Auditor Independence: The Voice of Shareholders

By Jeff Cheung and David Hay

The debate about auditors is ongoing. But the opinion of the ultimate consumers—the shareholders—have rarely been heard.

Ian Scott, Lattice No. 90, 1982, acrylic on canvas, Chartwell Collection, Auckland Art Gallery Toi o Tamaki

Controversy over auditor independence has raged in recent times, but little is known about what auditor independence means to the ultimate consumers of the auditors work. In New Zealand, the Institute of Chartered Accountants of New Zealand (called ICANZ) has held an inquiry into the issue (ICANZ, 2002, 2003), the New Zealand Stock Exchange has made changes to its listing requirements (NZX 2004), and the Securities Commission has undertaken a study and released a paper (Securities Commission, 2004). There has been public discussion of what should be done by leading chartered accountants (e.g. Hagen, 2003), and other commentators (e.g. Robb, 2003). But what about the views of shareholders? Auditors' reports on financial statements are addressed to the shareholders. If new requirements for auditor independence are to be developed, it seems essential that the views of these important financial report users are taken into account. This article reports a study that compared the views of shareholders to those of directors and auditors, using a survey of 178 members of the three groups.

Current issues in New Zealand

The importance of this issue is mainly due to audit failures outside New Zealand. Recent financial scandals are so well known in New Zealand that ICANZ commenced its discussion paper by referring simply to the "the disturbing events unfolding in the United States". Those events began with the Enron scandal (Hilzenrath, 2001), led to the downfall of audit firm Andersen (McRoberts, 2002), were extended with WorldCom (Pulliam and Blumenstein, 2003) and other scandals, and also included an Australian company, HIH Insurance (New Zealand Herald, 2002). Official responses in other countries have included the corporate law reforms in Australia known as CLERP 9 (Malmo, 2002) and the Sarbanes-Oxley Act in the US (Hamilton and Trautman, 2002).

Controversy over auditor independence also existed before the Enron scandal, when observers noted that the fees charged by auditors for non-audit services to their audit clients were growing rapidly. This trend was also apparent in New Zealand (Saint, 2002; Chan, Wong and Wong 2002).

In New Zealand, Enron and the other audit failures, and the growth in non-audit services, are considered to be important issues. This is demonstrated by the response of ICANZ, the stock exchange and the Securities Commission. These include the ICANZ discussion paper Corporate Transparency in 2002, and the ICANZ recommendations to the government in Improving Corporate Reporting (2003). In addition, the New Zealand Stock Exchange (NZX) initially proposed a rule that prohibited audit firms from providing non-audit services to their audit clients (Davies, 2002), but later changes left this issue to be monitored by the audit committees of the companies (NZX 2004, Appendix 16, 4.2 (b)). The new rules also require companies to ensure the lead audit partner is changed every five years (NZX 2004 3.6.3 (f)). The Securities Commission also carried out a study (Securities Commission, 2004). Its recommendations are for the board of directors and audit committee to monitor auditor independence, and for the lead audit partner to be rotated after no more than five years.

"...an auditor must ensure that 'his or her judgement is not imparied by reason of any relationship with or interest in the company'"

Much of the consideration of the issues, and setting of the rules, has been driven by directors, auditors and others within the existing system, without much input from those who rely on financial reports. For example, submissions on the ICANZ Corporate Transparency paper could be made by anyone, and included one from the Institute of Finance Professionals New Zealand (representing investment analysts and corporate treasurers), but most were from accountants or academics. None represented the views of the individual shareholder.

Previous studies

Previous research studies show that:

- There is often a gap between the perceptions by auditors of issues that affect independence and the perceptions of other groups;
- The studies have concentrated on other user groups, not shareholders;
- New Zealand may be different from other countries.

Previous studies tested whether there were significant differences between the views of auditors and financial report users about factors that affected independence. A frequent approach has been to present scenarios involving auditors, with respondents asked to identify whether various activities affect independence. Issues examined included auditors providing non-audit services, or longstanding relationships between auditor and client, or employment of former auditors by clients. In almost all previous studies (including Imhoff, 1978; Firth 1980; Shockley 1981; Gul 1989; Bartlett, 1993 and Beattie et al. 1999), there were significant differences between the views of auditors and financial report users.

