A study on Audit Independence and Corporate Governance of Private Commercial Bankers of Bangladesh

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ABSTRACT

Auditors lodge an exclusive position in the business community when they implement an audit for clients. Auditors are called upon to verify financial statements and to safeguard the interest of various parties. In recent years the audit practice because of several humilations has been diluted. This empirical study shows that several factors effect on audit independence in Bangladesh. The results show that there is a huge difference between auditors and bankers on audit independence. It has come to the conclusion that for solving this problem well-established corporate governance can improve audit independence.

Keywords: Audit independence; auditor’s perception; corporate governance; economic dependence

1. INTRODUCTION

Separation of proprietorship from management and limited liability of members are the two major features of corporate bodies that require giving a single thought to the governance of these organizations. For such an important advantage to investors and managers, not much of accountability was created for them initially. Usually a company was seen as a self-regulatory body which is a part of regulatory market mechanism, thus making it accountable primarily to the market and to its members. Rapid growth in the size of the companies and the consequent complexities in their structures have, however, challenged this traditional perspective all over the world; that is why corporate governance has become a topic of hot discussion in well-developed as well as developing countries. The global movement for better corporate governance progressed by fits and starts from the 1980s. Corporate governance is the implementation of best corporate practices which enhance shareholders value in the long run at the same time protecting the interests of other stakeholders. High-profile business failures such as Enron Corp., WorldCom, Inc., and Global Crossing, Ltd. have focused public’s attention on how management manipulates earnings in an apparent attempt to deceive the unwary public. Public confidence in corporate governance structures and the ability of corporate boards to monitor and control management’s behavior has been reduced to very low levels. Corporate governance deals with laws, practices and implicit rules that determine the company’s ability to take informed managerial decisions vis-à-vis its claimants in particular, shareholders, creditors, customers, the state and employees. The present study on corporate governance is
historical in nature. It seems that the concept has become widely circulated because of audit failure.

The basic objective of audit process is to ensure that the operations of an enterprise are carried out in good faith by the management without using the resources to satisfy self-interest. An auditor is expected to render his opinion on management’s operations from the viewpoint of carrying out such functions in good faith. It is important to note that the focus of corporate governance, in its broadest interpretation, incorporates this objective of audit process itself. Then the question arises as to why we should focus on corporate governance now, when we can achieve the objective of the verification of management working in good faith. The reason is that audit has itself failed in the realization of the stated objective of verifying the operations carried out by the management. One of the major reasons for the failure of audit effectiveness is the absence of auditor independence and this factor alone paved the way for corporate governance. In recent years the failure of auditor independence has necessitated for a study on corporate governance in Bangladesh, as a sequel to the global phenomenon.

The need for the study arises because (i) audit effectiveness has failed paving the way for corporate governance; and (ii) the crucial issue of auditor independence has not been empirically tested in Bangladesh. With the background of this problem, the present study aims at empirically testing the factors that hinder audit independence and also the factors that enhance auditor independence. This study has an argument that there is a strong relationship between corporate governance and audit independence.

2. LITERATURE REVIEW

Watts and Zimmerman (1983) have argued that auditors have incentives to maintain their independence, even in the absence of governmental regulations, so that self-monitoring might be sufficient. At least since the Securities Act, independence has been the focus of almost constant controversy, debate, and analysis. There is widespread agreement by regulators, accounting practitioners, and auditing academics that auditor independence enhances auditor credibility.

It is argued that independence enhances the credibility of financial statement on two grounds. First, independent auditors increase the likelihood that financial statements conform to generally accepted accounting principles (GAAP). Second, investors are more likely to rely on the financial statements if the auditor is independent. Under this set of arguments, auditor independence plays a central role in enhancing the credibility of financial statements, and any threat to auditor independence has undesirable effects on capital markets (SEC, 2000). Referring to more recent work that has been done on corporate governance, Shleifer and Vishny (1997) define corporate governance by stating that it “deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment.” Taking a broad perspective on the issues, Gillan and Starks (1998) define corporate as the system of laws, rules, and factors that control operations at a company. Irrespective of the particular definition used, researchers often view corporate mechanisms as falling into one of two groups: those internal to firms and those external to firms.

Of course, firms are more than just boards, managers, shareholders, and debt holders. As demonstrated by Pass (2004, pp. 52), corporate governance actually deals with the “duties and responsibilities of a company’s board of directors in managing the company and their relationships with the shareholders of the company and the stakeholder groups”. To put it into effective work, in essence, such dealing should be appropriately governed, regulated, imposed
and enforced. Hart (1995) suggests “corporate governance issues arise in an organization whenever two conditions are present.

