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AN INTEGRATIVE EMPIRICAL ANALYSIS OF AUDITOR INDEPENDENCE

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CHAPTER I

STATEMENT OF PROBLEM

According to the American Institute of Certified Public Accountants (1978, p. 6), the objective of the attestation function provided by public accountants is to facilitate the efficient operation of capital markets. This is accomplished by providing users of financial statement data with some degree of assurance that the information upon which their investment decisions are presumably based, has been prepared in a fair and consistent manner. If this service were not provided by auditing firms, the presumption is that the capital markets would not operate as efficiently as they do today. Individual investors would be required to expend substantially more of their resources to obtain reliable information for decision-making purposes.

In the last few years considerable skepticism has arisen concerning the degree to which the auditor is fulfilling his societal obligations. Probably the most convincing confirmation of the existence of this skepticism is found in the recent reports of two U.S. congressional committees, one in the House of Representatives (1976) which was chaired by Congressman Moss and the other in the Senate (1976) which was chaired by the late Senator Metcalf (and after his death by Senator Eagleton). This latter committee made the following comment.

> This study finds that public doubts concerning the performance of independent auditors of major corporations are well founded. Moreover, the problems causing an erosion of confidence in the "Big Eight" accounting firms and other independent auditors are inherent in their present system of practice, the procedure by which they are chosen, and their relationship to standard-setting bodies. Restoration of public confidence in the independence and competence of such auditors depends upon reforming the manner in which they perform their responsibilities. (p. 7)

Several academics and practitioners have also called for changes in the auditor's professional role. According to Causey (1976), the auditor should insist that financial statements portray as clearly as possible the economic realities of the client's financial position and operations irrespective of the dictates of generally accepted accounting principles. Philip Chenok, the current president of the AICPA, has stated that the profession must strive to strengthen its role as an intermediary between the business community and the investing public. "If we don't, the mood in this land for change could transform into irrational action. Government could set rules for all of us. They'll tell us what to audit - when to audit - how to audit - and then set the fee" (1978, p. 36). Mautz and Sharaf (1961) warned the profession that unless changes were initiated to broaden the auditor's responsibilities, his role would probably be assumed by other parties, most likely professional security analysts.

In response to the serious criticism addressed toward auditors and auditing firms, the profession in 1974 established the Commission on Auditors' Responsibilities (CAR) which was instructed to analyze the auditor's professional role and suggest ways in which it needed to be changed in order to provide an improved level of professional service to the public. In 1978 the Cohen Commission, the name by which the above body was more commonly known, released a lengthy report of its findings and recommendations.

> Because of the overall reasonableness of its recommendations and strong endorsement given by Congress and the SEC, the CAR report essentially became a mandate for the profession. And, the profession has responded vigorously and affirmatively to this mandate in several areas. (Lea, 1981, p. 65)

The need to strengthen auditor independence was one of the key issues which the Cohen Commission addressed. In Lea's analysis of the profession's responses to the recommendations of the Cohen Commission, he had the following to say concerning auditor independence: "In my opinion, the most significant area of non-response or inadequate response [by the profession] has been with respect to independence issues. . ." (p. 65). Thus, the Cohen Commission adds its voice to those of other unheeded observers who have noted that the structure of the relationship between the auditing firm and client does not seem to provide the auditor with an independent, pressure-free context in which to carry out his professional responsibilities.

In a 1977 interview with editors of the Journal of Accountancy, the then chairman of the SEC, Harold Williams, expressed concern with the harsh criticism of the profession by external parties and indicated his belief that the primary cause of the controversy was the lack of independence in the audit context. "I believe the crux of the whole problem is independence. Most of the other pieces fall into place as ways to safeguard and assure the existence of independence." (p. 42). The concern of Commissioner Williams for promoting the independence of external auditors as well as the conclusions expressed by Lea above provide substantial justification for further study of this dimension of the auditor's role. A final measure of justification in this regard is provided by Professor Edward Stamp who sees independence as an indispensable element of the auditor's role.

> If the auditor is not independent then the sole justification for his existence simply disappears. . .his function and his credibility as an auditor depends so completely upon his independence that an auditor who is not independent is no longer an auditor. (1978, p. 108)

There are several approaches that could be employed to study auditor independence, a few of which were discussed in a recent article by Amernic and Aranya (1981). Two of their recommendations were an analysis of the structural factors bounding and/or defining auditor independence, and an examination of the psychological attributes prerequisite to the formation of a mental state of independence in an audit context. In the next chapter, the distinction between the two recognized dimensions of auditor independence is discussed. At this time, it is sufficient to say that one dimension, apparent or perceived independence, is primarily a structural phenomenon that is bounded or defined by explicit guidelines or policies established by relevant parties in the financial reporting process. The other dimension, independence in fact, is primarily of a psychological nature. Thus, the structural approach to the study of independence suggested by Amernic and Aranya is the most appropriate method for examining the perceived independence of auditors while their second method is better suited for investigating auditors' *de facto* independence.

The focus of this study is upon the apparent independence of auditors. Two basic research approaches are involved. First, the relevance of numerous recommendations which have been brought before the profession in recent years concerning the strengthening and preserving of auditor independence are systematically evaluated. The primary research interests in this case are 1) to determine how financial statement users would redefine the auditor's role and/or responsibilities in order to provide for a greater degree of independence, and 2) to determine how well partners of national public accounting firms agree with financial statement users on this same issue.

The necessity for pursuing the first of these two research interests was provided by the Metcalf Committee's strong call for increased participation by the public in the standard-setting processes. "Again, participation by all segments of the public is necessary to develop auditing standards that will restore public confidence in the integrity of corporate reports" (p. 12). With respect to the second research interest, the Metcalf Committee implied (p. 153) that the large national accounting firms have a major and disproportionate influence in standard-setting processes. If this is the case, then it seems important to determine if there is a lack of consensus between the large accounting firms and financial statement users concerning how to "legislate" the independence of auditors.

The second approach taken in this study is an examination of a specific context identified in the professional literature as having the potential to seriously undermine the otherwise apparent independence of the external auditor, namely, auditor-client conflict episodes. This avenue of research focuses on determining how knowledge of such conflict may impact financial statement users' perceptions of auditor independence. Auditor-client conflict has several times been hypothesized to be capable of seriously impairing the objectivity of auditors. However, past researchers have not attempted to verify or dispute this presumption empirically.

In the following chapters, the specific objectives of this study are developed more fully. Chapter II contains an overview of the relevant literature concerning independence and auditor-client conflict. In Chapter III the specific research questions and hypotheses addressed are developed. Chapter IV describes the particulars of the research techniques employed while Chapter V contains the statistical and intuitive analysis of the data compiled from the empirical research. Finally, Chapter VI presents the overall research conclusions as well as suggestions for future research emanating from this study.

CHAPTER II

LITERATURE REVIEW

In the next several pages, the relevant literature related to perceived auditor independence and auditor-client conflict is reviewed. For clarity purposes, the literature review is organized into four sections. The first section is a discussion of the two officially recognized dimensions of auditor independence. This dichotomy has important implications for the manner in which auditor independence should be, and has been, historically studied. The second section reviews several proposals that have been discussed in the professional literature to strengthen the perceived independence of auditors. The third section addresses the relevant literature which has examined the sources and implications of auditor-client conflict. Finally, the fourth section contains an overall review of the professional literature concerning auditor independence including an analysis of the specific areas needing further research.

Perceived vs. De Facto Auditor Independence

Prior to examining the relevant professional literature related to the issues selected for examination, it seems pertinent to address a fundamental question in this context which most researchers have either ignored or dealt with only superficially. The question at hand is: Which of the two officially defined types or dimensions of auditor independence, perceived or de facto, should be the focal topic of experimental inquiry? The technical standards for auditing recognize that the independence of the auditor is of paramount importance, ". . . he must be without bias with respect to the client since otherwise he would lack that impartiality necessary for the dependability of his findings, however excellent his technical proficiency may be" (AICPA Professional Standards, AU 220.03). The standards go on to say that it is not sufficient for the auditor to possess a true state of judicial impartiality toward his clients for third parties may lose confidence in the auditor's professional opinion if the auditor is in a position where his independence appears to be impaired even though in reality it is not. Accordingly, the auditor must continually question not only whether circumstances in relationships with his client affect his independence in fact, but also whether they adversely impact third parties' perceptions of his independence.

A brief review of the empirical work which has investigated auditor independence will quickly reveal that the auditor's perceived independence has received practically all of the attention of researchers at the exclusion of independence in fact. Behavioral researchers have been much maligned by other researchers for measuring subjects' perceptions of, or attitudes toward, a phenomenon rather than measuring the actual phenomenon or subjects' actual behavioral responses to the phenomenon. This problem was addressed in detail by Schumann and Johnson (1976), two prominent social psychologists. However, in this particular context, the controversy is apparently a moot one since the issue of relevant parties' perceptions of auditor independence may be just as critical as the *de facto* level of auditors' independence, ". . . for credibility [of the auditor] depends ultimately on the perception rather than on the fact of independence" (Shockley, 1981, p. 785). Commissioner Williams was quoted in the previously referenced interview as saying that, "A major problem of the accounting profession is that it lacks the appearance of independence in an area where appearances are as important as realities" (p. 42). The conclusions reached by Shockley and Williams provide the rationale for researchers to place heavy emphasis on apparent independence at the exclusion of *de facto* independence. However, instead of entirely ignoring *de facto* independence, it seems necessary to more clearly define that phenomenon and its relationship to independence in appearance.

Berryman (1974) presented an excellent synopsis of the historical development of the auditor independence construct including how the profession came to distinguish between perceived and *de facto* independence. He noted that historically the primary emphasis in defining auditor independence has been from a financial or economic interest perspective. De Angelo (1980) outlined the rationale underlying this approach.

> The 'economic interest' concept presumes that the auditor is not independent with respect to a client in which he possesses a material economic interest. In fact, 'economic interest' is a necessary, but not sufficient, condition for auditor opportunism to occur. An economic interest in the client sets up the incentive for misrepresentation; in order for 'cheating' to actually occur, it is also necessary that auditors perceive the marginal benefits from misrepresentation to exceed the marginal costs. (p. 69)

As De Angelo noted, the profession wants to avoid those situations where the auditor has an economic incentive to 'cheat'. However, in studying the evolution of this construct we can see that the profession's thinking has changed drastically.

Until 1862 in Great Britain, the auditor was not only permitted to have an equity interest in his clients but was required by law to have such[1]. Apparently, the argument was that an auditor without an economic interest in his clients might be lackadaisal in examining the financial records. By having a direct equity interest in his clients, the auditor was presumed to have a sufficient motivation to determine that the auditees were disclosing all relevant information in a fair and consistent manner. Most relatively new members of the accounting profession are probably not aware that the

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[1]This stipulation was found in the Companies Clauses Consolidation Act of 1845, Section 102.

AICPA did not prohibit auditors from having direct equity interests in their clients in this country until 1962.

In early pronouncements the profession did not differentiate between the two types of auditor independence. The technical literature continually used such terms as 'intellectual honesty', 'judicial impartiality', or 'integrity and objectivity' in defining auditor independence. Clearly, the intention was to promote independence in fact. With the leadership of the SEC (Berryman, p. 6), the profession came to realize that *de facto* independence was not alone sufficient since certain characteristics of the auditor's role and the auditor-client relationship made third parties doubt the auditor's impartiality, thus began the move to protect the perceived independence of the auditor.

Barrett's analysis of auditor independence is one of the few cases where a clear distinction has been made between the two dimensions of auditor independence, ". . . the audit profession's ethical notion of apparent independence can be operationally defined as a sociological role construct, and . . . its conception of real independence can be operationally defined as a personality construct" (p. iii). According to Barrett, *de facto* independence is not an attribute of the profession as a whole but rather of individual auditors. Either the auditor has the prerequisite psychological traits to behave in an independent fashion within the pressurized context of the audit engagement or he does not. Essentially this same argument was made a few years later by Fritzmeyer and Carmichael (1972). Barrett went on to define the personality characteristics that a *de facto* independent auditor would possess, e.g., a low need for social approval. He then presented an argument that the tendency to be independent in fact can be measured empirically given the appropriate battery of psychological tests.

Perceived independence is not an attribute of individual auditors, according to Barrett, but rather is a characteristic of audit environments, ". . . [perceived independence] describes functional situations which promote or dysfunctional situations which impair the profession's auditor image as perceived by reasonable observers" (p. iii). Once dysfunctional situations in the audit context are identified, the appropriate measures should be taken to restructure the auditor's role. For instance, as users became more sensitized to the possible adverse effects of auditors simultaneously providing MAS and audit services, the requirements of the auditor's role were modified accordingly, i.e., the nature and amount of MAS provided to clients was required to be disclosed. Applying this rationale, the audit profession should provide financial statement users with as much accurate information as possible about all aspects of the environment within which audits are carried out.

Perceived auditor independence will be the focal topic of this research study. However, hopefully, there exists a close relationship between those variables which result in financial statement users doubting auditor's independence and the factors which may result in auditors actually behaving in a less than independent manner. Consequently, by studying perceived independence, a more comprehensive understanding of the *de facto* dimension of auditor independence should also be obtained.

Analysis of the Structural Parameters of Auditor Independence

This section reviews notable recommendations for strengthening the apparent independence of external auditors. An emphasis has been placed on current works; however, when the findings of the less recent studies are still of considerable importance, they have been included also.

The MAS Controversy

A structural facet of auditor independence which has received considerable attention in the professional literature is the provision of management advisory services (MAS) to audit clients. Schulte (1965) was one of the first researchers to address this issue directly. In a survey study, he found that one-third of his respondents disagreed with the official position of the AICPA that providing MAS to audit clients does not constitute a conflict of interest. Two years later, Schulte, Hoenemeyer, and Devore (1967) pointed out that the issue is not only whether the provision of MAS creates a conflict of interest problem, and thus, an impairment of the auditor's independence, but also whether such a situation adversely impacts third-party financial statement users' perceptions of the independence of the auditor. One recommendation of Schulte and his co-authors was that the auditor should obtain approval for an MAS engagement from the client's audit committee which would review each case for impairment of independence. Schulte, et al, felt their recommendation could serve as a temporary measure to reduce the severity of the problem while the profession studied the issue in more detail.

Milano (1979) and Shockley (1981) also studied the relationship between auditor independence and the provision of MAS. Milano's survey study found that CPAs and financial statement users agreed that auditors' independence would be promoted by restricting their right to provide executive search and placement services to audit clients. However, there was a lack of consensus among CPAs and users as to whether the benefits provided by such a prohibition would exceed the tangible and intangible costs of such action. Shockley's recent study presented strong evidence that the provision of MAS to audit clients impairs the perceived independence of auditing firms.

The MAS issue has been examined extensively in other countries as well. In a 1979 Australian study, Francis and Pollard concluded that if providing audit services and MAS to the same client is deemed a conflict of interest, then a significant problem exists in that economy. Those researchers found that 74.5% of publicly-owned firms in Australia receive significant non-audit services from their auditors. Michael Firth of Great Britain in a 1981 study found that financial statement users generally considered an auditor's independence to be impaired if consulting services are provided to the client by the auditor. Dykxhoorn and Sinning (1981) comprehensively assessed the current status of the auditor independence construct in the West German economy. They noted that approximately 30% of Wirtschaftspruder, German auditing firms, revenue comes directly from the provision of consulting services. Those same authors noted a 1976 survey which found that more than two-thirds of that country's business journalists believed consulting and auditing were incompatible services while only one-third of the auditor subjects held such an opinion.

Titard (1971) as well as Hartley and Ross (1972) concluded that perceptions of auditor independence were not materially affected as a result of the provision of MAS to a client. The empirical findings of these researchers is inconsistent with more recent studies. A speculative explanation for the apparent contradictory results of these two studies is that in the early 1970's, prior to the Moss and Metcalf investigations, the financial community was simply not aware of the possible impact that the simultaneous performance of MAS and auditing services can have upon auditor independence.

Subsequent to that time, the public has become more aware of the problems that can arise from such a situation, and consequently, this 'education' would explain why more recent studies have typically not agreed with Titard or Hartley and Ross.

Finally, a recent study by Reckers and Stagliano (1981) found that relatively sophisticated financial statement users were less likely to perceive auditors' independence to be impaired when providing MAS than were naive financial statement users. These researchers defined the subject classes for relatively sophisticated and naive financial statement users as chartered financial analysts and MBA students, respectively. When each subject class was presented a scenario in which an audit firm received consulting fees equal to 38% of the annual audit fee (the mean percentage for a random sample of one hundred firms selected by the researchers from SEC registrants), the composite confidence level of the 'sophisticated' group in the ability of the audit firm to maintain its independence was approximately 70% while the same figure for the naive group was around 58%. Reckers and Stagliano concluded that the above levels of confidence were not indicative of a serious problem with respect to the impairment of auditors' independence, a conclusion that certainly seems debatable given other recent research findings. Additionally, the researchers imply that the judgments of relatively sophisticated financial statement users such as chartered financial analysts should be weighted more heavily in deciding issues such as the MAS controversy. That presumption will be re-examined later.

Obviously, no consensus has been reached on how or whether the provision of MAS impairs the ability of auditors to retain the appearance of independence in the audit engagement. This issue will be addressed by both halves of the research design used in this study. Hopefully, the empirical results of this study will contribute to the resolution of this issue.

Auditor Rotation as a Means to Preserve Apparent Independence

Next to the MAS issue, the rotation of auditing firms has probably received more attention in the professional literature than any other proposed action for strengthening auditor independence. The empirical results of the studies which have examined this policy alternative have generally been quite consistent and are fairly well summarized by two recent studies. Both Shockley and Dawkins (1978) addressed the issue of auditor rotation, the former indirectly in an experimental context and the latter directly in a survey study. Dawkins found that corporate controllers were very adamant in rejecting a policy of mandatory auditor rotation, however, she did not consider such a policy's effect upon auditor independence. Shockley's empirical results demonstrated that the tenure of audit firms with clients did not significantly influence financial statement users' views of the auditor's independence in either direction. In fact, Shockley presented an argument that the long tenure of an auditing firm may actually improve its independence. The auditing firm with a long tenure is more valuable to the client since that factor should presumably lead to a higher quality and more cost-efficient audit. This means that the auditing firm would be in a better position to stave off attempts by the client to influence its behavior. Given the results of these two studies, the rotation of auditing firms does not appear to be a move which would signficantly improve auditors' ability to retain their appearance of independence nor is it an action user groups would like to see adopted.

Audit Committees and Apparent Independence

Another structural facet of the auditor's role related to preserving and strengthening his independence is the formation of audit committees. Although audit committees have received a great deal of attention in recent years, the AICPA has never directly endorsed their use within the technical standards of the profession. Mautz and Neary (1979) argued that even though the concept of having a highly impartial body serve as a liasion between management and the external auditor is a positive step toward protecting the independence and integrity of the attestation function, certain forces in the financial environment may have unrealistic expectations with respect to the overall utility of audit committees. The primary concern of these authors is that audit committees were originally intended to spend a minimal amount of time in carrying out their responsibilities, however, now with the pressure to expand the role of such committees, and consequently, an increase in the amount of time to be spent by committee members in performing their duties, it may well be that qualified individuals will be less willing to serve on them.

Milne and Weber (1981) in an article intended to rebut many of the recommendations made by the Metcalf Committee, expressed special displeasure for the suggestion of that body to expand the role of audit committees in the financial reporting process. These authors argued very sternly against the government taking any further regulatory action with regard to the audit function being provided by public accounting firms in our economy. Their non-interventionist approach precluded them from accepting any form of government control over the auditor's role since such action, in their eyes, would further disturb the efficient interaction of supply and demand forces in the audit market. According to their normative argument, the role audit committees should play in the economy, if any, should be determined wholly by the free marketplace. Their second reason for disputing the Metcalf Committee's position on audit committees has been expressed by other individuals as well.

> If corporate audit committees become mandatory, we predict that the behaviour of these committees will be explained best by their ability to achieve what corporate management wants them to achieve and not by their motivations to maximise the welfare of all consumers of auditing services or the society in general. (p. 203).

Another highly respected member of our profession, Frederick Neumann, in a 1981 article did not express the same concern of Mautz and Neary nor that of Milne and Weber with regard to the possible overuse or misuse of audit committees. He views audit committees as a very effective tool to employ in the profession's struggle against more governmental intrusion. "In fact, such a committee may very well be a company's best bulwark against governmental regulation in general and the Foreign Corrupt Practices Act of 1977 in particular" (p. 78).

There has been but a very modest amount of empirical research carried out with regard to the impact of audit committees on the independence of auditors. Milano found that CPAs and financial statement users both believed that having the client's audit committee make all of the fee negotiations and other arrangements with the auditing firm would provide the latter with more independence.

How Does the Client's Financial Condition Impact Perceived Independence?

Schultz and Gustavson (1978) employed a research design very similar to the one used by Shockley, but these researchers investigated the factors affecting the auditor's risk of legal liability rather than independence. Quite likely, the determinants of these latter two variables overlap to a certain extent. One of the independent variables Schultz and Gustavson manipulated in their experiments was the financial condition of the client. They found that a client in relatively poor financial condition increased actuaries' perceptions of the legal risk the auditor had to assume. This conclusion is certainly not earth-shaking but it does raise an issue in the context of the research study proposed in this paper, which is: How does the client's financial condition affect the auditor's perceived independence? Intuitively, a mutuality of interests situation might occur in an audit engagement in which the client is in relatively poor financial health. The auditor most likely perceives the higher level of audit risk associated with such a client and, as a result, may consciously or unconsciously attempt to divert financial statement users' attention away from the factors indicative of the client's financial problems. Another possibility is that the auditor would extend his examination to be certain that all aspects of the client's condition are fully communicated in the financial statements. If financial statement users perceive this latter situation to be more likely, rather than being jeopardized, the auditor's apparent independence would actually be improved. Of course, the financial condition of the client is one variable in the audit context which is not subject to a great deal of control. However, if this factor is highly influential in determining the apparent independence of auditors, then this knowledge will at least alert public accountants as well as the regulatory bodies to take additional precautions in the necessary circumstances.

Auditor Competition and Independence

An inherent structural feature of the independent audit engagement is the free enterprise nature of the market for audit services. As in any free market, competition prevails within the audit market. The last few years have seen a significant controversy arise over the level as well as the effect of competition on the audit function. The Metcalf Committee argued that one of the major problems with the auditing profession was the lack of significant price competition between auditing firms. The Cohen Commission also took issue with the level of competition between auditing firms but, surprisingly, reached a conclusion diametrically opposed to the position of the Metcalf Committee.

> It is not lack of competition, however, but excessive competition that appears to present a problem to the public accounting profession today. The Commission's research on cases involving auditors and its survey of partners' and staff members' attitudes provide persuasive evidence that time and budget pressures frequently cause substandard auditing. Time pressures are often the result of unrealistic and unnecessary deadlines for completion of audits. However, there are substantial, sometimes destructive, pressures to reduce the total time to complete audits, without regard to particular deadlines. (p. 109)

The Commission went on to say that there appear to be several factors contributing to this problem, one being the degree of price competition in the audit market. "We believe one probable cause is excessive price competition - that is, excessive competition among firms to offer lower fees - but the Commission has been unable to document this relationship" (p. 110). Recent professional literature tends to be more supportive of the Cohen Commission rather than the Metcalf Committee's viewpoint on price competition within auditing. Simunic's 1980 empirical study provided evidence supporting the presumption of price competition within auditing. In another relevant article, Bernstein (1978) did not provide empirical support for all of his arguments but he did discuss very candidly the aggressive pricing structures of the large national firms and the implications this has for the future of the profession.

An analytical study of the economics of the auditor-client relationship by DeAngelo addressed the issue of 'low-balling' by auditors, i.e., lowering current audit fees below current engagement costs. Low-balling is at the heart of the competition issue as it relates to auditor independence and raises another mutuality of interests question. If an auditor's fee restricts the number of hours that can be incurred on an engagement to less than the number that is required to do a professional, "state-of-the-art" audit, the auditor has an incentive to join with the client and work toward limiting the risk of liability being imposed against them by third-party financial statement users. This possibility may have been one factor contributing to Shockley's empirical finding that a high level of competition in the audit market seriously impairs the perceived independence of an audit firm.

One final reference to the problem of excessive competition in the auditing discipline was found in the July 1982 Wall Street Journal article quoted in the first chapter. The author of that article implied that the eagerness of auditors to please their clients may be heightened by the intense level of competition among auditing firms in recent years. According to that article, the number of auditor changes is at an all-time high with the turnover rate of 1982 running 30% higher than that of 1981. The message to auditing firms seems to be that if they do not acquiesce to the client's demands in the engagement, they may find themselves with a higher amount of unutilized staff time in the coming year.

Other Issues

Several other structural features of the auditor independence phenomenon have been studied by researchers and will be briefly reviewed. Pany and Reckers (1980) as well as Milano found that perceived auditor independence, as could be expected, was impaired by the granting of discounts or giving of gifts to auditors. Pany and Reckers also found that the relative size of the audit client, operationalized as the percentage of total audit office revenues received from the given client, did not have a negative effect on stockholders' perceptions of the auditing firm's independence. On the other hand, Shockley's study demonstrated that audit firm size was a significant determinant of perceived independence. Small audit firms face a higher risk of having this critical attribute endangered than do relatively large firms. Finally, two other issues Milano studied were the effect on independence of disclosing auditor changes in financial statements and of delegating the responsibility for selection and payment of auditors to the government. In each case the three classes of respondents; CPAs, financial analysts, and corporate lawyers; agreed that the proposed action would increase the auditor's independence, but, at the same time, the general consensus was that the benefits provided by such an action would be less than the costs required to affect the changes.

Auditor-client Conflict and Auditor Independence

The nature of the audit engagement is such that conflict between client management and the auditing firm is practically inevitable. Common types of disputes center around such points as the degree to which the client's personnel will be utilized in the audit engagement, the scheduling of audit tasks conflicting with the client's period-end closing procedures, and the percentage of new auditors' time which should be charged to the client. Of course, the conflicts which have more serious implications for the successful completion of the audit concern such items as the need to make certain adjustments to the financial statements, the propriety of the client's accounting principles, and the adequacy of disclosure of all pertinent items in the client's financial report.

