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THE IMPACT OF AUDIT FIRM SIZE AND AUDIT COMMITTEES ON PERCEPTIONS OF AUDITOR INDEPENDENCE AND FINANCIAL STATEMENT RELIABILITY IN IRELAND

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ABSTRACT

This study reports the results of an investigation of the effects of audit firm size and audit committees on perceptions of auditor independence held by corporate lenders, investment managers and financial analysts in Ireland. The study methodology combined the use of mail questionnaire and semi-structured interviews to allow both breadth of coverage and the opportunity to probe deeper into the nature of the perceptions held. The principal findings of the study were that perceptions of auditor independence were enhanced if the auditor was a member of the Big Six and also if the client had established an audit committee. Although these results were not in themselves unexpected, analysis of the interviews provided further insights into how users of financial statements formed these perceptions and also highlighted a significant minority concern as to the independence and efficacy of non-executive directors serving on audit committees in Ireland.

INTRODUCTION

Auditor independence is customarily considered to be crucial to the work of the company auditor because the primary function of the company auditor, the provision of an opinion on the financial statements, is furnished for the purpose of adding credibility to the management representations embodied in and constituting the financial statements (Mautz and Sharaf, 1961; Lee, 1993; Moizer, 1997). If auditors lack independence then it is questionable as to whether their opinion would add additional value to shareholders or other parties (Flint, 1988). This paradigm is not incontestable, both because many aspects of the auditor's work, for example the mode of their appointment and remuneration, raise *de facto* concerns as to their independence, and also because there are many other instances of society and groups within society placing value on the work or opinions of individuals where questions of independence are perhaps even more pressing, for example appointed actuaries in insurance companies. One response to the existence of relationships between the auditor and the client which might be seen as compromising independence has been the sub-division of auditor independence into the separate components of independence in fact and independence in appearance. Independence in fact has been defined in terms of honesty, objectivity and a mental attitude (American Institute of Certified Public Accountants (AICPA), 1991; Chartered Accountants Joint Ethics Committee (CAJEC), 1995; European Commission, 1996). Independence in appearance has been defined by the professional bodies as being free of interests in, or relationships with clients, or as avoiding any circumstances which would result in a third party questioning the auditor's independence (AICPA, 1991; CAJEC, 1995, European Commission, 1996). This distinction raises the possibility that auditors might be independent in fact (whether voluntarily or because the penalty function associated with non-independent behaviour exceeds the potential benefits) but independence might appear to be compromised in appearance. This too gives rise to the possibility that the credibility of the audit report might be weakened by the appearance of non-independence in situations in which the auditor is in fact behaving in an independent fashion. This study focuses on perceptions rather than the reality of independence as it is perceptions which are likely to shape attitudes to audit and confidence by the users of financial statements (Shockley, 1981; St. Pierre, 1984; Schilder, 1992). One further feature of this study is that it seeks to move beyond an assessment of perceptions of independence alone and attempts to give some insight into how this translates into concerns as to the reliability or otherwise of the financial statements which are subject to audit.

Over the years an extensive literature on the subject of auditor independence has developed and a focal point of much of this literature has been to identify those factors which impact upon perceptions of auditor independence. Two such factors are the subject matter of this study: the extent to which perceptions of auditor independence and financial statement reliability are affected by differences in auditor size (more specifically whether the auditor is or is not a member of the Big Six audit firms), and the extent to which they are affected by the existence or otherwise of an audit committee. Although the importance or otherwise of these factors has been examined in other audit markets they have not previously been studied in the Irish context. Here there is scope for variation both because the hegemony of the Big Six firms is not so complete in the Irish market, where there is a vigorous sector comprising small and medium-sized accounting and auditing firms, and because audit committees are relatively new to the Irish commercial environment and as yet have not been universally adopted.

In summary, the contribution of this paper to the existing literature is essentially threefold. Firstly, it builds on and extends previous studies, in particular by means of semi-structured interviews to complement a mail questionnaire. This has enabled identification of a greater richness and heterogeneity in the responses beyond that which could have been achieved by means of a questionnaire alone and this in turn has added significantly to the insights obtained. Secondly, the additional focus upon the reliability or otherwise of the financial statements allows further light to be shed on the question of whether or not differences in perceptions held matter. Clearly if perceptions of the quality of the financial statements are independent of perceptions of the independence or otherwise of the auditors, then the importance of these latter perceptions may be overstated. Thirdly, application to a particular audit submarket with its own identifying characteristics raises issues both as to the uniformity of perceptions across differing business and commercial environments, and to the appropriateness of uniform measures designed to enhance auditor independence.

