



**Damai Nasution**

Essays on Auditor Independence



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## ESSAYS ON AUDITOR INDEPENDENCE





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*“But seek, by means of what God has given you, to attain the abode of the hereafter, while not neglecting your share in this world. Be good to others as God has been good to you, and do not seek mischief in the land, for God does not love the mischief makers” (28:77).*

*“God will exalt those who believe among you, and those who have knowledge, to high ranks” (58:11).*

*“The best person among you is the one who is the most beneficial to others” (Prophet Muhammad).*

Åbo/Turku, June 2013

Damai Nasution



## Abstract

Auditor independence is a cornerstone of the auditing profession and the basic principle that underpins the reputation of the auditing profession in the public eye. Indeed, it is the attribute most demanded from auditors by the public. Therefore, the sustainability of the auditing profession depends on how auditors can protect this principle. This dissertation consists of four interrelated essays concerned with auditor independence. Specifically, it examines situations that can threaten and impair auditor independence. In addition, this dissertation also examines several variables that may enhance and protect auditor independence.

The first essay aims to examine the impact of social pressures occurring within audit firms on auditors' judgment in the setting of a society with "high power distance" and "low individualism" cultural dimensions. The social pressures consisted of obedience pressure exerted by an auditor's superior and conformity pressure exerted by an auditor's colleague. Moreover, two moderating variables—a multi-dimensional professional commitment and locus of control—were included as moderator variables in the relationship between the social pressures faced by auditors and their judgment. The findings show that obedience and conformity pressures influence auditor judgment. Auditors who face the social pressures will make a judgment that may be even diametrically opposite to the independence principle. The findings also indicate that a multi-dimensional professional commitment and locus of control may potentially influence auditor judgment in a situation with social pressures.

The second essay aims to investigate the association of advocacy and familiarity threats caused by auditor fee dependence and auditor tenure on auditor independence based on Finnish data, law, and auditing environment. This essay was motivated by the Green Paper on Audit Policy, published by the European Commission in 2010 that questions whether the maximum fee collected from a client should be regulated and whether consecutive assignments should be limited, among others. Contrary to popular belief, this essay does not find evidence that audit fees and long auditor tenure will jeopardise auditor independence. Therefore, the findings do not support policies to regulate auditor fees or limit auditor tenure in Finland.

The third essay aims to examine the effect of client intimidation on auditor independence in an audit-client conflict situation. Intimidation threat is one of five independence threats that are explicitly referenced in the IFAC's independence framework. Client intimidation was manifested in the client threatening to replace the auditor if the auditor did not adopt the client's position. In addition, this essay examines the role of auditor's perceived pressure and multi-dimensions of professional commitment as moderator variables. The findings suggest that auditors who experience client intimidation in an audit conflict situation are more likely to have their independence impaired than those who are in a similar situation but without client intimidation. Moreover, auditors who experience client intimidation perceive higher pressure than those who do not experience intimidation. Finally, auditors' affective and continuance professional commitment dimensions moderate the relationship between auditors' perceived pressures and auditor independence.

The aim of the fourth essay is twofold. First, it aims to develop a scale for measuring auditors' reputation awareness. Second, it aims to examine the correlation between the levels of auditor reputation awareness and auditor independence. A seven-item scale was developed as the reputation awareness scale. The findings indicate that the scale consists of one dimension. It also has a level of satisfactory reliability and a high level of validity. The findings show that there is a positive correlation between the level of auditors' reputation awareness and auditor independence.

**Keywords:** Auditing, Auditor, Auditor independence, Threats to auditor independence, Social pressures, Professional commitment, Locus of control, Awareness

## Sammanfattning

Revisorns oberoende är en hörnsten i revisorsyrket och den grundläggande princip som styrker revisorsyrkets anseende i offentlighetens ljus. Det är faktiskt den egenskap som allmänheten efterfrågar mest hos revisorer. Därför beror revisorsyrkets hållbarhet på hur revisorer kan skydda denna princip. Denna avhandling består av fyra essäer som hänger samman med varandra och har att göra med revisorns oberoende. Mer specifikt undersöker den situationer som kan hota och minska revisorns oberoende. Dessutom undersöker denna avhandling också flera variabler som kan öka och skydda revisorns oberoende.

Den första essän syftar till att undersöka inverkan av sociala påtryckningar på revisorers bedömning vilka förekommer inom revisorsbyråer inom ramen för ett samhälle med de kulturella dimensionerna ”hög maktavstånd” och ”låg individualism”. De sociala påtryckningarna bestod av lydnapåtryckning utövad av en överordnad till revisorn och likformighetspåtryckning utövad av en kollega till revisorn. Vidare inkluderades två modererande variabler – en flerdimensionell yrkesmässig förpliktelse och kontrollokus – i förhållandet mellan de sociala påtryckningarna som revisorer möter och revisorernas bedömning. Resultaten visar att lydnds- och likformighetspåtryckningar inverkar på revisorns bedömning. Revisorer som möter de sociala påtryckningarna kommer att göra en bedömning som till och med kan vara diametralt motsatt till oberoendepincipen. Resultaten tyder även på att en flerdimensionell yrkesmässig förpliktelse och kontrollokus potentiellt kan inverka på revisorns bedömning i en situation med sociala påtryckningar.

Den andra essän syftar till att utforska sambandet mellan försvars- och förtrolighetshot förorsakade av revisionsavgiftsberoende samt revisorns ämbets- och revisorns oberoende baserat på finländsk data, lag och revisionsförhållanden. Denna essä motiverades av pappret *the Green Paper on Audit Policy*, publicerat av Europeiska kommissionen år 2010, i vilket man bland annat frågar sig om den maximala avgiften som kan uppbåras av en klient borde regleras och om på varandra följande uppdrag borde begränsas. I motsats till allmän övertygelse, finner denna essä inga bevis för att revisionsavgifter och en långvarig ämbets- och revisorns oberoende. Därför stödjer inte resultaten handlingsprogram för att reglera revisionsavgifter eller begränsa revisorns ämbets- och revisorns oberoende i Finland.