Before looking in detail at the various antecedents and outcomes of this phenomenon, it should first be instructive to define specifically what is implied by the term 'dyadic conflict'. For this purpose we turn to Kenneth Thomas (1976), an organizational behavioralist.

> Conflict - the process which begins when one party (in a social dyad) perceives that the other has frustrated or is about to frustrate, some concern of his. (p. 891)

The existence of significant conflict between the auditor and client, regardless of whether the conflict centers around disagreements about the audit fee, the disclosure of certain information in the financial statements, or the timing of audit procedures, can impair the auditor's ability to exercise his professional judgment in a totally objective manner. An essential element of professional independence in an audit context is the maintenance by the auditor of an unbiased relationship with the management of the firm he is engaged to audit. If client management is continually attempting to influence the auditor's performance of his responsibilities, the result will likely be a loss of some degree of the auditor's independence as well as a lower quality audit.

Negative Consequences of Conflict: Empirical Support

A very pertinent issue is whether or not evidence exists supporting the presumption that auditor-client conflict diminishes auditor independence as well as the quality of audit services. Rhode (1978) carried out a study for the Cohen Commission which was intended to determine the influence of selected facets of the auditor's work environment on the professional performance of CPAs.

> The critical questions investigated whether certain aspects of an auditor's work environment, such as pressures from time budgets and concerns over job survival or advancement within the firm, affect the professional integrity and objectivity of auditors to an extent that challenges or compromises the independence of CPAs or impairs the quality of professional performance in other ways. (p. 175)

Rhode accumulated considerable evidence indicating that auditors' independence is frequently compromised as a result of such factors as time budget and client imposed deadline pressure. Lea (1981, p. 64) concisely summarized the most damaging evidence accumulated by Rhode.

1. Fifty percent of the respondents believed that time budgets have a negative effect on the auditor's performance.

2. Fifty-eight percent of the respondents still in public practice at the time of the survey had signed off for completing audit steps (not covered by another compensating step) when they had not performed the work.

3. Fifty-six percent of those in the profession and sixty-five percent of those who had left the profession believed that audit programs and time budgets are unduly influenced by client-negotiated fees.

4. Fifty-five percent of the respondents reported yielding to pressures to meet time budgets by completing work on their own time without recording chargeable hours.

5. Fifty percent of the respondents believed that the trend in time budget pressure is increasing.

Rhode's findings at first reading appear to be a serious indictment of the way in which the auditor performs his societal function, however, since Rhode used a nation-wide survey to collect his data and since his response rate was less than one-third of the original sample selected, his results have not been given a high level of credibility by the profession as a whole, or seemingly, by significant parties external to the profession.

Other empirical studies which employed more defensible research designs and which also arrived at conclusions reflecting poorly on the auditor's independence include Kida (1980); File (1981); Uecker, Brief, and Kinney (1981); and finally, Alderman and Dietrick (1982). These studies did not use a broad research scope such as that of the Rhode study. Rather, these researchers generally concentrated on one particular facet of the auditor's role and demonstrated, sometimes unintentionally, dysfunctionalities of that role which related directly or indirectly to the phenomenon of auditor independence. Kida experimentally investigated the ability of auditors to predict going-concern problems for business firms. His results demonstrated that auditors are generally as accurate in predicting possible insolvency problems as the discriminant model devleoped by Altman in 1968, however, auditors apparently many times refuse to recognize the continuity question in their report due to the likely unfavorable consequences of such action.

> . . . auditors who qualified least had slightly stronger beliefs that they would lose the client, the client would sue, the accounting firm's reputation would be negatively affected, and deteriorated relations with the client would occur, if the opinion were qualified for a firm without problems. (p. 516)

Thus, the auditor's perceptions of the client's reaction to the type of opinion he may issue may in fact influence his final reporting decisions, a result in direct contravention to the presumed objectivity and independence of the auditor. In a similar study, File (1981) also concluded that the auditor's judgment and reporting decisions are sometimes improperly influenced by client actions or anticipated actions.

Uecker, Brief, and Kinney used an 'in-basket' exercise to investigate the extent to which internal and external auditors are perceived by management to be deterrents to the perpetration of corporate irregularities. External auditors were not perceived to be significant preventive controls in that regard. According to the Cohen Commission, the overall purpose of the independent audit function is to facilitate the operation of the capital markets, however, a secondary but related purpose should be to serve as an economy-wide internal control mechanism to deter the perpetration of irregularities. Given the findings of Uecker, et al, this objective does not appear to be well satisfied, and although the argument is tenuous, the inability of the auditor to provide that function may be due to the lack of independence in his client relationships. The results of the Kida and File studies as well as that of Rhode's seem to indicate that clients have a measure of control, at least in some cases, over the auditor's exercise of professional judgment. If clients feel they can influence the reporting decisions of their auditors, then it is unlikely they will have much respect for the auditor's latent power to communicate internal control weaknesses or other deficiencies in their financial reporting process to the public. Of course, such a presumption needs to be subjected to empirical study before it can be accepted as valid.

Finally, the 1982 study by Alderman and Dietrick was both a replication and an extension of Rhode's investigation of dysfunctional facets of the auditor's role. As mentioned earlier, the findings of Rhode's study have not been given a high level of credibility primarily because critics of his work argued that his research design was flawed in a number of ways. Alderman and Deitrick made several improvements in Rhode's research design but the results of the two studies were still quite comparable. The primary finding of the latter researchers was that, due to time budget pressures, there exists a considerable risk of "premature sign-off" of audit program procedures especially in the critical area of review and testing of internal accounting controls.

Only a limited amount of research has focused upon the relationship between auditor-client conflict and auditor independence, but there does exist substantial intuitive support to at least tentatively assume the existence of an inverse relationship between the two variables. Accordingly, research intended to determine the particulars of this relationship seems to be in order if we accept the presumption that auditor independence is an attribute of the financial reporting process that should be preserved.

A Structural Analysis of Auditor-client Conflict

Structural and Processual Models of Conflict. One of two broad approaches is usually taken when studying dyadic conflict, regardless of the context. The first approach is structural in nature, the second employs a processual perspective of conflict. Thomas characterizes these two approaches as follows:

> The process model focuses upon the sequence of events within a conflict episode, and is intended to be of use when intervening directly into the stream of events of an ongoing episode. The structural model focuses upon the conditions which shape conflict behavior in a relationship, and is intended to help in restructuring a situation to facilitate various behavior patterns. (p. 889)

The two approaches are not necessarily mutually exclusive since they can be used jointly to resolve conflict situations. However, the process approach is more useful as a short-run technique for dealing with conflict in a specific situation while the structural perspective is more of a long-run tool most useful for providing permanent resolutions. In this context, the latter appears to be the most appropriate approach[2] to utilize since the research focus primarily relates to the structural parameters of the auditor independence phenomenon. The intent of this part of the study is to analyze the parameters of the audit context in order to determine how they can be changed in order to remedy the problem of auditor-client conflict.

The initial objective in applying the structural approach of conflict management is to identify those conditions which tend to influence conflict behavior. These conditions can include a wide range of elements such as the behavioral predispositions of each party, pressure applied to the parties from external reference groups, and the legal or quasi-legal structural boundaries prescribed by external entities within which the parties must interact. Once the primary conditions influencing the occurence of this type of behavior have been identified, one can go about analyzing the basic interrelationships in order to identify the sources of the conflict. Once the causes or sources of the conflict have been isolated, then one can employ a number of available action alternatives to work toward its elimination. Two recent analytical articles in the accounting literature have addressed many of these preliminary theoretical issues surrounding the phenomenon of

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[2]For an application of Thomas' process model to auditor-client conflict, see M.C. Knapp and B.H. Ward, "Conflict in the Audit Context: An Analysis of Its Sources and an Approach to Managing It," unpublished working paper, University of Oklahoma, October, 1982.

dyadic conflict in an audit context.

<u>Goldman and Barlev vs. Nichols and Price</u>. In 1974 Goldman and Barlev (GB) analyzed auditor-client conflict in order to determine its impact upon the independence of professional auditors and to recommend actions to alleviate its presumed negative consequences. The other major work along these same lines was an article written by Nichols and Price (1976) which was in some respects a rebuttal of arguments made in the GB paper and in other respects an extension and confirmation of the latter authors' analyses. Both sets of authors utilized the structural approach to conflict management defined by Thomas, but their analyses of the basic parameters of conflict behavior in an audit context and their views of the auditor's primary source of power.

According to GB, the ability of the auditor to withstand client pressure to act in a manner inconsistent with professional standards is a function of the relative amounts of power possessed by the two parties in an audit engagement. GB argue that the auditor is at a disadvantage to the client since there is an asymmetrical distribution of power in the favor of the latter in these relationships. This is not to imply that the auditor will be under the subjugation of the audited firm. In some cases, if not most, the client may have no need to exercise the latent power available and even if the choice is made to use this power, the auditor will still have the freedom to choose the most appropriate action; however, the opportunity cost of such action will be much higher than otherwise. Proper professional behavior may result in less client cooperation, pressure in other areas such as in management consulting projects being carried out by the auditor for the client, or even in complete dismissal of the auditor.

Tjosvold and Okun (1979) in an article entitled "Effects of Unequal Power on Cooperation in Conflict" note that the less powerful party in a dyadic situation is, of course, at a serious disadvantage. "Research suggests that persons of low power may be more likely to establish mutual cooperation if they can credibly threaten to pursue an alternative relationship or they can collaborate with another to devise effective strategies" (p. 239). Unfortunately, in the case of the auditor, threatening to pursue an alternative relationship is typically an ineffective means to counterbalance the client's more powerful position since a large pool of ready, willing, and capable audit firms is ever present and since clients have shown little hesitation in exercising their right to dismiss their auditors. Additionally, one of the strategies that the SEC has deemed effective to offset the possibility of an uncooperative client exercising its power to dismiss an audit firm, namely, the filing of a publicly available 8-K report in which the auditor is allowed to disclose any significant disagreements with the client that may have led to his dismissal, has been shown to be given little attention by the investing public (Fried and Schiff, 1981).

In order to gain a clear picture of the problems stemming from the asymmetrical distribution of power between auditors and their clients, there is first a need to identify the primary sources or bases of power for each of these parties. According to GB, the power of the auditor is a function of three conditions: the general complexity of the problem he has been assigned to resolve, the identity of the party who is the primary beneficiary of his examination, and the extent to which the profession's code of ethics is vigorously and visibly enforced. Of these three, GB argue that the first is the primary source of power that the auditor employs to act in a consistent manner with his behavioral predispositions. However, since the typical audit is usually not a complex undertaking, i.e., the degree of expertise required of the auditor is not substantial, the amount of expert power that can be wielded by the auditor is usually not significant. Given this argument, GB conclude that the primary obstacle to the auditor being able to affect a more symmetrical distribution of power in the dyadic relationship with the client is the high degree of routinism in the audit engagement.

In direct contravention to the above perspective of auditor-client conflict, Nichols and Price (NP) constructed an argument utilizing the posited power-dependence relationships of Emerson (1962) illustrating that the auditor's ability to withstand threats of replacement by the client is positively related to the degree of routinism in the auditor's services.

> . . . with highly routine or structured auditing procedures and accounting principles we would argue that the firm would be less likely to pressure the auditor, and the auditor would be less likely to comply with the firm's wishes. . . The reason is simply that the costs to each party associated with such action, both internal in terms of guilt and external because of possible sanction administered by third parties, are likely to be greater than rewards. (p. 340)

Ironically, a comparison of the specific recommendations of NP and GB for dealing with auditor-client conflict reflects agreement on all major points. The principal difference between the two sets of authors centers around their disagreement on how the auditor derives his power in the audit context. GB argue that routinism in the audit function reduces the power of the auditor. This is true because they see the primary source of the auditor's power as professional expertise. NP implicitly assert that the major source of the auditor's power is coercive in nature, in which case the more prescribed auditing and accounting procedures are, i.e., routine, the more power the auditor will have to force the client to accept the audit results. The structural changes recommended by the two sets of authors are very similar, but GB emphasize those changes which would decrease the routinism of the audit while NP place more emphasis on those recommendations intended to accomplish just the reverse.

Monger's Contribution. Monger (1981) is one of the few researchers who has empirically studied auditor-client conflict, however, he was not interested in the relationship between that phenomenon and auditor independence. Monger wanted to determine whether certain characteristics of the auditor-client relationship lead to differing perceptions of conflict by those two parties. Specifically, he examined the following nine attributes of the relationship between auditor and client: the proportion of routine issues in the engagement, quantity of MAS provided, size of the client, amount of audit team experience, length of engagement, degree of environmental uncertainty, financial position of the client, use of the collaborating mode of conflict resolution, and use of the competing mode of conflict resolution. Of numerous hypotheses tested, Monger's empirical evidence supplied support for only four. Audit team experience tended to be inversely related to the amount of conflict perceived by auditors and management while there was a direct relationship between this latter variable and the degree of environmental uncertainty. The use of a collaborating mode of conflict resolution resulted in a decrease in the perceptions of conflict by auditors. Finally, the codification of GAAP in such a way that less subjectivity would be required to interpret them was found to be the one action most likely to reduce perceptions of conflict by both parties in an audit context. This latter conclusion provides some measure of indirect support for the Nichols and Price position on auditor-client conflict.

<u>Summary</u>. The existence of conflict in the audit engagement most likely impairs the <u>de facto</u> independence of

the auditor and may impair his ability to determine whether client financial statements are fairly presented. It is quite unlikely that most financial statement users are fully aware of the high level of conflict existing in the typical audit context. Consequently, this phenomenon is not a factor which users would incorporate into their evaluation of the apparent independence of an audit firm. Nevertheless, if Barrett's concept of apparent independence as a sociological role construct is accepted, users should immediately be made aware of this factor so that they can adjust their evaluative processes accordingly. The interesting issue at hand is: How would such knowledge impact financial statement users' perceptions of the auditor's ability to retain his professional impartiality?

Summary

The preceding literature review has focused upon three distinct but closely related issues surrounding the auditor independence phenomenon. It was concluded that the majority of past research in this area has addressed the perceived dimension of auditor independence. One of the benefits of studying perceived independence is that the researcher may indirectly learn a great deal about the determinants of the *de facto* dimension of auditor independence at the same time. Second, several actions that have been proposed to strengthen the auditor's professional independence were reviewed. It seems obvious that there is no overall policy framework guiding the development of technical pronouncements in this regard and, as a result, the rules that are in effect are not comprehensive in scope nor totally coherent. Contributing to this situation is the lack of agreement among scholars on what actions are necessary in order to promote the independence of auditors and a lack of serious empirical inquiry to determine the views of financial statement users on many of these important issues. The primary research objective in this area seemingly should be to determine user groups' views on how auditor independence should be 'legislated'. Not until comprehensive and integrative research studies are undertaken to gather such data will it be possible for promulgatory bodies to piece together a cogent theoretical framework to guide the development of specific technical pronouncements.

The final section of the literature review was devoted to analyzing auditor-client conflict and how it may affect the auditor's actual and apparent ability to retain an objective point of view in fulfilling his professional responsibilities. A valid issue to raise at this point is why should auditor independence be studied in a very specific context prior to our obtaining a better grasp of its overall structure? First, the specific set of circumstances in which auditor independence will be studied poses a serious threat to the viability of the external auditor's role. Research is needed to determine how the auditor's true as well as apparent objectivity and impartiality can be preserved in conflict episodes with clients. Second, there already exists sufficient *a priori* justification to analyze certain variables or parameters of auditor-client conflict which means that the research design to be employed in this regard does not have to be strictly of an exploratory nature.

There has been almost a total dearth of empirical research with respect to the broad issue of auditor-client conflict. This seems surprising since two analytical articles concerning this topic have developed several testable propositions in this regard as well as a general framework or paradigm explaining the sources and correlates of this phenomenon. The exception to this rule is the recent study by Monger, however, the focal point of his endeavor was not oriented around the relationship between conflict in the audit context and the ability of the auditor to retain his independence. Hopefully, this research project will encourage other researchers to address this important topic.

The preceding literature review provides a background against which to develop research questions and testable hypotheses concerning the basic issues raised in each of the two major research areas. In the next chapter, the specific research questions and research hypotheses to be investigated will be delineated, and then in the following chapter, the methods to be used to operationalize those propositions will be discussed.

CHAPTER III

RESEARCH QUESTIONS AND HYPOTHESES

The issues surrounding auditor independence appear to require research on two levels. At a general level there is a need for research leading to the development of a theoretical framework for policy statements defining perceived auditor independence. The first part of this research is intended to satisfy that need. On a more specific level, there is a need for research to determine how the auditor's independence can be promoted or is jeopardized by particular circumstances. One such set of circumstances involving auditor-client conflict is studied in the second part of this research.

Barrett (1969) defined perceived independence as a sociological construct which is formed on a collective and dynamic basis by financial statment users. The first part of this research project is intended to roughly outline the boundaries of that construct. The data collected in this respect should assist promulgatory authorities in developing policy statements concerning auditor independence.

The objective of the second part of the research is to determine how financial statement users' perceptions of auditor independence would vary in a particular engagement as the level and nature of conflict between auditor and client varies. As indicated in the previous chapter, auditor-client conflict has apparently not yet been fully incorporated into the role construct of perceived independence. Knowledge of the conflict which occurs regularly between audit firms and their clients would more than likely alter user groups' perceptions of auditor independence. Accordingly, it seems very pertinent to experimentally investigate the causal relationship between auditor-client conflict and perceived independence.

Partners and User Groups: Examining Their Views on Independence Issues

The first part of the research design is exploratory. Specific research hypotheses concerning the causes of perceptions about independence are not tested. Rather the purpose is to specify which of many variables are perceived by relevant parties to significantly influence auditor independence. A discussion of the specific objectives and associated research questions used to accomplish this purpose follows immediately. The description of this part of the research concludes with a discussion of the rationale for the selection of the sixteen items to be used as the independent variable set.

Research Objectives and Research Questions

One of the objectives of this part of the research is to examine a broad set of relevant variables on a comparative basis. In contrast, research efforts such as Milano (1981), Shockley (1981), and Dawkins (1978) approached auditor independence in a piecemeal fashion. Accordingly, the results of such studies have not provided a comprehensive view of the relative importance of the determinants of perceived auditor independence. The first part of this research study is aimed at avoiding this problem. The specific research question associated with this objective can be stated as follows:

1. Which structural changes in the auditor's role do relevant parties consider the most significant determinants of perceived auditor independence?

The second objective of the first part of this research study is to determine which policies relevant parties in the financial reporting process want to see adopted. Milano noted the need to differentiate between actions users feel would strengthen the auditor's independence and those actions that user groups want to see adopted. That is, financial statement users (and presumably, other interested parties) may hold that a particular policy would improve the auditor's ability to act in a professionally autonomous manner, but might disapprove of adopting such a policy due to some overriding normative or affective concern. The second research question addresses this issue:

2. Which structural changes in the auditor's role do relevant parties believe should be adopted?

The final objective of the first part of this research regards determining the degree of consensus, on the previously raised questions, between two important groups in the financial reporting process. Financial statement users are neither the sole nor even the most influential group involved in establishing policies concerning auditor independence (Metcalf Committee, 1976, p. 153). Rather, members of the accounting profession dominate policy-setting bodies. Consequently, a final objective of the first part of this research study is to determine the degree of consensus on independence issues between representatives of one important user group, commercial lending officers, and representatives of the accounting profession, partners of national accounting firms. Thus, the final research question is stated in the following manner:

3. How much consensus exists between an important financial statement user group and partners of national accounting firms on the issues raised in the two previous research questions?

If there is a significant lack of consensus between these two groups, further research should be conducted to determine the causes of such differences, and to determine which views should prevail.

Variable Selection

Before turning to the second part of the research design, a word about the structural change variables used in the first part of the research is in order. The most prominent of these structural changes were discussed in the literature review. However, there are numerous other recommendations that have been suggested to improve the auditor's independence. These include the right of auditors to advertise, public disclosure of audit fees, restrictions on client solicitation, and the periodic rotation of audit personnel on an engagement. In addition, there are many other modifications in the auditor's role which, while they have not been widely discussed in the professional literature in recent years, could possibly provide for the strengthening of perceived independence. In this category would fall such actions as the establishment of an arbitration board to settle disputes between auditors and clients on financial reporting issues, disclosure of proposed adjustments to client financial statements by the auditing firm which were not incorporated in the publicly released statements, and governmental posting of suggested hourly audit fees. From the set of possible structural change variables, sixteen items were selected to be used in this part of the research and are listed in Table I. This group includes all of those actions addressed in the literature review as well as a number of other judgmentally selected items which have not been as prominently discussed in the professional literature. (Appendix I contains a brief discussion of where each of the items in Table I have been addressed in the professional literature.)

The eventual objective of this line of research is to provide sufficient data to authorities to allow them to develop an overall policy statement concerning auditor independence. This policy statement could then be used as the cornerstone of a set of deductively formulated policy

1. Restricting the amount of management consulting services provided by an auditing firm to audit clients to a maximum of 10% of the total annual audit fee.
2. Giving the SEC total responsibility for the external audit function. Auditors of financial statements of publicly-held companies would be government employees much like IRS auditors.
3. Requiring that any proposed auditor adjustments not incorporated by the client in its financial statements be disclosed within the footnotes to the statements.
4. Prohibition of executive search services by auditing firms.
5. Selection of auditors for SEC registrants by the SEC with fee negotiations within guidelines established by the SEC.
6. Requiring auditors to report on the preferability of all the client's accounting policies.
7. Requiring that the nature and amount of consulting services provided by the auditor to the client be disclosed within the client's financial statements.
8. Establishment of an arbitration board to settle disputes between auditors and clients involving financial reporting issues.
9. A ban on any form of advertising by auditing firms.
10. Requiring the mandatory use of audit committees composed of non-employee and non-management members of the client's board of directors.
11. Required disclosure in client financial statements of all major audit-client disagreements occurring in the eighteen months prior to an auditing firm's dismissal.
12. Prohibiting an auditing firm from accepting an engagement if the total revenue from the prospective client would be greater than 10% of the auditing firm's total annual revenues.
13. Re-instatement of the AICPA's ethical standard prohibiting client solicitation.
14. Requiring that audit fee negotiations be the complete responsibility of the client's audit committee rather than the client's management.
15. Mandatory rotation of all audit engagement personnel every three years.
16. Annual publication by the SEC of suggested audit fees per hour by staff level, e.g., staff, senior, manager, etc.

TABLE I

The sixteen variables employed in the first section of the empirical research design.

pronouncements concerning all of the specific issues raised in the preceding literature review.

Conflict and Independence: Delineating the Critical Issues

While the purpose of the initial part of this research design is exploratory, this latter part is designed to determine the veracity of explicit research hypotheses. This is possible because previous researchers have developed a tentative, but testable, theoretical framework to explain the sources and outcomes of auditor-client conflict.

The second part of the research design also differs from the initial part with respect to scope. In the first part of this research a very broad scope was demanded by the exploratory nature of the research objectives and the pervasiveness of the issues studied. In this latter part of the research the scope is quite limited since only one facet of the independence construct is addressed, i.e., the relationship between perceived independence and auditor-client conflict.

As mentioned in the introduction to this chapter, the overriding objective of this segment of the research design is to determine how perceptions of auditor independence can be promoted (or is jeopardized) in especially critical sets of circumstances. There are a number of different contexts within the audit environment which could have been selected for this purpose. The rationale for selecting auditor-client conflict as a focus of the second part of this study was twofold. First, aside from the formal requirement of SEC Accounting Series Release #247 which covers only the most radical conflicts (i.e., severance of relationship), user groups have no way of obtaining knowledge of the level or nature of conflict in an audit engagement. Second, conflict has been suggested to be an important determinant of perceived independence (Goldman and Barlev). If users' perceptions of independence do vary with the degree of conflict in the audit context, then policy makers should be advised. Authorities could use these findings to call for more complete disclosure of conflict as well as for further research to determine which structural changes in the audit engagement should be made to reduce the frequency and severity of conflict.

The primary motivation for the seminal study of auditor-client conflict by Goldman and Barlev (1974) was to determine the effect of auditor-client conflict on the capacity and willingness of the auditor to retain his de facto independence. That particular analysis, as well as the related subsequent work by Nichols and Price (1976), has a great deal of relevance for the research issues addressed in this study. The major difference between this empirical study and the two previous analytical articles is that the research focus in this case is upon the perceived (rather than <u>de facto</u>) independence of the external auditor from the perspective of the financial statement user. In this section of the project, the primary research objective is to investigate auditor-client conflict in order to more precisely specify how this phenomenon interacts with certain contextual variables of the audit engagement in determining the perceived independence of auditing firms. Specifically, the research question in this part of the study can be expressed as follows: How does knowledge by financial statement users of auditor-client conflict interact with their knowledge of the specific structural characteristics of a given audit context in determining their perceptions of auditor independence?

Given the analysis of the independence literature in the previous chapter, four of these structural characteristics were selected for study in the context of auditor-client conflict. These four independent variables along with the discrete levels of each used in this research include:

1. The degree of competition for auditing services in the immediate auditor-client environment.

    a. immediate environment is characterized by a number of large firms that are aggressively pursuing practice development programs
    b. other audit firms in the immediate environment are not perceived to be aggressive competitors

2. Whether or not the audit firm provides a significant amount of management advisory services to the client.

    a. the audit firm will provide consulting services in the current year equal to 40% of the audit fee[3]
    b. the audit firm will provide no consulting services to the client during the current year

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[3]For a random sample of 100 SEC registrants used in the Reckers and Stagliano study, the mean percentage of the annual audit fee paid to audit firms for MAS rendered was 38%.