The differences were that user groups were more likely than auditors to perceive these issues as reducing the auditor's independence, in all of the previous studies except one. The exception was the only study to be conducted using New Zealand subjects (Gul, 1989), which found that bankers perceived non-audit services as enhancing the auditor's independence. Gul (1989) suggested that users believe that providing other services increases the auditor's relative power over the client, and therefore enhances independence.

These previous studies examine the views of various financial experts, not shareholders. The previous studies were also conducted before the recent scandals, and it may be that the views of financial report users have changed. The need for this study therefore includes the difference between the previous New Zealand study and other countries; the lack of studies considering shareholders; and the recent scandals which could have changed the views of financial report users.

Ethical issues for investigation

Independence in New Zealand is defined for auditors by fundamental requirements in the Companies Act and more details in the ICANZ ethical requirements. We asked respondents to comment on scenarios that could affect auditor independence, covering the threats and safeguards in the ICANZ statements, and drawing our scenarios from previous studies by Imhoff (1978), Firth (1980), Shockley (1981), Dykxhoorn (1982), Gul (1989) and Beattie et al. (1999).

The Companies Act 1993 requires that an auditor cannot be a director or employee of the company, a partner or employee of a director or employee of the company or a related company, or a liquidator or receiver of the company or a related company. There is also a general requirement in the Act that an auditor must ensure that "his or her judgment is not impaired by reason of any relationship with or interest in the company".

The ICANZ Code of Ethics contains several requirements about independence, and was supplemented in 2003 by a further statement (Code of Ethics: Independence) based on the International Federation of Accountants Code of Ethics. The international auditing scandals were referred to by ICANZ when it announced the Exposure Draft of these new requirements (Carslaw and Lee, 2002).

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The ICANZ Code of Ethics requires that accountants performing audits must maintain independence of mind and independence in appearance. Specific requirements are that members of ICANZ must "carefully manage and continually review the risk" from any financial involvement with the client. This includes a financial interest in the client; or a situation where one audit client produces a significant proportion of the auditor's gross income; or audit fees that remain unpaid. The Code of Ethics also requires that chartered accountants should "continually review and manage the risks to their objectivity," with specific reference to financial involvement by the accountant or family, business and personal relationships. With respect to gifts and hospitality, it is required that accountants "must neither accept nor offer gifts or hospitality that might reasonably be believed to have a significant and improper influence on their professional judgement".

The more extensive new requirements include a 'threats and safeguards' model, with practical guidance on specific situations (Carslaw and Lee, 2002). The threats to independence are identified as self-interest, self-review, advocacy, familiarity and intimidation. Specific examples of each are given. Safeguards can eliminate threats to independence, or reduce them to an acceptable level. There are three categories: safeguards created by the profession and government legislation or regulation, safeguards carried out by the client, and safeguards within the audit firm's own systems and procedures.

Nigel Brown, The Life Tree, 1983, acrylic on paper, Auckland Art Gallery Toi o Tamaki, purchased 1983

Approach to the investigation

We chose to use a survey as the most appropriate method to obtain information about the views held by shareholders, and by auditors and directors. We obtained random samples of accountants involved in auditing from a database held by the professional institute, directors from a directory of New Zealand listed company directors (one director per company) and shareholders from the share register of a major company. We conducted a random sample of names on the share register. Where the name selected was not an individual shareholder, we took the next name on the list. We examined the propositions that:

- When the threats in the ICANZ statements are present, then shareholders will be more likely to perceive that auditor independence is reduced, and will perceive reduced independence about more issues;
- The safeguards in the ICANZ statements will be less likely to restore perceived independence for shareholders than for the other groups.

Our questions asked respondents to consider hypothetical auditing situations, and evaluate the independence of the auditor on a scale from 1 (lack of independence) to 7 (absolute independence). The hypothetical auditing situations were based on the previous research studies, with the issues selected based on the Companies Act and the ICANZ Code of Ethics.

The questions covered the five categories of threats to independence in the ICANZ statement *Code of Ethics: Independence*. These are self-interest, self-review, advocacy, familiarity and intimidation threats. The self-interest threats included financial interests by the auditor of various kinds, including shareholdings in the audit client, loans to or from the client, and involvement with suppliers or competitors. We also included examples where the audit fee was a large proportion of the client's gross income and unpaid audit fees. In addition, we raised the situation where an auditor is paid an increased fee if a share issue is successful. We also asked whether respondents thought that the client supplying auditors with meals or allowing them staff discounts on products had any effect on independence.

