EXTERNAL AUDITOR INDEPENDENCE:

SELECTED GROUP PERCEPTIONS

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for the degree of:

Doctor of Philosophy

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January 1992

EXTERNAL AUDITOR INDEPENDENCE (EAI):

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This thesis makes frequent reference to auditing and the auditor. Unless otherwise stated, such references are to external auditing and the external auditor respectively. Additionally, where not repugnant to the context, references made in the masculine only, apply equally to the feminine. Where abbreviations are used without immediate clarification, they are provided in Appendix A of Volume II (List of abbreviations used).

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"... economic, political and even military institutions persist because they have legitimacy, and that legitimacy comes from the perceptions of people. People give legitimacy and they can take it away." [Eisler and Loye, 1990: 37]

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"Quis custodiet ipos custodes?" - [Who is to guard the guardians themselves?] from Satires VI, written by Decimus Junius Juvenalis, Roman satirist (60-130 A.D.).

ACKNOWLEDGEMENTS

While writing this thesis and doing the underlying research, I have received help, guidance and useful criticism from many kind persons. To all these persons I convey my sincere thanks and admit my deep debt. Chief among them is my supervisor, Professor Taffler, who was a source of much inspiration and encouragement.

I am very thankful to all those who completed the research questionnaire and the institutions from which they came. Without their help, it would not have been possible to gain many insights revealed in the thesis.

I am also grateful to some of the academic staff at City University Business School, who not only gave me good counsel, but also made it possible for me to contact the groups who completed the questionnaire.

Finally, I thankfully and humbly acknowledge the continued encouragement and immense support I have received from my wife, parents-in-law, siblings and their families when writing this thesis.

While I have benefited greatly from the wisdom of many, I hold myself exclusively responsible for all errors, inaccuracies and omissions that may have persisted.

DECLARATION

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ABSTRACT

The professional independence of external auditors is fundamental to the auditing profession. Thus, it is important that auditors are not only independent **in fact**, but that they are also seen to be independent - i.e. independent **in appearance**.

In that light, it is clear that external auditor independence (EAI) is a perceptual issue. Yet there is a marked lack of empirical research done with a view to determine how users of audited accounts perceive EAI, or to contrast such views with comparable ones held by external auditors themselves. Thus, the major objective of the research is to empirically examine how relevant groups see EAI within specified audit situations.

The research examines how three groups of users of audited statements (bankers, credit managers and internal auditors - the user groups) and sets of external auditors (who issue audit reports - the issuer groups), see EAI in circumstances described in specific audit situations. This is the primary context of the empirical research.

An appropriate questionnaire was developed and used as the research instrument because of its natural accord with the Brunswick Lens Model approach to perceptual examinations. The facts specified in each of the twenty situations were cues upon which judgement of EAI, was made by judges (the questionnaire respondents).

Thus, the empirical chapters consider:
1. Areas of concern with EAI
2. Significant perceptual differences:
   a) between each user group and the issuer group
   b) within two sub-groups of the issuer group
3. Possible explanations for differences by examining:
   a) the dimensions underlying group views of EAI
   b) the importance attached by groups to EAI cues
   c) the pattern between bio-data and views on EAI

Main findings indicate, within an EAI context:
1. Significant differences of perception between the issuer group and each of the three user groups.
2. Generally non-significant differences of perception within the external auditor group.
3. Each group having its own unique set of underlying (factor or dimensional) constructs.
4. The cues (facts) contained in audit environments **are** of consequence in explaining such group differences.
5. Personal group characteristics (attributes) do not appear to be very helpful in explaining group views.

CHAPTER I

INDEPENDENCE IN THE AUDITING PROFESSION

1.1 Introduction

The audit profession is charged with the responsibility of providing an "independent" opinion on the financial statements of the corporate (and other) entities audited by its members [AICPA, 1973b: 1] and fulfilment of this responsibility provides the backdrop for a unique set of phenomena.

Users of such financial statements cannot often (or not without significant cost, time and effort) assess their underlying quality [DeAngelo, 1981: 43] because of physical remoteness, legal barriers etc. Equally, users may see a conflict between themselves and the preparers of statements [CAR, 1978: 5].

Thus, a (deemed) impartial (neutral) auditor is asked to perform an "independent" examination (audit) on such statements and to then give an "independent" report thereon. It is the auditor's duty to confirm (if so concluded) that the statements reported upon are free from bias, and so the auditor himself must be independent and free from bias. Lavin [1974: 14] states that "independence plays such an important role in auditing it is almost inherent in the term itself."

In fact, the auditor's freedom from all bias is his professional "independence" and it is this feature that is crucial in auditing. The AICPA [1972c: 7] describes it as the "cornerstone" of the auditing profession.

A professional auditor occupies a unique position in society. He is engaged and paid for by the audited entity but he can and does serve other interested parties who bear no direct cost for his audit services.

Among others, such interested parties are present and prospective investors, creditors, employees, and various government departments and/or agencies. In agency theoretic terms, this service to non-payers is seen as the "free rider problem" [Ng, 1978: 100].

The primary purpose of an audit is almost always for the auditor to provide an opinion on the client's financial statements [DeAngelo, 1981: 33] and to assure interested parties that they present truly and fairly the financial position and results of the audited unit.

Equally, as the objectives and interests of the management preparing the statements may be opposed to those who use or require them, the auditor is called upon to report on management's own representations of its stewardship [CAR, 1978: 5] function to owners.

However at this point that a seemingly conflicting situation arises. Because, even though parties outside the entity being reported upon do not employ, nor are reported to by the auditor, they are still entitled to a fair and impartial report of the client's operations.

The auditor can overcome this conflict of interests only if he himself is totally objective and impartial. In short, if he is independent. It is this independent status that gives the auditor's report value and significance. Independence is a key element (if not the key element) underlying all auditing practices.

Additionally, "apparent" independence is as important as "real" [Higgins, 1962] independence. If a statement user perceives a lack of external auditor independence (EAI) (even if not so in fact), then that user may well question the veracity of the auditor's representations.

Audit independence is indeed the cornerstone of all auditing practices [AICPA, 1972c: 3], for if user groups even suspect the auditor to be not independent, his professional use is reduced or, in the extreme, is absent. Thus, in an effort to maintain the professional EAI of their members, audit bodies have rules and ethical guidance [ICAO, 1982; ICAA, 1984; AICPA, 1986; and ICAEW, 1987] to which their members must adhere.

Because external auditor independence (EAI) is as much a question of perception as of fact, Berryman [1974: 14] recommends that:

> "research ... be undertaken with respect to user perceptions of independence; (in particular) the relationships which they (audit users) feel impair independence as well as those which promote independence."

As such, the empirical research presented in this thesis examines relevant group perceptions of EAI.

The research is presented within a theoretical and empirical context. Chapters 1 through 3 are devoted to a theoretical examination of EAI while the chapters then following are devoted mainly to the empirical aspects of this research.

This chapter has three further sections. Section 1.2 following, discusses the inherent professional dimension underlying EAI, while Sections 1.3 and 1.4 are devoted to a discussion of some of the **main** criticisms and concerns expressed in relation to EAI.

At this juncture, such criticisms are intentionally presented only in a general context, without drawing attention to specific cases where EAI may have been compromised. However, Chapter 4 does consider recent UK instances where this may have been the case.

1.2 The professional dimension underlying EAI

While the company auditor owes his appointment to provisions of company law, he does not derive the required or deemed independence attributed to him by law. In essence, that independence is attributed to him by virtue of him being a member of a profession. So any examination of EAI must be mindful of the professional domain within which the auditor functions.

For, it is not primarily because the auditor has a prescribed knowledge of auditing or academic standard that users of audited statements ascribe the independence attributed to him. Rather, it is attributed to him because of his membership of the audit profession and the ethical base underpinning it [Freidson, 1970] and all other professions. Thus some words about the nature of professions are in order.

One of the more distinctive features of a profession is that it possesses autonomy [Freidson, 1970] concerning matters such as entry requirements and professional standards, validation, certification, the enforcement of ethical standards and related disciplinary matters. However, in return for the autonomy granted to professions, society expects them to adhere to ethical standards that are far higher than those expected of or from non-professionals.

To meet such expectations, each profession establishes its own standards of work, professional norms and an ethical code [Freidson, 1971] to guide the behaviour of its members.

Another one of the main distinctive features of a profession (as opposed to an occupation) is the enforcement of a prescribed code of conduct [Greenwood, 1957; Benson, 1983] or ethical behaviour.

In turn, this feature raises more philosophical questions about ethical behaviour and ethics [Moizer, 1991: 38-40] which is generally seen as the science of morals, or as a study of human duty and the rules of conduct (or principle) governing right from wrong - a feature essential to the harmonious functioning of any civilised society.

While a code of ethics is indeed important for a profession, its mere existence does not guarantee on the one hand the public belief (perception) in the ethicality of the profession's members nor does it guarantee that its members are, in fact, totally ethical [Freidson, 1971]. That must remain the subject of continual assessment by concerned parties. And so it is with the auditing profession in the UK and other countries.

As noted previously, in order to achieve and uphold the credibility of the audit profession, it has established sets of nationally [ICAEW, 1987] and internationally [IFAC and UEC] agreed standards, to which its members must adhere. In general, they relate to:

1. Independence, integrity and objectivity
2. Knowledge, expertise and validation thereof
3. Communication
4. Enforcement

All the preceding standards deal with matters of importance relative to the credibility of the auditor and his work. However, it is above all the independence of the auditor (particularly from the management of the audited entity) that distinguishes him from all other information and communications practitioners.

Another distinguishing feature of a profession is its service to the public at large [Cullen, 1978], as opposed to a segment of society. Professionals are highly skilled in some science or art, and desire to serve the public [Carey and Doherty, 1966a: 4], placing such public service above personal gain.

Indeed, this "service to society" feature is a key feature of professions [Ritzer, 1975] and the audit profession is no different.

Thus, if this social responsibility feature, often expressed in the denial or rejection of personal self-interest or gain, were not present, then there would be little, if anything, to distinguish the audit profession from any other trade or craft.

More than 40 years ago, the executive committee of the AICPA [1947] declared that "independence, historically and philosophically is the foundation of the public accounting profession, and upon its maintenance rests the profession's strength and stature." [For a more recent practice-based discussion of professionalism in the US auditing profession, see Zeff, 1986]

As a consequence of their professional standing, society expects auditors to make sacrifices if necessary, to ensure their independence, and herein lies a unique phenomenon. The scale of sacrifice likely to be expected by society is all the greater because the costs of increased EAI are not borne by society as a whole, whereas its "benefits" accrue more generally to society and the audit profession.

[Examined in this light, EAI forms part of the "public good" debate as put forth by (among others) Alchian and Allen [1972] and Alchian and Demsetz [1972], as does the "free rider problem" noted previously (Page 14).]

1.3 Criticisms of and concerns with EAI

External auditor independence is currently subject to intense questioning so that even selected references to the issue are too numerous to state. However, some indication of that intensity is to be seen from just a cursory review of the attached bibliography.

In presenting criticisms levied against EAI, it is useful to adopt a distinction made by Aranya and Sarell [1975] when they considered EAI. They regard EAI as having two aspects - a macro-aspect and a micro-aspect.

The macro-aspect of EAI refers to the professional dimension underlying the audit profession and the fact that its general control is a matter of public and governmental concern and involvement. Aranya and Sarell [1975] also refer to this aspect of EAI as being its "institutional" feature, while Freidson [1968] refers to it as its "public interaction" feature.

Regardless, underlying all the terms applied to this aspect of EAI lies the fact that the macro-aspects of the auditing profession embrace matters relating to the **overall** structure and functioning of the profession - issues usually addressed in or governed by law on a national (UK), supra-national (EC), or quasi-statutory (SEC) basis.

On the other hand, the micro-aspects of the auditing profession embrace more **specific** matters relating to individual auditor-client relationships. Freidson [1968] refers to these aspects as being the "private interaction" of the profession while Aranya and Sarell [1975] refer to it also as its "interpersonal" aspects. Perceptions of relevant groups of such "interpersonal" micro-aspects are the essential focus of this research.

Underlying all micro-aspects of the audit profession lie the specific circumstances governing the relationship between an individual auditor and an individual client.

The degree of EAI exercised within any given auditor-auditee situation is a function of both macro-aspects and micro-aspects of EAI, and it is likely that the former influences the latter more than is the opposite case [Aranya and Sarell, 1975: 855].

In examining criticisms levied against EAI, the same micro- and macro- classification as that put forth by Aranya and Sarell [1975] has been used. As such, the following paragraphs first consider the main criticisms falling under the macro-aspects classification and subsequent paragraphs consider the same in terms of the micro-aspects classification.

1.3.1 Main criticisms of the macro-aspects of EAI

Criticism of EAI founded in its macro-aspects are levied not so much against individual auditors and/or their behaviour, but more against the structure of and environment in which the audit profession operates.

For example, the latter half of the Sixties saw criticism of the auditing profession (in the UK and the USA) on the basis that even where generally accepted accounting practices existed, on occasions they permitted a variety of (differing end-effect) accounting treatments [Briloff, 1966], and that in many other cases there was no prescribed accounting practice at all [Briloff, 1972].

This absence of prescribed accounting treatment, critics argued [e.g. Briloff, 1981 and Griffiths, 1986], enabled auditors to report without qualification on the accounts of companies, drawn up under different (and sometimes conflicting) accounting practices.

Thus it was argued that though an auditor may have found a particular accounting practice at odds with his own "independent" view, there was not much he could do, as there was often no accounting standard on the issue, or where one existed, it almost always permitted the practice of which the auditor did not approve.

In the UK, such criticism gave birth to the ASC set up in 1970 "in the face of mounting criticism of (then) prevailing accounting practices" [Dearing, 1988: 5]. So the first macro-criticism of EAI within the audit profession relates to the absence, of a well-defined and prescribed set of accounting standards.

In that context, some critics argued that even when accounting standards existed, they were developed exclusively by professional accountants and/or auditors. Accordingly, they maintained that auditors not only play the "game", but also to an extent, create the "rules" themselves.

However the charge is less true of the US where the FASB, a body independent from and not reliant on the AICPA, has for many years been mainly responsible for the setting of accounting standards there.

While the charge had only some UK basis (as the ASC - the successor body to the ASSC - had non-accountant, but accountancy informed, members from organisations concerned with and interested in the development, use and impact of accounting standards), it is no longer valid as, with the establishment of the ASB in 1991, the position with regard to the setting of accounting standards in the UK became much the same as in the US.

Additionally, some limitation on the choice of accounting practices in the UK is imposed by the European Community (EC) requirement for the UK government to enact legislation giving expression to its Directives. For example, the Companies Act 1989, implemented many of the company law requirements (including those relating to EAI) necessitated by the Eighth Directive. Equally, accounting prescriptions necessitated by the Fourth and Seventh Directives of the EC are now to be found within UK company law.

Additionally, even though UK company law may prescribe the specific accounting treatment required under given circumstances, in effect there is an overriding section (226) in the 1985 Companies Act that the annual accounts of a company show a "true and fair view".

The result of such legislation and standards is that the options available for use in accounts are now fewer but nevertheless continue to cause concern ["Five reasons not to trust company figures" - Financial Times, November 1, 1990: 14]. However, as more limitations are imposed on the accounting treatments auditors may permit, without qualification of their audit reports, requests made for or pressure placed on auditors to approve "inappropriate" accounting treatment(s) must also be proportionately reduced.

The second main macro-criticism of independence within the auditing profession relates to the establishment and enforcement of auditing and accounting standards. Critics argue that "the professional rules on EAI were drawn up by faceless people who never consulted the membership, far less any member of the public" ["Real audit reform needs statutory regulation" - Letters, Financial Times, Dec. 28, 1990: 9] and that there are no "teeth" to the standards set up by the profession. As such, there has not been much incentive for auditors to dissociate themselves from departures to standards.

One example of this is seen in the frequent lack of adherence to SSAP 16 (which came into effect from January 1980 and is now withdrawn) which related to accounting for the impact of inflation. Even though SSAP 16 had been duly set up and ordained, there were frequent and flagrant instances of non-compliance with it. Referring to this fact Smith [1986] states there had been "a great deal of resistance against ... this standard, and as a result the ASC has now decided that this SSAP will no longer be mandatory."

However, it is true that SSAP 16 had no **clearly defined** legal basis and thus no legal recourse could be had against non-compliers. Indeed, most non-compliances were clearly noted in the relevant audit report.

Thus, even the possible stigma attached to a qualified audit report was not always a means of ensuring compliance with standards.

The third main macro-criticism of EAI in the auditing profession relates to the enquiry and possible censure of auditors charged with the approval of accounting practices at odds with prescribed accounting standards.

The UK professional accounting bodies operate a Joint Disciplinary Scheme whereby auditors who are brought before the Disciplinary Committee are duly examined and if found to be at fault, penalised. Thus, the criticism in this instance is the fact that auditors are examined into and judged by their fellow professionals. So, the disciplining committee may easily be seen as a club whose members would be slow to fault fellow-members.

Thus, it is suggested, auditors are willing to allow themselves open to the charge of non-compliance with due standards (so compromising EAI) in the knowledge they will be examined and judged by co-professionals, with whom they are likely to have good rapport, persuasion and sway. As such, the belief has grown ["Why the DTI baulks at bringing auditors to book" - The Guardian, Dec. 3, 1990: 15] that self-regulation is "a self-serving exercise" for the audit profession.

However, recognising that EAI is only one determinant of audit quality and it is exercised with others, the Dearing [1988: 1] Report rightly holds that:

> "the effective working of the financial markets, the quality of the information available from companies to their shareholders, creditors, customers and workforce, and the quality of the service provided by accountants to their clients, are all bound up with the quality of the standards underpinning financial statements."

1.3.2 Main criticisms of the micro-aspects of EAI

Criticisms levied against EAI within its micro-context can be reviewed from the standpoint of four main sets of considerations. Each of these sets are considered in turn in the paragraphs following, and are as below:

1. Dependency considerations
2. Financial considerations
3. Personal considerations
4. Commercial considerations

1.3.3 Dependency considerations

1. Appointments (initial and subsequent) generally

The reality of an auditor's initial (and further re-) appointment is that for all practical purposes it depends on the board of the audited company. This leads to the key (dependency) criticism relating to potential threats to the auditor's independence. It is alleged that the auditor is in an insecure position and given the right conditions, may well be leveraged.

Recognising the genesis of this criticism, but in effect concurrently rejecting it, Michael Fowle, a partner in the London office of a Big-Six firm of auditors states ["Directors, not auditors, govern companies" - Financial Times, June 13, 1991: 12] that the above situation:

> "is the auditor's rule of life and we understand it, but the world apparently does not - probably because auditors are in effect selected and removed from by boards of directors and because they necessarily work behind closed doors".

If the above criticism is valid, then this position of auditor insecurity is perhaps aggravated in the present recession, especially against alleged "ferocious competition, one manifestation of which is the practice of lowballing" ["An uncertain future for a former safe career" - Financial Times, May 16, 1991: 19].

Even after having been appointed as auditor, the auditor's position still remains dependent on the (audit) client and so his position continues to remain insecure. The foundation of this criticism of EAI lies in the belief that he who appoints the piper calls the tune and the fact that the auditor is dependent on the board of the very company he audits, in order to be appointed (and re-appointed) as such. If so, is it reasonable to expect the auditor to take a totally independent stance on all matters relating to the company's audit?

1.3.4 Financial considerations

1. Trustee shareholder in audit clients

The UK auditing profession has received much criticism for its tacit acquiescence [ICAEW, 1987: 21] (with varying limits for public and private companies) to auditors holding shares on a trustee basis in their audit clients.

The basis of such criticism contrasts strongly with the situation in the US where for many years auditors have been prohibited both by the profession [AICPA, 1986: 4411 - see also "Ethics Feature: Independence" - Journal of Accountancy, September 1987: 112] and the SEC [Rule 2-01 of Regulations S-X], from holding trustee shares in their audit clients.

However the practice did evoke concern in the UK where Firth [1980] determined that 60% of respondents to his study perceived the auditor to be "not independent" when he held 10% of the shares in an audit client, even though in a trustee capacity only.

Thus, it is suggested that auditors should if the occasion requires, choose between being auditors and acting as trustees, as they cannot function as both, and still expect to be seen as totally objective in their role as professional auditors.

2. Fees

The question of fees has also been a source of criticism of EAI. Such criticism arises mainly because:

1. the auditor is dependent to **some** extent on the client for his audit fees
2. in some cases, that dependence may grow to unhealthy or undesirable proportions (in EAI terms).

While stating the first of these criticisms, one must recognise that it is impossible to redress it without radical changes, such as that suggested by Davies - Controller of the Audit Commission, ["A working model of audit regulation" - Letters, Financial Times, October 24, 1990: 17], in the total financial structure and relationship between auditors and their clients.

Further, given the present system of appointing and remunerating private-sector auditors, they must have an indirect financial interest in their clients, for, in the end, it is the client that appoints them and by paying their fees gives them their livelihood.

Consequently, it is alleged, ["Discipline for the auditor" - Editorial, Financial Times, April 10, 1991: 18] that this creates "a temptation (for auditors) to give in to management on points of principle in order not to lose fees".

In contrast, one notes the independence manifest by public sector auditors who are appointed and paid by the Audit Commission (not the audited local authority). Thus, because of their non-dependence of audit fee income on the authority, public sector auditors are perceived to have more independence than their private sector counterparts and, in some quarters, a highly similar system is being advocated for UK public companies ["BCCI collapse: auditing at the crossroads" - Financial Times, August 15, 1991: 10].

3. <u>Unpaid fees and analogous situations</u>

Unpaid audit fees and other analogous situations have also been the source of criticism of EAI. The AICPA [1986: 4444-4445] in the US dealt with the issue of unpaid fees by stating if a (material) fee remains unpaid for more than a year, this gives rise to the appearance of non-independence.

Thus, it is of interest to note that no similar formal prohibition or ruling is extant in the UK, where auditors are given only general guidance [ICAEW, 1987: 3] asking them to exercise professional judgement in resolving matters of this nature - and requiring them to be objective, impartial and "free from (the) influence of any consideration which might appear to ... conflict" with this requirement.

Analogous to the situation relating to unpaid fees is the situation where the auditor provides first year services on the basis of fees that are substantially below related costs, with the intention of recovering them in the following year(s) - i.e. the practice of "lowballing".

Within a US setting, the Cohen Commission [CAR, 1978: xxx] considered the practice of lowballing and concluded that it "is a threat to the (professional) independence of the auditor" and recommended that the "problem" should be considered by the Ethics Division of the AICPA.

The Commission arrived at this conclusion on the basis of a previous ethics ruling which stated that "when the preceding year's audit fee remains unpaid, independence is impaired" and in putting forth its view stating that lowballing gives the auditor the same "interest in the financial success of the client and (so) might influence his independence in carrying out the examination" [CAR, 1978: 121] as that created by unpaid audit fee circumstances.

On the other hand, the ICAEW offers no **definitive** stand on the practice of lowballing, merely stating [ICAEW, 1987: 12] that:

> "if, in the course of an investigation into allegations of unsatisfactory work on the part of a member there is evidence of the work having been obtained or retained through quoting a fee that is not economic in terms of the time needed and quality of staff necessary to perform that work to a satisfactory professional standard, that factor is likely to be taken into account in considering the member's conduct having regard to the obligations placed upon the member under Fundamental Principle 2",

i.e. in a professionally and technically competent manner. One implication of the above could be that lowballing practices are only appropriately judged within the context of investigations into unsatisfactory work.

However critics (even in the profession, e.g. Aldous, senior partner of Robson Rhodes and co-author of) ["An uncertain future for a safe career" - Financial Times, May 16, 1991: 19] allege that even when not accompanied by unsatisfactory work, lowballing is a threat to the,

> "public interest (role) and independence of the auditing firm (which) is compromised by its need to make a profit out of the relationship. Under this kind of pressure, the auditor is unlikely to take a robust stand on a point of principle: he will be putty in the hands of the management."

1.3.5 Personal considerations

Criticisms levied against EAI in this context flow mainly from two areas of concern, as below:

1. Personal and business relationships
2. Directorships and other officer appointments

1. <u>Personal and business relationships</u>

Another area giving cause for concern with EAI is the perceived or possible close association or involvement by some audit staff (especially partners and managers) with the management of some clients [Moizer, 1991: 34].

Critics allege that such close involvement (especially where audit staff have audited the client's accounts for a number of years, or where one or more of the client's senior management team are ex-employees of the audit firm), causes the audit staff to be adversely affected in terms of professional detachment and objectivity - and consequently EAI may become impaired.

Referring to the situation where audit staff have worked on an audit client for several years, the Chairman of the 100 Group states, ["Coopers set to face flak over Maxwell collapse" - Accountancy Age, December 12, 1991: 1]: "It's a time-consuming and expensive business, but it's certainly a good idea if audit partners and senior managers are changed periodically."

In similar vein, Mitchell ["Bankruptcies raise questions over auditors" - Financial Times, December 7, 1990: v] complains that "the same auditors go on auditing the same businesses for years, leading to over-cosy relationships."

Others express their similar criticism more abruptly ["Discipline for the auditor" - Editorial, Financial Times, April 10, 1991: 18], stating that "it is a fundamental weakness in corporate accountability that the relationship between auditors and management tends to be over-cosy."

In part, such cosy relationships are seen to be encouraged by a cross-over of professional staff from audit firm to audit client and vice-versa. The threat posed to EAI in situations where staff transfer from the audit firm to the client (especially in a senior financial capacity) arises from possibly continuing personal trust (links) held by current audit staff for former audit colleagues now employed by the client.

Firth [1981: 186] considered the possible impact of such crossover relationships and while admitting that UK ethical guidelines do not preclude them, sees them as problematic when he notes that "some discussion of the problems posed" by them is needed.

On the other hand, the Cohen Commission [CAR, 1978: 101] specifically held the view that their recommendations were not intended to limit such crossover relationships as they did not perceive them to be a threat to EAI.

2. Directorships and other officer appointments

Welcoming the fact that auditors are debarred (both professionally and legally) from holding directorships in their audit clients, critics of EAI argue that this should extend to all (auditor) directorships.

This argument is based on the view that such director-auditors run the risk of becoming so closely identified and of identifying themselves with the management view of corporate affairs, that they jeopardise their all important independent state of mind when auditing.

1.3.6 Commercial considerations

This particular set of criticisms finds strong expression in a recent book by Stevens [1991] which considers current US audit practices, the central thesis of which is ["Caught in the Savings and Loans backlash" - Financial Times, September 19, 1991: 11] that:

> "the new found commercialism of the big (six) firms has compromised their professionalism (a vital attribute of which is independence) to the point where they are no longer fulfilling their obligation to society."

In considering reasons why the "professionalism" referred to by Stevens, may have become obscured, the concurrent provision of management advisory services (MAS) and accounting services appears pre-eminent.

The basis of both these criticisms in the context of EAI are considered below:

1. <u>Provision of accounting services</u>

Criticism of EAI on this score is based on the view that it is impossible for someone to audit his own work or the outcome of such work, and still be independent and objective in the opinion he gives on such work.

Indeed, there is substance to that view, as it is axiomatic that one cannot audit his own work and the UK audit profession [ICAEW, 1987: 24] recognises that fact in imposing a virtual complete prohibition on the provision of any accounting or accounting type services to their publicly listed audit clients.

Thus, such critics argue auditors should not perform accounting and/or book-keeping services for clients, and should exercise great care and good judgement in performing any other services for their audit clients.

Such critics state that people who choose to practice auditing should reflect upon the fact that their professional independence is so crucial, such that they ought to be more than prepared to avoid involvement in any other form of activity that will (can) or even may appear to compromise (might impair) their independence.

2. <u>Provision of MAS</u>

The concurrent provision of MAS and audit service by the auditor is the source of significant, pronounced and frequent criticism of EAI.

Perhaps Austin Mitchell ["Bankruptcies raise questions over auditors" - Financial Times, December 7, 1990: v] best summarises criticisms on this score when he states that:

> "auditor independence is also compromised by the non-auditing services provided by the accounting firms. In the United States, the SEC bans auditors from performing certain services for their audit clients. In this country, (audit) firms are free to recruit company officers, write up the company records and then audit them. We are asked to assume that the extra revenue exerts no pressure on the compromises which auditors make."

While the UK audit profession generally, has not accepted criticisms made on this score, there does appear to be some basis for them.

For instance, it was recently reported in a US context, that ["Auditing independence with a European face" - Accountancy Age, March 14, 1991: 17]:

> "the US controller general (of banks) is believed to be intending to bring in regulations which would insist that the (auditors) of the 50 biggest US banks are not to be allowed to offer any services other than auditing"

to those clients during their tenure as auditors.

Further, despite earlier protestations by Harold Cottam, then UK managing partner of Ernst & Whinney ["Age of the all purpose salesman" - Financial Times, August 27, 1986: 13] about such a (MAS) problem being "theoretical" and lacking "evidence", there has been some reappraisal of such thinking in the profession.

For example, note recent remarks of Swinson, chairman of the ICAEW's financial reporting group, admitting concern with EAI when he declared ["Coopers set to face flak over Maxwell collapse" - Accountancy Age, December 12, 1991: 1]

> "People are extremely concerned about the way in which auditors are operating and the way in which the reports they produce are serving the public interest. We have to ask again whether other services can be sold to their (audit) clients. I believe the profession needs to review some of the sacred cows."

In addition to the provision of these two types of services, others detect another set of commercially inspired threats, which may cause the auditor to try to unduly satisfy client "demands", by acquiescing to unreasonable audit completion (time) and undue fee (budget) pressure - as levied by the client on him.

The Cohen Commission [CAR, 1978: Section 9] considered both these forms of commercial pressure and concluded [Wolnitzer, 1979: 37] that:

"1. the time and cost pressures to reduce the amount of audit work carried out tends to diminish independence; and

2. arbitrary time deadlines imposed on auditors impairs their independence"

1.4 EAI and expectations gaps

To the extent that criticisms of standards of EAI reflect gaps between reasonable and (professionally) practical audit-user expectations of EAI and those actually prevailing, that gap is an expression of the EAI aspect within the overall audit "expectations gap" [Liggio, 1974; CAR, 1978 and CICA, 1988].

In fact, Humphrey [1991: 14] sees EAI as integral to the audit expectation gap debate, concluding that "if any topic can be classified as going to the heart of the audit expectations (gap) debate, it is the issue of auditor independence."

In order to redress this aspect of the gap, several suggestions have been advanced to redress criticisms levied against the perceived weaknesses of external auditor independence in practice, and these tend to fall into one of four broad but distinct categories:

1. Restricting (or prohibiting) non-audit services by the auditor that might be or be seen to be incompatible with the audit function.

2. Protecting the auditor (primarily in an economic sense) from the influence of or the dependency on the management of the audited entity (e.g. audit committees, rotation of audit appointments, independent fee-setting and audit-appointing body).

3. Ensuring that audit firms are managed so that the necessary internal (e.g. compulsory rotation of audit staff and second partner review) or external (e.g. peer review) support for the independence of individual partners and staff is provided.

4. Prohibiting by statute the auditor from having any (beneficial or non-beneficial) financial involvement in/with audit clients (e.g. trustee shareholdings).

The long run welfare of the audit profession depends upon the auditor's independence and integrity. If he assumes a partisan role he sacrifices his professional status and his opinion is no more acceptable than the representations of the management preparing the relevant statements. The resolution of this and similar problems calls for the exercise of good judgement by the profession as a whole. If there should be any doubt as to how to handle a particular issue, it will be far better for the profession to err on the side of greater rigour and caution, rather than greater laxity.

For it is only through the enforcement of rigorous accounting and auditing standards that the profession will maximise its credibility - and in so doing its perceived professional independence.

This chapter placed EAI within its functional context. This it did first by considering the professional dimension attached to it and then highlighting some of the major criticisms of or concerns (expectation gaps) about it when considered within its practical setting.

The next chapter considers EAI from some of the theoretical stances from which it may be viewed and Chapter 3 reviews the major extant empirical research conducted into the issue of EAI.

CHAPTER II

THE NATURE OF EXTERNAL AUDITOR INDEPENDENCE

The previous chapter considered some of the more operational aspects and criticisms of EAI within its macro and micro contexts. It also asserted that the whole basis of the auditing profession rests on its ability to be, and to be seen to be independent, but made no attempt to examine (explain) the nature of EAI.

Thus the purpose of this chapter is to examine the underlying nature of EAI and to consider why confidence held in the auditor's opinion (and so in related audited statements) varies directly with the auditor's ability to physically and mentally disregard and dissociate himself from the client and its management.

This analysis of the nature of EAI is conducted on the basis that any research (empirical or other) into, and/or regulative measures governing EAI should only be conducted with a good knowledge of its underlying nature.

In order to examine the nature of EAI this chapter draws on the theoretical offerings provided by a number of authors, each of whom have generally considered EAI from or within a specific standpoint or perspective.

This chapter has five major sections. The first reviews some of the definitions offered for EAI and places it within a theoretical frame. The second section outlines and considers the nature of EAI from some of the more important perspectives from which it has been analysed.

The third section presents an understanding of the nature of EAI by assessing it from the main types of influences that are judged to possess power when shaping EAI in its practical forms. The fourth section of the chapter considers the nature of EAI in an agency theoretic and Efficient Market Hypothesis (EMH) frame.

The final section of the chapter consists of a summary and overall synthesis of the previous sections and some concluding thoughts as to the intrinsic nature of EAI.

2.1 Theoretical perspectives

Belkaoui [1985: Chapter 3] offers various competing approaches to the formulation of an accounting theory and identifies the "behaviourial approach" as one.

In his view [Belkaoui, 1985: 85], this approach "emphasizes the relevance to decision making of the information being communicated and the individual and group behaviour caused by (taking place within) the communication of information."

Accordingly, since EAI is essentially a behavioural and relative quality, any theoretical examination of it can be seen as taking place within the auditing equivalent of such a behavioural approach. However precisely because EAI is a behavioural issue, it remains an elusive feature which, despite the many definitions offered for it, auditors have found difficult to clarify precisely within their professional role.

Nevertheless, as definitions are useful commencement points in order to understand the nature of EAI, some exposition of them is appropriate. For instance, from among the many definitions offered for EAI, we note that Kohler [1970: 229] defines EAI as:

> "The property or a relation between the accountant and his client, such that the accountant's findings and reports will be influenced only by the "evidence" discovered and assembled in accord with the rules and principles of his professional discipline."

Schandl [1978: 193] however, sees EAI more as:

> "the assurance that the auditor's personal, emotional and material interests will not be affected by others because of his communicating an opinion, judgement, finding or decision."

Expressed in more mathematical terms [Watts and Zimmerman, 1986: 313], one may view total EAI as that which prevails when the probability of the auditor reporting <u>ALL</u> material facts about the client is 1.

In reality, since a probability of 1 equals certainty, such a state cannot be assumed because some uncertainty always remains attached to EAI.

From the opposite standpoint, one might maintain that for the auditor's opinion to be of some value, the auditor must have some incentive to tell the "truth" when the "truth" is bad or unwelcome from the client's view. DeAngelo [1980-1981: 68] regards the auditor's incentive to reveal unwelcome news (not in the client's self-interest) as one definition or expression of EAI.

However, a more pragmatic working definition might define EAI as the avoidance of situations which would indicate to others that an impairment (consciously or subconsciously) of the auditor's professional judgement could take place when there is a conflict or potential conflict between the auditor and the client or other parties.

While definitions are useful starting points, they always need further expansion and elucidation. Analysis of EAI shows it to be a multi-faceted quality and in recognising this fact, three main different perceptual approaches to its examination are indicated in the literature, viz:- perspective based, influence based and factor (with constituent attributes) based.

2.2 Perspective based approaches to EAI

This approach examines the nature of EAI from a number of alternative, equally valid, standpoints or perspectives. As such, any resultant understanding of EAI is governed by the particular perspective chosen when examining it. A survey of the literature identifies seven individual perspectives from which the nature of EAI may be considered.

1. The "existential" perspective

Auditors have for many years recognised that EAI exists within two broad dimensions - "fact" and "appearance". Thus, this distinction made over thirty years ago [Higgins, 1962: 31], refers to the form in which EAI "exists" and holds that:

> "there are actually two kinds of independence which a CPA must have - independence in fact and independence in appearance. The former refers to a CPA's objectivity, to the quality of not being influenced by regard to personal advantage. The latter means his freedom from potential conflicts of interest which might tend to shake public confidence in his independence in fact."

Many years later Arens et al [1984: 34] restated that two important aspects of EAI relate to "fact" and "appearance". This they did stating that:

> "not only is it essential that CPAs maintain an independent attitude in fulfilling their responsibility, but it is also important that the users of financial statements have confidence in that independence. These two objectives are ... identified as independence in 'fact' and ... 'appearance'."

> Independence in fact exists when the auditor is actually able to maintain an unbiased attitude throughout the audit (i.e. being independent), whereas independence in appearance is dependent on others' interpretation of this independence (i.e. being seen to be independent)."

Both dimensions are crucial to the proper fulfilment of an audit - one without the other is of little value. EAI in appearance, which involves the **perception** of the auditor's independence by all interested in the audit report has received much attention by US researchers.

In relation to users, every judgement by the auditor has an EAI aspect. Such judgements include his search for clientele, staff hiring, assignment of staff to the audit engagement, approach to audit investigation, evaluation of evidence and his development of opinions.

In fact, if any judgement (no matter how important), appears to involve compromise, then subordination may be alleged and consequently perceived independence could very well be questioned.

For example, agreement by the auditor to an audit client request not to seek direct confirmation of a particular trade receivable (whether or not the auditor deems it necessary), can be seen by users of the audited statement as a subordination of the auditor's judgement, and in effect an impairment of his professional independence.

The same can be said of the auditor's acquiescence to a change requested by the audit client to the wording of a particular note or set of notes to the financial statements, whether or not the auditor is convinced that the revised wording in fact assists with a true and fair view of the relevant financial statements.

While much emphasis has been placed on the determinants of the appearance of EAI, understandably, less emphasis appears to have been placed on determining what attributes create independence in fact.