3. The current financial condition of the client.

    a. the client's overall financial condition is quite good, all of their solvency and profitability ratios compare favorably with industry averages and net income has shown a modest but steady growth pattern over the last few years
    b. the client's overall financial condition is poor, the last few years have brought considerable deterioration in their solvency and profitability ratios and net income has shown a modest but steady decline over the last five years

4. The nature of the conflict issue.

    a. the issue in dispute between the audit firm and client is the materiality of unrecorded liabilities discovered during the performance of year-end audit procedures (Note: Technical standards do not explicitly define materiality.)
    b. the issue in dispute between the audit firm and client is the need to disclose a significant event occurring after the balance sheet date but prior to the release of the financial statements (Note: Technical standards specifically define the treatment of subsequent events.)

The above variables were selected for two closely related reasons: 1) The researcher's presumption that they have a high degree of relevance in influencing third parties' perceptions of auditor independence; and 2) the significant impact they may have in influencing how conflict episodes are eventually resolved.

Derivation of Research Hypotheses #1 and #2

As noted in the literature review, the Metcalf Committee and the Cohen Commission disagreed on whether a high level of competition is good or bad for the auditing profession. In fact, those two prominent bodies could not agree on the actual level of competition existing in audit markets. By incorporating both levels of this variable in the research, it should be possible to determine user groups' views on this issue. These views, since they are those of the primary benefactors of the financial reporting process, may be more consequential in the long-run than the opinions of either the Metcalf Committee or the Cohen Commission. The literature review also revealed that there has been substantial disagreement concerning the impact on the auditor's perceived independence of providing MAS to the client. Hopefully, the results of this study contribute to clarifying the confusion which currently exists with respect to this variable's relationship to perceived independence. Following are the two research hypotheses which were developed to address these initial variables.

H_1: Financial statement users will perceive that conflict episodes are more likely to be resolved in favor of the client's position when the environment in which the audit firm is operating is characterized by a high rather than a low level of competition.

H_2: Financial statement users will perceive that conflict episodes are more likely to be resolved in favor of the client's position when the audit firm provides management advisory services to the client as opposed to providing no such services.

Derivation of Research Hypothesis #3

The financial condition of the client is a variable which could influence perceived as well as *de facto* auditor independence in either direction. In the preceding chapter, arguments supporting both positions were outlined. For instance, with respect to a client in poor financial condition, the audit firm may intentionally or unintentionally try to help avoid its collapse. On the other hand, in such a situation, the audit firm may be especially careful that an objective assessment of the client's position is made so that the audit firm's risk of legal liability is reduced. Intuitively, the most defensible position seems to be that users will perceive that auditors are more likely to capitulate to demands of clients in good rather than poor financial condition. Regardless, this variable is such a pervasive factor in the audit context that empirically determining both the magnitude and direction of its influence would be a significant contribution to the body of knowledge involving auditor independence. Accordingly, the following hypothesis is posited.

> H_3: Financial statement users will perceive that conflict episodes are more likely to be resolved in favor of the client's position when the client is in a healthy as opposed to a poor financial condition.

Derivation of Research Hypothesis #4

Finally, Monger's primary conclusion was that technical standards should be codified in such a way as to reduce the degree of subjectivity required to interpret them. He argued that this move would diminish the frequency with which conflict is perceived by auditors and their clients. His study directly focused on the important routinism issue raised by Goldman and Barlev as well as by Nichols and Price. The fourth and final variable of this study also focused on that issue. This independent variable relates to the degree of subjectivity required to interpret the point of contention in the conflict episode.

> H_4: Financial statement users will perceive that conflict episodes are more likely to be resolved in favor of the client's position when the issue at the center of the dispute is not precisely treated by technical standards as opposed to the situation where the central issue is dealt with very specifically in the technical standards.

Summary

In this chapter, the basic research questions and hypotheses emanating from the literature review have been presented for each of the two major research areas. The following chapter describes in detail the research method used in operationalizing these directives.

CHAPTER IV

RESEARCH METHOD

Review of Viable Research Strategies For Auditor Independence

Research problems can be studied either empirically or non-empirically. Although there does not appear to be total agreement on exactly what the term "empirical" implies in a research context, most researchers would probably agree that an empirical study involves the collection of some type of data or evidence to resolve research questions or test research hypotheses. A non-empirical approach would involve the application of logical reasoning to some identified research issue or problem without an attempt to collect data to support or refute the researcher's presumptions. Both empirical and non-empirical approaches have been used to study auditor independence.

Attitudinal survey questionnaire techniques appear to have been employed more widely than any other empirical method in this context. The researchers who have used such an approach have typically addressed auditor independence in a piecemeal fashion, one issue at a time. A good example of this approach can be found in the studies of the relationship between the provision of MAS and auditor independence by Titard (1971) and Hartley and Ross (1972). Attitude surveys can provide important information concerning a research issue that has not received much in-depth study. Data collected via this technique can be used to help clarify and redefine the research problem and/or issues and to identify fruitful avenues of future research. For instance, the study by Hartley and Ross was one of the first to report a lack of consensus between financial statement users and CPAs concerning whether the provision of MAS threatens an audit firm's independence. Later researchers, e.g., Milano (1979) and Firth (1980), pursued that issue but employed more precise research designs in doing so, and thus, provided more conclusive and defensible empirical data in that regard.

More rigorous types of research techniques, full-factorial ANOVA (analysis-of-variance) or MANOVA (multivariate-analysis-of-variance) designs, have been employed recently in the study of auditor independence. In studies where ANOVA or MANOVA is used, the researcher usually has some strong *a priori* justification for examining the relationship between two or more predictor variables and one or more dependent or criterion variables. Libby (1981, p. 32) concisely reviewed the ANOVA model and how it has been applied in accounting research. Kerlinger, in a detailed discussion of the operational aspects of ANOVA and the wide-ranging ways in which it can be employed, had the following to say concerning the benefits provided by this technique.

> [ANOVA] frees us from working with only one independent variable at a time and gives us a powerful lever for solving measurement problems. It increases our possibilities of making our experiments exact and precise. The analysis of variance also permits us to test hypotheses that cannot be tested in any other way, at least with precision. (p. 238)

Shockley used an ANOVA design in his study of variables impacting the perceived independence of auditors as did Schultz and Gustavson in their study of the variables affecting actuaries' perceptions of the legal risk of auditors, a topic closely related to auditor independence.

Typically, analytical or non-empirical studies are used to develop or refine testable models of some research issue or problem. After such models have been established, they can then be subjected to empirical verification. With regard to non-empirical or analytical studies of auditor independence, Nichols and Price (1976) as well as Goldman and Barlev (1974) used this approach in their studies of auditor-client conflict. These researchers addressed the phenomenon of auditor independence from a social-psychological standpoint by analyzing the power-dependence relationships in the audit dyad. DeAngelo (1980) analyzed the economic nature of the auditor-client relationship and its implications for auditor independence by employing agency theory.

In this study, a two-part empirical research strategy was employed. The objectives of the individual segments of the research design varied markedly with respect to the depth with which individual issues were investigated. Correspondingly, there was a wide variance in the degree of rigor of the specific research techniques that were employed. For instance, the analytical work concerning auditor-client conflict laid a fairly solid framework upon which to define and empirically test explicit research hypotheses. In the case of the first research area, the degree of rigor of the research technique was somewhat less. Explicit research hypotheses were not examined because, even though there did exist considerable *a priori* justification for selecting the variables used in that part of the study, there is not yet available a theory of independence which integrates those variables into a comprehensive testable framework.

The remainder of this section outlines in detail the various procedures used in each part of the research design. Hopefully, this discussion provides additional insight concerning why the specific research techniques were selected.

Research Technique No. 1

Description of Research Tasks

Table I in Chapter III lists the sixteen independent variables employed in this part of the research. These sixteen items were presented to subjects drawn from two different populations: financial statement users and partners of national public accounting firms. Each subject sample was asked to rate the items in Table I twice using five-point scales with descriptive anchors. In the first ranking, the subjects were instructed to rate the sixteen items on the basis of the degree to which each would contribute toward safeguarding the independence of auditors. Using this criterion, the subjects were asked to place each of the items in one of the following classes.

5 - Actions contributing a very high degree of assurance that auditors' independence will be safeguarded.

4 - Actions contributing a high degree of assurance that auditors' independence will be safeguarded.

3 - Actions contributing a modest degree of assurance that auditors' independence will be safeguarded.

2 - Actions contributing a very modest degree of assurance that auditors' independence will be safeguarded.

1 - Actions contributing no assurance that auditors' independence will be safeguarded.

In the second rating task, the subjects were asked to apply a strictly affective or normative criterion to the items in Table I. Each subject was asked to evaluate, based upon his/her personal judgment, whether each item should be adopted or retained. The following five-point scale was provided to the subjects for this purpose.

5 - I feel very strongly that this particular action should be adopted or retained.

4 - I feel that this particular action should be adopted or retained.

3 - I am neutral with respect to whether or not this particular action should be adopted or retained.

2 - I feel that this particular action should not be adopted or retained.

1 - I feel very strongly that this particular action should not be adopted or retained.

As Milano has noted, relevant parties may feel that certain actions would strengthen auditor independence but would not support their adoption for some affective reason. For example, Milne and Weber have argued against further governmental intervention in the auditing profession. Accordingly, subjects sharing those researchers' views might conceivably rate an item calling for more SEC involvement in the audit process as a measure significantly strengthening auditor independence, but then in the second rating, place a low priority on whether the profession should move to adopt the particular action. An analysis of subjects' responses to the two evaluative criteria should disclose whether such a result occurred with respect to any of the items in this study.

Rationale for Choice of Scales Employed

From this point on, for clarity purposes, the initial scale depicted above is referred to as the positive scale while the second is referred to as the normative scale. The meaning of the two terms "positive" and "normative" is defined by analogy. In the study of economics, one can differentiate between "positive" economics and "normative" economics. In the former case, researchers attempt to answer such questions as "What is the marginal productivity of an hour of skilled labor?" or "What is the price elasticity coefficient for crude oil?" In normative economics, scholars address such issues as "Should we have a negative income tax?" or "Should rent controls be abolished in inter-urban housing projects?" In using a "positive" approach to a research issue the objective is to define reality whereas in a normative endeavor the motivating research interest is to determine how reality should be changed to provide for an optimal or at least an improved state of affairs. Accordingly, in the normative-scale rating task, the objective is not to find out how auditor independence can be maximized, but, rather, to determine what actions should be adopted to provide for an optimal level of auditor independence from the standpoint of financial statement users.

The two scales used in this part of the study were selected from a large number of available scales. It seems only reasonable to justify why these two Likert-scales were selected as well as to explain why they were structured in the given manner. The normative scale is a bi-polar scale with a definite midpoint while the positive scale is not bi-polar but rather uni-directional. In the first rating task, the subjects were instructed to employ the provided scale to record their perceptions of the effectiveness of each item with respect to promoting auditor independence. Since each item in the variable set was developed with that objective in mind, it was not necessary to supply subjects with a bi-polar scale (that is, with a scale including narrative anchors indicating the possibility of the actions promoting as well as detracting from auditors' independence). In the second rating task, the subjects were instructed to employ the provided scale to indicate whether or not they supported each action's adoption. Thus, a bi-polar scale was needed since it was expected that there would be considerable support for some actions while there would be considerable antagonism for others.

Each of the scales employed in the two rating tasks are Likert-type scales. Kerlinger (p. 496-499) discussed the relative merits and weaknesses of this broad category of scales as well as those of several other scaling methods and concluded that, overall, the Likert-scale ". . . seems to be the most useful in behavioral research" (p. 499). Likert-scales have been used widely by behavioral researchers in accounting, e.g., Shockley, Libby (1979), and Ashton.

Finally, there were several other available approaches which could have been used in evaluating the actions included in the variable set of the initial research technique. Two of the most obvious alternatives would have been a Q-sort or a paired-comparisons procedure. Each of these alternatives have definite merits but they are both quite time-consuming and can be difficult to operationalize. These disadvantages are magnified in a self-administered survey study such as this initial research technique.

Other Operational Features of the First Research Technique

Choice of Subject Classes. Firth (1980) noted that perceptions of auditor independence may vary widely among relevant parties in the financial reporting process. His empirical study found that financial statement users were much more skeptical of auditor's independence than were CPAs.

> Thus, those with the most to lose from the implementation of restrictions, accountants in practice, thought that auditors could maintain independence in many situations where others thought independence would be impaired. (p. 462)

In order to analyze the possible differential effect of these sixteen variables on the perceptions of practicing auditors and financial statement users, the experimental application was administered to two classes of subjects. The first group consisted of partners of ten national public accounting firms (see Appendix II) while the second group consisted of senior loan officers of commercial banks.

As mentioned in Chapter II, Reckers and Stagliano raised the issue of whether relatively sophisticated financial statement users or more naive users should be used in establishing standards against which to measure auditors' perceived independence. In a closely related vein, the Trueblood Commission in the AICPA publication <u>Objectives of Financial Statements</u> implied that financial statement information should be understandable by even naive investors (p. 17); however, the more recent <u>Statement of Financial Accounting Concepts No. 1</u> of the Financial Accounting Standards Board concluded that such information should be addressed to relatively sophisticated financial statements users (para. 34).

Accordingly, if one wants to follow the precedent established by the FASB, Reckers and Stagliano's decision to use relatively sophisticated financial statement users in their study of auditor independence was appropriate. The FASB defined relatively sophisticated financial statement users as "having a reasonable understanding of business and economic activiites". The surrogate class chosen in this study to represent the universe of relatively sophisticated financial statement users was senior loan officers of commercial banks.

Choice of Sample Size. In many, if not most cases, researchers faced with choosing a sample size simply follow the precedents established in previous studies. In the 1981 study by Shockley, which used a research design very similar to the second part of this study, approximately seventy subjects were chosen from each relevant universe. Due to the closely related objectives of the second half of this research design with those of the Shockley study, a sample of approximately seventy subjects was determined to be the most appropriate sample size for that research technique. For purposes of parsimony, the same sample size was used for each of the two subject classes involved in the first portion of this research.

Selection of Subjects. The subject samples for this study were drawn from the Oklahoma subsets of the universal populations for two reasons. The first reason being the high cost of obtaining a truly representative sample of the two universes, and the second reason being that using Oklahoma subjects might increase the likelihood of having a favorable response rate (i.e., out-of-state subjects might be less willing to respond to a University of Oklahoma study than subjects who are state residents). Of course, in return for the benefits provided by using such an approach, some degree of the generalizability of the research results was forfeited.

In the December 1981 roster of the Oklahoma State Board of Public Accountancy, there are 141 individuals listed as being partners in the ten national accounting firms operating in Oklahoma. Using random number tables, seventy-one of these individuals were selected as subjects for the two rating tasks included in the first research technique. An equal number of loan officer subjects were selected for participation in the first research technique and an additional seventy loan officers were selected to serve as the subject sample of the second research technique. The sampling frame employed in this latter case was the 1981 directory of the Oklahoma Banking Association which lists four hundred and fifty-one banks. Obviously, the smaller the bank the less experience its loan officers are likely to have in dealing with matters involving complicated financial reporting and/or accounting issues. Therefore, in order to provide for a higher overall level of expertise in the loan officer subject sample, the sampling frame was limited to those banks with total assets exceeding twenty million dollars. Two hundred and fifty-six banks surpassed that limit.

<u>Instrumentation and Mailing Procedures</u>. Appendix III contains a copy of the research instrument used in this first research technique. Also included in that appendix is a copy of the original cover letter and the second request letters. The second requests were mailed approximately three weeks after the initial mailing. As was the case in the instrument employed in the second half of the research design, a few supplemental biographical questions were asked of the subjects. In order to ensure that the subjects would employ the second rating scale in the second rating task (rather than simply copying their responses to the first task), the sixteen items were presented in a different randomized order. The order of the items in the first rating task was also randomly determined.

<u>Statistical Measures Employed</u>. Finally, to statistically determine the degree of consensus between the two samples on each rating criterion, Hotelling's T^2 statistic was used. This statistic analyzed the location of the two vectors of mean values for the two subject classes and determined if there was an overall significant difference between them. In all cases where such a difference was found, multiple t-tests were performed in order to determine which of the sixteen items the two subject groups did not agree upon. The Hotelling's T^2 test is important because when a variable set is quite large, such as is the case in the initial research

technique, a few random significant differences would be expected. If Hotelling's T^2 is significant, then one can be assured that differences disclosed in the multiple t-tests are not simply random differences. (For a discussion of Hotelling's test see Afifi and Azen, 1979, p. 285-288.) All of this analysis was done via the BMDP statistical package developed by the University of California, Los Angeles. The specific program employed was BMDPBD.

Research Technique No. 2

Description of Research Task

One of the problematic aspects of studying an issue involving behavioral conflict is the difficulty of operationalizing such a phenomenon in an experimental context. One obvious option would be to study conflict disputes on a case-by-case basis in the field as they occur. However, several inherent features of conflict, e.g., spontaneity and volatility, preclude this alternative as a feasible approach. Shockley's study of perceived independence provided a research method which could be readily adapted to the needs of this study. He employed hypothetical scenarios, which were simply combinations of treatment levels of four independent variables, to determine how certain parameters of the audit context influence financial statement users' perceptions of auditor independence. For illustrative purposes, one of his scenarios is reproduced below.

Scenario 1:

Level of competition	High
Size of audit firm	Large
Auditors' tenure (years)	More than five
Are MAS rendered?	No

Very Low Risk	1	2	3	4	5	6	7	Very High Risk

He simply instructed his subjects to indicate on the seven-point scale the level of risk they perceived of the auditor's independence being impaired given the information provided for each scenario.

Unlike Shockley's work, this research addressed a specific context or situation rather than a general, unspecified context. To determine how users' perceptions of auditor independence are affected in auditor-client conflict episodes, several parameters of such episodes were varied systematically in hypothetical scenarios. The subjects of this study were also provided with a concise, narrative explanation of each hypothetical context. These two modifications in Shockley's design should provide for a higher level of mundane realism and, as a result, enhance the validity of the data gathered.

A copy of the research instrument used in this part of the research is included in Appendix IV. Also found in that appendix are copies of the cover letters for the instruments as well as a copy of the second request cover letter. The second requests were mailed approximately three weeks after the initial mailing.

Controlling the Ordering Effect

Actually, two versions of the instrument shown in Appendix IV were used in the second research technique. In order to determine if the subjects' responses were partially the result of the ordering of the variables within the hypothetical scenarios, two different instruments were prepared. One-half of the subject sample received one version while the other one-half received the second version. In both instances, the ordering of the cases was determined randomly as was the ordering of the variables within each case. In addition, the second version of the research instrument intentionally began with the conflict episode involving the disclosure controversy whereas the first version began with the scenario involving the materiality controversy. In analyzing the subjects' responses, a nominal two-class (dummy) variable representing the two different orderings of items within the instruments was used. If this variable had proved to be statistically significant, then an ordering effect would have been inferred. To totally eliminate an ordering effect, it would have been necessary to randomly order all items in every instrument mailed to the subjects. Given the length of the instrument, such an undertaking would have been extremely burdensome.

Definition of the Dependent Variable

The operational definition of the dependent variable was the subjects' perceived likelihood of the conflict issue being resolved in favor of the client. In the case of the controversy involving the unrecorded liabilities, the hypothetical client favored not incorporating the adjustment for those items in the financial statements. In the second conflict episode, the client did not want a substantial loss on an account receivable to be disclosed in the footnotes of their annual statements.

Of course, the conflict episodes could be resolved in favor of the client without any negative reflection on the integrity of the auditing firm if the appropriate disclosures were made in the auditor's report. To preclude subjects from considering this possibility and thus confusing the purpose of the task, the scenarios specifically asked the subjects to record their perceived likelihood that the disputes would be resolved in favor of the client's position without any mention of the conflict issue being made in the auditor's report. A seven-point Likert scale, very similar to that employed by Shockley, was used by subjects to record responses.

Other Operational Features of the Second Research Technique

In the previous discussion of the first research technique, the rationale for using loan officers as the subject class to represent financial statement users was outlined. For the same reasons, loan officers were used in this part of the research. Additionally, the sample selection procedures and sample size decision variables for both halves of the research design were outlined within the discussion of the first research technique.

Evaluation of the ANOVA Results

The results of this task were evaluated by employing the Statistical Analysis System's (SAS) general linear model (GLM) procedures. The GLM procedures provide the necessary statistics to evaluate the data generated by this full-factorial ANOVA design. First of all, the GLM procedures report the R^2 or coefficient of determination for the overall ANOVA model. This statistic is simply the percentage of variation in the dependent variable explained by the independent variables and interaction effects specified in the ANOVA model. For each of the independent variables and interaction effects, the GLM procedures also report the F statistic, the significance level of that statistic, and the degrees of freedom. The marginal means by treatment level are not reported by the GLM procedures but that information along with some other relevant information which the researcher might want can be obtained by using other procedures provided by SAS.

One of the advantages of employing the ANOVA model is that the impact of the interactions between independent variables can be isolated and the statistical significance of each measured. In this particular study, no *a priori* hypotheses were posited with respect to such interaction effects; however, the statistical analysis of the empirical results included a determination of whether any of these factors were statistically significant.

In Figure I, the overall research design for this study is summarized. That graphic shows how the research objectives, questions, and hypotheses raised in the first three chapters relate to the research and analytical techniques discussed in this chapter.

Validity and Reliability Considerations

Figure II summarizes the major threats to the validity and reliability of this study's findings, defines the precautionary measures which were taken in order to prevent the realization of these threats, and the statistical tests which were performed to determine whether and/or the extent to which the threats were realized.

In a research context, Kerlinger defined reliability as the "accuracy of precision of a measuring instrument" (p. 443). Selltiz (1959) expanded somewhat on this definition.

> The evaluation of the reliability of any measurement procedure consists in determining how much of the variation in scores among individuals is due to inconsistencies in measurement. When independent but comparable measures of the same thing are obtained, they will yield the same results to the extent that the measurements are free from random or variable errors. (p. 155)

Regarding validity, Kerlinger noted that this attribute of experimental research is epitomized by the question: "Are we measuring what we think we are measuring?" (p. 457). A now classic discussion of experimental validity is found in Campbell and Stanley (1963) in which validity was dichotomized

FIGURE I

Summary of research design

	Research Objectives	Research Questions or Hypotheses	Research Techniques	Analytical Techniques	Statistical Measures
Research Technique #1	To assist promulgatory authorities in developing a comprehensive and integrative policy statement concerning auditor independence.	1. Which of the structural changes in the auditor's role, which have either been implemented or proposed, are the most important determinants of perceived auditor independence? 2. Which of these proposed or implemented changes would financial statement user groups like to see adopted? 3. How well do financial statement user groups and partners of national accounting firms agree on the above two issues?	A survey research instrument was developed and administered to two samples of subjects: loan officers, used as surrogates for the universe of financial statement users, and partners of 'Big 8' accounting firms. Each subject was asked to twice rate a set of sixteen policy actions related to promoting auditor independence. The first rating task required the subjects to evaluate the perceived ability of each action to promote the independence of auditors. The second rating task required subjects to express their own personal opinion of whether or not each action should be adopted or retained.	For purposes of the first and second research questions, the mean ratings of the actions by the loan officers were computed. Additionally, the ordinal rankings of the actions' mean ratings by loan officers were determined. To satisfy the final research question the mean ratings of the loan officers were compared to those of the partner subjects as well as to those of the subset of partners involved in the audit practices of their firms.	Hotelling's T^2 was employed to determine if there was a statistically significant difference between the vectors of loan officers and partners' mean ratings of the sixteen actions as well as the pairing of vectors for loan officers and audit partners. When significant differences were found, multiple t-tests were performed to determine on which specific actions each pairing of subject groups had significant differences.

FIGURE I, Cont'd

	Research Objectives	Research Questions or Hypotheses	Research Techniques	Analytical Techniques	Statistical Measures
Research Technique #2	To determine the impact of auditor-client conflict on user groups' perceptions of auditor independence as well as to determine how such an impact is mitigated or exacerbated by important contextual variables in the audit context.	Financial statement users will perceive that conflict episodes are more likely to be resolved in favor of the client's position when -- H_1: the environment in which the audit firm is operating is characterized by a high rather than a low level of competition; H_2: the audit firm provides management advisory services to the client as opposed to providing no such services; H_3: the client is in a healthy as opposed to a poor financial condition; H_4: the issue at the center of the dispute is not precisely treated by the technical standards as opposed to the situation where the central issue is dealt with very specifically in the technical standards.	A full-factorial ANOVA design was employed. The research instrument contained two hypothetical auditor-client conflict scenarios. Each scenario was followed by eight independent cases in which specific facets of the audit context were varied, e.g., amount of MAS provided by the audit firm. Loan officer subjects used a Likert-scale to record their perceptions of the likelihood of the audit firm's independence being impaired in each case.	The Statistical Analysis System's general linear model procedures were employed to determine the statistical significance of each main effect and interaction specified in the ANOVA model. Additionally, ANOVA models were constructed for each subject in order to evaluate the degree of judgment consensus among the subjects.	F-statistics were computed to determine the statistical significance of the main effects and interactions in the composite model as well as in the individual ANOVA models. The R^2 or coefficient of determination was also calculated for the composite and individual models.

FIGURE II

Summary of the threats to the validity and reliability of the research results and the preventive and detective measures taken in this regard.

	Threats to Validity and Reliability of Research Results	Precautionary Measures	Statistical Tests Performed
Internal Validity: Both Research Techniques	Lack of uniformity in administration of research instruments.	A single researcher was responsible for all contact with subjects.	None
	Existence of a social desirability bias influencing subjects' responses.	The research instruments were worded in as neutral and objective a manner as possible.	None
	Lack of comprehension by subjects concerning how to complete the research instruments.	The research instruments were pre-tested on subjects from each relevant population.	None
External Validity: Both Research Techniques	Response bias resulting from the self-selection process which occurs in a survey study.	Subjects were randomly selected.	Subjects who responded to the second requests for participation were used as surrogates for the non-respondents. An equal number of the earliest respondents to the first requests were then selected. Multiple t-tests were used to determine if there existed significant differences between the paired groups' responses.
	Subject samples being unrepresentative of relevant populations.	Subjects were randomly selected.	None

FIGURE II, Cont'd

	Threats to Validity and Reliability of Research Results	Precautionary Measures	Statistical Tests Performed
External Validity: Research Technique #2	Lack of mundane realism in research instrument.	Hypothetical scenarios were designed to be as realistic representations of actual auditor-client conflict episodes as possible.	None
Reliability: Both Research Techniques	Lack of subject conscientiousness in completing research instruments.	Research instruments were made as concise as possible.	Two small sub-samples of subjects who participated in the research tasks were re-administered the research instruments. The correlations between these subjects' paired responses, both individually and as groups, were computed and compared to benchmarks established by previous studies.
Reliability: Research Technique #2	Lack of judgment consensus among subjects in evaluating the importance of the independent variables included in the hypothetical scenarios.	None	The R^2, when considering only the significant main effects and interactions in the composite model, was found for each subject. Then, the mean and distribution of this statistic was determined for the subject sample. These measures of consensus were them compared to the benchmarks established by the Shockley (1981) study.

as follows.

