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Mishari M. Alfaraih

Faisal S. Alanezi

The Public Authority for Applied Education and Training, Kuwait

THE EFFECTIVENESS OF JOINT AUDITOR REQUIREMENTS IN PROMOTING CORPORATE DISCLOSURE QUALITY

Key Words

Joint Auditors; Corporate Disclosure Quality; Emerging Markets.

Abstract

The purpose of this study is to explore the effectiveness of requiring firms listed on the Kuwait Stock Exchange (KSE), to be audited by two external auditors on the quality of corporate disclosures. Consistent with prior disclosure research, the level of disclosure is examined using a self-constructed, item-based disclosure index. The study results show the average level of mandatory disclosures for all KSE-listed firms in 2006 was 72.6%; thus, indicating KSE-listed firms generally did not fully comply with all mandatory disclosure requirements. As KSE-listed firms are obligated to be audited by two different external auditing firms since 1995, a constant sample approach was used to assess the quality of corporate disclosures pre and post this requirement. The results show that average level of mandatory disclosure was 75% in 1994, and 78% in 2006, an increase of 4% over a 12 years period. The findings of the present study have a direct implication for the effectiveness of this requirement in promoting corporate disclosure quality. Given empirical evidence of widespread non-compliance with mandatory disclosure requirements, the results of this study are likely to raise questions about the quality and reliability of requiring two external auditors and the associated cost-benefit of this requirement for KSE-listed firms.

Introduction

Since 1995, firms listed on the Kuwait Stock Exchange (KSE) are obligated to be audited by two different external auditing firms. This requirement distinguishes the Kuwaiti

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accounting environment from that of countries with more developed economies, where only one external auditor is required. Motivated by the unique institutional setting that exists in Kuwait, the purpose of this study is to investigate the extent of compliance with disclosures required by the International Financial Reporting Standards (IFRS) with respect to firms listed on the KSE, and how a mandatory requirement to have two external auditors promotes corporate disclosure quality.

The study is unique in that the institutional setting that exists in Kuwait provides an opportunity to explore the quality and reliability of requiring two external auditors and the associated cost-benefit of this requirement for firms. No known research has yet been conducted to explore the implications of having two auditors on financial reporting. Given empirical evidence of widespread non-compliance with mandatory IFRS disclosure requirements by firms that claim to comply with the standards in different regions (Al-Shammari *et al.*, 2008; Glaum and Street, 2003; Street and Gray, 2001; Street and Bryant, 2000), this study can shed light on the effectiveness of the two-auditor requirement in promoting corporate disclosure quality as well as the associated cost-benefit of this requirement for firms.

The research method consists of examining the level of compliance with mandatory IFRS disclosures among all firms listed on KSE on 2006. Consistent with prior compliance research, the level of compliance is examined using a self-constructed, item-based compliance index. The results show the average level of compliance with IFRS mandatory disclosures for all KSE-listed firms in 2006 was 72.6%; thus, indicating that KSE-listed firms generally did not fully comply with all requirements. Significant variations in the extent of compliance are observed among firms and across accounting standards. As one of the purposes of this paper is to examine the effectiveness of requiring two external auditors on the quality of corporate disclosures, a constant sample approach was used to assess the quality of corporate disclosures in pre this requirement (year 1994) and post this requirement (year 2006). The results show that the average level of mandatory disclosure was 75% in 1994, and 78% in 2006, an increase of 4% over a 12 years period.

Ordinary least regression results shows significant differences in the level of compliance across the three possible auditor combinations of two Big-4, two non-Big 4, and mixed audit firm types. Given that none of the 163 KSE-listed firms comply fully with all IFRS in 2006 and the empirical evidence of widespread non-compliance with mandatory IFRS requirements, the results of this study are likely to challenge the effectiveness of the two-auditor requirement in promoting compliance with regulations as well as the associated cost-benefit of this requirement for firms.

The remainder of this paper is organized as follows. Section 2 discusses the regulatory framework concerning accounting and auditing in Kuwait and its impact on firms listed on the KSE. Section 3 provides an overview on prior research on IFRS compliance and the determinants of IFRS compliance. Section 4 outlines the relevant theory, while Section 5 discusses the research design utilized in the study. Section 6 presents an analysis of the data and multivariate regression analysis results. The paper concludes in Section 7 with a summary and discussion of results, and an outline of the study's major contributions and implications.

Accounting and Auditing Regulations in Kuwait

One of the most significant laws governing accounting in Kuwait is the Law of Commercial Companies No. 15/1960, which was issued by the Ministry of Commerce and Industry (MCI) on October 19, 1960 to organize the formation of new companies and to regulate the administration of existing companies (Al-Qahtani, 2005). The MCI Law requires companies to provide an audited annual balance sheet and a profit and loss statement to the MCI and all shareholders. However, the law has not provided guidelines for preparing these statements other than that they need to be prepared in accordance with "generally accepted accounting standards" to reflect a "true and fair view" of the company position and to maintain a proper book of accounts. Furthermore, the law does not define "generally accepted accounting standards" or "true and fair view."

Because of the ambiguity caused by not specifying a set of accounting standards, as well as the lack of direction on what constitutes a "true and fair view," significant differences have emerged among the disclosures provided in the financial statements of Kuwaiti companies (Shuaib, 1987). In response to these discrepancies and in an attempt to standardize accounting practices in Kuwait, the MCI issued Resolution No. 18 on April 17, 1990, which effectively mandated adoption of International Accounting Standards for all companies operating in Kuwait and those listed on the Kuwait Stock Exchange for financial periods beginning January 1, 1991 (MCI, 2000).

The Law of Commercial Companies and External Auditing Law No. 5/1981 governs the preparation of KSE-listed firms' financial statements. While the Law of Commercial Companies requires listed companies' financial statements to be prepared in accordance with IFRS, the quality of these accounting standards by themselves is not sufficient to guarantee quality financial reporting. Accounting standards must be effectively enforced (Ball *et al.*, 2003). An independent audit is one of the most important determinants of the effective implementation of quality accounting standards (Glaum and Street, 2003).

