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The Effects of Clients' Characteristics on Auditor Independence: A Perceptual Study

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ABSTRACT

The objective of this research is to investigate the effect of clients' characteristics -including clients' reputation, clients' audit committee and clients fee contribution- on auditor independence. This research uses qualitative approach. Semi-structured interviews with auditors have been conducted. Interviews data were summarized, pattern coded, (Miles and Huberman, 1984) and then analyzed through description, analysis and interpretation (Wolcott, 1994). The research result is expected to be able to explain auditors perceptions on their clients' characteristics whether their independence are affected by clients' reputation, clients' audit committee and clients' fee contribution. By doing this study, it will be able to see how auditor perceive and treat their clients to do audit works while at the same time they have to maintain their auditor independence.

Keywords: Client' Reputation, Audit Committee, Fee Contribution
JEL Classifications: M4, M42

1. INTRODUCTION

As a profession, auditor is a unique profession. She/he is different from a doctor or a lawyer, who are paid by their clients for the shake of client's maximum benefits. The central theme of this study rests in the professional belief that independent auditors have to perform their work independently. However, evidence shows that auditors are not only hired and fired by their clients, but they have to face many other interests and pressures. This situation is likened to two different grounds on which auditors must stand simultaneously. The Cohen Commission asserted that since the auditor is hired and paid by someone who is affected by the auditor's work, total independence is a practical impossibility (Clikeman, 1998).

This study also begins noting that auditors are like other human beings in that their behaviours are affected by environmental, organisational, physiological, psychological, and backgrounds (Ferris and Dillard, 1988. p. 282) and therefore the possibilities from this observation would be: First, auditors will successfully perform audit tasks independently; second, auditors tend to perform audit task according to their own interests and clients' pressures; and third, the auditors "harmonise" or "accommodate" their interests or clients' pressure but are still in the corridor of audit standards.

In relation to their clients' chracteristics which includes clients' reputation or background, clients' audit committee and clients fee contribution, auditor are facing a hard situation and haigh pressure to act and to do audit work independently. This study therefore, is intended to investigate the effect of clients' characteristic on auditor independence in performing audit works. The purpose of this study is to examine auditors' perceptions on factors affecting auditor independence especially clients' characteristics including clients' reputation/background, clients' audit committee and clients' fee contribution.

2. LITERATYRE REVIEW

In the literature, most studies concerning auditor independence relate to perceived independence rather than independence in fact (Falk et al., 1995). The following issues relate to perceived independence which have been studied extensively: Provision of management advisory services (MAS), competition among audit firms, the size of audit firms, tenure of the audit assignment, the nature of any conflict, the existence or non existence of an audit committee and the financial condition of the client (Gul et al., 1992. p. 95). Among these issues, MAS has become the most frequently researched in the perceived independence area.

As argued by Knapp (1982. p. 39) perceived independence has become a focus of the researchers' attention and independence in fact has not been included. Researchers like Knapp (1982. p. 10) have also supported Shockley (1981. p. 785) argued that perceived independence was of more concern to the public rather than independence in fact, when he made the following statement "… for credibility depends ultimately on the perception rather than on the fact of independence." Moreover, Falket al. (1995) argued that auditor independence in fact was not observable ex ante (Amernic and Aranya, 1981. p. 17; Beattie et al, 1999. p. 68). This section will review selected previous studies on auditor independence especially in related to clients financial background, the existence of clients' audit committee and clients' fee contribution as follow.

2.1. The Clients' Financial Background

The healthier a clients' financial condition the more likely auditors will have a good image of them and this could make auditors less motivated to resist management pressure (Knapp, 1985; Kleinman et al., 1998), and conversely auditors would be more "careful" when dealing with clients with worse financial conditions. A study conducted by Beattie et al. (1999) found that the weak financial condition of a client was perceived by public accountants and financial directors as a factor that could enhance auditor independence. On the other hand, according to the study by Beattie et al. (1999) financial journalists viewed the weak financial condition of a client as a factor that could threaten auditor independence. In investigating the audit conflicts perceived by financial users, Knapp (1995) found that a client in a good financial condition was more able to achieve its preferred outcome to an audit conflict.