> Internal validity is the basic minimum without which any experiment is uninterpretable: Did in fact the experimental treatments make a difference in this specific experimental instance. External validity asks the question of generalizability: To what populations, settings, treatment variables, and measurement variables can this effect be generalized. (p. 15)

Threats to the Reliability of the Research Results

The most obvious threat to the reliability of the results of the first research technique is the possibility that subjects performed the rating tasks in less than a conscientious manner. To assess the likelihood of lack of subject conscientiousness in performing the experimental rating tasks, a small sub-sample of the original subjects was selected and asked to repeat the tasks at a subsequent date. If the correlation between these respondents' two rank orderings of the sixteen items is relatively high, then the original responses to the tasks were most likely made in a thoughtful and responsible manner.

With regard to the ANOVA design, the two dimensions of reliability that past researchers have been most concerned with in such an experimental application are interrater reliability and test-retest reliability. Essentially, interrater reliability is an index of the degree of consensus among subjects within each subject group. One would hope that the degree of consensus would be rather high since the subject groups are composed of individuals with fairly similar backgrounds. A low degree of interrater reliability leads one to question whether subjects tended to interpret the scenarios in a consistent manner.

There exist several different methods available to assess this characteristic and some past researchers have used more than one approach. Ashton (1974) and Joyce (1976) calculated the Pearson product-moment correlation coefficients between paired judgments of individual subjects and then reported the range of such correlations and the mean. A similar approach was used in the study of radiologists' judgments by Hoffman, Slovic, and Rorer (1968) except that these researchers used the median correlation within the subject group to assess the overall degree of interrater reliability. The general nature of this research effort is more closely related to the ANOVA design utilized by Shockley than to the three studies referenced above. Accordingly, Shockley's approach to measuring interrater reliability was used and the magnitude of that attribute for his study was the benchmark against which this study's degree of subjects' judgment consensus was evaluated. Shockley measured interrater reliability by summing the R^2 statistic across all significant effects for each individual to yield an estimate of the proportion of variance which the model explained for each individual. Generally, a relatively low degree of variance explained is consistent with low within-group consensus.

Again, to determine the conscientiousness of subjects' responses to the experimental instruments in the auditor-client conflict research design, a small sub-sample of the original subject pool was selected. The instrument was re-administered to these individuals at a subsequent date. The higher the correlation between the sub-sample's two sets of responses, the greater the degree of inferred interest and attention given to the experimental task by subjects.

Preventive Measures Taken to Protect the Internal Validity of Research Findings

As indicated above, there are two general dimensions of validity that need to be considered in an experimental context. External validity concerns the relative degree of reality captured by the research design while internal validity relates to the degree to which the experimental treatments made a difference in subjects' responses. Three actions were taken to enhance the internal validity of the subjects' responses. First, in each application an emphasis was placed on uniformity in administration of the instruments. Reinforcing this strength was the fact that a single investigator was responsible for all contact with the subjects. Second, the possibility of a social desirability bias occurring in the subjects' responses was reduced substantially by wording the instruments in as neutral a manner as possible. Finally, since it is practically impossible to identify all threats to internal validity prior to administering a research instrument, the instruments were pre-tested on large samples of subjects drawn from the relevant populations. As a result of the pre-testing, several changes were made in the instruments.

External Validity Tests and Control Measures

With respect to external validity, the first research task appears to be fairly strong. The sixteen items included in that application represent a substantial number of all recent suggestions discussed in the professional literature to strengthen perceived independence. A more problematic situation exists with regard to the external validity of the scenarios used in the ANOVA application. In constructing the scenarios, a serious effort was made to design descriptively realistic auditor-client conflict episodes. To the extent that the scenarios are not deemed representative of reality, the generalizability of the research results is limited. Nonetheless, the empirical data provided by this ANOVA study may provide a theoretical framework that can be used to investigate the research issues in more true-to-life experimental settings in the future.

In any survey study, one of the most critical challenges to the external validity of the results is the bias introduced by obtaining less than a 100% response rate from the randomly selected subjects. The issue is whether or not the study tended to attract a certain subset of the sample with views or opinions significantly different from those of the non-respondents. As in the case of interrater reliability, there exist several alternative methods for measuring this feature of a study. The most obvious and effective approach would be to somehow determine non-respondents' views on the issues being studied. As Shockley indicated, this is typically impossible. These individuals have already refused to respond to the initial and second requests to participate in the study so it is very unlikely they would answer a third request. Frequently, those subjects who responded to the second request (but, of course, not the first request) are used as a surrogate class for the set of non-respondents. Then various statistical tests are performed to determine if significant differences exist between the responses of the initial respondents and those of the surrogate class of non-respondents. If there are no such differences, the risk of response bias influencing the research results is probably quite small.

The specific response bias test employed in this study has been used in several previous studies including that of Shockley. In both research techniques, multiple t-tests were performed between the mean responses on each data item for two subsets of subjects. The first subset consisted of all subjects responding to the second request letters while the other subset consisted of an equal number of the earliest respondents. If the t-tests show a substantial amount of disparity in these groups' judgments, then the conclusion must be that response bias has influenced the results. Typically, such is not the case, otherwise the use of a survey research methodology would be a questionable practice.

A final aspect of the external validity issue is the representativeness of the subjects used in the research design. Again, an effort was made to choose subject classes representative of the relevant universal populations, realizing of course, that truly random or representative samples are not a feasible possibility in a research study such as this.

One remaining issue in this context is the use of a non-metric scale to measure the dependent variable in the auditor-client conflict research design. According to Hair, Anderson, Tatham, and Grablowsky (1979), there are two basic classes of data: "non-metric (qualitative) and metric (quantitative)" (p. 12). Non-metric data includes such items as attributes or categorical variables (sex, race, etc.), while metric data typically reflects relative quantity, mass or distance. Non-metric data can be divided into two sub-classes, nominal and ordinal, while metric data can be divided into two categories as well, interval and ratio. According to some statisticians, including Hair, et al (p. 14), the scale of data required for a dependent variable in an ANOVA study is interval or ratio, however, ordinal data such as that to be collected from the subjects in the second half of the research design is often used. As Kerlinger noted (p. 440), this particular issue has created a long-standing controversy among researchers. Researchers in the hard sciences generally argue that ordinal data should not be treated as equivalent to interval data while researchers in the behavioral sciences assert that such an approach makes little difference if subjects are informed that the distances between points on an instrument, such as the one used in this study, are assumed to be equal intervals. This question of robustness will most likely never be completely resolved but certainly the support of such prominent behavioral researchers as Kerlinger and Guilford (1954) for the practice of treating ordinal data as being measured on an interval scale provides a large measure of justification in that regard. In an accounting context, such an approach has been used by several researchers including Shockley in his study of perceived auditor independence.

CHAPTER V

DATA ANALYSIS

This chapter presents results derived from conducting the empirical investigation described in the preceding chapter. This chapter has three major sections. The first section contains the results of the two tasks in which loan officers and partners of public accounting firms were asked to evaluate the desirability of adopting a number of actions which might strengthen perceptions of auditors' independence. The second section contains the results of the task aimed at determining the impact of conflict in the audit context on third parties' perceptions of auditors' independence. This chapter concludes with a discussion of certain threats to the integrity of the research project as well as a review of the steps taken to control and measure the impact of these threats.

The First Research Technique

Response Rates

As indicated in the previous chapter, the instrument used in this half of the research project was mailed to seventy-one loan officers and an equal number of partners in national public accounting firms. The overall response rates for these subject classes were 63.4% (forty-five respondents) and 66.2% (forty-seven respondents), respectively. These response rates are quite comparable to those obtained in other survey studies involving auditor independence, a few of which are summarized by the following:

Shockley (1981)	
Partners of Big Eight firms	62.3%
Commercial loan officers	67.2
Chartered financial analysts	60.9
Firth (1981)	
Bankers	74.0
Firth (1980)	
Partners of Big Eight firms	53.0
Loan officers	54.0
Financial analysts	57.0

Respondent Demographics

The average number years of experience in the banking profession for the loan officer respondents was 15.0 with a maximum of 35 years and a minimum of 4 years. With respect to commercial lending experience, the mean was 9.4 years with a maximum of 34 years and a minimum of zero (apparently, one subject had recently moved into a loan officer position without any prior experience in commercial lending).

Concerning the public accounting partner sample, 74.4% of those respondents (thirty-five individuals) worked within the auditing practice of their firms while the remainder (twelve individuals) were tax practitioners. The mean number of years of public accounting experience for the partners was 18.7 with a maximum of 34 years and a minimum of nine years.

The average number of years of non-public accounting experience was .7 with a maximum of five years and a minimum of zero years.

Results of Positive Criterion Rating Task

Table II summarizes the subjects' responses to the initial rating task in which the positive criterion rating scale was used. The mean ratings for each variable are reported for three subject groups: all partner subjects, all loan officer subjects, and the partner subjects working in the auditing practices of their firms. Included parenthetically in Table II are the ordinal rankings of the mean ratings of each variable for each of the above three subject groups. An indication is made in Table II of those items on which the two subject groups had statistically significant differences of opinion. The statistical significance of the differences was determined via multiple t-tests. The overall Hotelling's T^2 statistic which was computed to determine if there was a statistically significant difference between the location of the two paired vectors (loan officers & partners, loan officers & audit partners) of mean responses proved to be highly significant ($p < .001$) in each case.

The first two columns of Table II compare the loan officers' responses in the positive-scale rating task to those of the entire set of partner respondents; however, it seems that rather than comparing those two groups' responses,

TABLE II

Comparison of the group means and the relative ordinal rankings of those means for all partner subjects, loan officers, and audit partners - positive evaluative criterion.

* ~ .01 significance level
\+ ~ .001 significance level

		Perceived Effectiveness Ratings: Group Means (Relative Rankings)			Test of Differences in Group Means	
Item #	Description	All Partners	Loan Officers	Audit Partners	Loan Officers vs. All Partners	Loan Officers vs. Audit Partners
1.	Restricting the amount of management consulting services provided by an auditing firm to audit clients to a maximum of 10% of the total annual audit fee.	1.30 (14)	2.20 (12)	1.29 (15)	+	+
2.	Giving the SEC total responsibility for the external audit function. Auditors of financial statements of publicly-held companies would be government employees much like IRS auditors.	2.49 (3)	1.91 (15)	2.40 (3)		
3.	Requiring that any proposed auditor adjustments not incorporated by the client in its financial statements be disclosed within the footnotes to the statements.	1.47 (13)	3.58 (1)	1.40 (12)	+	+
4.	Prohibition of executive search services by auditing firms.	2.06 (6)	2.20 (12)	2.11 (5)		
5.	Selection of auditors for SEC registrants by the SEC with fee negotiations within guidelines established by the SEC.	1.72 (10)	2.36 (11)	1.83 (9)		
6.	Requiring auditors to report on the preferability of all the client's accounting policies.	1.79 (8)	2.87 (5)	1.66 (10)	+	+
7.	Requiring that the nature and amount of consulting services provided by the auditor to the client be disclosed within the client's financial statements.	1.49 (12)	2.60 (7)	1.40 (12)	+	+
8.	Establishment of an arbitration board to settle disputes between auditors and clients involving financial reporting issues.	1.79 (8)	2.76 (6)	1.86 (8)	+	+

TABLE II, Cont'd

Item #	Description	Perceived Effectiveness Ratings: Group Means (Relative Rankings)			Test of Differences in Group Means	
		All Partners	Loan Officers	Audit Partners	Loan Officers vs. All Partners	Loan Officers vs. Audit Partners
9.	A ban on any form of advertising by auditing firms.	1.19 (16)	1.69 (16)	1.09 (16)	*	*
10.	Requiring the mandatory use of audit committees composed of non-employee and non-management members of the client's board of directors.	3.30 (1)	3.04 (4)	3.37 (1)		
11.	Required disclosure in client financial statements of all major auditor-client disagreements occurring in the eighteen months prior to an auditing firm's dismissal.	2.06 (6)	3.16 (3)	2.03 (7)	+	+
12.	Prohibiting an auditing firm from accepting an engagement if the total revenue from the prospective client would be greater than 10% of the auditing firm's total revenues.	2.57 (2)	2.60 (7)	2.57 (2)		
13.	Re-instatement of the AICPA's ethical standard prohibiting client solicitation.	1.70 (11)	2.42 (10)	1.60 (11)	*	+
14.	Requiring that audit fee negotiations be the complete responsibility of the client's audit committee rather than the client's management.	2.47 (4)	2.51 (9)	2.31 (4)		
15.	Mandatory rotation of all audit engagement personnel every three years.	2.28 (5)	3.33 (2)	2.09 (6)	+	+
16.	Annual publication by the SEC of suggested audit fees per hour by staff level, e.g., staff, senior, etc.	1,28 (15)	1.93 (14)	1.34 (14)	+	*

more enlightening results would be yielded by contrasting and comparing the responses of loan officers and those of partners involved strictly in the functional area of auditing. A presumption of this section of the study is that the partners of national accounting firms have a significant amount of input in the process culminating in policy pronouncements concerning auditor independence. It seems only logical to make one further presumption: audit partners more than likely have a greater degree of influence in the above promulgatory process than would non-audit partners. Accordingly, the following analysis of the positive-scale data will focus primarily on the loan officers' and audit partners' responses. Table II indicates that loan officers and audit partners had highly significant ($p < .001$) differences on eight of the sixteen variables while on two additional variables differences which would have to be considered at least moderately significant ($p < .01$) were found.

Analysis of Positive Criterion Rating Task Results

Cross-sample Comparisons of Subject Groups' Ratings. In examining the ten variables in Table II on which significant differences were found between audit partners and loan officers, the most obvious pattern discernible is the tendency of the partners to rank the items more conservatively (lower) than the loan officers. A possible explanation for this result can be found in a voluntary comment written on an instrument returned uncompleted by an audit partner. The audit partner said this task was not very relevant since "auditor independence cannot be legislated." Apparently, some audit partners may be skeptical of the ability of ethical and/or governmental regulations to promote the independence of individual auditors. An alternative position is provided by De Angelo (1980). She argued that the auditor is strictly an economic creature. If the marginal revenues of unprofessional/non-independent behavior exceed the marginal costs, De Angelo asserts that unprofessional behavior will occur. According to her argument, the only way to provide for auditor independence is to legislate it, i.e., impose sanctions that would make the marginal cost of non-independent/unprofessional behavior on the part of the auditor financially disastrous.

There exist at least two other alternative explanations for the relatively conservative ratings given the proposed actions by the audit partners. First, the partners' responses may be due primarily to a self-serving motivation. Naturally, the partners would like to minimize the amount of governmental intervention in their profession. However, the partners did appear to quite objectively evaluate the action which would place the attestation function totally under the purview of a governmental agency. (As shown by Table II, that particular action was ranked the third highest by audit partners in terms of strengthening auditor independence.) The second explanation for the partners' low ratings would simply be that they are so deeply involved in the auditing discipline that they were unable to objectively evaluate the variable set of this first empirical task.

In all fairness, it is also necessary to consider the possibility that the audit partners' perceptions are accurate, i.e., that adopting the actions would not strengthen the independence of auditors. Certainly, audit partners' extensive active experience in the auditor's role have made them well aware of how contextual and noncontextual variables influence the ability and/or desire of an auditor to retain his independence. However, of the sixteen policy actions included in the rating tasks only four have actually been in force at one or more points in time. Accordingly, it is difficult to determine whether, in fact, most of the actions would be effective in promoting the independence of auditors. Additionally, if there does exist a disparity between the preferences of user groups and audit partners in this respect, it seems that the preferences of the former should prevail since they are the primary benefactors of the audit function.

The largest absolute difference between the two subject classes' ratings in Table II is on the item calling for the disclosure of auditor adjustments not incorporated by the client in its financial statements. Audit partners rated the item as contributing to the safeguarding of auditor independence to only a minimal degree while the loan officers' believed the action would contribute fairly substantially to that end. As indicated in Appendix I, this is the only variable included in the first section of the research design for which no direct support was found in the professional literature. This variable was used because it has direct relevance to the second half of the research project. One of the most frequent sources of conflict in the auditor-client dyad are disputes centering around the necessity to incorporate auditor-proposed adjustments in the financial statements. Speculating on why the item was rated as it was by the audit partners, they may have perceived that its adoption would simply shift the focus of client attempts to influence auditor behavior. Rather than pressuring the auditing firm to ignore adjustments, the client might simply try to coerce the auditing firm not to propose an adjustment. Alternatively, the audit partners may have deemed this action to be relatively ineffectual because they believe that all material adjustments are incorporated into the client's financial statements. Thus, this policy would simply force clients to disclose immaterial passed adjustments, a move which could confuse rather than enlighten financial statement readers.

The one policy alternative which was ranked higher by audit partners than loan officers in the first rating task was the mandatory use of audit committees composed of non-employee and non-management members of the client's board of directors. There was not a statistically significant difference between the two group's mean responses since the loan officers rated this item relatively high also. This finding confirms the results of the Milano study with respect to the use of audit committees. His empirical results demonstrated that both CPAs and financial statement users believe that using such committees in the audit engagement would strengthen auditors' independence.

Audit committees have been used in the audit context for quite some time, accordingly, the audit partners' familiarity with them (and, hopefully, the positive results of their use) may have contributed to the high rating given this particular item. Another contributing factor may have been that the New York Stock Exchange already requires their registrants to use audit committees. Since a moderate percentage of the audit partners' clientele likely consists of NYSE firms, adopting this requirement would not pose any significant additional regulatory burden.

Next to the action requiring disclosure of passed adjustments, the following three items resulted in the largest absolute differences between the loan officers and audit partners on the initial rating task: 1) requiring auditors to report on the preferability of their clients' accounting policies, 2) the mandatory rotation of individuals assigned to audit engagements, and 3) requiring that the type and amount of auditor-provided consulting services be disclosed in financial statements.

<u>An In-depth Analysis of the Loan Officers' Positive Criterion Ratings</u>. In analyzing the mean ratings of just the loan officers, it seems apparent that they believe most of the available policy alternatives would have at best a modest impact upon the ability of an auditor to retain his professional independence. The two possible exceptions to that generalization would be with respect to the disclosure of 'passed' adjustments and the mandatory rotation of audit engagement personnel. One possible explanation for the relatively high mean rating given the former item is that the loan officers believe such a requirement would provide an auditing firm a certain amount of leverage in disagreements with the client over the necessity of adopting auditor-proposed adjustments. As noted above, this view is obviously not held by the audit partner subjects.

One of the most recent empirical studies investigating auditor rotation was by Dawkins (1978) whose empirical data indicated that corporate controllers were heavily against the adoption of such a measure. Rather than addressing the basic issue of audit firm rotation, an issue which has been studied quite comprehensively and with relatively consistent results, this study examined the effect on apparent independence of rotating individual auditors on each engagement. Table II shows that the mandatory rotation of individuals on an audit engagement was evaluated very favorably by the loan officers with regard to promoting auditor independence. As will be seen shortly, these subjects also ranked this variable relatively high on the normative criterion. At first, these results may seem to contradict the findings of the Dawkins study. However, rather than creating confusion, these results may actually clarify how users feel on the related issues of firm versus individual auditor rotation. A factor which most likely contributed to the negative evaluation given the firm rotation variable in the Dawkins study is the incremental cost which it would bring to the audit engagement, a cost which would by and large is the responsibility of corporate controllers, the universe from which her subjects were drawn. By just rotating individual auditors rather than the entire firm, a large percentage of the incremental set-up costs for a new audit engagement would be avoided; however, this action would still provide the positive benefit of introducing individuals with a fresh, and perhaps, more objective perspective on the engagement. Thus, one of the major advantages provided by rotating audit firms is gained but a large portion of the costs of such an action would be eliminated.

Table II shows all of the actions ordinally ranked according to the mean rating given them by the loan officers. The third most highly ranked item, disclosure of significant auditor-client disagreements occurring prior to an auditing firm's dismissal, was the central focus of a 1981 empirical study by Fried and Schiff. Those researchers carried out an *ex post* study of the stock market's reaction to 8-K filings required by the SEC when a registrant changes auditors (Note: Fried and Schiff's study was not concerned with the relationship between this policy and auditor independence.). One of the requirements of this filing is that the registrant disclose all major disagreements with the auditing firm in the eighteen months prior to the dismissal. In Fried and Schiff's study, approximately one-fourth of their sample of firms which had filed such a report disclosed information concerning disagreements with their former auditors. Utilizing the capital asset pricing model, the researchers found that the 8-K disclosures did not significantly impact the stock prices of sample firms. In the current study, the loan officers expressed their view that disclosing auditor-client disagreements in instances of auditor dismissal should provide at least a modest degree of protection for the independence of auditing firms. If clients know that such information will be disclosed, then the argument is that they should be more hesitant to dismiss their auditors for fear of repercussions by the investing public. That is, the stock of traded firms which do not provide a totally free investigative and reporting environment might be discounted by the capital markets. However, Fried and Schiff's results do not provide even an indirect measure of support for this contention.

The remaining three items in the variable set which were rated by the loan officers as providing at least a modest increase in the ability of the auditor to retain his apparent independence were the mandatory use of audit committees, requiring that auditors report on the preferability of the client's accounting policies, and the establishment of an arbitration board to settle auditor-client disputes.

Results of the Normative Criterion Rating Task

Tables III and IV summarize the results of the normative rating task which was carried out by the same subjects as those which performed the initial rating task. (See page 63 for the five-point scale which the subjects used in this second rating procedure.) Table III reflects the mean responses by variable of the entire sample for each subject class. Notice, that once again a subset of the partner sample consisting of just the audit partners was formed for analytical purposes. In Table IV the five-point scale used by subjects was collapsed into an equal length scale centered at zero. By doing this it is much easier to quickly isolate those actions on which the subjects had an overall positive rating versus those on which they had a composite negative mean response. Tables III and IV also report parenthetically the relative ordinal rankings of the group means for each subject sample.

As in the case of the previous rating task, Hotelling's T^2 statistic was employed to determine if there was a statistically significant difference between the location of the

TABLE III

Comparison of the group means and the relative ordinal rankings of those means for all partner subjects, loan officers, and audit partners – normative evaluative criterion.

* – .01 significance level
\+ – .001 significance level

		Reported Desirability Ratings: Group Means (Relative Rankings)			Test of Differences in Group Means	
Item #	Description	All Partners	Loan Officers	Audit Partners	Loan Officers vs. All Partners	Loan Officers vs. Audit Partners
1.	Restricting the amount of management consulting services provided by an auditing firm to audit clients to a maximum of 10% of the total annual audit fee.	1.49 (13)	2.64 (13)	1.46 (12)	+	+
2.	Giving the SEC total responsibility for the external audit function. Auditors of financial statements of publicly-held companies would be government employees much like IRS auditors.	1.06 (16)	1.64 (16)	1.06 (16)	*	*
3.	Requiring that any proposed auditor adjustments not incorporated by the client in its financial statements be disclosed within the footnotes to the statements.	1.55 (12)	3.93 (1)	1.54 (11)	+	+
4.	Prohibition of executive search services by auditing firms.	2.28 (5)	2.89 (9)	2.40 (3)		
5.	Selection of auditors for SEC registrants by the SEC with fee negotiations within guidelines established by the SEC.	1.23 (15)	2.07 (15)	1.14 (15)	+	+
6.	Requiring auditors to report on the preferability of all the client's accounting policies.	1.85 (9)	3.18 (5)	1.77 (9)	+	+
7.	Requiring that the nature and amount of consulting services provided by the auditor to the client be disclosed within the client's financial statements.	1.85 (9)	3.29 (3)	1.71 (10)	+	+
8.	Establishment of an arbitration board to settle disputes between auditors and clients involving financial reporting issues.	1.94 (8)	2.98 (8)	2.00 (8)	+	+

TABLE III, Cont'd

Item #	Description	Reported Desirability Ratings: Group Means (Relative Rankings)			Test of Differences in Group Means	
		All Partners	Loan Officers	Audit Partners	Loan Officers vs. All Partners	Loan Officers vs. Audit Partners
9.	A ban on any form of advertising by auditing firms.	2.28 (5)	2.33 (14)	2.23 (6)		
10.	Requiring the mandatory use of audit committees composed of non-employee and non-management members of the client's board of directors.	3.45 (1)	3.18 (5)	3.67 (1)		
11.	Required disclosure in client financial statements of all major auditor-client disagreements occurring in the eighteen months prior to an auditing firm's dismissal.	2.13 (7)	3.27 (4)	2.11 (7)	+	+
12.	Prohibiting an auditing firm from accepting an engagement if the total revenue from the prospective client would be greater than 10% of the auditing firm's total revenues.	2.40 (4)	2.71 (10)	2.26 (5)		
13.	Re-instatement of the AICPA's ethical standard prohibiting client solicitation.	2.81 (2)	2.69 (11)	2.80 (2)		
14.	Requiring that audit fee negotiations be the complete responsibility of the client's audit committee rather than the client's management.	2.43 (3)	3.00 (7)	2.34 (4)		*
15.	Mandatory rotation of all audit engagement personnel every three years.	1.68 (11)	3.67 (2)	1.46 (12)	+	+
16.	Annual publication by the SEC of suggested audit fees per hour by staff level, e.g., staff, senior, etc.	1.40 (14)	2.69 (11)	1.31 (14)	+	+

TABLE IV

Group means from Table III after collapsing
the normative scale into a five-point,
bi-polar scale centered at zero.