To enforce the application of accounting standards and thereby promote the credibility of financial statements, Article 161 of the Commercial Companies Law states that, at the company's general shareholders meeting, the board should appoint at least one external auditor. Auditors are required to conduct audits in accordance with International Standards of Auditing (ISAs) as issued by the International Federation of Accountants (IFAC). This article was amended in August 1994, effective for financial statements beginning January 1, 1995, where it requires that a company should have at least two external auditors that are from different auditing firms. This requirement is considered one of the unique features of financial reporting in Kuwait, as most countries require only one external auditor. Although Article 161 of the amended Commercial Companies Law No. 15/1960 states that a company listed in or registered with the KSE shall have no fewer than two external auditors, provided that they are from separate auditing firms, no pronouncements from any regulatory body in Kuwait have prescribed the practices and procedures to be followed for the joint audit (Al-Bannay, 2002).

Article 163 allows auditors to inspect KSE-listed company books at any time and to request any documents deemed necessary. If company management refuses to comply with an auditor's request, the auditor is required to report non-compliance to the board of directors and to attendees at the shareholder's meeting. To qualify for auditing KSE-listed company accounts, the Law of Commercial Companies requires that auditors be registered with the MCI. In addition, external auditors should be appointed at a general meeting of shareholders. Similarly, auditors' remunerations must be determined by a general meeting of shareholders.

If the company receives a qualified audit report of its financial statements, a representative from the MCI's Companies Department must attend the general meeting of shareholders and call the matter to the attention of shareholders. After receiving clarification from the auditors, shareholders have the right to take action, including dismissing members of management, the board of directors, or the firm's external auditors (Article 178). It should be noted that auditors are fully responsible for ascertaining that their reports are correct. Under the Law of Commercial Companies, each shareholder has the right to question auditor reports and to receive full explanation for any matters raised, as auditors are considered agents of the shareholders (Article 165).

In this study, we observed that all Kuwaiti sample companies listed in the KSE in 2006 have received unqualified audit reports without explanatory language. However, this study measures the *actual* level of mandatory disclosure compliance with the IFRSs and is not dependent on what companies have declared or claimed in their annual reports, or on their external auditors' report of compliance with the IFRSs. Thus, considering and discussing the cases of unqualified audit reports are outside the scope of this study.

Literature Review

It is evident in most disclosure compliance studies that are beyond auditing effectiveness, several institutional and corporate characteristics influence corporate compliance behavior. For example, Glaum and Street (2003) investigate the impact of several corporate characteristics on the level of compliance with IAS and U.S. GAAP disclosure requirements for companies that are listed on Germany's New Market in their year 2000 financial statements. The corporate characteristics the study uses are: firm size, audit quality, reference to the use of International Standards of Auditing (ISA) or U.S. Generally Accepted Auditing Standards (GAAS) in the audit opinion, listing status, country of domicile, industry, profitability, internationality, ownership structure, maturity and rate of growth. Based on a sample of 100 firms that apply IAS and 100 that apply U.S. GAAP, the study reveals that the level of compliance with IAS and U.S. GAAP disclosure is positively and significantly associated with firms being audited by Big-5 auditing firms and with cross-listing on U.S. exchanges. The results also show that compliance levels are associated with reference to use of ISA or U.S. GAAS in the audit opinion. The study shows that none of the other attributes significantly explain the level of compliance with IAS and U.S. GAAP disclosure. Glaum and Street (2003) argue that the most important corporate characteristic that determines the level of compliance with IAS and U.S. GAAP is being auditor quality (as proxied by a Big-5 audit firm). A switch from a non-Big-5 to a Big-5 audit firm, on average, and with all other things being equal, is associated with a 10.8% increase in the level of compliance. In addition, the study shows that two of the Big-5 firms outperform the others in influencing client compliance levels.

Al-Shammari *et al.* (2008), in their determination of the extent of compliance with IAS in Gulf Co-Operation Council (GCC) countries (Bahrain, Oman, Kuwait, Qatar, Saudi Arabia and the United Arab Emirates), investigate factors that are associated with the level of compliance with IAS. Nine company attributes are examined. These attributes include: company size, leverage, internationality, ownership diffusion, auditing firm, company age, industry category, liquidity and profitability. Based on a sample of 137 GCC companies, the results show that for the 1996 to 2002 period, compliance is statistically and significantly associated with a company's size, leverage, internationality, and industry. However, company profitability, liquidity, ownership diffusion and whether the audit is conducted by a Big-5 audit firm, are not significantly associated with the level of compliance. Al-Shammari *et al*, (2008) note that their results differ from those that are found in developed countries, suggesting that company corporate characteristics associated with compliance with IAS may differ between developed and developing countries. However, they do not explore the impact of dual external auditors on the level of compliance. Hence, auditor effectiveness remains an open issue.

In summary, the literature on compliance with IFRS provides substantial evidence of non-compliance with IFRS by companies that claim to comply with the standards. In addition, these studies document that there is significant variation in compliance across countries. Moreover, variation in compliance is evident between companies based on several corporate characteristics, such as industry, internationality, leverage, size, ownership diffusion, growth, profitability and the quality and rigor of audit (Al-Shammari *et al.*, 2008; Glaum and Street, 2003; Street and Gray, 2001; Street and Bryant, 2000) No prior study has examined the impact of a mandatory joint external auditor requirement.

Theory Development

The relationship between a firm's extent of disclosure and the size of its external auditors is well established in the literature (Palmer, 2008). A positive relationship between disclosure level and the quality of external audit has been frequently reported in prior studies. The literature has provided a number of justifications for the association between the size of external auditing firms and the level of disclosure. DeAngelo (1981) argues that larger auditing firms have well-established reputations, and therefore have more to lose if they fail to report a discovered breach or make errors or misrepresentations in their clients' corporate reports. Thus, DeAngelo (1981) claims that larger auditing firms have a greater incentive to maintain independence from their clients and therefore, report noncompliance with rules and regulations.

