

DOES AUDITOR'S TRUST IN CLIENT'S MANAGEMENT IMPAIR HIS INDEPENDENCE? (AN EMPIRICAL STUDY)

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ABSTRACT

This paper examines the effects of auditors' trust in clients' management on auditors' decisions. It examines a scenario notably, a situation where auditors' independence becomes impaired as a result of his trust in client management. Cross-sectional survey was used. Data was collected through the use of questionnaires. The findings from the analysis and test of hypothesis revealed that there is insignificant relationship between the Auditors' trust in the clients' management and Auditors' fraud risk assessment, with higher trust associated with lower risk, and vice versa. The study recommends that in order to ensure success in auditing of financial statements, objectivity must be accorded a prime place regardless of client's disposition, company's orientation or related circumstances and disclosure of financial information must comply with international best practices and be identified as parts of the rights of an auditing service provider.

INTRODUCTION

The primary function of an auditor is to provide an independent and objective third party review of a company's financial statements (Messier et al, 2006); therefore the need for an auditor to be independent. The independence of an auditor is a quality considered by many to be the cornerstone of the auditing profession because without it, public trust is lost (Johnstone et al., 2001).

More so, if the audit is to provide the desired degree of assurance, the auditor must be able to form and express an independent opinion, without bias. Accountants traditionally use the term "independence" to refer to an auditor's ability to make audit judgment objectively, free of any influence that other parties or factors might bring to bear. Thus, audit decisions that are affected by lack of independence may lead to a reduction in the quality of the audit.

It is, however, believed that when the quality of an audit is problematic, there is a

higher tendency of inappropriate financial reporting, which when discovered can have a negative impact on the organization. For example, the discovery of inappropriate reporting may decrease the confidence of shareholders in the management of the organization, as well as bring about decrease in creditors' interests in the organization. Also, other negative effects include the increase in the clients' cost of audit and the cost involved for regulators to restore investors' confidence. Most importantly, is the loss of reputation by the auditors in particular and the profession in general (Johnstone et al., 2001).

Although the auditor examines the organization's financial statements on behalf of the shareholders, the management of the organization that prepares and issues the financial statements being audited appoints and pays the auditor 357, CAMA-2004 on appointment of auditor. The auditors' qualification is provided under section 358 (1)

CAMA- 2004 as amended, that a person shall not be qualified for appointment as an auditor of a company for the purpose of this Act, unless he is a member of a body of accountants in Nigeria established from time to time by an act.

Furthermore, the shareholders who constitute the company are the clients, may hire and fire auditors with concrete reasons. In addition to economic incentives that may influence the auditor's judgment in favor of the client who pays their fees, the relationship that accounting firms strive to develop with the clients may add to the auditor's psychological difficulty to make truly independent opinion, because of the level of trust that is developed over the years between the client and the auditor.

Therefore, in management-auditor relationship where such level of trust has been established, the client may have many opportunities to demonstrate good faith; thereby accumulating evidence of trustworthiness. As such, auditors' predisposition to trust, together with the consistent cooperation by client, can be mutually reinforcing. Thus, potentially causing a gradual increase in trust between the auditor and the client; thereby reducing auditors' professional skepticism.

More so, the role played by auditor's trust in client's management cannot be overstressed. This is due to its place in building confidence and trust between the Client's management and the auditor. In spite of the foregoing, the highly publicized accounting scandals in recent years have tarnished the accounting profession's reputation (Johnstone et al., 2001; Sikka et al., 1992). The central issue in many of these scandals is whether company's auditors were truly independent or not. In their framework for understanding the antecedents and consequences of impaired independence, Johnstone et al. (2001) proposed that an interpersonal relationship

between the auditor and the client is one incentive for auditors to allow their independence to become impaired. Sikka et al. (1992), and Latham et al. (1998) also believe that as the auditor-management relationship lengthens, a bond may develop between auditor and client and mutual trust may replace the auditor's objectivity (Latham et al., 1998). This suggests that auditors may develop trust in the client's management, and this trust may affect their audit decisions.

However, the auditor needs information provided by management and the cooperation of management to carry out the audit. The client's management has great deal of knowledge about the enterprise more than the auditor and it is based on this knowledge that the audit is being conducted. Therefore, the auditor has no option but to bestow some degree of trust upon client's management. Auditors currently have no guidance to help them understand what factors influence trust of client's management or to assess what level of trust is safe and what level may lead to a situation of compromised judgment. In view of all these conditions and issues, this paper examines the effects of Auditors' trust on client's management mainly on decisions taken by the Auditors.