PREVIOUS RESEARCH

Audit firm size

As auditing firms increased in size and the larger firms came to be multinational in their operations, commentators, for example Mautz and Sharaf (1961), began to identify the size of the audit firm as an important variable which may affect perceptions of the independence of auditors. For a number of decades the conventional wisdom has been that the larger the firm the greater their independence from their clients. Clearly size in itself does not guarantee independence but underlying this perception have been two main lines of argument. The first relates to the proportional diminution in reliance upon any one client for fee income as the audit firm increases in size. In these circumstances, Mautz and Sharaf (1961) and many others have argued that large audit firms were more likely to adopt an independent stance because the loss of any one client would cause a much smaller proportionate loss of fee income. Furthermore, it is arguable that because of their larger client base and more prominent profile, large audit firms have far more to lose if their reputation suffers because of publicity attendant upon the discovery of non-independent behaviour (DeAngelo, 1981). The second line of argument highlights the manner and practice of work in smaller firms with the reduced emphasis on formal procedures, review and rotation of personnel. This is often coupled with greater attention to developing interpersonal relations with the client and a more empathetic approach to their concerns and problems. Shockley (1982, p.135) argued that 'certain characteristics of the smaller audit practices may be inherently dangerous to independence, for example, the nature of a typical client or the tendency toward a more personalised mode of service'. This viewpoint was shared by Gul (1991) who identified the size of the audit firm as an important variable that may affect perceptions of auditor independence. He noted that (p.165) 'smaller audit firms were more likely to lose independence because they tend towards a personalised mode of service and have a close relationship with the client'. CAJEC (1995) recommended that because not all the safeguards suggested in their guidance will be available to the smaller audit firm, they should consult externally with another member or with CAJEC as a means of offsetting any threats to their independence.

The empirical research undertaken to date shows that the perceptions of the users of financial statements are that larger audit firms are perceived to be more independent than smaller firms[1] and that financial statements audited by larger firms are perceived to be more reliable than those audited by smaller firms[2]. In all of these studies audit firms were divided into the two categories Big Six/Eight and non Big Six/Eight and this dichotomy has been maintained in this particular study.

Audit committees

Mitchell, Puxty, Sikka and Wilmott (1991, p.25) argued that in the UK context 'the legal fiction is that auditors are hired and fired by shareholders, the practical reality is that auditors are hired and fired by the directors'. Where such decisions are left in the hands of management and/or directors, pressure may be seen to be placed on the auditors to follow the dictates of management if they wish to be re-appointed (Lam, 1975; Byrd, 1977). Mautz and Neumann (1970) maintained that an audit committee, by holding the auditor directly accountable to the board of directors, makes the auditor more independent of management. Goldman and Barlev (1974) also argued that management's power over the auditor would be limited if audit committees were established to deal with the selection of auditing firms, the negotiation of fees, and participated in matters regarding the replacement of auditors. One aspect of this reduced power of management is that the audit committee can provide the auditor with a forum to air his/her concerns and to raise issues which have the potential for auditor-management conflict (Lam, 1975; Robertson, 1976; the Accountants International Study Group (AISG), 1977; Christofi, 1977; Adams Committee, 1978, Cadbury Committee, 1992).

Audit committees are also perceived to enhance the reliability or credibility of financial statements. The AICPA (1967), when recommending that all publicly owned corporations appoint audit committees, argued that this would result in the continuing improvement of corporate financial reporting to the investing public by giving added assurance to stockholders as to the reliability of corporate financial statements. Auerbach (1973, p.104) shared this opinion stating 'in the long run, the establishment of audit committees will give stockholders greater confidence in the reliability of the financial statements'. Byrd (1977) believed that an audit committee would enhance the reliability of financial statements as it would permit a more thorough probing into all issues and a proper questioning of management decisions affecting the financial statements. Wolnizer (1978) maintained that by ensuring that the external auditor is free from the influence of management and, therefore independent, the establishment of an audit committee will result in an improvement in the reliability of financial statements. Collier (1997) argued that audit committees can increase the reliability of financial statements by demonstrating the board's intention to give due weight to reviewing external reporting, auditing, internal controls and other related matters.

However, an audit committee is likely to be effective in enhancing auditor independence and the reliability of financial statements only in circumstances in which the audit committee itself acts in a manner independent of management (Lam, 1975; AISG, 1977). A number of commentators have cast doubt upon the independence from executive management of the non-executive directors that normally comprise the audit committee. Lorimer (1996) presents the conditional nature of the value of the audit committee in forthright terms (p.130): 'on the basis that the non-executive directors are effective and independent (so often the non-executive directors are cyphers), the audit committee provides a forum for discussion and appraisal of executive directors' performance'.

Empirical work to date almost universally suggests that audit committees do in fact enhance the perceptions of the users of financial statements with respect to auditor independence[3]. One exception is Gul (1989). The participants in his study were indifferent to audit committees which Gul attributes to the novelty of audit committees in the New Zealand context. He states that (p.48) 'there was little awareness of the role and importance of audit committees amongst New Zealand bankers because relatively few companies in New Zealand have set up audit committees'. Empirical work focusing directly on the perceived reliability of financial statements is more limited but does provide some support for the assertion that audit committees do enhance the perceived reliability of financial statements[4].

EMPIRICAL ANALYSIS AND RESULTS

Population

The population chosen for this study comprised of corporate lenders, investment managers and financial analysts. These groups were chosen because they have been identified as primary users of financial statements (Accounting Standards Board, 1991) and have been shown to rely on financial statements to reach appropriate decisions (Bertholdt, 1979; Libby, 1979; Chang, Most and Brain 1983; Berry, Citron and Jarvis 1987; Bromwich, 1992). In addition, these groups have been identified as sophisticated users of financial statements (Lee and Tweedie, 1981) and on that basis their perceptions of auditor independence and the impact that such perceptions have on their assessment of the reliability of financial statements are likely to have added significance.