Malone *et al.* (1993) argue that smaller auditing firms tend to be sensitive to their clients' demands because of the economic consequences associated with the loss of a client. Due to the sensitivity phenomena commonly associated with smaller auditing firms, Wallace and Naser (1995) claim that larger auditing firms are less likely than smaller firms to depend on one or a few clients. The apparent lack of bonding with clients would thus enable larger auditing firms to demand a greater detail of disclosure in their clients' corporate annual reports (Wallace and Naser, 1995). Wallace *et al.* (1994) argue that firms audited by internationally affiliated auditing firms (i.e. Big-4' auditors) are more likely to provide more detailed information than firms audited by local auditing firms. The rationale behind this conclusion is that internationally affiliated auditing firms tend to be larger and offer more expertise than local auditing firms.

The empirical findings of prior research on the association between disclosure level and the quality of external audit have been reported in numerous studies. For example, Ahmed and Courtis (1999), in their meta analysis of 23 separate studies on the association between corporate characteristics and disclosure levels in annual reports, find the size of the external auditing firm has a significant positive association with the firm's disclosure level. Street and Gray (2001), based on a worldwide sample, find a significant positive association between the level of compliance with IAS disclosure requirements and being audited by one of the Big-5 auditing firms. For firms listed on Germany's New Market, Glaum and Street (2003) report a positive association between IAS-required disclosures and audits by one of the Big-5 auditing firms. Gallery *et al*. (2008) and Palmer (2008) show that firms audited by the Big-4 auditing firms disclose better quality information about the impact of adoption of Australian Equivalents of International Financial Reporting Standards (AIFRS) than firms audited by non-Big-4 auditing firms.

Based on previous studies, it is expected that the level of compliance with IFRS-required disclosures among KSE-listed firms will vary between those firms audited by Big-4 auditors and firms audited by non-Big-4 auditors. It is also expected that firms audited by the international Big-4 auditing firms will have a higher level of compliance with IFRS-required disclosures than firms audited by the non-Big-4 auditing firms. Joint audit would give clients more choice and an opportunity to diversify and minimize risk. It would also allow greater rotation of auditors and can minimize the disruption caused when a single audit firm is changed. Two independent auditors are perceived to protect independence, specifically the objectivity of professional judgment, by diluting the effect of potential managerial pressure across two different auditors. It is more difficult on management to carry out pressure on two big-4 firms that the case of having only one big-4 firm. This could enhance compliance with IFRS-required disclosure. In Kuwait, where regulations require that each listed firm be audited by two external auditors (either Big-4 or non-Big-4, or a combination of both), it is expected that more frequent use of Big-4 auditing firms will be associated with greater IFRS compliance. Other factors identified by previous studies to influence the level of compliance include firm age, liquidity, ownership diffusion, growth, leverage, size, profitability and industry category as control variables.

Data and Research Methods

Sample Selection and Data Sources

The *2006 Kuwait Stock Exchange Investor Guide* shows that by the end of 2006, there were 163 Kuwaiti companies listed on the KSE. The KSE administration divides all listed companies into seven sectors: banking, insurance, investment, real estate, industry, service and food. Due to the similarities among some of KSE sector operations and in order to avoid categories with a small number of firms, some of these sectors are combined into one category. These are as follows: the banking sector and the insurance sector are combined into one financial institutions category, and the food and industry sectors are combined into one industrial category. Table 1 shows the number of KSE-listed companies in each sector.

Table 1
KSE Investment Sector and Number of Listed Companies, 2006

Sector	Number of Firms	Percentage
Financial (banks and Insurance)	16	9.8
Investment	43	26.4
Real estate	29	17.8
Industrial (Industry and Food)	30	18.4
Service	45	27.6
Total	163	100

All firms operating on the KSE must comply with IFRS disclosures. In addition, due to the relatively small number of firms listed on the KSE, the sample for measuring compliance with IFRS consists of all the companies listed in the KSE in 2006. The primary data source for investigating the extent to which KSE-listed firms comply with mandatory IFRS disclosures, is the company's consolidated financial statements. All the required consolidated financial statements for the KSE companies were purchased from the Auto Documentation and Archival Department at the KSE.

Measurement of the Extent of Compliance with IFRS (the Dependent Variable)

A compliance index has been used by several studies to measure compliance (i.e., Al-Shammari *et al.*, 2008; Glaum and Street, 2003; Street and Gray, 2001; Street and Bryant, 2000).The self-constructed compliance index is developed based on the applicable and relevant IAS and IFRS for the Kuwaiti financial reporting environment in effect over the study period. At the end of 2006, the International Accounting Standards Board (IASB) had issued 41 IASs/IFRSs. However, the IASB has replaced, amended, or superseded some of these standards. As a result, there were 39 IASs/IFRSs at the end of 2006 (IASB, 2007).

Selection of International Financial Reporting Standards (IFRS)

Since all KSE-listed companies are required by law to comply with IFRS, the focus here is on all the mandatory IFRS disclosures that are required in the financial statements and footnotes. However, it should be noted that not all of the IFRS issued at the end of 2006 are applicable at that date, and, therefore, some standards are not relevant to this study. In addition, there are some standards that are not applicable to the Kuwait financial reporting environment. Thus, the selection of the IFRSs for inclusion in the constructed compliance index is based on the following criteria:

1 - Applicability of the IFRS to the fiscal year ending on December 31, 2006.
2 - Relevance to the study focus.
3 - Applicability and relevance of the IFRS to the Kuwaiti financial environment and company practices.