LITERATURE REVIEW

The Concept of Trust

Trust is an essential component for business to be conducted. Trust, although intangible, is related to understanding interpersonal and group behavior, managerial effectiveness, economic exchange and social and political stability. Weber (1930) in discussing capitalism claimed that the exchange of goods and services is possible only on the basis of personal far-reaching confidence and trust. Similarly, it has been argued that, the concept of trust is complex, multi-dimensional, multi layered, and exists in almost every economic event; that researchers have had much

difficulty with. As such, the concept does not have a universally accepted definition (Rosseau et al 1998, Nooteboom, 1996).

From the foregoing, it can be deduced that trust is a necessary antecedent for cooperation. Thus leads to constructive behavior which is vital for relationships. Also, Barney and Hansen (1994) stressed that trust is vital for innovative work within an organization (project team), between organizations (strategic alliances, R & D partnership), and even between the auditor and the audited. The evolution of accounting and Audit (both internal and external) has included various forms of "trust" along with increased government / market attempts to curb opportunism in commerce. According to Zaheer et al. (1988) interpersonal and inter organizational trusts are strongly related, they are different constructs, and the link between personal and organizational trust has not been clear. Barney & Hansen (1994) stated that lack of clarity does illustrate that trust is between people not organizations, and exchanges between firms are exchangers between individuals of small groups of individuals. Yet, organizations have reputations and images, and they develop routines processes, and culture which unify the behavior of their employees and the responses to external contacts.

Consequently, we can see that trust is essential to the operation of a functional society; therefore, it works as a lubricant of a social system (Arrow, 1974). Asserting Arrow's view, Rotter (2006) sees trust as an integral part to the social fabric, and that neither individual organizations nor the market economy itself can operate effectively without it. Trust is also pivotal to the economy, as without it, currency will not be used, savings makes no sense, and transaction costs rise precipitously. In short, it is hard to conceive a modern economy without a strong element of trust running through it (Etzioni, 1988) Also, La

Porta (1997) provided evidence that a country's social effectiveness and effectiveness of its economy are positively correlated with the level of trust demonstrated by that country's citizens.

Professional Skepticism

A key provision in Statement of Auditing Standard (SAS) 99, issued by the American institute of Certified Public Accountants (AICPA) is an increased emphasis on professional skepticism. Professional skepticism is defined as "an attitude that includes a questioning mind and a critical assessment of audit evidence" (AICPA 2002, paragraph 13, p. 10). Section 5090 (audit of financial statements) of the Canadian Institute of Chartered Accountants (CICA) handbook states: "The auditor should plan and perform an audit with an attitude of professional skepticism, recognizing that circumstances may cause the financial statement to be materially misstated. Even though the standard does not address trust explicitly, it addresses the issues of honesty and integrity; which ultimately means trust. Honesty and integrity on the part of the management of those charged with the responsibility of preparing financial statements are critical for the effective audit process.

Therefore, in planning and performing an audit, the auditor neither assumes that the management is dishonest nor assumes an unquestioned honesty. This simply means that, it is not the auditor's objective to prove managements' honesty and integrity, but to approach the audit with an attitude of professional skepticism that includes being alert for indications of dishonesty. It also means that, notwithstanding prior experience indicating that management is honest; the auditor generally obtains corroborating evidence for management representations, including responses to enquires resulting from performance of analytical reviews (CICA, 2006,

). Similarly, the Nigerian Standard on Auditing (NSA) 9, addresses the issue of material misstatement and professional skepticism. The standard states that the auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform other audit procedures. Furthermore, the NSA 9, provides that the members of the engagement team should discuss the susceptibility and the entity's financial statements to material misstatement. The discussion provides an opportunity for more experienced engagement team members, including the engagement partner to share their insights based on their knowledge of the entity, and for the team members to exchange information about the business risks to which the entity is subject and about how and where the financial statements might be susceptible to material misstatement.

An attitude of Professional skepticism can be looked upon as a form of suspicion. In this context, Hilton et al. (1993) described suspicion as to question the motives that underlie a person's behavior or to question the genuineness of that behavior. Therefore, the audit relationship provides a good overview of trust and its workings, which is most often disguised as compliance. The breach of trust in audit-client relationships is provided hereunder. While professional skepticism is crucial to audit practice, it is not precisely defined by the audit standards as a diagnostic reasoning process, but instead is discussed in terms of general states of mind or behaviors (e.g., PCAOB 2006). AU Section 230.07 states that professional skepticism involves a questioning mind and a critical assessment of audit evidence.