Den tredje essän syftar till att undersöka effekten av hot från klienten på revisorns oberoende i en revisor-klient-konfliktsituation. Faran för hot från klienten är en av fem faror gällande oberoende som uttryckligen hänvisas till i IFACs ramverk för oberoende. Hot från klienten manifesterades i att klienten hotade att byta ut revisorn, om revisorn inte antog klientens ståndpunkt. Dessutom undersöker denna essä den roll som revisorns upplevda påtryckningar och en flerdimensionell yrkesmässig förpliktelse har som modererande variabler. Resultaten talar för att det är mer sannolikt att revisorer som upplever hot från klienten i en revisionskonfliktsituation blir mindre oberoende än de som är i en liknande situation, men utan hot från klienten. Vidare uppfattar revisorer som upplever hot från klienten mer påtryckning än de som inte upplever hot från klienten. Slutligen modererar dimensionerna gällande revisorns affektiva och varaktiga yrkesmässiga förpliktelse förhållandet mellan revisorns uppfattade påtryckningar och revisorns oberoende.

Syftet med den fjärde essän är tvåfaldigt. För det första syftar den till att utarbeta en skala för att mäta revisorers ryktesmedvetenhet. För det andra syftar den till att undersöka korrelationen mellan nivåerna på revisorns ryktesmedvetenhet och revisorns oberoende. En sjupunktsskala utarbetades som skalan för ryktesmedvetenhet. Resultaten tyder på att skalan består av en dimension. Den har också en nöjaktig reliabilitetsnivå och en hög validitetsnivå. Resultaten visar att det finns en positiv korrelation mellan nivån på revisorers ryktesmedvetenhet och revisorers oberoende.

**Nyckelord:** revision, revisor, revisorns oberoende, faror gällande/hot mot revisorns oberoende, sociala påtryckningar, yrkesmässig förpliktelse, kontrollokus, medvetenhet

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## List of the Original Essays

This dissertation consists of an introductory chapter and the following four essays:

- I. The impact of social pressures, locus of control, and professional commitment on auditors' judgment: Indonesian evidence, 2012, *Asian Review of Accounting*, 20 (2), 163-178 (co-author: Ralf Östermark).
- II. Auditor fee dependence, auditor tenure, and auditor independence: The case of Finland, 2013. Forthcoming in *International Journal of Accounting, Auditing, and Performance Evaluation* (co-author: Ralf Östermark).
- III. The effect of client intimidation on auditor independence in an audit conflict situation, presented at Nordic Accounting Conference 2012, Copenhagen (co-author: Ralf Östermark).
- IV. Auditors' reputation awareness and independence, manuscript (co-author: Ralf Östermark).

# 1 INTRODUCTION

## 1.1 Background

The auditing profession performs a role in giving reasonable assurance to the public and users' of financial statements, specifically investors and creditors, of the reliability and credibility of a firms' financial statements. To fulfil this role, there are several principles that auditors should espouse. One of the most important principles is independence. By demonstrating their independence, auditors' opinions on financial statements will be valued by the users.

In essence, auditor independence refers to an absence of interest by the auditor in the auditing assignment, thereby avoiding material bias that could affect the reliability and credibility of the financial statements. The auditing profession promotes the principle of independence to define, defend, and extend the profession (Sikka and Willmott, 1995). It is widely accepted that independence is the most priceless asset in the auditing profession and the basic principle that underpins the reputation of the auditing profession in the public eye. By conducting an auditing work independently, auditors protect the public's confidence in such services. In fact, the viability of the profession depends on how it can ensure adherence to the principle of independence.

Despite this, several firms' scandals, directly or indirectly involving auditors, have damaged public confidence in auditor independence. These scandals have taken place not just in one country but across the world: HIH Insurance (March, 2001) and One.Tel (July, 2001) in Australia; Enron (October, 2001), Hewlett-Packard (2012), and WorldCom (June, 2002) in the US; Vivendi (July, 2002) in France; Ahold (February, 2003) in the Netherlands; Parmalat (February, 2003) in Italy; and Kanebo (2006) and Olympus (2011) in Japan, among others. These scandals have caused the public suffering huge losses and have also damaged the reputation of the auditors and the auditing profession. In fact, the Enron failure led to the collapse of the Arthur Andersen audit firm, which at the time was one of the Big Five audit firms.

Although these scandals cannot solely be attributed to the failures of the auditors, the public perceived that a large part of the responsibility lay with them. This is because the public expects the auditing profession to perform not just as watchdogs that give them reasonable assurance but also as bloodhounds that track out everything even when there is nothing to provoke auditors' suspicion. Moreover, it is also widely believed that these scandals took place because of the auditors' lack of independence, as a result of accommodating their clients' interests during audits.

The literature shows that there are several situations that can potentially threaten auditor independence. The International Federation of Accountants (IFAC) (2012) reveals five threats to auditor independence: self-interest, self-review, advocacy, familiarity, and intimidation.

Furthermore, based on their survey of practicing auditors in the US and Australia, Umar and Anandarajan (2004) found that there are two pressures that may impair auditor independence: the pressure to retain the client and the pressure to conform. The former is caused by the need for sustainable revenue for the audit firm and the need to retain the client for future auditing assignments. The latter, on the other hand, is a result of superiors asking the auditors to take certain actions. In addition, Lord and DeZoort (2001) maintain that social pressures were comprised of obedience pressure exerted by auditors' superiors and conformity pressure exerted by auditors' colleagues can impair auditor independence. These pressures can impair auditor independence since auditors are motivated to protect their careers (obedience pressure) and to avoid feeling uncomfortable or not being considered as a peer's member because of a disagreement with their peers (conformity pressure).