However it is obvious that this "**factual**" aspect of EAI calls for the total intellectual honesty of the auditor and his complete absence of any indebtedness or obligation to any user of his report.

2. The role perspective

Judged from this perspective, EAI has two main role-based dimensions [Carmichael and Swieringa, 1968], the first being "practitioner independence" and the second being "professional independence".

The dimension relating to practitioner independence refers to the attitude of the individual auditor's mind and his personal principles and self-reliance (such as illustrated in the public's perception of a priest).

On the other hand, the professional dimension relating to EAI refers to the image of the auditor as a member of a distinct group to which is attributed certain features (e.g., the public's negative view of used car salesmen). Thus membership of a particular group acts as a surrogate assurance of the qualities or character traits attributed to all members of the group.

3. The human dynamics perspective

Agency theory [Watts and Zimmerman, 1983] views the firm in terms of a "nexus of contracts" [Jensen and Meckling, 1976] between different parties operating in a socio-economic framework. The interactions between them which gives rise to the need for an independent audit, are predicated on inter-personal dynamics.

Thus, assuming that an auditor is fully competent and knowledgable, and has all the means to apply his skills and knowledge, then the only other determinant that may stand in the way of a credible audit report, is the auditor's willingness and ability to act independently.

Unaudited accounts lack credibility because of the questionable objectivity of their issuers. However the auditor's non-involvement in the daily activities of a company provides the required objectivity for his audit opinion on the company's financial statements.

The need for EAI stems from the "remoteness" between the management of a company and users of its accounts. This gives rise to the "stewardship" aspect underlying accounts [CAR, 1978: 93] and the need for an auditor. Further, the larger the company, the more remote from each other owners and managers are likely to be.

The auditor acts as a bridge in the process of ensuring management remains accountable to (primarily) the company's shareholders and (generally) to other users of the company's audited financial statements. Clearly then, it is vital to the strength of this bridging that the auditor is not only independent "in fact", but is also seen to be so independent "in appearance".

As a result, user confidence in the financial data presented by a company is closely related to the position of independence taken by its auditor. The more independent or objective the auditor, the greater the probability that shareholders and other interested parties will have confidence in his EAI and in his underlying work and opinion. The CAR [1978: 105] puts forth its belief that:

> "the obligations created by the audit function may require the auditor to persuade management to present a measurement of earnings or disclose material information that reflects unfavourably on its performance. Often, the independent auditor's task is to persuade people to do precisely what they do not want to do."

Thus, the value of an audit to consumers of audit services, depends on and stems from the auditor's ability to withstand client pressures to do or not do precise actions and to disclose information partially and/or selectively.

Considering EAI from a human dynamics perspective, one notes that the closer the perceived alignment of incentives between the auditor and the client, the lower the value of the auditor's opinion on the client's financial statements to consumers of audit services.

4. <u>The environmental perspective</u>

Certain auditing theoreticians [e.g. Aranya and Sarell, 1975] have considered EAI from the perspective of the environment within which it is exercised, contending that the degree of independence an auditor brings to bear in any situation is a composite result of factors that are external (i.e. "macro" aspects) or internal (i.e. "micro" aspects) to the audit parties themselves.

The distinction between these two aspects from which EAI may be regarded, was explained within, and formed the structure for the criticisms of EAI presented in, Chapter 1 and so are mentioned here for the sake of completeness only.

5. The sociological perspective

Such studies view auditing and audit phenomena (such as EAI) within a sociological framework and attempt to analyse it using sociological concepts and terms.

Barrett [1969: iii] views EAI as containing two underlying sociological role constructs and maintains that:

> "the audit profession's ethical notion of apparent independence can be operationally defined as a sociological role construct, and its conception of real independence can be operationally defined as a personality construct."

Barrett [1969: iii] further puts forth the view that:

> "Interpersonal independence describes functional situations which promote, or dysfunctional situations which impair, the profession's auditor image as perceived by reasonable observers. Intrapersonal independence is the second order factor containing three operational content variables.
>
> It is assumed that male individuals - who are field analytical rather than global field types, who evidence a low social approval need rather than being approval motivated and who prefer to describe themselves in terms of independent rather than intermediate or dependent personality typologies - tend to possess a high degree of intrapersonal independence as characterised by their behaviour in test and non-test situations."

On the basis of his exploratory studies, Professor Barrett concludes that interpersonal and intrapersonal EAI are both amenable to identification and determination by empirical testing.

6. The components perspective

Here the individual components associated with EAI are considered directly. For example, considering EAI from this perspective, Berryman [1974] views "time" as an important component. In this regard, he contends within each audit engagement, that EAI must exist for some minimum period of time.

An independent state of mind must exist from the time an audit contract is first contemplated (bidding, tendering) or comes into existence, until the time the relevant audit report is rendered and subsequent responses interpreting reactions to the report have been given.

In practice this means an independent attitude must be maintained (by all audit personnel concerned) from the time that an audit engagement is considered until all audit work is done and the audit report is duly communicated.

Berryman's second component is a "party" component. As such, the auditor must not be under the influence of any party (client or otherwise) who is or may become interested (positively or otherwise) with the outcome of the audit. In giving due recognition to this "party" component of EAI, Berryman poses questions such as:

1. Who should select the auditor?
2. Who should decide to change the auditors?
3. Who should pay the audit fee?
4. With regard to whom must the auditor be independent?

In considering this "party" component attached to EAI, one notes that the auditor must guard his independence not only in terms of shareholders, but also in terms of all potential users of the accounts under audit.

Until relatively recently shareholders were generally regarded as the sole beneficiary of the audit, and so auditor independence was conceived of solely in terms of protecting their interests.

This traditional view appears to have been reinforced in the recent House of Lords decision in the "Caparo" case [Caparo Industries PLC v. Dickman, 1990 - All ER HL 568] limiting the scope of the auditor's professional liability.

However, recognition, use and acceptance of the audit report by a much wider audience and reader group has meant that EAI is potentially as important to the company audited, its lenders, suppliers, bankers and employees, as it is to its shareholders and is increasingly being regarded as such.

Accordingly, previous decisions arrived at in lower courts on the Caparo case (and other cases elsewhere, e.g. the 1963 Australian case of Reid-Murray Holdings Ltd) give closer legal expression and substance to the more "modern" view that the auditor must safeguard his independence within the widest possible scope, if he is to pay due respect to the wide "party" component attached to EAI.

7. The (integrative) phases perspective

Mautz and Sharaf [1961] integrate within one framework, some of the previously considered perspectives, using a three phase model.

The first of these three phases is described by Mautz and Sharaf [1961: 230-231] as:

> "the independence of approach and attitude which any professional man should have ... a combination of self-reliance, freedom from client control, expert skill and ability, and considered judgement based on training and experience not available to those who are not members of the profession."

Carmichael and Swieringa [1968: 698] refer to this phase as "professional independence" - a feature to be observed not only in the audit but in all professions. Its basis is control by self-imposed standards, self-regulation of professional standards, and peer-group surveillance.

This phase of EAI therefore implies and requires freedom from control and/or pressure from and by superiors or other vested interests. To exhibit this form of independence, an auditor must accept and conform to all the obligations arising from his professional status.

To do this effectively requires that the auditor be an individual of high morals, character and integrity. Pearson [1979: 20] states the auditor "must be willing to conform to the norms of his profession, while at the same time be willing to speak out on matters where he or she feels the profession is deficient."

Additionally, the auditor's personal value system must prohibit him from obeying commands that are clearly in violation of professional standards and prohibit him from performing duties less than professionally.

Comparing this particular phase of auditor independence with its parallel features in other professions, Carey and Doherty [1966a: 18] note that:

> "Independence, in the sense of being self-reliant, not subordinate, is essential to the practice of all professions. No self-respecting professional man - physician, lawyer or certified accountant - will subordinate his professional judgement to the views of his patient or client. He cannot evade his professional responsibility for the advice, opinions, and recommendations which he offers.

> If his patients or clients do not like what he says, the practitioner may regret it; but no one would condone his changing his honest opinion so as to avoid giving offence or to secure a fee."

Professional training alone will not assure this phase of EAI, because in addition to the professional aspects noted above, it is a composite function of personal values, heredity, and family and social background.

Mautz and Sharaf [1961: 231] see the second and third phase of EAI as being particular to the audit profession. They see the second phase of EAI as:

> "that required by an auditor if he is to perform his function of review and verification in a satisfactory manner. Independence here consists of freedom from bias and prejudice, whether recognised or not ...
>
> The practitioner must be aware of the various pressures, and an auditor must be constantly alert to any deleterious influences on his planning (programming), investigative, or reporting independence."

The above three freedoms must be present in this second phase of EAI. Impairment of any of them results in a loss of EAI and must not be endured by an auditor. The importance attached to these freedoms in an EAI context warrants brief clarification viz:-

<u>**Programming**</u>: Freedom from control or undue influence in the planning, programming and the selection of audit techniques and procedures and the extent of their application.

Investigative: Freedom from control or undue influence in the selection of areas, activities, personal relationships, and managerial policies to be examined.

Reporting: Freedom from control or undue influence in the statement of facts revealed by the examination or in the expression of recommendations or opinions as a result of the examination.

The third and final phase of EAI per Mautz and Sharaf [1961: 231] focuses on the recognition that "public ... acceptance of the auditor's status is significant to the successful accomplishment of his purpose."

2.3 Operational influences on EAI

Certain authors [Goldman and Barlev, 1974 and 1975; Nichols and Price, 1976; Shockley, 1982 and Farmer et al, 1987] have attempted to obtain a better understanding of the nature of EAI by identifying those features, forces or factors that may influence it. In turn, the following considers each of these attempts.

Features influencing the operation of EAI

Shockley [1982] identifies the following 10 features of the audit environment which, in his view and with varying degrees of underlying significance, act as influencing determinants of EAI. These features are:

1. Client-auditor dependencies
2. Accounting flexibility
3. The provision of other services (MAS) to the client
4. Size of the audit firm
5. Degree of competition for audit services
6. Years the auditor has acted as such (tenure)
7. Professional integrity
8. Professional sanction
9. Fear of loss of reputation and clientele
10. Legal liability

Empirical research conducted by Shockley [1981] indicated that (in order of significance) the degree of competition, the size of the audit firm and provision of MAS to audit clients are the features that most influence an audit firm's independence being impaired.

Forces (conflicts) influencing the operation of EAI

Other authors Goldman and Barlev [1974] (using behavioural analysis) and Nichols and Price [1976] (using exchange theory) consider EAI in terms of asymmetrical power structures between the auditor and management and in sets of conflict relationships, viz:-

1. between the auditor and the firm
2. between the shareholder and the management
3. between the auditor's self-interest and professional standards

Despite their consideration of essentially the same conflict relationships, as a result of differing logic and views, Nichols and Price [1976] and Goldman and Barlev [1974] arrived at totally contradicting conclusions.

However, they both agreed that the position of management was stronger than that of the auditor on the basis that it was relatively less difficult for management to find a replacement auditor than it was for the auditor to find an equivalent audit client.

Three broad approaches are recommended by the authors to assist the auditor to withstand firm pressure in the first conflict relationship. In the first of these conflict relationships they suggest increasing the power of the auditor, primarily by increasing the ability of a replaced auditor to cause sanctions to be imposed on the firm resulting from unjustified removal replacement.

In the second case they recommend increasing the expected cost to the auditor and/or the firm from taking inappropriate actions. Finally Goldman and Barlev [1974] argue for a change in the structure of the auditor-firm contractual relationship so as to reduce the firm's discretionary options.

Factor (attributes) influencing the operation of EAI

Farmer et al [1987: 5] provide an identification of five major constructs governing EAI. They contend that within each of them lies differing sets of attributes. The five constructs identified by Farmer et al and some of the attributes contained within them are:

1. The psychological construct, which refers to the auditor's psychological framework, with particular significance being attached to the auditor's objectivity and sense of realism.

2. The economic construct, which refers to the facts governing the auditor's own economic standing, which in turn normally functions as a determinant of his propensity to succumb to pressure on his EAI.

3. The third party construct, which refers to the auditor's recognition that he is his own agent and once appointed is professionally independent of both primary audit parties (owners and management).

4. The technical competence construct, which refers to the auditor's possession of more than due accounting and auditing knowledge so that he may professionally assess the appropriateness of accounting treatments and the related auditing of them.

5. The standard setting factors, which refer to the existence of a strong standard setting body that dictates firm accounting principles, thus providing a more limited area for judgement disagreements between the client and the auditor.

2.4 EAI in an agency theory and EMH context

In addition to providing an explanation (information asymmetry) for the practice of auditing, agency theory [Watts and Zimmerman, 1981; 1983 and 1986: Chapter 13] also allows one to obtain an understanding of the nature of EAI by focusing on EAI's role in the theory.

The theory suggests that, in an efficient market, "rational" agents [Moizer, 1991: 36] will view auditors having a known economic interest in their clients as having increased incentives to "cheat" and so they are seen as less likely to be independent.

The costs of increased uncertainty caused by such incentives to cheat ("opportunism") are likely to be imputed into the share/bond price of the client (if current) or its price of attracting fresh capital (if new). This view is reinforced by the theory of the EMH which states that the securities market quickly receives all publicly available data and promptly reflects it in the prices of relevant securities.

Thus, even if one accepts that auditing or EAI has little to do with an efficient market, one cannot deny that audits at least provide a means of confirming or correcting data previously received by the market.

In this context therefore, audited statements help to assure the efficiency of the market by limiting the life of incorrect or inaccurate information or by deterring its further dissemination.

Such thinking also suggests that in a truly efficient market, the expected economic benefits of EAI will be fully reflected in the market price of the relevant share or bond.

Under non-regulated conditions, audit clients would have the incentive to contract with auditors in such a way as to maximise, by virtue of the audit process, the incremental value of the firm. The independent assurances provided by an audit hold significant information value for users of financial statements.

2.5 Summary and synthesis of the nature of EAI

This chapter provided an analysis of the underlying nature of EAI, first by offering some definitions of it and then by examining it using some of the perspectives from which it has been studied.

This perspective-based examination of EAI was conducted from varying but equally valid standpoints. It determined that EAI is a multi-faceted feature which is perhaps best assessed using suitable multivariate approaches, so that due provision is made for these multi-facets of EAI to be captured and/or unfolded.

A section of the chapter explained the linkage between EAI and agency theory and the Efficient Market Hypothesis - noting that there is a basis for convergence between these two theoretical paradigms.

Summarising the main aspects relating to EAI when it is being exercised, we note that for it to be present and so perceived, it is vital that an auditor possess not only the necessary characteristics to be independent, but that he must in fact exercise them fully so that users of accounts see them to be present and functioning.

By the same token, we note that the nature of EAI requires that the auditor be aware of and constantly re-assess and examine the likely causes or situations that may result in his professional EAI being impaired.

First, in the sense of not being subordinate, EAI implies honesty, integrity, and complete objectivity.

Second, in the narrower sense in which it is used in connection with audits and the expression of opinions on financial statements, independence means avoidance of any relationship which would be likely, even subconsciously, to impair an auditor's objectivity. Third, it means avoidance of any and all relationships which may reasonably suggest a conflict of interest.

But how can auditors be assured that users of audited statements have (at least) a high level of confidence in their independence? To do so, the independence perceptions of audit users must be determined.

Further, how does one measure perceptions of EAI as seen by the users of audited financial statements? Could it be possible to develop a sort of measuring or gauging instrument, such that the profession could use to monitor users perceptions about their independence?

Differing users and user groups may have varying concepts of auditor independence and may thus have conflicting perceptions about it, its importance and the degree to which it must be present.

Such differences in views will present difficulties, as would attempts to develop universal recommendations for actions to raise the level of perceived EAI.

Berryman [1974] raises an important point in asking what relationships should be avoided and/or proscribed by the auditing profession. However one wonders whether the same auditor-client relationship is uniformly perceived by all relevant groups. Further, one might enquire as to those relationships or situations that best distinguish between EAI views of such groups.

The empirical part of this research attempts to identify and examine some such relationships in the context of both selected groups of UK users of audited statements and the UK audit profession.

Further, as the nature of EAI appears to be multi-perspective and therefore multi-faceted, much of the empirical research in this thesis adopts a multivariate approach.

Despite the increased understanding of EAI made possible through its consideration from several perspectives and the influences that appear to govern it, in the final analysis EAI is an issue of integrity and so a part of the general characteristic of human honesty. However honesty is itself a relative concept and varies with individuals, so determining if an auditor has or has not been honest is not without problems.

Perhaps Shakespeare offers some useful practical guidance to professional auditors in Hamlet (I. iii), in the words spoken by Polonius, when he says:

> "This above all - to thine own self be true
> And it must follow, as the night the day
> Thou canst not then be false to any man."

This chapter examined the nature of EAI within a theoretical context. In the main, the next chapter presents results made available from previous empirical research into specific aspects of external auditor independence.

CHAPTER III

SIGNIFICANT RESEARCH CONTRIBUTIONS TO EXTERNAL AUDITOR INDEPENDENCE

The purpose of this chapter is to review previous important research into external auditor independence that (inter alia) also considered aspects of the subject empirically assessed in the present research.

Most research into EAI has been done in the last thirty years in the US. However, in order to consider only the more current findings in this chapter, research conducted pre-1970 is not necessarily addressed here.

This chapter has three major sections. The first considers the theoretical research conducted on EAI while the second addresses three differing types of empirical research on the same issue. The third section presents a brief integrative review of, and conclusions drawn from the chapter.

3.1 Theoretical research

Research into EAI has been both theoretical and empirical. The theoretical research considers EAI devoid of any practical or "real-world" setting and confines itself only to conceptual models or analyses. In turn, this research has also been of two types.

The first type of theoretical research into EAI has its origins in the literature of psychology [Gul, 1987 and Wilkinson, 1988] and/or that segment of the sociological literature relating to professionalism [Schilit, 1981], as considered in Chapter 1.

This type of research considers those influences likely to condition EAI [Nichols and Price, 1976]. Further, it has generally viewed auditor behaviour in terms of conflict, essentially between the auditor and company management, and has examined [Shockley, 1982] or built models [Goldman and Barlev, 1974] of the influences (variables) likely to prevail upon EAI.

More recently this type of research has been furthered by the second type of theoretical research, which concerns itself with the development of formal economic models considering EAI mostly in the frame of agency theoretic [DeAngelo, 1981a] contractual relationships.

Both types of theoretical examination have helped with an understanding of the dynamics of the auditor-client relationship. For example, it drew attention to the fact that while audit clients have some ease and choice in selecting auditors, audit firms have comparatively less choice in accepting audit appointments and much difficulty in replacing lost audit clients.

However, such theoretical study is yet to produce the definitive model of influencing variables on EAI, and with the emergence of audit tendering and lowballing, this relationship is further compounded. As such there is still no overall consensus as to which aspects of this relationship likely strengthen or impair EAI.

3.1.1 Influence based theoretical research

The theoretical contributions to the study of EAI provided by Goldman and Barlev [1974], Nichols and Price [1976] and Shockley [1982] have been alluded to in Chapter 2 when considering the nature of EAI. Hence only brief details of their research are noted below:

Goldman and Barlev [1974]

The authors see the auditor-firm relationship as the composite result and inter-action of the influences of three distinct sets (independent, intervening and dependent) of variables upon each other. They suggest that auditor independence is, in many ways, a symptom of the power asymmetry existing in this role structure.

They hold that the more non-routine the auditor's work, the greater is his strength (power) and so the basis of his independence. They see MAS (because it is a non-routine service) provision as strengthening the auditor's independence [Moizer, 1991: 42].

In contrast, they see the statutory audit as a routine service and in consequence auditors who only provide external audit services are likely to be less independent. Considering their power-analytical model, Goldman and Barlev suggest three possible approaches which together would be helpful in strengthening EAI. These approaches are:

1. Decrease the potential power of management vis-a-vis the auditor by limiting its freedom of action.
2. Reduce the auditor's flexibility of action by laying down rigid accounting and auditing standards.
3. Change the very structure of the audit role and/or the auditing profession.

Nichols and Price [1976]

The consideration of EAI done by these authors utilised interpersonal exchange theory and focused on those variables which, in their view, are likely to affect the auditor's ability to withstand pressure from a client.

Based on their assessment of the variables that influence the auditor-firm relationship, Nichols and Price suggest that there are three reasonably distinct approaches or sets of procedures that are likely to increase the auditor's ability to withstand pressure to comply with the client's demands.

1. Increase the power of the auditor (e.g. requiring a new auditor to consult with the previous one so as to obtain <u>all</u> relevant information he may require <u>before</u> accepting a new audit appointment).
2. Increase the expected cost to the auditor and/or the firm from taking inappropriate actions (e.g. more precise formulation and specification of auditing and accounting standards).
3. Change the structure of the auditor-firm contractual relationship so as to inhibit or limit the firm's discretionary options (e.g. statutory basis to audit committees made up of only non-executive directors).

The conclusions arrived at by Nichols and Price appear to be quite contrary and opposed to those arrived at by Goldman and Barlev. Contrary to these authors, Nichols and Price held that the more limited the possibility of discretionary judgements available to auditors, the less likely it is that there will be violations of generally accepted accounting or auditing standards.

They opine that even though the statutory audit is a routine service, if it is bound by tightly prescribed rules, so that the scope of individual auditor judgement is limited, the potential pressure on the auditor to act unprofessionally will be limited and so the auditor will in fact be more able to exercise EAI.

Shockley [1982]

Shockley's theoretical contribution to the subject of EAI has been the provision of a model (developed using causal analysis) that integrates differing research directions on it within a conceptual framework. He concluded that whether or not a particular auditor or firm of auditors is seen to be independent, is the result of interactive variables which are causally related to each other. He also held that the variables of significance to audit user views of EAI are the ten previously noted in Chapter 2 (Section 2.3).

3.1.2 Agency theory based theoretical research

Certain researchers [DeAngelo, 1981a and Antle, 1984] have used models arising from the auditor-client (and other) contractual relationships identified within the framework of agency theory [Watts and Zimmerman, 1986: Chapter 13] which is premised on a network of deemed or real contractual relationships.

Such research investigated the behaviour of management and auditors when both are seen as agents of the same principal (the owners) in an environment where the actions (and their results) of management are assumed to be not directly observable by the principal, but are observable by the auditors (the asymmetrical knowledge or action situation) [Thornton, 1984 and 1985].

DeAngelo [1981a and 1981b]

Using agency theory as a mainstay, DeAngelo considered EAI generally, and more specifically the practice of "lowballing" - setting audit fees below costs on initial audit engagements, with a view to recovering them in the future or possibly through the provision of more lucrative non-audit services to the audit client.

The practice has been cited by both the SEC and CAR [1978: xxx] as one likely to impair independence and is one aspect of EAI judged in the research questionnaire developed for this research (Situation 14). With the growing number of UK companies trying to limit audit costs by requesting tenders for their audit, the topic has become of much concern in the UK also. It is thus pertinent to examine how lowballing is seen by DeAngelo within agency theoretic terms.

DeAngelo's model reflects a simple multi-period depiction of the market for audit services in terms of audit fee, start-up and transaction costs.

Using this model DeAngelo demonstrates that normal competitive market equilibrium requires initial fees to be less than costs (i.e. lowballing to take place). However, DeAngelo's view is that lowballing in itself does not constitute a threat to independence.

DeAngelo's rationale is based on the fact that because initial fee reductions are sunk-costs, in future time periods they will have no effect on the magnitude of future quasi-rents or on the auditor's EAI. She argues that it is the very existence of these quasi-rents that is detrimental to EAI and so holds that lowballing in itself is not a threat to EAI, so that rules prohibiting lowballing will have little effect on EAI.

Antle [1984]

Antle's model, also developed within an agency theory framework, holds that if the remuneration of both management and auditor is a function of their respective reports, then there are incentives for them to co-operate, or to even enter into direct collusion (perhaps involving side-payments), with each other, and that in such circumstances lucrative MAS contracts might act as a good cover for possible side-payments.

Antle's model assumes auditors to be no different from any other "economic agent" and so regards him in the same way as any other type of economic agent. The model uses "casual empiricism" and considers those pressures that might induce the auditor to forgo the "benefits" of non-independence, while employing game theory and related statistical concepts to substantiate its mathematical validity.

In developing his single-period (partial-equilibrium) model, Antle concurs with Watts and Zimmerman [1981] who state that even without regulations auditors have incentives (especially "reputation effects" - a multi-period phenomenon) to maintain their independence, and so self-monitoring (regulation) is enough to maintain a reasonable level of auditor independence.

Antle's model suggests appropriate checks to encourage EAI include:

1. continual monitoring of transactions between the two agents - auditor and management (by say, reporting the extent and value of non-audit services).

2. long-run observation of tendencies of audit reports on the basis that audit firms actively colluding with client managements will present fewer unfavourable reports.

Antle's model is premised on the view that while there may be powerful incentives for individual audit firms to act in a non-independent manner, if all firms acted in like manner, then in the long run, the market for audits (other than statutory audits) would rapidly contract as principals perceived that management and auditor were effectively acting as one agent.

However, generalising from his model, Antle recognises that differing long-term results may be noticed, because firms would have a common incentive to act in a collective manner so as to maintain appropriate levels of independence, precisely to ensure against the collapse of the market for audit services as a whole.

3.2 Empirical research

The more pragmatic type of research into EAI recognises that it is a concept difficult to define in finite or absolute terms and whose meaning may shift over time. Thus, it sets itself the more limited goal of identifying what current perceptions of EAI (as held by various groups interested with audits) are, and of comparing these views with the current requirements of relevant professional auditing and other (SEC) bodies.

As with the theoretical research into EAI, most of its empirical research has been conducted in the US. In general, the empirical research has been of two types.

The (more frequent) first type of this empirical research has addressed itself to the perceived impact on EAI when the auditor provides various types of non-audit services - usually classified as management advisory services (MAS). Hence research of this type can be termed as MAS-based empirical research.

The (less frequent) second type of research, like that conducted within this thesis, has addressed itself to examining EAI within differing audit environments or specific situations. Hence research of this type can be termed as situation-based empirical research.

Empirical research into EAI has sought the views of auditors themselves [Amernic and Aranya, 1981] or those of audit users [Firth, 1981]. On some occasions, such research has sought the EAI views of both auditors and the users of their services [Firth, 1980], as is the case in this research.

A small segment of research into EAI [Scheiner and Kiger, 1982; Scheiner, 1984] has researched the impact of US disclosures made as a result of the ASR-250 SEC-regulation. The disclosures required related to details (primarily fees) about MAS services, when provided by the company's auditors. [The regulation was withdrawn - so the experience may be indicative in a UK context.]

However, as the present research does not directly address disclosure issues relating to MAS fees paid by companies to their auditors, this segment of research is not elucidated further, nor for the same reason is that conducted by Simunic [1984], which judged the joint impact of MAS-provision and internal audit costs.

3.2.1 MAS-based empirical research

One of the audit environments considered in the present research questionnaire relates to an auditor's dual provision of audit and MAS (Situation 13), so the following section reviews previous research examining views of EAI in such MAS-providing situations.

Dermer, Evans and Pick [1971]

This Canadian study, one of the earliest to investigate the perceived compatibility of auditing and MAS, was targeted at 300 individuals, who because of their occupations (bankers, mutual fund managers, stock brokers etc.) were deemed to be users of audited statements and so concerned with EAI - particularly with the concurrent provision of audit and MAS (as for Situation 13 of the present research questionnaire).

Curiously, 60% of the respondents had never even considered the potential incompatibility posed by the dual provision of auditing and MAS. A like number responded that their confidence in audit independence would in no way be affected by the auditor providing these dual services, while only 26% indicated a lessening of confidence and 14% were undecided. "In contrast, the comparable statistics of a similar US study [Schulte, 1965] were 43%, 33% and 24% respectively" [Dermer, Evans and Pick: 23].

Titard [1971]

As in Situation 13 of this research, Titard examined the issue of EAI when audit services are accompanied by the provision of MAS. It updated Schulte's 1965 study, by sending a mail questionnaire to 220 users of audited financial statements, all of whom were employed by large institutional investors. The sample intentionally included only the largest US financial institutions.

After confirming that the majority of respondents did use audited financial statements and that they were aware of the concurrent dual provision of audit and MAS by some CPA firms to their audit clients, Titard asked whether providing MAS "might possibly result in a CPA losing some of his audit independence".

The questionnaire included 33 specific types of MAS offered by CPA firms to their clients. Although he concluded that there was no great concern over the dual provision of audit services and MAS, 49% of respondents felt that when combined with audit services, at least one of the 33 MAS listed in Titard's questionnaire inhibited EAI. However, 42% did not believe that a loss of EAI would occur and 9% had no opinion at all.

Conclusions put forth by Titard on the basis of his research included the following:

1. That there was more concern with the dual provision of accounting-type services by some auditors than with MAS services - (a finding with bearing to Situation 3 of the present research questionnaire).

2. The auditing profession should inform members of the financial community what the former expects of those of its members who also who render MAS - (relevant to Situation 13 of the present questionnaire).

Titard's general conclusion was that MAS and the appearance of independence was not a **serious** problem for the profession at that time. However, he cautioned [Titard, 1971: 24] that since society and the audit profession are ever changing, his "should not be the final research on this topic", and that the profession must keep itself informed about the opinions of its most important client - the public. In UK terms, the present research is a response in that direction.

Hartley and Ross [1972]

Within a MAS context, similar to that of Situation 13 of the present research, Hartley and Ross surveyed practising CPAs, financial analysts, and senior financial executives in companies with annual audits. Thus, members of all three groups can be regarded as persons associated with audited financial statements.

After confirming that respondents viewed EAI as being "very important" and determining that they were aware of the MAS controversy, respondents were asked to state to what extent they felt a CPA's performance of MAS affects his audit independence.

In total, just under half (48%) of all respondents believed that the provision of MAS decreased auditor independence. However, perhaps more expectedly, 77% of the financial analyst respondents believed it "decreases independence", while in marked contrast, only 37% of the auditors responded in the same way.

Thus, this study into EAI revealed that financial analysts perceived the rendering of MAS by auditors to be more of a threat to auditor independence than did auditors themselves.

Respondents were also asked to state if they agreed or disagreed with the view that even though MAS provision might appear to lead to a loss of auditor independence, the professional integrity of the auditor would provide a reasonably high assurance that EAI would not be lost.

Again, of the total respondents, 48% agreed with this statement. In terms of individual groupings, 77% of the CFAs and 37% of the CPAs agreed with the statement.

Thus, it was interesting to note that the same percentage of respondents from each classification who felt that MAS decreases auditor independence also believed that the integrity of the auditor prevented him from losing his independence.

Rhode [1978]

This empirical study was done at the Berkeley campus of UCLA at the request of the CAR [1978]. It considered the "work environment" of the professional auditor and (inter alia) asked professional auditors for their views on EAI when MAS was also provided by the auditor.

As with most of Rhode's findings, those relevant to here were consistent with traditional expectations. Thus, a substantial majority of the subjects did **not** believe that consulting work performed by audit firms (the essence of Situation 13 in the present research) affected EAI, so contributing to substandard audits.

Further, as Rhode's survey was conducted at the behest of the CAR, it is of interest to consider what the final report of the Commission stated in terms of the management advisory services controversy. In this context, the Commission stated that [CAR, 1978: 97] apart from the three (US) cases, brought to its attention by Professor Briloff [1976], its own

> "analysis of legal cases did not disclose any other examples where (providing other nonaudit services has resulted in a loss of independence, and our survey [Rhode, 1978] of audit staff members failed to indicate any significant relationship between the provision of MAS and substandard audits. In addition, both AICPA committees that studied the issue, and one other researcher, Arthur Schulte, Jr., solicited evidence from a variety of groups without uncovering additional examples."

Reckers and Stagliano [1981a] and [1981b]

This study sought evidence not only on how the dual provision of audit and MAS affect perceptions of EAI, but also on the extent to which such nonaudit services were, in fact, being supplied.

The data analysed came from the ASR-250 filings of 100 randomly selected companies. For this sample, it was observed that the mean value of MAS fees earned by auditors was 32% of the relevant audit fee. The median value of this ratio was 17%, and 25% of companies paid more than 40% of their audit fee to their auditors for MAS. [Situation 13 of the present questionnaire (see Appendix B of Volume II) is one where MAS-related "billings have averaged 40% of the year's audit fee."]

The most common nonaudit services provided by auditors to their audit clients were taxation advice, actuarial and pension reviews, and the design of accounting systems, which on average attracted the highest fees.

These researchers also carried out a (case study) questionnaire survey to determine the extent to which the provision of nonaudit services affects perceptions of auditor independence, and in particular, whether concern about the potential conflict between MAS and auditing decreased as relevant "familiarity with the nature of services offered" by auditors and the financial sophistication of the user increased - a view upheld by the CAR [1978: 96].

To that end, participants in this study were 50 financial analysts (more sophisticated users) and fifty MBA students (less sophisticated users). Each participant received an identical set of 32 cases in which the percentage value of 5 specified nonaudit services provided by the auditor varied randomly with the value of audit services provided. Nevertheless, the percentage of any individual type of nonaudit services provided was limited to 12% of the audit fee, while the aggregate percentage of fees for nonaudit services provided, varied between 8% and 51%.

In each of the 32 cases described, participants were asked to assess their confidence in the independence of the auditor on a percentage scale. As such, the researchers implicitly recognised that in a given case an auditor may or may not act independently.

Thus, one method of assessing possible concern with the auditor's independence in each case would be to measure confidence in the likelihood that the auditor will be independent in his audit function, while providing nonaudit services. [An extremely similar approach was used for the present research questionnaire.]

The 5 nonaudit services assessed in the 32 cases were:

1. Acquisition Search
2. Pension and Actuarial Computation
3. Systems Design
4. Tax Planning
5. Tax Preparation

Consistent with the previously noted view of the CAR [1978: 96], the results strongly suggested that the "more sophisticated" group of users had greater confidence in the independence of the auditor than the "less sophisticated" group. The researchers concluded that overall neither group seemed particularly worried by the provision of nonaudit services (even when their value exceeded 30% of the relevant audit fee).

Additionally, the "more sophisticated" group expressed a very high degree of confidence in the CPA's ability to remain independent while providing nonaudit services in conjunction with audit services.

Pany and Reckers [1984]

These researchers also investigated the issue of the provision of nonaudit services. They noted that the AICPA [1981] Peer Review Manual proscribes members of the SEC Practice Section (i.e. those auditors that undertake audits of SEC registered clients) from performing the following types of nonaudit services for their SEC registered audit clients:

1. Executive Recruitment
2. Public Opinion Polls
3. Merger and Acquisition (on a finder's fee basis)
4. Psychological Testing
5. Actuarial Computations for Insurance Companies

Against this background the researchers carried out a mail survey in order to provide evidence as to whether these services are perceived as being more or less harmful to auditor independence than other services, (such as say, systems design) which are not proscribed. [They also tested if a respondent's understanding of the audit affected his view of EAI, but as they are not germane, these results are not considered here.]

200 questionnaires were sent to financial analysts and another 200 to stockholders. 67 (33.5%) of the analysts and 46 (23%) of the stockholders replied.

Respondents evaluated EAI in each of ten sets of circumstances in which various nonaudit services were performed, either by an individual involved in the audit, or by a member of the auditor's associated management services department (though not by a separate but associated management consulting entity).

However, the results showed that the distinction between whether a service was provided by the auditor or by the separate (but associated) MAS section was significant, with the adverse effect on EAI being reduced in the latter case. [It is interesting to note that this finding somewhat contrasts with Shockley [1981], who found that a separate MAS department had little effect on perceptions of EAI.]

The results also suggested that respondents had neither extreme confidence in, nor extreme concern with, the level of EAI when nonaudit services were concurrently provided by the auditor.

There was little clear evidence that the particular nonaudit services proscribed by the AICPA, were seen as significantly more damaging to EAI than other nonaudit services. [In passing, one notes that none of the MAS proscribed by the SEC appear to be similarly proscribed either by law or professional ruling for UK auditors].

3.2.2 Other issue based empirical research

In addition to examining EAI perceptions surrounding the MAS controversy, some of the above researchers also addressed similar issues that may be of consequence when shaping such perceptions. To the extent that such issues are common to those also addressed in the present questionnaire, their relevant findings are presented and discussed below.

Discounts - Situation 14

In his research, Rhode [1978] also addressed the issue of an auditor accepting gifts from clients and the purchase by them of clients' products at discounts not available to the general public.

In a sense, one may regard the receipt of an unwarranted or unusual discount as receiving a gift and in that context, gifts and discounts may be considered to be of the same ilk. Thus, even though the present research questionnaire does not directly address the question of the auditor receiving gifts, that feature is nevertheless discussed further.

The basis of Rhode's research in this direction was the contention that, whether or not such practices cause an actual or real loss of independence, they are likely to lead others to believe that EAI had in fact decreased.

Indeed, a majority of Rhode's respondents felt that the acceptance of gifts does affect an auditor's ability to resist pressures on his professional judgement. In fact 76% of respondents agreed that there was always an effect, or that there was an effect depending upon the scale of the gift.

The facts of Situation 14 of the present research questionnaire refer to an audit firm accepting auditorship of a printing company on a beneficial trade discount arrangement. Thus, unlike the situation researched by Rhode, the discount here is directed more at the firm rather than the individual auditor(s).

Nevertheless, Rhode's findings are pertinent. He determined that a majority of the respondents (57%) believed that purchases at discounts not available to the public generally, adversely affected an auditor's ability to resist pressure to subordinate his or her professional judgement.

A similar study by Pany and Reckers [1980] also explored the perceived effect of client gifts and discounts on auditor independence, in the light of the Rhode survey carried out at the behest of the CAR. The survey sought views on the issue from both practising (CPAs) auditors and registered stockholders.

The research questionnaire, sent to 480 registered stockholders, identified four levels of gifts or discounts (no gifts, $3, $40, $125), set against two possible percentages (1% and 10%) of fee income derived from the client in question.

Respondents were asked to evaluate, on a graded scale, the auditor's ability to resist client pressure to act unprofessionally, when judged against specified backgrounds (relating to various "mixes" of level of gifts or discounts and percentage of audit fee income).