The process used to determine the applicability and relevance of each IFRS to the Kuwait financial environment reveals the inapplicability of IAS 12, IAS 19, IAS 26, IAS 29, IAS 34, IFRS 7 and IFRS 8 to the Kuwaiti financial reporting environment. Consequently, of the 39 standards that have been set up at the end of 2006, 27 standards are applicable to the investigation of the extent of compliance by KSE-listed firms.

Developing the Disclosure Compliance Index (CINDEX)

Consistent with prior disclosure research (Al-Shammari *et al.*, 2008; Glaum and Street, 2003; Street and Gray, 2001; Street and Bryant, 2000; Cooke, 1989b, 1991, 1992), the extent of compliance with IFRS among KSE-listed firms is measured using a self-constructed item-based compliance index (*CINDEX*). The index focuses on mandatory disclosures that are required in financial statements and footnotes. In constructing and developing the compliance index, the official International Accounting Standard Board (IASB) volume for 2006 is used to obtain details about each IAS/IFRS requirement. Based on the requirements of each standard, a comprehensive index is developed to address each disclosure requirement of the 27 standards applicable to the study period and Kuwaiti financial environment.

The *CINDEX* is constructed to specifically address the required disclosures in financial statements prepared in accordance with IFRS requirements. Each IAS/IFRS is carefully scrutinized for mandatory disclosure requirements. Disclosures that are explicitly voluntary, or merely encouraged and suggested by IFRS are not considered relevant to this study, and, thus, they are not included in the *CINDEX*. From the 27 applicable IFRS, 419 mandatory disclosure requirements are obtained. To ensure completeness and comprehensiveness, the *CINDEX* is validated by reviewing it by academic experts and practicing professionals.

Weighing and Scoring the Disclosure Compliance Index

Consistent with Al-Shammari *et al.* (2008), Glaum and Street (2003), Street and Gray (2001), Street and Bryant (2000), and Cooke (1989a), each of the disclosure requirements mentioned in the *CINDEX* is assigned an equal weight, on the grounds that IFRS-required disclosure is targeted at all users of financial statements, to whom it is assumed items are equally important to all users. Argument for allocating different weights to each item in a disclosure index based on their perceived importance has been advanced by Zarzeski (1996). Nevertheless, arguably more convincing contradictory arguments have been offered for attaching equal weights, the course adopted in the current study.

Prior studies revealed substantially identical results of using both weighted and un-weighted approaches (Chow and Wong-Boren, 1987); an un-weighted is possibly the most appropriate approach when the research focus is on all users of financial statements, rather than specific users (Hossain, *et al.* 1995); employing different weights (weighted method) to each item shows that definite items are more preferred than others by the users of financial statements, which is not always the case (Adhikari and Tondkar, 1992); assessing the relative importance of each item of information across all users of financial statements is highly subjective and could be avoided it if the un-weighted approach is used (Owusu-Ansah, 2000). The arguments are valid: for example, attaching weights to certain items according to their perceived relative importance may be misleading, since the level of importance differs according to users and the time of study (Cooke and Wallace, 1989); and companies better at disclosing important items are also better at disclosing less important items and thereby companies would be scored the same way regardless of whether the items are weighted or un-weighted (Meek *et al.*, 1995). Accordingly, each of the disclosure requirements mentioned in the *CINDEX* is coded one (1) if the required disclosure has been made and zero (0) if it has not. When the required disclosure is not applicable to the firm, the item is dropped from the scoring system for that firm. This scoring procedure is based on a careful review of the complete annual reports of the companies. Following Al-Shammari *et al.* (2008), Glaum and Street (2003), Street and Gray (2001), Street and Bryant (2000), and Cooke (1989a), the total disclosure (TD) score for a company is additive, as follows:

$$TD = \sum_{i=1}^{m} d_i$$

where d = 1 if item d_i is disclosed, d = 0 if item d_i is not disclosed, and m

After the total disclosure score (TD) is obtained for a company, an index can be constructed to measure the relative level of disclosure by that company. The index is the ratio of a company's actual disclosure score (TD) to the maximum score (M) that the company is expected to achieve if the company fully complies with the mandatory disclosure requirements of IFRS. As a result, a company is not penalized for omitting a disclosure item that is not relevant or applicable to its business. Consequently, the maximum score (M) a company can earn may vary from company to company and is computed as follows:

$$M = \sum_{i=1}^{m} d_i$$

where d is the expected item of disclosure, and n is the number of items that the company is required to disclose.

Accordingly, the disclosure index for compliance (*CINDEX*) for each firm is calculated by dividing the total number of mandatory disclosures (TD) that are provided by a company by the total number of applicable mandatory disclosures (M):

$$CINDEX = \frac{TD}{M}$$

Quality of Corporate Disclosures pre and post the Adoption of Two Auditors Requirement

External audit quality is expected to be the most important factor affecting the quality of corporate disclosures. Article 161 states that the board should appoint at least one external auditor at the company's general shareholders meeting, and the company financial year must align with the calendar year. Recognizing the importance of the role audits play in promoting compliance with laws and regulations, the MCI amended in August 1994 this article to require a company to have at least two external auditors from different auditing firms, effective for financial statements beginning 1 January 1995. One of the purposes of this paper is to examine the effectiveness of requiring two external auditors, and the associated cost-benefit of this requirement on the quality of corporate disclosures. To do so and to ensure comparability of the results over time, a constant sample approach was used to assess the quality of corporate disclosures in pre this requirement (year 1994) and post this requirement (year 2006). By the end of 1994 there were 26 IASs, however six standards were inapplicable to the Kuwaiti financial environment or contradicted existing local laws. Based on the 20 relevant and applicable IASs in 1994, a CINDEX is constructed to specifically address the required disclosures in these standards.