Based on the discussion above, this study therefore is intended to answer the research question "What is the effect of clients' reputation/background on auditor independence?"

2.2. Clients' Audit Committee

It is a dangerous situation where the company's management is able to appoint and dismiss an auditor. This obviously could put more pressure on the auditor and then consequently the auditor would be reluctant to disagree with the management. Mautz and Neuman (1970. p. 7) stated that a corporate audit committee is "a standing committee of the board of directors established to work directly with the auditors both independent and internal, as well as with representatives of other accounting related activities as seem appropriate." Furthermore they asserted that the purpose of an corporate audit committee is to strengthen the audit function within a company and therefore it adds protection both for directors and shareholders (p. 56). A corporate audit committee consisting of non-director members is likely to enhance auditor independence (Wolnizer, 1987. p. 156). This is because the committee which consists of non-director members has no conflict of interest in executing their duties. A Malaysian case study of Teoh and Lim (1996) found that the formation of a corporate audit committee was perceived to have a strong positive impact in enhancing auditor independence. In the UK, Beattie's et al. study (1999) supported Teoh and Lim's study.

Based on the discussion above, this study therefore is intended to answer the research question "What is the effect of clients' audit committee on auditor independence?"

2.3. Clients' Audit Fee Contribution

The issue of audit fees contributed by major clients to audit firms is also viewed as a factor that could affect auditor independence. The reason is because a large fee contribution generated by a particular client could lead to the dependency of audit firms on that client. However, studies that have investigated this issue have no conclusive findings. The archival studies of Barkess et al (1995) and Craswell et al. (1997) did not find any impairment in having major clients. On the other hand, another group of studies found evidence that having major clients could impair auditor independence (Supriyono, 1988; Teoh and Lim, 1996; Beattie et al. 1999). Study by Kleinman et al. (1998) found that auditors maybe more flexible with larger clients.

Based on the discussion above, this study therefore is intended to answer the research question "What is the effect of clients' fee contribution on auditor independence?"

3. RESEARCH METHOD

The reason for investigating auditors' perceptions is because auditors are the most familiar party to their independence. Since this study investigates the insiders' perceptions, a semi-structured interview is the most valuable because the questions are more likely to conform to the native's perception of reality (Fetterman, 1998. p. 481). In selecting auditors to be interviewed and in order to get the right sources of data, the study considers "representativeness" of the object being studied as suggested by Le Compte and Goetz (1984. p. 46). Interviewees are audit partners or auditors who are in charge in dealing with clients. 29 auditors have been interviewed both from small and big audit firms.

In the data analysis, the study uses a combination of Wolcott's (1994) description, analysis and interpretation and that of Miles and Huberman (1984) because by using transforming qualitative data proposed by Wolcott (1994), the researcher will be able to analyse and interpret the meaning of what the auditors say. Second, by using data reduction, display and a conclusion that draws on Miles and Huberman (1984), the researcher will be able to organise and present data in a comparable format between responses.

There are four steps in the data analysis: First, summarizing the interviews data (Miles and Huberman, 1984); second, pattern coding to classify the category (Miles and Huberman, 1984); third, making a description of data summarized and patter coded (Wolcott, 1994); and fourth, analyzing and interpreting the data (Wolcott, 1994).

4. DISCUSSION

In this section, it will be discussed the research results found in this study. This part contains three major sections: It will discuss firstly, the effect of clients' backgrounds/reputations; secondly, the effect of clients' audit committees; and thirdly, the effect of the role of the audit fee paid by clients.

4.1. The Effect of Clients' Financial Backgrounds

To investigate auditors' perceptions about the effects of the clients' financial backgrounds on auditor independence, the interviewees were asked the following question, "What is the effect of clients' background/reputations on auditor independence during the performance of audit tasks?" Before asking this question, the auditors were told what was meant by clients' backgrounds/ reputations. They were asked whether conditions such as strong financial condition, healthy ratios, well recognized owners and management, listed or non-listed companies affected auditor independence. Of the 29 auditors interviewed, all of them stated that the clients' financial backgrounds/reputations had no effect on auditor independence, but eighteen of them believed that clients' backgrounds/reputation had other effects. These other effects related to the scope of the audit work and differing audit requirements, and they built the auditors' early perceptions of the client as well as being a consideration in accepting audit engagement.