The Pany and Reckers graded response scale (whose two extreme points were "strong belief" and "strong disbelief") had seven points (the same number as that used in the response scales for the present research) for respondents to register their degree of agreement (or not) with the statement made in the questionnaire.

Notwithstanding the low 26% response rate (a problem with most mail surveys) responses to the research questionnaire, showed that as gift size increased, stockholders became more concerned with the auditor's independence. However, it was observed that the percentage of fee income generated by the audit client did not have any significant effect on the perceptions of auditor independence by respondents.

The survey also revealed that with respect to the 1,126 CPAs who responded, that:

1. 32% worked for a firm where there was no rule prohibiting the acceptance of gifts from clients
2. 66% worked for a firm where there was no rule prohibiting the use of client discount facilities.

<u>Time and Budget Pressure - Situations 11 and 10</u>

One of the important aspects examined in the study of Rhode [1978] was designed to see whether the auditor's time pressures (be they inspired as a consequence of [unrealistic?] tight fee budgets - as is the case in Situation 10, or extremely stringent reporting requirements - as is the case in Situation 11 of the present research) were affecting their professional integrity and objectivity. If this were so, auditor independence may be impaired.

The study [CAR, 1978: 116] revealed some alarming facts:

> "58% of (auditor) respondents had signed for completing audit steps (not covered by another compensating step) when they had not performed the work. Of the several deficiencies revealed by the survey, the Commission believes that this is the most serious"

> "56% of auditor respondents believed that audit programs and time budgets are unduly influenced by client-negotiated fees. Further, pressures to meet time budgets also cause approximately 52% of respondents in the profession ... to complete (audit) work on their own time without reporting the chargeable hours."

These facts assume even more serious dimensions when one reads that the survey [CAR, 1978: 116] "directly identified time-budget pressure as a primary cause of substandard audits". The Commission summarises the views of respondents to this survey by stating that,

> "in summary, the profit motive, competition among firms, and the need to attract new clients and keep existing ones are, in the opinion of the respondents to the survey, emphasised too much. Therefore, it is reasonable to assume that excessive competition producing low fees can cause unrealistic budgets and that such budgets can increase substandard performance."

Staff Crossover - Situation 9

Rhode 1978

Pressures to complete an audit within time constraints may manifest itself in forms other than signing for audit steps not in fact completed. In situations where senior management are ex-employees of the audit firm in question (a staff "crossover"), it is alleged, that on occasions more junior audit staff are "pressured" by ones more senior, to accept without due verification, representations and assurances of such management.

In turn, worries about advancements and survival on the job by such junior staff are alleged to cause them to do so. Thus Professor Rhode was mindful to obtain if EAI was in fact being impaired by such a "pragmatic" audit approach, and one part of Professor Rhode's survey addressed itself to this possibility.

While the survey did not reveal a widespread occurrence of such a feature, a very low number of the subjects responding believed there was pressure from supervisors of audit firms on less junior members of the firm to accept (prima-facie) the representations made by either former members of the audit firm now employed by the client, or by executives placed with the client following an executive search by the audit firm.

Imhoff [1978]

In recognition that the practice of staff crossovers appeared to be not infrequent, Imhoff's research concerned itself with this very specific aspect of EAI. It focused exclusively on the practice of professional auditors in (the then) Big-Eight firms leaving to take senior financial positions with their audit clients, and the effect that practice had on perceptions of external auditor independence.

Regrettably, Imhoff's survey lacked the support of six of these audit firms and so the assessed data was severely restricted. What data that became available was thus restricted to certain offices of the two Big-Eight participating firms. Nevertheless, it showed that out of 258 audit staff leaving these offices in a particular year, 42 (app. 16%) took up positions with clients on whose audit they had previously worked.

To test the effect of such employment moves on respondents' perceptions of auditor independence, a survey of CPAs (auditor group) and bankers and analysts (user groups) was undertaken. This showed that a majority of all groups questioned independence only if the employee had been engaged on the client's audit in a supervisory role within the last six months.

However, a minority of respondents, more significant in the two user groups than the CPA group, expressed concern as to the effect on audit independence of moves by more junior audit staff, even when accompanied by a longer elapsed time interval between engagement by the audit client and service in the audit team charged with the audit of the client in question.

3.2.3 Situation based empirical research

The present research is very much of the situation based type of empirical research, in that within specified audit scenarios or situations, it researches relevant views of confidence in the external auditor - and in so doing his professional independence.

Thus, the present research is of the same genre as that conducted by Lavin [1974], Firth [1980 and 1981], Dykxhoorn and Sinning [1981a and 1982], Moore [1983], Badran [1983] and Agacer [1987].

Indeed, the conceptual genesis of the present research owes something to these previous research studies and shares many features in common with them. Thus, these studies are reviewed individually in the next section with some of their more detailed findings noted in the (questionnaire development) context of Chapter 6.

Lavin [1974]

The main thrust of Lavin's research compared the requirements of the AICPA's Code of Professional Ethics with the SEC position on EAI as expressed in ASR 126. Its purpose was to provide empirical evidence on the existence of differences in opinion regarding the concept of independence between accountants themselves, and between accountants and financial statement users.

Equally, the research sought to determine whether the financial statement users' perceptions of EAI (or lack of it), had an effect on related business decisions.

Twelve situations describing relationships between auditors (CPAs) and their clients were used as the basis of the questionnaire. Each of these twelve (hypothetical) situations were essentially drawn from ASR 126, the SEC document issued in 1972 which provided illustrations of 39 situations in which an auditor may or may not be independent (i.e. EAI was suspect).

The situations selected by Lavin included those in which the SEC considered it likely that independence would be impaired but which, at that time, the AICPA considered to be compatible with an objective opinion.

The hypothetical situations included relationships such as the provision of book-keeping services to the audit client by the auditor, and the renting of computer time from the auditor by the audit client. The questionnaire was mailed to three sample groups and 390 usable replies were received.

The first sample group consisted of CPAs listed in the 1972 AICPA members register. The second sample group was made up of bankers selected from banks listed in a Bank directory and the third sample group was selected from brokerage houses listed in "Finance".

The samples were based on the fact that financial analysts (concerned with investments) and loan officers (concerned with loans) almost always use audited statements when making financial decisions.

Lavin's study examined only one independent variable in detail - the effect a financial decision maker's perceptions of the auditor's professional independence would have on a related financial decision.

Lavin based his research on the belief that those respondents who perceived the auditor to be lacking in independence might permit that perception to adversely impair a financial prospect. Conversely, the views of those respondents who perceived the auditor not to be lacking in independence, would not affect adversely or may even improve, a financial prospect.

Generally, financial analysts perceived the auditor's EAI as having less of an effect on their investment decision than loan officers on their lending decision.

Further analysis showed that for the majority of cases there was a consensus of opinion within each group (particularly the CPA and Loan Officer groups). The findings with respect to some of the twelve research situations showed that:

1. The CPA group showed marginally more concern with a possible lack of independence with regard to book-keeping services than the bankers and brokers.

2. Two of the financial statement user groups (bankers and brokers) did consider that the acceptance of a promissory note in payment of the audit fee impaired independence, whereas there was no CPA consensus on this issue.

3. No group considered the provision of computer time to impair professional auditor independence.

Although respondents did not concur entirely with the SEC's or the AICPA's position, they tended to concur more with the AICPA than the SEC. Nevertheless, within the CPA group there was a significantly different response between members of Big-Eight auditors, who were more inclined to follow the SEC's view, and members of smaller firms, who were not so inclined.

Firth [1980] and [1981]

In addition to these research studies being situation based (as is the present research), the summaries of the two following studies by Firth are interesting because they appear to be the earliest attempts of empirical research into the subject of EAI in the UK.

Firth [1980]

This mail study examined the role and importance of EAI as perceived by various individuals in the UK who would normally be concerned with the issue. In setting the context for the study Firth briefly reviewed the regulatory environment for auditor independence as set up by the professional accounting bodies in the UK. Then differences in perceptions of EAI according to job roles were hypothesised.

The questionnaire postulated 29 auditor-client relationships and major groups of interested parties were asked whether these relationships were likely to impair or improve investment and lending decisions. 750 individuals from the groups identified below were randomly selected as sample respondents and asked to assume the role of investor and lender when responding.

The prime thrust of the analysis was to examine if there were any significant differences between the EAI perceptions, and therefore the lending decisions, of individuals within the job roles listed below, given that all other data and relationships were the same.

1. CAs grouped by those working in:
   a) A Big-Eight firm
   b) Any other professional accounting practice
   c) Industry or commerce
2. Financial analysts
3. Bank credit officers

The study achieved a 50% response rate and showed that in general non-independence was perceived to impair investment/loan decisions, a finding supported by the traditional view of EAI which states that total auditor independence lends itself to total credibility, while impaired independence leads to impaired credibility.

[Exceptionally, in a very few situations, a small number of respondents felt non-independence might even improve the prospects of an investment/loan decision].

The results also showed that there were significant differences between the various respondent groups as to what constitutes professional EAI and its importance. In general, qualified accountants working outside the auditing profession, analysts, and bankers were much less prepared than practising auditors to accept certain of the specified relationships as independent.

There was, however, some variances in the responses between the two audit groups - the (then) Big-Eight and nonBig-Eight professionals, the former being less tolerant than the latter of the EAI suggested in some of the auditor-client relationships considered.

Response differences were in line with those expected, given the roles of the groups. Those with the most to lose from the implementation of restrictions, accountants practising as professional auditors, thought auditors could maintain independence in many situations where others thought independence would be impaired. Further, accountants in practice often perceived breaches of EAI to be of a lesser importance in their investment decisions than the other groups.

In general, the views of accountants in practice were similar to those of the major British professional accounting bodies, while the users of financial statements were often more sceptical.

The results showed few significant group differences for situations judged to have an "independent" auditor. However, there were significant differences in the importance scores attached to those situations where the auditor was judged "not independent".

Thus, an interesting finding generated as a by-product of such differences in the study was the reported importance placed by the analysts group and the bankers group [Firth, 1980: 461-462] on the presence of an independent audit report.

> "Specifically, financial analysts and bank loan officers gave lower importance scores for "not independent" situations than did accountants in public practice. Although all groups perceived "not independent" situations as reducing the loan and credit potential of a firm, the users of financial statements viewed such auditor-client relationships more seriously."

The year after this study was reported, Firth published the results of a similar study - an examination of which follows. This later study was also situation based, but offered for consideration in an EAI context, only 9 of the 29 auditor-client relationships set out in the questionnaire of the 1980 study.

Firth [1981]

This study assessed the effect of bankers' loan decisions, consequent to their views of EAI within nine specific situations. A sample group of 1700 bankers, all of whom were members of the UK Institute of Bankers, were sent a set of audited statements for a hypothetical company and asked to participate in the research. 74% of them provided usable responses.

800 respondents from the selected sample were provided with two types of financial statements. The first type was predicated on an auditor-client relationship of complete EAI. This type was used as a control group.

The second type was predicated on and described one of nine particular auditor-client relationship where independence may be impaired. Thus, relationships described in the second type of statements were ones where individual perceptions may or may not be judged to impair auditor independence. 900 respondents received only the second type of financial statements.

In all cases, the financial statements carried an unqualified or "clean" audit report. The audit reports of some financial statements were based on an independent auditor-client relationship, while those of the others may not necessarily have been so.

Responding bankers were then asked to state the maximum amount of money they would be prepared to lend the company or companies whose financial statements they had been sent and assessed.

The results were studied to see if there were any significant differences between the loan responses for companies with perceived "independent" and those with perceived "non-independent" auditor-client relationships. They [Firth, 1981: 187]

> "showed that seven of the nine relationships described in the questionnaire reduced the bankers' perceived confidence in the company's statements and that significantly lower loans were granted in these situations than if the company had an independent audit."

Additionally, Firth concluded that five of these seven "non-independent" relationships would be considered to be independent by the major British professional auditing bodies.

His general conclusion was that the study revealed some discrepancy between the views on EAI of, on the one hand the ICAEW/ICAS and the perceived decision making of UK bankers on the other - implying that the ethical standards afforded to UK bankers by the UK audit profession fall short of those expected by these bankers. On that basis, one might read into such findings the beginnings of a UK audit expectations gap.

Dykxhoorn and Sinning [1981] and [1982]

Much of the literature surrounding the issue of auditor independence outside the UK and USA relates to (then) West Germany, and has been put forth by Dykxhoorn and Sinning.

Dykxhoorn's interest in the subject stems from his doctoral thesis [Dykxhoorn, 1978] at Michigan State University. His concern, and that of Sinning's, in the subject lay in the volume of US investment in West Germany, often by way of a West German subsidiary company whose financial statements were audited not by US auditors, but by "Wirtschaftspruefer" (WP), the German equivalent of US CPAs or UK CAs.

German financial statements are often consolidated into the financial statements of a US parent corporation, and to that extent, investors in the US rely on audit practices, customs and conventions in another country, i.e. Germany. However, often US investors may not be fully aware of such foreign practices and conventions and the implications attached to them.

Dykxhoorn and Sinning contend that if foreign financial statements are to be consolidated into those of a US parent, then the foreign auditors must comply with the SEC requirement that auditors be independent.

The 1981 study was essentially a survey to determine WP perceptions of auditor independence, while the 1982 paper investigated the impact of perceptions of auditor independence on investment and loan decisions of West German bankers.

The 1981 study encompassed a virtual replication of Lavin's work in the context of studying the perceptions of EAI of WPs. The questionnaire that was the basis of the study listed ten auditor-client relationships for which the SEC position on auditor independence was known in ASR 126. Nine of these relationships were considered by the SEC to compromise independence.

The questionnaire was mailed to a random sample of WPs in Germany and sample subjects were asked to indicate for each situation whether they considered the relevant auditor independent or not.

The results of the questionnaire showed that, on the whole, German auditors take a less strict view of EAI than the SEC. By a narrow majority, the WPs considered only one of the ten relationships described to impair independence. There was however, evidence to suggest that WPs affiliated to firms carrying out US subsidiary audits had perceptions of independence closer to those of the SEC than other WPs.

Dykxhoorn and Sinning's 1982 study also employed a questionnaire and respondents were asked to assess the independence (or otherwise) of each of a set of auditor-client relationships. Respondents were also asked to indicate on a five-point verbal scale (i.e. not numbered) the effect of the relationship on their investment or loan decision.

The results showed that there was a significant correlation between the independence assessment and the conclusion generated on the investment or loan decisions. Perceptions of non-independence were clearly associated with a negative effect on the investment and loan decisions and vice-versa.

The authors suggest that, since the SEC rules on independence are, with minor exceptions, applicable to all auditors of SEC registrants, it is important that foreign auditors be made aware of the SEC rulings concerning auditor independence.

Other situation based studies

The above situation-based research of Lavin, Firth and Dykxhoorn and Sinning have been more closely examined because they appear to be the first major studies in a US, UK and European context, respectively, of EAI within specified auditor-client relationships.

However there have been other situation based studies. For instance, in a US context, one might mention the work of Pearson [1979] which examined the EAI construct with specific reference to Big-Eight auditors. Of equal interest is the research contribution of Moore [1983], who considered on a research basis, the MAS debate, auditor rotation and peer review.

As examples in a more international context, one might refer to the work of Badran [1983] (which examines EAI views of Egyptian auditors) and Agacer [1987]. Agacer's research is truly international in that it is a cross-cultural study of EAI in Germany, Philippines and USA.

While Agacer's research is not strictly situation-based, it presents audit scenarios (akin to audit situations) evolved from various "mixes" of Shockley's EAI influencing variables - and offers these scenarios for consideration in terms of EAI perceived therein.

3.2.4 <u>Other empirical research</u>

In addition to the MAS based and situation based research into EAI, there is a third type of empirical research that cannot be appropriately classified as either of the two identified. Two such research contributions, having a bearing on the present research are noted below.

Shockley [1981]

The theoretical assessment of auditor independence undertaken by Shockley suggested to him that there were four main factors likely to influence auditor independence.

These factors were:

1. The level of competition for auditing services.
2. The provision of MAS (i.e. nonaudit services).
3. The size of the audit firm.
4. The length of the auditor's tenure in office.

Shockley used a mail questionnaire and sent it to a sample from:

1. Professional auditors (CPAs) in practice within:
   a) A Big-Eight audit firm
   b) A nonBig-Eight audit firm
2. Financial analysts
3. Bank credit officers

The overall results suggested that respondents saw the first three factors (level of competition within the auditing profession, provision of MAS, and the size of the audit firm) as likely to impair auditor independence, whereas the last factor (the number of years the audit firm has been auditor to the client) was not seen as significant in this context.

On the basis that the larger the audit firm, the more likely is it to act independently, the size of the audit firm was not seen as significant by nonBig-Eight firm respondents, whereas respondents from Big-Eight firms deemed this factor to be very significant.

Given that Big-Eight and nonBig-Eight auditors were in effect commenting on themselves, the findings stated in the preceding paragraph may have been somewhat expected or anticipated.

However respondents from nonBig-Eight attributed more importance to the degree of competition in the auditing profession and the provision of MAS as negatively influencing EAI than those from Big-Eight firms.

Shockley did not find that the views of financial statement users group (i.e. bankers and financial analysts) were less tolerant of relationships and factors likely to affect EAI than those of the auditor groups (i.e. from Big-Eight and nonBig-Eight firms).

Nevertheless, he did observe that the views of the Big-Eight auditor group tended to coincide with those of the banker group, whereas the opinions of the nonBig-Eight auditor group tended to be the same or at least similar to those held by the financial analyst group.

Amernic and Aranya [1981]

This study is important because it concentrated on examining perceptions of EAI as held by professional auditors in Canada. In that sense, there is a parallel to the similar Big-Six v nonBig-Six assessment done later in this research (Chapter 11).

Amernic and Aranya's research dwelt on the individual auditor's own perception of the degree to which he/she considered him(her)self to be independent. Respondents were all registered professional auditors (members of the CICA), though not all were engaged as such.

This Amernic and Aranya research focused on two structural factors which (inter alia) may potentially affect EAI. These two factors were the size of the audit firm and an individual auditor's level in the professional hierarchy established therein.

The basic findings were that in general, public accountants in larger firms perceive CAs generally and they themselves as being more independent than do smaller firm practitioners.

It also appeared that senior practitioners (i.e. at higher levels in the firm hierarchy) saw themselves as more independent than less senior auditors.

Significantly, partners perceived that CAs in general and they themselves are more independent than did CA firm employees. In addition, there was the suggestion that they rejected the acceptability of modifying one's standards of independence to a slightly greater degree than do CA firm employees.

The study suggested that there is a differential distribution of, and attitudes towards, independence among auditors in firms of varying sizes and at varying ranks. Partners appeared to be "more independent" than employees, and large firm practitioners appeared to be "more independent" than smaller firm practitioners.

ICAS [1987]

One further UK study is pertinent to some of the aspects of EAI researched in the present context. This empirical research was undertaken by the ICAS in the autumn of 1986 and its results made public in January 1987.

The research instrument was a simple questionnaire containing five questions, each posed against the background of a statement on EAI arising from the DTI's [1986] Consultative Document entitled "Regulation of Auditors". Respondents chosen for the questionnaire were the chairmen of the Top 1000 UK companies.

The results unearthed no great concern with present practice surrounding EAI. Some mild uneasiness was made apparent, but it was certainly not of the magnitude to warrant radical change to the present order.

In general, respondents were not perturbed with EAI in the UK and did not see two of the proposals set out in the DTI's Document (fixed term appointments for and automatic rotation of auditors) as necessary.

While there was some variation amongst the responses from the chairmen of the 571 companies (from the Top 1000 UK companies) who responded to the questionnaire, in general the responses showed that a significant majority of respondents (at least 70% in every case and quartile of the Top 1000 UK companies) believed that:

1. There was no need for any detailed legislation on (auditor) independence to safeguard against any conflicts of interest that may arise.

2. Auditors should be allowed to provide audit clients with services in addition to the audit (i.e. MAS)

3. The independence of auditors was not prejudiced by the provision of management consultancy services to audit clients.

4. Fixed terms of office would not increase the independence of auditors, at least not to an extent that could justify the extra cost.

5. Regular rotation of auditors would not bring significant benefits to the British economy.

3.3 Chapter summary

By necessity this chapter provides only the main ingredients of previous important research into EAI sharing elements in common with this present research. Thus the review is not intended to be a comprehensive summary of all theoretical and empirical research work previously conducted in terms of EAI.

The research review shows that in the earlier stages of the controversy surrounding EAI, the debate focused almost only on its MAS dimension [Dermer, Evans and Pick, 1971 and Titard, 1971].

However the research arena seems to have widened in the early 1980s, with researchers [Pearson, 1979 and Firth, 1980 and 1981] recognising EAI can be vulnerable in a variety of auditor-client situations and so attempting to obtain perceptions of it within these situations (perhaps an implicit recognition of the multi-faceted nature of EAI).

In general, the research showed that auditors tend to be more confident of their ability to preserve their professional EAI than users of their services. Indeed, all relevant studies revealed some concern by users when auditors provide both audit and MAS.

While user groups revealed a degree of commonality in terms of their perceptions of EAI, their views on all researched aspects EAI were not identical. Equally, significant differences of views were noted between auditors from (then) Big-Eight and nonBig-Eight firms.

The research review also shows that the subject of EAI (specifically within the context of the audit expectations gap) has not really been addressed in the UK - and certainly as not as much as it has in the US.

This apparent non-attention to external auditor independence within a UK empirical context - despite the issue being central to the whole profession of auditing, provides much of the motivation behind and rationale for the present research.

CHAPTER IV

THE CALL TO RESEARCH EXTERNAL AUDITOR INDEPENDENCE

The previous chapter provided a summary of research (mainly empirical and US) into EAI. The purpose of this chapter is to explain why EAI should be researched at this time - to present the case for researching EAI.

The case for researching EAI is based mainly on three sets of considerations. Firstly, the paucity of UK-based empirical research. Secondly, the consequences of not conducting research into EAI, and thirdly the growing frequency with which current standards of auditor independence are criticised and questioned.

Thus, the first section of the chapter laments the scarcity of UK-based research on the subject and the second section of the chapter outlines possible consequences of not conducting research into EAI.

The third section has two major segments. The first highlights the growing frequency with which EAI is criticised and considers some of the possible causes provoking such concern. Then, to demonstrate that EAI is a "live" issue, the second segment presents recent instances where EAI may have been impaired and recent criticisms made of it by members of differing groups.

4.1 The paucity of UK-based empirical research

Given the importance of EAI to the auditing profession, it is surprising how little theoretical examination has been done on it. Even less UK-based empirical research has been done. Only two empirically based academic studies in the UK are noted in the literature, and both are from the same author, i.e. Firth [1980 and 1981].

Thus when one considers that the very structure of the auditing profession rests on its ability to proclaim itself as being independent, that fact is alarming. Thus the prime case for research into EAI in the UK, is that it has received scant attention of that nature.

While auditors manifestly continue to research their technical methods and procedures, regrettably no major profession driven studies on EAI are at hand. [ICAS, 1987 and LSCA, 1988] are essentially surveys.] However, given the importance of EAI to the profession, in the long run, the lack of it, may be more damaging to the profession than deficient technical standards.

Even when the profession does conduct research, it is accused of providing little evidence to support claims of empirical analysis. Rather, the approach has usually been to establish committees who tend to focus on the views of practising auditors (e.g. ICAEW, 1986).

In similar vein, Sikka [1987: 23] berates the fact that "hardly any steps are taken to ascertain the views of the users of audit opinions, and consequently very little is learnt about user anxieties and their perceptions of an audit and auditors."

Sikka carries on to question whether an audit "monopoly" created by the state can justifiably continue if the views of the users (consumers) of audit services are constantly ignored. Consequently, he suggests that research should be undertaken to establish what the EAI views of UK users of audited statements are.

4.2 Consequences of EAI not being researched

Research into EAI should be undertaken on the grounds that if it were not conducted, then some unwelcome (in the eyes of the audit profession) consequences might follow. Such consequences are likely to see a loss of the (virtually) self-regulating character that the profession in the UK has long guarded and enjoyed.

The consequences of not conducting research into EAI can be seen from three distinct dimensions, as below:

1. The UK government dimension
2. The audit profession dimension
3. The European Community dimension

The UK government dimension

The UK government has manifest a willingness to get involved in accounting and auditing matters if the audit profession is unable to put its own house in order. Witness its stands on fraud and inflation accounting. Alternatively, the government may involve itself more with audit matters and in doing so move towards a state controlled audit board.

The mere fact that some of these possibilities are mentioned by the DTI [1986] in its Consultative Document, gives an indication that such approaches are at least being considered at governmental level.

The audit profession dimension

Professional auditing bodies have a strong vested interest in EAI and in particular in its appearance. If outside parties doubt the independence of auditors, then a number of possibilities may arise.

Such possibilities are likely to be against the self-interest of the professional bodies and individual auditing firms. For instance, audits may begin to be seen as valueless and so audit work and audit fees would disappear. Another possibility is that stock exchanges and/or other large institutional investors may become more closely involved in auditing matters.

This outside involvement could result in lower earnings for auditors and would lessen the self-regulatory powers of the professional auditing bodies and their members.

Recognising the impact of such possibilities, some efforts have been made by the UK audit profession to forestall them by issuing revised (updated) Ethical Guidelines [ICAEW, 1987] to which members must adhere.

<u>The European Community dimension</u>

When researching EAI, sight must not be lost of the European dimension - one that will be very evident in the UK after implementation of the Single European Act. The years post-1992 will see moves towards a European audit profession, when EC citizens will be free to engage in their professions all over the EC (Mutual Recognition Directive - effective January 4, 1991).

While legal provisions can be made to ensure that professionals from other EC countries acquire the relevant UK knowledge and experience, there is presently no method to ensure that the audit professional who arrives in the UK from another EC country, will adhere to ethical norms woven into the UK cultural fabric [e.g. Agacer, 1987], as opposed to those prescribed by statute or professional guidelines.

Thus before devising methods to ensure compliance, research should first be undertaken to establish what such norms are, and how they are perceived by persons affected by them. This is particularly true of EAI. Consequently, research into EAI should be undertaken in order to help evolve a harmonious pan-EC audit environment in that respect.

4.3 Summary review of EAI in the UK

4.3.1 The increasing frequency of EAI criticisms

Even though Berryman [1974] traces UK legal attention to EAI as far back as the 1845 English Companies Clauses Consolidation Act, expression of any major concern with it is of relatively recent appearance. Thus, concern with the question of external auditor independence has grown since the late 1960s. Davison [1977: 87] maintains that to some degree this may be attributed to the fact that:

> "a large proportion of the recent Department of Trade investigations into company frauds and company bankruptcies have criticised auditing firms regarding standards and firmness in dealing with company chairmen of strong personality. Some of these investigations have concluded that the auditors had not exercised independence in their work."

Thus, in recent years, UK auditors (in particular their professional independence) and their relationships with their audit clients have been the subject of increasing scrutiny and criticism.

In the main, this has been due to the failure of major companies shortly after they have received clean bills of health in the form of "unqualified" audit reports. Such events have raised eyebrows, if not suspicions, so as to allege that individual auditors may have compromised their positions of independence. [The important distinction between audit failure and business failure is assumed and so not clarified here.]

A few examples of recent UK company (bank) failures (though until now not <u>proven</u> audit failures) are De Lorean [1981], Johnson Matthey Bankers [1987], Polly Peck [1990], British & Commonwealth [1990], BCCI Bank [1991] and even more recently Maxwell Communications Corporation [1991].

However, one <u>must</u> reiterate that while all the above are cases of business failure only, they have not helped improve perceptions held by interested parties of auditors generally and EAI in particular. However, there is presently still no evidence to <u>prove</u> impairment of EAI in any of these cases.

Nevertheless, it is not difficult to infer that the concern of public and professional (regulatory) bodies with EAI is partly a result of their perception of some prima-facie evidence of the lack of EAI in such cases.

In their consultative document "Regulation of Auditors", the DTI [1986] noted some concern about a possible conflict with EAI arising from the provision of MAS and other selected auditor-client relationships.

The document [DTI, 1986: 32-33] issued to elicit views on possible UK legislation so as to reshape the audit profession to conform with the EC's Eighth Directive, called for research on specific aspects of EAI saying that such points for consideration would include:

> "a) the extent, if any, to which there may be a conflict between independence and objectivity and attempts to gain new business by offering reduced rates or other benefits to potential clients
>
> b) whether more specific rules should be developed relating to any financial interests held by an auditor in the affairs of an audited company
>
> c) whether there is a need for rules regulating situations where there is a close family or personal connection between an auditor and one or more of the directors of a client company
>
> d) whether rules which disqualify one member of a firm from carrying out a particular audit should not similarly disqualify the firm as a whole
>
> e) generally, whether rules on independence should not state positively what is required of approved auditors rather than merely outline what should not be done."

Given such concern, UK audit bodies in acknowledging the importance of EAI have reacted by re-formulating and revising their ethical guidelines [ICAEW, 1987].

While it is also important to identify manifestations of instances where EAI may have been impaired, it is of more consequence to search for possible reasons as to why perceptions of impaired EAI might arise. The next section considers such reasons on a macro-level.

4.3.2 Macro-level criticisms of EAI

In situations where observers believe EAI has been compromised, at a macro-level one might observe that a basis for such perceived compromise lies in one or more of the following main causes, each considered in turn:

1. imprecise understanding of EAI and its nature
2. conflicting views on the role of the auditor
3. alleged secrecy when developing professional codes
4. plethora of acceptable accounting treatments
5. cultural diversity

Imprecise understanding of EAI and its nature

The very notion of "Independence" itself is somewhat nebulous and not uniformly perceived. This is seen in the variety of interpretations and/or explanations that have been offered for the concept and, as an indication of the same, some are repeated below:

> "In the auditor-firm conflict situation, the power of the firm can be represented by its ability to influence the audit or report of the auditor. The independence of the auditor can be represented by the auditor's ability to withstand such influence" [Nichols and Price, 1976: 336]

"By definition, there is perfect independence when the conditional probability that the auditor will report a discovered breach is one." [Watts and Zimmerman, 1981: 7]

"The concept of independence implies freedom from control and domination by another party. It implies impartiality and the absence of bias in the gathering of evidence, interpretation of evidence and opinion formulation. The auditor as an independent party must be willing to and be in a strong position to insist on that course of action which his professional judgement urges is the appropriate one in the circumstances." [Berryman, 1974: 10]

"Essentially an attitude of mind characterised by integrity and an objective approach to professional work." [ICAEW, 1987: 9]

"Professional independence is a concept fundamental to the accountancy profession requiring integrity in and an objective approach to professional work." [ICAA, 1984: 23061]

"the concept of independence ... is fundamental ... because it implies an objective analysis of the situation by a disinterested third party." [SEC, 1972 - ASR 126].

One notes from the above that, in a strict sense, there is not one all-comprehensive definition of auditor independence. It would be practical and useful to have one. In turn, that calls for research and close study of the nature of EAI. It is because of the variety in views about and definitions of auditor independence, that research is called for.

The nature of EAI does not appear to be uniformly nor universally understood. Thus, research should be conducted to assess where these pockets of ignorance and/or misunderstanding lie.

Conflicting views on the role of the auditor

However even when research has been undertaken, researchers have sometimes arrived at conflicting conclusions.

For example, the Metcalf Committee [1977] concluded that EAI was impaired when auditors supplied MAS to clients. AICPA committees however, have concluded that whereas these services **may appear** to impair EAI, they generally do not.

One reason why such differing conclusions have been arrived at may be the different definitions of external auditor independence employed by the researching committees.

Watts and Zimmerman [1981: 1] contend that these "definitional differences are not just a semantic debate but rather result from different roles assumed for the auditor."

Hence, even the very role of the auditor, let alone the independence on which his role is based, does not appear to be generally perceived or understood. On that basis, research should be undertaken to establish the nature of auditor independence within the auditor's role.

Alleged secrecy when developing professional codes

A weakness alleged to prevail when developing or revising guidelines for the audit profession is that they are developed behind "closed doors" and without consultation with audit users or "the public" ["Bankruptcies raise questions over auditors" - Accountancy Age, Dec. 6, 1990: 13]. It is alleged their formulation takes place with much secrecy.

If this be so, then of course it would be desirable if future revisions of such guidelines took place with greater account of the views of the public and other non-auditor but audit interested parties. It is they, after all, whom the auditors are trying to convince about their independence.

Plethora of acceptable accounting treatments

Concern with EAI appears to be compounded by the choice of accounting policies within generally accepted accounting policies.

Hence, EAI cannot and should not be examined in isolation. EAI should be examined in the context of accounting and the choice of acceptable accounting principles, which in the UK, has recently been examined in the Dearing [1988] Report and is being examined by the Solomons Committee of the ICAEW.

It is argued that the need for independent auditors, both in fact and appearance, is reinforced by the choice of accounting policies, each as valid as the other. Many examples of the variety of accounting treatments are noted and need no restatement. [For some of the more significant choices of accounting treatments, see Griffiths, 1986.]

Nevertheless, as varying interpretations of accounting rules evolve, users may begin to believe that the auditor's acceptance or concurrence of a "particular" accounting principle, is governed by a "special" relationship with the audit client, which may not be desirable, or at least questionable.

This "special" relationship may influence the auditor's independence and so research should be undertaken to establish the nature of those relationships that are seen to negatively influence the auditor's EAI.

Thus auditors are well served by recalling that the crucial characteristic underlying the quality of audited information is EAI. If auditing is to give assurance of the propriety, credibility and veracity of financial information, that information must correspond with a specified set of facts.

If the choice of which facts are to be reported is left open, or if non-facts may be reported, and if the manner of presentation may be selected from a range of options, then the mere requirement that auditors be totally independent will in itself not ensure that accounts possess these attributes.

Thus, auditing has two features. The first is documentable and evident, the other non-documentable and non-visible. The operational aspects of the auditor's work covers the former, while EAI encompasses the latter. It is because EAI is non-visible and non-documentable, that the audit profession must examine it carefully.

It must also develop and maintain an environment such that the degree of non-visibility and non-documentability is minimised, recognising that these two features can never be totally eliminated.

The establishment and maintenance of such an environment calls for research. More pointedly, this research must be empirical and "real world" based. UK audit bodies need to show they have developed ethical codes (part of which relates to EAI) based on the perceptions of the public generally and users of audited accounts specifically.

Cultural diversity

Ethical norms often vary between cultures. For example, receipt of shares as gifts by a senior government official in Japan may well be seen as a "measure of thanks" for having progressed corporate developments in the company or group concerned.

However anglo-saxon norms would likely consider it as a form of bribery, and not as it might be seen in Japan - as a "perk" that goes with such a senior position. Some of this perceptual difference may be attributed to differences between underlying cultural norms.

[For research contributions regarding perceptions of EAI within differing cultures see Badran, 1983; Agacer, 1987 and Dykxhoorn and Sinning, 1981a and 1981b. In turn, these contributions examine differing and specific aspects of EAI as seen in Egypt, West Germany, USA and the Philippines, mindful of possible ethical diversity expressed as a sub-set of cultural diversity.]

While recognising that cultural norms may indeed be different, it must also be recognised that differences in themselves do not make one set of cultural norms better or worse than any other.

But research should be undertaken to see what ethical views exist on a number of subjects, recognising the cultural norms within which they prevail. In particular, if varying ethical perceptions exist in terms of "gifted" shares, might they not also exist in terms of external auditor independence?

4.3.3 Cases of impaired EAI in the UK

In an ideal Utopian world all would function according to plan, and with complete integrity, so that there would be no need for the likes of (internal or external) auditors. However the world is far from ideal, and so there is a need for external auditors and for reliance on their professional independence.

The question then arising is: "Have auditors lived up to, and do they currently appear to be living up to, the expectations of EAI placed in them, by persons who rely on audited statements?"

One way of addressing the question is to identify past or recent instances where EAI has in fact been impaired, and/or to list instances where concern about EAI has been voiced (whether or not backed by proof of actual impairment).

Thus, in part answer to the preceding question, the following section of the chapter examines some past instances of alleged or identified cases of impaired EAI in the UK. The paragraphs then following focus on expressions of recent concern with EAI in the UK.

Past instances of impaired EAI in the UK

One medium of searching for past instances of impaired EAI in the UK, is a review of reports written by inspectors appointed by the DTI under Section 165(b) of the (then) 1948 Companies Act.

Less recent (quasi-) judicial reports

However, DTI reports from the 1970s, offer few examples of EAI being "in fact" impaired, a fact borne out in (inter alia) the following instances:

1. Harmood Banner re: London and County Securities Limited [1974]
2. Price Waterhouse re: Peachey Property Corporation [1976]
3. Dixon Wilson re: London Capital Group [1975]
4. Carter Alliban re: Peek Foods Limited [1981]

Examination by DTI inspectors in these cases, with a prima-facie suggestion of impaired EAI, only confirmed [Waters, 1986: 16-17], that in their view, the relevant auditors had acted independently.

Nevertheless, it appears [Waters, 1986: 17] that in these cases, the concern of DTI investigators was "more on the inability of auditors to communicate their misgivings, rather than on the question of whether they were independent in the first place."

More recent (quasi-) judicial reports

Despite severe criticism of EAI in the UK, there appears to be few actual instances where legal (or similar) processes have confirmed impaired EAI. A review of recent UK instances revealed only two cases where, according to either a professional body or DTI inspectors, EAI may have been impaired.

As the facts of these cases are themselves of interest and share broad parallels with some of the situations described in the present research questionnaire, they are briefly reviewed below:

Sieff Davidson re: Garston Amhurst Ltd

Sieff Davidson (SD) were auditors to Garston Amhurst Ltd (GAL), an investment company that went into liquidation in October 1989. In addition, SD owned the majority of shares in a company, OFML, whose minority interests were owned by some of the directors of GAL. Further, the MD of GAL was a non-executive director of OFML.

An ICAEW disciplinary enquiry held that these inter-relationships had put SD "in the position of having an interest which might be seen to detract from ... independence and objectivity" and SD partners were censured. ["Partners at Sieff Davidson censured by English ICA" - Accountancy Age, April 25, 1991: 2]

Levy Gee re: Aldermanbury Trust Ltd

Aldermanbury Trust Ltd (ATL) collapsed in 1988, when the DTI appointed reporting inspectors. In their report the inspectors criticised ATL's auditors for having "failed in a number of significant areas, to obtain adequate audit evidence." The DTI report also criticised the relevant audit firm (Levy Gee) for failing to act with "objectivity and independence".