Compliance with IFRS Regression Model

The level of compliance (*CINDEX*) is used as the dependent variable in a multivariate regression model. Audit quality (Big 4 or non-Big 4 combinations) is included as an independent variable. Other company attributes expected to influence IFRS compliance i.e., age, liquidity, ownership diffusion, growth, leverage, size, profitability, and industry category are included as control variables. The regression equation that is tested in the regression analysis is specified as:

$$CINDEX_i = \beta_0 + \beta_1 AUDIT_i + \beta_2 AGE_i + \beta_3 LQUIDITY_i + \beta_4 LEVERAGE_i + \beta_5 LSIZE_i + \beta 6 PROFIT_i + \beta_7 OWNERSHIP_i + \beta_8 GROWTH_i + \beta_9 IND\_INVST_i + \beta_{10} IND\_INDUS_i + \beta_{11} IND\_SERV_i + \varepsilon_i \quad (1)$$

where:

CINDEX = compliance score

β_0 = constant term

AUDIT = coded 2 if two Big-4 audit firms audit the company's financial statements, 1 if one Big-4 audit firm audits the company's financial statement, and 0 otherwise

AGE = number of years that have passed since being founded to the end of 2006

LIQUIDITY = the ratio of current assets to current liabilities at the end of 2006

LEVERAGE = the ratio of total debt to total shareholders' equity at the end of 2006

LSIZE = the natural logarithm of the total assets at the end of 2006

OWNERSHIP = Ownership diffusion is measured by number of shares owned by outsiders / number of outstanding shares at year-end,

GROWTH = The growth in sales over the previous fiscal year.

PROFIT = Return on Equity (ROE) at the end of 2006, which is the ratio of net income to average common shareholders' equity

IND_FT = a dummy variable that equals 1 for firms in the financial institutions category and 0 otherwise

IND_INVST = a dummy variable that equals 1 for firms in the investment category and 0 otherwise

IND_INDUS = a dummy variable that equals 1 for firms in the industrial category and 0 otherwise

IND_SERV = a dummy variable that equals 1 for firms in the service category and 0 otherwise

Results

Descriptive Statistics

The Extent of Compliance with IFRS in 2006 (the Dependent Variable)

Table 2 presents descriptive statistics for *CINDEX*. Table 2, Panel A indicates that the mean (median) *CINDEX* score for all KSE-listed firms in 2006 was 72.6% (74%), with a minimum score of 49% and a maximum of 92%. The results show that no KSE-listed firm complied fully with all the IFRS-required disclosures. Table 2, Panel B presents the frequency distribution of *CINDEX* scores for the firms in 2006. The table shows that 10% of the firms achieved an IFRS-compliance score between 49% and 59%. Twenty-seven percent achieved scores between 60% and 69%, and 38% achieved scores between 70% and 79%. Only 25% achieved scores above 79%. The frequency distribution of *CINDEX* scores among the 163 listed firms in 2006 reveals a noticeable variation in IFRS-compliance levels. At least three important observations can be made from the frequency distribution of *CINDEX* scores presented in Table 2, Panel B.

First, with only one firm scoring below 50% (*CINDEX* = 49%) most firms comply with the majority of IFRS mandatory disclosures. Second, with no firms complying fully with all IFRS-mandated disclosures and with more than one-third having a compliance score below 70%, the effectiveness of the regulatory body overseeing firm compliance with IFRS-required disclosures is questionable. Third, the large number of firms with relatively low compliance levels raises concerns about the quality of auditing because two external auditors must attest to a

Table 2
Descriptive Statistics for the IFRS Compliance Index (CINDEX) in 2006

Panel A: Descriptive Statistics for CINDEX

Dependent Variable	N	Mean	Median	Standard Deviation	Minimum	Maximum
CINDEX	163	0.726	0.740	0.10	0.49	0.92

Panel B: Frequency Distribution of CINDEX Scores

CINDEX Range	Number of Firms	Percentage	Cumulative Percentage
= 0.49	1	1	1
0.50-0.59	15	9	10
0.60-0.69	44	27	37
0.70-0.79	63	38	75
0.80-0.89	35	21	96
0.90-0.92	5	4	100
Total	163	100	

firm's full compliance with IFRS requirements. Interestingly, some KSE firms have reported less than 60% of the required IFRS disclosures; however none of these firms has received qualified audit opinions with respect to noncompliance with IFRS required disclosures as all of the 163 KSE listed firms in 2006 received an unqualified audit opinion.

Comparative Analysis

Table 3 present the results of a constant sample of 42 firms that existed in pre the adoption of two auditors requirement (year 1994) and post the adoption (year 2006). Table 3 shows that the mean CINDEX for firms listed in 1994 was 75%, where none of the 42 firms had scored above 89% nor below 43%. In addition, Table 3 reveals that the CINDEX for firms listed on 2006 was 78%. The results suggest that no KSE-listed firm fully complied with all required disclosures post the adoption of the two auditors' requirement, as none of the 42 firms listed in 2006 had scored above 92%. Although a slight upward trend of 4% was found in the level of disclosures from 1994 to 2006, the increase in the level of disclosures was not noticeable when taking into account the increase was over a period of 12 years.

In summary, the findings reveal that the mean level of compliance with all applicable IFRS required disclosures for all firms in the 2006 reporting year was 72.6%, ranging from 49% to

Table 3
Descriptive Statistics for *CINDEX*

CINDEX	N	Mean	Median	Standard Deviation	Minimum	Maximum
CINDEX 1994	42	0.751	0.75	0.093	0.43	0.89
CINDEX 2006	42	0.786	0.78	0.085	0.50	0.92

92%. The fact that none of the KSE listed firms has complied fully with all IFRS requirements is likely to raise a concern about the effectiveness of the regulatory body overseeing firm compliance with IFRS-required disclosures. In addition, the role and quality of external auditing is likely to be questionable as a result of these findings. The results show a wide variation in the level of compliance among the 27 IASs/IFRSs. Some standards exhibit a high level of compliance, generally those that contain requirements that are easy to meet. Other standards attain a medium level of compliance. Firm-specific characteristics are likely to be factors in determining the level of compliance with these standards. Still others exhibit a low level of compliance; for this group, proprietary cost, difficulty in adherence, sensitive nature of the disclosure requirement, and lack of experience are potential contributing factors.