A list of banking institutions which were members of the Irish Bankers Federation was obtained. Out of a total of 21 institutions contacted, 18 agreed to participate. Each of the 18 institutions furnished lists of names of their corporate lenders who operated in Dublin and were engaged in lending to the Irish business community. In total 141 names were put forward. The investment manager population was based on the Irish Association of Investment Managers' list of institutional members, which comprised of a total of 17 members. Co-operation was obtained from 15 of these members who in turn furnished a list containing the names of 34 investment managers. The final list of 21 financial analysts came from the four largest stockbroking firms in Ireland each of which co-operated in full[5].

Data collection

The collection of data was in three stages: preliminary interviews[6] with fellow academics and a small number of corporate lenders, investment managers and financial analysts; mail questionnaires to the 196 individuals comprising the three separate sub-populations described above; and in-depth interviews with selected corporate lenders, investment managers, and financial analysts.

The questionnaire

In addition to seeking demographic details, information on the use and importance of financial statements as a decision-making tool was sought from the mail questionnaire respondents. Respondents were presented with a number of statements[7] and were asked to indicate, on a five point scale, their level of agreement with the statement[8] or the frequency that they perceived the financial statements to be reliable[9]. In constructing these scaled items, a conscious effort was made to ensure brevity and clarity, to avoid neutral statements, and to ensure a balance between positive and negative items in order to minimise the effects of a response set (Oppenheim, 1966; Moser and Kalton, 1979). In order to control for how participants interpreted the concepts addressed by the questionnaire, definitions were provided[10].

Of the total 196 questionnaires mailed, 155 were returned, a response rate of 79.1 per cent[11]. However, seven of the questionnaires were not completed by the respondents either because they did not use financial statements for decision-making purposes or because they did not consider the independence of the auditor when making their decisions. This gave an overall response rate of 75.5 per cent. A summary of the responses is shown in **Table 1**.

Table 1: Timing of Mail Questionnaire Responses

	Number of Responses	**Response Rate %***
First mailing	66	33.7
Second mailing	58	44.6
Third mailing	19	26.4
Follow-up telephone call	5	9.4
Total	148	75.5

Note
*Calculated by reference to the residual population, e.g. second mailing (58/196-66) = 44.6%

The high response rate suggested that non-response bias was unlikely to be a major problem nevertheless respondents and non-respondents were analyzed in terms of both gender and sub-population in order to identify any significant differences. The results shown in **Table 2** indicate that the null hypothesis that respondents and non-respondents have the same distribution is not rejected for the gender variable but is rejected for the group variable. Further analysis of the group variable indicated that a rather higher response rate was obtained from corporate lenders (80.1 per cent) than from investment managers (67.6 per cent) or from financial analysts (57.1 per cent) which may indicate some bias in the results.

Table 2: Comparison of Respondents and Non-Respondents

	Pearson Chi-Squared		
	Value	**D.F.**	**Significance**
Group	6.60355	2	0.03682*
Gender	0.19093	1	0.66214
*Significant at p<0.05			

Note

The test of association was based on the Pearson Chi-Square because only nominal measurement had been achieved, and the power distribution of this test tends to 1 for moderately large samples (Siegel, 1956, p.179).

Conventional comparison of the responses from early and late respondents was also carried out[12]. The results shown in **Table 3** indicate that the null hypothesis that early and late respondents have the same distribution is not rejected for any of the variables tested.

Table 3: Comparison of Early and Late Respondents across Eight Variables

	Pearson Chi-Squared		
	Value	**D.F.**	**Significance**
Group	0.99772	2	0.60722
Gender	0.99645	1	0.31917
Length of work experience	1.14263	2	0.56478
Nature of work experience	0.03784	2	0.98126
Age	0.99778	2	0.60721
Accounting knowledge	0.01374	1	0.90670
Prior experience with auditor independence	0.06520	1	0.79846
Request for summary of results	0.32149	1	0.57072

The interviews

The mail questionnaire provided a wealth of quantitative data but advantage was taken of the opportunity to carry out semi-structured interviews to complement and enhance the information obtained from the questionnaire. Fielding and Fielding (1986) suggest that such a combination of methodologies increases researcher confidence in the findings and allows them to be better imparted to the audience with lessened recourse to the assertion of privileged insight. Faulkner (1982) highlights the manner in which each approach can enrich and validate the other while according to Patton (1990, p.132) 'qualitative data can put flesh on the bones of quantitative results, bringing the results to life through in-depth case elaboration'.

Clearly to attempt to interview in-depth all 196 individuals to whom the questionnaire was sent would have been a very major undertaking. Instead, in keeping with usual practice[13], numbers were restricted to a sub-sample of those to whom the questionnaire was sent. This sub-sample consisted of 15 corporate lenders, 10 investment managers, and 10 financial analysts. In fact 30 individuals participated in the interview process[14]. A semi-structured interview approach with the use of an interview guide[15] was adopted and the interview length ranged between one and two hours. Except for one interviewee, all interviewees allowed their interviews to be recorded by tape. To ensure accuracy and comprehension of the interview data at the analysis stage the tapes were transcribed immediately after each interview and a copy was sent to the interviewees for their comments and approval. Except for minor grammatical changes, no adjustments were made to the transcripts.