Levy Gee have refuted such criticisms as "distorted" and the matter is now subject to further legal processes, while the report is reviewed by the ICAEW Ethics Committee ["Levy Gee hit back at "distorted" criticism" - Accountancy Age, March 28, 1991: 1].

[Some argue that DTI inspectors' reports do not necessarily provide a complete source of observed UK cases of impaired EAI, as not all such reports are made public - "DTI investigations under fire from academics" - Accountancy Age, July 11, 1991: 13.]

Nevertheless, in the above two cases, it would appear that the auditors concerned have at least placed themselves in situations where a reasonable observer may doubt their professional independence.

Recent suggestions of impaired EAI

In addition to the two actual cases identified in the previous paragraphs, there have been more recent "suggestions" or "accusations" of impaired external auditor independence (or objectivity) by UK auditors.

However, it must be stressed that at this stage, these accusations remain totally unproven, and continue to be only a basis of enquiry. Notable among such cases of "suggested" impaired EAI are:

1. Stoy Hayward re: Polly Peck Int.
2. Coopers & Lybrand Deloitte re: Polly Peck Int.
3. Stoy Hayward re: Levitt Group & Polly Peck Int.
4. Coopers & Lybrand Deloitte re: AGIP (Africa)
5. Baker Tilly re: Royal Borough of Kensington and Chelsea Assured Homes PLC ["Ethical guidelines breach is denied by Baker Tilly" - Accountancy Age, September 27, 1990: 11]
6. Coopers & Lybrand Deloitte re: Mirror Group Newspapers and Maxwell Communications Corporation

4.3.4 <u>Criticisms of EAI in the UK</u>

Despite the paucity of **confirmed** cases of impaired EAI in the UK, it (EAI) has been under strong fire in recent months. During this period, the press has been a forum for much debate on it, and has had frequent references to it. Thus, to state there is interest and concern with EAI is an understatement.

While such concern **may** prove baseless, it is true that virtually every week an article on EAI is found in the press. The following list is a very limited random selection of recent press articles expressing concern with (inter alia) current standards of EAI:

1. Real audit reform needs statutory regulation
   Letters, Financial Times, December 28, 1990: 9
2. Blowing the whistle on accountancy
   The Economist, December 22, 1990: 16
3. Professional self-regulation is more efficient than statutory interference
   Letters, Financial Times, December 14, 1990: 17
4. Audit Reform
   The Guardian, December 3, 1990: 13
5. Auditing the auditor
   Editorial, Financial Times, October 19, 1990: 18
6. Great expectations - but auditors fail to deliver
   The Guardian, October 31, 1990: 15

Current criticism of EAI in practice

Criticism of current standards of EAI in the audit profession comes from many quarters - academics, parliamentarians and financial journalists and are to be read in sources as differing as "The Guardian" daily newspaper and "The Economist" magazine.

Parliamentarian criticism

One ardent critic of the present status in the audit profession, and its standards of independence, is Austin Mitchell - a Labour MP (and self-appointed vigilante of the auditing profession).

Mitchell's main contention is that despite the profession's ethical standards and self-regulation procedures, auditors have today become "too dependent on their clients". As such, Mitchell argues that members of the profession are unable to maintain the level of EAI required of them.

Thus, referring to "opinion-shopping" practices, he voices concern with EAI stating that audit firms are constantly "going into beauty contests to get new business, but the problem with beauty contestants is they often go to bed with the judges" ["Mission to keep contestants out of judges' beds" - Financial Times, December 13, 1990: 15].

Mitchell also criticises auditors for, in his view, "putting profit before professional independence". ["Bankruptcies raise questions over auditors" - Financial Times Supplement, December 7, 1990: V. Similar criticisms are expressed by another Labour MP - see Cousins, 1990: 10-11.]

<u>Press Criticism</u>

One financial journalist ["Audit Reform", The Guardian, December 5, 1990: 13] criticises current UK practices of EAI stating, "the most worrying concern (is) that commercial pressures make auditors more concerned with client service than EAI."

Even "The Economist" magazine ["Blowing the whistle on accountancy" - December 22, 1990: 16], an oft-perceived defender of the establishment and the established, states that auditors "are no longer seen to be impartial."

In assessing criticism of external auditor independence one recognises that financial journalists may not be **perfect** surrogates for the users of audited financial statements. However, despite limitations, they have been used as such, and are at least a good medium to help identify issues of concern to audit users.

[Views of financial journalists have been used in empirical studies on business issues. For example, Richter, 1976 (in Dykxhoorn and Sinning, 1981a: 165) used financial journalists to see if in their view, MAS-provision by auditors impaired their EAI.]

Academic Criticism

Accounting academics have expressed concern with EAI. Puxty, Sikka and Willmott (academics from three UK tertiary institutions) ["Why the DTI still baulks at bringing auditors to book" - The Guardian, December 3, 1990: 15], enumerate in a joint article, the various reasons why they are concerned with the status of EAI within the UK auditing profession.

Government criticism

Even the present UK government has expressed its discontent with current audit ethics and indicates that the DTI "may move to enforce a stricter definition of" EAI ["Redwood may act on audit ethics" - Accountancy Age, November 8, 1990: 1]. In that context, the Corporate Affairs Minister, stated that the government will look at various options once it became "clear what professional rules there will be governing" EAI (i.e. after further steps to tighten ethical standards are put down by the audit bodies themselves).

Audit-User Criticism

Curiously, while criticism of EAI comes from many quarters, one seldom comes across such critical articles written by the users of audited statements. Perhaps journalists act as their spokespersons.

Does this apparent silence on EAI by users of audited financial statements mean that they are in fact content with the prevailing ethical standards of EAI as seen by them? Or, are they concerned about this and related issues, but have merely refrained from making their views manifest? Inter alia, this research attempts to answer that question.

The issue of EAI presents an interesting profile. On the one hand, there are few proven (and recorded) cases of external auditor independence actually having been impaired in the UK, but, as evidenced by the many written references to it, there is significant concern about it. Thus, the area of EAI lends itself to fruitful examination.

However, the concern with EAI mentioned above may be the result of the fact that what really disturbs observers, is not EAI in fact, but rather EAI in appearance. For it is on what is apparent to, or perceived by people, that they form their beliefs.

As such, these serious criticisms of EAI call for a close study of the surrounding facts. Further, since the phenomenon of independence "in appearance" is concerned with the <u>collective perceptions</u> of the users of audited statements (including external auditors), any rules covering EAI in appearance should be based on such group perceptions.

Determining areas of concern with and perceptions of EAI within various situations are only a first step towards a meaningful solution of the external auditor independence problem, and are important objectives of this research.

Such research should recognise that peoples' perceptions are heavily influenced by their individual values and the belief systems to which they ascribe. Further, the research must focus on perceptions of auditor independence and attempt to isolate at least some of the auditor-client relationships that are perceived to be of concern.

In calling for a fresh assessment of the subject, Olson [1980: 80] states that "any standards for (auditor) independence must define the types of relationships that would cause reasonable persons to conclude that an auditor had become an insider."

Having regard to the preceding comments, research into external auditor independence is also called for on the grounds that it is the central plank of the auditing profession. Thus, quite properly, the issue is undergoing close scrutiny by the profession itself and other concerned parties.

Such re-examination and research should open the way to remedy areas of weakness within the training and formation of accountants themselves and the ethical rules that govern them.

However in order to produce effective results, in terms of meaningful rules and guidelines, any current re-examination must be based upon a sound knowledge of the factors that influence auditor independence. Accordingly, a significant part of the empirical research offered in this thesis is a contribution in that direction.

The next chapter is (partly) devoted to an identification of the specific and individual aspects of external auditor independence offered for examination in the present research questionnaire, and considerations relating to the overall development of the questionnaire itself.

CHAPTER V

RESEARCH PROBLEM, NATURE AND OBJECTIVES

The prime purpose of this chapter is to describe the basis and nature of the main research problems herein addressed and to outline the main objectives of the research. To achieve this, the chapter is structured within five sections whose respective functions are to:

1. state the nature of the research problem
2. describe the basis and nature of the research
3. state the objectives of the research
4. present the framework (background) to the research
5. explain the use of the research instrument employed

5.1 Nature of the research problem

Chapter 1 stated that EAI in "fact" and "appearance" is the very basis of auditing and that only when the auditor is perceived by users of audited financial statements to be independent, will his opinion be relied upon by them.

On the other hand, the theoretical analysis of EAI in Chapter 2 indicates it to be a multi-faceted feature whose "appearance" may not be uniformly seen by all persons concerned with it. Thus, what is uncertain is whether (groups of) users of audited accounts have similar or significantly differing views of EAI.

Translating this uncertainty into a practical real-life UK context, one notes contradicting views being offered by some of the parties concerned with EAI.

For instance, an Editorial in the Financial Times ["Auditing the auditor" - October 19, 1990: 18], maintained that recently (or soon to be) implemented measures (introduced by the Companies Act 1989), for the monitoring of the auditing profession are less than fully effective, because they fail "to address the **central question** (of auditing), which relates to the **independence of the auditor"**.

On the other hand, Brandon Gough (the senior partner of Coopers & Lybrand Deloitte - the largest firm of chartered accountants in the UK), argues that the benefits offered to the auditing profession by the Single Market, must not be "surrendered in response to exaggerated concerns about scale, ... competition or independence." ["Big will be beautiful as Europe opens up" - Financial Times, September 13, 1990: 12.]

Even the government appears to be concerned with EAI. In a written reply (on ethics within the auditing profession) to the House of Commons in the first week of November 1990, the corporate affairs minister, John Redwood [Accountancy Age, November 8, 1990: 1] stated:

"the Secretary of State (for trade and industry) will consider whether to exercise the power (in the Companies Act 1989) to specify by regulations, further disqualifying connections (between auditor and client) once it is clear what professional rules and guidance there will be, governing the independence of auditors."

The underlying implication is that there is **some concern** about the independence of auditors in practice, and this concern appears to focus on the "connections" that subsist between auditors and their clients.

However, it **may** be that Brandon Gough is right and concerns about EAI are indeed "exaggerated". Thus, this research is, in part, an attempt to determine those (types of) situations that appear to cause concern to the users of audited statements.

Refocusing on the "appearance" of EAI in the UK, one notes that it has been criticised by many and on a variety of accounts. As three examples only, the following references clearly state their authors to be less than content with current UK standards of EAI.

1. Real audit reform needs statutory regulation - Financial Times, December 28, 1990: 9
2. Blowing the whistle on accountancy - The Economist, December 22, 1990: 16
3. Why the DTI still baulks at bringing auditors to book - The Guardian, December 3, 1990: 15

However, despite a spate of such criticism in recent months, the UK audit profession has consistently stated that (while it is impossible to professionally or legislatively guarantee independence **"in fact"**) current legislation and professional standards are adequate to secure objectivity and independence **"in appearance"**.

As examples of the profession's defence of such criticism, one may refer to articles written by two stalwarts of the UK auditing profession.

These defendants of the UK profession are Chris Swinson (the Managing Partner of BDO Binder Hamlyn) and Brandon Gough (the Senior Partner of Coopers & Lybrand Deloitte), both firms being one of the six biggest (the Big-Six) firms of auditors in the UK:

1. Auditors' independence and integrity (Swinson) - Financial Times, October 26, 1990: 19
2. Big will be beautiful as Europe opens up (Gough) - Financial Times, September 13, 1990: 12

Nevertheless, given the manifestly strong debate on EAI, it must be more than reasonable to ask to what extent and which of the preceding views are shared by those who use the services of auditors, and if they are indeed satisfied with current standards of EAI. These are the main research areas presently addressed.

5.2 Nature of the research

Thus, against the background of the above debate, this research was conducted to assess how EAI is seen by four sample groups (the Research Groups). The first was made up of a sample of external auditors (who issue audit reports - the Issuer Group). The other three were sample groups of persons (bankers, credit managers and internal auditors) who use audit opinions (User Group).

Using the questionnaire methodology this research focused on twenty unrelated, individual relationships (situations) between auditors and their clients, and from among these situations tries to identify those that (audit) relevant persons see as a threat to EAI.

In this respect, the research gives expression to research suggestions made both by Berryman [1974: 14] and Olson (a past AICPA president) [1980: 80], when the latter states that "any standard for professional independence must define the types of relationships that would cause persons to conclude that an auditor had become an insider" and thus in effect lost EAI.

The research makes an important distinction between auditor-client relationships that may merely engender an impairment to audit independence, and the actual manifestation of EAI having been impaired.

The distinction is important, because the research is not concerned with how impaired EAI is (or may be) manifest, but with why it became manifest (a "positive theory" approach), and the environment permitting it.

For example only, take the virtually impossible and hypothetical situation of an auditor who derives 55% of his gross income from one client. The auditor has been under much pressure (including the threat of loss of office) from the client, to persuade him to accept a method of recording and presenting some accounting data whereas the auditor's judgement dictates otherwise.

After considering the factors involved, including the impact on his fee income if he lost the client in question, the auditor succumbs to the client pressure. Thus, contrary to his professional judgement, the auditor agrees to the requested method of dealing and presenting the accounting transactions, without due qualification (or reservations) in the audit report.

This, admittedly hypothetical, situation has two aspects. First the environment in which it was possible for the auditor's independence to become impaired, and second its actual manifestation. The pernicious features of both aspects is they are usually obscured (at least initially) from public view and knowledge.

This is because UK auditors are presently not required to divulge the percentage of fee income derived from each client, and neither is it possible to instantly detect any impairment of EAI when an audited financial statement is released to the public.

At best, such impairment may become evident only in some months, when events overtake the company. But even then, one cannot really make firm conclusions about the auditor's apparent lack of independence. Thus the distinction between the environment that engendered an impairment to EAI, and the manifestation of that impairment is important.

Consequently, the research is not concerned with the manifestation of impaired auditor independence. On the other hand, it is concerned with the audit environment and auditor/client relationships that permitted or encouraged the impairment of external auditor independence.

Such an investigation (of relevant perceptions) may well suggest a theory to help predict, inter alia, why an individual auditor may be perceived to be not independent by users of audited financial statements, and perhaps predict the eventual loss of that audit contract by the auditor in question.

This research is premised on the belief that only certain types of auditor-client relationships permit (encourage) EAI to become impaired. Relationships other than these types do not usually engender such a threat.

In that vein, UK legislation and/or professional guidelines clearly rule out and prohibit certain types of relationships between an auditor and his client. For example, under no circumstances may an auditor own shares in a beneficial capacity in a client company.

However other relationships that are not specifically excluded by law or professional rulings may exist between an auditor and his client. Nevertheless, it may be that such relationships do not inspire an observer to the auditing process with due confidence in the professional independence of the relevant auditor.

Accordingly, the research singles out for examination, some auditor-client relationships that are not prohibited by legislation and/or professional rulings, but which **may** nevertheless be seen as a threat to EAI. Thus, the focus of this research is the nature of relationships between auditors and their clients. More specifically, the research attempts to uncover the nature of relationships that persons associated with audited statements see as a threat to EAI.

Expressed as more general questions, the overall thrust and nature of the research may be stated as:

1. Do specific auditor-client (relationships) situations by themselves ring alarm bells for EAI?
2. If so, what are these situations?
3. Are they presently adequately safeguarded by statutory requirements and professional guidelines?

5.2.1 Agency theory basis of the research

The research is also based on implications that, inter alia, flow from Agency Theory [Watts and Zimmerman, 1986: Chapter 13], a "positive" theory that seeks to explain why audits occur. The theory views the economic activity of the firm as part of a nexus of contracts and contractual relationships. Seen in that light, the firm may be regarded as having entered into contracts with, inter alia, its employees and suppliers.

Progressing in that direction, Agency Theory (AT) might even be seen as a micro-economic theory which provides a rationale for auditing in an economic framework. In doing so AT reinforces the pivotal importance of EAI. The theory's rationale for auditing lies in its tenet that the inherent conflicts between "principals" and "agents" call for agency information to be "monitored" and/or confirmed by an "independent" person, and the auditor is put forth as that individual.

A central plank of agency theory is the contention that the very basis on which the services of an auditor are engaged, is his independence. Without that professional independence the auditor would be of little or no value, and have no role to play within agency theory.

Further, AT contends that even without the backdrop of professional ethics or legal statute, auditors would be, and hold themselves out to be, truly independent. Further, they would see themselves as being so.

Because, it is argued, if it became evident that an auditor were not acting independently, then no monitoring contracts would be offered to him, and in time he would be unable to earn a living as an auditor.

Watts and Zimmerman [1981] take exactly this view when providing a historically based explanation for the practice of auditing and when offering an explanation for the prevalence (and continuance) of auditing even before it was required statutorily.

As such, it is an attribution of the theory that, in general, auditors are and will remain independent. Further, they will so remain in order to establish and then exploit (good) "reputation" effects, so as to serve their own economic "self-interest".

Equally, AT would maintain, users of audit services must see the auditor to be independent, or else they would not use his/her services. As such, an underlying assumption of the theory is the belief that (in general) users of audit services will perceive auditors to be truly and completely independent.

In this respect, agency theory supports the traditional professional view, which contends that the auditing profession is dependent not only on it being independent in fact, but also on it being seen to be independent by users of its services.

While agency theory does not confirm or reject the assertion that differential perceptions of EAI may exist, it does imply that there will be an identity or near-identity of such perceptions, when relevant views of auditors and users of their services are compared.

In other words, in situations where due regard has been had for relevant legal and professional requirements on EAI, there should be no significant differences of opinion in the way in which it is seen by these two (audit associated) groups. However some previous UK empirical evidence indicates that non-auditors do have differential perceptions of EAI [Firth, 1980 and 1981] when compared to those held by professional auditors.

Another construction of AT [DeAngelo, 1981b and Watts and Zimmerman, 1986: 318] holds that the size of an audit firm is likely to be positively correlated with the stand it takes on auditor independence issues, so that larger audit firms are "more likely to be independent" than firms of a smaller size.

If so, this increased likelihood of independence is possibly also to be seen in varying EAI views between auditors from differing (Big-Six vs. nonBig-Six) sizes of audit firms.

In fact, some prevailing commercial practices do tend to support the preceding AT derived construction. For example, note the requirement sometimes seen in loan covenants requiring the borrower to use the services of a specified auditor (or at least one of a set of specified auditors) to audit its annual statements.

If all auditors were viewed equally and uniformly (and they are in terms of professional qualifications and statutory licensing) then such terms in loan covenants would be redundant and rarely witnessed. However such terms do exist within loan covenants, and as a result, it is logical to maintain that some differences must be seen amongst firms of auditors and their individual characteristics.

In part, such differences may be attributable to the fact that auditors from varying firm sizes may themselves have differing perceptions on the nature of EAI (a form of acculturation).

In that sense, agency theory can also be drawn on to explain how varying perceptions of EAI (as held by auditors from different sizes of audit firms) may influence auditor choice. In fact, it may be that an audit firm's standing in the league of audit firms acts as a surrogate (guarantee) for professional EAI.

Further, as Big-Six auditors provide audit opinions on the accounts of the majority of listed companies [see Briston and Perks, 1977 and Briston, 1979], which in turn generate a significant part of the UK's GNP, it is pertinent to determine if there are significant differences of perception between auditors with a Big-Six affiliation and auditors not so affiliated.

Accordingly, based on the agency theoretic implications relating to perceived EAI being functionally associated with audit firm size, and considerations offered in the previous paragraph, one thrust of the research concerns itself with determining if differing views on EAI exist between samples of auditors from Big-Six and nonBig-Six audit firms.

5.3 Research objectives

As stated in Chapter 2, the continued existence of the audit profession's reporting function is dependent on it maintaining the appearance of total professional independence.

Thus, in order to determine how this independence is viewed by groups concerned with EAI and audited financial statements, the overall general objective of this research is to statistically analyse (compare and contrast) views held by the (previously noted) research groups, in relation to EAI within specified audit situations.

As such, a major objective of the research is to empirically examine whether there is indeed a general consensus of (group) opinion on EAI, between the Issuer Group and (in turn) each one of the three User Groups.

Consequent to AT implications, another objective of the research is to empirically examine and test for similar consensus within the Issuer Group only - on the basis of auditors from Big-Six and nonBig-Six auditing firms.

Thus, following previously noted implications derived from AT, the principal objectives of the research may be stated more expansively as:

1. To determine if significantly differing perceptions of EAI exist, firstly between the Issuer Group and each of the User Groups in turn, and secondly within the Issuer Group itself.

2. Should such differences be revealed, to attempt to explain them by hypothesising that these differences arise from one or all of the following phenomena:

a. the identification of differing group constructs (or factors) underlying each group's overall perceptions of EAI

b. the identification of differing importance (weights) attached to key aspects of EAI by the Issuer and User Groups (i.e. differing group models of EAI)

c. the identification (within each research group) of differing personal features that appear to be of relevance in explaining group views on EAI.

However, in order to first better consider the nature of EAI, an ancillary objective of the research is to:

1. Assess how EAI is seen by all the Research Groups within the specified situations.
2. Determine if there is concern with EAI within these situations by the User Groups.

In summary, one might state that the above research objectives have four distinct underlying dimensions, each of which are considered, in turn, in the paras immediately following. These four dimensions are:

1. Differential (considered in Chapters 10 and 11)
2. Factor (considered in Chapter 12)
3. Discriminating (considered in Chapter 13)
4. Personal characteristics (considered in Chapter 14)

<u>The differential dimension</u>

This research dimension identifies from the twenty researched audit situations, those where:

1. Users of audited statements see EAI significantly differently from those who provide audit services
2. Big-Six auditors see EAI significantly differently from nonBig-Six auditors
3. Partners in audit firms see EAI significantly differently from non-partners in the same audit firms.

Expressed in null hypothesis terms, the above may be stated in relation to the individual EAI aspects considered within each of the twenty audit situations as:

HO-1: There are no significant differences between practising auditors and each of the three other respondent groups.

HO-2: There are no significant differences between auditor respondents with a Big-Six affiliation and those with a nonBig-Six affiliation.

HO-3: There are no significant differences based on a partner/non-partner rank basis in regard to respondents in audit firms (size disregarded).

Considering group views from a differential dimension allows one to also judge them on an "expectation gap" basis. Accordingly, in those situations where such gaps are significantly different (and negative) between the views of individual audit-user groups and the issuer group, they may be regarded as a quantified measure of individual aspects of this expectations gap.

The factor dimension

In the event that significant group differences are unfolded, it is necessary to determine possible reasons why this may be so.

Thus, the statistical application undertaken with a factor dimension in mind, is premised on the basis that one possible reason why these differences unfold is to be found in the fact that each group brings to bear a different and varying factor framework or set of underlying constructs when they consider EAI issues.

Should such meaningfully identifiable factors be revealed as a result of the appropriate statistical procedure (Factor Analysis), then it would be of benefit to the audit profession in that future revised ethical pronouncements may be developed or revised on the basis of a full knowledge of such group factor constructs.

<u>The discriminant dimension</u>

Should significant group differences emerge with respect to some or all of the twenty audit situations presented for consideration, it will also be pertinent to determine those situations that best "capture" most of the individual group variations.

This dimension is achieved by applying the statistical technique known as Linear Discriminant Analysis (LDA) to the underlying responses. LDA results in a linear model which incorporates and duly weights those situations (EAI aspects) that have good distinguishing features within the particular groups considered.

Successful development of such models with good group predictive ability, will help reveal those specific aspects of EAI by which views of each of the three user groups may be best distinguished from those of the issuer group.

The personal characteristic dimension

However, on the basis that differing views between groups may have more to do with the underlying personal characteristics of the members within each group, this research dimension explores for possible reasons for group differences in varying group patterns of personal characteristics (such as age, education, experience, familiarity with audit opinions, etc.).

Consequently, in order to assess the impact of such personal characteristics on group views of EAI, they are all assessed in concert using the multiple regression statistical technique.

Should the relevant r-squared statistic (multiple coefficient of determination) of the model reveal high explanatory power (in terms of explaining variation between groups), it indicates that the model's predictive ability using the (duly weighted) personal characteristics indicated is good.

Results flowing from these multiple linear regression models will highlight those personal characteristics that may be regarded as formative when shaping EAI views, and should corrective action be required in a personal context, one may focus on only the identified aspects of the regression model.

5.4 Research frame and background

The need for EAI has long been recognised in the auditing literature. References to auditing go back as far as 1200 A.D., and even then, mechanisms existed to monitor and foster EAI [Watts and Zimmerman, 1981: 13].

The issue continues to remain important in the UK. The ICAEW's "Guide to Professional Ethics" [ICAEW, 1987: 9] states that "independence is a concept fundamental to the accountancy profession. It is essentially an attitude of mind characterised by integrity and an objective approach to professional work."

To assist its members, the ICAEW highlights in the explanatory notes to the above mentioned guide, a number of relationships (associations) that would usually be considered undesirable in terms of EAI. The broad sets of these relationships, when assessed from the auditor's position, relate to the following:

1. Undue Fee Dependency (Set 1)
2. Close Personal Relationships (Set 2)
3. Financial involvement with or in a client (Set 3)
4. Conflicts of interest (Set 4)

Each of these sets are illustrated, as on the following page, by examples of situations that may threaten EAI.

1. Undue fee dependency

   Examples within this set include the derivation of too great (material) a part of a firm's professional income from a client or group of connected clients.

2. Close personal relationships

   Examples within this set include personal relationships between the auditor and the client, such that the relationship can affect objectivity. They may arise through blood connections, marriage, or indeed through strong friendships.

3. Financial involvement with/in clients' affairs

   Examples within this set include the holding of beneficial shares in audit clients, giving to or taking from clients of most loans, and acceptance of goods/services on terms more favourable than to the clients' employees. Acceptance of undue hospitality by the auditor from the client is also illustrative.

4. Conflicts of interest

   Examples falling under this set include, with relation to audit clients, the provision of other services, the holding of a previous appointment by the auditor in a company now audited and the preparation of accounting records for public (but not private) companies.

When developing the research situations stated in the questionnaire, each situation was designed so that it was fairly readily recognised as belonging to or coming from one of the preceding four sets of auditor-client relationships. The purpose in doing so was to be able to "house" individual situations, should they prove to be statistically indicative in one way or another.

[The perceived association of each of the twenty questionnaire situations with one of the four ICAEW factors was judged by a classificatory exercise conducted using 44 MBA students at City University, London (see Chapter 6). Good classifying concordance was observed for all twenty situations.]

Using this four set classifying approach on the twenty situations, permits one to draw generalisations from results more meaningfully than if the situations were not readily seen to be connected in any way. Thus, the "leitmotif" of this research can be regarded as the four sets of relationships identified in ICAEW [1987].

Thus, it is true to state that in addition to having regard to an underlying sense of commercial realism, the twenty research situations were developed with due cognition of the four classification sets structured within ICAEW [1987].

5.5 Research methodology and instrument used

By definition, empirical research is based on observation (experiment) and not theory. Thus, it was concluded that the optimal way of observing what really transpires in the "real world" (in an EAI context) was to ask the views of persons who functioned in it and who would also normally be concerned with EAI.

Kerlinger [1973: 411] considers the questionnaire survey to be the most appropriate method to determine the views of people. He states that "survey research focuses on people, the vital facts of people, and their beliefs, opinions, attitudes, motivations and behaviour."

Thus after considering alternative research approaches, and recognising that it was "beliefs, opinions, ... and attitudes" that were sought in this research, it was concluded that the analytical questionnaire survey method was most appropriate in this instance.

Further, as it was not possible to enquire about perceptions based on specific real-life audit situations, the facts contained in the twenty questionnaire audit situations were designed to parallel, as closely as possible, actual or anecdotal audit relationships and/or environments.

Consistent with the presentation of facts grounded in reality (or near-reality), respondents were asked to give their views on much the same basis. Thus, they were asked to state their responses (per questionnaire completion instructions [Appendix B, Vol. II: 248]) "on the basis of what you expect WOULD really happen, and NOT on the basis of what you consider should happen."

Furthermore, the decision to employ the questionnaire methodology was reinforced by the natural convergence of perceptual concepts integral to the Brunswick [1952] Lens (BL) model and the former. In its simplest form, the model holds that perceptions are the judgements of specific stimuli as processed by individual judges.

The natural convergence between the BL model of human information processing (especially per Libby, 1981: 6) and questionnaire methodology comes about because:

1. the respondents to a questionnaire can properly be regarded as the judges envisaged by the model - for it is they who assess or decide on the facts provided within (or without) the questionnaire

2. the preceding facts can also be appropriately considered as the specific stimuli or cues that the judges are asked to assess

3. the responses given by respondents can rightly be considered a measured reflection of the result (or perception) of the relevant stimuli, after having been processed by the judge(s) in question.

This component classification provided by the Brunswick Lens model also provides the basis for the next three chapters, all of which are devoted to matters arising from the use of the questionnaire methodology.

Thus, in Brunswick model terms, Chapter 6 is devoted to an examination of matters that are mainly concerned with the relevant stimuli (cues) placed for judgement - in other words, the facts contained in each of the twenty individual situations that questionnaire respondents were asked to judge.

In similar terms, Chapter 7 is devoted to a discussion of matters that are mainly concerned with the judges (respondents) used in the research, particularly their choice and usage in the research.

Of no less importance are the contents of Chapter 8, which is devoted mainly to clarifying matters that arise from the responses provided by the respondents to the questionnaire - i.e. in Brunswick Lens model terms, their judgements.

CHAPTER VI

DEVELOPMENT OF THE RESEARCH QUESTIONNAIRE: FORM AND CONTENT

In applying the Brunswick Lens paradigm referred to in the previous chapter, this chapter considers and examines each of the cues (the individual situations) presented for due assessment by the judges (the respondents to the questionnaire).

As such, the purpose of this chapter is to amplify details related firstly to the basic development of the questionnaire (i.e. form, in Section 6.1) and secondly to those EAI aspects examined in each of the twenty researched situations (i.e. content, in Section 6.2).

6.1 Questionnaire development

As the main thrust of the research was to obtain views of EAI in certain auditor-auditee situations, two criteria were set for inclusion of a situation in the questionnaire.

The first was that the situation must bear some real-world quality and be one that provokes attention in the literature. The second was that it should rather easily be "housed" in one of the four EAI classifying sets of the ICAEW [1987] referred to previously (Chapter 5.4).

Additionally, most of the twenty questionnaire situations have provoked some empirical attention [Lavin 1974; Pany and Reckers 1980 and 1984; Firth 1980 and 1981] or are based on anecdotal and/or reported experiences of auditors and audit users. Equally, they were developed on the basis that each fell (primarily) into one of the four classifying sets suggested by the ICAEW [1987].

Development versions of the questionnaire were pre-tested formally (in groups) and informally (on an individual basis) and discussed with academics and auditing professionals concerned with EAI. Thus, the final questionnaire reflected the fruits of discussions with, and evaluation by academics at City University Business School and the London technical partners of four major firms of chartered accountants.

In addition, a pilot study using a development version of the questionnaire was conducted. The pilot study was done with the acknowledged and much appreciated help of 119 qualified accountants from several UK offices of a Big-Six firm of accountants. As a result of their participation in the pilot study, and in order not to permit any form of pre-knowledge to influence final responses, this firm was precluded from offering respondents to the final questionnaire.

Thirty situations (variables) were presented in the pilot questionnaire. However, after pilot-testing only twenty were considered optimal for retention in the final questionnaire.

In addition to judging EAI in the thirty situations presented in the pilot questionnaire, pilot-respondents were also asked to state if in their view any of the situations presented, or terms used in the pilot questionnaire were ambiguous or required clarification.

While some pilot-respondents did comment on that score for some situations, there was no overall consistency of comments across situations. Nevertheless, the final questionnaire reflected additions, deletions and other improvements indicated as a result of the pilot study.

6.1.1 Questionnaire design considerations

It is clearly impossible to examine real or factual auditor-client situations, where there may be concern with EAI. Such details are almost always private, and not available for study by academics and the public.

Equally, assuming it were possible, it would be somewhat futile to compare the views held by individuals or groups on their overall composite perception of EAI.

Rather, the view was taken, that it is more pragmatic and fruitful to examine views of external auditor independence within or as circumscribed by specified scenarios or "situations", as they are termed in this research.

Thus, the final questionnaire [Appendix B, Volume II: 247-257] outlined (by briefly describing) 20 individual and unconnected situations (relating to an auditor and his client), that may be perceived to influence or impact on external auditor independence.

As the research was not intended to (nor could it) be, a comprehensive study of EAI, the twenty questionnaire situations do not reflect every possible situation that may engender impaired external auditor independence. Rather the research concerns itself with EAI only within the confines of the twenty questionnaire situations.

Further, the research recognises that while the facts of the twenty research situations are not specifically prohibited by legal and/or professional rules in the UK, many professional auditors would not allow themselves to be involved in situations such as those outlined in the questionnaire and take specific steps to ensure that this is so.

6.1.2 Stimulus assessment exercise

Each of the questionnaire situations was designed to trigger off a particular and single stimulus, which may be seen as a form of (potential) pressure on EAI. Thus while each situation was unique, they were also developed on the basis that they could easily be classified within one of the four classifying sets as stated in the Ethical Guidelines of the ICAEW [1987].

In order to confirm the consistency of the perceived stimulus intrinsic to each situation, 44 MBA (Finance) students at City University (most of whom had had some practical and/or academic accounting exposure), classified each of the twenty situations within one of the four ICAEW sets, using only the questionnaire information. While individual classification was by no means identical, there was broad agreement that the situations fell into the classifying sets as follows:

SET 1: __Fees__

Situations 5, 12 and 18

SET 2: __Personal Relationships__

Situations 1, 9, 17, 19 and 20

SET 3: __Financial Involvements__

Situations 2, 4, 6, 7, 8, 14 and 16

SET 4: __Conflicts of Interest__

Situations 3, 10, 11, 13 and 15

The precise stimulus inherent in each situation was:

Sitn. Variable Examined

1. A prolonged tenure by the auditor.
2. Indebtedness by the client to the auditor's associated management consulting company.
3. Provision of certain accounting services by the auditor to the audit client.
4. Existence of an auditor-beneficial trade relationship between the auditor and a client.
5. Presence of a level of insecurity of office by the auditor, given a competitive audit environment.
6. Indebtedness by a client to the auditor for the previous year's audit fees.
7. Existence of a tenant-landlord relationship between the auditor and an audit client.
8. Ownership of trustee shares in a small listed company by a partner in the audit firm who serve as auditors.
9. Employment as managing director of the (former) partner in the company's (continuing) auditors.
10. Application of severe pressure by the audit client on the budget for audit costs.
11. Application of severe audit completion (time) pressure.
12. Dependence by an audit firm for about 10% of its fee income on the firm's only listed client.

13. Provision of management consulting services by a firm of auditors to an audit client, the consulting services generating annually about 40% of the audit fee for the firm of auditors.
14. The existence of "lowballing" by an audit firm.
15. The dual functioning by a partner in a firm of auditors, as director of an investment trust and as audit partner responsible for the company in which the trust holds a "not material" interest.
16. Retention by the local office of a Top Ten auditing firm as auditors to the largest employer in a given area.
17. Previous employment as finance director by an audit client of a firm of auditors, the partner not being involved with its audit.
18. The generation of 20% of the billing of the local office of a Top Ten firm from an audit client of the firm.
19. The chairmanship of a client of an audit firm being held by a life peer who is a leading figure in the City of London and a director of several PLCs with much political clout.
20. The existence of a fraternal relationship between a partner in a firm of auditors and the managing director of one of the firm's audit clients, the audit for which the brother concerned has no responsibility whatsoever.

6.1.3 Situations: rationale for and responses to

The questionnaire introduction gave details about the purpose of the research, a promise of confidentiality, and due instructions for completion. It also provided a definition of EAI. This definition was given to ensure that all respondents were using the same conceptual basis when responding. Further, respondents were asked to use that definition when responding.

Additionally, as it was important to ascertain each respondent's personal views, they were asked to ignore any ethical rulings and/or professional guidelines of which they were aware when responding and do so only on the basis of personal opinion.

The major part of the questionnaire was designed to assess respondents' views within the twenty situations, each of which reflected differing aspects of an auditor-auditee relationship and which may suggest the possibility of impaired EAI. In general, all twenty situations were ones which relevant UK audit bodies would deem to be not necessarily harmful to EAI.

Respondents were asked to judge each situation in turn, and to then indicate (on the numbered scale given for each situation) the level of confidence that they would have in the relevant auditor(s) acting independently.

While it is possible to state with some certainty if an auditor has acted with due EAI or not after the fact - before the fact, this is well nigh impossible. In this case, only judgements about the likely independence of the auditor can be made, and in asking for degrees of confidence relative to the auditor, the questionnaire recognised this.

In other words, the questionnaire recognised that before an auditor provides his opinion on a set of financial statements, only judgements can be made on the probability of him acting in an independent manner.

Probability in this context can be expressed using the degrees of confidence as its surrogate. Thus no confidence at all in the auditor's independence would be a surrogate expression of him not being independent, and complete confidence in his independence would be a surrogate expression of him being independent.

As such, an alternative way of capturing respondents views on probable independence was to ask them to assess and register their degree of confidence in the auditor acting independently in each of the given situations. The higher the degree of confidence, the higher the probability of the auditor's independence, with confidence acting as a surrogate for EAI.

On this basis, the questionnaire asked respondents to merely state the "Level of Confidence" they would have in the relevant auditor acting independently in each of the situations.

At the end of the relevant questionnaire section (after respondents had provided their responses to all twenty situations) respondents were posed a single question relating to EAI in the overall audit environment. This question was asked only in general terms and sought the respondents' views unrelated to any specific facts.

The question read [Appendix B, Volume II: 254]:
"What do you consider to be the Minimum Level of Confidence (MLC) in the independence of external auditors that users of audited financial statements may justly demand? Circle your response at the appropriate numbered level on the scale alongside."

The same response scale as that for the twenty situation questions was provided for this MLC question. The benefit of posing this general question was that it provided an individual yardstick, by which one could evaluate responses between individual respondents. Completed questionnaires showed no evidence of responses to the twenty situations being amended as a result of the response to the general question on EAI.