* - .01 significance level
\+ - .001 significance level

		Reported Desirability Ratings: Group Means (Relative Rankings)			Test of Differences in Group Means	
Item #	Description	All Partners	Loan Officers	Audit Partners	Loan Officers vs. All Partners	Loan Officers vs. Audit Partners
1.	Restricting the amount of management consulting services provided by an auditing firm to audit clients to a maximum of 10% of the total annual audit fee.	-1.51 (13)	-.36 (13)	-1.54 (12)	+	+
2.	Giving the SEC total responsibility for the external audit function. Auditors of financial statements of publicly-held companies would be government employees much like IRS auditors.	-1.94 (16)	-1.36 (16)	-1.94 (16)	*	*
3.	Requiring that any proposed auditor adjustments not incorporated by the client in its financial statements be disclosed within the footnotes to the statements.	-1.45 (12)	.93 (1)	-1.46 (11)	+	+
4.	Prohibition of executive search services by auditing firms.	-.72 (5)	-.11 (9)	-.60 (3)		
5.	Selection of auditors for SEC registrants by the SEC with fee negotiations within guidelines established by the SEC.	-1.77 (15)	-.93 (15)	-1.86 (15)	+	+
6.	Requiring auditors to report on the preferability of all the client's accounting policies.	-1.15 (9)	.18 (5)	-1.23 (9)	+	+
7.	Requiring that the nature and amount of consulting services provided by the auditor to the client be disclosed within the client's financial statements.	-1.15 (9)	.29 (3)	-1.29 (10)	+	+
8.	Establishement of an arbitration board to settle disputes between auditors and clients involving financial reporting issues.	-1.06 (8)	-.02 (8)	-1.00 (8)	+	+

TABLE IV, Cont'd

Item #	Description	Reported Desirability Ratings: Group Means (Relative Rankings) All Partners	Loan Officers	Audit Partners	Test of Differences in Group Means Loan Officers vs. All Partners	Loan Officers vs. Audit Partners
9.	A ban on any form of advertising by auditing firms.	-.72 (5)	-.67 (14)	-.77 (6)		
10.	Requiring the mandatory use of audit committees composed of non-employee and non-management members of the client's board of directors.	.45 (1)	.18 (5)	.67 (1)		
11.	Required disclosure in client financial statements of all major auditor-client disagreements occurring in the eighteen months prior to an auditing firm's dismissal.	-.87 (7)	.27 (4)	-.89 (7)	+	+
12.	Prohibiting an auditing firm from accepting an engagement if the total revenue from the prospective client would be greater than 10% of the auditing firm's total revenues.	-.60 (4)	-.29 (10)	-.74 (5)		
13.	Re-instatement of the AICPA's ethical standard prohibiting client solicitation.	-.19 (2)	-.31 (11)	-.20 (2)		
14.	Requiring that audit fee negotiations be the complete responsibility of the client's audit committee rather than the client's management.	-.57 (3)	.00 (7)	-.66 (4)		*
15.	Mandatory rotation of all audit engagement personnel every three years.	-1.32 (11)	.67 (2)	-1.54 (12)	+	+
16.	Annual publication by the SEC of suggested audit fees per hour by staff level, e.g., staff, senior, etc.	-1.60 (14)	-.31 (11)	-1.69 (14)	+	+

vectors of mean responses for the loan officers and partners. Again, this statistic proved to be highly significant ($p < .001$) for both the pairing of loan officers and the entire partner sample and the pairing of loan officers and just the audit partners. Also significance levels of .01 and .001 were again used in evaluating the results of t-tests in which the mean responses for each subject group were compared with the respective mean responses of the other group.

Analysis of Normative Criterion Rating Task Results

Cross-sample Comparisons of Subject Groups' Ratings. The partner subjects tended to rate the sixteen variables considerably lower than the loan officers on the normative criterion. As shown by Table III, in all cases where there was a statistically significant difference between the two mean scores, the higher rating always belonged to the loan officers. Of the six items where significant differences were not found, the loan officers' mean rating was higher in all but two cases. The two items rated more highly by partners than by loan officers were the mandatory requirement to use audit committees and the re-instatement of the AICPA's prohibition on client solicitation. In fact, the audit committee requirement is the only variable which received a positive mean score by the partner subjects. As indicated before, the adoption of this action would probably prove to be significantly less onerous for public accounting firms than most of the other proposals since the NYSE already requires the use of audit committees. Concerning reinforcing the ban on client solicitation, the partner group was slightly against that proposal, but less so than the loan officers.

Of the items in Table IV on which significant differences were found between loan officers and audit partners, five were rated positively by loan officers and negatively by audit partners, five were rated negatively by both groups but each significantly more negatively by audit partners, and on the final variable the loan officers were exactly neutral but the audit partners were unfavorably disposed.

The largest absolute difference between these latter two groups was on the item calling for the disclosure in financial statement footnotes of auditor adjustments not accepted by the client. The audit partners were very adamant in calling for the rejection of this proposal. Disclosing such adjustments could possibly place their firms in a difficult position of being forced to explain why they were able to issue an unqualified opinion when their clients refused to incorporate certain of their proposed adjustments into the financial statements. An alternative explanation for the audit partners' stance on this issue is that they believe that all material auditor-proposed adjustments are being incorporated in client financial statements. Consequently, this measure would simply result in the disclosure of immaterial 'passed' adjustments, a move which might confuse financial statement readers.

There was also a substantial absolute difference between the two subject groups on the issue of the mandatory rotation of audit engagement personnel. Loan officers were moderately in favor of this action's adoption while audit partners were even more strongly against this item than they were against the disclosure of 'passed' adjustments. Loan officers probably perceived that rotating auditors would periodically bring fresh new perspectives to the audit. Auditors who work on an engagement for several years may become too 'close' to the job and client employees and, consequently, lose a certain degree of their impartiality and objectivity. With regard to the audit partners' reaction, since this requirement would likely cause a considerable increase in the time and cost of administering an audit practice, their high negative mean rating is easily understood.

Loan officers were favorably predisposed toward being informed of the nature and amount of consulting services provided by auditing firms to their clients while the auditor subjects were clearly against such disclosures. These subjects would also like to be informed of all major disagreements occurring in the eighteen months prior to an auditing firm's dismissal whereas audit partners apparently do not believe disclosure of such disputes is necessary, a position somewhat supported by the Fried and Schiff (1981) empirical study referred to previously. The final action on which the two groups had a diametrically opposed view was the proposal requiring auditors to report on the preferability of the client's accounting policies.

Loan officers were indifferent with respect to delegating the responsibility for audit fee negotiations to the audit committee. However, surprisingly, the audit partners were moderately against this proposal. This is surprising since the audit partners were in favor of the mandatory appointment of audit committees. A second item on which the loan officers were essentially neutral was with respect to the creation of an arbitration board to settle disputes between auditors and their clients. The audit partners were firmly against this proposal, perhaps because they do not want to be placed in a situation where they would have to publicly take a position opposed to that of a client.

Three of the four remaining proposals on which significant differences existed, each of which were rated negatively by both subject groups, involved policies requiring a higher degree of SEC intervention in the financial reporting process. The largest absolute ranking, positive or negative, given by either subject class in either rating task was the negative rating given by auditors to the proposal to place the audit function totally under government jurisdiction. Rated almost as negatively by these same subjects was the suggestion to have the SEC match up auditors and auditees and establish guidelines for audit fee negotiations. Finally, the audit partners were firmly against the proposal to have the SEC simply publish suggested audit fees per hour by staff level. In each of the above cases, the loan officers were also in disfavor of the action's adoption but not as adamantly as were the audit partners.

The final variable on which there was a significant difference of opinion between loan officers and audit partners was the proposed restriction on the amount of management advisory services which auditing firms could provide to their clients. This is another item for which the auditors expressed firm disapproval while the loan officers rejected it but without any great enthusiasm.

Of the five remaining actions for which significant differences were not found, all were rated negatively by both subject classes. Generally, the partners were more in disfavor of the proposals than were the loan officers. The one exception to this rule being with respect to the re-instatement of the ethical ban on client solicitation. Both groups were mildly against this alternative but the loan officers' mean rating was slightly more negative than that of the audit partners.

An In-depth Analysis of the Loan Officers' Normative Ratings. The preceding analyses have concentrated on comparing and contrasting the normative ratings of the two subject groups. As has been emphasized repeatedly, the major objective of this study is to determine how user groups would structure the auditor's role in order to provide for, at least in their perceptions, the optimal level of auditor independence.

The two actions which loan officers would most like to see adopted are also the two alternatives which they ranked highest in the positive-scale rating task. Loan officers want to see the disclosure of proposed adjustments by the auditor which are rejected by the client as well as the mandatory rotation of individuals assigned to an audit. The third most highly ranked item by loan officers was the variable calling for the disclosure of the nature and amount of consulting services provided by auditing firms to their clients. For several years, the SEC has required registrants to disclose this information, however, this reporting rule has been eliminated as a part of new SEC commissioner Shad's program to cull out many of the SEC's ASRs[4]. Shad's motivation was to eliminate many of the unnecessary and/or ineffectual policies. Given the results of the current study, the elimination of this requirement may need reevaluation.

As in the case of the disclosure of MAS activities, the next three most highly ranked actions by loan officers were given rather modest absolute ratings. The fourth item, required financial statement disclosure of major disagreements occurring between the auditing firm and client prior to the

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[4]See "News Reports", Journal of Accountancy, October, 1981, p. 7.

auditing firm's dismissal, is essentially required currently by the SEC. This information is not reported in registrant financial statements but is required to be disclosed in an 8-K report to the public. Loan officers would also like to be informed of whether or not the client is using the most appropriate accounting policies. Finally, the loan officers agreed with the audit partners on the desirability of formally requiring the establishment of audit committees to serve as liasions between client management and auditing firms. Of course, there was a noticeable difference in the mean rating given this variable by the two groups as audit partners were much more in favor of its adoption than were the loan officers.

With respect to the actions ranked seventh, eighth, and ninth, the loan officers were either exactly neutral or practically so with regard to their implementation. It was noted previously that the loan officers really did not care either way whether audit fee negotiations are made the responsibility of the audit committee or whether an arbitration board is established to settle disputes between auditors and their clients. The third item which the loan officers were essentially indifferent toward was the prohibition of executive search services. This result is quite surprising since the provision of this service by auditing firms caused somewhat of a brouhaha in recent years within the financial community (Cohen Commission, 1978, pp. 100-101). The argument was that by recruiting executives for their clients, the large accounting firms were essentially placing individuals in these organizations that were somewhat obligated or indebted to them. At the very least, such a practice causes the executives of auditees and their auditing firms to have a closer relationship than otherwise, a fact which can lead to the impairment of an auditing firm's de facto if not apparent independence. Milano's (1981) study found that both CPAs and financial statement users believed that banning executive search services by auditing firms would strengthen the latter's apparent independence, however, both groups doubted that the marginal benefits provided by this action would be greater than the marginal costs of its implementation. The results of this study tend to confirm the general apathy expressed toward this issue by Milano's subjects.

The loan officers disapproved of each of the remaining seven proposals. As mentioned before, the loan officers agreed with the audit partners' rejection of the action which would place the audit function totally under the auspices of the SEC. The above action was given the lowest mean rating by loan officers in the normative rating task while the next lowest rating belonged to the closely related alternative which would delegate to the SEC the responsibility for assigning audit firms to publicly-traded companies. Even though a ban on advertising would provide some limited degree of protection for auditing firms' independence, according to the loan officers' positive-scale ratings, these subjects were against re-instating such a prohibition. The amount of advertising within the discipline is somewhat of a barometer of the degree of competition which prevails. Apparently, the loan officer subjects are willing to forego a measure of auditor independence in order to protect auditing firms' right to compete via the advertising media.

The proposal ranked thirteenth in the normative rating task, according to the loan officers' mean ratings, was the prohibition concerning the amount of MAS revenue which an auditing firm could generate in an engagement. The evaluation of this item as well as the other proposed standard relating to the MAS issue sheds considerable light on the long-standing controversy surrounding the provision of consulting services by auditing firms. It seems apparent that financial statement users are concerned with the effect which the simultaneous provision of MAS and auditing services may have on an auditing firm's independence. Shockley (1981) demonstrated that the provision of a significant amount of MAS to an audit client impairs the auditing firm's apparent independence. The results of the current study indicate that even though the provision of MAS may impair independence, financial statement users are willing to forfeit some degree of auditor objectivity in order to protect the latter's right to provide such consulting services. Obviously, one is required to speculate as to how users would trade-off these two variables, but regardless, by requiring the disclosure of the nature and amount of consulting services provided by an auditing firm to its client, financial statement users will have sufficient evidence to make those trade-offs. If the users feel too much independence is being sacrificed, then they can take the appropriate actions via the appropriate channels to remedy the situation.

With respect to the items ranked tenth, eleventh, and twelfth in Table III, loan officers were only mildly against their implementation. Again, the tendency of the loan officers to grant auditing firms a high level of freedom in the marketplace was evident by the negative rating given to the proposal to ban client solicitation. Even though auditing firms are providing a professional service, loan officers are not about to deny them their economic freedoms. The loan officers also appear to be generally in disfavor of those actions mandating more SEC involvement in the financial reporting process as evidenced again by the negative rating given the suggestion to have the SEC annually publish audit fee guidelines.

Finally, the loan officers are slightly against restricting auditing firms' right to accept clients which would contribute a disproportionate amount to their total revenue. Shockley's study found that relatively small auditing firms face a greater risk of having their apparent independence jeopardized than do large firms. Generalizing from that study to the current study, one would expect the above prohibition to be rated by user groups as an action which would promote auditors' independence, and such was the case as reflected by the rating loan officers gave this action on the positive-scale criterion. Nonetheless, loan officers supported the right of the small auditing firms to take on relatively large clients. This instance clearly points to the need to evaluate actions intended to alleviate pressures on the independence of auditors from both positive and normative perspectives. If the above policy alternative had been assessed on only a positive criterion, one might have come away with the opinion that loan officers support its adoption, a conclusion contrary to their evaluation of the item on the normative criterion.

The Second Research Technique

In the preceding tasks auditor independence was studied in a non-contextual manner. The data resulting from those tasks gives us a better understanding of how financial statement users would structure the auditor's role in order to provide for an improved level of auditor independence. In this section, this phenomenon was studied in a context-specific manner. Subjects were given defined sets of circumstances in which the auditor's independence appeared to be threatened and then were asked to report the likelihood of an auditor behaving in a compromising or non-independent manner. An attempt was also made to determine which variables or structural conditions of the audit context made it more or less likely that an auditor's apparent independence would be negatively affected. To accomplish this latter objective, key variables thought to influence users' perceptions of auditor independence were varied systematically within the situations presented to the subjects.

An advantage of studying auditor independence in both a situation-specific and a non-contextual manner is that the results can be contrasted and compared to determine if the two approaches yield general agreement concerning the determinants of this phenomenon. If such is the case, then the results of each method serve as support for the other and provide a higher overall degree of credibility. If the independent results of each method do not agree, then further ananlysis would be needed to determine why the subjects evaluated independence in a different manner when it was presented under differing sets of circumstances.

Response Rate and Demographics

The instrument used in this half of the research design was mailed to seventy loan officers of Oklahoma banks. The usable response rate for these subjects was 61.4% (forty-three respondents). In a similar study, Shockley obtained a 62.3% response rate from partners of several Big Eight accounting firms while from loan officers and chartered financial analysts his response rates were 67.2% and 60.9%, respectively. Accordingly, the response rate of this study compares favorably with those of Shockley's. With respect to the loan officer subjects, the mean length of employment within the banking profession was 17.0 years with a minimum of two years and a maximum of thirty-six years. The average amount of commercial lending experience was 12.2 years with a minimum of one year and a maximum of thirty-six years.

Overview of Empirical Results

Analysis of the Combined ANOVA Model. Table V presents the overall analysis of variance (ANOVA) results for the combined subject sample. Past ANOVA studies published in the accounting literature have generally used a significance level of .05 to indicate a moderately strong relationship between independent and dependent variables while a significance level of .01 has been used to indicate a strong relationship.[5] Employing a significance level of .01, four of the main effects and one of the interactions in Table V would be considered to have a significant impact on subjects' responses to the hypothetical scenarios. Using a level of .05, no additional main effects or interactions would surpass the significance threshold.

Table V does not disclose the directional effects of the four independent variables; however, the direction of each variable's impact is obviously discernible by analyzing Table VI which presents the marginal means for the dependent variable[6] by treatment level of each significant independent variable. The presence of a materiality dispute (Level 1) had a much

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[5]Kerlinger (1973, pp. 160-170) discusses levels of statistical significance and why the .01 and .05 levels are most commonly applied in behavioral research.

[6]As noted in Chapter IV, the dependent variable was the subject's perceived likelihood of the conflict episode being resolved in favor of the client's position. This variable was used as a surrogate measure to represent the degree to which the subjects' believed the hypothetical audit firm's independence would be impaired as a result of the conflict dispute.

	df	F	p
Main Effects			
I Conflict issue	1	111.01	.000 *
C Competition	1	14.04	.000 *
F Financial condition	1	156.18	.000 *
M MAS	1	15.59	.000 *
O Ordering variable	1	.51	.476
Interactions			
IC	1	.40	.530
IF	1	12.57	.000 *
IM	1	2.35	.126
IO	1	.58	.446
CF	1	.00	.980
CM	1	.05	.821
CO	1	.41	.522
FM	1	.05	.821
FO	1	.30	.585
MO	1	1.59	.208

TABLE V

Analysis of variance for all main effects and interactions.

* - Significance level of .01 or less

Independent Variable	Treatment Level 1*	2
Conflict issue	3.92	2.70
Competition	3.52	3.09
Financial condition	4.03	2.58
MAS	3.53	3.08

TABLE VI

Marginal means for treatment levels of independent variables.

* - The table below summarizes the treatment levels of each independent variable.

	Treatment Level 1	2
Conflict issue	Materiality dispute	Disclosure dispute
Competition	High	Low
Financial condition	Good	Poor
MAS	40% of audit fee	None

higher negative impact on the subjects' perceptions of the auditing firm's ability to retain its apparent independence than did the presence of a disclosure dispute (Level 2). Subjects perceived that the more intense the degree of competition in the audit market the more likely that the auditing firm would submit to the client's demands in a conflict episode while the provision of a substantial amount of MAS to the client had a similar effect. Finally, the healthier the financial condition of the client involved in a dispute with its auditors, the more likely subjects were to doubt the latter's ability to obtain their preferred resolution to the conflict episode.

The final independent variable was the nominal, two-level ordering variable. As discussed in Chapter III, one-half of the research instruments began with the materiality dispute scenario while the other one-half began with the conflict episode involving the disclosure dispute. Additionally, the ordering of the cases in each scenario as well as the order of each of the four variables in each case was determined randomly in each version of the instrument. To determine whether the different orderings caused a response set bias, a variable representing the two orderings was incorporated into the ANOVA model. As indicated by the p-level of this variable in Table V, the ordering of the conflict disputes within the two versions of the research instrument did not materially affect subjects' responses.

Of the ten two-way interactions specified in the combined ANOVA model, Table V reports that only one was found to be significant at the .01 level. Figure III illustrates the interaction of the financial condition and conflict issue variables. When the materiality dispute treatment level of the conflict issue variable was coupled with the healthy status of the financial condition factor, the resulting upward effect on the subjects' responses was more than that which could be ascribed to the independent effects of these two variables. Table VII reports the marginal means of all sixteen cases included in the research instrument. In the four instances where the good financial condition and materiality dispute treatment levels were paired together (cases #1, 2, 5 and 6), the resulting dependent variable means were the largest of the sixteen cases, another indication of the significant interaction of these two independent variables.

The total amount of the variation in the loan officers' responses explained by the ANOVA model was 31.97% as reflected by Table VIII. Certainly, that percentage is modest; however, it is quite comparable to the R^2s of previous ANOVA studies published in the accounting literature. Shockley's overall R^2 in the closely related study involving auditor independence was .28. In the 1977 Hofstedt and Hughes study of materiality, the R^2 was .39. The 1978 ANOVA study by Gustavson and Schultz which investigated the variables affecting actuaries' perceptions of auditor's legal liability had an R^2 of .301.

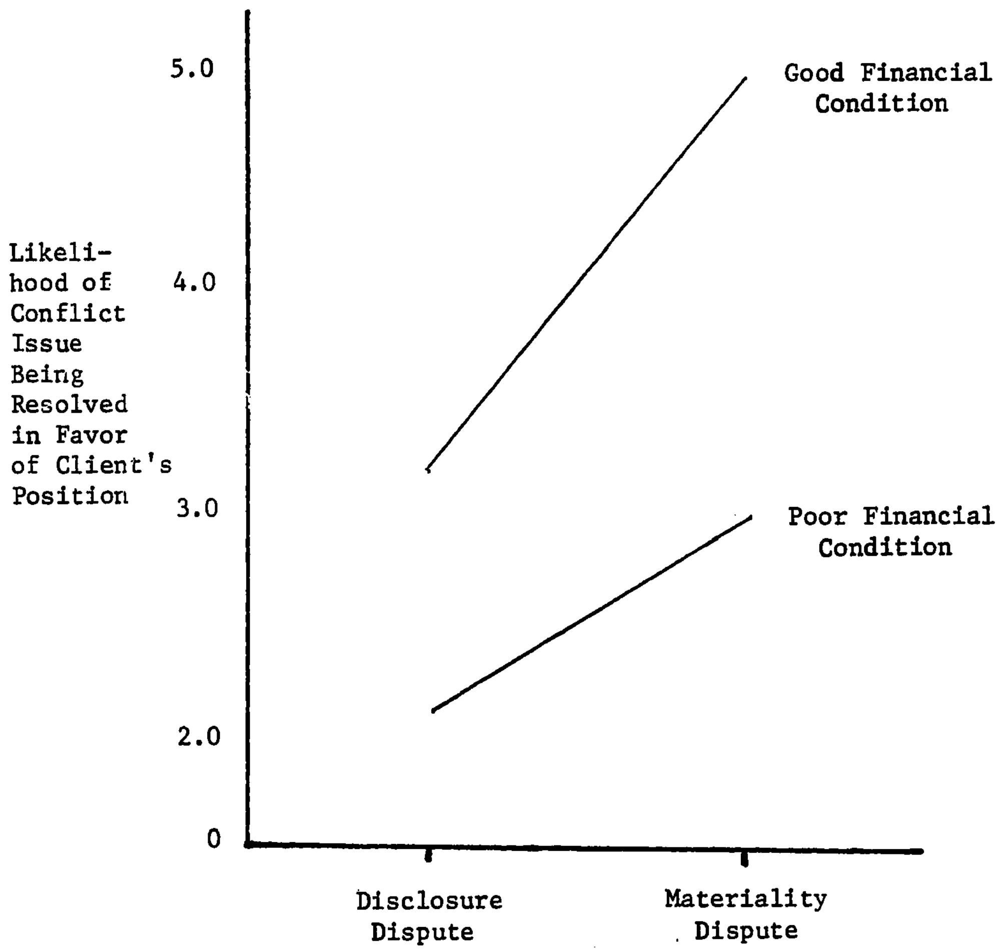

FIGURE III

Significant interaction effect in composite ANOVA model: financial condition-conflict issue.

Case #	Conflict Issue	Competition	Financial Condition	MAS	Mean
1	1*	1	1	1	5.40
2	1	1	1	2	4.70
3	1	1	2	1	3.53
4	1	1	2	2	3.04
5	1	2	1	1	4.91
6	1	2	1	2	4.37
7	1	2	2	1	3.09
8	1	2	2	2	2.28
9	2	1	1	1	3.53
10	2	1	1	2	3.35
11	2	1	2	1	2.49
12	2	1	2	2	2.14
13	2	2	1	1	3.14
14	2	2	1	2	2.84
15	2	2	2	1	2.19
16	2	2	2	2	1.91

TABLE VII

Dependent variable means by case.

* - The table below summarizes the treatment levels of each independent variable.

	Treatment Level	
	1	2
Conflict issue	Materiality dispute	Disclosure dispute
Competition	High	Low
Financial condition	Good	Poor
MAS	40% of audit fee	None

	F	% of Variance Explained	Relative % of Variance Explained
Main Effects			
I Conflict issue	111.01	11.24	35.16
C Competition	14.04	1.42	4.44
F Financial condition	156.18	15.82	49.47
M MAS	15.59	1.58	4.94
O Ordering variable	.51	.05	.16
Interactions			
IC	.40	.04	.13
IF	12.57	1.27	3.97
IM	2.35	.24	.75
IO	.58	.06	.19
CF	.00	.00	.00
CM	.05	.01	.03
CO	.41	.04	.13
FM	.05	.01	.03
FO	.30	.03	.10
MO	1.59	.16	.50
		31.97	100.00

TABLE VIII

Amount of variance explained by each main effect and interaction specified in the composite ANOVA model.

Even in those cases where the R^2 for the combined ANOVA model is relatively small, the variance explained by the individual models can be quite substantial. A good case in point would be the Gustavson and Schultz study which had an overall R^2 of .301. For individual subjects in that study, the variance explained ranged from a minimum of .864 to a maximum of 1.00. This result points to the low level of consensus among subjects as to which independent variables were relevant in their decisions and to disagreements as to how the variables should have been weighted. Later on, we will look at the ANOVA models of individual subjects in this study and compare the results to those of the above studies.

Table VIII reports the amount of variance in the subjects' combined responses which was explained by each main effect and interaction. It is apparent that the most important variable used by loan officers in formulating their judgments was the financial condition variable. That factor accounted for almost one-half of the total explained variation in the subjects' responses. The other variable which explained a large percentage of the variance in loan officers' judgments was the conflict issue factor. Even though the competition and the MAS variables were found to be statistically significant in the composite ANOVA model, they accounted for relatively little of the variance in the subjects' responses.