Results

The results from the mail questionnaire were analyzed using SPSS while the results from the interviews were analyzed using the cross-interview approach suggested by Patton (1990). This involved grouping together answers from the different interview transcripts by topic per the interview guide and allowing the guide to act as a descriptive framework for analysis. Once answers had been grouped by topic, they were analyzed by content analysis, a 'process of identifying, coding, and categorizing the primary patterns in the data' (Patton, 1990, p.381). The primary patterns identified from this process were used to develop matrices. Interviewee responses to the questions in each topic were then entered onto these matrices.

Demographics

Table 4 presents demographic and other background details on questionnaire respondents and interviewees. The respondents were predominantly male lenders whose main responsibility included the review of loan proposals, having had at least five years' experience in this role.

Table 4: Demographics

	Total		Questionnaire only		Interviews & Questionnaires	
	#	%	#	%	#	%
Group:						
Corporate lenders	113	76.4	98	83.1	15	50.0
Investment managers	23	15.5	15	12.7	8	26.7
Analysts	12	8.1	5	4.2	7	23.3
	148	100.0	118	100.0	30	100.0
Gender:						
Male	130	87.8	103	87.3	27	90.0
Female	18	12.2	15	12.7	3	10.0
	148	100.0	118	100.0	30	100.0
Age:						
Under 30 years	25	16.9	22	18.7	3	10.0
Between 30 and 40 years	88	59.5	70	59.3	18	60.0
Over 40 years	35	23.6	26	22.0	9	30.0
	148	100.0	118	100.0	30	100.0
Nature of Work Experience:						
Authority to sanction (i)	42	28.4	33	28.0	9	30.0
Review proposals but final decision is referred to a higher authority (ii)	82	55.4	68	57.6	14	46.7
Combination of (i) and (ii)	24	16.2	17	14.4	7	23.3
	148	100.0	118	100.0	148	100.0
Length of Work Experience:						
Under 5 years	34	23.0	28	23.7	6	20.0
Between 5 and 10 years	63	42.6	49	41.5	14	46.7
Over 10 years	51	34.4	41	34.8	10	33.3
	148	100.0	118	100.0	30	100.0

	Total		Questionnaire only		Interviews & Questionnaires	
	#	%	#	%	#	%
Accounting Knowledge:						
None	23	15.6	22	18.6	1	3.3
Accounting course at college	70	47.3	57	48.3	13	43.4
Qualified accountant	48	32.4	38	32.2	10	33.3
Other	7	4.7	1	0.9	6	20.0
	148	100.0	118	100.0	30	100.0
Training of Chartered Accountants:						
Big Six firm	16	80.0	10	71.4	6	100.0
Non Big Six firm	3	15.0	3	21.4	0	0.0
Industry	1	5.0	1	7.2	0	0.0
	20	100.0	14	100.0	6	100.0

Non-parametric tests were performed in order to determine whether responses to the questionnaire were in any way associated with these demographic and related details. The only significant results, which are presented in **Table 5**, related to the variables 'accounting knowledge' and 'the training of chartered accountants'.

Table 5: Significant Effects of Demographics on Responses

Mann-Whitney U Tests		
	No Accounting (n=23)	**Some Accounting (n=125)**
	Mean Rank	
1. Non Big Six firms when compared with Big Six firms are less independent	54.63	78.16
	z=-2.5502^	p=0.0108*
2. Financial statements perceived to be reliable when the audit is performed by a Big Six firm	91.50	71.37
	z=-2.3369^	p=0.0196*
	Trained with Big Six (n=16)	**Trained with non Big Six (n=3)**
	Mean Rank	
3. Non Big Six firms when compared with Big Six firms are less independent	8.91	15.83
	z=-2.1422^	p=0.0322*

Notes

- ^Corrected for ties * 2-Tailed Probability
- The mean rank is the sum of the ranks divided by the number of cases. For statements 1 and 3 above, the lower the mean rank the more that respondents agreed with the statements. For statement 2, the lower the mean rank the more reliable the financial statements were perceived to be.
- The tests of association were based on the MWU test because at least ordinal measurement had been achieved and the power efficiency of this test is close to 95% for moderately large samples (Siegel, 1956, p.126).
- See **Table 4** for split in accounting knowledge

The level of accounting knowledge held by the respondents appeared to influence their perception of the independence of Big Six as compared to non Big Six firms. Respondents with no accounting knowledge had less confidence than respondents with some accounting knowledge in the independence of non Big Six audit firms. In addition, those respondents who had some accounting knowledge attached a significantly greater reliability to the financial statements audited by Big Six audit firms than respondents with some accounting knowledge.

The other variable which showed a significant difference was the training of chartered accountants. Respondents who had trained with a non Big Six audit firm were more confident in the independence of non Big Six audit firms than respondents who had trained with a Big Six audit firm. However, their training did not significantly influence the reliability that they attached to financial statements audited by Big Six or by non Big Six audit firms.