6.1.4 Response scale considerations

Some previous similar research [Lavin, 1976; Firth 1980] has researched EAI only on a dichotomous basis. In such research, respondents classified the external auditor in each of the situations presented for examination, as being in their view "independent" or "not independent". However, while dichotomous responses provide data about the direction of each respondent's views on EAI, within the specified situations, they do not provide data about the intensity of these views.

To remedy this deficiency, this research also sought to quantify respondents' intensity of views on EAI, a feat achieved by respondents registering their responses on the numbered scale given for each of the situations.

For purposes of this research, the actual responses given by respondents were termed the "raw responses" while these "raw responses" as reduced by the same respondent's MLC, were termed the "refined responses".

Thus a negative refined response indicated that in that instance, the respondent had less confidence than his/her stated MLC in the independence of the relevant auditor. Equally, a positive refined response indicated that in that case the respondent had more confidence in the auditor's independence than his/her MLC.

By inference then, negative refined responses indicated a doubt, concern or gap, with EAI, while positive refined responses indicated no such doubt, reservation or concern. Equally, the strength of negativity or positivism on individual refined responses indicated the degree of concern evoked with or assuredness provided for EAI in each situation.

By establishing individual refined responses in every situation and for each respondent, it was possible to assess each respondent's views, using his/her own personal base as the appropriate yardstick and as these personalised views were considered more revealing, the research focused on and used only the refined responses derived for each situation.

The choice of statistical operations available for use on information obtained through empirical enquiry is governed by the type of scale assigned to the data. Hence some consideration of the nature of data provided by the scale used in this research is called for.

The scales in Section 1 of the questionnaire [Appendix B, Volume II] required respondents to select one of seven confidence levels in the auditor's independence. They were 7-point scales commencing with 0 (NONE), and ending with 6 (TOTAL) and so were ordinal in nature.

However, the response scales were presented in such a manner so as to ensure that (where applicable) the physical distance between preceding and following measurement points were exactly equal. As such, the scales reflected interval-scale properties so that the relevant values were amenable to addition or subtraction [Bund Jackson, 1983: 3].

Consequently, while the response scales used were ordinal in nature because they conveyed information about rank or order, they also possessed cardinal qualities by virtue of the fact that they reflected interval-scale properties.

The nature of the response scale used becomes important given that parametric tests require that the relevant values analysed come from (at least) an interval scale, whereas nonparametric tests require (at least) an ordinal scale, the values of which must have an underlying continuity and be independently determined [Siegel, 1956: 31].

Thus, as the response scales that were used in this research are best described as ordinal-interval scales, both parametric and nonparametric tests were (available for use and) employed on the situational and MLC responses provided when completing the questionnaire.

6.2 Questionnaire content

The purpose of this section of the chapter is to explain the rationale underlying the inclusion of each of the twenty research situations in the questionnaire. In doing so, some of the more detailed findings arrived at by other empirical researchers when examining views of situations based on similar facts are presented.

The twenty research situations are considered in sets that, with a slight variation, reflect the four EAI sets identified by the ICAEW [1987]. Situations falling into each set are discussed in the following paragraphs and the factors themselves are:

1. The Reliance Factor

This factor refers to the auditor's reliance on the client firstly to be appointed as auditor in the first place and secondly for his continuance in office. This factor also recognises that no matter what the level of fee dependency on the client, at least to that extent, the auditor is economically reliant on the client.

2. The Relationship Factor

This factor includes those auditor-client relationships which, because of the circumstances on which they are predicated (e.g. family, previous professional connections etc.) may pose a threat to EAI.

3. The Pressure Factor

This factor refers to situations where specific forms of pressure (e.g. budget or time pressure) are levied on the auditor and which, though that may not be the prime or ultimate intention, may effectively cause the external auditor to sacrifice his professional independence.

4. The Involvement Factor

This factor refers to those situations where the auditor's independence may be impaired because of his involvement (primarily financial), no matter how such involvement arise, with or in the affairs of the audit client.

In turn, the following paragraphs consider, within their appropriate classifying factor, as indicated above, each of the twenty auditor-client (situations) relationships described in the present research questionnaire.

6.2.1 The reliance situations

One of the more important micro-level criticisms with external auditor independence stems from the auditor's reliance on his client. That reliance extends not only to the initial engagement, but also to the auditor's annual re-appointment.

The impact of that reliance is made more real because the client provides fee revenue to the auditor. Indeed, in some cases, the extent of that revenue can be an important consideration to the auditor, in terms of his (economic) life and standard of living. In turn, each of the two types of reliance (identified above) are considered in this chapter.

Reliance for (re-)appointment

Concern within this issue arises from the fact that auditors are (in practice) almost always appointed by the boards of client companies, and continue in office only at the behest, and with the approval of these boards.

Even though the Companies Act 1989 (Sec. 385) states that a company's auditors are to be appointed by its shareholders at a general meeting of the company, in practice, there is often little or no involvement in that process by shareholders, the entire matter being (effectively) dealt with by the board.

Thus, auditors owe not only their first appointment but also their continued office, to the directors. Further, if the board be so minded (within limitations and after due process) the auditor may be excluded from being reappointed.

Directors thus have effective power to "hire" and "fire" auditors. As such, is it reasonable to expect directors not to take cognition of the auditor's reliance on them, or, is it more reasonable to expect them to exert some form of pressure on auditors, on the basis that "he who pays the piper calls the tune" - especially knowing that if the piper refuses to play the desired tune, it is within their power to end the association and seek out a piper who will?

In audit terms, the analogous processes are a mix of "tendering" and "opinion shopping", whereby the board terminates the engagement of the auditor, mainly because he refuses to be as "pliable" as required, and the audit is then put to tender, with the board letting it be known what their preferred accounting method, on one or several relevant accounting issues, is.

Against such practices, Mitchell complains that "with a suitable firm selected, the directors ask shareholders to rubber-stamp their decision. Shareholders are kept in the dark. No details about the tenders ... are given." ["Bankruptcies raise questions over auditors" - Financial Times, December 6, 1990: 13]. In his view then, the basic issue is that inevitably, and in due course, auditors become "indebted" to the (board of) directors of the companies they audit.

Accordingly, Mitchell contends that there are severe pressures placed on the independence of auditors, as they owe their very appointment as auditors to the Board, and to that extent, become reliant on it. Further, as may be expected, that reliance increases as its relative importance in relation to the auditor's overall client and fee portfolio also increases.

For such reasons, it is argued, the auditor acquires an interest in the continuance of the client and, on that basis it is also argued, auditors will never be really be independent of their clients. Further, given that directors are agents of the shareholders, and that auditors are appointed to report on accounts presented by the same directors, a conflict element must arise.

So it is stated "no amount of new standards will persuade investors to trust figures, unless they know that accountants have no interest in buttering up the managers of the companies they audit." ["Blowing the whistle on accountancy" - The Economist, December 22, 1990: 16]

The Guardian states "that the obvious answer is to make auditors of ... companies truly independent of (their) clients through appointment by an outside body." ["Audit Reform" - The Guardian, December 5, 1990: 13]

Pearson and Ryans researched this issue in the US using four groups associated with audited statements. Two groups were CPAs from Big-Eight and nonBig-Eight firms. The other two were users of audited statements, being either Chartered Financial Analysts (CFAs) or holders of a Certificate in Management Accounting (CMAs).

In the context of management exerting pressure on the auditor, Pearson and Ryans [1981-82: 5] determined:

> "that over 70% of each of the four groups agreed with the statement that boards of directors of publicly-held companies should have audit committees consisting of outside independent board members as a means of assuring independence. Additionally, over 50% of each group registered their belief that audit fees and other arrangements should be determined by the board of directors/audit committee and the CPA firm, as a means of assuring CPA independence."

However, given that auditors are very often appointed by the board (or a committee of it), this research might have proved more fruitful had it asked: "Should CPAs be appointed by a totally neutral organisation; i.e. one not at involved with the client?"

Having been appointed auditor, one of the more real threats faced by him is the possibility of being replaced by another. No doubt, the extent of the threat is governed by the availability of, and degree of competition between, alternative auditors in the market [Shockley, 1981: 787 and 1982: 136; Lindsay, 1989: 5].

Lindsay [1989: 16] determined that "members of two important user groups perceived auditors who operated in highly competitive environments ... as having a higher likelihood of acquiescing to a client's demands." For these groups, the degree of competition was an important factor in the exercise of EAI.

In similar vein, Shockley [1981: 786] tested the hypothesis that "CPA firms operating in an environment characterised by a high level of competition are perceived as having a greater risk of losing their audit independence than are CPAs operating in a low-competition environment".

Shockley tested this hypothesis between and within four groups (and sub-groups) associated with the issue or use of audited financial statements (including CPAs). His results [Shockley, 1981: 791] revealed that, overall, respondents from all the four research groups perceived "that higher levels of competition increase the risk of independence being impaired".

As such, it is quite likely that this perceived threat assumes greater significance, and more than a touch of reality, when there are very good "commercially" pragmatic reasons for the replacement of a company's current auditors.

Such pragmatic reasons might well include the need for a uniformly associated set of auditors throughout the clients group's sphere of operations, as it is a widely held view that there are efficiencies and economies to be derived from the appointment of the same set of associated auditors across an enterprises' operations.

Such a recent example is seen in the appointment of Price Waterhouse as the (only) worldwide auditor for Dalgety Plc, the company having formerly used the audit services of Price Waterhouse, Touche Ross and KPMG Peat Marwick McLintock for specific parts and locations.

In making the announcement, the Finance Director stated "having three auditors was not a very efficient way of operating" and at the same time noted the trend for companies to cut down to just one firm of auditors for their worldwide operations ["Dalgety appoints Price Waterhouse" - Accountancy Age, March 7, 1991: 2].

A further example is seen in the appointment of PMM as auditors to Hoare Govett, following the latter's acquisition by Security Pacific. The change was held as "a move designed to bring about a more efficient centralised (audit) system worldwide" ["Audit Switch" - Accountancy Age, March 31, 1988: 2], as PMM were already auditors to Security Pacific.

The trend to one set of auditors is evidenced even within the area of bank and financial institution audits, where the practice of joint audits has prevailed for many years. Canadian law [Bank Act, 1980] requires banks to be audited by two auditors jointly.

One such recent example is the appointment of Price Waterhouse as the sole auditor to Nationwide Anglia Building Society, in preference to either of the two joint auditors (Coopers & Lybrand Deloitte and Touche Ross) previously engaged by the Society ["Nationwide drops auditors" - Accountancy Age, June 20, 1991: 2].

A second such instance is seen in the retention by National Westminster Bank Plc of Peat Marwick McLintock as sole auditors to the bank, displacing Ernst & Young who previously acted with PMM ["E&Y lose Natwest audit" - Accountancy Age, February 7, 1991: 2].

As still more evidence to suggest that even Big-Six firms are not immune to competition in the trend to rationalise audit costs and reassess the practice of joint-auditors, one more instance is offered. For example, note the removal of Deloitte Haskins & Sells as a joint auditor to Standard Chartered Bank, in favour of the continuing sole auditor (PMM) ["Solo Audit" - Accountancy Age, August 11, 1988: 2].

Auditors themselves are known to have made public their desire to audit their clients' activities in all the countries where the clients operate. For example, in 1989 Ernst & Young made a presentation to PA Consulting Group for their "worldwide audit assignments" ["Merger is last straw as Ernst lose PA audit" - Accountancy Age, August 3, 1989: 1].

Considering the above comments and (recent) facts, and the reliances showed in them, Situation 5 was developed to examine perceptions of the threat to EAI when there is insecurity attached to the auditor's tenure and (by suggestion) a competitive audit environment.

Fee reliance (nationally)

There are other aspects of the reliance of an audit firm upon its audit client. Reliance is restricted not only to the first appointment, for, once appointed, the client is the source of a continuing (but varying) proportion of the audit firm's total income.

Even a cursory observer would be alarmed if that proportion were more than 50%. Thus guidance offered [ICAEW, 1987: 20] states: "a practice, ... should endeavour to ensure that the recurring fees paid by one client or group of connected clients do not exceed 15% of the gross fees of the practice ...".

Obviously the intent of the guidance is to avoid auditors from becoming reliant on one particular source for a significant part of their fee income. But at what point does a proportion of fee income become materially significant to the practice concerned?

In general, the ICAEW sees amounts in excess of 15% as being the cut-off point. But could that point be seen by audit-users to be closer to 10%? Lueck [1986: 54] notes that German expression to the Eighth Directive allows for "the financial dependence of an auditor vis-a-vis a client (to be) questioned when more than 10% of the auditor's billings depend on a single client."

However in the words of a partner in one of the smaller firms of Chartered Accountants in London, "even 6% can be an influential proportion when times are tough ... as they are right now." [Private Interview - April 12, 1991.] This suggests that the proportion itself may vary with economic conditions and (perhaps) firm-size.

UK empirical research conducted by Firth [1980: 465] with three groups concerned with EAI (CAs, Financial Analysts and Bank Loan Officers) determined that a relationship where the firm received "15% of its gross fees from one client" was seen as non-independent by at least (roughly) half the respondents from each group.

In total, only about 20% of respondents considered the auditor to be independent in the situation. Respondents took that view despite the fact that the SEC and the professional UK and US audit bodies would (normally) view the auditor to be professionally independent in that situation.

Later research by Firth [1981: 184] examined how certain auditor-auditee relationships influenced lending decisions by bankers. The bankers were asked to assess various auditor-auditee relationships and state the amount of loan they would grant under each relationship and the totally independent one as well.

In a situation identical to the one above (i.e. 15% fee dependency), the mean loan granted by bankers was significantly less than that granted by them under an "independent" relationship. This would suggest that even a 15% fee dependency relationship was one that tended to cause concern with EAI and reduce confidence in the lending decision.

Similar research conducted by Dykxhoorn and Sinning [1982: 337-347] in Germany examined perceptions of EAI within 17 specified auditor-auditee relationships. One such was based on audit fee dependencies of varying (5, 10, 25, 50, and 75) percentages.

Their research was conducted within German banks (in West Germany) and examined the views of (49) Loan Directors and (31) Investment Directors. Inter alia, they determined that at a 10% fee dependency more than 80% of the respondents from both groups perceived the relationship to be independent. However, at a 25% fee dependency the comparable group fell to at least 30%.

Unfortunately they did not examine views based on a 15% fee dependency, as that might have been used as an appropriate yardstick in the UK. However, in the same research study, Dykxhoorn and Sinning concluded that perceptions of EAI significantly affected the loan decisions of the banker respondents used therein.

Mindful of the preceding findings and those in Firth's [1980] research, where most respondents appeared concerned when 15% of an auditor's fee income was derived from one client, Situation 12 was developed precisely to assess how dependence by an audit firm for only 10% of its total fee income on the firm's only listed client was seen by the research respondents.

Fee reliance (locally)

It is not uncommon for national London-based firms of auditors to operate on the basis of (smaller) local offices throughout the UK.

Thus, it is quite possible that while an individual audit client accounts for a significant proportion of the local firm's fee income, it constitutes an immaterial proportion in total national terms.

Nevertheless, given that individual local audit offices deal with their clients on a basis that is not governed by national considerations, it may be that perceptions of auditor-auditee relationships are essentially governed by local and not national considerations.

Against the preceding possibility, Situation 18 examined how EAI was perceived when 20% of the fee income of the local office of a Top Ten firm came from one client, but nevertheless accounted for less than 1% of the firm's national billings.

Thus, Situations 18 and 12 are very similar. The only main difference between them is the percentage of fee revenue generated from the client in question.

Situation 12 is one where the firm generated fee revenue of 10% of its total revenue (5% less than the cut-off limit suggested by the ICAEW's guide) from its only listed client. In contrast, Situation 18 is one where the proportion of revenue generated is 20% in local office terms, but only 1% in national terms.

6.2.2 The relationship situations

When auditors view or treat their clients on a non-arms length basis, then it is likely that their EAI may become impaired. Thus, it is of benefit to identify and examine situations that may cause auditors to drop their arms-length defence. Analyses [Shockley, 1982; DTI, 1986 and Waters, 1986] suggest that such situations may arise as a consequence of (inter alia):

1. the auditor having held office for a significant number of years (Length of Tenure).
2. the cross-transfer of personnel from the auditor to the client and vice-versa (Personnel Cross-Overs).
3. the presence of family ties (Family Relationships).
4. the effect of the personal prestige, position or power of client chairmen or other senior officers (Human Psycho-Dynamics).

Each of these possibilities are considered in relation to a situation in the research questionnaire.

Length of Tenure

Once appointed, auditors can legally remain in office indefinitely. Indeed, in some cases they are re-appointed to office each year without much question, and with little or no attempt to reassess their original (or continuing) appointment.

In such cases, in time, it is alleged, conflicts of interest develop because auditors develop "cosy" relationships with the managements of these clients - relationships which may very well reduce (impair) their professional audit integrity, objectivity and independence.

While stating that "close friendships" may indeed cause a threat to EAI, the ICAEW [1987] guidelines do not offer a precise explanation of what may constitute such a relationship. Hence audit practitioners are required to interpret the phrase "close friendships" according to their own personal yardsticks.

Nevertheless, if the guidelines tend to frown on "close friendships" only, one inference must be that friendships that are not close, are ethically and professionally in order.

As stated, the formal guidance offered in this context, to auditors by the ICAEW is less than precise. However it does state that:

> "Personal relationships can affect objectivity. There is a particular need, therefore, for a practice to ensure that its objective approach to any assignment is not endangered as a consequence of any personal relationship.
>
> By way of example, problems may arise where the same partner or senior staff member works for a number of years on the same audit ... " [ICAEW, 1987: 21]

When developing his conceptual model of EAI, Shockley [1982: 137] considered the possibility that this issue (length of time an auditor has been in office - i.e. tenure) may affect the risk of impaired EAI.

Shockley's model indicates both positive (in terms of beneficial effects caused by the provision of MAS) and negative (in terms of possible harm to the audit) causality on EAI, of an auditor's extended tenure.

In its report assessing the US audit profession, the Senate Committee on Governmental Operations [US Senate, 1976: 21] called for "a mandatory change of accountants after a given period of years", stating that:

> "long association between a corporation and an accounting firm may lead to such close identification of the firm with the interests of its client's management, that truly independent action by the accounting firm becomes difficult"

In comparable UK terms, the DTI states that:

> "it is arguable that in situations where there is a long standing relationship between a client and a firm of auditors, standards of objectivity and independence may not be as strict as might otherwise be the case." [DTI, 1986: 31].

Thus, in order to avoid such a situation the DTI suggests that one "approach might be to require a change of auditors at regular intervals, so as to limit the scope for any identification of interests between auditors and management." [DTI, 1986: 31].

Proponents of such suggestions argue that since, in the rotating scenario, the auditor's tenure would be fixed, his incentive to resist pressure from management would be considerably enhanced.

Equally, these proponents suggest, that when new auditors are appointed to an audit, they would usually bring a fresh perspective (and viewpoint) to the client and the relevant audit. Simplistically expressed, the basic underlying justification for that view is the belief that "new must be better".

However, on the other hand, the CAR [1978: 109] determined that according to their studies of substandard performance by auditors, "several of the problem cases were in fact first or second-year audits". The Commission's view was that it may well be there is a higher audit risk associated with new audit clients, rather than ones of long-standing.

Further, in the Commission's view, there might even be a reduction of audit risks once an auditor becomes well acquainted (over time) with the operations of a client. Accordingly, it concludes that "if a relationship between audit failures and new clients does exist, rotation would increase the problem and be detrimental to users." [CAR, 1978: 109].

In summary then, the basis for any possible association between a lack of independence and auditors of long standing, is the view that over long periods of time, "close personal relationships" could or do develop, between the auditor and the management of the client.

[In practice, one must not ignore the fact that many firms do rotate both partners and staff on clients, some firms rotating the second partner each year!!]

In empirical terms, Shockley [1981: 785-800] conducted research into the effect of tenure (5 or fewer years, contrasted with more than 5 years, of holding office) on perceptions of EAI.

Shockley's research was conducted amongst four groups associated with (or the use of) audited statements.

1. Partners in Big-Eight CPA firms.
2. Partners in other CPA firms
3. Commercial Loan Officers
4. Financial Analysts.

The only group where significant effects for the tenure factor were evident was with the Loan Officers. All other groups indicated tenure not to be a significant determining factor. Interestingly, some respondents actually perceived an increase (rather than a decrease) in EAI, as the tenure increased.

Thus, there is evidence of a two-way significance related to the tenure factor. As such, Shockley [1981: 798] advises caution in interpreting his result, stating:

> "The non-significance of the tenure factor ... must be interpreted with caution. Individual analyses indicated that of the 36 subjects who found the tenure factor significant, 17 weighted it in the direction opposite to the hypothesised negative effect."

In examining perceptions of EAI in the situation where "an audit partner has been in sole charge of a large audit (taking up to 3 months of the partner's time) for the past ten years", Firth [1980: 451-466] determined that tenure (in and by itself) did not appear to be an EAI influencing factor, because at least 78% of all the research groups perceived that auditor-auditee relationship as being independent.

A comparable study by Bates et al [1982: 60-63] investigated the effect of varying lengths (and forms) of auditor-client affiliation on auditing judgements.

The results showed that auditing judgements made by the group of auditor respondents that were not subject to rotation, were more generous towards their clients. In contrast to Firth's [1980] findings, the overall indication was "that auditor judgements do appear to be affected by long-term auditor-client relations."

Against that background, Situation 1 was developed to examine views of EAI when the auditor has held office for an extended time (15 years). Thus, given varying views on this aspect of EAI, it was of interest to see how it was seen by issuers and users of audit reports.

Personnel Cross-overs (audit firm to audit client)

Another possible means of breeding and concurrently manifesting a possible "cosy-relationship", between auditor and client is, the appointment of partners (or senior audit staff) as Directors of audit clients. Exceptionally, the reverse process whereby senior client staff are employed by the audit firm may obtain.

In fact, it is not uncommon for senior staff in audit firms to become officers of the clients they previously helped to audit. Indeed, some enter auditing in the hope that it will provide such an opportunity and (it is alleged) certain firms are very disposed to such arrangements, fostering them to the extent possible.

Such fertilisation by the audit firm is not without merit from the client's view. The transferring auditor will have usually audited the client's financial system and records. In doing so, he would have acquired a good knowledge of the client's MIS and learnt many of the unique aspects and problems of its operations.

Additionally, he would be able to offer the client the breadth of his experience with other systems and businesses - factors not readily available to the client, but ones that are certainly of benefit to it.

However the negative implications are that the threat to independence in such situations arises by virtue of the fact that the current work, results and decisions of such former senior audit staff are now required to be audited by former (and usually) less-senior staff.

On that basis, some concerned analysts ask how objective can the ensuing audit be, and can the audit staff impartially consider the explanations offered by their former partners or audit managers?

In fact, there is some limited basis for a justified measure of concern. Some auditing cases (Escott v. BarChris for instance) "have revealed instances of audit staff members accepting false accounting representations" from senior financial staff of audit clients, such staff having previously been employed by the audit firm in question [CAR, 1978: 100].

In this context, the CAR [1978] looked at the issue of Executive Search and Placement - a service most large audit firms offer their audit clients and non-clients.

To clarify, the term "placement" refers to finding employment for professionals terminating their employment in the audit firm, with an audit client. The term "executive search" covers employment services other than placements.

In the view of the Cohen Commission, "there is a potential for conflicts (of interest) arising from executive search and other personnel recruitment service." However, the Commission also believed that "the adverse implications of this particular independence problem are easily outweighed by the benefits of the present manpower development structure." [CAR, 1978: 101-102].

While the phenomenon of placement is certainly present in the UK, no published research is at hand to quantify its extent. One relatively recent UK example is to be seen in the appointment of Michael Armitage (a former Binder Hamlyn partner) as the Group Finance Director of Eurocopy PLC, which continues to be audited by staff from Armitage's former Binder Hamlyn office. ["Partner Quits" - Accountancy Age, August 18, 1988: 2].

More recently (July 1991), one notes the appointment of Kathleen O'Donovan, a former London audit partner with Ernst & Young, as the Finance Director of BTR Plc.

It is reported that while with Ernst & Young, O'Donovan was involved with the audit of BTR for 13 years, the last two as the audit partner responsible for it ["BTR chooses female auditor for FD" - Accountancy Age, June 20, 1991: 2].

While the guidelines of both the ICAEW and the AICPA refer to the situation where an officer of a client, becomes a partner in the firm auditing the client, they appear to be relatively silent on the reverse (a former audit partner becoming an officer in an audit client).

However, interpretation of the ICAEW's and AICPA's position, shows that, in general, employment or directorships in audit clients by former audit partners (or senior staff) is ethically acceptable.

Nevertheless, acceptance is based on the proviso that the partner sever all financial relationships with the firm so that no leverage is available to him, by which he may influence his own personal income via profits of the firm, and in addition he must clearly hold himself out to be no longer associated with his former firm.

The AICPA [1978: 4447] makes a distinction between the decision to engage an employee and the putting forward of a short-list of highly recommended candidates.

The AICPA's view is that if the client takes the final decision to hire a candidate, and the audit firm's role is confined to merely putting forward a list of very recommended names, then no impairment of independence is likely to prevail.

However, given the merits of a client engaging staff previously engaged on its audit (and who would therefore already be cognitive of the client's financial systems), one wonders how persuasive such a distinction really is. Is it one that is easily made by users of audited accounts?

Imhoff's [1978] research on this aspect of EAI in the US, sought to evaluate the potential external auditor independence problems posed to continuing auditors by CPAs from these firms accepting employment with one of their clients. The research was conducted with selected users of audited financial statements and (a nonrandom sample of) CPAs in local US offices of only two Big-Six firms.

Thus, recognising any consequent inherent limitations, the research revealed that, within a given time frame, 23% of audit staff had left employment with their audit firm, and of them, 20% had taken up employment with a client.

Imhoff's research also determined that the severity of the independence problem was different for the two groups, and that the rank (supervisor or non-supervisor) of the auditor, and the length of time elapsed between auditing the client's records and later employment by the client (time interval), were factors influencing the severity with which impact on EAI was seen by both groups. In both cases users were more sensitive to rank and elapsed time than the auditor group.

Firth's [1980: 451-466] study of facts similar to those of Situation 9, showed that of the four groups studied, at least 65% of each group, and 71% of all respondents together, perceived the situation to be an independent auditor-auditee relationship.

On that basis, employment by an audit client of a former partner from its firm of auditors, is generally not seen as a threat to EAI by these groups of persons concerned with it. However, bankers used as respondents in a later study by Firth [1981: 179-188], registered their willingness to grant significantly lower loan facilities based on a relationship of this nature, than when compared to the comparable loan granted on an "independent auditor-client relationship". To that extent, these findings echo those of Imhoff [1978].

Against the preceding considerations, Situation 9 was developed to assess perceptions of EAI where a (former) partner in the company's (continuing) auditors is appointed as MD of an audit client.

Personnel Cross-overs (Audit client to audit firm)

Audit firms are not only the occasional providers of personnel for their clients. They are (sometimes) also the recipients of personnel from their clients.

The AICPA [1986: 4411] addresses concern with this phenomenon indirectly when it states that the independence of a member (or a firm in which he is a partner) shall be impaired if a report is made on statements and if:

> "during the period covered by the financial statements, during the period of the professional engagement, or at the time of expressing an opinion, (an auditor) or his firm ... was connected with the enterprise as a ... member of management or an employee"

In further clarification, the AICPA [1986: 4419-5] states when citing cases where EAI would be impaired in appearance, that this does not apply to an auditor (or his employee):

> "solely because he was formerly associated with the client in any capacity ..., if such employee has disassociated himself from the client and does not participate in the engagement for the client covering any period of his association with the client"

According to the German Stock Corporation Law (1965), an auditor is prohibited from auditing a company if he had an employee-employer relationship with it during the three years prior to his appointment as auditor. In practice, this generally means "responsible and continuing" employment of the auditor by the client for these three years [Dykxhoorn and Sinning, 1981: 98].

The Australian Institute of Chartered Accountants [ICAA, 1984: 23062] also recognises the possibility of impaired EAI in such circumstances, when it states:

> "No person ... shall personally take part in the exercise of the reporting function in respect of a client if, during the period in respect of which the report is to be made or at any time in the twelve months prior to the first day of the period in respect of which the report is to be made, the person or a near relative has been an officer ..., partner or employee of the client"

The ICAEW provides for the possibility of staff moving from employment with a client to engagement as a professional with the audit firm, declaring that:

> "No one should personally take part in the exercise of the reporting function on a company if he has, during the period upon which the report is to be made, or at any time in the two years prior to the first day thereof, been an officer (other than an auditor) or employee of that company" [ICAEW, 1987: 24].

While there is no hard evidence of significant movement of staff from clients to firms in the UK, there is a growing trend for firms to absorb staff from sources other than their own trainees or other audit firms.

For example, many audit firms have set up specialised financial services departments, often (but not always) within their consulting divisions, to provide advice on the increasing complexities of the financial markets. To staff such specialised departments audit firms have had to recruit staff from outside sources.

For instance, Price Waterhouse recently appointed a senior banker from the Bank of England to be chairman of their world regulatory advisory group for banks and other financial institutions. On occasions, audit firms have even resorted to hiring staff from their clients, and there is a growing trend of them recruiting staff from the Tax and VAT Departments of the Government.

An example of this is seen in the case of a former Inland Revenue regional controller joining Price Waterhouse as head of a new division assisting companies facing tax investigations ["Revenue defector" - Accountancy Age, February 25, 1988: 2].

Situation 17 was presented for consideration against the background of varying periods of the critical employer-employee relationship - 3 years in Germany and in effect, 2 and 3 years respectively in Australia and UK. In the US it appears to be the period covered by the relevant audit report.

Thus, Situation 17 was presented in order to see if its facts evoked a measure of concern with respondents, given that the ICAEW would (normally) see nothing ethically repugnant in them.

Family Relationships

Professional auditing bodies recognise that the existence of close family ties between the auditor and the owner and/or a senior officer of the audit client may pose a threat to the independence of the auditor, and so can be perceived as a provocation to EAI.

The matter is specifically recognised by the ICAEW, when it states in notes to its guidance document that:

> "Such (EAI) problems can also exist in situations of close friendship or relationship by blood or marriage ... " [ICAEW, 1987: 21]

However, guidance given by the ICAEW [1987: 19] is intended to be less than fully definitive, on the basis that "guidance ... cannot be all embracing and it is for members to use their own good sense in applying the spirit of the guidance".

The parallel guidance on the issue offered to auditors in Ontario (Canada) by the ICAO, is very similar to that offered by the ICAEW, with the ICAO also refraining from offering any precise formal guidance on particular or specified close relationships.

The ICAO's guidance, found in its Professional Conduct Rules, which in terms of "close relationships" and rules on "objectivity" (used as a more pragmatic synonym for independence by ICAO), in Rule 204 states:

> "Where one or more close relatives of a member, even if not having the same home as the member, holds a material interest in any organization, the member and his firm, is unlikely to have the appearance of objectivity" [ICAO, 1982: 608]

As does the ICAEW, the ICAO [1981: 608] refrains from offering guidance on specified close relationships stating that, "the facts in each case determine whether or not there appears to be an acceptable degree of objectivity," while indicating the readiness and willingness of its professional conduct committee "to give rulings in individual cases."

In contrast, the AICPA's approach is to provide precise guidance based on hypothetical situations and so its Professional Standards [AICPA, 1986: 4437] distinguish close relationships on the basis of "spouses and dependent persons" and "nondependent close relatives".

It further distinguishes such relationships on the basis of whether or not they are "audit sensitive". In general, its view is that close relationships with audit sensitive persons impair the appearance of EAI.

The relevant AICPA [1986: 4419-7] ruling states that:

> "members must be aware that it is impossible to enumerate all circumstances wherein the appearance of a member's independence might be questioned by third parties because of a (close) family or dependent person relationships."

Hence the AICPA [1986: 4419-7] advises its members to assess **all the relevant factors** in order to determine whether:

> "a reasonable person aware of all the facts, and taking into consideration normal strength of character and normal behaviour under the circumstances, (would) conclude that the situation poses an unacceptable threat to the member's objectivity and appearance of independence"

Additionally, in order to provide even more formal guidance on this issue, the AICPA [1986: 4419-7] goes on to state that:

> "the independence of a member and his firm is impaired with respect to the enterprise if:
>
> 1. A proprietor, partner, shareholder, or professional employee, any of whom are participating in the engagement, has a close relative who:
>
> a: can exercise significant influence over the operating, financial, or accounting policies of the client;
>
> b: is otherwise employed in a position where the persons activities are audit sensitive;
>
> c: has a financial interest in the client that is material to the close relative and of which the proprietor, partner, shareholder, or professional employee has knowledge.
>
> 2. A proprietor, partner, shareholder, or managerial employee, any of whom are located in an office participating in a significant influence over the operating, financial, or accounting policies of the client."

Quite clearly, the issue of close personal relationships does not lend itself to clearly defined rules. However, while the ICAEW offers minimal formal guidance on it, the AICPA is more forthcoming in clarifying EAI problems of this nature.

Indeed, the AICPA offers a pertinent question and answer based on facts similar to those of Situation 20. The question relates to a situation where the brother of a partner in an audit firm "is a stockholder and one of three vice-presidents of a closely held" company, the firm being located in the same locale as, and acting as auditors to, the relevant corporation.

Clarifying EAI considerations in this situation, the AICPA states that "the appearance of independence is lacking since the relationships between the member and his brother are presumed to be so close as to suggest that the member may not be objective in his examination" [AICPA, 1986: 4437].

Firth [1980: 451-466] examined perceptions of EAI in a similar situation, where the Controller (a non-elected financial employee) of a company was the brother of the partner in the firm auditing the company's accounts, and the controller's brother was "the partner in charge of the audit".

Firth's research showed that for this situation, a minority of (at least) 13% of the groups surveyed felt the situation reflected an independent auditor-auditee relationship. [UK auditing bodies would certainly consider the relationship to be non-independent.]

However, Situation 20 differs from Firth's (preceding) situation in two important respects:

1. In Firth's situation the relationship is assessed around the client's controller, whereas the present situation relates to the client's Managing Director.

2. In Firth's situation the partner responsible for the audit, is the controller's brother, whereas in the present situation, the audit partner is a partner of the MD's brother, and the brother takes no part in the audit.

In the same study, Firth [1980: 463] assessed views of EAI in a relatively similar situation reflecting a family relationship, except that:

1. the family relationship assessed was that of a brother-in-law (not brother), with a senior employee of the audit client being so related to a partner in the firm auditing the company's accounts.

2. the partner responsible for the audit was not the brother-in-law of the senior employee of the client.

3. the senior employee was not "directly involved in the financial affairs" of the client, being employed as its Sales Director.

In relation to this situation, Firth determined that at least 80% of all the research groups he surveyed perceived the relevant relationship to be independent. However, consistent weak concern with EAI was noted across all groups, with at least 10% of each putting forth a "not independent" opinion on the relationship.

Against that background, Situation 20 was developed to judge how concerned respondents might be with an auditor-auditee relationship with indications of a close personal (fraternal) relationship between the partner of the client's auditor and the client's MD.

Human Psycho-Dynamics

Even if one ignores the alleged "vulnerability" of the auditor caused by the basis on which his initial and annual appointments are made, and the threat posed by close or family relationships, one must recognise that as individual human beings, auditors also reflect human qualities, features, weaknesses and characteristics.

On that basis, it must be reasonable to expect some auditors to stand in awe of persons wielding dominant power; whether such power be a reflection of financial success and acumen, political standing or any other factors.

The ICAEW recognises just such a potential threat to EAI when it states that "problems may arise where ... work is being done for a company dominated by one individual" [ICAEW, 1987: 21].

The question then arises as to how auditors respond to such persons holding important positions with audit clients and/or powerful positions in society.

In this regard, Waters [1986: 17] states that a lack of auditor independence can often be caused by factors much more subtle "than the obvious cases of pressure from directors".

In support Waters offers remarks made by Sampson Marks, a partner in Citroen Wells, (auditor to many of the private companies run by John Stonehouse, who at that time was a former PMG, respected politician, MP and an apparently successful businessman) to DTI inspectors appointed to examine the affairs of the failed London Capital Group in 1974.

Referring to his relationship with Stonehouse, Sampson Marks stated (in his defence):

> "When one is dealing with somebody who, through government posts, one had assumed to be a person of integrity ... a person who had been so responsible that he had been given ministerial posts, it did not occur to one that monies were being used for improper purposes."

In this context Waters [1986: 17] contends that "the auditor's keen eye was dimmed by preconceptions about and familiarity with a company director".

A similar instance is that of (the late) Robert Maxwell and Pergamon Press Limited, which was effectively controlled and dominated by him. In the late 1960s the company was the subject of a DTI enquiry under Sec. 165(b) of the (then current) Companies Act 1948. Having assessed the relationship between Maxwell and Chalmers Impey (now part of Kidsons Impey) - auditors to Pergamon Press Limited at the time - the inspectors state the company's auditors "should not have been satisfied by Mr. Maxwell's ever ready explanations and that they (Chalmers Impey) failed to rumble him."

Elsewhere, the DTI Inspectors' report goes on to state:

> "In considering Chalmers Impey's position it should be remembered that ... Mr. Maxwell enjoyed an enviable reputation in the City of London and the political world, and seems to have been able to overwhelm almost everyone with whom he had dealings by the force of his personality. Even now some scientists and academics ... believe they cannot deal with anyone other than Mr. Maxwell over the question of learned journals."

Such acceptance and trusting of senior corporate personnel is not a phenomenon restricted to the era of the sixties and seventies. Even now there is concern in this direction. For example, at a recent seminar on "Avoiding Corporate Failure", Barbara Mills, head of the Serious Fraud Office, "called upon auditors to resist pressure from strong-willed chairmen and chief executives" (i.e. resist pressure on EAI) to concur with creative sets of accounts ["Auditors blameless says report" - Accountancy Age, June 6, 1991: 3].