Analysis of the Individual ANOVA Models. As mentioned above, it can be quite misleading to focus entirely on the combined ANOVA model of a study such as this. Shockley's analysis (p. 796) of his research data indicated that even though the R^2 of a composite model may be quite small, when one looks at the ability of the model to predict the direction of the individual subjects' responses, its utility can be greatly enhanced. In Table IX the number of significant main effects and interactions for the individual ANOVA models is reported. Even though the amount of variance explained in the combined ANOVA model for any one main effect or interaction was quite modest, Table IX shows that for the financial condition and conflict issue variables there was substantial agreement among subjects as to their importance. In almost 89% of the individual models the financial condition variable figures prominently in the subjects' judgments while the corresponding percentage for the conflict issue variable was 79%. Slightly less than one-half of the loan officers believed that the degree of competition in the audit market would be a determining factor in how conflict episodes are resolved. Finally, the relatively modest impact which the MAS variable had in the combined ANOVA model is reaffirmed by the fact that it was found to be significant in just slightly more than one-third of the individual models. One minor anomaly in these results concerns the fact that even though the competition variable accounted for less variance in the composite model, it was a significant factor more frequently in the individual decision models of the subjects. With respect to the

	Number of Significant Effects in Individual Models (n=43)	
Main Effects	.01*	.05*
I Conflict issue	28	6
C Competition	9	12
F Financial condition	31	5
M MAS	7	8
Interactions		
IC	2	5
IF	11	13
IM	5	3
CF	1	5
CM	0	2
FM	0	4

TABLE IX

Number of main effects and interactions reaching significance in the individual ANOVA models.

* - Levels of Significance

interaction effects, only the conflict issue-financial condition factor was an important decision variable in several of the subjects' models.

One note of caution is necessary with regard to the interpretation of the results reported in Table IX. Because a variable was found to be statistically significant in an individual model does not mean that the subject agreed with the directional impact ascribed to that factor by the composite model. For this reason, the individual ANOVA models were analyzed to determine if in fact there were any subjects who disagreed with the directional effects of the independent variables reported in the combined ANOVA model which in all cases agreed with the hypothesized directional effects. Table X shows that only a few of the subjects disagreed with the group judgments and research hypotheses in this regard. Practically all of the disagreement was confined to the conflict issue variable. Four of the subjects who rated that variable as a significant factor believed that the disclosure dispute was a more threatening situation to the auditors' independence than the materiality controversy, a conclusion contrary to the result reported by the composite ANOVA model.

Table XI reports the distribution of R^2 for the individual ANOVA models of the loan officers considering first, only the four main effects and the sole interaction which were found to be significant in the composite model, and in the second case, considering all independent variables and

Hypothesis	Number of Significant* Effects Consistent with Research Hypotheses	Number of Significant* Effects Inconsistent with Research Hypotheses	Total Significant Effects
Conflict issue	30	4	34
Competition	18	1	19
Financial condition	37	1	38
MAS	16	0	16
Total	101	6	107

TABLE X

Number of significant main effects consistent and incontent with research hypotheses.

* - .05 significance level or higher

Amount of Variance Explained	Significant* Main Effects and Interactions only	All Main Effects and Interactions
100%	3	5
95-99	4	22
90-94	8	12
85-89	6	3
80-84	6	0
70-79	8	0
60-69	7	0
0	1	1
Mean R^2	81.3%	93.6%

TABLE XI

Amount of variance explained by individual ANOVA models.

* - .05 significance level or higher

interactions. As reported earlier, the R^2 for the combined ANOVA model is quite modest, however, Table XI illustrates that a subject-by-subject analysis presents somewhat of a different picture. The average amount of variance explained in the individual loan officers' judgments is just slightly less than 94% when all interactions and independent variables are considered while the corresponding figure for just the significant main effects and interaction is still an impressive 81%.

The above R^2s are informative by themselves in that they immediately indicate how effective the respective models were in explaining subjects' decisions. However, much more can be learned by comparing these R^2s to the related figures reported in previous ANOVA studies. Shockley calculated the variance explained for individual subjects by summing the R^2 measures for variables which were significant in the composite model. The percentages of variance explained in his study for Big Eight CPAs, local and regional CPAs, bank loan officers, and financial analysts were 69.6, 56.4, 64.0, and 71.0, respectively (p. 795). In Gustavson and Schultz, all variables were considered in arriving at the R^2s for the individual models. As reported before, these amounts ranged from a low of .868 to a high of unity (p. 635). Finally, Joyce computed variance explained for individual subjects in the same manner as Shockley and arrived at an average R^2 of .78 (p. 47). Obviously, the R^2 amounts for the subjects of this study are at least as impressive as those reported in the previous ANOVA studies. Overall, the relatively high amounts of variance explained by the loan officers' individual models seem to indicate that the contextual variables presented to the subjects in the hypothetical scenarios were very relevant to their decision processes.

Empirical Results and the Research Hypotheses

Research Hypothesis No. 1. In chapter III, four specific research hypotheses were posited with respect to this part of the research. The first hypothesis concerned the degree of competition in the audit market.

> H_1: Financial statement users will perceive that conflict episodes are more likely to be resolved in favor of the client's position when the environment in which the audit firm is operating is characterized by a high rather than a low level of competition.

As shown by Tables V and VI, the competition variable proved to be significant in the predicted direction at a .01 significance level. However, it is important to look not only at statistical significance but also the practical significance of this particular result. Table VIII indicates that less than 1.5% of the total variance in the loan officers' judgments was accounted for by the competition variable. In Table VI the marginal means for the two treatment levels of the competition variable are reported and even though there is a statistically significant difference between these figures, the absolute difference is rather modest. Given all of this evidence it is difficult to make a definitive statement concerning the acceptance or rejection of the initial research hypothesis other than to say that a high degree of competition in an audit context slightly increases the likelihood that loan officers will perceive that conflict episodes will be resolved in favor of the client's wishes.

The relative weakness of the competition variable is rather surprising given the earlier findings of the Shockley study. In the combined ANOVA model for all subjects in that study the degree of competition was found to be a highly significant determinant of perceived auditor independence. In fact, the competition variable explained more variance in the overall model than any other main effect or interaction. With respect to the commercial loan officers of Shockley's study, the level of competition in the hypothetical scenarios was the second most important determinant of perceived independence. In trying to explain the different results of these two studies with respect to this variable one must look at the dependent variable that was being measured in each case. In the previous study, Shockley addressed the impairment of independence problem in a strictly general, unspecified context. Essentially, he was asking his subjects to assess the degree to which each of his independent variables would affect the auditing discipline's ability to retain a profession-wide appearance of independence. On a macro-level, the competition issue is a very relevant variable in determining whether the integrity of the profession's role, vis-a-vis impairment of apparent independence, is being damaged. However, in a very specific context, such as those used in this study, the competition issue is somewhat removed. It is a background variable which is considered by subjects but apparently not weighed heavily in their final decision process.

An important underlying theme of the Cohen Commission's report was that the increasing level of competition in the audit market is exacerbating the impairment of the independence problem with which the auditing profession is faced. The results of this study should not be taken as evidence that the competition variable is no longer relevant to that issue. As Shockley's research has shown, financial statement users do believe that the integrity of the auditor's role is being prejudiced as a result of the increasing competitiveness of the auditor's economic environment. The current study simply shows that when financial statement users are faced with the need to decide in a specific case whether an auditing firm's independence is being impaired, the competition variable is too far removed from the decision context to have any substantial bearing on their final judgments.

<u>Research Hypothesis No. 2</u>. The second research hypothesis related to the longstanding controversy of how the auditor's independence is affected by the simultaneous provision of both auditing and consulting services.

> H_2: Financial statement users will perceive that conflict episodes are more likely to be resolved in favor of the client's position when the audit firm provides

> management advisory services to the client as opposed to providing no such services.

Of course, in order to operationalize the above variable in the research instrument some "significant" level of MAS had to be selected. The level selected was an amount equal to 40% of the annual audit fee, the approximate amount of MAS that Reckers and Stagliano (1981) found was provided to one hundred randomly selected SEC registrants by their auditing firms. As shown by Table V the MAS variable was significant at a .01 level in the composite ANOVA model. Even though the factor was statistically significant, again we have a situation where the practical significance of this result is open to question. The amount of variance in the combined ANOVA model which this factor explained was quite nominal, just slightly more than 1.5%. In approximately one-third of the individual models the MAS variable was found to be either highly significant or moderately significant as reflected in Table IX. As in the previous case, the direction of the MAS variable predicted in the experimental hypothesis was confirmed by the research results. The above evidence seems sufficient to again conclude that the existence of this factor in an audit context slightly increases the likelihood of financial statement users perceiving that conflict disputes will be resolved in favor of the client.

The next issue to address is how well the above finding coincides with the previously accumulated evidence concerning the MAS controversy. In the Shockley study, the MAS variable was significant for the class of commercial loan officers, however, in terms of explanatory power, its impact was essentially trivial as it accounted for less than ½ of 1% of the variance in those subjects' judgments. Accordingly, the results of the current study confirm those of the Shockley study. The amount of MAS provided to clients by their auditing firms is a factor that financial statement users consider in evaluating the latter's independence in both a generic as well as a situation-specific context, but it is not a major factor in that process within either context.

The findings of this study with respect to the MAS variable are both somewhat supportive of the conclusions reached in the recent study by Reckers and Stagliano and, at the same time, somewhat inconsistent. For the sophisticated financial statement user group of Reckers' study the composite confidence level in the ability of an auditing firm to maintain its independence when providing significant MAS to a client was 70%. Surprisingly, almost exactly that same percentage, 65%, of the loan officer subjects in this study did not treat the MAS variable as a significant factor in the hypothetical scenarios. Of course, those two percentages are not directly comparable but they do indicate some degree of consensus in the two subject groups' judgments. The real difference between the results of this study and that of Reckers and Stagliano is not due to a substantial disparity in the empirical findings, rather the difference is due to how the two studies' findings were interpreted. Reckers and Stagliano subjectively concluded that the 70% confidence level of their subjects was sufficient evidence to reject the possibility of an impairment of independence problem occurring when an auditing firm provides substantial MAS to a client. In using the conventional approach to determine statistical significance in an ANOVA design, this researcher arrived at a conclusion somewhat opposed to that of Reckers and Stagliano. So the problem is not to explain a disparity in the empirical results of the two studies, but rather to determine which analytical mode is most appropriate. One reasonable conclusion seems to be that which was arrived at above: the amount of MAS provided is a factor but only a minor one which users employ in evaluating an auditing firm's independence. Later, when the results of the two halves of this research design are compared and contrasted, more insight on this relationship will hopefully be provided.

Research Hypothesis No. 3. Research hypothesis #3 raised the issue of how the relative financial condition of a client impacts financial statement users' perceptions of the likelihood of conflict episodes being resolved in favor of the client's preferred alternative.

H_3: Financial statement users will perceive that conflict episodes are more likely to be resolved in favor of the client's position when the client is in a healthy as opposed to a poor financial condition.

In this particular case, there is no controversy whatsoever concerning whether the hypothesis should be accepted or rejected. All of the following empirical evidence indicates that it should be accepted. 1) Table V shows that in the loan officers' combined ANOVA model this variable was highly significant and the most significant of the main effects and interactions. 2) Table VIII reflects that the financial condition variable accounted for almost one-half of the explained variance in the combined loan officers' ANOVA model. 3) Table VI confirms the predicted direction of this variable's effect and demonstrates a relatively large absolute difference in the marginal means for its two treatment levels. Finally, 4) Table X illustrates that almost 89% of the loan officer subjects considered this variable to be a determining factor in their personal decision models.

In the Gustavson and Schultz study, the financial condition of the client was found to be a key determinant of the magnitude of the risk of legal liability that an auditing firm had to assume. A client in relatively poor financial health significantly increased the likelihood that an auditing firm would be expected to incur legal liability. One can build defensible arguments both supporting the view that a good financial condition would diminish as well as increase the chances of an auditing firm retaining its apparent independence. The loan officers obviously opted for the first argument. In their view, an auditing firm is much more likely to acquiesce to a client's demands in a conflict episode when the client is in a relatively good financial condition. One possible rationale for this position being taken by the loan officers is that they perceive audit firms to consciously weigh the risks of compromising behavior. In the case of a client in solid financial condition, the chances of the auditing firm being asked to account for a questionable decision is so remote that the expected losses from such an action would be trivial. Thus, following this line of reasoning, audit firms would be more likely to capitulate to a client's demands in a conflict episode when the client is sound financially.

This argument is not a new one and is closely related to the economic analysis of the auditor's role presented by DeAngelo (1980). She presumes that there is no such thing as _de facto_ independence since the auditor is strictly an economic creature. In any free choice situation, such as that presented to the auditor in a confrontation with the client, the auditor will simply weigh the marginal revenues of each behavioral alternative against the marginal costs and choose the option that maximizes his economic wealth without regard to professional ethics.

Hopefully, financial statement users do not hold as harsh a view of the auditor as DeAngelo. Nevertheless, the financial condition of the client is one factor in the auditor-client relationship which is very difficult to control for purposes of ensuring the apparent independence of the auditor.

The most appropriate actions to take in this regard seem to be simply the imposition of tough sanctions in those cases where the auditor is shown to have behaved in a compromising manner which is exactly the conclusion to which DeAngelo's argument would eventually bring us.

Research Hypothesis No. 4. The final research hypothesis is centered around the issue which was the focal point of the Goldman and Barlev (1974) article as well as that of Nichols and Price (1976). The issue being: Does the degree of routinism in the auditor's role increase or decrease the auditor's ability to withstand pressure exerted by the client to act in a manner inconsistent with professional standards?

> H_4: Financial statement users will perceive that conflict episodes are more likely to be resolved in favor of the client's position when the issue at the center of the dispute is not precisely treated by technical standards as opposed to the situation where the central issue is dealt with very specifically in the technical standards.

This hypothesis was operationalized by choosing two types of conflict disputes which commonly occur between an auditing firm and its client. The dispute employed in the initial hypothetical scenario involved a disagreement over the materiality of a financial statement adjustment proposed by the auditing firm. Materiality is an attribute of financial data that has been very difficult for the profession to operationally define in the technical standards. Currently, those standards provide only limited guidance to practitioners in determining the materiality of financial statement amounts.

As a result, auditors and their clients often find themselves in disagreements concerning whether a given amount is material, and consequently, must be reported in the financial statements. In the second hypothetical scenario, the conflict issue centered around the disclosure of an event occurring subsequent to the fiscal year-end. In this case the technical standards are very explicit with regard to how such an item should be treated. The client's supposed position in this latter context was obviously contrary to the prescribed dictates of the technical standards.

The empirical results clearly call for the acceptance of this final research hypothesis. Table V shows that the conflict issue variable was the second most highly significant of the four primary independent variables. This factor also accounted for a rather substantial amount of the total explained variation in the subjects' responses as indicated by Table VIII.

Nichols and Price asserted that the primary source of the auditor's power in conflict episodes with the client is the degree of routinism in the audit engagement. Consequently, they argued that by reducing the amount of subjective judgment necessary in the auditor's role, the latter's power in confrontations with the client would be increased. With a more symmetrical balance of power in the audit context, there would be less likelihood of the client attempting to influence the auditor's professional judgment. According to

Goldman and Barlev's analysis, the major source of auditor's power is professional expertise. By reducing the need to exercise his subjective judgment, the primary source of the auditor's power would be diminished.

The empirical results of this study provide some measure of support for the position taken by Nichols and Price. The loan officers perceived a significantly higher likelihood that the client would prevail in the scenario involving the disclosure of the subsequent event. In the latter situation, if the auditor agrees to the alternative preferred by the client, he has taken a position directly contrary to the professional standards, an action which could result in a substantial opportunity cost if it is brought to the attention of regulatory authorities. Apparently, the loan officers concluded that the auditor would be reluctant to incur such a large opportunity cost.

Validity and Reliability of the Research Results

In the last section of Chapter IV, the validity and reliability considerations of this research design were discussed. This section summarizes the actions which were taken in attempts to ensure the reliability and the validity of the research results. Additionally, those tests which were performed to measure the degree to which this research effort captured those characteristics are reported.

A Review of the Internal Validity of the Research Results

Generally, the degree of internal validity that a particular study possesses is subjectively measured by comparing the actions which were taken by the researcher to provide for this attribute to the practices generally employed for that purpose in the researcher's discipline. In this case, the steps which were taken to provide for internal validity were discussed in Chapter IV. These measures included strict uniformity in the manner in which the research instruments of each method were administered. To the greatest extent possible, social desirability bias was eliminated by wording the instruments in a neutral manner. Finally, the two instruments were pre-tested on subjects of the relevant populations.

Degree of External Validity Captured in Research Results

With regard to the external validity of this study, one must first question the representativeness of the subject groups selected from each universe. If the subject groups are not deemed to be representative of the universe from which they were selected, it would be inappropriate to generalize the findings of the study to the other members of the subject population. In this study, the intent was to sample two classes of subjects, financial statement users and partners of large national accounting firms. The latter group is a fairly homogenous and well-defined class and even though the sample of this study was drawn from a rather small subset of that class, i.e., partners engaged in public accounting in the state of Oklahoma, the generalizability of the research results should not be limited to any significant degree. However, in the case of the class of financial statement users, that universe consists of an extremely large and diverse set of individuals. Thus, in order to operationalize the research design, certain homogenous subsets of the universe of financial statement users were identified as possible surrogate classes for the entire population. Of course, the external validity of the study could have been improved by selecting samples from several such subsets, however, time and resource constraints precluded that possibility.

According to a recent pronouncement of the FASB, financial information should be addressed to relatively sophisticated user groups. A readily accessible user group which regularly is faced with complicated financial transactions and reports is commercial loan officers. Consequently, the members of this user group which are employed with Oklahoma banks were chosen as the sampling frame from which to select subjects for this study.

In evaluating the results of the two research techniques, one must keep in mind the bias that may have been introduced into the results solely as a result of the choice of the surrogate class for financial statement users. As indicated earlier in this chapter, the loan officers' reluctance to impose more regulatory structure on the auditor's role may have been a function of the relatively high degree of governmental regulation which they have to deal with on a day-to-day basis in the banking profession. Additionally, one must consider the self-selection process that results in individuals choosing one career role over another. It seems rational to assume that individuals with a deep-rooted belief in a laissez faire economic system would be attracted to the banking profession where a large measure of risk taking and entreprenurial ability is required in order to succeed. If such is the case, then this would explain the general inclination of the loan officer subjects to negatively react to those proposed actions included in the variable set of the initial research method which would impinge upon the economic liberties of auditing firms.

Another self-selection process which could threaten the external validity of any survey study is the individual subjects' decisions of whether or not to participate in the study. It is possible that the research tasks appealed to a certain subset of the original subject sample with a very different biographical and/or psychological profile from the remaining members of the sample. As in most survey studies, the subject samples of the two research methods used in this research design were selected randomly, a practice which increases the likelihood of obtaining a sample representative of the profile of the sampling frame. However, if response bias occurs, the benefits of random sampling are destroyed.

The test used to check for response bias in this study is identical to that employed by Shockley. First, a determination was made of the number of individuals in each subject group that responded to the second requests to participate in the two research techniques. For the initial research technique, thirteen of the partners and nineteen of the loan officers answered the second request letters. For the second research technique, thirteen of the loan officers responded to the second requests. In each of the above cases, an equal number of the earliest respondents was selected from the respective subject groups, thus, three pairings of equal-sized subject groups were formed. For each of these three pairings multiple t-tests were performed to determine if there were statistically significant differences between the two subject groups on any of the data items. The assumption here is that the subjects who responded to the second requests are the best available surrogates for the group of non-respondents. If numerous significant differences exist between the two groups, then the presumption is that some degree of response bias influenced the research results.

Tables XII through XVI summarize the results of the response bias tests. Tables XII and XIII present the response bias test results for the normative criterion rating rask of the first research technique while the following two tables reflect the comparable tests for the positive criterion rating task. The test results for the loan officer subjects participating in the second research technique are reported in Table

First Requests	Second Requests	
2.79	2.53	1. Restricting the amount of management consulting services provided by an auditing firm to audit clients to a maximum of 10% of the total annual audit fee.
1.37	2.11	2. Giving the SEC total responsibility for the external audit function. Auditors of financial statements of publicly-held companies would be government employees much like IRS auditors.
3.79	3.95	3. Requiring that any proposed auditor adjustments not incorporated by the client in its financial statements be disclosed within the footnotes to the statements.
2.74	2.95	4. Prohibition of executive search services by auditing firms.
1.84	2.37	5. Selection of auditors for SEC registrants by the SEC with fee negotiations within guidelines established by the SEC.
3.37	3.00	6. Requiring auditors to report on the preferability of all the client's accounting policies.
3.42	3.21	7. Requiring that the nature and amount of consulting services provided by the auditor to the client be disclosed within the client's financial statements.
3.00	3.00	8. Establishment of an arbitration board to settle disputes between auditors and clients involving financial reporting issues.
2.37	2.42	9. A ban on any form of advertising by auditing firms.
2.79	3.21	10. Requiring the mandatory use of audit committees composed of non-employee and non-management members of the client's board of directors.
3.05	3.47	11. Required disclosure in client financial statements of all major audit-client disagreements occurring in the eighteen months prior to an auditing firm's dismissal.
2.79	2.68	12. Prohibiting an auditing firm from accepting an engagement if the total revenue from the prospective client would be greater than 10% of the auditing firm's total revenues.
2.63	2.68	13. Re-instatement of the AICPA's ethical standard prohibiting client solicitation.
2.95	2.95	14. Requiring that audit fee negotiations be the complete responsibility of the client's audit committee rather than the client's management.
3.74	3.63	15. Mandatory rotation of all audit engagement personnel every three years.
2.84	2.58	16. Annual publication by the SEC of suggested audit fees per hour by staff level, e.g., staff, senior, etc.

TABLE XII

Results of response bias test for loan officers: normative criterion.

Note: No statistically significant differences exist between the above pairs of means at a .05 significance level.

First Requests	Second Requests		
1.18	1.27	1.	Restricting the amount of management consulting services provided by an auditing firm to audit clients to a maximum of 10% of the total annual audit fee.
1.00	1.09	2.	Giving the SEC total responsibility for the external audit function. Auditors of financial statements of publicly-held companies would be government employees much like IRS auditors.
1.45	1.45	3.	Requiring that any proposed auditor adjustments not incorporated by the client in its financial statements be disclosed within the footnotes to the statements.
2.36	2.27	4.	Prohibition of executive search services by auditing firms.
1.00	1.55	5.	Selection of auditors for SEC registrants by the SEC with fee negotiations within guidelines established by the SEC.
1.82	1.91	6.	Requiring auditors to report on the preferability of all the client's accounting policies.
1.55	1.64	7.	Requiring that the nature and amount of consulting services provided by the auditor to the client be disclosed within the client's financial statements.
1.82	1.91	8.	Establishment of an arbitration board to settle disputes between auditors and clients involving financial reporting issues.
2.09	2.18	9.	A ban on any form of advertising by auditing firms.
3.82	3.45	10.	Requiring the mandatory use of audit committees composed of non-employee and non-management members of the client's board of directors.
2.27	1.73	11.	Required disclosure in client financial statements of all major audit-client disagreements occurring in the eighteen months prior to an auditing firm's dismissal.
2.36	1.91	12.	Prohibiting an auditing firm from accepting an engagement if the total revenue from the prospective client would be greater than 10% of the auditing firm's total revenues.
2.91	3.18	13.	Re-instatement of the AICPA's ethical standard prohibiting client solicitation.
2.45	2.18	14.	Requiring that audit fee negotiations be the complete responsibility of the client's audit committee rather than the client's management.
1.82	1.73	15.	Mandatory rotation of all audit engagement personnel every three years.
1.18	1.45	16.	Annual publication by the SEC of suggested audit fees per hour by staff level, e.g., staff, senior, etc.

TABLE XIII

Results of response bias test for partners: normative criterion.

Note: No statistically significant differences exist between the above pairs of means at a .05 significance level.

First Requests	Second Requests		
2.00	2.26	1.	Restricting the amount of management consulting services provided by an auditing firm to audit clients to a maximum of 10% of the total annual audit fee.
1.79	2.00	2.	Giving the SEC total responsibility for the external audit function. Auditors of financial statements of publicly-held companies would be government employees much like IRS auditors.
3.16	3.79*	3.	Requiring that any proposed auditor adjustments not incorporated by the client in its financial statements be disclosed within the footnotes to the statements.
2.26	2.00	4.	Prohibition of executive search services by auditing firms.
2.63	2.32	5.	Selection of auditors for SEC registrants by the SEC with fee negotiations within guidelines established by the SEC.
3.00	3.00	6.	Requiring auditors to report on the preferability of all the client's accounting policies.
2.79	2.42	7.	Requiring that the nature and amount of consulting services provided by the auditor to the client be disclosed within the client's financial statements.
2.68	2.84	8.	Establishment of an arbitration board to settle disputes between auditors and clients involving financial reporting issues.
1.68	1.84	9.	A ban on any form of advertising by auditing firms.
3.11	2.79	10.	Requiring the mandatory use of audit committees composed of non-employee and non-management members of the client's board of directors.
2.84	3.42	11.	Required disclosure in client financial statements of all major audit-client disagreements occurring in the eighteen months prior to an auditing firm's dismissal.
2.47	2.74	12.	Prohibiting an auditing firm from accepting an engagement if the total revenue from the prospective client would be greater than 10% of the auditing firm's total revenues.
2.11	2.84	13.	Re-instatement of the AICPA's ethical standard prohibiting client solicitation.
2.37	2.53	14.	Requiring that audit fee negotiations be the complete responsibility of the client's audit committee rather than the client's management.
3.42	3.26	15.	Mandatory rotation of all audit engagement personnel every three years.
1.95	2.11	16.	Annual publication by the SEC of suggested audit fees per hour by staff level, e.g., staff, senior, etc.

TABLE XIV

Results of response bias test for loan officers: positive criterion.