Use and importance of financial statements

Table 6 reveals that financial statements are used very frequently as an aid to decision making with over 90 per cent of the questionnaire respondents using them 'always' or 'often' and over 90 per cent of the respondents considering them to be 'important' or 'very important' as a decision-making tool. Although a small minority considered financial statements to be of limited importance for decision-making purposes (six of those respondents who used financial statements 'always' or 'often' only considered them to be 'moderately' or 'slightly' important for decision making), it is clear that for the great majority of the sample financial statements were seen as containing useful information. Non-parametric tests were undertaken to determine whether there were differences in the perceptions across the three sub-samples: corporate lenders; investment manager; and financial analysts. The results revealed no differences in the propensity to use financial statements but some differences in the importance which was attached to their use. These results suggested that corporate lenders placed a greater emphasis on financial statements than investment managers and financial analysts. This was borne out by the interview findings.

Table 6: Use and Importance of Financial Statements

6a: Frequency that financial statements are used for decision-making purposes:

	#	%
Always	93	62.8
Often	45	30.4
Sometimes	8	5.4
Rarely	1	0.7
Never	1	0.7
	148	100.0

6b: Importance of financial statements for decision-making purposes:

	#	%
Very important	80	54.8
Important	52	35.6
Moderately important	12	8.2
Slightly important	2	1.4
Unimportant	0	0.0
	146*	100.0

6c: Kruskal-Wallis 1-Way Anova Tests

	Lender	**Investment Manager**	**Analyst**	**Kruskal-Wallis 1-way Anova Test Results**
	Mean Rank^			
Use	71.52	87.35	77.96	Chi-square = 3.7186 Significance = 0.1558 D.F. = 2
Importance	69.43	92.89	87.00	Chi-square = 7.8039 Significance = 0.0202 D.F. = 2

Notes

- *Two respondents who 'rarely' or 'never' use financial statements were not required to indicate the importance that they attached to financial statements.
- ^The mean rank is the sum of the ranks divided by the number of cases. The lower the mean rank, the more frequently that financial statements were used or the more importance that respondents attached to financial statements.
- The Kruskal-Wallis 1-Way Anova test was used because there were three independent samples, at least ordinal measurement had been achieved and this test has a power efficiency of 95% (Siegel, 1956, p.194).

The interview responses showed that investment managers, who were more critical of financial statements than corporate lenders, relied more heavily upon other sources to aid their decision making. Analysts too proved to be equally critical of the information provided in financial statements and claimed that they only used it to corroborate and to confirm what they already knew about the company. The following interview excerpts provide a flavour of the responses made. The first two are typical of responses from corporate lenders:

> L6[16]: "We wouldn't lend without them really."

> L10: "The audited accounts are absolutely critical."

whereas the responses of investment managers tell a rather different story:

> IM3[17]: "What is in actual published financial statements is of very little value. To get real information, you need to look at management accounts."

> IM4: "We would rely more heavily on brokers' research than on the financial statements."

and financial analysts too saw the role of financial statements as one of confirmation rather than in themselves adding new information:

> A1[18]: "When they report their accounts you are pretty familiar with what the composition of them should be."

> A5: "When the audited statements come out, an analyst would read down through them to see if there is any extra information but there is usually very little extra information."

Although corporate lenders saw financial statements as being extremely important to their lending decisions they did not base their lending decisions on financial statements alone but used financial statements in conjunction with other information:

> L1: "They are not the only criterion for making a decision but we would not make any lending decision without seeing the financial statements."

> L13: "Yes, we would use them but they would have to be used in conjunction with information which pertains to the present and future."

Effect of audit firm size on perceptions held

As **Table 7** shows, half of the respondents held the view that non Big Six audit firms were less independent than Big Six audit firms. Here one relevant factor appears to have been the widely held perception that non Big Six audit firms were more likely to provide a more personalised mode of client service than Big Six audit firms and this particular feature of the type of service provided by the smaller firms was emphasised by a number of interviewees:

> L4: "The Big Six are less likely to give a personalised approach to their clients."

> L9: "In the bigger audit firms you would find a huge diversity of clients whereas in the smaller audit firms, you may find that the auditor is a close friend of the company."

Table 7: Effects of Audit Firm Size on Perceptions Held

7a: Non Big Six firms when compared to Big Six firms are:
i: less independent
ii: tend towards a more personalised mode of client service

	i		ii	
	#	%	#	%
Strongly agree/ agree	74	50.0	125	84.4
Undecided	45	30.4	18	12.2
Disagree/ strongly disagree	29	19.6	5	3.4
	148	100.0	148	100.0

7b: Financial statements perceived reliable when the audit is performed by:
i: a Big Six audit firm
ii: a Non Big Six audit firm

	i		ii	
	#	%	#	%
Always	62	41.9	12	8.1
Often	77	52.0	94	63.5
Sometimes	7	4.7	35	23.7
Rarely	2	1.4	7	4.7
Never	0	0.0	0	0.0
	148	100.0	148	100.0

7c:Wilcoxon Matched-Pairs Signed-Ranks Test Reliability of Financial Statements when Audited by Big Six versus non Big Six

Mean Rank	Cases
36.00	3 -Ranks
41.71	79 +Ranks
	66 Ties
	148

Notes

- z=-7.3666; 2-Tailed P<0.0001.
- The Wilcoxon Matched-Pairs Signed Ranks test was used because each respondent was asked to respond to two conditions (Big Six and non Big

Six), at least ordinal measurement had been achieved, and this test has a power efficiency of 95% (Siegel, 1956, p.83).