Self-review threats include preparing data or performing services that affect the matters being audited; and auditors having been employees or directors of the client. We included examples of these issues.

The category of advocacy threats includes promoting the client's interest, perhaps through promoting a share issue or acting as an advocate in litigation. We included a question about advising a client in a takeover bid.

We asked questions about the familiarity threats of close family members of the auditor being involved in management of the client; and former auditors being employed at the client. This category also includes long-term involvement of an audit partner with the client.

Intimidation deters the auditor from acting objectively. We asked questions about conflicts over accounting principles, and threats to put the audit work out for tender.

Other issues that fall generally under the heading of threats to independence, and which have been frequently discussed were also included. We covered management consulting and other non-audit services provided by the auditor; internal audit services provided by the (external) auditor; systems de-

TABLE 1: Responses

	Shareholders	Auditors	Directors	Overall
Number of responses	48	82	48	178
Response rate	24.00%	32.80%	37.20%	30.70%
Qualifications and experience				
Degree	12.80%	86.60%	68.10%	61.90%
New Zealand diploma of business	14.90%	3.70%	4.30%	6.80%
Other diploma	0.00%	12.50%	8.70%	8.10%
Chartered Accountant	12.80%	87.70%	50.00%	57.50%
Accounting technician	6.30%	4.90%	2.10%	4.50%
No qualification	54.30%	0.00%	4.30%	15.40%
Average years experience	N/A	11.03	19.31	N/A

N/A: shareholders were not asked about their number of years of experience.

sign by the auditor; and a tight budget imposed on the audit team.

Regarding safeguards, we asked about the effect on independence of:

- a regulatory safeguard, rotation of the audit firm;
- client safeguards, namely discussion of the issues with the audit committee and obtaining acknowledgement of responsibility from the client, and
- firm safeguards of staff selection, requiring staff to dispose of financial interests, and review by another audit firm.

Results

Descriptive statistics of the questionnaire responses are shown in Table 1. Most shareholders had no business qualification, while the majority of the directors had a degree, and virtually all of the auditors had some qualification. As in New Zealand business generally, many of the directors are also chartered accountants. Of the auditors, 88% were chartered accountants.[1] Shareholders are quite different from the other groups, with most having no qualification. We did not obtain a high response rate – perhaps because these issues are not well understood by some of the respondents. Response rates were 33% for auditors, 29% for directors and 24% for shareholders. However, considering the complexity of the issue, a response rate as high as we achieved is good in the circumstances, and is substantially better than in many of the overseas studies of financial experts. The reliability of the data (measured by its internal consistency using a standard method) was high, with a Cronbach alpha statistic of 0.8198.

Shareholders disagree with auditors or directors on some issues

The first issue examined was whether shareholders are more likely to perceive reduced independence than auditors and directors. Table 2 shows the 15 questions about which shareholders showed the greatest concern, listed in order of importance, with the responses by the other groups for comparison. The questionnaires obtained the respondents' view using a scale from 1 to 7, where 1 indicated 'no independence' and 7 'absolute independence'. Mean responses of less than 4 suggest that respondents had a concern with that issue. In the tables we show whether the responses were statistically significantly below 4. While the important issues are generally agreed upon by all of the groups, there are a number of differences which indicate areas where shareholders concerns are different from those of shareholders and directors.

Non-audit services were the most important threat to independence for shareholders, ranking higher than fee dependence, while auditors and directors put the two issues in the opposite order. The difference between the ratings by shareholders and auditors was statistically significant. However, all three groups rated both as important.

Providing non-audit services to an audit client significantly reduced perceived independence for all groups. This is in contrast to Gul's (1989) New Zealand study, which had the unusual result that the non-audit services were perceived to enhance independence.

An auditor being a candidate for a job with the client was viewed as an extremely serious breach of independence by both shareholders and auditors (4th most important), but it was considered relatively less important by directors (13th).

Other conflicts of interest, including advocacy (advice to one of two client companies making a takeover bid) and providing internal audit services, created a lack of independence according to shareholders, but had no effect according to the other groups.

An interest-free loan from the client to the audit partner was ranked much more highly by shareholders, and also directors, than by auditors.