Firm Specific Characteristics (Independent and Control Variables)

Table 4 presents descriptive statistics for all independent continuous variables. Table 5 shows the types of auditors used by KSE-listed firms in 2006. The descriptive statistics presented in Table 4 show that the age of KSE-listed firms ranged from 2 to 55 years, with a mean (median) of 22 (24) years. There is a noticeable degree of variation in the liquidity and leverage ratios among KSE-listed firms. Liquidity ranged from 0.19 to 39.63 with a mean (median) of 4.51 (2.83), while leverage ranged from 0.69 to 9.20 with a mean (median) of 1.30 (0.7). For profitability, Table 3 statistics show that the mean (median) return on equity for KSE-listed firms in 2006 was 11% (13%), ranging from -92% to 48%. The greatest variation found among the independent variables (i.e., firm-specific characteristics) was the firms' size. Firm size varied significantly, ranging from KD 3.50 million to KD 7898.25 million, with a mean (median) of KD 325.23 (69.69) million. The descriptive

Table 4
Descriptive Statistics for Independent Continuous Variables

Independent Variable	Mean	Median	Standard Deviation	Minimum	Maximum
AGE	22.00	24.00	12.90	2.00	55.00
LIQUIDITY	4.51	2.83	6.81	0.19	39.63
LEVERGE	1.30	0.70	1.80	0.69	9.20
SIZE	325.23	69.69	952.21	3.50	7898.25
LSIZE	11.26	11.15	1.53	8.15	15.88
OWNERSHIP	0.57	0.57	0.21	0.00	0.96
GROWTH	0.17	0.08	0.75	-0.97	5.17
PROFIT	0.11	0.13	0.21	-0.92	0.48

AGE is the number of years passed since foundation to the end of 2006; **LIQUIDITY** is the ratio of the current assets to the current liabilities at the end of 2006; **LEVERAGE** is the ratio of total debt to total shareholders' equity at the end of 2006; **SIZE** is the amount of firms' total assets (KD million) at the end of 2006; **LSIZE** is the natural logarithm of total assets at the end of 2006; **OWNERSHIP** diffusion is measured by number of shares owned by outsiders / number of outstanding shares at year-end, **GROWTH** is the growth in sales over the previous fiscal year, and **PROFIT** is the Return on Equity (ROE) for the year ended 31 December, which is the ratio of net income to average common shareholders' equity.

statistics indicate that the firm-size mean is significantly greater than the median, which suggests that the distribution of firm size is positively skewed and non-normally distributed. The non-normality was largely corrected with the natural logarithm transformation of the variable (LSIZE).

Panel A of Table 5 presents the distribution of firms that were audited by either two Big-4 audit firms, one Big-4 audit firm, or a non-Big-4 audit firm in 2006. Panel B of Table 5 presents the distribution of the Big-4 and non-Big-4 audit firms' share in auditing of KSE-listed companies in 2006. Panel A reveals that about 51% of KSE-listed companies had at least one Big-4 audit firm in their audit team combination, 41% of the companies were audited by non-Big-4 audit firms, and 8% were audited by two Big-4 audit firms. Panel B shows that Ernst & Young had the largest market share among the Big-4 audit firms in 2006, auditing about 18% of the KSE-listed firms, while KPMG had the smallest market share among the Big-4 audit firms, auditing only 1% of the companies.

Bivariate Relationships between the Variables

Pearson and Spearman Correlations among the independent vari-

Table 5
Type of Auditor Used by KSE-Listed Firms in 2006

Panel A: Auditor Combination

Combination	Frequency	Percent
Non-Big-4	67	41
One Big-4	83	51
Two Big-4	13	8
Total	163	100

Panel B: Distribution of Business among Big-4 and Non-Big-4 Audit Firms

Accounting Firm	Frequency (Number of Firms Audited)	Percent
Deloitte	13	4
Ernst & Young	59	18
KPMG	4	1
PricewaterhouseCoopers	35	11
Non-Big-4	215	66
Total	326	100

ables are presented in Table 6. The results show that no pair-wise correlation coefficient is in excess of 0.8, thus suggesting that multicollinearity is not likely to be a serious problem in interpreting the multiple regression results (Gujarati, 2003).

Multivariate Regression Analysis Results

Table 7 provides the results from estimating the model 1. They show that the auditor combination (*AUDIT*) is a significant factor in explaining variations in the level of compliance with IFRS-required disclosures ($p < 0.01$), suggesting that the higher the frequency of Big-4 auditing firms in a company's audit team, the greater the level of compliance with IFRS disclosure and reporting requirements. Thus, accounting quality appears to be enhanced when a company is audited by dual auditor combinations containing more brand-named (Big-4) audit firms.

Table 7 shows that the level of IFRS-required disclosures is positively associated with firm age ($p < 0.10$), leverage ($p < 0.05$), size ($p < 0.01$), growth ($p < 0.10$) and profitability ($p < 0.01$). Significant differ-

Table 6
Bivariate Correlations among the Independent Variables

Independent Variable	AGE	LIQUIDITY	LEVERAGE	LSIZE	OWNERSHIP	GROWTH	PROFIT
AGE	**1.00**	-0.05	0.23**	0.34**	-0.22**	0.08	-0.08
LIQUIDITY	-0.13	**1.00**	-0.45**	-0.30**	0.12	0.09	-0.23**
LEVERAGE	0.31**	-0.24**	**1.00**	0.46**	0.02	0.20*	0.23**
LSIZE	0.38**	-0.21**	0.55**	**1.00**	-0.35**	0.11	0.21**
OWNERSHIP	-0.24**	0.19*	0.01	-0.35**	**1.00**	-0.04	0.09
GROWTH	0.12	0.04	0.11	0.10	-0.05	**1.00**	0.26**
PROFIT	-0.03	-0.11	0.16*	0.18*	0.15	0.20**	**1.00**