In other words, Mumford et al. (2003), defined Professional skepticism as a

diagnostic-reasoning process that involves identifying unusual items or situations and imposing enough structure to determine potential causes. The actions the auditor might take once an unusual or unexpected item is identified, such as obtaining additional evidence, are important to the efficient, effective conduct of an audit.

Bedards and Biggs (1991) provide an insight into which cognitive skills auditors need to improve in order to act in a more skeptical manner. They further experimented that, senior and manager level auditors evaluated an analytical review case and generated a hypothesis that they believed best explains the unusual relationships found within the case contains four crucial facts embedded that, if properly combined, pointed to a singular solution. Verbal protocols captured why each participant generated a particular hypothesis and provided insight into the reasons that participants failed to identify the correct solution. The analysis shows that acquisition errors (failure to identify the necessary piece of information) were uncommon since most participants were able to identify all four crucial facts. However, errors were likely to arise after the acquisition stage through either pattern recognition errors (i.e., failure to combine all the four crucial facts) or hypothesis-generation errors (i.e., failure to generate the correct hypothesis).

Auditor- Management Disagreement

The auditor mostly, encounters situations where he/she has a concern that the unaudited financial statements may be materially misstated. When the auditor challenges client management about this issue, a disagreement incident occurs. Disagreement can also arise from issues around the audit process, audit scope, audit fees, and other matters.

Disagreements are significant events within the auditor and client relationship and events of this type help define the relationship between auditor and client in the future. Disagreements underline the fact that conflicts arise from the differing role of auditors in client management with respect to the financial statements. A disagreement is a necessary pre-condition for negotiation event (Gibbins et al. 2005). Gibbins et al. (2001) developed a model of auditor and client negotiation based on a survey in which experienced auditors were asked to describe an example of a negotiation incident and answer a series of questions around that incident. The purpose was to learn, in a descriptive sense, about the process of negotiation itself. Gibbins, et.al (2005 & 2006) have built on this research by incorporating the perspective of management.

The Gibbins et al. (2001) study auditor client negotiation. Trotman and Weright (2005), recognizing the importance of auditor client negotiations, examined three intervention methods for enhancing auditor negotiation skill. They described these methods as Role-playing and Passive intervention approach. Role-playing entails having the auditor take the counterpart's place in a mock negotiation prior to actual negotiation with the client. While passive intervention approach explicitly considers the client's interests and options prior to negotiation but does not proactively consider the client's situation by taking their position, as in the role playing approach.

Beattie et al. (2004) used a grounded theory approach to develop a model of the negotiation process and the factors that influence the nature of the outcomes of the interactions. Ng and Tam (2003) and Bamealdred and Kida (2004) took an experimental approach looking at judgment in an auditor client negotiation context.

Effect of Moral Reasoning on Audit Decisions

At the heart of moral reasoning research is the question of how and why individuals make decisions when an ethical dilemma presents itself. Based on the work of the child psychologist Piaget et al. (1959) developed a justice-based model of moral reasoning that consists of a series of three cognitive levels, with each level containing two stages. According to Piaget et al., individuals develop sequentially through this model one stage at a time.

Similarly, Kee and Knox (1970); Lieberman (1981); Ganesan (1994); and Mayer et al. (1995) opine that ethical reasoning is used interchangeably with moral reasoning. Reasoning is influenced by wanting to please others, such as peers or the law. In the final level, post conventional level, an individual's reasoning involves individual rights, self-chosen principles, and belief in ideals such as equality and justice.

Research involving the ethical reasoning of accountants shows that for a wide variety of judgments and behaviors, higher moral reasoning accountants generally make more ethical decisions and act in a more ethical manner (e.g. Ponemon, 1992; Ponemon and Gabhart, 1993; Bernardi, 1994; Windsor and Ashkanasy, 1995; Tsui and Gul, 1996). Ponemon (1992) finds that auditors with low moral reasoning underreported audit time more severely than auditors with high moral reasoning. Windsor and Ashkanasy (1995) show that auditors with the highest moral reasoning were better able to resist the client's management economic power, compared to groups of auditors with lower moral reasoning.