* - .05 significance level

First Requests	Second Requests		
1.18	1.27	1.	Restricting the amount of management consulting services provided by an auditing firm to audit clients to a maximum of 10% of the total annual audit fee.
2.73	2.36	2.	Giving the SEC total responsibility for the external audit function. Auditors of financial statements of publicly-held companies would be government employees much like IRS auditors.
1.27	1.82	3.	Requiring that any proposed auditor adjustments not incorporated by the client in its financial statements be disclosed within the footnotes to the statements.
1.91	2.27	4.	Prohibition of executive search services by auditing firms.
1.64	1.64	5.	Selection of auditors for SEC registrants by the SEC with fee negotiations within guidelines established by the SEC.
1.82	1.91	6.	Requiring auditors to report on the preferability of all the client's accounting policies.
1.27	1.36	7.	Requiring that the nature and amount of consulting services provided by the auditor to the client be disclosed within the client's financial statements.
1.45	2.09	8.	Establishment of an arbitration board to settle disputes between auditors and clients involving financial reporting issues.
1.09	1.36	9.	A ban on any form of advertising by auditing firms.
3.18	3.64	10.	Requiring the mandatory use of audit committees composed of non-employee and non-management members of the client's board of directors.
1.91	1.82	11.	Required disclosure in client financial statements of all major audit-client disagreements occurring in the eighteen months prior to an auditing firm's dismissal.
2.55	2.45	12.	Prohibiting an auditing firm from accepting an engagement if the total revenue from the prospective client would be greater than 10% of the auditing firm's total revenues.
1.55	1.91	13.	Re-instatement of the AICPA's ethical standard prohibiting client solicitation.
2.45	2.54	14.	Requiring that audit fee negotiations be the complete responsibility of the client's audit committee rather than the client's management.
2.27	2.45	15.	Mandatory rotation of all audit engagement personnel every three years.
1.00	1.45*	16.	Annual publication by the SEC of suggested audit fees per hour by staff level, e.g., staff, senior, etc.

TABLE XV

Results of response bias test for partners: positive criterion.

* - .05 significance level

Case*	First Requests	Second Requests
1	5.43	4.71
2	4.57	4.43
3	3.21	3.36
4	2.64	2.79
5	4.43	4.36
6	4.07	4.14
7	2.57	2.71
8	2.14	2.07
9	4.07	3.00
10	3.57	2.86
11	2.86	2.14
12	2.43	1.86
13	3.43	2.64
14	3.00	2.50
15	2.50	1.93
16	2.00	1.79

TABLE XVI

Results of the response bias test for the second research technique.

* - See Table VII for the combinations of treatment levels included in each case.

Note: No statistically significant differences exist between the above pairs of means at a .05 level.

XVI. There obviously is no evidence of response bias influencing the results of the normative criterion rating task. Tables XII and XIII indicate that there were no significant differences between the two subject groups on any of the thirty-two data items. In Tables XIV and XV there were two data items on which significant differences were found to exist between the first and second request groups. Since sixty-four paired comparisons were made in testing for response bias in the first research method, the finding of two significant differences at a .05 level does not seem unlikely. The larger the number of comparisons made, the more likely it is that significant differences will be found in a few cases. Given these results, it seems safe to conclude that the amount of response bias which influenced the results of the two rating tasks was minimal.

With respect to the second research method, Table XVI reports the sixteen paired comparisons which were made to test for response bias. There is no evidence of response bias since there were no statistically significant differences at the .05 level.

Measures of the Reliability of Research Results

As noted in Chapter IV, there are several available methods for analyzing the degree of interrater reliability in an ANOVA design. Again, since the second half of the study employed a research design very similar to that of Shockley's, his approach to evaluating this attribute was used. Essentially, interrater reliability is a measure of the degree of consensus between subjects concerning the relative importance of the independent variables incorporated in the research design. A low degree of consensus leads one to question whether the predictor variables provided to subjects to assess the criterion variable were highly relevant for that purpose. The first step in analyzing the degree of consensus among subjects in an ANOVA design is to calculate the R^2. This statistic simply reports the total percentage of the variation in subjects' responses which was accounted for by the composite ANOVA model. Generally, the level of R^2 is quite modest, a result which does not reflect positively on the degree of consensus among subjects. In this study the R^2 was 31.97%, while Shockley achieved an R^2 of 28.0%. However, for several reasons it can be misleading to concentrate entirely upon the composite model's R^2 in assessing the degree of consensus among subjects.

Shockley noted that the primary reason for the substantial loss of explanatory power when shifting from an analysis of the individual ANOVA models to that of the combined model is the averaging across individuals inherent in the latter case. This averaging process results in substantial losses of explanatory power due to individual differences among subjects. These differences are generally attributable to three factors: 1) differences among subjects in the variables considered important, 2) differences in the weights ascribed the variables, and 3) differences in the perceived direction of the variables' effect. The most damaging of these possibilities is the latter one (Shockley, p. 795). If the subjects did not agree to any great extent on the directional effect of the independent variables, then any further analysis would be essentially meaningless. In this study there is little evidence of any significant disagreement among subjects in this regard. Table X shows that in only a few cases did individual subjects use independent variables in a direction opposed to that suggested by the composite model. Thus, the primary reasons for the loss of explanatory power when analyzing the combined ANOVA model of this study were disagreements among subjects as to which variables were important and disagreements concerning the relative importance of these same variables.

In order to gauge the severity of the first of the above two possibilities, the average R^2 for each individual subject's model was computed considering only those main effects and interactions which were found to be significant in the composite ANOVA model. Table XI reports the distribution of these R^2s and the mean which was 81%. The comparable means for the four subject classes of Shockley's study ranged from 59.4% to 71.0%. Since over 80% of the variance in subjects' responses was explained by the significant factors in the combined model, it seems apparent that there was considerable consensus among subjects as to the importance of those variables. Accordingly, the lack of consensus in the composite model appears to be attributable to differences in how the subjects weighted the individual significant variables, a conclusion which is not as negative a reflection on the judgment consensus of subjects as would be the two other possibilities mentioned by Shockley.

The other dimension of reliability which was measured in this study was test-retest reliability. The primary motivation for evaluating this characteristic of a behavioral study is to determine the degree of conscientiousness with which subjects approached the research tasks. Of course, in order to measure this attribute the researcher must obtain two sets of responses from a group of research subjects. In the initial research technique, twenty-seven of the ninety-two respondents indicated a desire to receive a synopsis of the research results. Given these subjects' interest in the study, it was concluded that they would likely be more willing to complete the research instrument a second time than would the other respondents. Accordingly, each of these individuals was mailed an identical version of the instrument approximately two months after the initial requests were mailed. Eleven responses were received from this one mailing. Nine of these respondents completed the instrument as instructed while the other two subjects simply returned it uncompleted and stated that their responses would not change. For each of the nine respondents who completed the instrument a second time, the correlation between their two sets of responses was calculated. For the total group the correlation was .78 while the correlations for the individuals were .33, .46, .56, .65, .76, .77, .83, .99, and 1.00. The above figures compare favorably with those reported in the ANOVA studies by Ashton (1974) and Joyce (1976). In Ashton's study the mean correlation for the test-retest procedure was .81 with a range from .43 to .96 while Joyce had a mean of .86 with a range from .085 to 1.00.

The above approach was also used to determine the degree of test-retest reliability in the second research technique. Of the forty-three respondents to the instrument used in that task, seventeen individuals indicated a desire to receive a synopsis of the research results. Each of these subjects was asked to complete the instrument a second time. Six responses were received from one mailing. The mean correlation between these subjects' responses as a group was .83. On an individual basis, the correlations were .75, .82, .91, .96, .97, and 1.00. Again, these results are very consistent with those of the Ashton and Joyce studies.

There remain certain cautions which should be taken in interpreting the above results. First, it seems somewhat suspicious to have a subject with complete judgment stability over time. It is quite possible, if not likely, that the two subjects in this study whose two vectors of responses correlated exactly may have kept a copy of their original instrument and simply filled in their original responses on the second instrument. Second, the manner in which the subjects were selected may have influenced the results of this latter test. The subjects who asked to receive a synopsis of the research conclusions may have been more likely to conscientiously complete the instruments in the first case, a fact which may have inflated the above judgment stability statistics somewhat.

CHAPTER VI

CONCLUSIONS AND RECOMMENDATIONS FOR FUTURE RESEARCH

The overriding objective of this study has been to obtain a broader and more in-depth understanding of the phenomenon of perceived auditor independence. The primary means employed toward this end was an empirical research design consisting of two research techniques. The first part of this study was designed to clarify many of the contradictory results of previous studies of perceived independence. Two samples of subjects, commercial loan officers and partners of national accounting firms, were asked to evaluate sixteen actions which have been proposed in recent years to promote the perceived independence of external auditors. The subjects were instructed to rate the items in two independent tasks, the first involving a non-normative or positive rating criterion while the second required the subjects to use a normative criterion. In the first case, the subjects were asked to evaluate the actions on the basis of the degree to which each would, if adopted, strengthen auditor independence. The normative rating task essentially required the subjects to express how strongly they were in favor (or disfavor) of each action's adoption.

Another problem noted during the review of the relevant literature was that auditor independence has not been studied in a context-specific manner. The potential for impairment of auditor independence arises in very specific situations and it seems that interesting insights could be obtained by examining such situations rather than simply studying the phenomenon in a non-contextual manner. One such situation in which the auditor's independence is threatened is within conflict episodes with the client.

A research task was designed and carried out to determine the extent to which loan officers believe that auditors' professional judgment may be compromised in conflict episodes and also to determine which factors in the audit context make it more or less likely that such a situation will result. Based upon a review of the professional literature, the following four features of the audit context were selected for this latter purpose: the relative degree of competition in the audit market, whether or not a substantial amount of consulting services was provided by the auditing firm to the client, the relative financial condition of the client, and the degree of subjectivity required to interpret the focal issue of the controversy.

The results of both research techniques shed considerable light on many of the unresolved issues surrounding the auditor independence construct. However, in interpreting the results one must keep in mind the particular biases that each subject class may have brought with them to the experimental context. For example, partners' responses may have been influenced by a motivation to retain the status quo. It seems likely that the partners would not want to see the adoption of additional rules and technical guidelines which would, in most cases, complicate their professional roles. On the other hand, it is important to realize that the loan officers may also have prejudices and predispositions which influenced their responses. Accordingly, the results of this study should not be generalized to groups other than those represented in this research design.

Review of the Results of Research Technique No. 1

In Chapter III, three specific research questions were raised with regard to the first section of this research project:

1. Which structural changes in the auditor's role do relevant parties consider the most significant determinants of perceived auditor independence?

2. Which structural changes in the auditor's role do relevant parties believe should be adopted?

3. How much consensus exists between an important financial statement user group and partners of national accounting firms on the issues raised in the two previous research questions?

Turning to the third research question, the empirical results tend to indicate a substantial amount of disparity between the two groups. In each of the ratings tasks the pattern of dissimilarity between the partners and loan officers' ratings was easily discernible. The audit partners were much more skeptical of the ability of the proposed actions to 'legislate' auditor independence and, as a result, were much less likely to suggest that the recommended actions be adopted. One exception to this generalization was with respect to the use of audit committees. The partners were rather positive about the required use of such committees in an audit context on both of the evaluative criteria. In fact, on the normative criterion, this alternative was the only one which the partners as a whole believed should be adopted.

In both rating tasks, the largest difference between the two groups was reflected on the item calling for the disclosure in the financial statements of auditor-proposed adjustments not accepted by the client. The loan officers believed that such an action would promote the auditor's independence and were rather firm in advocating the adoption of this policy alternative. On the other hand, the partners were adamant in expressing their disfavor with this action on the normative criterion and gave it a very low rating on its ability to strengthen auditor independence.

The general inability of the partners and loan officers to agree on which actions should be taken to promote auditor independence is not a positive reflection upon the financial reporting process or the auditing discipline. It seems that the stature of the auditing profession could be enhanced if the opinions of user groups were given more consideration in the standard-setting processes. Additionally, such a move would be a first step in satisfying many of the concerns expressed in recent years by critics of the profession.

With respect to the first two research questions, the results of this study for the first time present a rather comprehensive picture of financial statement users' views on how auditor independence could be strengthened and what actions should be taken to achieve this end. Fortunately, there appeared to be a substantial amount of agreement on the ratings of the sixteen actions by the loan officers when employing the two different evaluative criteria. The items which were rated as being highly likely of improving the auditor's ability to remain independent were also generally ranked high on the normative criterion of whether or not the loan officers wanted to see the action adopted.

Of the six items that the loan officers would like to see implemented, four would simply require more or new disclosures concerning the auditor-client relationship. Only two of the six actions would actually require an explicit change in how the audit engagement is performed. Loan officers would require that audit engagement personnel be rotated every three years and would also like to see the mandatory use of audit committees composed of non-employee and non-management members of the client's board of directors.

In reviewing those policies which the loan officers rejected it is quite easy to discern two apparent trends. First, the loan officers tended to be very negative with regard to those proposed actions which would require the further encroachment of governmental regulatory bodies into the affairs of the accounting and auditing profession. Second, the loan officers were very hesitant to call for the adoption of any policy which would infringe on the economic liberty of auditing firms.

Overall, the results of the first research technique are quite reassuring. If one assumes that commercial loan officers are fairly representative of the universe of financial statement users, then it seems obvious that no really drastic measures are necessary in order to improve the appearance of independence of external auditors. In fact, the most appropriate policy to follow in this regard is already being embraced by the SEC. For many years that body has espoused the policy of full and fair disclosure in the financial reporting process. The loan officers do not believe it is necessary to totally restructure the auditor's role in order to provide the latter with a more pressure-free environment in which to carry out the attestation function. The loan officers are, in several cases, willing to forego actions which they believe would strengthen the auditor's independence in order to keep from infringing on his economic liberties. What these individuals do demand is that they be kept informed of all facets of the auditor-client relationship. Given this information, they can decide for themselves when the auditor's independence appears to be endangered.

Review of the Results of Research Technique No. 2

The loan officer subjects of the second research technique provided many interesting insights concerning auditor-client conflict. The two features of the audit context which these individuals thought substantially increased the likelihood of such conflict episodes being resolved in favor of the client were the relative financial condition of the client and the degree of subjectivity required to interpret the focal issue of the controversy. The loan officers perceived that the client in a healthy financial condition has a moderately better chance of prevailing in a dispute than a client in relatively poor financial condition. With respect to the other important determinant of these situations, the subjects believed that the auditing firm was more likely to defer to the client's wishes in the materiality rather than the subsequent event controversy.

The primary difference between the conflict episodes presented to the subjects was the degree of subjectivity which was required in each to interpret the basic source of the dispute. Concerning the situation involving the subsequent event, the technical standards explicitly require that such an item be disclosed in the financial statements of the reporting entity. Thus, in that conflict episode, the hypothetical client was essentially asking the auditing firm to agree with a position contrary to the dictates of reporting and accounting guidelines. The subjects did not perceive that the client would be likely to induce the auditing firm to agree with such an untenable position. In the other scenario, the technical standards provided very little in the way of guidance to resolve the issue at the heart of that controversy. The loan officer subjects of this study generally believed that the client in this latter case would be more successful in eventually obtaining the auditing firm's approval of their preferred alternative, i.e., rejection of the proposed adjustment for unrecorded liabilities on the grounds that the amount was immaterial.

The important issue to face now is how to deal with the above two variables in the audit context in order to decrease the likelihood that auditing firms will be pressured to submit to the demands of their clients in conflict episodes. The financial condition of the client is a variable which is not subject to a large degree of control by regulatory authorities. Rather than attempting to control this variable, a surrogate measure would be to follow De Angelo's (1980) argument and impose strict sanctions against auditing firms which subjugate their professional judgment to the wishes of their clients. With respect to the second issue, the profession should make an effort to develop more objective criteria for determining the materiality of financial statement amounts. This recommendation applies not only to this issue, but to the technical standards of the profession in general.

Nichols and Price argued that this latter move would bring about a more symmetrical distribution of power in the auditor-client relationship. With more objective specification of technical standards, auditors would not be required to use as much subjective judgment in carrying out the audit function. Naturally, this would decrease the frequency of disagreements arising between auditing firms and their clients. The position taken by Goldman and Barlev was that by reducing the degree of subjective judgment which the auditor must employ in carrying out the audit function, the power base of the auditor would be diminished. The degree of expertise in the auditor's role is the primary source of his power, according to these researchers, and thus, specifically defining auditing and accounting principles would essentially reduce the auditor's function to that of a mechanic.

Certainly, these two sets of researchers' positions are not necessarily mutually exclusive. Each position is probably at least partially valid. Nichols and Price's suggestion would increase the degree of legitimate power which the auditor could exercise in the audit context but, at the same time, it would tend to reduce the degree of professionalism within the auditor's role. Goldman and Barlev's recommendation would likely increase the status of the auditor as a professional possessing an in-depth knowledge of financial issues. However, the ability of the auditor to exercise his professional role would be further constrained by the increased pressure exerted by management to interpret specific financial reporting issues in such a way as to show their company in a more favorable light. Regardless of which of the above two positions is considered the most valid, if implemented, each would benefit greatly by the imposition of strict sanctions against auditing firms for failing to follow prescribed technical standards and against the management of reporting entities for attempting to influence their auditors' professional behavior.

With respect to the second part of this study, the recommendations that have been suggested are obviously very general in nature. It seems that prior to taking specific action with regard to the points which have been raised above the profession first needs to determine exactly what role it wants to serve in the financial reporting process. Do auditing firms want their employees to be perceived as highly trained professionals who have a thorough understanding of complicated financial accounting and reporting standards, or would they rather define the auditor's role as narrowly as possible?

Certainly, this latter alternative is not an appealing one and it does not seem that members of the auditing discipline would consciously choose such a course. However, many of the decisions which have been made in recent years seem to point the profession along that route. Just recently a proposed reporting standard which would have entirely revamped the auditor's reporting responsibilities was rejected by the Auditing Standards Board.[7] That standard would have required auditors to report on their clients' financial condition and results of operations in much more detail. The uniform auditors' report would have been abandoned and in its place auditing firms would have had the responsibility of designing a unique reporting format for each of their clients. Some auditing firms may have been fearful that the adoption of this new standard would substantially increase the risk of legal liability being imposed against them. As Mautz and Sharaf (1961) warned, moves such as this to limit the auditor's professional responsibilities may ultimately result in the auditor relinquishing his function to other professional roles.

Research Techniques No. 1 and 2: Correlating the Results

The two halves of this research project were oriented around the central theme of the need to strengthen financial statement users' perceptions of auditor independence. Although the approaches taken in each case were quite dissimilar,

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[7]See D.R. Carmichael, "Late Developments - ASB opts to keep current auditor's report," Journal of Accountancy, April, 1981, p. 3.

the results yielded can still be profitably compared and contrasted. Hopefully, some degree of synergism was obtained as a result of employing this two-dimensional design.

Many of the sixteen policy alternatives used in the two rating tasks of the first research technique related directly or indirectly to the degree of competition in the audit markets, one of the four primary independent variables of the second research technique. The results of the rating tasks clearly illustrated that the loan officer subjects were very hesitant to call for the adoption of any policy action which would limit auditing firms' right to freely compete in the marketplace. Such was the case even though the bankers believed that the implementation of certain of these competition-related actions would modestly increase the ability of auditors to retain their apparent independence. In the second part of the research the empirical data demonstrated that the level of competition was a factor, albeit a relatively weak one, in loan officer's judgments concerning the outcomes of auditor-client conflict episodes. The subjects expressed their beliefs that the high degree of competitiveness in audit markets makes it less likely that an auditing firm will appear to be independent or would be expected to act in a professionally autonomous manner, but that does not imply that they would necessarily deny the auditor the right to compete.

The second variable incorporated in the hypothetical scenarios concerned the amount of consulting services provided by the auditing firm to its client. The MAS factor was found to be a significant variable in the loan officers' decisions even though, as in the case of the competition variable, it accounted for only a small amount of the explained variation in those decisions. In the rating tasks it was found that the loan officers leaned more toward the disclosure of MAS activities rather than toward prohibiting or restricting these ancillary services of auditing firms. As in the case of the competition-related actions, the subjects expressed their views that limiting the right of auditing firms to provide MAS would most likely strengthen auditor independence, however, when it came to normatively supporting such measures the subjects were not at all favorably predisposed. Apparently, financial statement users simply want to be informed of the amount of MAS being provided by auditing firms to their clients. As long as this information is available, user groups can employ their own judgment, not to determine whether such activities impair independence; the empirical data seems to have established that fact. Rather, user groups can employ such information to determine the degree to which independence has been impaired, and finally, to decide whether actions should be taken to remedy the situation.

The action which the loan officers wanted implemented more than any other according to the ANOVA design was the mandatory financial statement disclosure of adjustments proposed by the auditing firm but not accepted by the client.

Such a high degree of subjective judgment is required in many financial reporting decisions that substantial differences of opinion can occur between auditors and their clients in the process of preparing financial statements. In most such situations the client has a vested interest in the reporting alternative which would present its financial condition in the best possible light to the public, and consequently, the auditor may be subjected to lobbying attempts by the client to influence his professional behavior. In the loan officers' evaluation of the hypothetical scenarios they were quite skeptical of the ability of the auditor to withstand such pressure in the conflict episode involving the materiality dispute. The key issue in that particular dispute was the necessity of the client incorporating in its financial statements an adjustment for an amount of unrecorded liabilities discovered by the auditing firm in its year-end examination. There is a two-step remedy for overcoming the problem of clients exerting pressure on their auditors to overlook such proposed adjustments. First, would be the adoption of the alternative highly regarded by the loan officers in the rating tasks, i.e., requiring that all 'passed' adjustments be disclosed in the financial statements. The second measure would be to implement and enforce harsh sanctions against auditing firms not complying with the rules of professional conduct.

Another result of the first research technique which is interesting in relation to the second research technique concerns the disclosure of major disagreements occurring in the eighteen months prior to an auditing firm's dismissal. That action was rated third most highly by the loan officers on the positive rating criterion and fourth highest on the normative criterion. These results indicate that the issue of auditor-client conflict is an important one to financial statement users, a result which provides a higher level of validity for the second half of the research design. The loan officer subjects also expressed a desire for the auditor to report on the preferability of the client's accounting policies. If such disclosures were mandated, then a major source of auditor-client conflict would more than likely be eliminated. Clients would likely be averse to having the fact disclosed that they are not using the most preferable accounting policies, and thus, would have an incentive to adopt such policies.

Recommendations for Future Research

As in most cases, this study raised just as many questions as it resolved and suggests a number of areas for future researchers to explore. One of the most obvious ways in which this study could be extended would be to obtain the views of other financial statement user groups on the issues addressed in this study. As emphasized several times, the other major user groups may not necessarily share the opinions expressed by the commercial loan officers who participated in this research project.

Another very meaningful question to examine in this research context is exactly how promulgatory bodies establish a set of policy guidelines with respect to such global issues in the accounting and auditing disciplines as independence, materiality, etc. One of the presumptions of this study was that the partners of national accounting firms have a disproportionate influence in the standard-setting processes. That presumption or accusation has been made by several individuals and organizations but its veracity should be thoroughly researched before it is accepted. The manner in which rules and policies are supposed to be formulated is quite specifically defined by the quasi-legal and legal promulgatory bodies within the profession, however, are the rules and policies actually established in the prescribed manner? Are there powerful lobbying forces operating within the above processes, and if so, are they successful in having their demands satisfied? For instance, it seems quite surprising that the proposed reporting standard referred to previously was not adopted since there seemed to be a large ground swell of support for it in the financial community. If this was in fact the case, then the utilitarian philosophy that supposedly prevails in the standard-setting processes should have resulted in that standard's adoption. It seems imperative that all of the idiosyncracies of the promulgatory processes be identified. Once a firm understanding of all aspects of such has been obtained, then suggestions for changing the system in order to make it more responsive to the needs of user groups can be made.

Another general recommendation for future research with respect to auditor independence is the utilization of qualitative research methodologies to investigate the critical factors which can lead to auditors losing their impartiality and objectivity. The use of qualitative research techniques such as case studies, participant observation, and personal interviews is widely accepted and esteemed in most behavioral disciplines. However, such procedures are not highly regarded by accounting and auditing researchers. Especially in the case of auditing, qualitative methods would seem to be very promising tools to employ since a number of the most important problems in this discipline are behavioral in nature. For instance, a case study approach should yield interesting insights concerning the impairment of auditor independence which would not be available from employing the more conventional research methods. There have been only a very limited number of 'audit failures' in the last few decades. In many of these instances, a contributing factor has been a lack of impartiality on the part of the auditing firm. By using a case study approach to investigate these isolated incidents, it is possible that certain variables or environmental conditions would be identified which were common to each situation. Of course, this type of information would be invaluable to policy makers charged with developing a framework of guidelines to promote the independence of external auditors.

The above recommendations are obviously very general in nature, however, there are other specific research issues and questions which the results of this research suggest. The focus of the first research technique was primarily upon the response of loan officer subjects, however, the analysis of the partners' responses pointed out several interesting avenues of research. For instance, the loan officers were heavily in favor of the disclosure of 'passed' adjustments in client financial statements while the audit partners were strongly against such a proposal. One has to speculate as to why the partners held such a view. Is it because they do not want user groups to perceive that audit firms are being coerced into overlooking deficiencies or errors in financial statements? Or, conversely, do the audit partners feel that such disclosures would simply confuse rather than enlighten financial statement readers?

Another interesting issue to examine is exactly why audit partners are opposed to reporting on the preferability of their client's accounting policies. The loan officers were in favor of this action's adoption more than likely because financial statement readers would benefit from having an objective assessment of the preferability of firms' accounting policies disclosed. Such a move would also appear to benefit auditing firms by extending their role in the financial reporting process, and thus, enhancing their stature in the financial community.

Both subject groups were in favor of the mandatory use of audit committees, however, there has been only a very limited amount of empirical research concerning the effectiveness of such committees to date. In the context of the second part of this research, it would be interesting to explore how the use of an audit committee impacts the balance of power in the audit dyad. Does the existence of an audit committee reduce the frequency and volatility of auditor-client conflict? A natural source of data to be used in resolving this question would be members of corporate audit committees. In a related vein, Mautz and Neary (1979) implied that the effectiveness of such committees may be diminishing with the increased workload being imposed upon their members. Can that presumption be supported empirically, and if so, what are the implications for auditors' independence?