*, ** Correlation is significant at 0.05 and 0.01 levels, respectively (2-tailed).
Above the diagonal presents Spearman's correlation and below the diagonal presents Pearson's correlations of the independent variables. Variables are defined as follows: CINDEX is the IFRS-mandated disclosures index score; **AGE** is the number of years passed since foundation to the end of 2006; **LIQUIDITY** is the ratio of the current assets to the current liabilities at the end of 2006; **LEVERAGE** is the ratio of total debt to total shareholders' equity at the end of 2006; **LSIZE** is the natural logarithm of total assets at the end of 2006; **OWNERSHIP** diffusion is measured by number of shares owned by outsiders / number of outstanding shares at year-end, **GROWTH** is the growth in sales over the previous fiscal year, and **PROFIT** is the Return on Equity (ROE) at the end of 2006, which is the ratio of net income to average common shareholders' equity.

ences exist in the level of compliance with IFRS-required disclosures across the five KSE industry categories. Table 7 shows that liquidity and ownership variables are not significant in explaining the variations in level of compliance with IFRS-required disclosures.

Sensitivity Analysis

Several robustness tests were conducted to ensure that the regression results were not sensitive to alternative measures of the dependent and independent variables. All the alternative proxies produced results that were not quantitatively different from the main findings previously reported.

Conclusion

This study investigates the extent of compliance with International Financial Reporting Standards (IFRS) with respect to firms listed on the Kuwait Stock Exchange (KSE). More specifically, this study aims to explore the implications of having two external auditors on regulatory compliance and the factors that affect compliance levels among KSE-listed firms. A review of compliance with IFRS literature presents evidence of widespread

Table 7
Multivariate Regression Analysis Results

Corporate Characteristics Explaining the Level of Compliance with IFRS
Dependent Variable: ***CINDEX***

Variable	Predicted Sign	Coefficient	*t*-statistic	
Intercept		0.152	4.453***	
AUDIT	+	0.025	2.607 + + +	
AGE	+	0.016	2.048 + +	
LIQUIDITY	-	-0.004	-1.082	
LEVERAGE	+	0.010	2.237 + +	
LSIZE	+	0.038	7.644 + + +	
OWNERSHIP	-	0.263	0.995	
GROWTH	+	0.011	1.515 +	
PROFIT	+	0.134	4.417 + + +	
IND_FT	?	0.108	3.882***	
IND_INVST	?	0.099	6.193***	
IND_INDUS	?	0.049	2.814***	
IND_SERV	?	0.092	5.534***	
N	R^2	Adj.R^2	***F***-statistic	***p***-value (F-statistics)
163	0.631	0.601	21.230	0.000

+ , + + , + + + significant at the 0.10, 0.05, and 0.01 levels respectively (one-tailed)
, * significant at the 0.05, and 0.01 levels respectively (two-tailed)
CINDEX is the ratio of a firm's actual disclosure score to the maximum score that the firm is expected to achieve if the company fully complies with the mandatory disclosure requirements of the IFRS. **AUDIT** coded 2 if two Big-4 audit firms audit the company's financial statements, 1 if one Big-4 audit firm audits the company's financial statement, and 0 if otherwise; **AGE** is the number of years passed since foundation to the end of 2006; **LIQUIDITY** is the ratio of the current assets to the current liabilities at the end of 2006; **LEVERAGE** is the ratio of total debt to total shareholders' equity at the end of 2006; **LSIZE** is the natural logarithm of total assets at the end of 2006; **OWNERSHIP** diffusion is measured by number of shares owned by outsiders / number of outstanding shares at year-end, **GROWTH** is the growth in sales over the previous fiscal year; **PROFIT** is the Return on Equity (ROE) at the end of 2006, which is the ratio of net income to average common shareholders' equity; **IND_FT** is a dummy variable that equals 1 for firms in the **Financial Institutions** category, and 0 otherwise; **IND_INVST** is a dummy variable that equals 1 for firms in the **Investment** category, and 0 otherwise; **IND_INDUS** is a dummy variable that equals 1 for firms in the **Industrial** category, and 0 otherwise; **IND_SERV** is a dummy variable that equals 1 for firms in the **Service** category, and 0 otherwise (the omitted industry category when all categories are zero is the **Real Estate** category).

non-compliance with mandatory IFRS requirements by companies that claim to comply with the standards in different regions. Prior studies show that the external auditing firm's role in examining financial statements is one of the most important determinants of effective compliance with accounting standards. The institutional setting in Kuwait provides an interesting opportunity to explore the influence of requiring two external auditing firms to audit companies' financial statements.

The extent of compliance with 27 applicable IASs/IFRSs was measured using a self-constructed, item-based compliance index, *CINDEX*. The index focuses on the mandatory disclosures in financial statements and footnotes in the 2006 annual reports of all KSE-listed firms. The results reveal that the average level of compliance with all applicable and relevant IFRS disclosures was 72.6%. The IFRS-compliance level among KSE-listed firms was found to be, not only lower than that of firms in developed countries, but also lower than that of firms in some developing countries. None of the 163 KSE-listed firms complied fully in 2006 with all IFRS-required disclosures. Finding that no firm has fully complied with all IFRS mandatory disclosures, and the observed variations in the level of compliance across listed firms raises concerns about the effectiveness of the enforcement body that oversees compliance with IFRS-required disclosures in Kuwait, and about the quality of external auditing in promoting compliance. Some KSE listed firms have reported less than 60% of the required IFRS disclosures; however, none of these firms have received qualified audit opinions with respect to non-compliance with IFRS required disclosures.