- '-Rank' means financial statements audited by non Big Six ranked more reliable than those audited by Big Six.
- '+Rank' means financial statements audited by non Big Six ranked less reliable than those audited by Big Six.
- 'Ties' means that financial statements ranked equally in terms of reliability whether audited by non Big Six or by Big Six.

Other factors highlighted by the interviewees as underlying the lack of confidence in the independence of non Big Six audit firms included the smaller firms' greater dependency on specific clients for their fee income (and this was referred to by more than one third of the interviewees), and the lack of structure, laid-down procedures and standards within the smaller firms. Examples included:

- Fee dependency

  L9: "In the bigger audit firms you would see a huge diversity of clients whereas in the smaller audit firms, you may find that they make most of their income from one company. In those circumstances, where they are more dependent on one client for fee income, it is more difficult to be objective."

  IM8: "If it is a Big Six firm, I would have more confidence. There is a greater spread of expertise, less likely to have an independence problem, whereas with a smaller audit firm, they may be more dependent on one audit."

  A3: "The non Big Six are more prone to fee-driven income and are more sensitive to this."

- Lack of set procedures

  L10: "There is a greater opportunity to influence a smaller practice than a larger practice because the latter is very well organised, has its own structures in place. A small firm won't have the same resources and will depend on individuals within the practice to try and bring the same checks and balances which a large firm, by having the structures in place, can automatically impose."

> IM3: "I wouldn't necessarily be comfortable that the smaller audit firms would have the procedures or methodologies that the Big Six would have."

> A3: "The Big Six are part of international groups which are obliged to satisfy international standards. The smaller firms don't have such ties, reporting structures or quality standards."

The importance of reputation to the Big Six firms provided interviewees with a greater confidence that such firms would behave more independently than non Big Six firms:

> L12: "I have the confidence, as a banker, that bigger audit firms have their reputations to consider and they can't be seen to be doing something that might damage this."

> IM2: "I would have more confidence in the Big Six, in that, their professional reputation and the spread of partners would make it less likely for independence clashes to occur."

> A4: "I would think that for the Big Six firms that their reputation is their biggest regulator."

Although the majority of interviewees perceived Big Six audit firms to be more independent than non Big Six audit firms, in three cases this confidence was extended to the medium-sized firms of the non Big Six category:

> IM4: "I would extend my confidence to wider than just the Big Six. There would be a reasonable number of medium sized firms in Ireland and although they do not form part of the Big Six, you would still attach a greater credibility to them than the smaller firms."

Table 7 also shows that there was a perception among the respondents to the questionnaire that financial statements audited by Big Six firms are more likely to be reliable than those audited by non Big Six firms. However, the interview responses indicated that the reasons underlying this perception were more complex than a simple feeding through of a belief in Big Six firms being more independent than non Big Six firms. Interviewees highlighted the fact that the wider public exposure and greater interest in the financial statements of larger commercial entities would in itself bring pressure to ensure that their financial statements were reliable. For example:

> L5: "The Big Six would be dealing with the higher profile companies so as a result most of their accounts are cleaner."

> A6: "The Plc's use international audit firms and I would have more confidence in their financial statements because of this."

Effects of audit committees on perceptions held

Table 8 shows that over 70 per cent of the questionnaire respondents agreed that the existence of an audit committee ensures that the auditor is more likely to be independent. More than two thirds of the respondents agreed that the independence of the auditor would be enhanced if the audit committee was responsible for the selection, dismissal and remuneration of the auditor.

Table 8: Effects of Audit Committees on Perceptions of Auditor Independence

8a: The existence of an audit committee ensures that the auditor is more likely to be independent.

	#	%
Strongly agree/agree	105	71.0
Undecided	35	23.6
Disagree/strongly disagree	8	5.4
	148	100.0

8b: Auditor independence is perceived to be enhanced if the audit committee is responsible for:

	auditor selection		determination of audit fees		auditor dismissal	
	#	%	#	%	#	%
Strongly agree /agree	121	81.8	101	68.2	110	74.3
Undecided	23	15.5	34	23.0	26	17.6
Disagree/ strongly disagree	4	2.7	13	8.8	12	8.1
	148	100.0	148	100.0	148	100.0

The importance of audit committee involvement in these issues and the beneficial effects thereof on auditor independence was stressed by a number of interviewees:

> IM4: "The more that the audit committee is involved in deciding whether the audit firm should be changed to another firm and decides on fees, the better it will be in relation to the independence of the auditor."

> L6: "Audit committees should enhance the independence of the auditor because the people who are in executive roles within the firm aren't making decisions as to who the auditor is. Say something happens in a particular area in the business, auditors don't have that fear that this person will remove him."

All of the interviewees believed that the appointment of the auditors was at the behest of the company directors and that the role of the shareholders was limited to ratification of this appointment. A number of interviewees considered that this vested too much power in company management and led to the auditors being overly responsive to the wishes of company management. Shareholders' power was reduced because their interests were too diverse and they were insufficiently organised to vote against an auditor nominated by management.

A number of interviewees identified the benefit that an audit committee gave in terms of providing an additional channel of communication.