The numerous scandals mentioned above not only damaged the reputation of the audit firms directly involved, but also the auditing profession as a whole. The *adagium* that the actions of a few bad "apples" can be devastating to the entire profession is valid in this case (Cravens and Oliver, 2006). The action of a few bad audit firms could endanger the viability of the auditing profession. Members of the auditing profession should be aware of the importance of independence and to avoid these types of scandals in future.

## 1.2 Purpose of Dissertation

This dissertation aims to contribute both theoretically to the literature, and practically to the auditing profession, through four interrelated essays. All four essays are concerned with auditor independence.

In particular, three of the essays investigate situations that potentially create threats that could impair auditor independence, including social pressures, self-interest, familiarity, and intimidation. Additionally, a recent essay developed an auditor reputation awareness scale and explored the possibility of relationship between the levels of auditors' reputation awareness and their independence. The research questions in this dissertation were as follows: Would social pressures impair auditor independence in the setting of the "high power distance" and "collectivist" cultural dimensions? Is auditor independence impaired by a threat to self-interest caused by an auditor's fee dependence to clients and a familiarity threat caused by long tenure? Is auditor independence impaired by an intimidation threat caused by a client's threat to replace the auditor? Does a high level of auditor reputation awareness protect auditor independence, especially when facing client intimidation?

### **1.3 Contribution and Structure of Dissertation**

The interrelated essays in this dissertation aim to contribute to the extant literature on auditor independence by increasing the understanding of situations that potentially threaten auditor independence. In addition, this dissertation offers factors that may theoretically and practically enhance and protect auditor independence.

The first essay contributes to the literature on auditor independence by examining the effect of social pressures on auditor independence. In contrast to the many studies on the pressures experienced by auditors from parties outside of audit firms, only a few studies concerned with the pressures experienced by auditors from within an audit firm. The social pressures within an audit firm consist of obedience pressure exerted by auditors' superiors (i.e., managers or partners) and conformity pressure exerted by colleagues or peers. Moreover, two individual variables were also examined as moderating variables in the relationship between social pressures and auditor independence: multi-dimensions of professional commitment and locus of control. In contrast to prior research (Lord and DeZoort, 2001), this essay considered the cultural dimensions of auditors in the analysis. The data was collected from auditors in a country that has "high power distance" and "low individualism" cultural dimensions (Hofstede, 1998). This essay argues that specific cultural dimensions make auditors more vulnerable to the impairment of their independence when experiencing social pressures.

The second essay contributes to the literature on auditor independence by examining the effect of a self-interest threat caused by an auditor's economic dependence on a client and a familiarity threat caused by an auditor's long tenure with the same client. The literature shows that there are competing theoretical arguments and inconclusive empirical evidence regarding the association between these two threats and auditor independence. This essay was prompted by a green paper on audit policy published by the European Commission (2010), which considered several threats that could jeopardise auditor independence, including the two mentioned above. This essay examines the effect of economic dependence and tenure on the basis of Finnish data, law, and auditing settings, which are characterised by aspects such as legal tradition in a code-law country, lower external investor rights, higher legal enforcement, middle importance of equity market, higher level of ownership concentration, and lower litigation risk for auditors. Besides contributing to the literature, the analysis also provides regulators with empirical evidence that the highest bracket of fees that a client pays the auditor does not need to be regulated and that auditor tenure does not need to be limited in Finland.

The third essay contributes to the literature on auditor independence by examining the effect of an intimidation threat by a client on auditor independence in an audit conflict situation. An audit conflict situation arises when there is a disagreement between the client and the auditor over certain accounting issues. Intimidation threat is one of five independence threats that are explicitly referenced in the independence framework (IFAC, 2012). Although this threat is considered the worst, surprisingly, this is the threat for which the auditor independence framework offers the least amount of prohibition and safeguard (Fearnley, Beattie, and Richard, 2005). Moreover, while prior studies have examined the impact of conflict on auditor independence and found important evidence to this effect, to the best of our knowledge, there are no studies that directly examine the impact of client pressures (i.e., explicit client intimidation to replace the auditor) on auditor independence in an audit conflict situation. Hence, this essay is the first attempt to investigate such a situation. In addition, this essay empirically tests a general model of pressures developed by DeZoort and Lord (1997) by

examining the effects of an auditors' perceived pressure variable in the relationship between client intimidation and auditor independence.

The final essay in this dissertation contributes to the literature on auditor independence by developing a reputation of independence-awareness scale for auditors and exploring the correlation between the auditors' reputation awareness and independence. While the literature has placed great emphasis on the importance of a reputation of independence, this has been at the audit firm level instead of the auditing profession as a whole. Moreover, the psychology literature shows that an individual's awareness of an issue can increase the probability that the individual will pay more attention to related information and take it into account when making decisions. This increased attention will subsequently affect how the individual will behave when facing situations related to the issue.

The remainder of this introductory section comprises 4 sections. The next section briefly describes the theoretical background concepts employed in the essays such as demand for auditing, auditor independence, and threats to auditor independence; this is followed by a summary of the essays. The general conclusions are then presented, and the final section contains the original essays.

## 2 THEORETICAL BACKGROUND

### 2.1 Demand for Auditing

Management is responsible for allocating a firm's resources efficiently and effectively as well as operating the firm on behalf of the principals (i.e., shareholders). In terms of this responsibility, management has to report and disclose to the principals information about the firm's conditions, including its past performance, the current condition, and future prospects (Wallin, 1992). All of this information is captured in the financial statements. Therefore, the financial statements will be used by the principals and other related-parties as a basis for evaluating the management's performance and the firm's conditions, and also for making sound decisions regarding investments and lending, among other things. However, information contained in the financial statements may be biased and unreliable for several reasons (Arens, Elder, and Beasley, 2012; Rittenberg, Schwieger, and Johnstone, 2008):

- 1) Remoteness of information: A modern firm separates between ownership and management. In this situation, most shareholders as well as other users of the firm's financial statements, cannot interact directly and get first-hand knowledge about the firm from the management. They also cannot monitor or control the firm's reporting process. In addition, they face difficulties in directly interviewing management, inspecting the firm's plants, and reviewing the firm's accounting records. Such remoteness of information may increase the probability of intentionally or unintentionally misstated financial statements.
- 2) Biases and motives of the management: The management has their own interests in providing information to shareholders and users of financial statements. It also has inside information that they may or may not choose to share. Since information contained in the financial statements is controlled by the management, it is possible that they may try to bias the information in their favour. A conflict of interest and incentive between the management and shareholders and the other users could result in bias in the financial statements.
- 3) Voluminous data: As firms grow larger, the volume of their transactions also increases. This increases the probability that transactions will be recorded improperly and included in the records either intentionally or unintentionally.
- 4) Complex exchange transactions: Over the past few decades, transactions between firms have become more complex. Consequently, it becomes more difficult to record these transactions properly.