TABLE 2: Top 15 questions that most concerned shareholders

Top 15 questions (in order of importance to shareholders)	Mean response on a scale of 1 to 7 (ranking by each group)			Difference between shareholders and auditors
	Shareholders	Auditors	Directors	
Fees from non-audit services are more than fees from audit services from that client	1.51** (1)	2.02** (4)	1.81** (3)	0.51*
The audit partner owns 10% of the shares	1.52** (2=)	1.86** (3)	1.79** (2)	0.34
Audit fees from one client are 75% of the auditor's revenue	1.52** (2=)	1.41** (1)	1.53** (1)	-0.09
Audit partner is a candidate for a job with the client	1.55** (4)	2.18** (6=)	2.65** (13)	0.63**
Higher audit fee if a share issue is successful	1.81** (5)	1.73** (2)	2.23** (6=)	-0.08
Two clients are bidding for a takeover, the audit firm is advising one	1.98** (6=)	4.13 (No effect)	3.50 (No effect)	2.15**
Audit fees from one client are 50% of the auditor's revenue	1.98** (6=)	2.30** (8)	2.23** (6=)	0.32
Interest free loan to audit partner from client	2.02** (8)	2.79** (10)	1.98** (4)	0.77**
Fees from non-audit services are more than 50% of fees from audit services from that client	2.07** (9)	2.86** (11)	2.48** (11)	0.79**
Partner owns 1% of the client's parent company	2.11** (10)	2.62** (9)	2.06** (5)	0.51
Audit firm provides internal audit services	2.25** (11)	4.64 (No effect)	4.33 (No effect)	2.39**
More than 50% of audit fee remains unpaid for a year	2.38** (12)	2.18** (6=)	2.25** (8)	-0.20
Auditors own a business that competes with the client	2.44** (13)	3.20** (13)	2.35** (10)	0.76*
Audit partner is a beneficiary of a trust which holds shares in audit clients	2.48** (14)	2.17** (5)	2.74** (12)	-0.31
The audit partner owns 3% of the shares, representing 10% of his net worth	2.52** (15)	4.07 (No effect)	2.31** (9)	1.55*

* t-test results significant at 0.05
** t-test results significant at 0.01

The audit firm providing internal audit services was a substantial difference – shareholders viewed this issue as significantly affecting independence. The other two groups gave it an average rating of greater than 4, showing they did not view it as reducing independence.

Share ownership by auditors was not seen as such a major issue – only a massive conflict of interest (where the audit partner owns 10% of the shares) ranked highly. Smaller holdings were much lower ranked. The auditors, but not the others, identified shares held by a trust for the benefit of the auditor as a high-ranking problem. But the auditors tended to view a substantial shareholding by the audit partner of 3%, representing 10% of the partner's net worth, as having no effect, although both the shareholders and directors saw it as affecting independence.

Some issues are important to shareholders but not auditors or directors

We also looked for issues that concern shareholders but not the others. As Table 3 shows, shareholders were significantly concerned about approximately twice as many issues as the other groups were. Table 4 lists the issues that concerned shareholders but not auditors or directors.

The first three issues in Table 4 have already been discussed above. Other issues that shareholders see as important, but directors and auditors do not, include employment relationships

TABLE 3: Number of issues of significant concern to shareholders, auditors and directors

	Significantly below the mid-point	Not significantly below the mid-point	Total
Shareholders	31	12	43
Auditors	16	27	43
Directors	16	24	43

– where a former audit firm partner becomes a director of the client, or where a company executive moves to the audit firm. Shareholders were also concerned with conflicts of interest, including situations where an audit partner is a director of a supplier to the client, the partner lends money to the client, audit partners invest in a franchise issued by the client, and auditors provide management consulting services to the client or design the client's accounting system.

Shareholders concerns go further, and include issues such as the auditor managing a building owned by a client, or renting premises from the client. Other issues which probably seem trivial to auditors and directors raised concerns among shareholders. These include the client offering staff discounts to audit staff, or providing free meals. More issues that concerned the shareholders (but not the other groups) included the auditor maintaining some general ledger accounts in a confidential ledger on behalf of the client, conflict over preferred accounting treatment when there are non-audit services provided, and the audit partner having been in charge of the audit for more than ten years.