Some highlighted the independence of non-executive directors and their involvement as enhancing auditor independence:

- Additional communication channel

  IM3: "Independence is enhanced because it (audit committee) gives the auditor the opportunity to talk to non-executive directors who are going to be equally keen not to be swayed by the prevailing management."

  L3: "It (audit committee) gives another channel for communication, for example, say the auditor had a suspicion and he may worry about losing that part of his business, it provides him with a valuable method of resolving that issue and in a way which minimises losing the account."

- Independent non-executive directors

  L12: "The audit committee is good to have there because the non-executive directors will have their own interests elsewhere and they will act as guardians of the company and will make sure that the management of the company don't drive the company in a direction that the shareholders wouldn't want it driven. The non-executive directors have no real axe to grind."

  IM8: "The non-executive directors are well known to the business community and would have no function, whatsoever, in the day-to-day running of the company."

The issue of whether non-executive directors carried sufficient weight and were in fact themselves independent of executive management did however concern a number of the interviewees. For a significant minority this was a crucial factor in determining the likely effectiveness or otherwise of the audit committee:

> L5: "It would depend on how influential the non-executive director is and what his function is."
>
> L2: "I think it depends on what audit committees do. If they only meet once a year to effectively approve the accounts, (auditor independence will) probably not (be improved). However, if they are

more involved, for example with internal control issues and with half yearly reports, they may enhance auditor independence."

IM5: "Audit committees should enhance auditor independence but it all leads to the question of the strengths of the boards of Plc's. Some of them have obviously very strong boards where the non-executive directors have the applicable knowledge. However, some of them don't and some of the non-executive directors are basically puppets."

A3: "I suppose it (audit committee) should (enhance independence) but it depends on the quality of the non-executive directors and who is paying their fees. At the end of the day, you have to ask the question what are the non-executive directors working towards, what is in their interest and what is not."

Five interviewees concluded on the basis of their own experience that audit committees were in fact ineffective because of the relatively low calibre and lack of independence of the non-executive directors:

L8: "I think in theory it (audit committee) should enhance auditor independence, but in practice, I wonder if it makes a lot of difference. If I take a cross-section of the public companies that we would deal with, I wouldn't have thought, with a couple of exceptions, that the calibre of non-executive directors would be sufficiently high to have a major say in changing what the chief financial officer might do. I think that it is only in unusual circumstances that the non-executive directors would overrule the executives."

IM7: "Are the non-executive directors independent, I would have questions with that. It's not down to one specific thing, there would be a whole array of things where we would have potential difficulties with non-executive directors, in terms of their real independence. It would vary from close connections with the company and working with connected companies, to being paid by the company and their pay being a substantial element of their income, to the work that they could provide that company given all their responsibilities that we would know they have, and given their general status and experience as we would perceive it to be."

Irrespective of these minority concerns as to the role and efficacy of audit committees, **Table 9** shows that the existence of an audit committee in a company resulted in approximately 83 per cent of the questionnaire respondents perceiving the financial statements to be 'always' or 'often' reliable, whereas when an audit committee was not in place only half of the respondents responded in this manner. This difference in perceptions was significant.

Table 9: Effects of Audit Committees on the Perceived Reliability of Financial Statements

9a: Financial statements perceived to be reliable when the company:

	has an audit committee		does not have an audit committee	
	#	%	#	%
Always	43	29.0	13	8.8
Often	80	54.0	62	41.9
Sometimes	14	9.5	56	37.8
Rarely	10	6.8	16	10.8
Never	1	0.7	1	0.7
	148	100.0	148	100.0

9b: Wilcoxon Matched-Pairs Signed-Ranks Test

Mean rank	Cases	
72.08	6	-Ranks
41.92	81	+Ranks
	61	Ties
	148	
z=-6.2703; 2-Tailed P<0.0001		

Notes

- '-Ranks' means when no audit committee exists, financial statements ranked more reliable than when one exists
- '+Ranks' means when no audit committee exists, financial statements ranked less reliable than when one exists
- 'Ties' means financial statements ranked equally in terms of reliability whether audit committee exists or not.

DISCUSSION OF THE FINDINGS

The main findings of this study are in accord with those of the majority of previous research in that perceptions of auditor independence and of the reliability of financial statements were increased if the auditor was one of the Big Six and if the client had established an audit committee. Underlying the perception that non Big Six auditors were less independent than Big Six auditors was a belief that the more personalised mode of audit service provided by the smaller audit firms impaired their independence. The fact that for the smaller audit firms any single client was likely to provide a larger proportion of fee income than for larger firms also contributed to this perception. The interviewees highlighted the perception that smaller firms did not have structures or procedures in place to cope with independence issues and problems and also the belief that reputation effects were of such importance to the Big Six audit firms that they would not be prepared to compromise their independence even for short term financial advantage.

However, these perceptions were not independent of the previous background and accounting knowledge of the questionnaire respondents. Respondents who had trained with Big Six firms viewed non Big Six auditors as less independent than respondents who had trained with non Big Six firms[19]. Respondents without significant accounting knowledge too had a greater propensity to view Big Six firms as more independent than non Big Six firms. Furthermore, certain of the interview responses suggested that the Big Six/non Big Six dichotomy used in this study and in many previous studies might not adequately capture distinctions made between the independence of the second-tier or medium-sized firms who are active in the Irish market and that of very small firms.