For these reasons, the principals and users of financial statements need assurance regarding the reliability and credibility of financial statements. They need an independent agent that they can rely on for this information, and an auditor plays the role of such an agent.

In addition, in an era in which the capital market plays an important part in the economy, auditors provide two critical roles to capital market participants (Mansi, Maxwell, and Miller, 2004): an information role and an insurance role. As an information role, auditors provide independent verification of the information contained in the financial statements. By doing so, auditors increase the reliability and credibility of the financial statements. For the insurance role, auditors, either jointly or separately from management, provide capital market participants with indemnity insurance that covers potential losses. This is because, in many countries, a Corporate Act gives the public the right to sue auditors in case of flawed financial statements.

### 2.2 Auditor Independence

As mentioned above, independence is the attribute most demanded from auditors by shareholders and other users of financial statements (i.e., the public) when an audit is being conducted. By acting independently, auditors can validate and assure the public of the credibility and reliability of the audited financial statements. If this principle is not maintained, the auditors' opinions on the financial statements will be of no value (Firth, 1980). Therefore, independence is a cornerstone of the viability of each auditor as well as the auditing profession as a whole. It is also the most priceless asset of the auditing profession (Melancon, 2002). The auditing profession promotes the principle of independence as part of its image in order to define, defend, and promote the profession (Sikka and Willmott, 1995). Indeed, independence has become the maxim of the auditing profession (Barlett, 1991).



There are various definitions of auditor independence in the literature. Academics, regulatory, and professional bodies are still at odds in identifying an authoritative definition. The International Federation of Accountants (2012) divided independence into two dimensions: independence in mind and independence in appearance. The former is defined as “the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional scepticism.” (p. 46)

On the other hand, independence in appearance is defined as “the avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm’s, or a member of the audit team’s, integrity, objectivity or professional scepticism has been compromised” (p. 46).

Barlett (1991) described independence in fact as a characteristic of the individual auditor in which auditors will be unbiased when conducting the auditing assignment, from the planning phase through to the reporting phase. He describes independence in appearance as a set of constraints on the behaviour of auditors that creates the appearance of not having a vested interest in the auditing outcome. In their seminal book, Mautz and Sharaf (1980) referred to these two dimensions of auditor independence as practitioner-independence and profession-independence, respectively.

Academics have several definitions of auditor independence. For instance, Knapp (1985) defines independence as “the ability of auditors to resist management pressure” (p. 203). Meanwhile, McKinley, Pany, and Reckners (1985) define independence as the “[ability] to act with integrity and objectivity in performing the audit” (p. 892). Bartlett (1993) defines independence as “an unbiased mental attitude in making decisions about audit work and financial reporting” (p. 55). Additionally, Younkins (1996) cited by Nouri and Lombardi (2009) defines independence as “freedom from the control of those whose records are being reviewed” (p. 1).

Overall, auditor independence is the most demanded principle by the public. In essence, auditor independence means that auditors will keep themselves impartial and free from bias and vested interests. Auditor independence will give the public confidence in the opinions offered regarding a firm’s financial statements. Therefore, it will increase the reliability and credibility of the firm’s financial statements, and shareholders as well as other users can rely on these statements to make sound decisions about investments and lending, among other things.

### 2.3 Proxies of Auditor Independence

The literature shows that there are several proxies employed to measure auditor independence. Commonly, the proxies employed by the researchers determined by the type of research method or approach that they apply. Table 2.1 presents summary of the proxies of auditor independence.

**Table 2.1: Proxies of Auditor Independence**

<b>Proxies</b>	<b>Literature</b>
Auditors’ propensity to issue going concern opinion	Lennox (1999); DeFond et al. (2002); Craswell, Stokes, and Laughton (2002); Dahlia (2008); Li (2009); Ruiz-Barbadillo, Gomez-Aguilar, and Carrera (2009); Hope and Langli (2010), Ye, Carson, and Simnett (2011)
Earnings restatements	Raghunandan et al. (2001); Bloomfield and Shackman (2008); Paterson and Valencia (2011); Schmidt (2012)
Abnormal accruals	DeFond and Jiambalvo (1994); Becker et al.(1998); Francis et al. (1999); Frankel, Johnson, and Nelson (2002); Gul, Chen, and Tsui (2003); Krishnan (2003); Ashbaugh, LaFond, and Mayhew (2003); Chung and Kallapur (2003); Reynold et al. (2004); Gul et al. (2007); Chen, Lin, and Lin (2008)
Earnings benchmark	Frankel et al. (2002); Ashbaugh et al. (2003)
Auditors’ judgment	Windsor and Ashkanasy (1995); Goodwin and Trotman

	(1995); Lord and DeZoort (2001); Haynes, Jenkins, and Nutt (1998); Patel, Harisson, and McKinnon (2002); Gul, Ng, and Tong (2003), Moreno and Bhattacharjee (2003); Bamber and Iyer (2007); Cianci and Bierstaker (2009); Martinov-Bennie and Pflugrath (2009); Hatfield, Jackson, and Vandervelde (2011); Peytcheva and Gillett (2011); Paino, Smith, and Ismail (2012)
Users' perception	Firth (1980); Shockley (1981); Knapp (1985); McKinley, Pany, and Reckers (1985); Gul (1989); Gul (1991); Hussey and Lan (2001); Iyer and Rama (2004); Brandon and Mueller (2006), Dart (2011)

This dissertation employed two of the proxies above: absolute discretionary accruals in the second essay and auditors' judgments in the first, third, and the fourth essay. The first proxy is employed by a reason that higher absolute discretionary accruals are consistent with the conclusion that auditors allow the clients to exercise a greater accounting flexibility to conceal poor performance or save current earnings for future use (Krishnan, 2003). Therefore, the higher absolute discretionary accruals the more auditor independence is impaired.