While ethical codes refer to the more tangible aspects of EAI, it would be impractical for them to make comments (other than in the most general of terms) on the more involved aspect of the human dynamics that also influence such matters. As such, it is of consequence to see how respondents view such human dynamics and Situation 19 is an attempt to do just so.

Against such considerations, Situation 19 was developed to see how potential audit relationships (environments) not formally addressed in relevant guidance, are seen by the research groups. The situation was developed to test for the possibility that questions such as the relative strength of the auditor vis-a-vis a powerful and respected client chairman may figure in one's view of when and how EAI is impaired.

6.2.3 The pressure situations

It is a naive and somewhat simplistic view to expect auditors to be free of **all** forms of pressure when performing their professional duties. For, as the audit profession in many countries is presently structured, auditors must run their organisations and offices on a sound economic and commercial basis in order to remain operating.

Thus, auditors must be concerned with economies when purchasing materials and (inter alia) must be concerned with managing cash-flow efficiently. They must also be concerned with efficiency and productivity, client satisfaction and, in the final analysis, they must be concerned with retaining clients. For without clients, the auditor has no professional purpose.

In general, users and beneficiaries of audit services have recognised the threat such considerations place on auditors, and in the main appear to have been satisfied that auditors have not fallen victim to such pressures.

Recently however, there has been strong criticism of, and concern with, certain pressures encountered by the auditor in fulfilling his professional duties ["Bankruptcies raise questions over auditors" - Financial Times, December 7, 1990: Supplement V].

Such pressures tend to be of two broad categories. Firstly pressure from the client, in the form of "client pressure" and secondly pressure from the immediate society (community) in which the auditor operates, in the form of "social pressure".

Some of the more common forms that client pressure (and responses to it) may assume are: Excessive Time Pressure and Excessive Budget Pressure. Social pressure may assume a variety of forms, often garbed in the form of considerations of (pressure from) the surrounding society, or elements of it (Community Pressure).

There appears to be some basis for these concerns, both in the US and the UK. In the US, the CAR [1978: 94] stated that the "relationship between management and the auditor needs to be modified substantially to provide more support for the auditor's independence."

In the UK, the Labour MP, Austin Mitchell, maintains that a major problem with the audit profession is that "audit firms are too dependent on their clients" ["Mission to keep contestants out of judges' beds" - Financial Times, December 13, 1990: 15]. Hence the next three segments are devoted to an analysis of the nature of, and empirical assessment of the underlying extent of, concern with the above pressure factors.

Excessive Time Pressure

It is not unknown for some audit clients to exert strong pressure on their auditors by requiring them to complete their professional duties within a highly limited time period. Such pressure is usually referred to as "time pressure", and denotes both the influences and the attempts, to reduce time spent on the audit.

One possible basis for such time pressure is a widely held belief (more prevalent in the US than the UK) that efficient corporate financial management is manifest in an extremely prompt release of its audited financial results, shortly after the company's fiscal year-end.

Further, in the belief that perceptions of such efficient financial management positively influence a company's share price, auditors of some listed companies are sometimes additionally pressured by the senior management in these companies to release complete audited results within extremely limited time intervals after the company's year-end.

However, there is insufficient evidence to confirm a direct causal relationship between these time-related phenomena. Timely financial reporting is of course desirable, but it is unclear if, by itself, undue speed in the issuing of audited results is of any merit.

Indeed, "empirical investigations indicate that share prices are rarely affected by the issuance of annual reports" [CAR, 1978: 119]. This finding is consistent with the Efficient Market Hypothesis, which contends that, on publication of audited corporate data, it transpires that the market has almost always already taken regard of the information so presented.

Thus, in an effort to conform to the wishes (pressures) of the client, audit partners sometimes exert significant pressure on their staff to complete audit procedures faster than practically possible, or with less diligence than that professionally required.

If this is a continuing phenomenon, then considerations other than professional thoroughness have been regarded by the partners concerned, and in so doing their EAI (and that of their staff) may well have been impaired.

Thus, if time pressure is unreasonable, it places a strain on the auditor's professionalism, causing him to "cut corners" and in so doing to (perhaps) cast aside an independent and impartial attitude of mind towards the client's affairs. The CAR [1978: 115] states that "although there are other factors, the Commission believes that excessive time pressures are one of the most persuasive causes of audit failures."

In the relevant words of the Commission [CAR, 1978: 116]:

> "closely related to budget pressures imposed by the public accounting firm are client (imposed) time pressures that sometimes cause the auditor to subordinate judgment to unreasonable demands and, therefore, to compromise independence."

No published results appear to be available for the presence of such phenomenon in the UK, but the Cohen Commission in the US, stated that "56% of respondents still in public practice had signed for completing audit steps (not covered by another compensating audit step) when they had not performed the work" [CAR, 1978: 116].

The Commission believed this audit deficiency to be the "most serious, for it reflects on the auditor's own control system for the audit." It concluded that "elements of the business environment such as arbitrary time deadlines affect the quality of the audit, place unnecessary stress on the auditor's independence, and should be changed" [CAR, 1986: 94].

Against the preceding background, Situation 11 was developed and presented in order to assess how any threat to professional EAI is perceived within the UK audit environment, in a situation where there is intense audit completion pressure being levied on the auditor by the client.

Excessive Budget Pressure

Another type of pressure (closely related to time pressure) a client may exercise on the auditor is that of fee pressure - specifically intense pressure to operate under a very restricted fee (and time) budget for the audit.

Manifest in its most extreme form, such pressure assumes the form of a questioning of, and resistance to, even the most efficiently priced and optimal audit fee. In audit terms, such pressure is referred to as budget pressure.

However, given that audit costs are an element of overhead, and good financial management dictates that all overheads be contained to their lowest optimal levels, a certain level of budget pressure is in fact healthy, and should not necessarily be perceived as a negative phenomenon in terms of external auditor independence.

Thus while realistic fee (and time) budgets are important and to be welcomed, unacceptable consequences arise if less than economical fees cause audit hours to be thoughtlessly reduced, without regard to the effect on audit quality. Similar views are expressed by a Working Party of the ICAEW [1986: 78-79] which states:

"Current competitive pressures may lead to practices which could jeopardise independence and compromise technical performance. These pressures represent a threat which has grown in importance in recent years."

However such pressures appear to have been present in the US for some years now. Indeed, to an extent they may have become institutionalised within the auditing profession there, for an introductory text book on auditing [Stettler, 1970: 36] even alerts potential auditors to the fact that budget "pressure is always present and is often severe."

In summarising its views on the issue, the Cohen Commission [CAR, 1978: 116-118] states that:

> "it is reasonable to assume that excessive competition producing low fees can cause unrealistic budgets, and that such budgets can increase substandard performance ... When a budgeting system induces behaviour such as signing off for work not performed or performing work but not recording the time for billing purposes, that budgeting system is producing conduct that is the opposite of the goals of a budgeting system and is inconsistent with professional auditing standards."

Against the foregoing, Situation 10 was developed in order to assess if the application of excessive budget pressure by the client was seen as cause for concern by the four research groups, and if so, to quantify the absolute and relative concern of each group.

Community Pressure

The ICAEW describes a practice as being "all the offices carrying on the practice of accountancy within Great Britain, Ireland, the Channel Islands or the Isle of Man under the same or similar name" [ICAEW, 1987: 20].

In doing so, it gives implicit recognition to the fact that, at times, local considerations and priorities of an office within a national practice, may not always be the same as those of the latter, and as such, the matter warrants attention in a professional context.

Further implicit recognition of the importance of local considerations and criteria is made evident in the ethical guidance document issued by the ICAEW [1987: 20], wherein it is declared that:

> "in circumstances where a member is dependent for his income on the profits of any one office in a practice and the gross income of that office is regularly dependent on one client or a group of connected clients for more than 15% of its gross fees, a partner from another office of the practice should take final responsibility for any (audit) report made ... on the affairs of that client".

Thus, given the practice structure of the audit profession in the UK, it is not uncommon for a firm of auditors located in smaller non-urban areas, to act as auditors to, in local terms, a very large and important local business organisation (almost always a company).

In many cases, such companies are the largest employer in the area, and consequently the employment, lives and economic activities of a large number of persons in the area, are dependent upon and integral to the financial success and well being of the company in question.

In fact, such dependencies are not limited only to the employees of the company in question, but extend to all those whose economic activities (and lives) are, to one extent or another, governed by and related to the needs of these employees (i.e. the economic ripple effect).

Thus, the ramifications of adverse comments on the business affairs of a local client may often have wide-reaching financial and socio-economic effects. Aware of the local ramifications his comments may raise, a local auditor may unduly consider the consequences of any adverse audit report he may finally determine for a local client, and to that extent, local considerations may have some leverage over opinions arrived at by local audit firms.

If however, as implicitly recognised by the ICAEW, ultimate responsibility for the local audit were taken by staff from a(n) (associated but) non-local office, then scope for such local considerations will be reduced.

Such pressure presents an interesting feature because, in such circumstances, the auditor himself does not stand to benefit from any deviation from ethical standards.

The benefit would appear to devolve primarily on the members of the local community with whom the auditor works and lives - giving basis to the view that such "altruistically" inspired thinking assumes some place in the auditor's thinking and behaviour.

Referring to the possibility of such a situation obtaining, Moizer [1991: 40] presents this aspect of the external auditor independence issue in the following words,

> "Auditors should report truthfully irrespective of the consequences. To what extent auditors do ignore the consequences of their actions is impossible to answer, because the data to the answer the question is unobtainable. However, it has to be allowed that ... on certain, admittedly rare, occasions an auditor may prefer to report dishonestly from entirely altruistic motives (i.e. taking account of the interests of others rather than the auditor's own self-interest)."

Against such considerations and background, Situation 16 was developed to assess if respondents are concerned with external auditor independence, in a situation where the local office of a Top Ten firm in a small provincial town, acts as auditor to the largest employer in that area.

6.2.4 The involvement situations

The ICAEW recognises that financial involvements by its members with audit clients can pose a threat to their professional independence. Its guidance on the matter [ICAEW, 1987: 21] is brief, stating (inter alia): "Financial involvement with a client may affect objectivity (and) ... can arise in a number of ways."

However the position held by the AICPA is offered in much greater length in its Ethics Section 100 [AICPA, 1986: 4391-4452], with the document's essential stand being encapsulated in Rule 101, which (inter alia) states that:

> "Independence (of an auditor) will be considered to be impaired if ... during the period of his professional engagement, or at the time of expressing his opinion, he or his firm ... had or was committed to acquire any direct or material indirect financial interest in the (audited) enterprise ..."

An analysis of the relevant sections of the ethical positions of both institutes suggests that two of the more important methods by which such (direct or indirect) financial involvements might arise are:

1. the auditor acquiring a financial interest in the audit client
2. the auditor entering into commercial arrangements with the audit client

Thus, in order to avoid financial involvements of either type, auditors are normally required to refrain from acquiring a pecuniary interest of whatever sort in their clients and, from entering into relationships with their clients on a commercial or similar basis.

The auditor acquiring a financial interest in the audit client:

Examination of this type of threat to EAI shows that an auditor may acquire a (direct or indirect) financial interest in his client through a number of means, some of the more important ones being:

1. Financial indebtedness (client to auditor)
2. Financial indebtedness (client to auditor's MAS arm)
3. Ownership of trustee shares (auditor in client)
4. Directorship (by the auditor) in an investment trust owning shares in a client of the auditor
5. Auditor's acquisition of an indirect financial interest in the client as a resulting of lowballing

Financial indebtedness (client to auditor)

One indirect (and involuntary) means by which an audit client may become materially indebted to the auditor is through the non-payment of audit fees due to him. In this case, if the amount(s) is(are) material, then EAI may be impaired if more than one year's fees remain unpaid to the auditor, when the audit report is signed.

For, in circumstances such as these, unpaid amounts of that nature take on some of the features of a (short-term) loan, and so it may reasonably appear that the auditor is providing working capital for the client.

More critically, it may be that the receivability of amounts due to the auditor will depend on the nature of the auditor's report on the client's statements. Thus, the ICAEW and AICPA (normally) prohibit auditors from granting loans to, or taking loans from, their clients.

With minor exceptions, the ICAEW prohibits loans to (or from) the practice and/or those closely related to a partner in it, from (or to) clients. Its basic position is summed up in the ruling that "a practice should not make a loan to a client, nor guarantee a client's borrowings, nor ... accept a loan from a client or have borrowings guaranteed by a client" [ICAEW, 1987: 23].

Also with minor exceptions, the AICPA states that EAI is impaired if, during the audit engagement, or at the time of issuing his opinion, the auditor or his firm "had any loan **to or from** the (audited) enterprise or any (of its) officers, directors, or principal stockholders." One such exception is the allowance for loans "made under normal lending procedures, terms and requirements" [AICPA, 1986: 4413-4414].

In particular, the issue of continued non-payment of fees to the auditor is addressed in the AICPA's Ethics Ruling No. 52 on "Independence, Integrity and Objectivity" when it states (assuming materiality to both client and auditor) that "at the time a member issues a report on a client's financial statements, the client should not be indebted to the member for more than one year's fees" [AICPA, Professional Standards, Vol. 2: ET Section 191.104]. In contrast, the ICAEW offers no ruling based directly on such circumstances.

Consequently, against that background, Situation 6 was developed in order to assess if, in a situation where there was indebtedness by a client to the auditor for the previous year's audit fees, concern was expressed by the four research groups with regard to the quality of EAI contained therein.

<u>Financial indebtedness (client to auditor's MAS arm)</u>
Companies in difficulties often request (or are obliged to take) MAS from their auditor's consultancy arm. In order to allow for such instances, some audit firms go to great lengths to establish consulting arms that are (related through common ownership, but nevertheless) distinct entities functioning quite autonomously. [For example, see "SEC recognises Andersen's split" - Accountancy Age, August 30, 1990: 2.]

Rightly, such organisational barriers are erected in order to obviate even the most remote possibility of executive or managerial involvement in the affairs of the client by the audit firm itself.

As such, there is no permanent pooling of staff resources for (audit and consultancy) assignments, (though permanent transfers may occur), and in effect "Chinese Walls" are erected between the auditing and consulting arms of the firm.

Regrettably, on occasions the consulting and advisory services come too late, and for that or another reason, they do not result in a turn around of the company. A creditors' liquidation is usually the enforced result. A by-product may be that consulting fees incurred often remain unpaid to the consulting arm of the audit firm.

It appears that neither the AICPA nor the ICAEW offer any clarification about EAI in the situation where material fees are unpaid by a client to an organisation closely associated with (but separate from) the auditor. Are the above circumstances to be viewed in the same way as unpaid fees to the auditor? If so, are they also a threat to the independence of the audit firm, given that material unpaid audit fees can constitute a threat to EAI?

Thus, it is of interest to see how material consulting fees, when unpaid to the consulting arm of the relevant audit firm, are viewed both by the issuers and users of audit reports. Against that background, Situation 2 was developed in order to assess how such circumstances were seen by each of the four research groups.

Ownership of trustee shares (auditor in client)

The area in which this issue falls is "the financial involvement with or in the affairs of clients." In this regard, the ICAEW distinguishes between an auditor owning shares on a non-beneficial (trustee) or beneficial basis and in private or public companies.

US and UK ethical requirements prohibit the auditor from holding shares in private or public companies audited by them (or in their group companies) on a beneficial basis. However, in the UK only, auditors are permitted to hold shares in companies audited by them, on a trustee (non-beneficial) basis.

The ICAEW's position with regard to auditors holding trustee shares in public companies audited by them is:

> "A practice should not have as an audit client a public company if a partner in the practice, or the spouse of a partner, is a trustee of a trust holding shares in that company and the holding is in excess of 10% of the issued share capital of the company or of the total assets comprised in the trust" [ICAEW, 1987: 21].

The guidance document goes on to state that, in general, and in situations other than those described above, a partner who is a trustee (or the spouse of a trustee) of shares in an audit client, should where possible not personally take part in the audit.

Further, in these instances, such shareholdings should be disclosed in either the accounts themselves, or the directors' or audit report.

The ICAEW's position with regard to the auditors (or their spouses) of private companies holding trustee shareholdings in them is similar. Firstly, they require such shareholdings to be similarly disclosed (as above), and secondly where possible, a review of the files in the companies should be undertaken by a partner other than the one holding the trustee shares.

Applying the above guidance to the facts of Situation 8, it would appear that the ICAEW's position sees (prima-facie) nothing ethically distasteful in terms of EAI.

That view is based on the fact that the client in the situation is a publicly listed company, in which the percentage of shareholding owned by the auditor as trustee, is less than 10% (i.e.7%).

However, the AICPA maintains a different stand on the matter, and suggests that any holding (even less than 10% of the total issued) of non-beneficial shares in a publicly quoted company by its auditor, impairs EAI. Thus Situation 8 is presented to ascertain if the views of respondents were more in accord with the distinction made by the ICAEW in the UK, or those of the AICPA.

The holding of trustee shares by an auditor in a company audited by him or his firm is not only allowed according to corporate law and audit ethics, it occurs in reality - e.g. 1987 accounts of M.J. Gleeson Plc, a listed company in which a partner from the company's auditors discloses holdings of trustee shares in it.

The issue of an auditor holding trustee shares in his client has been examined by Firth [1980 and 1981]. The first study was conducted amongst two auditor (Big-Eight and nonBig-Eight) groups, and a group each of CAs in Industry and Commerce, Financial Analysts and Bank Loan Officers - the user groups.

This study first listed a series of auditor-auditee relationships, one of which related to a partner in an audit firm holding, as trustee, 10% of the issued shares of a company audited by his firm, with the partner himself taking no part in the audit.

Respondents were then asked to indicate if, in their view, they perceived the auditor to be independent or not. Significant concern with EAI was registered by user groups in this situation, with at least 60% of the groups regarding the auditor as "not independent".

Firth's 1981 study however was conducted with UK bankers only. It then asked how their perceived assessment of EAI in each relationship influenced their lending decision, when compared to a relationship in which the auditor was independent.

Firth's study indicated that the mean loan advanced by banker respondents under the trustee situation described above, was significantly lower (@ .10). The mean loan advanced for an independent relationship was £9.7m and £7.3m for the trustee situation.

The above results suggest that those banker respondents who participated in this study registered a level of concern with external auditor independence in such a trustee situation. However such concern is inconsistent with the ethical position maintained by the ICAEW/ICAS in the UK. Further, it should be noted that even though the holding of trustee shares by the auditor is ethically accepted by the ICAEW and ICAS in the UK, in the US it is not acceptable by the AICPA or the SEC.

Additionally, such trustee situations have also been criticised [Stamp, 1977] in the UK. As such, the situation begs the question asking why this UK - US difference prevails, and is it a difference that users of audited statements in the UK accept.

Against the preceding considerations, Situation 8 was developed in order to assess attendant views on EAI, as perceived by respondents from the research groups, when ownership of 7% of the shares issued by a public company are held, in a trustee capacity, by a partner in the audit firm acting as auditors to the company.

Directorship (by the auditor) in an investment trust owning shares in a client of the auditor

The ICAEW's guide is clear in relation to the holding of offices (e.g. directorships) in audit clients by a company's auditor. It states:

> "no one should personally take part in the exercise of the reporting function on a company if he has, during the period upon which the report is to be made, or at any time in the two years prior to the first day thereof, been an officer (other than auditor) or employee of that company" [ICAEW, 1987: 24].

However, the guide does not provide a comprehensive and definitive ruling on the ethics prevailing when the auditor is a director of an investment trust, and it is the trust that holds an interest in a company, of which the same trust director is also auditor.

In Situation 15, to the extent that the investment trust has an (immaterial) interest in the financial well being of the company referred to therein, and the partner responsible for that company's audit is also a director of the investment trust, it may be construed that the auditor has an indirect financial interest in the financial well being of his client (the PLC).

Thus, Situation 15 relates to "financial involvement with or in the affairs of clients" by the auditor, with the auditor holding an indirect involvement (through trust directorship) in the operational affairs of his client.

Nevertheless, if allowance is made for the fact that the holding of shares by the investment trust in the public company is "immaterial", both to the investment trust and the company as well, then, to that extent, the relationship may be permitted (but not encouraged) by the ICAEW. The AICPA's stand is similar, with Rule 101 of its Ethical Rules [AICPA, 1986: 4417] stating that:

> "a member or a firm of which he is a partner or shareholder shall not express an opinion on financial statements of an enterprise unless he and his firm are independent with respect to such an enterprise. Independence will be considered to be impaired if for example ... during the period of his professional engagement, or at the time of expressing his opinion, he or his firm ... had or was committed to acquire any direct or material indirect financial interest in the enterprise."

[The issue of an auditor owning shares in clients remains alive. For example, see Re: Brebner Allen & Trapp, "Auditors held shares in client subsidiary" - Accountancy Age, July 18, 1991: 2.]

The issue of a director of an investment trust being auditor to a company in which the trust has an interest has been examined empirically by Lavin [1976 and 1977] and Firth [1980].

Lavin [1976 and 1977] assessed views held on EAI in a situation similar to Situation 15. He asked respondents to assess EAI in a situation where a partner in a firm was a member of an investment club with an immaterial amount of stock in a client, and the same partner was responsible for that client's audit.

Lavin's 1976 research was conducted in the US and assessed the views of CPAs (both in and out of public practice) - the accountant group, and bank loan officers and financial analysts - the user group. Lavin's 1977 US study was conducted only with financial analysts in brokerage houses as the research respondents. In addition to assessing the auditor-auditee relationship for the 12 situations presented, brokers were also asked to give an investment decision for the company, based on the facts provided.

Lavin's results from this [1977] study showed that 88% of the respondents indicated the auditor would be independent in such a situation. Further, this situation was one of two where respondents perceived the auditor's independence as having little significant effect on their investment decision. Thus, for this situation, it would appear respondents were not much disturbed by potential threats posed to EAI.

However, Lavin's 1976 study was conducted not only with research financial analysts from brokerage houses and loan officers from banks (the user groups), but also with CPAs from within and without public accounting. The general approach and basis of this 1976 study was the same as Lavin's 1977 study.

The respondents to the 1976 study showed that in general, the auditor in this situation would be considered independent. Curiously though, whereas at least 84% of both user groups concluded so, only 63% of the CPA group indicated likewise.

Another curiosity emerging from the study was the contrast arising from the fact that whereas about 65% of industry or a nonBig-Eight affiliated CPAs saw the auditor to be independent in the situation, only 29% of CPAs with a Big-Eight affiliation considered the same.

This would indicate that the ethical standards expected of Big-Eight auditors appear to be higher than those expected by accountants in industry or those by auditors in nonBig-Eight firms.

Firth's [1980] study was conducted amongst two auditor groups (Big-Eight and nonBig-Eight) - the auditor groups, and a group each of CAs in Industry and Commerce, Financial Analysts and Bank Loan Officers - the user groups.

The study first listed a series of auditor-auditee relationships, the facts of one of which were very similar to the one above studied by Lavin.

In the comparable situation presented by Lavin, the partner was a member of an investment club, whereas in Firth's 1980 study the partner was a director of an investment trust. Further, whereas in Lavin's study the investment club held shares of an amount stated to be "immaterial" in the audit client, in Firth's study the trust held 10% of the shares in the audited company.

A final point of contrast remains between comparable situations in Lavin's and Firth's studies. In Lavin's studies the auditor was responsible for the company's audit, but in Firth's study he played no part in it.

Having been presented with the relevant facts, Firth's respondents were then asked to indicate if, in their view, they perceived the auditor to be independent or not. Significant concern with EAI was registered by user groups in this situation, with a maximum of only 39% of any group regarding the auditor as independent.

Against the preceding background, the facts of Situation 15 were developed in order to assess how research respondents view the threat to EAI, given the dual functioning by an audit partner both as a director of an investment trust and as the partner responsible for the audit of a public company in which the same investment trust holds an immaterial interest.

<u>Auditor's acquisition of an indirect financial interest in the client as a consequence of "lowballing"</u>

While it is not unusual for some clients to exert significant budget pressure at all times, there is additional fee pressure that the auditor may encounter when the audit market is highly competitive.

As such, this form of pressure is probably most evident when there is keen competition for audit work, to the extent that the auditor is required to devise novel methods of responding to it, one such response being the practice of "lowballing".

According to this practice, first year (or initial) audits are tendered for at significantly below projected audit costs, on the basis that these initial "losses" will be more than recouped in later years, either through audit activities, or the provision of other advisory services to the client, or both.

There is no accepted position of the extent of competition in the audit profession. Regretfully, the UK has seen no detailed examination of these issues, as have been considered by the Metcalf Subcommittee of the US Senate [US Senate, 1977] or the Cohen Commission appointed by the AICPA [1978: 121] in the US, or the Adams [CICA, 1978] or Macdonald [CICA, 1988] Committees appointed by the CICA in Canada.

Consequently, there are conflicting suggestions of the extent of competition in the UK audit market. Intense competition on the one hand ["Auditors cut prices in scramble for clients" - Evening Standard, June 17, 1991: 29] and suggestions of cosy "oligopolistic" power on the other ["Escaping Lightly" - The Guardian, February 27, 1990: 11]. However, given the current shrinkage in the UK audit market, caused by the current (July 1991) recession, there are more reasons to indicate strong competition than those of a more settled and orderly market.

Lowballing can be seen as the auditing equivalent of the "loss leader" concept derived from the retail world. In the retail world, sale of a loss leader is usually accompanied by the concurrent sale of other profitable items. In the auditing world however, lowballing is premised on the future sale of auditing or other services, on a super-normal profit basis.

One interpretation of the facts of lowballing suggests that once a lowballing audit firm has issued its report, it acquires a vested interest in the continuation of the client. An interest expressed in the hope that the client will indeed remain functioning and continue in business. That hope is based on the fact that if the firm wishes to bill its client in future time-periods, then the client must in fact remain in business for those time-periods, or else no billing will be possible.

On that basis, is it unreasonable to conclude that an auditor that has lowballed, will not then be influenced and motivated to extend and protect the life of the client? To that extent also, may one argue that the auditor has now become involved in the financial well-being of the client? Such involvement is clearly prohibited by the ICAEW [1987] and, it would thus appear, should be similarly prohibited.

Lowballing is not just a mere theoretical concept. In the view of one financial columnist ["An uncertain future for a former safe career" - Financial Times, May 16, 1991: 19], current competitive conditions in the UK audit market "are not helped by the ferocious price competition, one manifestation of which is lowballing."

An alleged recent instance of lowballing in the UK relates to the audit of the Prudential Assurance Company PLC, acquired in 1991 by the London office of Price Waterhouse ["PW offered Prudential cut-price fee to win audit" - Accountancy Age, May 2, 1991: 1].

The article alleges that Price Waterhouse "offered financial services giant, Prudential Assurance a £900k discount on the proposed (audit) fee in order to win the prestigious audit appointment." [For some instances of lowballing in the US see DeAngelo, 1981: 114.]

There is much debate about the impact of lowballing on EAI. At a May 1991 symposium on auditing, Theresa Graham, Chair of the London Practitioner Board, stated that "audit independence does not go hand in hand with lowballing." However, Michael Lickiss, then ICAEW president, "felt it was the right of members to charge what they want, to who they want." ["Audit 2001" - Capital Account, July-August 1991: 13.]

While a minority of audit firms have publicly declared their strong opposition to lowballing, some observers believe the practice to be quite prevalent and current in the UK for at least five years now ["Age of the all-purpose salesman" - Financial Times, August 27, 1986].

Further, there is evidence to suggest lowballing is not confined to Big-Six firms. Top-10 firms have criticised Big-Six firms for alleged lowballing, and they in turn have been criticised by even smaller firms for the very same practices ["Pannells accused of discounting hypocrisy" - Accountancy Age, May 23, 1991: 1].

The issue of "lowballing" has been researched by various commissions and committees. In Canada, the Adams Committee concluded lowballing was undesirable and recommended changes to the CICA ethical rules to prohibit the practice [Johnston et al, 1980: 261].

In examining lowballing the Cohen Committee expressed concern with the practice and recommended that "the Ethics Division of the AICPA should consider this problem" [CAR, 1978: 1231]. The SEC [1978] also voiced concern with it in ASR 250, requiring disclosure of "fee arrangements where the accountant has agreed to a fee significantly less than a fee that would cover expected direct costs in order to obtain the client."

However, a 1986 report prepared by a Working Party of the ICAEW (and thus not the ICAEW's official view) states:

> "it is difficult to specifically identify ... (lowballing) behaviour given the fixed-cost versus marginal-cost structure of audit firms, and the fact that temporary spare capacity in firms can make the practice worthwhile." ["Report of the Working Party on the Future of the Audit" - ICAEW, 1986: 84].

By contrast, these remarks do not appear to be extremely critical of lowballing, and may even tend to suggest that it is a normal and acceptable competitive response of the auditing environment. However, it may be that the users of audited financial statements perceive otherwise?

Against that background, Situation 14 is certainly topical and consequently, its facts were developed to assess how respondents may be concerned with the phenomenon of "lowballing".

<u>The auditor entering into commercial arrangements with the audit client:</u>

In addition to becoming financially involved with his audit client by (inter alia) means as detailed above, an auditor may also become financially involved with his client by entering commercially-based contracts (e.g. MAS) as opposed to professionally-based contracts (e.g. pure audit services) with the client.

Thus, in addition to offering a professional service, many auditors also operate commercially inspired enterprises, and so to that extent must function with due regard for good commercial practice. Consequently, the auditor is obliged to operate, maintain, equip and furnish his offices on the basis of sound and efficient commercial principles.

If such commercial arrangements are entered into by the auditor with non-clients, it is agreed that no threat is posed to professional independence. However, if such arrangements are entered into with audit clients, then EAI **may** become suspect and appear to be threatened.

Two commercial transactions that the auditor must enter into in order to provide his services, is to rent (or buy) the premises from which he runs his practice and, secondly to purchase printing and stationery supplies, so he may prepare and then issue printed documents.

Thus, Situations 4 (purchase by the auditor of printing and stationery supplies from an audit client) and 7 (renting by the auditor of office premises from an audit client) were designed to assess how a trade relationship, between the auditor and his client, is seen in terms of external auditor independence, by respondents from each of the four research groups.

Purchase by the auditor of printing and stationery supplies from an audit client on specified terms

The ICAEW recognises that the "acceptance of goods or services from a client ... by a partner, his spouse or minor child or by the staff of the practice save on terms no more favourable than those available to the generality of the employees of the client" may be a threat to EAI [ICAEW, 1987: 23]. Thus, when volumes warrant it, the auditor should not be denied the benefit of volume or trade (e.g. wholesale) discounts.

In the facts of Situation 4 (which per anecdotal evidence parallel fact), it is unclear if the wholesale discount is offered to the auditor on the basis of the estimated volume of purchases to be made by the auditor (a situation that would not prima-facie threaten EAI - as presumably the auditor should have no difficulty in attracting the same discount from another stationery supplier), or as a "special incentive" in order for the auditor to purchase his printing and stationery needs from the (client) stationer concerned.

If the latter ("special incentive") prevails, then it would appear that the auditor concerned has put aside the ICAEW's guidance on EAI and chosen to act in a manner whereby his independence may well in fact be threatened.

Equally, on that basis, the ICAEW's guide would show that such an auditor-client relationship is effectively prohibited.

Against that background, Situation 4 was developed and presented for research assessment by the four research groups, because of its believed closeness to fact, and to assess if users of audited financial statements would indeed grant the auditor in this situation a measure of commercial pragmatism, without being concerned about the loss of his professional auditor independence.

Renting by the auditor of office premises from an audit client

The facts of Situation 7 state that the lease entered into between the auditor and his client is on an arms-length basis, but in real-life it is likely that it would be virtually impossible to state with absolute certainty, whether or not the lease has been drawn up on that basis.

As such, there is nothing intrinsically repugnant to external auditor independence in the facts of Situation 7, which fall under considerations headed "financial involvement with or in the affairs of clients" [ICAEW, 1987: 21].

Furthermore, to the extent that an element of the client's income is dependent on the auditor concerned, there is an enforced (and involuntary?) involvement in the affairs of a client. While such involvements may be rare, they are not without precedent. For example, a real-life instance of this type of situation is seen in a lease agreement entered into between Price Waterhouse and its (then) client Peachey Properties Plc.

In such situations, a matter that must then also be of significance is the willingness of the client to renew the lease with its auditor, upon the expiry of the lease, and the like renewal intentions of the auditors. One can only surmise about such facts in the present instance as they are not provided. Nevertheless, it is possible that such considerations may influence auditors to adopt (or not) an independent stance in the context of their professional dealings.

The SEC and the auditing bodies both in the UK and US would deem an auditor who managed a building owned by an audit client of his to be non-independent. Such an arrangement is quite clearly regarded as a commercial transaction and so would be ethically unacceptable. However the auditing professions in the US and UK do not appear to speak with one voice on a lease relationship such as that presented in Situation 7.

Subject to the specific facts of course, UK auditing bodies would likely declare that the details of this situation reflect an independent auditor-client relationship.

However, in US terms, the AICPA would most likely find that this situation to be one with a non-independent auditor-client relationship. This view is based on the clarification provided by AICPA, which relates to the reverse situation, (i.e. the auditor leasing space to the client) and states that:

> "the leasing of property to a client creates a commercial business relationship beyond the normal professional relationship, resulting in an indirect financial interest in that client (and as such the auditor's) independence would be considered impaired if the members' indirect financial interest in (the) client is material to the member" [AICPA, 1986: 4447-4448].

As such, this type of issue, the lease-renting of offices between auditor and client, has been of concern to other researchers [Firth, 1980; Lavin 1976 and 1977; and Dykxhoorn and Sinning 1981a and 1982].

Lavin [1976 and 1977] assessed views held on external auditor independence in a very similar situation where the auditor rented only 25% (as opposed to the 30% stated in Situation 7) of a building owned by the audit client.

Lavin's [1976 and 1977] research was conducted in the US, and assessed the views of CPAs (both in and out of public practice) - the accountant group, and bank loan officers and research financial analysts - the user group. His 1976 research showed that in this situation, at least 60% of the user groups surveyed indicated the relevant auditor to be independent, whereas 68% of the accountant group indicated the same.

Thus Lavin's 1976 study revealed US concern with EAI in such a (lease) situation - with at least 30% of respondents expressing a concern with underlying EAI. Lavin's 1977 research was very similar to the 1976 study and was conducted among 74 research financial analysts from brokerage houses. With regard to the same situation, 60% of respondents determined the auditor to be independent - though 40% did not. Equally, this was one of the three situations studied by Lavin [1977] which revealed no consensus among the analysts.

By the same token, this auditor-auditee relationship caused concern with respondents in as much as the mean loan they would grant under it was significantly lower than that granted on an independent relationship. Based on a 5 point decision scale (1 to 5), the mean loan facility granted on an independent basis was 3.15, while that based on the lease relationship was 2.41.

Thus, both the studies conducted by Lavin indicate strong concern with such a lessor-lessee relationship between the auditor and client, wherein the auditor rents 25% of a client-owned premises.

In similar vein, Firth [1980] studied EAI views in exactly the same situation as the one above, but with UK respondents. His study was conducted amongst two external auditor groups (Big-Eight and nonBig-Eight) - the external groups, and a group each of CAs in Industry, Financial Analysts and Bank Loan Officers - the user groups.

Firth's study showed that at least 90% of each of the two auditor groups, and at least 69% of the three audit-user groups stated that, in their view, the situation reflected an auditor that was independent of his client.

Dykxhoorn and Sinning [1981b and 1982] also studied views on EAI in an identical situation in (then West) Germany. Their 1981 study was conducted amongst two sets of "Wirstchaftsprufer" (WP - licensed corporate auditors in Germany). The first set of WP had acted (or were acting) as auditors to German subsidiaries of US corporations, and the second set had not had such exposure.

In the above study, 76% of all WPs indicated that they perceived the auditor to be independent in a situation identical to the one examined studied by Lavin [1976 and 1977]. However 93% of the first set of WPs examined by Dykxhoorn and Sinning [1981b] and 89% of the second, shared the view that the auditor was independent.

Whereas Dykxhoorn and Sinning's 1981b study was confined to WP (audit opinion issuers), their 1982 study was limited to directors of loan and investment departments in financial institutions (some users of audit opinions).

The 1982 study was undertaken in Germany and asked the two groups for their views of EAI, within a (lease) situation, identical to that of Firth [1980]. The study showed that at least 71% of both groups considered the auditor to be independent in that situation.

Comparing the two studies by Dykxhoorn and Sinning [1981b and 1982], it is fair to state that about 20% fewer of the user groups (compared to the issuer groups), considered the auditor to be professionally independent in these circumstances. It is of equal import to note that in general, Situation 7 would be declared as reflecting an independent auditor by the UK professional bodies.

Against that background and discussion, Situation 7 was developed and presented for assessment in order to assess if the research respondents were concerned with EAI in the situation. If so, they may also perceive the need for a more rigid code of audit behaviour - a code which would permit no commercial dealings at all (even at arms-length) between an auditor and his client.

In addition to trade-based commercial relationships, there is another type of service-based relationship that auditors may enter into with their clients. Far more controversy and concern with EAI is provoked by the latter type of relationship than the former.

However, it is possibly no exaggeration to state that the largest single area of concern with EAI (and consequently the most studied) is the provision of nonaudit services by auditors to their clients.

In broad terms, there are really two types of nonaudit services. The first type encompasses the provision of accounting or accounting-type services (e.g. writing up the underlying accounting records). The second type includes the provision of consultancy advice and/or services related to, resource acquisition and/or utilisation or, the design and/or implementation of systems.

However, in general, when the term MAS is used, it refers mainly to the second type of nonaudit service - i.e. the provision of management advisory (consulting) services by the auditor to his client.

However, both types of nonaudit services require the auditor to take no part in the client's executive decision making. Such decision making is reserved exclusively to and for the management of the client.

In general, the first type of MAS is rendered by auditors to their smaller-sized (private) audit clients, while the second type of MAS is rendered by auditors to their larger-sized (public) clients.

In essence, provision of both types of nonaudit services is only one sort of a commercial transaction between an auditor and his client. As such, it may be judged no differently than (say) an auditor renting premises or computer resources to his client. When EAI is viewed in that light, the provision of nonaudit services creates an involvement by the auditor with the client, and so would be ethically unacceptable.