First, there is an agency problem, or conflict of interest, involving members of the organization – these might be owners, managers, workers or consumers. Second, transaction costs are such that this agency problem cannot be dealt with through a contract”. Garvey and Swan (1994) assert that “governance determines how the firm’s top decision makers (executives) actually administer contracts”, while they also argue that governance arises when such contracts are incomplete. In accordance to the above, John and Senbet (1998) define corporate governance in a more comprehensive way since they argue that it “deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected”. It is worth noting that by the term stakeholders we mean not just shareholders, but also debt holders as well as non-financial stakeholders such as employees, suppliers, customers, and other interested parties.

3. OBJECTIVES OF THE STUDY

The main objective of the study is to evaluate the audit independence and corporate governance of private commercial bankers of Bangladesh. The specific objectives are as follows:

(1) to know the auditor’s perceptions on the economic value;
(2) to know the professional ethics of auditors and bankers; and
(3) to know the auditor’s and banker’s economic dependence.

4. SCOPE OF THE STUDY


5. LIMITATIONS OF THE STUDY

This study has some limitations. One of its limitations is that due to unavailability of data it did not include all the bankers of all commercial banks working in Bangladesh. This study also does not cover the foreign commercial bankers due to non-availability of relevant data.
6. AUDIT INDEPENDENCE

The concept of auditor independence has been argued from many perspectives. Many research works have been conducted on the auditor independence. From amongst them some of the important definitions and views have been presented in the study. The auditor independence has been defined by International Auditing Practices Committee of the International Federation of Accountants in its I.A.G.-3, Sept 1980 as the auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity. Moizier (1991) viewed in an economic sense, the term auditor independence. There is an expectation that the auditor will have performed an audit that will have reduced the chances of a successful negligence lawsuit to a level acceptable to the auditor. In the language of economics, the auditor will perform auditor work until the cost of undertaking more work is equal to the benefit the auditor derives in terms of the reduction in the risk of a successful lawsuit being possible, that is the minimum amount of work that the reader can expect the auditor to perform. However, all auditors are individuals with different attitudes to risk and return and so one auditor's minimum standard of audit work will not necessarily be that of another.

6.1. Origin of audit independence

Independent auditing is an essential feature of efficient capital markets. The auditing profession in the developed world has long argued that the main objective of independent audits is to render an expert opinion on the fairness of financial statements. Independence both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depend the profession's strength and its stature. The concept of auditor independence has varied over the last 150 years. In a general sense, auditor independence has borne a relationship to the prevailing commercial environment in different time periods. There has not, however, been a clear transition from one concept of auditor independence to another. The initial concept of auditor independence, which arose during the nineteenth century, was based on the premise, primarily British in origin, that the principal duty of professional accountants and auditors was to oversee absentee investments in the existing and former colonies of the British Empire. The concept of auditor independence during this era did not conceive of auditors as advocates for audited entities. British investors explicitly forbade auditors from investing or working in the businesses that they audited. At the same time, as long as auditors maintained their primary loyalty to the investors back home, the scope of professional accounting services could be reasonably broad. This initial concept of auditor independence changed during the late nineteenth and early twentieth century. During this time there was an economic shift from capital coming primarily from foreign sources to capital deriving primarily from domestic sources. The crux of the management-auditor relationship is often viewed in terms of the independence and objectivity of the auditors. However, in order to form an independence and objective view of something the auditors need to be aware of it.

6.2. Importance of audit independence

The audit of accounts in the corporate sector by an independent auditor is obligatory by statute which defines his duties rights and powers. It is essential because of the separation of ownership from the management in the corporate sector as the former needs someone who can keep a professional watch on the latter and to whom they can trust for the reliability of accounts.
as the preparation of financial statement is the prerogative of the management. The auditor has not much to suggest on the form and adequacy of financial statement and independent auditor is responsible for his audit report. The reliability of an audit report is nothing but the degree of trust reposed by its users. The various users are bound to react differently because of the variation in their nature and objectives. The following are some of the important features of auditor independence:

1. The reliability of auditor's independence depends on auditor's independence on the one hand, and the degree of his experience, competence and knowledge, on the other;
2. The independence of the auditor is of prime importance as his report is persuasive and subjective in nature;
3. Independence is a state of mind and implies that auditors should remain firm enough to withstand any type of influence;
4. Independence is of prime importance as wide spectrums of users are interested in his professional report and if his independence is not maintained, expectations of users will be belied;
5. The auditor is beholden to be independent without resorting to confuse rather than enlighten the business community by his work and report on the task entrusted to him in a clear straightforward manner; and
6. Traditional view of auditor independence is that lack of independence will reduce the importance placed on audit reports and that investment and loan decisions will be impaired.

6.3. Empirical evidences regarding audit independence

Auditor independence is an issue that has been debated since the birth of the profession. The global conception among users of accounts is, and has always been quite rightly threat. If one wants to place trust in the auditor's report, it must be a precondition that the views expressed by the auditor are based on objectivity. Objectivity can only be achieved if the auditor is independent of the client. Audit independence has been a significant issue in accounting literature in recent years.