The second proxy is employed widely in the literature applying an experimental or a survey method. Commonly, the auditors who participate as the subjects or the participants will be presented with an auditing case. In the end of that case, the participants will be asked to make judgments regarding the presented case. Prior studies usually asked the participants to respond in probability or likelihood estimation forms. However, borrowing Solomon's (1994) argument, using these response forms will produce a mixed response variable and it is not clear what can reliably be discerned from such measures. This dissertation presented the participants with an auditing case regarding questioned equipment found by the auditors in an auditing work. The pressures were included and manipulated in that case according to the aim of each paper. In the end of that case, the participants were asked to determine the value of the net equipment account balance that they will sign off on. The higher the amount of the net equipment balance signed off by the auditors, the lower their independence.

## 2.4 Threats to Auditor Independence

A series of corporate scandals recently occurred that unfortunately, to some extent, involved auditors. The public commonly attributed these scandals to lack of auditor independence. Accordingly, the literature shows that certain situations can create threats to auditor independence. IFAC (2012) discussed that threats to auditor independence can fall into several categories. Three of such threats, directly related to this dissertation, are briefly described as follows:

1. **Self-interest threat:** This refers to a threat caused by a financial or other self-interest conflict, including a direct or indirect financial interest in the client, dependence on the client's audit or non-audit fees, and motivation to retain the client. The auditor fee dependence is one factor that Beattie, Brandt, and Fearnley (1999) suggest could impair auditor independence. Logically speaking, in order to ensure their future revenues, auditors will try to retain their clients. Intuitively, the higher the revenue, the more dependent will the auditors be on the clients, and the more likely will be the need to retain them. To retain these clients, the auditors will be reluctant to take actions that would adversely affect the client's interest, even if this means sacrificing their own independence. Accordingly, DeAngelo (1981) argues that a greater shared economic interest between the auditor and the client decreases auditor independence. Several studies have examined the association between the auditor fee dependence and auditor independence; however, the evidence about such association is mixed (e.g., Gul, Chen, and Tsui, 2003; Frankel, Johnson, and Nelson, 2002; Hoitash, Markelevich, and Barragato, 2007; Ashbaugh, LaFond, and Mayhew, 2003; Hope and Langli, 2010).
2. **Advocacy and Familiarity threat:** This refers to a threat mainly caused by long-term consecutive auditing assignments, namely, auditor tenure, with the same client. According to Davis, Soo, and Trompeter (2003) the longer the auditors conduct auditing for the same clients, the more may

auditor independence be impaired. The impairment of auditor independence due to long tenure is based on the following reasons:

- a. Over time, an auditor is more likely to identify and act as the management's advocate for the client's position rather than as an external auditor required to maintain a sceptical perspective. As an advocate, the auditor will adopt a position that closely aligns with management.
  - b. Over time, an auditor will experience a belief perseverance syndrome, that is, a tendency to cling to one's initial belief even after receiving new information that contradicts or disconfirms the basis of that belief (Anderson, 2007). In such a case, an auditor fails to revise the appropriateness of management's assertions even though the facts and conditions have changed.
  - c. An auditor will try to retain a client over the long term assignment to cover the auditor's start-up costs incurred during the first-year assignment. As a result, the auditor may become lenient with the client. Moreover, DeAngelo (1981) suggests that "client-specific rent," which the auditor can extract only over time, may create an economic dependence and possibly impair auditor independence.
3. **Intimidation threat:** This refers to a threat caused by intimidation, commonly arising from management, whether actual or perceived, that may deter auditors from acting independently and exercising their professional scepticism (IFAC, 2012). A common form of an intimidation threat is the threat of replacement. Auditors are commonly in a weak position because of an asymmetrical power relationship, or an imbalance of power that exists between auditors and their clients (Goldman and Barlev, 1974). This is normal given the nature of the auditing process, in which the client selects the auditor, determines the scope of the audit, and terminates or replaces the auditor. Moreover, the client also provides the auditor with the facilities and information needed to perform the audit. Even in a situation where the auditor is selected by an audit committee, there is no specific enforcement mechanisms to ensure that the client does not become involved, directly or indirectly, in selecting the auditor or determining the audit fee and the scope of the audit (Windsor, 2005; Baker, 2005). Consequently, auditors are vulnerable to intimidation by clients in a conflict situation, where a disagreement occurs between the client and the auditor over certain accounting issues, including the need to make adjustments to the financial statements, the appropriateness of the accounting principles applied by the client, or the adequacy of financial statement disclosures (Knapp, 1985). In addition to this asymmetrical power situation, the auditor position is impacted by their motivation to retain their clients for future auditing assignments to ensure future revenues.

## 2.5 Social Pressures

Besides the situations discussed above, there are additional situations emerging within the audit firms that can impair auditor independence, for example, social pressures. There are two types of social pressures: obedience pressure and conformity pressure. Obedience pressure is exerted by an individual with authority in a hierarchical context, namely, a superior (Milgram, 1974). An authority figure can shape subordinates' actions through specific commands. These subordinates may feel relatively unconcerned about carrying out such actions, even if these actions contradict their personal beliefs and principles, when they were commanded by an authority to do so. A seminal experimental study conducted by Milgram (1974) showed that under obedience pressure, an individual would even be willing to act in an unethical manner. This is due to a lack of perceived responsibility. The individual feels responsible to the authority but not responsible for the action that the authority commands. Indeed, the individual will accept the authority's definition of the ethics of the action (i.e., in terms of right or wrong). In an audit firm, managers and partners are the authority figures. An auditor will obey their superiors' commands or suggestions, not only to avoid punishment or to achieve rewards but also to preserve their careers.