Some suggested issues are not important to any of these groups

There are some non-issues which did not have an effect on perceived independence for any of the groups. These are listed in Table 5.

Although small shareholdings by individual auditors are frowned upon by some audit firms, the respondents were not concerned about a small holding of 1,000 shares. All three groups were not concerned about family relationships where an audit partner has a brother or brother-in-law employed at a high level in the company, provided the partner is not directly involved in the audit. The respondents were concerned about unpaid audit fees, but only if more than 20% remains unpaid. They were also not concerned about threats of in-

TABLE 4: Issues of concern to shareholders but not auditors or directors

Issue	Mean response by shareholders
Two clients are bidding for a takeover, the audit firm is advising one	1.98*
Audit firm provides internal audit services	2.25*
The audit partner owns 3% of the shares, representing 10% of his net worth	2.52*
Company financial director was previously a partner in the audit firm	2.64*
Audit partner was previously company financial director	2.65*
An audit partner is a director of a supplier to the audit client	2.68*
A partner has lent 1% of her wealth to an audit client	2.71*
Accounting firm partners have invested in a franchise issued by an audit client	2.77*
Audit fees from one client are 25% of the auditor's revenue	2.81*
Audit firm provides management consulting to an audit client	2.82*
A partner manages a building owned by an audit client	2.83*
Client offers discounts on its products to the audit team	2.87*
Accounting firm rents office space from a client	3.02*
Accounting firm designed the financial system of an audit client	3.02*
Fees from non-audit services are between 11% and 50% of fees from audit services from that client	3.16*
Audit partner has been in charge of the audit for more than ten years	3.26*
Client offers free meals during the audit	3.27*
Accounting firm is in conflict with its client over preferred accounting treatment, and there are non-audit services	3.37*
The accounting firm maintains selected general ledger accounts in a confidential ledger	3.38*

* All of these issues are significantly different from the mid-point of the scale for shareholders, and not significant for the other two groups.

TABLE 5: Issues not of significant concern to shareholders, auditors or directors

Non-issues
Partner owns 1000 shares, less than 0.01% of share capital
Partner owns 1% of the shares of the client's parent company, and would not be involved in the audit
Partner owns a small number of shares, less than 1% of his net worth
Financial controller's brother is a partner in the audit firm, but not partner in charge of the audit
Sales vice-president is brother-in-law of a partner in the audit firm not connected with the audit
Audit firm prepares executive payroll
Auditing job is up for tender
Unpaid fees 1-20%
Fees from one particular client are 5% of total fees
Fees from one particular client are 10% of total fees
The audit firm provides non-audit services amounting to less than 10% of audit fee
Audit firm and client are in conflict over an accounting choice, and the size of the audit is large relative to the client base
Requirement to disclose non-audit audit fees
Accounting firm revenue consists only of audit fees
Audit firm has placed its staff on a tight budget

timidation of the auditors, such as the audit being put up for tender, and the audit firm and client being in dispute over accounting treatment, even if the audit is large (but only where the auditor does not also provide non-audit services).

Some safeguards have some effect

The ICANZ response to the issue of auditor independence includes the use of safeguards by audit firms. Table 6 shows that some safeguards can have some effect on restoring independence.

Several of the safeguards suggested in our survey had a significant effect on restoring independence. Exceptions were rotation of the audit firm (if that took place over a period longer than ten years), which all groups perceived as reducing independence. In addition, shareholders did not see the auditor discussing independence issues with the audit committee of the company as making any difference, although the other two groups saw that as a safeguard. The very simple safeguard of requiring the client to acknowledge responsibility for the results of the non-audit services by the auditor was seen as a safeguard by the shareholders and the auditors (perhaps surprisingly), but not by the directors.

Discussion

This study provides some evidence about independence as shareholders see it. They are concerned about it – more so than those on the other side of the corporate fence.

Overall, the study shows that there is a large core of major issues that are important to all, and another group of issues that no one cares about. Between the extremes lies a body of issues that shareholders care about but others do not. Any reforms to auditor independence need to consider the views of these important users of financial reports.

The categories of five threats to independence are helpful in analysing the results. Self-interest threats are very common, and there were many of them in the survey. These tended to be issues that all of the users agreed could impair independence, including non-audit services. Shareholders rated the auditor receiving more from non-audit services than from the audit as the greatest threat to auditor independence. This high level of non-audit services is not unknown among major New Zealand companies.