Based on the interviews, all the auditors agreed that clients' backgrounds/reputations had no effect on auditor independence. The reasons were because the auditors apply the same audit rules and standards to all clients and there are no "special" treatments for certain clients. However, 18 auditors stated that the clients' backgrounds/reputations raised some differences but not in relation to auditor independence. Those differences include the scope of the work as mentioned by 12 auditors and different audit requirements as stated by 4 auditors caused by different clients' backgrounds as stated by Mr. E, a partner of a big four audit firm.

> *I never differentiate my clients by such backgrounds, because we have to do the same audit program and procedures for all clients. What will make a difference for them are things such as the companies' size, complexities and whether they are listed or non-listed companies. These differences will make a difference in terms of audit time, scope and audit requirements, but not in the perceptions of whether they are better or worse than others. So in my opinion companies' backgrounds have nothing to do with my independence (Mr. E).*

For Mr. F and Mr. Y, -both of them partners of non big four audit firms- the clients' backgrounds/reputations will influence them in building their "perceptions" or "images" about clients, however, it doesn't mean that audit findings will be ignored. Both Mr. F and Mr. Y will make a correction if they find anything wrong, as stated by Mr. F "However, all of those will depend on the audit process. This is a view just like a feeling, not a final judgment." Mr Y clearly said "…this perception will not affect audit findings. If I find something that needs to be adjusted or corrected I have to tell them to change it." This situation was also acknowledged by Mrs. T, a senior manager of a big four audit firm.

Another auditor stated that clients' financial backgrounds/ reputations can be a consideration in accepting engagements but once again it has no effect on auditor independence. Mr. F said.

> *"Clients who had good reputations will be good to audit. So, I am not in doubt in accepting that type of engagement, because I hope that the client will have a clean opinion, or that the clients will have good reports to be audited." This is similar to Mr. Y's view "I think I have a feeling that a good person should have a good report."*

In conclusion, the research question on "what is the effect of clients" financial background on auditor independence? The answer is all of auditors (interviewees) believed that clients' reputations have no effect on auditor independence. The interviewees' reasons were because in their view all clients must be audited with the same rules and standards. This view did not support the study by Beattie et al. (1999) who found that a weak financial condition of a client was perceived by public accountants and financial directors as a factor that could enhance auditor independence.

On the other hand, auditors expressed the views that clients' reputations affected the scope of audit work as mentioned by 12 auditors. While 4 auditors believed that clients' background could affect audit requirements as for instance in the case of listed or non-listed clients. 3 auditors suggested that the effects of clients' reputations would only affect auditors' "perception" or "images" of their clients. However, this would not endanger auditor independence, because as Mr. F, Mr. Y and Mrs. T said, everything depends on audit findings, and their "perceptions" are not a final judgment, but only an initial view. All the auditors interviewed have properly practiced scepticism in the performance of their audit tasks, although 1 auditor said that clients' background could be a consideration in accepting audit engagement.

The study shows that the clients' background have no effect on auditor independence but have some effects on other issues discussed.

4.2. The Effects of Clients' Audit Committee

According to the interviews, only 16 auditors have dealt with clients who have a corporate audit committee. This is understandable because the existence of corporate audit committees are something new in Indonesia. These 16 auditors were asked the following questions, *"Can you tell me the role of the audit committee in relation to your audit work, and what is the effect of the existence of an audit committee on your independence?"*

The 16 auditors indicated that there were four main roles for audit committees in relation to the audit work of the auditors. These roles were first, the audit committee was useful and cooperative to the audit work, second, the audit committee was a source of additional information, third, auditors can discuss findings with the audit committee and, fourth the audit committee was perceived as a representation of commissioners and a mediator between clients and auditors.