Conformity pressure is pressure exerted by colleagues or a peer group. In this case, an individual is under pressure to conform to the beliefs, actions, and attitudes of their peer group. Although obedience and conformity pressures are exerted by external sources, these are different in the following ways (Milgram, 1974):

- (1) Hierarchy: obedience pressure occurs within a hierarchical structure in the organisation; meanwhile, conformity pressure occurs among those of equal status;
- (2) Imitation: conformity is an imitation of one's peers' behaviours whereas obedience is not;

- (3) Explicitness: in obedience pressure, the prescription for some behaviour is commonly explicit. In conformity pressure, it often remains implicit;
- (4) Voluntarism: in conformity, individuals use voluntarism to explain their behaviour.

The main reason why an individual conforms to a peer is a desire to gain recognition as a member of the peer group, which leads to the situation in which they begin to lack independence. This is known as the situation of uncritical acceptance of group ideas and evaluations (Asch, 1956). Asch (1956) investigated how an individual will behave during a disagreement with the peer group about a clear and simple issue of fact. The study was designed such that the group reported incorrect judgments while the individual could only judge the facts correctly. The findings showed that some subjects experienced a lack of independence with their judgments being influenced by the group's judgments.

Both obedience and conformity pressures can impair auditor independence when the commands or suggestions of the auditors' superiors or colleagues contradict the independence principle. However, the findings of Lord and DeZoort (2001) only confirmed the former in the auditing context. It is possible that other variables (e.g., cultural dimensions) play a significant role in the context of social pressures.

Hofstede (1998) identified five cultural dimensions that are distinguished among nations. It seems that two of them relate to how auditors would respond to social pressures, namely power distance and individualism/collectivism. Hofstede (1980) (cited in Smith and Hume, 2005) defined power distance as a degree of a society's tolerance and preference for unequal hierarchical power on the job. Meanwhile, individualism is a degree of relative importance that societal members place upon their own views and welfare. It is possible that society members in nations with high power distance are more vulnerable to obedience pressure compared with others from low power distance nations. Moreover, society members in nations with low individualism are more vulnerable to conformity pressure compared with others from high individualism nations.

## **2.6 Factors Enhancing Auditor Independence**

### **2.6.1 Auditors' reputation of independence awareness.**

The literature shows that awareness influences the manner in which individuals act and behave in certain situations. For example, Butterfield, Trevino, and Weaver (2000) emphasised the significant role of (moral) awareness as a critical step affecting how an individual behaves. They stated that without (moral) awareness, individuals cannot identify the (moral) issue when facing it in certain situations, rendering them unable to factor it into the decision-making process. Additionally, Mautz and Sharaf (1986) also stated that when auditors are aware of the nature of independence, they take the necessary precautions to maintain this independence. Hence, awareness of the importance of independence in the auditing profession could prevent auditors from engaging in behaviours that damage this reputation.

### **2.6.2 Perceived pressure**

DeZoort and Lord (1997) developed a general pressure model in accounting. There are three variables in their model. One of these variables is auditors' stress response, which refers to how auditors perceive an individual pressure at a specific point in time as well as the cumulative effects of pressure over time. They proposed that auditors' stress response would influence their behaviours and judgments when they experience certain pressure situations. Until now, there has been no research that attempted to examine this variable empirically.

### **2.6.3 Professional commitment**

Aranya, Pollock, and Amernic (1981) stated that the concept of professional commitment (PC) has been a concern for both accounting researchers and practitioners because of its consequences. PC is defined as "the relative strength of identification with and involvement in a particular profession, as well as the willingness to exert effort on behalf of the profession and the desire to maintain membership in it" (Aranya and Ferris, 1984, p. 3). Meyer and Allen (1991) developed a concept of multiple dimensions of organisational commitment, which was adapted by Hall, Smith, and Langfield-Smith (2005) as multiple dimensions of PC. The dimensions are Affective PC (APC), Continuance PC (CPC), and Normative PC (NPC). APC refers to the extent to which individuals