The Concept of Audit Evidence

The Nigerian standard on Auditing (NSA) 13 (2007) is on Audit Evidence. The purpose of this standard is to establish standard and to provide guidance on what constitutes audit

evidence in an audit of financial statements, the quantity and quality of audit evidence to be obtained, and the audit procedures that auditors use for obtaining that audit evidence. More so, the auditor should obtain appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion. Similarly, the Statement of Auditing Standard (SAS) 106 on Audit Evidence, issued by the American Institute of Certified Public Accountants (AICPA) came into effect on December 15th, 2006 when it superseded SAS 31, Evidential Matter (Boone, 2007). It states that "The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit" (AICPA, 1997). Sufficient and appropriate evidence is a measure of the quality of the information gathered.

The basis for determining what is sufficient and appropriate evidence lies with the professional judgment of the auditor (Loughran, 2010). There is no standard across the board that dictates how much evidence there needs to be gathered, or the quality of such. SAS 106 merely provides guidance on the subject of audit evidence rather than requirements, and does not explicitly provide auditors with the tools to ensure that every audit performed advocates to the same level of competence. The lack of adequate audit evidence in reaching the audit opinion has been identified by the PCAOB as a weakness in the audit work of a number of major firms it has audited.

METHODOLOGY

The study adopts a survey research that investigates the effects of auditors' trust on client's management. It is a cross-sectional survey that collects data from one particular organization to another, in order to determine the relationship between Auditors and their clients. A structured

questionnaire was developed to generate data in form of responses from both the auditors and their client's management. Data collected from the administration of the structured instrument were used to test the hypothesis of the research

The population of the study comprises of all the accounting firms in Sokoto metropolis. The management and staff of the Cement Company of Northern Nigeria (CCNN) as well as management and staff of Bursary department of Usmanu Danfodiyo University sokoto.

Only one accounting firm was selected from a total of five (5) firms in sokoto metropolis using purposive sampling technique. The justification for selection of this sampling technique was due to the fact that the research was based on a case study involving small samples (Neuman W.L, 2005). The sample selected (Mu'Allahyidi & Co.) has a total of thirteen (13) staff, comprising of six (6) chartered accountants and seven (7) professional staff. The other respondents are the staff of finance department of Cement Company of Northern Nigeria (CCNN) plc and staff of Bursary department of Usmanu Danfodiyo University Sokoto.

The questionnaire was structured into two sections. In section A, the instrument generated data on the demographic statistics of the respondents. Section B elicit data from the auditors and their client. The questionnaires were mainly made up of single choice answers with some open ended questions.

Data collected from the field was summarized and presented in tables to enable readers to easily understand the responses. Thus, the responses presented in tables were summarized in percentages to aid the understanding of analysis. The study use inferential statistics method to analyze the data collected. The study analyses data using Chi-Square test.

DATA PRESENTATION AND ANALYSIS

Chi-Square Result

It was Hypothesised that “Auditors’ impaired independence is affected by his decision to trust the client’s management. And to test the hypothesis, the chi-square statistical procedure was employed. It was further revealed that the counts outside the brackets are the observed frequencies, the counts inside the curly brackets are the expected frequencies and the counts inside the brackets are the chi-square contributions. See appendix I

Chi-Sq = 8.420, DF = 9, P-Value = 0.492 , 10 cells with expected counts less than 5.

Interpretation: Since the chi-square calculated is reported at 8.40, with a probability value of 0.492, at 0.05 level of significance, then the null hypothesis is accepted, because there is no significant difference between auditors’ risk assessment and their opinion. This also shows that a close relationship between the auditor and its’ client, may cause the auditors’ independence to become impaired, as per as expression of an independent opinion is concern.

FINDINGS/CONCLUSION

From the analysis and interpretation of data, the following major findings were made:

- i. That professionalism is accorded greater emphasis in the practice of auditing in Nigeria. This is evident noting that greater proportion of those working as auditors have professional accreditation with at least one or a combination of professional bodies such as ICAN, ANAN or related bodies.
- ii. That long standing experience of an auditor facilitates his/her productivity/efficiency as opposed to instances where a professional may be discouraged by the attitude of the client’s management. The

kind of attitude expressed by the client’s management will not appear to be unprecedented to them considering their experience in handling information (financial statements) provided by the management. This has made it possible for them to excel regardless of the attitude expressed by the management. This concurs with analyzed data indicating all the auditors who responded to the questionnaires distributed having past experience of fraud risk assessment.

- iii. A close relationship between the auditor and its’ client, may cause the auditors’ independence to become impaired, as far as expression of an independent opinion is concern. The result revealed that the Chi-Square value of 8.40 with a probability value of 0.492, falls within the accepted region of null hypothesis.