The majority of respondents perceived that the existence of an audit committee enhanced the independence of the auditor. Interviewees argued that by being involved in the selection, remuneration and dismissal of the auditor, the audit committee enhanced auditor independence by reducing the power asymmetry between the auditor and company management. An audit committee also had beneficial effects in its role either as an additional channel of communication or as a forum in which issues of concern can be raised with parties other than executive management.

Although the majority of interviewees concurred with these views, significant differences were highlighted between those interviewees who were confident as to the quality of non-executive directors and those who voiced concerns that the low calibre and lack of independence of many non-executive directors would significantly ameliorate the benefits and effectiveness of an audit committee. Audit committees are a relatively new phenomenon in Ireland and it was perhaps not surprising that their role and relevance have not been fully understood by the participants in this study. However, the strong feelings expressed by a significant minority of the interviewees, based apparently on direct experience of the functioning of audit committees, were a little unexpected.

CONCLUSION AND FURTHER IMPLICATIONS

How important these findings are and whether they have specific policy implications are difficult questions to answer. As noted above, although independence in fact and appearance are desirable characteristics for auditors to possess it may be that the audit market can function efficiently in circumstances where users of financial statements perceive, rightly or wrongly, some auditors to be more independent than others. One aspect of the structure and practices of Big Six firms which appears to reassure users of financial statements as to their independence is their greater degree of organisational structure and formalisation of procedure. Whether it would be cost effective for smaller firms to seek to emulate this organisational form is perhaps debatable. Another perception held is that the Big Six have a greater investment in their reputation and are therefore less likely to engage in non-independent activity. One possibility which would allow smaller audit firms to signal their intentions to maintain their independence would be to licence auditors of certain types of company separately, as for example in the USA where only firms within the SEC Practice division can audit SEC registered clients. Another possibility, which would impose costs more widely across audit firms, would be to strengthen the investigation and monitoring procedures of the Joint Monitoring Unit so as to demonstrate to the users of financial statements the independence of auditors whether they be small firms or large.

The majority of respondents and interviewees clearly believed that the presence of an audit committee added to auditor independence and gave greater confidence in the reliability of financial statements. This would suggest that thought should be given to a wider scope for audit committees in Ireland and a strengthening of the present recommendation that listed companies should establish audit committees. However, audit committees too are not costless and the concerns expressed by a minority of the interviewees as to whether these committees had in some instances themselves been 'captured' by executive management suggest that they are not a universal panacea.

NOTES

[1] Refer to studies undertaken by Shockley (1981); Pearson and Ryans (1981/82); McKinley, Pany and Reckers (1985); Jackson-Heard (1987); and Gul (1989).

[2] The only study to date which has looked at the effects of audit firm size on the perceived reliability of financial statements was the experiment undertaken by McKinley et al. (1985). They found that subjects considered financial statements audited by a non Big Eight audit firm to be more likely to include undetected fraud and not to adhere to GAAP (the surrogates used to measure the reliability of financial statements) than financial statements audited by a Big Eight audit firm.

[3] Refer to studies undertaken by Lam and Arens (1975); Pearson (1980); Pearson and Ryans (1981/82); Jackson-Heard (1987); Schleifer and Shockley (1990); and Collier (1992).

[4] Refer to the empirical studies undertaken by Lam and Arens (1975); and Lam (1976).

[5] Size is based on their dealings in Irish equity market shares which in 1995 amounted to approximately 91 per cent (Finance Stockbroking Survey, 1996).

[6] These interviews were used to identify any problems with the language used in the draft questionnaire and to obtain a clearer understanding of the make-up of the population under investigation.

[7] The questionnaire, a copy of which is available from the authors, was used for the purposes of a wider study. Out of the total of 102 statements, 10 relate to what is being reported in this paper.

[8] The five point scale for level of agreement was as follows: 1=strongly agree; 2=agree; 3=undecided; 4=disagree; and 5=strongly disagree.

[9] The five point scale for frequency was as follows: 1=always; 2=often; 3=sometimes; 4=rarely; and 5=never.

[10] Definitions of independence, reliability, Big Six/non Big Six and audit committees were provided in the questionnaire.

[11] This response rate was achieved by means of the initial mailing, two follow-up mailings and further follow-up telephone calls in the months of October-December 1995.

[12] Early responses were defined as those received from the first mailing and late responses were defined to those received from subsequent mailings and follow-up.

[13] Williamson et al. (1982, p.184) notes that 'the typical intensive interview study is based on fewer than fifty respondents'.

[14] Full co-operation was obtained from the corporate lenders. Out of the ten investment managers contacted, eight agreed to participate. Seven of the ten financial analysts contacted were willing to participate in the interviews.

[15] A copy of the interview guide is available from the authors.

[16] L6 refers to corporate lender, number six. Fifteen corporate lenders were interviewed and will be referred to as L1, L2,... L15.

[17] IM3 refers to investment manager, number three. A total of eight investment managers were interviewed and will be referred to as IM1, IM2,... IM8.

[18] A1 refers to financial analyst, number one. Seven financial analysts were interviewed and will be referred to as A1, A2,.. A7.

[19] It should be noted that only a relatively small proportion of respondents (13%) had in fact trained with an accounting firm (see **Table 4**).

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