Self-review threats in the survey included the auditor keeping a confidential executive payroll. No group was concerned about this specific threat. But shareholders were significantly concerned about the auditor providing internal audit services or designing financial systems.

Advocacy threats are rare. We included one – an auditor advising a client involved in a takeover (but not advising another client who is also involved). This was top of the list of issues that concerned shareholders but not others.

Familiarity threats were the main area where auditors and directors were out of touch with shareholder concerns. An auditor becoming a director of the client, and a movement in the opposite direction, were of major concern to shareholders. A partner managing a building owned by the client was another issue about which shareholders were concerned but not the others.

Intimidation threats were rated as fairly harmless by all groups. The audit being put up for tender, or conflict over accounting choice (so long as there were no non-audit services) were of no concern to any group.

When audit firms implement internal safeguards over independence, it may be useful for them to know the views of the shareholders in our survey. For example, small shareholdings by an auditor were not seen as affecting independence – but staff discounts and meals were considered a threat.

Relatively simple approaches, including the client acknowledging responsibility for the results of non-audit services, have a measurable effect on independence as seen by shareholders and auditors, but not directors. Discussing these issues with the entity's audit committee affects the perception of independence by auditors and directors, but not shareholders. Very strong safeguards, such as removing individuals from the audit, or engaging another firm to review results, have a strong effect on restoring independence.

ICANZ also recommends disclosure and use of safeguards to overcome independence issues. Its recommendations are to allow auditors to provide non-audit services to the audit client, but require companies to disclose the fees, and also the measures taken by the company to ensure audit

TABLE 6: The effect of safeguards to independence

Safeguards	Response by		
	Shareholders	Auditors	Directors
Effect on reducing independence[a]			
Rotation of audit firm within less than five years	5.72	6.03	6.48
Rotation of audit firm within five to ten years	4.21	4.59	4.78
Rotation of audit firm after more than ten years	2.62**	3.34**	3.36**
Effect on restoring independence[a]			
Discuss independence issues with the audit committee	4.30	4.57**	4.98**
Client acknowledges responsibility for results of non-audit services that may have impaired independence	4.66*	4.59**	4.24
Preclude personnel affected by conflict of interest from being involved in the audit	6.20**	5.49**	5.60**
Engage another firm to review or re-perform services	6.33**	5.87**	6.00**
Require individuals who have a material conflict of interest to dispose of items that cause a the conflict	4.80**	5.85**	6.17**
Require individuals who have a material conflict of interest to partly dispose of items until the conflict of interest is not material	5.44**	5.41**	4.89**

[a] Questions were expressed as either "effect on reducing independence", with answers on scale from 1 (lack of independence) to 7 (absolute independence), or where necessary as "effect on restoring independence" with answers on a scale from 1 (no effect) to 7 (fully restored independence).
* t-test results significant at 0.05
** t-test results significant at 0.01

independence in the face of non-audit services. Audit firms would also be required to use safeguards. Our results show that safeguards can have some effect on perceived independence – but nevertheless, issues such as non-audit services have an extremely severe effect on independence and it is not possible to know whether safeguards will be sufficient.

Limitations of the study include lack of response, as in most survey studies. In addition, our shareholders were drawn from the share register of only one company and this may restrict the applicability of the results. In addition, some of the groups overlap – especially, many directors are also chartered accountants, which reflects real life.

Nevertheless the contribution of the study is that it provides information which was not previously available and helps to illuminate this issue, and does so at a time when there is considerable concern about the issue.

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[1] The remaining 12% are likely to be audit staff who have not yet completed the qualification.

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Suggested Further Reading

Previous research studies are referred to in the article and references are given below. All but one of the previous studies was conducted outside New Zealand, and all were published before financial report users were influenced by the "recent disturbing events." The study by Beattie, Fearnley and Brandt (1999) (see below) was especially influential in developing this study.

Current readings on the issue of independence are mainly professional and regulatory sources. We recommend for further reading:

Corporate Transparency: Making Markets Work Better (2002) and Improving Corporate Reporting: A Shared Responsibility (2003) by the Institute of Chartered Accountants of New Zealand.

Corporate Governance in New Zealand: Principles and Guidelines by the Securities Commission

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