CONCLUDING REMARKS

This paper concludes that a major criticism of the auditors – client’s management relationship hinders the auditors’ ability to remain objective. This is supported by Herrick and Barrionuevo, (2002). In much the same way, Johnstone et al., (2001) suggests that close relationship with a client can create an incentive for auditors to allow their independence to become impaired , while Latham et al.,(1998) agrees that trust may replace auditors’ objectivity as the auditor-client relationship lengthens

Secondly, the study concludes that an auditors’ trust is negatively related to his or her fraud risk assessment in relation to financial statements and that with higher levels of trust associated with lower risk, and lower levels of trust associated with higher risk, risk assessment is bound to be affected depending on the nature of such association (as the case may be) between the auditor and client’s management.

RECOMMENDATIONS

In view of the findings that emerged from this study, and the conclusions drawn there from, the following recommendations are proffered:

- i. In order to ensure success in auditing of financial statements, objectivity must be accorded a prime of place regardless of client` disposition, company`s orientation or related circumstances. Achieving the above requires regulatory measures (to be streamlined into Companies and Allied Matters Act,1990 as amended, 2004) or equivalent legislations capable of establishing and/or enforcing strict compliance with NSA 9 and SAS 99(Assessing the Risk of Material Misstatement) at company level where a unit (established by the auditing firm) monitors and reports to appropriate agency(ies) or professional body(ies) as appropriate. Should this strategy be adopted, it will lead to a practice where standards are complied with in the process of rendering auditing services as
- both internal and external moderations will be strengthened and applied. The implication is that auditing practice in Nigeria stands an opportunity of being accepted as a best practice both domestically and internationally.
- ii. Disclosure of financial information must comply with international best practices and be identified as parts of the rights of an auditing service provider. This can be achieved by ensuring that regulatory agencies` intervention where appointment of auditor should be externally controlled as against the prevailing practice. In addition, where a client under feeds an auditing firm, the later should have the right to undertake confirmatory steps and perhaps resort to legal avenues to ascertain the authenticity of the said (provided) information in the interest of professionalism. This will facilitate a regime of due process, true disclosure, responsible corporate citizenship and enhanced service quality.

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APPENDIX I

Chi-Square Test: risk, opinion

Expected counts are printed below observed counts

Chi-Square contributions are printed below expected counts

	risk	opinion	Total		
1.	1	13	14	3.75	13.25
	0.417	0.118			
Total	30	106	136		
Chi-Sq = 8.420, DF = 9, P-Value = 0.492					
	3.09	10.91			
	1.412	0.400			
2.	1	12	13		
	2.87	10.13			
	1.216	0.344			
3.	2	14	16		
	3.53	12.47			
	0.663	0.188			
4.	2	7	9		

10 cells with expected counts less than 5.

Interpretation: Since the chi square calculated is reported as 8.40, p-value 0.492, at 0.05 level of significance then the null hypothesis of no difference between Auditors' risk assesment and their opinions is accepted.

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Welcome to Minitab, press F1 for help.

Retrieving project from file: 'C:\Program Files\MINITAB 14 Demo\Data\Kaoje
minitab.MPJ'

CORRELATIONS

/VARIABLES=Auditors' Trust, Auditors' Fraud Risk assesment

/PRINT=TWOTAIL NOSIG

/MISSING=PAIRWISE.

Correlations

		Notes
Output Created		02-Jan-2012 03:19:25
Comments		
Input	Active Dataset	DataSet0
	Filter	<none>
	Weight	<none>
	Split File	<none>
	N of Rows in Working Data File	5
Missing Value Handling	Definition of Missing	User-defined missing values are treated as missing.
	Cases Used	Statistics for each pair of variables are based on all the cases with valid data for that pair.
Syntax		CORRELATIONS /VARIABLES=VAR00001 VAR00002 /PRINT=TWOTAIL NOSIG /MISSING=PAIRWISE.
Resources	Processor Time	00:00:00.094
	Elapsed Time	00:00:00.110

Table.4.4 **Correlation Coefficient Between Auditors' Trust and Auditors' Fraud Risk Assessment**
Correlations

		Auditors' Trust	Auditors' Fraud Risk assesment
Auditors' Trust	Pearson Correlation	1	.469
	Sig. (2-tailed)		.425
	N	5	5
Auditors' Fraud Risk assesment	Pearson Correlation	.469	1
	Sig. (2-tailed)	.425	
	N	5	5

NONPAR CORR

/VARIABLES=Auditors' Trust Auditors' Fraud Risk assesment

/PRINT=SPEARMAN TWOTAIL NOSIG

/MISSING=PAIRWISE.