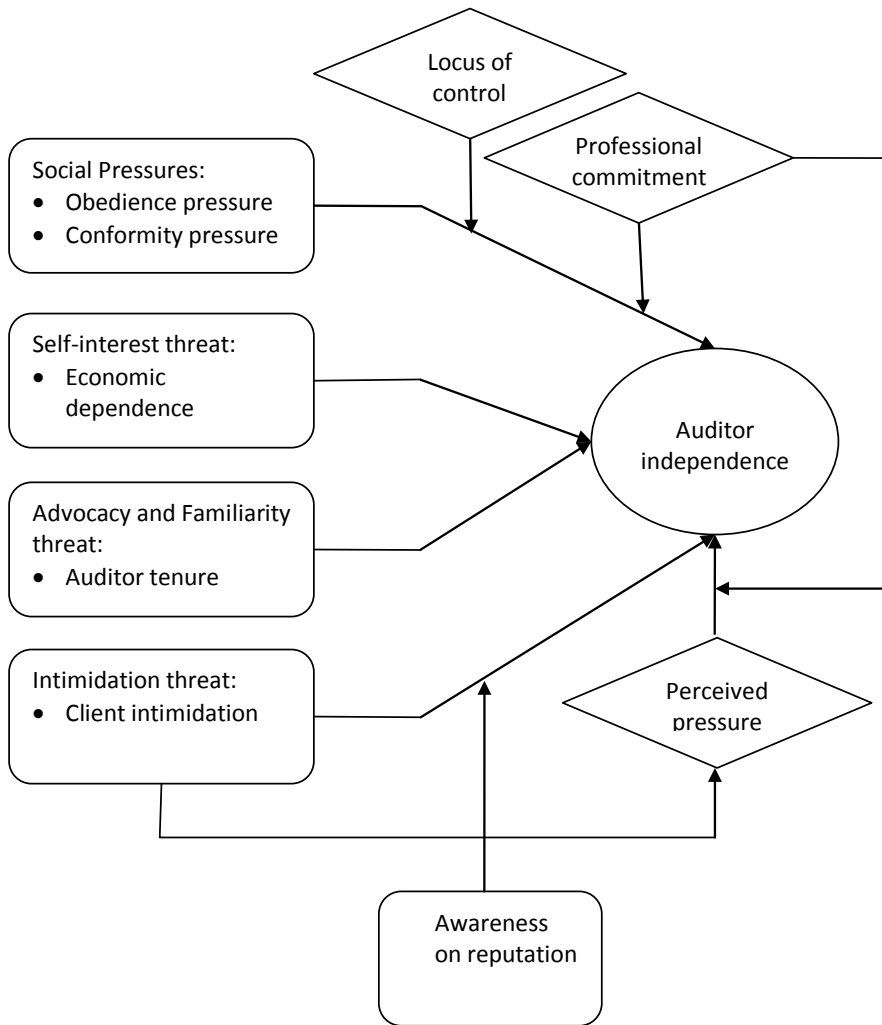
"want to stay" in the profession because they identify themselves with the goals of the profession and want to contribute to the achievement of those goals. CPC refers to the extent to which individuals feel they "have to stay" in the profession because of the accumulated investment that they have made (e.g., in study effort, training, etc.) and also because of the lack of other alternatives. Finally, NPC refers to the extent to which individuals feel they "ought to stay" in the profession as an obligation. It is argued that the levels of an individual's multiple dimensions of PC are a strong predictor of turnover intention, job satisfaction, work behaviours, as well as judgment, among other things.

#### **2.6.4 Locus of Control**

Locus of control (LOC) is one of the most studied variables both in psychology and other social sciences (Rotter, 1990), including accounting research (e.g., Singer and Singer, 1985; Tsui and Gul, 1996; Hyatt and Prawitt, 2001; Patten, 2005). LOC refers to the extent to which individuals believe that reinforcement or an outcome of their behaviour is contingent on their own behaviour or personal characteristics (namely, internal LOC); or is a function of chance, luck, fate, under others' control, or simply unpredictable (namely, external LOC). These beliefs will significantly influence individuals' behaviour. For instance, individuals that have external LOC tend to be less responsible for the consequences of their behaviour and will blame these on external factors. Hence, LOC is a good predictor of an individual's behaviour.

Based on the theoretical background described above, the conceptual model of the hypotheses developed in this dissertation can be summarised in Figure 2.1.

**Figure 2.1: The Conceptual Model**



## **3 SUMMARY OF THE ESSAYS**

### **3.1 Essay 1: The impact of social pressures, locus of control, and professional commitment on auditors' judgment: Indonesian evidence**

The first essay aims to examine the impact of social pressures occurring within audit firms on auditors' judgment. Pressures exerted by external parties or external audit firms have received extensive attention; however, only a few attempts have been made to examine pressures arising from within audit firms. Pressures from within audit firms are comprised of obedience pressure exerted by an auditor's superior (i.e., a manager or partner) and conformity pressure exerted by an auditor's colleague or peer. These pressures were examined by Lord and DeZoort (2001) in the US context. However, they failed to find evidence supporting the hypothesis that conformity pressure influences auditors' judgment. This essay argues that cultural dimensions should be taken into account. Moreover, since auditing in terms of public accountants or auditors is a worldwide profession, it is important to understand the impact of cultural dimensions on how auditors behave and make judgments under certain situations. This essay examines the impact of social pressures in the setting of a society with the "high power distance" and "low individualism" cultural dimensions. This essay argues that these dimensions would intensify the impact of obedience and conformity pressures on auditor judgment.

This essay employs a between-subjects experimental design, with 70 auditors who work for Big Four and non-Big Four audit firms in Indonesia as the subjects. The independent variables of obedience and conformity pressures were manipulated through an auditing case that was initially developed by Lord and DeZoort (2001). A few modifications were made in adapting the case to the aim of this essay. Moreover, two moderating variables—a multi-dimensional professional commitment and locus of control—were included to predict factors that could influence auditors' judgment when they experience social pressures.

The findings suggest that both obedience and conformity pressures influence auditor judgment. These findings are partly consistent with Lord and DeZoort (2001), particularly in relation to the impact of obedience pressure on auditor judgment. However, the difference is that the analysis in this essay supports the hypothesis that conformity pressure also influences auditor judgment. Hence, these findings support the argument that social pressures will influence how auditors behave and make judgments and that some specific cultural dimensions intensify these pressures. Moreover, the findings indicate that a multi-dimensional professional commitment and locus of control may potentially influence auditor judgment in a situation with social pressures.

### **3.2 Essay 2: Auditor fee dependence, auditor tenure, and auditor independence: The case of Finland.**

The second essay aims to investigate the association of advocacy and familiarity threats caused by auditor fee dependence and auditor tenure on auditor independence based on Finnish data, law, and auditing environment. This essay was motivated by the Green Paper on Audit Policy, published by the European Commission in 2010. The green paper questions whether the maximum fee collected from a client should be regulated and whether consecutive assignments should be limited, among others. In addition, the literature shows that there are competing theoretical arguments and inconclusive empirical evidence regarding association of these two questions and their impact on auditor independence.

