Javanese collectivistic culture is of great importance and society forges strong relationships where each group member takes responsibility for his fellow members. They revealed that less confidence on auditor independence was perceived when the auditor firm's family members are involved with the client in some other professional work.

The earlier studies covered family, business and professional relations. Nevertheless, they were carried out in Western countries which have distinctively different societal structures compared to Arab countries. In the latter, the business environment is greatly under various traditions control. These include customs, rules, norms and attitudes towards social activities and practices originating from Arab history (Haniffa and Hudaib, 2007). In other words, specific societal structure is prevalent in many Arab countries and at its extreme, tribal fanaticism exists despite the civil state.

More importantly, the tribe is the basic social unit of Arab social structure. In the Arab countries, tribal customs cater to the interests of the tribe and its members which often times adversely influence the political, social and economic issues of the country as a whole (Anthony, 1982; Muhammad, 1999; Corstange, 2008; Makhfee, 2011). According to Hofstede (1997)'s classification, the Arab speaking countries are characterized by large power distance collectivistic culture where individual's loyalty to the inner group prevails.

In a society rife with collectivistic tendencies, the process of hiring tends to be in-group where hiring preference tends to favor relatives. In the workplace environment of this type of society in-group is also deemed in an emotional level. While in-group differs from one collectivistic country to another, the feeling is more often than not, always in existence. With regards to the moral aspect of the employer-employee relationship in-group relationship entails mutual obligations of protection of enduring loyalty (Hofstede, 1997).

In the same way, the tribal customs in the Arab world caters to the tribal interests and the interests of its members. These customs manifest the interdependence among the tribal members (Anthony, 1982; Muhammad, 1999; Corstange, 2008; Barr, 2011; Makhfee, 2011). According to Hudaib and Haniffa (2009), Arab culture significantly impacts auditor independence. In support of this, Hofstede (1997)'s study revealed that the dimension of collectivism reinforces the Arab tribal custom as the individual vigilantly supports his group's interest in what is commonly known as permanent loyalty to the group. Hofstede further added that people primarily act as members of a coherent group. People having large extensive families, are ensured protection in lieu of unwavering allegiance to the family/tribe. As a result, tribalism may threaten auditor independence.

CONCLUSION

Prior studies largely ignored tribal relationship and its association with auditor independence, primarily owing to the distinct structures of Arab countries and societies. These countries possess a significant well-organized structure that links society with various tribes. According to culture theory, culture is described as the different concepts, perceptions, beliefs, values and knowledge. It manifests in people's analysis of their environment. Moreover, collectivistic societies comprise of individuals behaving as a group in a logical and well organized manner. However where the families of this society or tribe are extensively spread out, this ensures protection in lieu of unwavering allegiance to the tribe. As such, the collectivism dimension reinforces the tribal traditions in the Arab world where attention is focused on the tribal interests and the interests of its members. This phenomenon of tribalism may pose as a threat to auditor independence, specifically:

- When both auditor and client come from the same tribe or
- When both auditor and client come from the same social network of tribes (tribal confederation)

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