However, in addition to these (commercial) nuances, the provision of MAS causes concern to audit-report users on grounds that (when provided) the auditor may then:

1. Have to audit his own decisions and recommendations.
2. Become personally involved in the client's results.
3. Develop a conflict of interest in preserving the interests of the client and users of accounts.
4. Lose objectivity by developing the same perceptions as the client, a desirable feature in MAS terms.
5. Become even more economically reliant on the audit client in question (because of MAS derived fees).

The Economist ["Blowing the whistle on accountancy" - December 22, 1990: 16] expresses its concern thus:

> "Auditors say they already have the terror of malpractice suits to keep their calculators on the straight and narrow. Better to remove the temptation altogether, ... by banning auditors from providing such (MAS) services to the companies they check.
>
> Accountancy firms can continue to hawk consulting and the like to non-auditing clients. After all, nobody objects to a referee playing for a team in a match that he is not supervising."

[See also "Play or Score - not both says Collum" (Finance Director of SmithKline Beecham PLC) - Accountancy Age, July 11, 1991: 4]

However, previous research has identified no major concern with concurrent provision of some forms of advisory services to clients. For example, tax planning, tax return preparation and filing [Rosenbaum, 1968] and provision of computer resources [Lavin, 1974], did not cause concern with EAI to audit users.

On the other hand, provision of accounting (or accounting-type services) by the auditor has been found to be of concern (to some extent) to audit-users [Titard, 1971; Hartley and Ross, 1972 and Lavin, 1974].

This is also true of the rendering of consultancy (i.e. the second) type of MAS, whose provision has been determined as causing concern to the users of audited financial statements [Briloff, 1966; Hartley and Ross, 1972; Lavin, 1974 and Shockley, 1981].

Nevertheless, some contrary UK evidence is provided by the results of a relatively recent survey undertaken by the ICAS [1987]. The survey was conducted amongst the chairmen of the Top 1000 companies in the UK, 571 of whom replied to the brief questionnaire on EAI.

Of these 571 respondents, 73% of respondents did **not** "believe that auditor's independence is prejudiced by the provision of management consultancy services to audit clients".

In fact, 80% of them did **not** "see any need for detailed legislation on" EAI in terms of conflicts of interest, and the vast majority (91%) of respondents to the survey indicated that "auditors should be allowed to provide additional (advisory) services" (i.e. MAS).

Accordingly the following paragraphs of the chapter singles out for study within the context of external auditor independence, the provision by the auditor to his audit client, these two main types of Management Advisory Services.

Provision of accounting (or accounting-type) services

The ICAEW and the ICAS in the UK, and the AICPA and the SEC in the US, recognise that the provision of accounting or accounting type services by the auditor to an audit client can often present a threat to EAI, and accordingly have issued relevant clarifications on the matter.

In terms of the UK professional auditing bodies, such services are categorised under the ICAEW's [1987] set of considerations relating to "Conflicts of Interest", and in particular to conflicts that may arise through the "provision of other services to audit clients" [ICAEW, 1987: 24].

In this context, the ICAEW [1987: 24] guide states:

> "whilst it is right that members should provide, for audit clients, other services beyond performing the audit, nevertheless care must be taken not to perform executive functions or to make executive decisions. These are the duties of management. In particular members should beware lest, in providing such services they drift into a situation in which they slip across the border-line of what is proper."

Interestingly though, the guide does not provide clear guidance of where the border-line lies. Nevertheless, to a large extent the AICPA and the ICAEW voice the same views in relation to the provision of accounting services by the auditor.

The ICAEW prohibits in all but "exceptional circumstances", the provision of such accounting services for public (i.e. exchange listed or traded) companies.

Likewise, in endorsing requirements of the SEC, the AICPA gives substance to a similar prohibition for SEC regulated (public) corporations in the US, and concurrently implies that such services may be provided to and for non-SEC regulated corporations, by stipulating that:

> "when a client's securities become subject to regulation by the SEC ..., responsibility for maintenance of the accounting records, including accounting classification decisions, must be assumed by accounting personnel employed by the client. The assumption of this responsibility must commence with the first fiscal year after which the client's securities qualify for such regulation" [AICPA, 1986: 4413].

Thus, in effect, both Institutes permit with caution, the provision of other accounting services (in addition to the audit) to companies whose shares are not publicly listed (private companies) or SEC-regulated.

However both institutes insist that in all situations, the auditor must ensure that the relevant client has a full understanding of, and accepts full responsibility for, any auditor-prepared financial statements.

In such circumstances, the AICPA states that "the CPA must discuss (all) accounting matters with the client to be sure that the client has the required degree of understanding" of such matters [AICPA, 1986: 4413].

The AICPA rationalises its above position [AICPA, 1986: 4412-4413] on the basis that its:

> "members are skilled in, and well accustomed to, applying techniques to control mechanical accuracy, and the performance of the record-keeping function should have no effect on application of such techniques.
>
> With regard to accounting judgements, if third parties have confidence in a member's judgement in performing an audit, it is difficult to contend that they would have less confidence where the same judgement is applied in the process of preparing the underlying accounting records."

Unlike the ICAEW, the AICPA does provide some guidance as to when the provision of accounting services can assume an executive role. It states [AICPA, 1986: 4413]:

> "a member performing accounting services for an audit client must ... retain **the appearance** (emphasis applied) that he is not virtually an employee, and therefore lacking in independence in the eyes of a reasonable observer."

In sharp contrast, German auditors are totally prohibited by a directive of their Chamber of Auditors, from offering "bookkeeping services for audit clients" [Dykxhoorn and Sinning, 1981b: 98]. Thus, perhaps because of a lack of (and conflicting) professional guidance, this issue has been much researched empirically [Lavin, 1976 and 1977; Firth, 1980 and 1981; Dykxhoorn and Sinning 1981b and 1982].

These studies sought EAI views in a situation similar to that of Situation 3, i.e. one where: "in addition to the audit, an auditor provides for the audit client, accounting services which includes maintaining basic accounting data and, preparing financial statements."

Lavin's 1976 US study sought views on EAI in this situation, on the one hand from CPAs (1. in/out of practice 2. Big-Eight/nonBig-Eight) - collectively the accountants group, and on the other from loan officers in finance institutions and research financial analysts in brokerage houses - collectively the users group.

The study revealed that it was not so much the users that were concerned with EAI in this situation, but the accountants. At least 53% of both user groups felt the auditor would be independent in the situation. But, only 36% of the accountants group so concluded.

Even within the accountants group, there were wide variations on the issue. Whereas 12% of accountants with Big-Eight firms concluded as above, the comparable statistic for accountants in nonBig-Eight firms was more than four times greater - 52%.

This may well be explained by the fact that it is likely that a higher proportion of Big-Eight firm clients are SEC-regulated, so that their auditors are in no way permitted to offer them accounting services.

Equally, it is likely that a higher proportion of clients in nonBig-Eight firms are nonSEC-regulated, so that their auditors may (and do) offer them accounting services.

If so, the livelihood of many auditors from nonBig-Eight firms is more closely related to the provision of accounting services to clients, than their Big-Eight counterparts (where this is less likely to be the case).

On that basis, one may perhaps anticipate a somewhat natural reluctance within the former group to see an impairment to EAI in this situation, for so doing may (perhaps) prejudice their continued offering of such services.

Lavin's comparable study in 1977 was based on only the responses received from the financial analysts who participated in his 1976 study the year before. 53% of respondents to this study did not find the auditor's EAI to be threatened in one similar to Situation 13.

Nevertheless, there was some general concern with EAI, as the mean loan granted by these analysts under that auditor-client relationship, was significantly lower than that granted under a deemed independent situation.

Firth 1980 and 1981 examined the same situation with respondents from three auditor groups (Big-Eight, nonBig-Eight and Industry/Commerce) and two user groups (Analysts and Loan Officers). In total, only 23% of respondents to Firth's 1980 study indicated the situation to be independent in EAI terms.

While the results obtained by Lavin [1976 and 1977] were to an extent repeated in Firth's 1980 study, in some ways their results were quite different.

The wide variation (in degree and direction) between Big-Eight and nonBig-Eight auditors in Lavin's [1976] study was also seen in Firth's study. However a minority of Big-Eight (41%) and a majority of nonBig-Eight auditors (88%) saw the auditor as independent.

While a majority (>53%) of users in Lavin's study saw the auditor as independent, this was not so for the Firth [1980] study. In that study, 15% of analysts and 23% of loan officers saw the auditor as independent.

Further, the results obtained by Firth [1981], in terms of the mean loan that bankers would advance under this relationship, were significantly (@ .05) lower than that advanced under a deemed independent relationship; and to that extent are consistent with Lavin's 1977 findings.

Dykxhoorn and Sinning [1981b and 1982] examined much the same situation in the context of EAI with duly informed and/or associated respondents in West Germany.

Dykxhoorn and Sinning's 1981b study showed that the majority (58%) of the German State Licensed Auditors - "Wirtschatspruefer" (WP) surveyed by them, considered the auditor not to be professionally independent in this situation.

Within this WP group, 75% of those associated with the audit of German subsidiaries of US corporations (and so more likely to be associated with a Big-Eight firm) saw the auditor to be not independent, whereas only 52% of WPs not so linked, saw the auditor as such.

[While the chi-square statistic for this difference was not found to be significant (@ .05), Dykxhoorn and Sinning advise caution when interpreting these results, as (a small) sample size may have influenced them.]

Dykxhoorn and Sinning's 1982 study examined the effect of perceived EAI in the same situation. This survey was conducted amongst directors of loan and investment departments in selected German financial institutions.

In addition to registering their view as to the independence (or otherwise) of the auditor in the situation, respondents were also asked to indicate (by reference to a scale) the extent to which their assessment of the perceived auditor independence would influence an underlying financial decision.

Interestingly, even though an auditor-client relationship, such as that described in the situation, would be prohibited in Germany, more than 70% of both groups (loan and investment directors) of respondents declared the auditor to be independent therein.

Further, as may be expected, the perceived financial decisions for both groups of respondents were affected by their underlying perceptions of the relevant auditor's independence.

The study [Dykxhoorn and Sinning, 1982: 344] also noted that "the perception that auditors lacked independence ... had a more pronounced negative effect", than the positive perception had on the positive effect, for the related financial decision.

In other words, these researchers determined that the financial decisions of those who use audited statements "tend to be more negatively affected when (they) consider the auditors to lack independence, than positively affected if they consider the auditors to be independent" [Dykxhoorn and Sinning, 1982: 344].

Two inferences can be made from the positions of the ICAEW and AICPA. First, that the EAI issues underlying public companies are presumably different from those of private companies. Second, that there is a frontier in terms of providing accounting services, after which the auditor is a client-administrator and so EAI will be impaired.

Further, given the variation in prescribed ethical and professional rules between UK public companies (or SEC regulated corporations in the USA) and private companies, it is of interest to see how that variation is seen by both issuers and users of audit reports in the UK.

Against the preceding background, Situation 3 was developed and presented for assessment in order to determine whether the distinction held out by the UK and US accounting professions between an auditor rendering basic accounting services to public as opposed to private companies, is also upheld by UK users of audited financial statements and others so concerned.

<u>The provision of consultancy advice related to resource utilisation or the design and implementation of systems</u>

Provision of MAS by auditors to audit clients has been an issue within auditing and the subject of much study, both theoretically [Carmichael and Swieringa, 1968; Goldman and Barlev, 1974; Nichols and Price, 1976 and Shockley, 1981] and empirically [Schulte, 1965; Dermer et al, 1971; Titard, 1971; Reckers and Stagliano, 1981a; Shockley, 1981; Scheiner and Kiger, 1982; Pany and Reckers, 1984 and Knapp, 1985] by many authors.

The case for the provision of MAS by the auditor is summed up in the following extract from the Cohen Commission [CAR, 1978: 95] which states that:

> "An audit requires considerable knowledge about a company, its operations, and its industry. Providing MAS for an audit client may increase the auditor's understanding and knowledge and prove advantageous in conducting the audit. The auditor is also better situated than other consultants to provide MAS:

> He is known by management, and his knowledge of the company may make him more aware of consulting needs and opportunities".

The case against the provision of MAS by the auditor is essentially that the auditor who does so is then more likely to become involved with the audit client, and in time will (perhaps) develop a personal interest in its success. If he does so, the auditor then sets aside his independent "state of mind" - (the quality that is vital to assure his professional EAI).

The fundamental argument against the provision of MAS is stated by Mautz and Sharaf [1961: 155] in the following words:

> "once advice leading to business decisions is given, a mutuality of interest between the consultant and the company begins to develop. He (the auditor) now has an interest in that company, a financial interest based on his prestige as a successful advisor; and this interest differs not in kind but only in degree from that of a full-time employee".

Recent UK statistics confirm that the provision of MAS continues to constitute an important part of the total fee income derived by Big-Six auditors in the UK [Accountancy Age, June 6, 1991: 1]. The statistics show that (in their most recent year-ends) these firms relied on the provision of MAS for an important (if not significant) percentage of their total fee income. These ranged from about 16% (for both Ernst & Young and Touche Ross) to 50% (Arthur Andersen).

Opponents of MAS provision by auditors to audit clients claim that if such provision were restricted only to non-clients, then there would be no concern with EAI. However, assessed against the above statistics, it would not be unreasonable for observers to be concerned with EAI when some (or all) of the MAS derived revenues of auditors were to come from their audit clients.

While the AICPA and the ICAEW do prohibit the provision of certain types of MAS by auditors, in general they have not prohibited their members from offering MAS to audit clients. Their view is that each situation must be assessed on its own facts, and by inference, do not see MAS-provision as **necessarily** being a threat to EAI.

The SEC also prohibits like provision of certain types of MAS activities. In fact, at one time the SEC were clearly concerned with the effect that the provision of MAS by a company's auditors had on EAI, and as a consequence introduced ASR 250 to address that concern.

ASR 250 required SEC-registrants to disclose in their proxy statement the services provided to the company during the last fiscal year by its principal independent auditor, and the percentage relationship that fees for nonaudit services bore to the audit fees, individually if over 3% and (in all cases) in total.

Further, ASR 250 required such MAS-recipient companies to disclose whether the board or the audit committee had approved, in advance, each professional service provided by its auditors, and if they (the board) had, prior to such contracting, considered its possible effect on the auditor's professional independence by the performance of such services. [Within a US context, a 1979 AICPA publication entitled "Public Oversight Board Report: Scope of Services by CPA firms" gives an extensive list of references, relating to the provision of various types of MAS offered by an auditor to its client.]

However, even the SEC became sceptical about the usefulness of the requirements contained in ASR 250 [SEC, 1982], as they were subsequently withdrawn by ASR 341, because "the detailed nonaudit services disclosure required by that provision were not of sufficient utility to investors to justify continuation of the disclosure requirement."

The matter also appears to be of current concern to the present UK government. Thus, in the light of the above experiences, it is highly relevant to note that it is very seriously contemplating use of an enabling clause in the Companies Act 1989 to issue regulations, similar to those contained in ASR 250 issued by the SEC.

The regulations, if approved and implemented, will require the financial statements of companies to disclose all fees paid by a company (or its associated organisations) for nonaudit work to its auditors (and their associates) ["DTI forces disclosure of non-audit income" - Accountancy Age, May 2, 1991: 1].

By way of contrast, one notes that UK local authority auditors appointed by the Audit Commission and company auditors in France and Germany are prohibited (by law) from providing all types of MAS to their audit clients.

Previous empirical research into the concurrent provision of MAS and statutory audit has produced varying results and differing conclusions.

Schulte's [1965] study in the US examined "the compatibility of management consulting and auditing". In that context, he looked at the views of three major groups using audited statements. His three groups were:
1. Research financial analysts in brokerage firms
2. Commercial loans and trust officers in banks
3. Investment officers in financial institutions

His study showed that questionnaire respondents from the very large banks and brokerage houses were much less concerned by this issue, than other respondents.

Schulte explained this result by suggesting that employers of respondents from large institutions, are more likely to be audited by a Big-Eight firm, where it is generally considered that the staffing of MAS and audit services are kept separate and distinct. This, isolation of MAS and audit staff, he suggests, may account for the manifest reduction in concern with EAI.

Dermer et al [1971] empirically examined the issue in Canada. Their respondents came from seven important groups, ranging from fund and portfolio managers to investment counsellors and brokers. Their findings showed a large majority (60%) of respondents had not been faced with this issue in real life. Asked to consider the issue, 50% of respondents stated they had "mixed feelings" (reservations) on it. A minority (16%) stated the two services were definitely inconsistent.

However, 60% of respondents indicated that the concurrent provision of both services by the auditor did not affect their confidence in the EAI. Still, the comparable views of 26% of the respondents were adversely affected and 14% were left undecided.

As did Schulte, the Dermer study found that audit-firm size was important when judging the compatibility of the concurrent provision of MAS and audit services.

In the same year as the Dermer study in Canada, Titard [1971] published the results of similar US research. Within this context, Titard sought to examine the views of 200 audit report users, with reference to 33 types of MAS that an auditor may provide to his audit client.

Some caution with Titard's findings are in order, as they may have contained some bias arising as a consequence of the underlying survey being restricted to users of audited financial statements in only the very large financial institutions.

Nevertheless, Titard determined that under such circumstances, 49% of respondents stated that at least one of the 33 MAS identified would in fact inhibit EAI, while 42% of them did not believe such an inhibition would occur. A small but notable minority (9%) offered no opinion at all. Overall, Titard concluded "MAS and the appearance of EAI was not a serious problem for the (US audit) profession at" that time.

Reckers and Stagliano's [1981b] paper offered findings within this context on EAI "as perceived by financial analysts". The respondents to this study were two groups of what the authors termed "more sophisticated" (50 financial analysts) and "less sophisticated" (50 MBA in Finance) students.

The research assessed perceptions of EAI in situations where varying aggregate percentages (8 to 51) of a company's audit fee, were also generated by the auditor providing various types of MAS to the client. However, within these varying situations, the revenue generated from any one type of MAS was always limited to an amount less than 12% of the total audit fee.

The authors concluded that neither research group was "particularly disturbed" by concurrent provision by the auditor of both audit and MAS. They also concluded that, in general, the "more sophisticated" group had consistently greater confidence in the independence of the auditor, (even when MAS generated more than 30% of the audit fee) than the "less sophisticated" group.

Shockley's [1981] study assessed views of EAI against four sets of considerations, one of which was MAS-provision by the auditor to his client. This research was conducted amongst auditors (from Big-Eight and nonBig-Eight firms), commercial bank loan officers and financial analysts in important financial institutions. The overall results of the study confirmed that the provision of MAS was seen as a major EAI determining factor by all groups. Further, he determined that nonBig-Eight auditors levied more importance (concern) to the provision of MAS than did Big-Eight auditors.

The basis of Pany and Reckers' [1984] study was the provision of MAS services proscribed by the SEC Practices Section of the AICPA, compared with those that are not.

Contrary to the findings of Shockley [1981], this study suggested that the distinction between whether MAS was provided by the auditor by the audit department itself, or a separate and distinct MAS department associated with it, was significant. In cases where this was not so, perceptions of EAI were adversely affected.

The results of this study also indicated that respondents had neither extreme confidence in, nor extreme concern with, the level of EAI when nonaudit services were also provided.

The results offered little clear evidence to suggest that those MAS proscribed by the AICPA, were regarded as significantly more damaging to EAI than other forms of MAS (not so proscribed).

The study by Knapp [1985] examined how certain contextual factors, one of them being provision of MAS by the audit firm, in auditor-client conflicts, affected the perceived ability of the auditor to resist client pressure (i.e. EAI).

In particular, the study tested the hypothesis that users of audited financial statements will perceive that the client management is more likely to obtain its preferred (accounting) resolution in a conflict when the auditing firm provides a significant amount of MAS to the client, as opposed to providing no MAS at all to the audited client.

The results with regard to the preceding hypothesis were not conclusive. Provision of MAS was found to be statistically significant at .001, however the total amount of overall variance explained by it was minimal.

Thus, it appears that the provision of a significant amount of MAS by an audit firm, only slightly increases the apparent likelihood of a conflict being resolved in favour of the client.

Studies of the above kind continued to be undertaken in the US during the 1980s, however for the first time the results of similar research conducted in the UK were published in that decade.

Firth conducted a UK-based empirical assessment of audit-user perceptions of EAI when the auditor also provided MAS to his audit client, and published his findings in Firth [1980 and 1981].

These surveys assessed EAI views of respondents concerned with the issue, based on a series of auditor-client relationships. One such relationship was where "a professional accounting firm provides MAS to a company which it also audits. The MAS arm and the audit arm of the audit firm are separate autonomous units."

Firth's 1980 and 1981 studies judged views of the preceding situation with respondents from three CA groups (Big-Eight, nonBig-Eight and Industry/Commerce) and two user groups (Analysts and Loan Officers). More than 60% of all respondents to the 1980 study perceived the auditor to be "not independent" in this situation.

This perception was marked in respondents from the two user groups, where at least 61% of each group declared the auditor to be likely not independent, and less pronounced in the accountant groups, where this view was shared by a maximum of only 41% of those groups.

The findings of Firth [1981] were an extension of the 1980 study. In the 1981 study, respondents were also asked to indicate the impact such a relationship would have on a financial decision based on audited accounts, supported firstly by an independent auditor-client relationship, and secondly on a series of auditor-client relationships described and presented for study.

In this situation (provision of MAS), the impact of the relationship was significant at .01, and while the mean loan offered on an independent auditor-client basis was 10.6 units, the mean loan based on the above basis (i.e. auditor providing MAS) was only 8.6 units.

The position of auditors providing MAS to their clients is worth close study. Some, like the Metcalf Committee [US Senate, 1977] or Austin Mitchell ["Mission to keep contestants out of judges beds" - Financial Times, December 13, 1990: 15], ask that "the provision of non-audit services to audit clients be curtailed" or at best completely prohibited.

On the other hand, important members of the UK audit profession, like Martin Scicluna, chairman of the ICAEW's Auditing Committee, argue that:

> "preventing auditors from providing ancillary services, such as consulting to audit clients, would cut off an important source of advice for many companies" ["Professional self-regulation is more efficient than statutory interference" - Letters, Financial Times, December 14, 1990: 17].

The limited empirical evidence is persuasive. When more than 61% of audit users indicate that the auditor is likely to be not independent when MAS are also provided, (even when the audit and MAS providing arms are operated autonomously), then there is strong suggestion of concern with EAI in the UK [Firth, 1980].

However, contrary views are derived from the Chairmen of some of UK's Top 1000 companies. In answer to the question "Do you believe that auditors' independence is prejudiced by the provision of management consultancy services to audit clients?", posed in the ICAS [1987] survey, at least 70% of these company chairmen (in each of the four quartiles) replied in the negative.

Such views are also supported by opinion from the US, where the Cohen Commission stated that "with the exception of the Westec case, ... (their) research has not found instances in which an auditor's independence appears to have been compromised by providing other (MA) services" [CAR, 1978: xxviii-xxix].

Against the preceding background, Situation 13 was developed and presented for assessment so as to judge how EAI is viewed in a situation where auditors to a major PLC have provided it with MAS over past years, related billings being about 40% of the audit fee.

The prime purpose of this chapter was to provide a discussion of considerations underlying, and the rationale for presenting for assessment each research situation. The next chapter presents considerations relating to details of the respondents who provided their views of EAI in the 20 questionnaire situations.

CHAPTER VII

THE RESEARCH GROUPS AND RESPONDENTS

The purpose of this chapter is to provide details of the groups and respondents that participated in the research and the rationale underlying use of these particular groups. Expressed in Brunswick Lens model terms, this chapter can be seen as a clarification of the judges used in obtaining the relevant perceptions (i.e. those individuals who were asked to respond to the research questionnaire).

The chapter has two major sections. The first section presents the rationale for assessing the external auditor independence views of each of the four groups who participated in this research, and details of the main criteria required from all groups of respondents. The second section states, for respondents from each of the four groups, the basis on which their participation was achieved.

7.1 Group considerations

The auditor's report puts the auditor in touch with the public at large. Accordingly, it would be interesting and relevant to establish views based on a sample of the entire public. However this is undoubtedly very difficult and highly impractical.

Instead, selected surrogate groups were used as respondents to the final research questionnaire. Four distinct groups (one of which provided two sub-groups) were selected to act as respondents.

Use of the four groups as respondents to the questionnaire, was determined by the fact that they either report on or use audited financial statements. Thus, store is placed by them on the audit report and, in doing so, the independence of the relevant auditor.

Additionally, two important criteria were also laid down for the use of respondents from all four groups:

1. Respondents should be reasonably familiar with the work of auditors, and their relationships with audit clients.
2. Respondents should belong to a clearly recognisable and homogeneous group.

Having regard to the above criteria, the following four groups, who came from one of two functional categories, were selected for use as respondents to the research questionnaire.

I. Audit Report Issuers Category

1a. Auditors in Big-Six firms

1b. Auditors in nonBig-Six firms

II. Audit Report Users Category

2. Bank credit/loan officers.
3. Credit Managers.
4. Internal Auditors.

The following paragraphs present the rationale for the use of each group, and subsequent paragraphs details relating to respondents within each group.

External Auditors

External Auditors (EAs) issue audit reports, and as such their views on their own professional independence are of course very important and essential as a basis of comparison with comparable views of other groups. The participation of EAs to this research was pivotal, because it was their views of their independence that was contrasted with the same views of each of the other groups.

In addition, EAs from both Big-Six and nonBig-Six firms were used. Use of EAs from both these sizes of audit firms, gives recognition to Pearson's [1979: 186] suggestion, wherein he states:

> "it should be noted that in any future research project that utilises CPAs (auditors) as subjects, researchers would be wise to recognise that the CPA population cannot always be viewed as one homogenous group. Big-Eight CPAs' perceptions are sometimes different from nonBig-Eight CPAs' perceptions."

Bankers

Bank credit officers, or bankers (BAs), are frequent users of audited statements when extending loan or credit facilities to customers. In doing so, they place reliance on the auditor's report and in that sense, are no different from other credit-granting persons or organisations. As such, bankers can be seen in the same standing as creditors, and so form a good surrogate group for providers of funds generally.

Credit Managers

Respondents for the third research group were sought in the form of Credit Managers (CMs) whose views were sought because CMs often make important credit decisions in industry, trade and commerce - partly basing their decisions on the audited financial statements of the credit applicant.

In doing so, CMs implicitly assume EAI and would therefore normally be expected to be concerned with EAI and disposed to assist with research into it.

Internal Auditors

The fourth group of respondents was Internal Auditors. IAs' views are a good basis for comparison with those of EAs, as there is much commonality of approach and purpose in their professional work.

Indeed, often and increasingly EAs rely on the work of IAs - and this feature in itself provides good basis for a comparative study of the two groups' views of EAI - said to be the only distinguishing feature between EAs and IAs.

Further, like EAs, IAs hold professional independence very important and in extremely high regard. Indeed, the very first of the Professional Practice Standards of the IIA - UK is on independence, stating that "IAs should be **independent of the activities they audit**".

However, unlike EAs, IAs are not required to be **independent of the organisations for whom they audit.** Thus, it is argued, it is professional independence - the research subject - that distinguishes IAs from EAs. If so, it is important that both groups' perceptions on EAI be known.

7.2 Respondent considerations

While sample respondents for the professional auditor and banker groups could have been obtained from professional membership lists, the incremental benefits derived from so doing, did not warrant the incremental expenditure of resources (time and money). Instead, respondents for these two groups were obtained as detailed below.

External Auditors

Respondents for the EA research group came in the form of qualified auditors employed in the London offices of five major firms of chartered accountants, who arranged for completion of the questionnaires by suitable respondents, and so assisted with the research. Two of these firms were Big-Six firms, and the other three, while nonBig-Six firms, ranked in the Top Ten UK firms.

Bankers

Similarly, respondents for the banker group were provided in the form of loan/credit officers in the employ of six major UK banks, who also very kindly assisted with the research by arranging for suitable respondents to the questionnaire. Three of the six banks participating in the research were clearing banks, while the other three were important non-clearing banks.

Credit Managers

CMs from whom questionnaire completion was requested were all 490 UK-resident Fellow Members of the ICM. Their selection was made by reference to the ICM's (then current) List of Members. The ICM was established in 1939, its purpose being to assist its "members to acquire the most advanced Credit Management skills and knowledge of the most up-to-date credit techniques."

The ICM has over 4500 members in total, spread over four grades of membership, the highest being a Fellow (FICM). Institute rules require that Fellows must:

1) be at least 30 years of age and have been a member of the ICM for not less than seven years,
2) have been in an executive position and had the direction and control of credit staff for not less than seven years,
3) satisfy the ICM Council that his or her experience and standing are sufficient to justify admission as a fellow.

Thus, it is reasonable to conclude that Fellows of the ICM hold firm views on EAI, distilled by years of experience with and reliance on audited statements.

Questionnaires to this group were sent out together with a covering letter (First Request) from the ICM's Chairman, informing the recipient that the Institute was assisting with the research and inviting his/her co-operation in completing the questionnaire attached.

Those who had not returned the questionnaire after the first request, were sent a "Second Request" from the Chairman, asking them to return the completed questionnaire. No further requests were sent to Fellows who had still not returned the questionnaire.

Internal Auditors

(IAs) were selected from among only Full Members of The Institute of Internal Auditors - UK (IIA - UK). Again, selection was made by reference to the institute's (then current) List of Members.

The IIA - UK is a part of the International Institute of Internal Auditors and the only UK professional body for IAs. Its main objectives are "to represent all IAs and to further the advancement of Internal Auditing."

The IIA - UK's most senior membership category is Full Members, though all members must uphold its Code of Ethics, Article 7 of which declares that "members shall adopt suitable means to comply with the Standards for the Professional Practice of Internal Auditing", and the first of these relates to independence.

Full Members are those who (having passed the Institute's examinations) "have direct jurisdiction over Internal Auditing activities, or are actively engaged as Internal Auditors."

Thus, it is reasonable to conclude that they would hold firm and relevant views on professional independence - particularly EAI, distilled by years of involvement with auditing and association with audited statements.

IAs work in the private and public sectors, but most interface between them and EAs occurs in the private sector. Hence the research focused only on Full Members of the IIA-UK employed in the private sector by PLCs or their subsidiaries, except those in the financial services sector. This was because views from that sector were already reflected by the banker group.

Questionnaires were sent to the 500 duly selected (as above) members of the IA group with a "First Request" from the President of IIA-UK, informing the recipient that the Institute was participating with this research into external auditor independence, and inviting co-operation by completing the questionnaire attached.

Those members who had not returned the questionnaire after the initial request, were sent a further request (Second Request) from the President of the IIA-UK, asking them to complete the questionnaire. This request produced a further set of responses, and no further questionnaire completion requests were sent to members who had still not returned completed questionnaires.

Respondent Participation

Final statistics showed that the questionnaire was responded to by a total of 707 respondents, the composition of which was as follows on the next page:

External auditors:	(Big-Six 72)	(nonBig-Six 51)	123
Bankers:	(clearing 55)	(non-clearing 33)	88
Credit managers:	(early 172)	(late 73)	245
Internal auditors:	(early 179)	(late 72)	251
Total respondents:			707

The response rates for the two postal groups were 50.0% (245/490) for the CM group, and 51.3% (251/489) for the IA group. Per Babbie [1990: 183] these rates excluded "all questionnaires that could not be delivered" and, were acceptable for study, as Babbie [1990: 182] holds "a rate of at least 50% is ... adequate for analysis."

The purpose of this chapter was to outline the rationale used for research usage of each research group, so as to confirm their relevance and appropriateness when studying EAI. This was completed in the first section of the chapter. The second section of the chapter described how, within each group, questionnaire respondents were obtained. Thus this chapter provided the relevant background details of each research group and respondents belonging to it.

In summary, this chapter concerned itself with providing details of the judges used in the EAI perceptual exercise. In continuing the application of the Brunswick Lens paradigm, the next chapter concerns itself with the provision of relevant details (attributes) attached to the responses provided by the judges used in this research exercise.

CHAPTER VIII

SOME ATTRIBUTES OF THE QUESTIONNAIRE RESPONSES

The purpose of this chapter is to describe some of the attributes attached to the responses derived from the completed questionnaires. In Brunswick Lens model terms, this chapter may be seen as a revelation of some of the main features underlying the "verdicts" or "judgements" provided by the "judges". As such, the chapter does not describe the responses themselves (done in the next chapter) but focuses more on their intrinsic nature.

The reason for presenting this discussion of the nature of the responses is based on the facts that;

1. limitations attached to the results themselves will restrict the validity of any results achieved from statistical treatment of them
2. any statistical treatments applied to the responses must be in accord with the nature of the responses, as not all statistical treatments lend themselves to all types of response data.

In considering both the above facts, this chapter has two main sections. The first section is devoted to a discussion of the underlying nature of the responses and related statistical possibilities.

The second section of the chapter concerns itself with the detection of a feature that may limit the interpretation of those responses derived from the mailed questionnaires used in the research - i.e. non-response bias (NRB).

8.1 Nature of the responses

In considering the underlying nature of the responses, this section of the chapter focuses on the following issues:

1. Their "refined" nature
2. Their "statistical" nature

The "refined" nature of the responses

As previously noted, this research recognised that external auditor independence is a multi-faceted issue, and so rather than seek views of it in pure abstract terms, sought views of (it as held by respondents in the four research groups) within specified auditor-client situations, the circumstances of which were described as succinctly as possible.

The rationale employed was that it is more useful to obtain views of EAI with regard to specified possible and/or potential provocations to it (stimuli), rather than generalised views of the subject, with little practical significance.

Previous similar research [Lavin, 1974] examining perceptions of EAI within clearly described situations suffered from the weakness that it allowed for judgements to be provided only on a ("independent" - "not independent") dichotomous basis. In other words it did not allow for expression of intensity.

Later research [Pearson, 1979] attempted to address this weakness by seeking responses on a 7-point scale (as is the case in this research) by asking for responses on an "agree" (positively numbered) or "disagree" (negatively numbered) basis, and so allowing for their underlying intensity to be registered, by indicating the extent of agreement or disagreement.

However, Pearson did not allow for the fact that responding individuals may themselves have different numeric weights attached to the scales. In other words no provision was made for individual interpretation of the response scale provided.

Accordingly, in addition to requesting respondents to provide their underlying degree of confidence (intensity), they were also asked to provide their own personal yardstick (using the same response scale) of the Minimum Level of Confidence (MLC) in EAI that they consider may be reasonably demanded or expected.

The consequence of obtaining each respondent's MLC was that it allowed for their responses to each situation to be judged against the standard or level that they had personally put forth. Thus, in this research, the actual responses provided to the questionnaire are considered the "raw" responses, while raw responses as reduced by the relevant individual respondent's MLC are considered the "refined" responses.

Equally, a negative refined response indicates a dissatisfaction or concern with EAI whereas a positive refined response denotes a lack of (negative) concern, or perhaps even an assurance with EAI. Further, as refined responses contain within them a personalised expression of each respondent's view both on EAI within a particular situation but also his own expectations as to EAI, this research focuses only on the refined responses and raw responses are not considered further.

<u>The "statistical" nature of the responses</u>

It is important to consider the underlying statistical nature of the responses obtained from completed questionnaires, as it is that feature that determines the appropriateness (or otherwise) of applying particular statistical tests. In other words, the nature of responses governs the choice of statistical tests to which they may be validly applied.

By ensuring that the response scale employed for this research revealed ordinal-scale and interval-scale data, the responses accordingly derived reflected properties attributable to both ordinal-scale and interval-scale data.

Thus, the response data obtained was amenable to both parametric-tests (appropriate for interval-scale data) and non-parametric tests (appropriate for ordinal-scale data).

Further, comparison of the results of significance tests derived from parametric (t-test) and non-parametric tests (Mann-Whitney), tended to corroborate each other in the vast majority of instances - suggesting appropriate and valid usage of both parametric and non-parametric tests (as conducted in some of the following chapters).

8.2 Non-response bias

As the views of the credit manager and internal auditor groups were sought through a mailed questionnaire, their responses were examined for non-response bias (NRB), a feature that may arise in any mail survey because not all those questioned respond. This (non-response) may be because only those with an empathy for or negativity against the research subject respond.

If that is the case, the responses of those who have responded will contain a bias, and in assessing the results of research conducted through mail questionnaire surveys, it is important to test for and confirm the absence of NRB.

An approach often used (and employed in this research), when testing for NRB is the "surrogate method", which is premised on the that belief that non-respondents (respondents who do not reply at all - despite two or more requests) are very similar to late-respondents (respondents who reply, but after two or more requests).

On that basis, confirmation of no significant differences between the late-respondents and the early-respondents (those who reply upon the first request), one may infer no significant differences between respondents and non-respondents, with the research findings being unlikely to contain elements of NRB.

The methods employed to test for NRB are as suggested by Wallace and Mellor [1988: 136] and Wallace and Cooke [1990]. Though the former suggest that "non-parametric tests may be more efficient, and more appropriate" when testing for NRB, the responses of these two groups were tested for NRB using both types of tests.

The parametric test used to test for NRB was the t-test. The non-parametric tests used to test for NRB were the Mann-Whitney and Kolmogorov-Smirnov tests.

In this research, responses of those of the two mail-surveyed groups who replied to the first request (early respondents) were compared with those of the same group responding to the second request (late respondents). Only two completion requests were made for both groups. Further, in judging NRB, responses related not only to the main questionnaire were judged, but also responses related to the few biographical details requested in Section 3 of the questionnaire (Appendix B).

Parametric (t-) test (IAs and CMs)

Main questionnaire responses

Identical results were obtained for both relevant groups (IAs and CMs), when refined responses were t-tested. Such findings suggest strong evidence of freedom from NRB within these responses.

Biographical responses

With the exception of two features, the same t-test results were obtained for biographical responses of both groups. The two excepted features were, frequency with which use made of audited statements and familiarity with the process of issuing audit opinions.

Nonparametric (M-W and K-S) tests (IAs and CMs)

Two non-parametric tests, the Mann-Whitney U-test (M-W) and the Kolmogorov-Smirnov (K-S) test were also applied to both (early and late responding) sets of (main questionnaire and biographical) responses for the IA and CM groups.