To examine the effectiveness of requiring two external auditors, and the associated cost-benefit of this requirement on the quality of corporate disclosures, a constant sample approach was used to assess the quality of corporate disclosures in pre this requirement (year 1994) and post this requirement (year 2006). By the end of 1994, there were 26 IASs, however six standards were inapplicable to the Kuwaiti financial environment or contradicted existing local laws. Based on the 20 relevant and applicable IASs in 1994, a CINDEX was constructed to specifically address the required disclosures in of these standards. The results show that the average level of mandatory disclosure was 75% in 1994, and 78% in 2006, an increase of 4% over a 12 years period.

The results reveal a significant difference in the level of compliance with IFRS mandated disclosures across the three possible auditor combinations. The highest level of compliance with IFRS required disclosures was achieved by firms audited by two Big-4 audit firms, followed by firms audited by one Big-4 and one non-Big-4 firm, which is followed by firms audited by two non-Big-4 audit firms. These findings highlight the significance of the quality and rigor of external audits in promoting compliance with IFRS requirements. Several robustness tests were conducted to ensure that the regression results were not sensitive to alternative measures of the dependent and independent variables. All of the robustness tests conducted confirmed the results obtained in the primary model.

The findings present in this study provide a number of significant contributions and implications to the understanding of the level of compliance with IFRS among KSE-listed companies and the factors that influence the extent of compliance. First, concerns about the quality of audits were raised in this study because external auditors must attest to a firm's full compliance with IFRS requirements. This study finds that none of the 163 KSE-listed firms comply fully with all IFRS mandates; nevertheless, the external auditors for all firms attest to full compliance with IFRS. This observation confirms the arguments of the International Accounting Standards Board and the President of the International Federation of Accountants (IFAC), which criticize external auditors for asserting that financial statements indeed fully comply with prescribed IAS/IFRS requirements when in fact, accounting policies and notes indicate otherwise (Cairns, 1997). As KSE-listed companies are obligated to be audited by two different external auditing firms, the findings of the present study have a direct implication for the effectiveness of this requirement in promoting compliance with laws and regulations. Given empirical evidence of widespread non-compliance with mandatory IFRS requirements, the results of this study are likely to raise questions about the quality and reliability of requiring two external auditors and the associated cost-benefit of this requirement for KSE-listed firms. Although the results appear to indicate that the joint auditor combination can make a significant positive difference in the level of compliance if they have a greater number of Big-4 auditors, none of the firms audited by two Big-4 audit firms has fully complied with all IFRS-required disclosures.

Second, concerns are also raised about the effectiveness of the enforcement body that oversees compliance with IFRS required disclosures in

Kuwait. These results suggest that the enforcement body's current enforcement mechanisms may need to be strengthened. Finally, users of KSE-listed firms' financial statements might reasonably expect the greater the number of Big-4 audit firms on a KSE-listed company's auditing team, the greater the expected level of compliance with IFRS.

The findings of non-compliance in the study raise serious concerns about the quality of external auditing. In this study, it is observed that auditors assert that financial statements fully comply with IAS/IFRS when in fact; the findings of the study provide evidence of widespread non-compliance with mandatory IFRS requirements. Surprisingly, given the existence of widespread non-compliance, in 2006, none of the 163 KSE-listed firms received a qualified audit opinion. One possible area for future research would be to investigate the factors that influence the quality of external auditing in Kuwait. In addition, it would be interesting to investigate why external auditors are willing to attest to accounts that do not comply fully with IFRS requirements.

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الملخص

فعالية التدقيق الثنائي المشترك في تعزيز جودة الإفصاح في التقارير السنوية للشركات الكويتية المدرجة بسوق الكويت للأوراق المالية

مشاري محمد الفريح
فيصل صبار العنزي
الهيئة العامة للتعليم التطبيقي والتدريب

تهدف هذه الدراسة إلى بيان العلاقة بين مستوى الإفصاح في التقارير السنوية للشركات الكويتية المدرجة فى سوق الكويت للأوراق المالية وبين متطلبات التدقيق المشترك على مستوى الإفصاح في هذه الشركات. نتائج الدراسة أظهرت أن متوسط متطلبات الإفصاح الإجباري لجميع الشركات المدرجة في سوق الكويت للأوراق المالية لعام ٢٠٠٦ بلغ ٧٢,٦٪ وهذا يعني أن الشركات المدرجة في البورصة لم تمتثل امتثالا تاما لجميع متطلبات الإفصاح الإجباري ورصدت تباينات كبيرة في مستوى الإفصاح بين الشركات. تم استخدام أسلوب العينة الثابتة لمقارنة مستوى الإفصاح قبل وبعد إقرار قانون التدقيق المشترك. نتائج المقارنة أظهرت أن متوسط متطلبات الإفصاح الإجباري بلغت نسبتها ٧٨٪ لعام ٢٠٠٦ بالمقارنة بعام ١٩٩٤ حيث بلغت نسبتها ٧٥٪، بمعدل زيادة قدرها ٤٪ خلال ١٢ سنة. نتائج هذه الدراسة من المحتمل أن تثير تساؤلات حول مدى جدوى الاعتماد على اثنين من مراجعي الحسابات الخارجيين في تدقيق حسابات الشركات وما يرتبط بها من زيادة في تكاليف التدقيق.

Mishari M. Alfaraih Ph.D., CPA, CIA is an Assistant Professor of Accounting at the College of Business Studies, The Public Authority for Applied Education and Training, Kuwait. He holds a Ph.D. in Accounting from Queensland University, Australia. He is a certified public accountant and a certified internal auditor. His research interests include financial information flows and information quality in capital markets.

Faisal S. Alanezi Ph.D., is an Associate Professor of Accounting at the College of Business Studies, The Public Authority for Applied Education and Training, Kuwait. He holds a Ph.D. in Accounting from University of Newcastle, Australia. His research interests include financial reporting and disclosure.