One of the advantages of studying the independence construct is the large number of research issues it provides. This feature of the auditor's role has direct or indirect implications to a wide range of contexts including such areas as the planning of the audit, the interpretation of audit results, and the reporting of these results to the investing and lending public. As long as the auditor's role survives, it appears there will be no dearth of independence and independence-related issues to investigate.

To paraphrase Professor Stamp (1978), an auditor who is no longer independent is no longer an auditor. The importance of independence is so pervasive as to be the one characteristic of the auditor's role which is essential to his being able to retain his integral function in the financial reporting process. In recent years the confidence of financial statement users in the integrity of the auditor's professional role has been shaken considerably. This research has examined a number of the issues contributing to the controversy surrounding the auditor's current problems. Possibly, this study's results will provide some measure of input to the resolution of these problems. At the very least, it is hoped that these findings spur regulatory bodies to expand their efforts to find the necessary corrective actions in order to assure that the auditor will maintain his important position in the financial reporting process.

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APPENDIX I

LITERATURE REFERENCES FOR ITEMS

INCLUDED IN TABLE I

1. Restriction on the amount of MAS which auditing firms can provide. The MAS controversy has been discussed very widely in the professional literature. A few of the more prominent works in recent years which have addressed this issue are Shockley (1981), Firth (1981), and Milano (1979).

2. Giving the SEC total responsibility for the external audit function. This alternative was discussed by Dykxhoorn and Sinning (1981, p. 174). Chenok (1978) alluded to this possibility but did not endorse its adoption.

3. Disclosure of auditor-proposed adjustments not accepted by the client. No evidence could be found in the professional literature to support this action; however, intuitively, it seems that such a requirement would most likely have at least a modest positive impact on the perceived independence of auditors. If auditors know that 'passed adjustments' which they have approved will come under the scrutiny of financial statement readers, management pressure to disregard such may not be as effective as it would be otherwise.

4. Prohibition of executive search services by auditing firms. The Cohen Commission (1978, p. 174) recommended stringent restrictions on the scope of executive search services provided by auditing firms. The Commission argued that such a move would strengthen third parties' perceptions of auditor independence.

5. Selection of auditing firms for SEC registrants by the SEC with fee negotiations within guidelines established by the SEC. Dykxhoorn and Sinning in their overview of auditor independence in the West German economy mentioned that certain parties in that country had discussed the possibility of establishing an 'SEC-type' agency which would have the additional responsibility of assigning auditors to firms and/or paying the audit fees directly to the audit firms.

6. Requiring that auditing firms report on the preferability of their clients' accounting policies. A few years ago, a significant controversy over this issue arose in the financial community. The Cohen Commission expressed its view that auditors should evaluate the accounting principles employed by clients and make a determination of whether they are preferable to other alternatives available (p. 20). SEC Commissioner Williams endorsed that position (1977, p. 44) but the AICPA has largely ignored the issue.

7. Disclosure of the nature and amount of auditor-provided MAS in the client's financial statements. Reckers and Stagliano (1981) carried out an empirical study related to this requirement which was established by ASR #250. These researchers concluded that financial statement users' confidence in the auditor's ability to remain independent was not greatly affected by the ASR #250 disclosures, however, their empirical data did not totally support this conclusion.

8. Establishment of an arbitration board to settle auditor client disputes. Berryman (1974, p. 13) did not direct call for such a board, but he did speculate about the need to consider an institutionalized procedure for periodically reviewing auditors' professional behavior.

9. A ban on advertising by auditing firms. Advertising is another topic that has been very widely discussed in th professional literature relative to auditor independenc The Cohen Commission briefly alluded to the relationshi between advertising and independence (p. 109-110).

10. Required use of audit committees. Milano's study found that the use of audit committees tended to increase the level of auditors' perceived independence. Several other parties including Mautz and Neary (1979), Wolnize (1980), and Neumann (1981) have discussed the relative merits of audit committees.

11. Required financial statement disclosure of all major auditor-client disagreements occurring in the eighteen months prior to an auditing firm's dismissal. In 1974 the SEC issued a requirement that registrants changing audit firms had to file an 8-k report informing the public of such, and disclosing any disagreements over auditing or accounting issues between them and their auditors in the preceding eighteen months. ASR #247 issued in 1978 went a step further by requiring that the registrant disclose whether the change in auditors was approved by the audit committee and board of directors. Fried and Schiff (1981) found that such disclosures had only a minimal impact on stock market prices of firms filing such 8-ks.

12. Prohibiting auditing firms from accepting an engagement if the total revenue from the prospective client would be greater than 10% of the auditing firm's total annual revenues. Shockley found that small auditing firms fac a higher risk of having their professional independence jeopardized than do large firms. This proposed alterna tive is one way in which Shockley's finding could be operationalized in the form of an ethical or government regulation.

13. Re-instatement of the AICPA's ban on client solicitation. This action is one alternative that could be used to offset the excessive level of competition that the Cohen Commission feels is threatening auditors' perceived independence.

14. Requiring that audit fee negotiations be the complete responsibility of the client's audit committee. Milano found that, generally, relevant parties in the financial reporting process feel this move would improve auditors' perceived independence.

15. Mandatory rotation of all audit engagement personnel every three years. This is one of the more widely discussed policies for strengthening auditing firms' independence. See Shockley and Dawkins (1978).

16. Annual publication by the SEC of suggested audit fees per hour by staff level. DeAngelo (1980) and the Cohen Commission both discussed the issue of 'low-balling' and its relationship to auditor independence. This particular action could possibly diminish the tendency of firms to bid much lower than competitors on audit engagements offered in competitive bidding scenarios.

APPENDIX II

PUBLIC ACCOUNTING FIRMS FROM WHICH
RESEARCH SUBJECTS WERE SELECTED

Alexander Grant & Company
Arthur Andersen & Company
Arthur Young & Company
Coopers & Lybrand
Deloitte Haskins & Sells
Ernst & Whinney
Main Hurdman
Peat, Marwick, Mitchell & Company
Price Waterhouse & Company
Touche Ross & Company

APPENDIX III

COVER LETTERS, SECOND REQUEST LETTER, AND INSTRUMENT FOR RESEARCH TECHNIQUE NO. 1

The University of Oklahoma

Office of the Dean
College of Business Administration

Dear Sir:

As a loan officer, you are in an excellent position to help us analyze the independence of external auditors such as those who report upon the financial statements of your customers. We ask you to contribute 20-25 minutes of your time to assist us in more clearly defining those features of the auditor-client relationship which are most important in assuring that the auditor's independence is safeguarded.

Along with this letter is an enclosure the first page of which is completion instructions. Please take the time to respond to each item called for by the enclosure and return it to us in the enclosed postage paid envelope. Your responses will be held in strict confidentiality.

If you so desire, we will mail you a summary of the research results. To indicate that you wish to receive this synopsis, print your name and address on the enclosed 4 x 6 card.

Sincerely,

Lawrence S. McKibbin

Lawrence McKibbin
Dean

Enclosures

307 West Brooks, Norman, Oklahoma 73019 (405) 325-3611

The University of Oklahoma

DIVISION OF ACCOUNTING
COLLEGE OF BUSINESS ADMINISTRATION
307 West Brooks, Room 200
Norman, Oklahoma 73019
(405) 325-4221

As a partner in a national accounting firm, you are in an excellent position to help us analyze the independence of external auditors. We ask you to contribute 15-20 minutes of your time to assist us in more clearly defining those features of the auditor-client relationship which are most important in assuring that an auditor's independence is safeguarded.

Included with this letter is an enclosure which asks your opinion on several possible actions which could be taken or have been taken to strengthen auditors' independence. Please take the time to respond to each item called for by the enclosure and return it to us in the enclosed postage paid envelope

Your responses will be held in strict confidentiality. If you so desire, we will mail you a summary of the research results. To indicate that you wish to receive this synopsis, print your name and address on the enclosed 4 x 6 card.

Thank you very much for your assistance,

Bart Ward

Bart Ward, Ph.D., CPA
Associate Professor

Enclosures

The University of Oklahoma

DIVISION OF ACCOUNTING
COLLEGE OF BUSINESS ADMINISTRATION
307 West Brooks, Room 200
Norman, Oklahoma 73019
(405) 325-4221

Three weeks ago you received a copy of an instrument that is being used in a research project here at OU. Enclosed is another copy of this instrument. Would you be so kind as to complete this questionaire and return it in the enclosed postage-paid envelope. This task will require only 15-20 minutes. All responses will be held in strict confidentiality.

Your cooperation will be greatly appreciated.

Sincerely,

Bart H. Ward

Bart H. Ward, Ph.D, CPA
Associate Professor

Enclosures

Instructions: The sixteen proposals which follow have been discussed in the professional literature as potential means for strengthening the independence of external auditors. Please rate each item based solely upon the degree to which you believe it would promote the independence of the external auditor. A factor that you should not consider in this task is your personal feeling as to whether or not the particular item should be adopted or retained, which ever the case may be. Use the following scale.

5 - Actions contributing a very high degree of assurance that auditors' independence will be safeguarded.

4 - Actions contributing a high degree of assurance that auditors' independence will be safeguarded.

3 - Actions contributing a modest degree of assurance that auditors' independence will be safeguarded.

2 - Actions contributing a very modest degree of assurance that auditors' independence will be safeguarded.

1 - Actions contributing no assurance that auditors' independence will be safeguarded.

_____ 1. Mandatory rotation of all audit engagement personnel every three years.

_____ 2. Required disclosure in client financial statements of all major auditor-client disagreements occurring in the eighteen months prior to an auditing firm's dismissal.

_____ 3. Requiring auditors to report on the preferability of all the client's accounting policies.

_____ 4. Selection of auditors for SEC registrants by the SEC with fee negotiations within guidelines established by the SEC.

_____ 5. Annual publication by the SEC of suggested audit fees per hour by staff level, e.g., staff, senior, manager, etc.

_____ 6. Requiring the mandatory use of audit committees composed of non-employee and non-management members of the client's board of directors.

_____ 7. Prohibition of executive search services by auditing firms.

_____ 8. Establishment of an arbitration board to settle disputes between auditors and clients involving financial reporting issues.

_____ 9. Giving the SEC total responsibility for the external audit function. Auditors of financial statements of publicly-held companies would be government employees much like IRS auditors.

_____ 10. Requiring that audit fee negotiations be the complete responsibility of the client's audit committee rather than the client's management.

_____ 11. Requiring that the nature and amount of consulting services provided by the auditor to the client be disclosed within the client's financial statements.

_____ 12. A ban on any form of advertising by auditing firms.

_____ 13. Restricting the amount of management consulting services provided by an auditing firm to audit clients to a maximum of 10% of the total annual audit fee.

_____ 14. Requiring that any proposed auditor adjustment not incorporated by the client in its financial statements be disclosed within the footnotes to the statements.

_____ 15. Prohibiting an auditing firm from accepting an engagement if the total revenue from the prospective client would be greater than 10% of the auditing firm's total annual revenues.

_____ 16. Re-instatement of the AICPA's ethical standard prohibiting client solicitation.

TASK #2

Instructions: Please rate the above sixteen items again, using the following five-point scale.

5 - I feel <u>very strongly</u> that this particular action <u>should be</u> adopted or retained.

4 - I feel that this particular action <u>should be</u> adopted or retained.

3 - I am <u>neutral</u> with respect to whether or not this particular action should be adopted or retained.

2 - I feel that this particular action <u>should not be</u> adopted or retained.

1 - I feel <u>very strongly</u> that this particular action <u>should not be</u> adopted or retained.

_____ 1. Restricting the amount of management consulting services provided by an auditing firm to audit clients to a maximum of 10% of the total annual audit fee.

_____ 2. Giving the SEC total responsibility for the external audit function. Auditors of financial statements of publicly-held companies would be government employees much like IRS auditors.

_____ 3. Requiring that any proposed auditor adjustments not incorporated by the client in its financial statements be disclosed within the footnotes to the statements.

_____ 4. Prohibition of executive search services by auditing firms.

_____ 5. Selection of auditors for SEC registrants by the SEC with fee negotiations within guidelines established by the SEC.

_____ 6. Requiring auditors to report on the preferability of all the client's accounting policies.

_____ 7. Requiring that the nature and amount of consulting services provided by the auditor to the client be disclosed within the client's financial statements.

_____ 8. Establishment of an arbitration board to settle disputes between auditors and clients involving financial reporting issues.

_____ 9. A ban on any form of advertising by auditing firms.

_____ 10. Requiring the mandatory use of audit committees composed of non-employee and non-management members of the client's board of directors.

_____ 11. Required disclosure in client financial statements of all major audit-client disagreements occurring in the eighteen months prior to an auditing firm's dismissal.

_____ 12. Prohibiting an auditing firm from accepting an engagement if the total revenue from the prospective client would be greater than 10% of the auditing firm's total annual revenues.

_____ 13. Re-instatement of the AICPA's ethical standard prohibiting client solicitation.

_____ 14. Requiring that audit fee negotiations be the complete responsibility of the client's audit committee rather than the client's management.

_____ 15. Mandatory rotation of all audit engagement personnel every three years.

_____ 16. Annual publication by the SEC of suggested audit fees per hour by staff level, e.g., staff, senior, manager, etc.

Note: See reverse for supplementary questions.

Supplementary Questions

1. In total, how many years of experience do you have in the banking industry?

2. How many years of experience do you have in commercial lending?

Thank you again for your assistance.

Supplementary Questions

1. In which of the following functional areas do you work? (Circle one)

   Auditing - Consulting - Taxes

2. How many years of experience do you have in the practice of public accounting?

3. How many years experience, if any, do you have in accounting other than in public practice?

APPENDIX IV

COVER LETTER, SECOND REQUEST LETTER, AND
INSTRUMENT FOR RESEARCH TECHNIQUE NO. 2

The
University of Oklahoma

DIVISION OF ACCOUNTING
COLLEGE OF BUSINESS ADMINISTRATION
307 West Brooks, Room 200
Norman, Oklahoma 73019
(405) 325-4221

As an executive member of the banking industry, you are in an excellent position to evaluate the apparent independence of public accountants such as those who report upon the financial statements of your customers. Your help in an important research project being carried out here at OU concerning the above issue would be greatly appreciated. Would you be so kind as to complete the attached research instrument and return it in the enclosed stamped envelope. This task will require only 15-18 minutes.

Your responses will be held in strict confidentiality. If you so desire, a summary of the research results will be mailed to you. To indicate that you wish to receive this synopsis, print your name and address on the enclosed 4 x 6 card.

Sincerely,

Bart H. Ward, Ph.D, CPA
Associate Professor

Enclosures

The University of Oklahoma

DIVISION OF ACCOUNTING
COLLEGE OF BUSINESS ADMINISTRATION
307 West Brooks, Room 200
Norman, Oklahoma 73019
(405) 325-4221

Three weeks ago you received a copy of an instrument that is being used in a research project here at OU. Enclosed is another copy of this instrument. Would you be so kind as to complete this questionaire and return it in the enclosed postage-paid envelope. This task will require only 15-20 minutes. All responses will be held in strict confidentiality.

Your cooperation will be greatly appreciated.

Sincerely,

Bart H. Ward

Bart H. Ward, Ph.D, CPA
Associate Professor

Enclosures

INSTRUCTIONS

Attached are narrative descriptions of two fairly common disputes that could occur between an audit firm and one of its clients. Scenario A on page 1 and Scenario B on page 6 provide brief background descriptions of the two disputes. Following each of these scenarios are eight independent cases which describe certain additional details of the respective disputes. Your task is to record your personal perception of the chance (likelihood) that the dispute will be resolved in favor of the client.

In addition to completing the research tasks, please respond to the following supplemental questions.

Supplementary Questions

1. In which of the following functional areas do you work? (Circle one)

   Auditing - Consulting - Taxes

2. How many years of experience do you have in the practice of public accounting?

3. How many years experience, if any, do you have in accounting other than in public practice?

SCENARIO A

Jackson Manufacturing is a publicly-owned producer of electronic equipment used in hospitals and medical laboratories. Jackson is audited by a local office of a national public accounting firm. In the current year's audit, a dispute between Jackson and their auditors has arisen over the materiality of certain unrecorded liabilities discovered by the auditors. The unrecorded liabilities consist primarily of expenses incurred in 1981 that were neither paid nor recorded in Jackson's accounting records until 1982. Jackson's controller argues that the total amount of the unrecorded liabilities is immaterial and that it is therefore unnecessary to adjust the financial statements in this regard. The auditors feel the amount is material and that the 1981 financial statements should be adjusted accordingly. Technical accounting standards provide very little guidance in determining the materiality of given amounts in financial statements, and thus, Jackson's management believes they themselves should know as well as anyone what their financial statement readers would or would not deem to be a material amount. Other available facts include:

Case #1

- Jackson's overall financial condition is quite good. All of the firm's solvency and profitability ratios compare favorably to industry averages. Net income has shown a modest but steady growth pattern over the last five years.

- Jackson's auditors are also currently working on a large management consulting project involving Jackson's cost accounting system. The consulting engagement will most likely not be completed for another twelve months. The total fee for this project is expected to be equal to approximately 40% of the current year's audit fee.

- The immediate audit market within which Jackson's auditors compete is characterized by a number of large auditing firms that are aggressively pursuing practice development (expansion) programs.

In your view, given the above information, how likely is it that the unrecorded liabilities will be ignored for purposes of the financial statements as well as the auditor's report, which is the alternative that Jackson's management desires. Record your answer by circling the most appropriate number on the following equal-interval scale.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood

Case #2

- Jackson's overall financial condition is quite good. All of the firm's solvency and profitability ratios compare favorably to industry averages. Net income has shown a modest but steady growth pattern over the last five years.

- Jackson's auditors are also currently working on a large management consulting project involving Jackson's cost accounting system. The consulting engagement will most likely not be completed for another twelve months. The total fee for this project is expected to be equal to approximately 40% of the current year's audit fee.

- The other major auditing firms in the immediate area in which Jackson's auditing firm operates are not aggressive competitors.

Given the above information, how likely is it that the unrecorded liabilities will be ignored.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood

Case #3

- Jackson's auditors are also currently working on a large management consulting project involving Jackson's cost accounting system. The consulting engagement will most likely not be completed for another twelve months. The total fee for this project is expected to be equal to approximately 40% of the current year's audit fee.

- The other major auditing firms in the immediate area in which Jackson's auditing firm operates are not aggressive competitors.

- Jackson's overall financial condition is poor. The last few years have brought considerable deterioration in their solvency and profitability positions. Net income has shown a modest but steady decline over the last five years.

Given the above information, how likely is it that the unrecorded liabilities will be ignored.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood

Case #4

- The immediate audit market within which Jackson's auditors compete is characterized by a number of large auditing firms that are aggressively pursuing practice development (expansion) programs.
- Jackson's overall financial condition is quite good. All of the firm's solvency and profitability ratios compare favorably to industry averages. Net income has shown a modest but steady growth pattern over the last five years.
- Jackson's auditing firm will not provide any consulting services to Jackson in the coming twelve months.

Given the above information, how likely is it that the unrecorded liabilities will be ignored.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood

Case #5

- Jackson's auditing firm will not provide any consulting services to Jackson in the coming twelve months.
- The immediate audit market within which Jackson's auditors compete is characterized by a number of large auditing firms that are aggressively pursuing practice development (expansion) programs.
- Jackson's overall financial condition is poor. The last few years have brought considerable deterioration in their solvency and profitability positions. Net income has shown a modest but steady decline over the last five years.

Given the above information, how likely is it that the unrecorded liabilities will be ignored.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood

- Jackson's overall financial condition is poor. The last few years have brought considerable deterioration in their solvency and profitability positions. Net income has shown a modest but steady decline over the last five years.

- The other major auditing firms in the immediate area in which Jackson's auditing firm operates are not aggressive competitors.

- Jackson's auditing firm will not provide any consulting services to Jackson in the coming twelve months.

Given the above information, how likely is it that the unrecorded liabilities will be ignored.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood

Case #7

- The other major auditing firms in the immediate area in which Jackson's auditing firm operates are not aggressive competitors.

- Jackson's overall financial condition is quite good. All of the firms's solvency and profitability ratios compare favorably to industry averages. Net income has shown a modest but steady growth pattern over the last five years.

- Jackson's auditing firm will not provide any consulting services to Jackson in the coming twelve months.

Given the above information, how likely is it that the unrecorded liabilities will be ignored.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood

- The immediate audit market within which Jackson's auditors compete is characterized by a number of large auditing firms that are aggressively pursuing practice development (expansion) programs.

- Jackson's overall financial condition is poor. The last few years have brought considerable deterioration in their solvency and profitability positions. Net income has shown a modest but steady decline over the last five years.

- Jackson's auditors are also currently working on a large management consulting project involving Jackson's cost accounting system. The consulting engagement will most likely not be completed for another twelve months. The total fee for this project is expected to be equal to approximately 40% of the current year's audit fee.

Given the above information, how likely is it that the unrecorded liabilities will be ignored.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood

Lewis Equipment Company is a publicly-owned manufacturer of electric pumps. In the current year's audit a dispute has arisen between Lewis and their auditors, a large national accounting firm. The dispute centers over whether a material loss on an account receivable, which occurred after the end of the fiscal year, should be disclosed in the footnotes of the Lewis financial statements. At the fiscal year-end, there was no evidence available which indicated that this particular customer would default. The customer's default was the result of extensive damage to their physical facilities resulting from a fire occurring after year-end. The technical standards of the profession are quite explicit with regard to the above situation. The standards support the audit firm's contention that the loss of the receivable should be disclosed in the footnotes of the Lewis financial statements. Nonetheless, the controller of Lewis disagrees with the standards and asserts that since the event occurred after the end of the fiscal year it does not have to be disclosed in any manner. Other available facts include:

Case #1

- Lewis' auditors are also currently working on a large management consulting project involving Lewis' cost accounting system. The consulting engagement will most likely not be completed for another twelve months. The total fee for this project is expected to be equal to approximately 40% of the current year's audit fee.

- The other major auditing firms in the immediate area in which Lewis' auditing firm operates are not aggressive competitors.

- Lewis' overall financial condition is poor. The last few years have brought considerable deterioration in their solvency and profitability positions. Net income has shown a modest but steady decline over the last five years.

Given the above information, how likely is it that the loss of the receivable will be ignored for purposes of the financial statements and the auditor's report, which is the alternative that Lewis' management desires. Record your answer by circling the most appropriate number on the following equal-interval scale.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood

Case #2:

- The immediate audit market within which Lewis' auditors compete is characterized by a number of large auditing firms that are aggressively pursuing practice development (expansion) programs.

- Lewis' auditing firm will not provide any consulting services to Lewis in the coming twelve months.

- Lewis' overall financial condition is poor. The last few years have brought considerable deterioration in their solvency and profitability positions. Net income has shown a modest but steady decline over the last five years.

Given the above information, how likely is it that the loss of the receivable will <u>not</u> be disclosed.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood

Case #3:

- Lewis' overall financial condition is quite good. All of the firm's solvency and profitability ratios compare favorably to industry averages. Net income has shown a modest but steady growth pattern over the last five years.

- The other major auditing firms in the immediate area in which Lewis' auditing firm operates are not aggressive competitors.

- Lewis' auditors are also currently working on a large management consulting project involving Lewis' cost accounting system. The consulting engagement will most likely not be completed for another twelve months. The total fee for this project is expected to be equal to approximately 40% of the current year's audit fee.

Given the above information, how likely is it that the loss of the receivable will <u>not</u> be disclosed.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood

Case #4:

- The other major auditing firms in the immediate area in which Lewis' auditing firm operates are not aggressive competitors.

- Lewis' overall financial condition is quite good. All of the firm's solvency and profitability ratios compare favorably to industry averages. Net income has shown a modest but steady growth pattern over the last five years.

- Lewis' auditing firm will not provide any consulting services to Lewis in the coming twelve months.

Given the above information, how likely is it that the loss of the receivable will <u>not</u> be disclosed.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood

Case #5:

- Lewis' overall financial condition is poor. The last few years have brought considerable deterioration in their solvency and profitability positions. Net income has shown a modest but steady decline over the last five years.

- The immediate audit market within which Lewis' auditors compete is characterized by a number of large auditing firms that are aggressively pursuing practice development (expansion) programs.

- Lewis' auditors are also currently working on a large management consulting project involving Lewis' cost accounting system. The consulting engagement will most likely not be completed for another twelve months. The total fee for this project is expected to be equal to approximately 40% of the current year's audit fee.

Given the above information, how likely is it that the loss of the receivable will <u>not</u> be disclosed.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood

Case #6

- Lewis' overall financial condition is quite good. All of the firm's solvency and profitability ratios compare favorably to industry averages. Net income has shown a modest but steady growth pattern over the last five years.

- Lewis' auditing firm will not provide any consulting services to Lewis in the coming twelve months.

- The immediate audit market within which Lewis' auditors compete is characterized by a number of large auditing firms that are aggressively pursuing practice development (expansion) programs.

Given the above information, how likely is it that the loss of the receivable will not be disclosed.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood

Case #7

- The immediate audit market within which Lewis' auditors compete is characterized by a number of large auditing firms that are aggressively pursuing practice development (expansion) programs.

- Lewis' auditors are also currently working on a large management consulting project involving Lewis' cost accounting system. The consulting engagement will most likely not be completed for another twelve months. The total fee for this project is expected to be equal to approximately 40% of the current year's audit fee.

- Lewis' overall financial condition is quite good. All of the firm's solvency and profitability ratios compare favorably to industry averages. Net income has shown a modest but steady growth pattern over the last five years.

Given the above information, how likely is it that the loss of the receivable will not be disclosed.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood

Case #8:

- The other major auditing firms in the immediate area in which Lewis' auditing firm operates are not aggressive competitors.

- Lewis' auditing firm will not provide any consulting services to Lewis in the coming twelve months.

- Lewis' overall financial condition is poor. The last few years have brought considerable deterioration in their solvency and profitability positions. Net income has shown a modest but steady decline over the last five years.

Given the above information, how likely is it that the loss of the receivable will not be disclosed.

Very Low Likelihood	1	2	3	4	5	6	7	Very High Likelihood