Main questionnaire responses

In terms of refined responses, both nonparametric tests indicated much the same results. In fact this was consistently true for the credit manager group.

In terms of the Internal auditor group, this was also so with the exceptions of Situations 13 and 20 for both tests, and Situation 12 for the M-W U-test only. As such, allowing for these limited exceptions, the non-parametric tests findings suggested that both respondent sets for both groups were essentially drawn from the same population.

However, with respect to the Internal auditor group only, the result for the K-S test for Situation 12 only did not confirm the comparable result indicated by the M-W U-test. Equally, the data only very marginally failed to meet the pre-established (5%) significance level for the K-S test with reference to Situations 13 and 20.

Biographical responses

With regard to the biographical responses for the IA group only, the results of both nonparametric tests indicated (with one feature excepted) that the two (early and late responding) groups were likely to have been drawn from the same overall population, and hence unlikely to hold elements of NRB. However, this did not appear to be true of the feature regarding the frequency with which respondents made use of the audit opinions on audited financial statements.

With regard to the biographical responses for the credit manager group only, the nonparametric tests did not reveal totally consistent results. The results of K-S test indicated for all the personal features, that the two respondent sets were likely to have been drawn from the same overall population. However this was so for only two of the biographical responses in terms of the M-W U-test, these were the respondents' age-range and area of specialisation.

The remaining four biographical responses where this was not so, were respondents' years of experience using audited financial statements, familiarity with issuing audit opinions, possession of a university degree, and frequency with which use made of audited financial statements.

While it would be incorrect to state that the NRB tests within the responses for the two mail-surveyed groups revealed <u>no</u> traces of it at all, it is true to state that this was so in only an <u>extremely limited</u> number of responses.

Further, where this was so, it is also true to state that in many cases the results only very marginally failed to meet the pre-established criteria, or in many other cases were not confirmed by another statistical test. As such, the overall conclusion in relation to the responses used as the dataset for this research may well be said to be free from NRB and a good basis for further investigation.

This chapter has attempted to ensure that the responses obtained from all respondents were amenable to both parametric and non-parametric tests. Furthermore, it attempted to confirm that there was no NRB inherent within the CM and IA groups, from whom responses were obtained by (first and second) postal requests.

In general, this appeared to be the case and because of the general consistency between the results of parametric and non-parametric (significance) tests and the nature of the response scale employed, assurance was taken for appropriate usage of both types of tests.

CHAPTER IX

STATISTICAL DESCRIPTION OF THE DATA ANALYSED

This chapter provides a brief descriptive overview of the refined responses to the twenty situation questions on EAI in the research questionnaire. The first section of the chapter considers aspects of the data relating to all four research groups, while the second considers the same within the external auditor group only.

The data is also described in two sets of statistical tables, the first relating it across the four research groups and the second relating it within the external auditor group only on a Big-Six/nonBig-Six or Partner/non-Partner basis. Except where otherwise indicated, responses considered in this research consistently relate only to the refined responses obtained from respondents.

9.1 Data for the four research groups

As the Minimum Level of Confidence (MLC) indicated by a respondent was vital to the development of his/her refined (or personalised) responses, Table 9.1 presents for each research group individually, and for all respondents together in one group, their collapsed percentage frequency statistics with reference to their responses to the MLC question [App. B, Vol. II: 254].

The MLC response

Of note is the fact that Table 9.1 shows that the mean MLC for the EA Group (4.29) was higher than that of the three User Groups - Bankers, Credit Managers and Internal Auditors (which ranged from 3.87 to 4.02).

Thus, it is likely that the degree of tolerance permitted auditors in terms of EAI by User Groups, is higher than that granted by EAs (the Issuer Group) towards themselves. If so, this is an interesting insight into these User Groups' attitudes towards EAI.

To have an insight into the dispersion for each group's mean response, Table 9.1 also provides, on a group by group basis, the standard deviations (SD) for the MLC response. At 0.78, the SD for the MLC question was lowest for EAs, and at 0.92 the highest for BAs. SDs for CMs and IAs were much the same at .90 and .89.

A consistency of approach was noted in the response to the MLC question. In this regard, Table 9.1 shows that the median response for all groups to that question was 4, indicating a strong consistency on this feature by all groups, and the fact that all groups consider a HIGH degree of confidence in EAI to be the **MINIMUM** level that may be justly demanded and expected by users of audited financial statements.

TABLE 9.1

SELECT STATISTICAL DATA FOR AND PERCENT OF GROUPS' RESPONSES TO MINIMUM LEVEL OF CONFIDENCE (MLC) QUESTION

	External Auditors	Bankers	Credit Mgrs.	Internal Auditors	All Groups
Select Statistical Data:					
MEAN	4.29	4.02	3.87	3.97	4.00
S.DEV. (MEAN)	0.78	0.92	0.90	0.89	0.89
MODE	4	4	4	4	4
MEDIAN	4	4	4	4	4
SKEWNESS	0.08	0.34	0.61	0.53	0.43
KURTOSIS	0.13	-0.55	0.04	0.34	-0.07
n=	120	81	244	251	696
NOT STATED=	3	7	1	0	11
Levels of Confidence as stated by Percent of Group:					
NONE: 0	-	-	-	-	-
VERY LOW: 1	-	-	-	-	-
LOW: 2	0.8	1.2	2.1	2.3	1.9
MEDIUM: 3	11.7	30.9	35.6	25.9	27.4
HIGH: 4	50.9	38.3	42.2	51.8	46.7
VERY HIGH: 5	30.8	23.4	13.9	12.0	17.2
TOTAL: 6	5.8	6.2	6.2	8.0	6.8

Central tendencies and dispersion

In order to have an insight into central tendencies within the group responses, Table 9.2 presents the mean response for each group individually, and for all groups combined. Further, to help with an understanding of the dispersion for these means, the table also gives their standard deviation (SD). The table shows no major dispersion across responses to situational questions and all groups, with ranges of SD being as below:

Group	**Responses**	**Range of SD**
External Auditors	Refined	0.94 to 1.61
Bankers	Refined	0.88 to 1.29
Credit Managers	Refined	1.15 to 1.41
Internal Auditors	Refined	1.14 to 1.45

The above shows the highest SD within all groups for responses to be 1.61 and the lowest to be 0.88. As such, there appears to be no strong or significant dispersion of group responses from their mean, which suggests an element of centralising tendency within the refined responses for all groups.

Ranking of mean responses

Table 9.3 presents a ranked order presentation of the twenty situations - the situations being ranked on a descending (intensity or concern) basis, of the appropriate group mean response.

TABLE 9.2

MEAN AND RELATED STANDARD DEVIATION: REFINED GROUP RESPONSES TO SITUATION QUESTIONS

	Sitn.	EAs	BAs	CMs	IAs	All
Mean	1	0.42	0.07	-0.09	-0.25	-0.04
S. Dev.	1	1.08	1.18	1.28	1.26	1.25
Mean	2	0.07	-0.36	-0.91	-0.75	-0.62
S. Dev.	2	1.11	1.15	1.27	1.32	1.30
Mean	3	0.08	-0.07	-0.61	-1.17	-0.63
S. Dev.	3	1.13	1.13	1.30	1.45	1.39
Mean	4	-1.15	-0.95	-1.73	-1.78	-1.56
S. Dev.	4	1.61	1.21	1.41	1.45	1.47
Mean	5	-0.38	-0.21	-0.30	-0.41	-0.34
S. Dev.	5	1.26	1.23	1.22	1.20	1.22
Mean	6	-0.12	-0.48	-1.11	-0.83	-0.76
S. Dev.	6	1.21	1.13	1.29	1.31	1.31
Mean	7	-0.05	0.03	-0.49	-0.45	-0.34
S. Dev.	7	1.16	0.88	1.19	1.14	1.15
Mean	8	-0.28	-0.19	-0.55	-0.43	-0.42
S. Dev.	8	1.48	0.99	1.24	1.33	1.29
Mean	9	-0.35	-0.42	-0.85	-0.83	-0.71
S. Dev.	9	1.21	1.09	1.31	1.39	1.31
Mean	10	0.43	-0.06	-0.18	-0.22	-0.08
S. Dev.	10	0.94	1.19	1.15	1.18	1.15
Mean	11	-0.13	-1.00	-1.29	-1.02	-0.96
S. Dev.	11	1.19	1.29	1.41	1.29	1.38
Mean	12	-1.63	-1.04	-1.14	-1.17	-1.22
S. Dev.	12	1.23	1.16	1.27	1.20	1.24
Mean	13	0.08	-0.43	-0.73	-0.85	-0.60
S. Dev.	13	1.09	1.07	1.29	1.17	1.23
Mean	14	-0.64	-0.90	-1.68	-1.33	-1.29
S. Dev.	14	1.28	1.22	1.36	1.41	1.40
Mean	15	-0.98	-0.41	-0.82	-0.85	-0.81
S. Dev.	15	1.61	1.05	1.22	1.35	1.33
Mean	16	-0.18	-0.26	-0.27	-0.44	-0.32
S. Dev.	16	1.09	1.01	1.18	1.19	1.15
Mean	17	-0.85	-0.46	-0.58	-0.66	-0.64
S. Dev.	17	1.36	1.15	1.26	1.34	1.30
Mean	18	-0.80	-0.21	-0.43	-0.69	-0.56
S. Dev.	18	1.11	1.00	1.18	1.20	1.17
Mean	19	-0.10	-0.49	-0.66	-0.60	-0.52
S. Dev.	19	1.27	1.07	1.17	1.31	1.24
Mean	20	-0.47	-0.43	-0.87	-0.76	-0.71
S. Dev.	20	1.43	1.05	1.24	1.31	1.29

KEY TO SCALES OF ASSURANCE IN OR (CONCERN WITH) EAI

(-)=CONCERN(CON): (+)=POS. ASSURANCE(PA): 0=NO CON/PA

1=V.LOW 2=LOW 3=MEDIUM 4=HIGH 5=V.HIGH 6=TOTAL

TABLE 9.3

ORDERED RANKING OF SITUATIONS BASED ON MEAN VALUE OF REFINED GROUP RESPONSES TO SITUATION QUESTIONS

Groups	EAs	BAs	CMs	IAs	All
Rank	Situation Number				
1	12	12	4	4	4
2	4	4	14	14	14
3	18	11	11	12	12
4	15	14	12	3	11
5	17	19	6	11	15
6	14	6	2	13	6
7	20	17	20	15	20
8	9	13	9	9	9
9	5	9	15	6	2
10	16	20	13	20	3
11	8	15	19	2	17
12	11	2	3	18	13
13	6*	16	17	17	18
14	19	5	8	19	19
15	7	18	7	16	8
16	3	8	18	7	5
17	13*	10	5	5	16
18	2	3	16	8	7
19	10	1	10	10	10
20	1	7	1	1	1

* = Tied with immediately following rank

Table 9.3 clearly does not reveal any total consistency of approach for the groups' refined responses. In fact, no single pattern of consistently overall group ranking emerges. However, what commonality there is, indicates some continued and general consistency of approach to EAI issues between the research groups analysed.

One method of detecting similarity in approach to an issue by various respondents, is to assess any patterns of commonality in the way in which they rank the issues under consideration. Thus, the mean ranks for the refined responses to the twenty research questions for all groups were computed. The table does not reflect total similarity, or even a very high degree of commonality between the four research groups, as no group's order of ranking was echoed by another. However, pockets of similarity were detected between some of the groups.

While the elements of each group's ranking order varied in its central parts, there appeared to be some parallel approach in terms of the extremes. It became evident that situations 4 and 12 figured strongly at the lowest end, while at the highest end, the same was true of situations 1 and 10. This would suggest most concern with EAI in situations 4 and 12, and least concern with the same in situations 1 and 10.

The modal responses

Further, on the same group basis, and in order to provide an indication of other measures of central tendency, Table 9.4 presents the mode and median (refined) responses to the questionnaire situations.

While the mode is not usually considered to be the preferred measure of central tendency for ordinal and interval data [Norusis, 1988b: B-85], used together with other measures, there are often insights to be derived from the use of modal values in many instances.

Thus, Table 9.4 states the modal value of each group's refined responses to the twenty situations. The table shows good correspondence between the CM and IA groups only, with them sharing modes for fifteen of the twenty (75%) situations (all except, 2, 4, 6, 13 and 14). A better modal consistency was noted between the EA and BA groups, with them having differing modes in only three situations (4, 11 and 12).

Other situations showed varying and inconsistent group modal patterns. Thus when viewed in modal terms, there is some consistency of approach on EAI between the CM and IA groups, while this is somewhat better for the BA and EA groups.

TABLE 9.4

MODE AND MEDIAN: REFINED GROUP RESPONSES TO SITUATION QUESTIONS

	Sitn.	EAs	BAs	CMs	IAs	All
Mode	1	0	0	0	0	0
Median	1	0	0	0	0	0
Mode	2	0	0	-1	0	0
Median	2	0	0	-1	-1	0
Mode	3	0	0	0	0	0
Median	3	0	0	-1	-1	0
Mode	4	0	-1	-1	-2	-1
Median	4	-1	-1	-2	-2	-1
Mode	5	0	0	0	0	0
Median	5	0	0	0	0	0
Mode	6	0	0	-1	0	0
Median	6	0	0	-1	-1	-1
Mode	7	0	0	0	0	0
Median	7	0	0	0	0	0
Mode	8	0	0	0	0	0
Median	8	0	0	0	0	0
Mode	9	0	0	0	0	0
Median	9	0	0	-1	-1	0
Mode	10	0	0	0	0	0
Median	10	0	0	0	0	0
Mode	11	0	-1	-1	-1	0
Median	11	0	-1	-1	-1	-1
Mode	12	-2	-1	-1	-1	-1
Median	12	-2	-1	-1	-1	-1
Mode	13	0	0	0	-1	0
Median	13	0	0	-1	-1	0
Mode	14	0	0	-2	-1	-1
Median	14	0	-1	-2	-1	-1
Mode	15	0	0	0	0	0
Median	15	-1	0	-1	-1	-1
Mode	16	0	0	0	0	0
Median	16	0	0	0	0	0
Mode	17	0	0	0	0	0
Median	17	-1	0	0	0	0
Mode	18	0	0	0	0	0
Median	18	-1	0	0	-1	0
Mode	19	0	0	0	0	0
Median	19	0	0	-1	0	-1
Mode	20	0	0	0	0	0
Median	20	0	0	-1	-1	-1

KEY TO BASIS LEVELS OF ASSURANCE IN (CONCERN WITH) EAI

(-)=CONCERN(CON): (+)=POS. ASSURANCE(PA): 0=NO CON/PA

0=NONE 1=V.LOW 2=LOW 3=MEDIUM 4=HIGH 5=V.HIGH 6=TOTAL

Table 9.4 also shows that (on a modal basis) no group was consistently satisfied with EAI for all situations. However a strong pattern of modal consistency was revealed, with all groups sharing the same modal value in thirteen of the twenty (65%) situations (1, 3, 5, 7 to 10 and 15 to 20), and all User Groups registering the same mode in a further two (11 and 12).

Thus, when judged in terms of respondents' refined responses, there appears to be some consistency of approach towards EAI by all four groups. Further, in modal terms only, EAs appeared most content with their levels of confidence in EAI in the 20 situations, as they received their MLC (or better) in 19 of them. Situation 12 was the only one where this was not so.

Equally, in modal terms, CMs and IAs appeared least satisfied with EAI, as they were provided with their MLC (or better) in 16 and 15 of the 20 situations respectively, while Bankers received their MLC in 17 of the situations.

Table 9.4 shows that in modal terms there was only one situation (12) where **all** groups consistently failed to receive at least their respective MLC. By the same token, there were only two situations (4 and 11) where all User Groups only failed to receive their MLC.

Situations 2, 4, 6, 11, 12, 13, and 14 were ones in which at least one of the User Groups failed to receive its respective MLC. In all other situations, all groups received their respective modal MLCs.

The median responses

The median value of a distribution (being that observed value in it, such that one half of the observations in the distribution fall above it and the other half fall below it), is usually a good measure of central tendency for ordinal data, as it makes use of the rank information contained within such data [Norusis, 1988b: B-85].

Further, when the population is skewed negatively or positively, the median is often the best measure of location, because it is always between the mean and the mode, and it is not as highly influenced as the frequency occurrence of a single value as the mode is, nor is it pulled by extreme values as in the case of the mean [Levin, 1984: 90].

Thus, as skewness was revealed (Table 9.5) with reference to all the responses for all situations and across all groups, it is more than appropriate that the appropriate median value response for each group be duly considered.

In terms of median group refined responses, Table 9.4 shows reasonable consistency of approach to EAI by the groups. Firstly, six situations (1, 5, 7, 8, 10 and 16) showed the same median value for all research groups. Secondly, two more situations (11 and 12) showed the same median value for all three User Groups only.

As such, User Groups had the same median value for nine of the twenty (45%) situations, showing some uniformity towards EAI by the groups. However, equally significant is the fact that in 14 situations (all except, 11, 12, 14, 15, 17 and 18), the same median values were shared by the EA and BA group on the one hand.

Comparison of group means, modes and medians

It is of benefit to note any correspondence between the mean, mode and median of given distributions, because symmetrical distributions usually have the same value for each of these statistics. In such a case, any one of them is suitable as an inferential statistic, as all give similar estimates of central tendency.

This comparison was done for responses to the twenty situations. The comparison showed only weak response symmetry, because they consistently registered the same mean, mode and median, across groups, in only 8 of the 20 situations (i.e. 1, 5, 7, 8, 10, 11, 12 and 16).

Exceptionally however, the refined responses of the Banker group appeared to have extremely strong symmetry, with only one of the twenty situations registering varying mean, mode and median values.

<u>The response distributions (skewness and kurtosis)</u>

In addition to considering measures of central tendency, it is also useful to learn the nature of the distribution(s) underlying responses. To do this, the skewness and kurtosis of each set of responses was examined on a group basis and Table 9.5 presents these values for refined responses to the twenty situation questions.

<u>Skewness</u>

Skewness describes the symmetry (or lack of it) within a distribution. Positive skewness values suggest a high proportion of observations, when plotted on a graph, lie towards the right of it (the larger values judged). Negative values of skewness indicate the opposite.

[While values for skewness are zero in an exactly normal distribution (indicating neither positive nor negative skewness), this is not true for samples taken from a normal distribution, where measures of skewness will usually not be exactly zero, but will rather fluctuate around it because of sampling variation.]

TABLE 9.5

SKEWNESS AND KURTOSIS ON RESPONSE DISTRIBUTIONS:

REFINED GROUP RESPONSES TO SITUATION QUESTIONS

	Sitn.	External Auditors	Bankers	Credit Mgrs.	Internal Auditors	All Groups
Skew.	1	-0.05	-0.57	-0.60	-0.89	-0.71
Kurt.	1	0.43	1.03	1.15	1.92	1.43
Skew.	2	-0.21	-0.86	-0.38	-0.57	-0.49
Kurt.	2	0.01	0.76	0.58	0.30	0.41
Skew.	3	0.60	-0.71	-0.42	-0.54	-0.60
Kurt.	3	1.06	1.93	0.45	0.36	0.62
Skew.	4	-0.10	-1.09	-0.30	-0.50	-0.34
Kurt.	4	-0.59	1.30	-0.81	0.40	0.06
Skew.	5	-0.38	-0.63	-0.68	-0.84	-0.66
Kurt.	5	0.11	0.48	0.49	0.98	0.55
Skew.	6	-0.21	-0.98	-0.58	-0.63	-0.55
Kurt.	6	0.67	1.06	0.31	0.31	0.46
Skew.	7	-0.69	-0.61	-0.48	-0.64	-0.60
Kurt.	7	2.52	0.23	0.52	0.87	0.98
Skew.	8	-0.94	-0.65	-0.72	-1.08	-0.91
Kurt.	8	1.32	0.84	0.51	2.36	1.54
Skew.	9	-0.62	-0.92	-0.45	-0.98	-0.76
Kurt.	9	1.42	1.68	0.72	1.62	1.32
Skew.	10	-0.21	-1.12	-0.55	-0.48	-0.60
Kurt.	10	0.40	3.17	0.81	1.07	1.20
Skew.	11	-0.66	-0.36	-0.52	-0.25	-0.43
Kurt.	11	1.41	-0.40	-0.07	0.23	0.14
Skew.	12	0.16	-1.07	-0.35	-0.37	-0.34
Kurt.	12	1.10	1.25	0.32	-0.05	0.22
Skew.	13	-0.31	-1.43	-0.54	-0.62	-0.59
Kurt.	13	0.78	4.52	0.04	0.54	0.63
Skew.	14	-0.97	-1.00	-0.07	-0.55	-0.46
Kurt.	14	1.88	1.91	0.02	0.45	0.21
Skew.	15	-0.58	-0.72	-0.43	-1.18	-0.84
Kurt.	15	-0.03	1.23	0.49	2.17	1.21
Skew.	16	-0.69	-0.35	-0.56	-0.31	-0.47
Kurt.	16	3.06	0.31	0.65	0.65	0.91
Skew.	17	-0.32	-0.84	-0.64	-0.36	-0.49
Kurt.	17	-0.43	0.72	1.14	0.84	0.63
Skew.	18	-0.33	-0.18	-0.40	-0.46	-0.41
Kurt.	18	-0.17	0.19	-0.08	0.11	0.03
Skew.	19	-0.73	-0.51	-0.48	-0.39	-0.45
Kurt.	19	2.03	0.72	0.23	0.59	0.68
Skew.	20	-0.53	-1.32	-0.65	-0.68	-0.65
Kurt.	20	0.69	3.73	1.53	1.51	1.39

Table 9.5 shows the refined responses reflected negative skewness for all groups and situations, the only exception being situation 12 for the EA group. The likely conclusion to be drawn from this phenomenon, may be that in terms of refined responses, all groups had distributions skewed towards the lower values of the response scale - lower degrees of confidence in EAI.

Kurtosis

Another method of describing a given distribution is to assess the extent to which observations in it cluster around a central point for a given SD. Such an assessment is available in the measure of kurtosis.

In terms of the refined responses (Table 9.5), with the maximum exception of four situations for each group, all of the research groups had a positive kurtosis in all twenty situations. This would suggest that the responses for all groups (in general) tended to be leptokurtic, and so more than normally clustered around a single value on the response scale.

Degree of Concordance

In addition to the nature of the underlying distributions, it is always of interest to determine the degree of accord (or concordance) within respondents from individual respondent groups.

One statistic available for such assessment is the Kendall Coefficient of Concordance (W). A "high or significant value of W may be interpreted (to mean) that ... judges are applying ... the same standard in ranking the objects under study" [Siegel, 1956: 237].

The Kendall test is available for use in relation to two or more variables in the same set of cases (i.e. responses). It judges the concordance in rankings for pairs of observations and, after making allowance for "ties", computes W, which is a composite measure of the overall concordance present in the rankings.

Kendall's W is appropriate in the present instance, as it is a nonparametric test designed for use on ordinal data, which the responses being considered are. When computed, values of W range from 0 (indicating no agreement at all) to 1 (indicating total agreement).

Thus, W and its related significance for the refined responses provided by each research group individually, and by all groups pooled, were computed. Table 9.6 is a summary of these statistics. As Table 9.6 shows, the degree of rank concordance within the EA and CM groups was much the same at $W = 0.24$ and 0.23 respectively, while that within the IA and BA groups was also about the same at $W = 0.17$ and 0.16 respectively.

TABLE 9.6

KENDALL COEFFICIENT OF CONCORDANCE STATISTICS *: REFINED GROUP RESPONSES TO ALL SITUATION QUESTIONS COLLECTIVELY

Group	Kendall's W	Chi-sq.	Significance
Research Groups:			
External Auditor	0.24	545.28	0.00
Banker	0.16	246.94	0.00
Credit Manager	0.23	1039.36	0.00
Internal Auditor	0.17	774.87	0.00
All respondents	0.10	1301.34	0.00
Ext. Auditor Group:			
Big-Six Auditors	0.31	400.29	0.00
nonBig-Six Auditors	0.21	197.36	0.00
Partner Auditors	0.27	147.89	0.00
non-Partner Auditors	0.25	414.63	0.00

* Rounded to two decimal places

However, there appeared to be very little accord within responses when those from all groups were assessed together. On that basis, W amounted to only 0.10, suggesting little uniformity within the responses from all the groups when viewed collectively.

Assessing each group individually, the W-statistics showed very high similarity between the raw and refined responses provided by each of them, as in all cases the statistic remained the same. However, while the overall level of concordance remained constant for both raw and refined sets of responses, specific pairs of rankings within each groups' responses may individually have been in discord.

The most likely inference is that individual MLCs do not cause a significant variation between the rankings for group raw and refined responses; certainly not enough to reduce the degree of concordance (W) within each set of responses.

9.2 Data for the external auditor group only

When analysing views of EAI within the EA group, their responses were considered on a Big-Six/nonBig-Six basis and/or on a partner/non-partner basis, with regard to the same features as those previously examined for all four research groups (mean, mode, median etc.).

The MLC response

There appeared to be remarkable similarity in the MLC indicated by external auditor respondents (Table 9.7). For all sets of them (Big-Six, nonBig-Six, partner and non-partner), the MLC was just somewhat over 4.0 (a "HIGH" level of confidence) and this is corroborated in consistent modes and medians of 4 for these groups.

Thus (despite a significant difference in MLC for Big-Six vs nonBig-Six auditors - Chapter 11), it is with substance to claim some uniformity of approach by all external auditor sets in terms of the MLC responses.

Central tendencies and dispersion

In general, refined responses from the external auditor group reflected only moderate variability. As stated on Table 9.8, their mean standard deviations ranged from a low of .81 (Big-Six auditors on Situation 10), to a high of 1.75 (nonBig-Six auditors on Situation 4). Standard deviations in the partner/non-partner groups were similar with the lowest being 1.04 for both.

This lowest SD of 1.04 was noted for the partner group on Situation 1 and on Situation 2 for the non-partner group. The highest SD of 1.67 and 1.56 for these two groups was registered on Situation 8 for the partner group, and Situation 4 for the non-partner group.

TABLE 9.7

SELECT STATISTICAL DATA FOR AND PERCENT OF EXTERNAL AUDITOR GROUPS' RESPONSES TO MINIMUM LEVEL OF CONFIDENCE (MLC) QUESTION

	BIG-SIX	nonBIG-SIX	PARTNERS	non-PARTNERS
Select Statistical Data:				
MEAN	4.49	4.02	4.20	4.32
S.DEV. (MEAN)	0.74	0.76	0.93	0.73
MODE	4	4	4	4
MEDIAN	4	4	4	4
SKEWNESS	0.03	0.25	0.42	-0.04
KURTOSIS	-0.23	1.14	0.89	-0.37
n=	69	51	30	89
NOT STATED=	3	-	1	2
Levels of Confidence as stated by Percent of Group:				
NONE: 0	-	-	-	-
VERY LOW: 1	-	-	-	-
LOW: 2	-	2.0	3.3	-
MEDIUM: 3	7.2	17.6	10.0	12.4
HIGH: 4	43.5	60.8	63.4	47.2
VERY HIGH: 5	42.1	15.7	10.0	37.0
TOTAL: 6	7.2	3.9	13.3	3.4

TABLE 9.8

MEAN AND S.D.: REFINED RESPONSES TO SITUATION QUESTIONS

EXTERNAL AUDITORS FROM BIG-6 AND NONBIG-6 AUDIT FIRMS

	SITN.	BIG-6	nonBIG-6	PARTNERS	NON-PARTNERS
Mean	1	0.54	0.26	0.57	0.39
S. Dev.	1	0.98	1.20	1.04	1.07
Mean	2	0.13	-0.02	0.40	-0.02
S. Dev.	2	1.03	1.23	1.22	1.04
Mean	3	0.12	0.04	0.27	0.05
S. Dev.	3	1.08	1.20	1.14	1.11
Mean	4	-1.09	-1.24	-0.40	-1.38
S. Dev.	4	1.51	1.75	1.55	1.56
Mean	5	-0.51	-0.20	-0.47	-0.33
S. Dev.	5	1.18	1.36	1.28	1.26
Mean	6	-0.06	-0.20	0.17	-0.20
S. Dev.	6	1.15	1.30	1.39	1.14
Mean	7	0.19	-0.37	0.37	-0.19
S. Dev.	7	0.91	1.37	1.27	1.10
Mean	8	-0.46	-0.02	-0.33	-0.26
S. Dev.	8	1.50	1.42	1.67	1.43
Mean	9	-0.30	-0.41	-0.07	-0.44
S. Dev.	9	1.24	1.19	1.14	1.23
Mean	10	0.57	0.24	0.63	0.36
S. Dev.	10	0.81	1.07	0.96	0.93
Mean	11	0.20	-0.57	0.47	-0.32
S. Dev.	11	0.87	1.42	1.11	1.16
Mean	12	-1.80	-1.39	-1.40	-1.69
S. Dev.	12	1.12	1.34	1.38	1.17
Mean	13	0.19	-0.08	0.37	-0.02
S. Dev.	13	0.93	1.26	1.16	1.06
Mean	14	-0.42	-0.94	-0.40	-0.72
S. Dev.	14	1.22	1.32	1.43	1.23
Mean	15	-1.33	-0.51	-1.00	-0.94
S. Dev.	15	1.60	1.52	1.82	1.52
Mean	16	-0.12	-0.28	0.03	-0.25
S. Dev.	16	0.95	1.27	1.13	1.08
Mean	17	-0.91	-0.77	-0.37	-0.98
S. Dev.	17	1.36	1.37	1.47	1.25
Mean	18	-0.68	-0.96	-0.50	-0.89
S. Dev.	18	1.13	1.07	1.08	1.11
Mean	19	-0.01	-0.22	0.23	-0.20
S. Dev.	19	1.23	1.33	1.25	1.27
Mean	20	-0.33	-0.65	0.00	-0.61
S. Dev.	20	1.36	1.51	1.49	1.38

Ranking of mean responses

The ranking of mean refined responses (Table 9.9) indicated some level of consistency, in that all auditor groups had their highest level of mean concern on Situation 12 (10% of gross fees from only listed client). Equally, all EA groups recorded their highest assurance with EAI in either Situations 1 (nonBig-Six and non-partners) or 10 (Big-Six and partners).

The modal responses

Again, in terms of their modal refined responses (Table 9.10), external auditors appeared to be speaking with some uniformity. For at least 16 of the 20 situations, the modal responses for any of the four auditor groups was 0. While modal responses of -1 and -2 were noted, these were certainly the exception. Interpreting this modal statistic, one would infer that in the majority of situations, auditors were not perturbed by the EAI issues intrinsic to them.

The median responses

The uniformity present in terms of modal responses from external auditors was also noticed in terms of their median responses (Table 9.10), but to a lesser degree. Thus, in at least 14 of the 20 audit situations, was the median refined response recorded by the four auditor groups, equal to 0.

TABLE 9.9

EXTERNAL AUDITOR GROUP: RANKING OF SITUATIONS BASED ON MEAN VALUE OF REFINED RESPONSES TO SITUATION QUESTIONS

Groups	Big-Six	nonBig-Six	Partners	non-Partners
Rank	Situation Number			
1	12	12	12	12
2	15	4	15	4
3	4	18	18	17
4	17	14	5	15
5	18	17	14*	18
6	5	20	4	14
7	8	11	17	20
8	14	15	8	9
9	20	9	9	5
10	9	7	20	11
11	16	16	16	8
12	6	19	6	16
13	19	5*	19	19*
14	3	6	3	6
15	2	13	7*	7
16	7*	8*	13*	13*
17	13*	2*	2	2*
18	11	3	11	3
19	1	10	1	10
20	10	1	10	1

* = Tied with immediately following rank

TABLE 9.10

MODE AND MEDIAN: REFINED RESPONSES TO SITUATION QUESTIONS - EXT. AUDITORS: BIG-6 & NONBIG-6 AUDIT FIRMS

	SITN.	BIG-6	nonBIG-6	PARTNERS	NON-PARTNERS
Mode	1	0	0	0	0
Median	1	0	0	0	0
Mode	2	0	0	0	0
Median	2	0	0	0	0
Mode	3	0	0	0	0
Median	3	0	0	0	0
Mode	4	-1	0	0	-1
Median	4	-1	-1	0	-1
Mode	5	-1	0	-1	0
Median	5	0	0	-1	0
Mode	6	0	0	0	0
Median	6	0	0	0	0
Mode	7	0	0	0	0
Median	7	0	0	0	0
Mode	8	0	0	0	0
Median	8	0	0	0	0
Mode	9	0	0	0	0
Median	9	0	0	0	0
Mode	10	0	0	0	0
Median	10	0	0	0.50	0
Mode	11	0	-1	0	0
Median	11	0	-1	0	0
Mode	12	-2	-2	-2	-2
Median	12	-2	-1	-2	-2
Mode	13	0	0	0	0
Median	13	0	0	0	0
Mode	14	0	-1	0	0
Median	14	0	-1	0	-1
Mode	15	0	0	0	0
Median	15	-1	0	-1	-1
Mode	16	0	0	0	0
Median	16	0	0	0	0
Mode	17	-1	0	0	-1
Median	17	-1	0	0	-1
Mode	18	0	0	0	0
Median	18	-1	-1	0	-1
Mode	19	0	0	0	0
Median	19	0	0	0	0
Mode	20	0	0	0	0
Median	20	0	-1	0	0

In a minority of situations, median responses other than 0 (-.5, -1 or -2) were observed. Thus, a median response of -1 was noted in 6 situations for the nonBig-Six auditor group and 5 situations for the non-partner auditor group.

Comparison of group means, modes and medians

In general, it would appear that the EA group had a reasonable level of uniformity within their refined responses. While it would be unreasonable to expect a sharing of mean responses, the four groups shared most of their modal and median responses (at a value of 0).

The response distributions

As for the responses from each of the four research groups, responses of the sub-groups within the EA group may be considered in terms of skewness and kurtosis.

Skewness

In general, it may be concluded (Table 9.11) that refined responses from the EA group were negatively skewed. Indeed, this was so in at least 15 of the 20 responses for all the four groups. However, as Table 9.11 shows, with 19 and 20 of the situational responses from the nonBig-Six and non-partner group negatively skewed, their responses registered more negative skewness than those from partners or Big-Six auditors.

TABLE 9.11

SKEWNESS AND KURTOSIS: REFINED RESPONSES TO SITUATION QUESTIONS - EXT. AUDITORS: BIG-6 & NONBIG-6 AUDIT FIRMS

	SITN.	BIG-6	nonBIG-6	PARTNERS	NON-PARTNERS
Skewness	1	-0.10	-0.59	-0.19	-0.51
Kurtosis	1	0.31	0.11	-0.20	0.72
Skewness	2	-0.02	-0.30	-0.61	-0.14
Kurtosis	2	-0.28	0.07	0.89	-0.05
Skewness	3	-0.24	-0.95	-0.57	-0.66
Kurtosis	3	-0.16	2.17	1.44	1.28
Skewness	4	-0.06	-0.09	-0.35	-0.07
Kurtosis	4	-0.56	-0.68	-0.13	-0.60
Skewness	5	-0.17	-0.68	0.13	-0.58
Kurtosis	5	-0.33	0.78	1.68	-0.14
Skewness	6	-0.01	-0.37	-0.16	-0.39
Kurtosis	6	0.19	1.03	0.12	0.97
Skewness	7	0.33	-0.74	-0.54	-0.99
Kurtosis	7	1.01	1.60	0.30	3.97
Skewness	8	-0.91	-1.05	-1.44	-0.68
Kurtosis	8	1.54	1.35	3.54	0.09
Skewness	9	-0.63	-0.63	-1.20	-0.48
Kurtosis	9	1.77	1.13	4.13	1.13
Skewness	10	0.46	-0.39	0.09	-0.35
Kurtosis	10	0.28	-0.25	-0.99	0.80
Skewness	11	-0.55	-0.16	0.09	-0.99
Kurtosis	11	2.33	0.55	0.07	1.48
Skewness	12	-0.16	0.25	1.04	-0.38
Kurtosis	12	-0.61	2.05	2.48	-0.00
Skewness	13	0.18	-0.41	-0.51	-0.31
Kurtosis	13	0.62	0.26	1.04	0.89
Skewness	14	-0.69	-1.31	-1.43	-0.85
Kurtosis	14	1.23	2.37	3.80	1.39
Skewness	15	-0.64	-0.57	-1.03	-0.36
Kurtosis	15	-0.10	-0.04	1.12	-0.64
Skewness	16	-0.30	-0.81	0.24	-1.10
Kurtosis	16	0.95	3.42	1.98	3.46
Skewness	17	0.02	-0.79	-0.49	-0.36
Kurtosis	17	-0.59	0.08	-0.62	-0.32
Skewness	18	-0.10	-0.82	-0.63	-0.28
Kurtosis	18	-0.62	0.26	0.31	-0.12
Skewness	19	-0.51	-0.96	-0.25	-0.93
Kurtosis	19	1.34	2.81	0.76	2.43
Skewness	20	-0.71	-0.31	-0.34	-0.74
Kurtosis	20	0.84	0.78	-0.17	1.10

The inference to be drawn from the preceding is that responses from the nonBig-Six and non-partner auditors were more frequently to be observed near the lower end (negative values) of the response scale than those provided by partners or Big-Six auditors.

Kurtosis

Refined responses from the EA group showed that most (at least 60% for all groups) distributions reflected a positive kurtosis (Table 9.11). As such, they would reflect more than normal clustering around values on the response scale. Kurtosis values ranged from a low of -.62 (Big-Six) to a high of 4.13 (partners).

Degree of Concordance

In general, auditors tended to register more uniformity than non-auditors when declaring their views on EAI in the audit situations. This is inferred from the W-statistic of the Kendall concordance test (Table 9.6).

Big-Six auditors appeared to be most in accord with the views of each other with a W-statistic of 0.31, and, nonBig-Six auditors least in accord with the views of each other with a W-statistic of 0.21. Equally, the degree of concordance of view registered by partner and non-partner auditors appeared much the same, with respective W-statistics of 0.25 and 0.27.