The 16 auditors had different perceptions when they were asked the question "Can you tell me what is the effect of the existence of a corporate audit committee on auditor independence?" Thirteen said that the existence of an audit committee had no effect on auditor independence. While the other 3 auditors had different beliefs.

There were 13 auditors interviewed who stated that a corporate audit committee had no effect on auditor independence. There are two main reasons for this that emerge from the interviews. First, they believe that the existence of a corporate audit committee had no good or bad effect on auditor independence as long as they were aware and careful of it. They believed that it assisted the audit work. As stated by Mr. E, a big four audit partner.

We have audited some clients with such a committee. Here, the clients who have an audit committee are normally banks and large companies. The role of this committee to our audit work is very useful. I prefer to audit companies who have an audit committee, however, it won't affect my independence, because I believe that the committee works for them not for us, so we have to be careful, but as I said it is very helpful to the audit work (Mr. E).

The second reason why they think that the audit committee has no good or bad effect on auditor independence is because they do not view the audit committee as the only "reference." The following statement by Mr. G, a big-four audit manager makes this clearer.

We have some clients with an audit committee, and their role normally supports our work, but we do not rely on them. We see this committee as our partner to support us, but we do not treat them as our reference. The role of this committee has no effect on my independence (Mr. G).

A similar view was also delivered by Mr. R, a big-four audit partner who also said that a corporate audit committee was useful in terms of audit work, but had no effect on auditor independence.

The audit committee is a new thing in Indonesia. But I have met them at several clients, banking clients or big company clients. Their role is to discuss our audit findings and the existence of an audit committee is very helpful. However, there is no correlation between an audit committee and our independence. We audit all clients with "skepticism," so we do not rely on them. We treat all clients with same treatment. In my experience, many clients complain to us by stating "why are your audit staff so suspicious of us?" Do you know what it means? It means that in this audit firm all audit staff must be independent, not just rely on information given by clients, but we have to investigate them (Mr. R).

There were 3 auditors who stated that an audit committee had an effect on auditor independence. One auditor believed that a corporate audit committee could enhance auditor independence. He argued that he must be careful with that client because its audit committee consisted of non-director members so consequently he felt that he must be more independent. Another auditor stated that a corporate audit committee could impair or enhance auditor independence. It depended on how auditors took advantage of this committee and how the auditor interacted with it. If auditors tended to be steered by the corporate audit committee, their independence would be impaired. But if auditors followed the audit rules and standards, it wouldn't be a problem for auditor independence. While another auditor stated that the effect of a corporate audit committee on auditor independence is dependent on who were members of that committee. The following opinion was put by Mrs. T, a big-four audit senior manager regarding the effects of a corporate audit committee on auditor independence.

Yes, I audited some clients with an audit committee. Their roles was to assist us in providing information and assist us when we needed some discussion, they also discussed with us our audit findings. In my opinion, their existence is useful to our audit tasks, but if their members consist of management or directors, their independence should be questioned. But if their members consist of the owners or other independent elements, it would be independent, and we could better work together with them (Mrs. T).

From these 3 auditors' views, it can be concluded that the existence of an audit committee could enhance auditor independence when the members of the committee consists of non-director members. The reason is because in performing their tasks the non-director members would have no conflict of interest.

This research concludes that auditors in view the effect of a corporate audit committee on auditor independence have various views. Most of them state that the corporate audit committee has no effect. This view is consistent with the study of Gul (1989). And only 1 auditor supported the findings of Teoh and Lim (1996) and Beattie et al. (1999) who argued that the corporate audit committee could enhance auditor independence. Another auditor said that, it was dependant on its members. A third auditor said that it depended on how the auditor perceived and interacted with the corporate audit committee. From these views, it appears that the existence of a corporate audit committee could assist audit work. None of the interviewees said that auditor independence was impaired by the existence of this committee. The establishment of an audit committee would be expensive, since it is a new thing in Indonesia, and it is still limited to the banking businesses only. However, it is suggested that the existence of a corporate audit committee is significant especially in assisting audit work, and it is important that members of this committee be considered as independent to avoid conflict of interests.