This essay employs audit, non-audit, total fees, and client importance as proxies of auditor fee dependence. Moreover, auditor tenure is divided into short (that is, one, less than two, and less than three years) and long tenures (that is, equal to or more than three years). Auditor independence is proxied by absolute discretionary accruals. Higher absolute discretionary accruals indicate impaired auditor independence because auditors allowed clients to exercise a greater accounting flexibility to conceal poor performance or save current earnings for future use (Krishnan, 2003). An archival approach was employed to test the hypotheses. The population of interest comprised Finnish firms listed on the Helsinki NASDAQ OMX Stock Exchange with account closings on December 31, 2007 and 2008.

The findings can be summarised as follows. First, auditor fee dependence on a client is not associated with absolute discretionary accruals. Second, short auditor tenure is positively associated with absolute discretionary accruals; however, only a one-year tenure is statistically significant. Third, long auditor tenure is negatively associated with absolute discretionary accruals. Taken together, these results do not support policies to regulate auditor fees or limit auditor tenure in Finland.

### **3.3 Essay 3: The effect of client intimidation on auditor independence in an audit conflict situation**

The third essay aims to examine the effect of client intimidation on auditor independence in an audit-client conflict situation (that is, a disagreement between auditors and clients over certain accounting issues). The audit-client conflict situation in this essay relates to an auditor's proposal to write off the equipment in question in the auditing work. On the other hand, the client suggested keeping the equipment according to the recorded balance and depreciating it for five years. Client intimidation was manifested in the client threatening to replace the auditor if the auditor did not adopt the client's position. This essay also attempts to empirically test a general pressure model developed by DeZoort and Lord (1997) by investigating the impact of auditors' perceived pressure on auditor independence and exploring the moderating/interacting role of auditors' professional commitment dimensions in the relationship between auditors' perceived pressures and their independence.

An instrument-based case was administered to 119 auditors from national auditing firms in Indonesia. This essay argues that these audit firms are more suitable for testing this essay's hypotheses because they face greater competition to win and retain a client as opposed to the Big Four audit firms. The subjects were divided into two groups: those facing intimidation and those without client intimidation in an audit conflict situation. Auditor independence is measured through the net equipment account balance signed off by the auditors on the equipment in question. The higher the net equipment account balance signed off on by the auditor, the more likely it is that auditor independence is impaired.

The findings can be summarised as follows. First, auditors who experience client intimidation in an audit conflict situation are more likely to have their independence impaired than those who are in a similar situation but without client intimidation. Second, auditors who experience client intimidation perceive higher pressure than those who do not experience intimidation. Third, auditors' affective and continuance professional commitment dimensions moderate the relationship between auditors' perceived pressures and auditor independence.

### **3.4 Essay 4: Auditors' reputation awareness and independence**

The aim of the fourth essay is twofold. First, it aims to develop a scale for measuring auditors' reputation awareness. This essay argues that auditors' awareness of their reputation of independence is important for the sustainability of the auditing profession. Auditor reputation awareness is defined as the degree to which auditors recognise the importance of the auditing profession's reputation and acknowledge the impact of their decisions or actions on the profession's reputation. Second, this essay examines the correlation between auditor reputation awareness and auditor independence. It was hypothesised that auditors that have a higher level of reputation awareness will maintain their independence when facing a situation that could impair it. In this essay, that situation manifests in the auditor being intimidated by the client to adopt the client's position in a disagreement on accounting treatment for the equipment in question.

A seven-item scale was developed as the reputation awareness scale. The dimensionality of the scale was tested by employing explanatory factor analysis (EFA) with principal component analysis (PCA) and confirmatory factor analysis (CFA). The reliability was assessed by employing Cronbach's alpha and a composite reliability estimate. Meanwhile, the validity of the scale was assessed by employing an average variance extracted (AVE). Lastly, the correlation between auditor reputation awareness and auditor independence was tested by employing Pearson's correlation.

The findings can be summarised as follows: First, EFA and CFA indicate that the auditor reputation scale is one-dimensional. Second, Cronbach's alpha and the composite reliability estimate suggest that the scale has a satisfactory reliability level. Third, the AVE suggests that the scale has a



high validity level. Finally, the correlation analysis shows that the higher the auditors' reputation awareness, the higher is their independence when facing client intimidation.

## 4 CONCLUSIONS

This dissertation examined situations that can threaten auditor independence. Auditor independence is a cornerstone of the auditing profession. It promotes public confidence in the profession and consequently influences the viability of the future of the profession. Therefore, it is very important to examine how threats to independence could impair auditor independence and to identify the factors that may help prevent the impairment of it.

This dissertation investigated four of the five threats (self-interest, advocacy, familiarity, and intimidation) to auditor independence. This dissertation also investigated the impact of social pressures within an audit firm on auditor independence. These social pressures, while predicted to impair auditor independence, have only received little attention in the literature. Additionally, several factors comprised of multi-dimensions of professional commitment, locus of control, perceived pressure, and reputation awareness were predicted to influence how auditors behave and make judgments when experiencing those threats and pressures.

This dissertation provides empirical evidence that certain independence threats and social pressures could impair auditor independence. Specifically, the findings show that social pressures exerted by an audit partner or an audit manager, and by an auditor's colleague, as well as intimidation by a client, could impair the auditor's independence. This dissertation also provides evidence that all proposed factors, except for the perceived pressure, and could help prevent the impairment of auditor independence. Limitations and suggestions for future research are presented in each essay.

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## Essays on Auditor Independence

Auditor independence is a cornerstone of the auditing profession and the basic principle that underpins the reputation of the auditing profession in the public eye. This dissertation consists of four interrelated essays concerned with auditor independence and aims to contribute both theoretically to the literature and practically to the auditing profession. The research questions in this dissertation were as follows: Would social pressures impair auditor independence in the setting of the "high power distance" and "collectivist" cultural dimensions? Is auditor independence impaired by a threat to self-interest caused by an auditor's fee dependence to clients and a familiarity threat caused by long tenure? Is auditor independence impaired by an intimidation threat caused by a client's threat to replace the auditor? Does a high level of auditor reputation awareness protect auditor independence, especially when facing client intimidation?



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