4.3. The Effect of Clients' Audit Fee Contribution (Major Clients)

To avoid a misunderstanding of the questions asked, the interviewees were given a definition of the term "major clients." Major clients were regarded to be audit clients who generated a significant fee compared to total firm audit incomes. Then, all the auditors were asked the following question "Can you tell me your opinion about the effects of major clients on auditor independence during audit work?"

From the 29 auditors, there were 3 auditors who had no major clients. Therefore, there were only 26 auditors who had major clients. From 26 auditors who had major clients, 22 auditors said that major clients had no effect on auditor independence. While 4 auditors said that major clients had an effect on auditor independence.

In responding to the question in the interviews, each auditor provided one or more reasons why major clients did not impair auditor independence. The responses given by 22 auditors can be classified into five main reasons. First, 9 auditors were confident with their audit quality therefore they believed that they could retain their major clients. They believed that they could be independent even though they had some major clients, because they were not dependant on those clients. The following statement of Mr. CC, an assistant manager of a big-four audit firm highlights this.

> *Yes we have some major clients. But our audit firm has many other clients, so it is not a problem with our independence. We are a big audit firm, we have confidence and clients will come to us to be audited (Mr. CC).*

Since seven of the 9 auditors were members of big 4 audit firms, the above statement seems to indicate the self-confidence of auditors, especially the big-5 auditors. A similar view was also stated by Mr. X, an audit partner of a big-four audit firm when he said.

> *Yes we do have some major clients. As I have said that we are not worried about losing clients, so in conducting an audit we are confident of our performances and therefore we don't really care whether clients will be coming back or leaving us. It doesn't affect my independence (Mr. X).*

Second, 5 auditors argued that the bigger the clients they had, the more work they needed to do and the more risks they had to be aware of. In other words, they thought that the larger fee they received, the more work and risk they would have to face. This could be compared to small clients who generated small fees, but also had less work and risks. This was stated by Mr. D, a non big-four partner.

> *Yes I have some major clients, but we have to remember that the bigger the clients the riskier and more work we need to do. So in my opinion, big or small clients are not significant, because they are proportional in size in terms of fee and risks or work (Mr. D).*

Third, 4 auditors said that they were not worried about losing clients. Three of them were big-five audit partners and only one of them was a non big-five audit partner. Their reason was that because they had so many clients even though some of them terminate they would be replaced by new clients. It seems that these auditors were very confident with their position and they had strong bargaining power. The following is a statement by Mr. R, an audit partner of a big-four firm.

> *You can't think that our independence is affected by major clients. We have more than a thousand clients, we won't be worried if some clients leave us. We are not dependant on individual clients. Every year about one hundred become new clients and about thirty clients leave us. Even though we have some major clients they cause no problems to our independence. We maintain our independence as tight as possible because this is our commitment (Mr. R).*

Fourth, 4 auditors (2 auditors were members of big-five firms and two were members of non big-four firms) said that by following the rules and standards, they would be independent or at least they could minimize auditor impairment from dependence on major clients. The following is a statement by Mrs. U, a big-four audit manager.

> *Yes I have some major clients. But I think when I perform audit work I never follow what they want, but rather I refer to audit standards. As long as we remain professional, major clients have no effect on our independence (Mrs. U).*

Fifth, an auditor said that by applying religious values she could do audit tasks independently and not be affected by major clients. She believed that clients were given to her by God and the only thing she does is her best by following the audit rules and standards.

In contrast, 4 auditors said that major clients could impair auditor independence. These 4 auditors were three members of non big-four firms and only one partner of a big-four firm. The following paragraphs contain the reasons stated by these 4 auditors as to why major clients could impair auditor independence. Mr. E, a partner of a big-four audit firm, states that there is a tendency to fear losing major clients when performing audit work. The larger the clients, the greater the fear will be.

> *Yes we have major clients among several hundreds of our clients. When we audit those major clients to be honest there is a tendency to fear losing them, the more extreme our major clients, the more fear of losing clients (Mr. E).*

The key reason why major clients could impair auditor independence is because the firms are afraid of losing income. It seems that income dependence on certain clients can lead auditors to impair (or tend to impair) their independence. This experience was stated by Mr. A, a partner of a non big-four audit firm:

> *I feel pressured because, to be honest, I am worried about losing my major clients. But I always work to maintain standards. That is my key point, because maintaining independence is my business (Mr. A).*

Mr. A was also worried about losing major clients, however he tried to follow the rules and standards, because by doing that he could minimize the chance of further "wrong doing."

Mr. B, a partner of a non-big-four firm stated that major clients could put him into a difficult situation and consequently major clients could lead to independence impairment.

> *Yes I have some, but not really extreme major clients. In my experience this position can put us into hard situation, I think it could lead into independence impairment (Mr. B).*

While Mr. W, a partner of a non big-four firm stated that even though major clients sometimes could affect auditor independence it was still tolerable because he tried to follow audit rules and standards, not to violate them.

> *Sometimes there are effects from this situation. However, I have some restrictions in doing this, I can suggest and compromise about our audit works but those are still in the audit standards. I can be flexible but still not violate our standards (Mr. W).*

In conclusion, of the 29 auditors who were interviewed, twenty-six had major clients. From that number of auditors, most of them (twenty two) believed that major clients had no effect on auditor independence. However, there were 4 auditors believed that audit fee contribution (major clients) can affect auditor independence.

5. CONCLUSION

This study has examined and discussed the effect of the nature of clients on auditor independence. This included the clients' reputations, whether there was a corporate audit committee and the size of the audit fee paid by the clients. On the issue of client reputation this study found that most auditors (twenty-seven out of twenty-nine) did not agree with the proposition saying that auditor independence was affected by the client's reputation. Their argument was that auditors performed an audit task based on the same audit rules and standards for all clients. They did not differentiate their clients based on the clients' backgrounds. Regardless of their clients good or bad reputations this did not affect auditor independence.

Conversely, 2 auditors believed that a client's reputation could influence the perceptions of the auditor before the acceptance of an audit engagement and at the beginning of the audit examination. According to their view, the better the client's reputation then the better the audit opinion would be. This argument is somewhat consistent with the study by Knapp (1985) and Beattie et al. (1999) stating that a better financial condition of a client could impair auditor independence. However, these 2 auditors, in an audit examination would try to go back and rely on the "facts" they found in the audit work and not be influenced by their clients' reputations. On this issue, auditors seem to use professional judgments rather than emotional judgment. Even though clients' background had no effect on 27 auditors it did influence 2 auditors, so this study therefore concludes that a client's background could "potentially" have an effect on auditor independence. The better clients' backgrounds would "potentially" be perceived as having a better audit opinion, consequently auditors would potentially agree with the clients' opinion.

On the issue of corporate audit committees, this study found that they were new in Indonesia. The study found that only sixteen of the 29 auditors have dealt with clients who had an audit committee. Of the 16 auditors, 13 auditors did not agree with the proposition saying that a corporate audit committee could enhance auditor independence. They believed that the existence of a corporate audit committee assisted audit work, but that it had no effect on auditor independence. Whereas, 3 auditors agreed that a corporate audit committee could enhance auditor independence and also suggested that the committee could assist them in doing the audit as long as most of the committee members were non-directors. On this issue this study found that all auditors acknowledged the benefits of the existence of a corporate audit committee, and some of them felt that it could enhance auditor independence. This study therefore concludes that corporate audit committees could assist auditors' work and it "potentially could enhance" auditor independence.

On the issue of audit firms' dependency on major clients, this study found that 26 of 29 auditors stated that they had major clients, whereas the other 3 auditors did not. The majority of those who had major clients believed that major clients did not impair auditor independence. Their arguments were based on their confidence in their audit quality and the view that the more fees they received the more work and risks they faced.

Conversely, this study identified that there were 4 auditors who supported the proposition saying that audit firms' dependence on major clients could impair auditor independence. Their reasons were because they feared losing clients or incomes. Even though only 4 auditors of the 26 auditors who had major clients believed that major clients could impair their independence and the other 22 auditors did not agree, this study considers major clients as a "potential factor" that could negatively affect auditor independence. This is based on the logical reason that the larger the clients the more audit firms would depend on them.

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