This is often tested by statistical analysis of the relationship between audit fees, non-audit fees, qualified audit reports and so on. There is a broad range of accounting literature that investigates whether the independence of the auditor has been actually impaired. Majority of the perceived independence research has emanated from the developed countries, especially in the United States, where there have been two government commissions, viz., The Cohen Commission (1978) and the Treadway Commission (1987) with many debates about the effect of management advisory services on the independence of the auditors. However, the views of natural shareholders have not been sought in much of this research.

Schulte (1965) specifically focused on Non-Audit Services (NASs). Third parties were asked whether management consulting seriously impaired CA’s audit independence. There were great variations in views. It was found that 43 percent did not think so (indeed 20 percent indicated that their confidence in audit reports were thereby improved), 33 percent did think so and remaining 24 percent were unsure. Titard (1971) undertook a similar study, asking financial statement users on whether NAS’s provision to audit clients may result in CA’s losing some of their audit independence. The interesting feature of this study was that this same question was asked with respect to 33 specific types of services. Over 20 percent of respondents answered in the affirmative to five types of service: mergers and acquisitions (32 percent), executive recruitment (27 percent), policy determination (27 percent), personal appraisal and/or selection (23 percent), and executive and wage incentive plans (21 percent). It was noticeable that no
single item was checked by more than one-third of respondents, although 49 percent answered “Yes” to an initial question asking about NAS generically. Respondents were asked also whether each service should be prohibited assuming separation of personnel. For the above five services, the percentage agreeing was between 10 percent and 20 percent. Emby and Davidson (1997) conducted an experiment using auditors to examine the impact of four factors (including NAS provision) on auditor’s ability resist management pressure in a dispute over the disclosure of a contingent claim.

They found that auditors were more likely to insist on disclosure when they provided the client with NAS. Hussey (1999) asked the UK finance directors about a range of issues concerning the familiarity threat and auditor independence. One question asked whether auditors should be allowed to undertake other than audit work for the same client. The majority agreed that joint provision should be allowed, however 20 percent of independent public respondents disagreed, compared to 13 percent of private company respondents. Kornish and Levine (2000), a survey commissioned by the ISB indicated that respondents believed that the evolution of audit firms into consulting fields was logical and published in most consultancy services was not likely to create real problem of independence. It is believed that auditor’s responsibility and independence are crucial issues underlying the independent auditing function and has significant implications on the development of auditing standards and practices. In this regard, a survey was taken up by Lin (2004) in China with respect to audit objectives, auditor's obligation to detect and reporting frauds and third party liability of auditors. The study evidenced the emergence of the expectation gap in China and the majority of audit independence by reducing governmental control on intervention and moving towards self-regulation of the profession. This study has a limitation in the sense that it should cast light on understanding of the institutional setting and related development of independent audits in China and may also serve as an annotation to the recent accounting reform debates in the western world. Myers (2005) perceived that audit independence is fundamental to the profession credibility. The audit independence can be viewed from two angles: (i) Actual independence is the achievement of actual freedom from bias, personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure; and (ii) perceived independence is the belief of financial report users that actual independence has been achieved.

7. CORPORATE GOVERNANCE

Despite that the term corporate governance is relatively new; the aspects surrounding it have been around since the first half of the century (Berle and Means 1932; Smith, 1776). In the modern society, the first corporate governance codes were established in the USA in the 1970s, a period in which the corporate sector of the country was confronted with a wave of mergers and hostile takeovers. In 1978, a report was published by the so-called Business Roundtable, entitled “The role and composition of the board of directors of the large publicly owned corporation” as a response to a trend of increased corporate criminal behaviour, as well as to support the establishment of new laws to set clear boundaries to hostile takeovers (Aguilera and Cuervo-Cazzura, 2004). In Europe, the first code was established in 1992 with the issuing of the so-called “Cadbury Report”. This report was published after increased public concern about a series of unexpected failures of major British companies such as Polly Peck, P&C, BCCI and Maxwell (Parkinson, 1993). The Cadbury Report in 1992, containing a code of best practices for listed companies, added an additional source of regulation to the British corporate governance environment in parallel with the relevant legislation.
The widely accepted positive outcomes of that initiative have instigated the adoption of similar codes of best practice in almost all European Union countries. Yet, the appreciation for codes as an instrument to improve corporate governance systems increased only after 1997. Between 1992 and 1997 only three countries (Spain, The Netherlands and France) established a code. From 1998 several other European countries decided to come up with their own version of a corporate governance code. By 2004, a total of 22 European countries has established their own code, and in some cases even more than one. Reviewing the various definitions of corporate governance it is clear that they all refer to the existence of conflicts of interest between insiders and outsiders arising from the separation of ownership and control. During the recent past a growing interest in corporate governance has been observed. In the first place, the efficiency of the prevailing governance mechanisms has been questioned while this debate intensified following financial scandals and business failures and, more recently, a number of high visibility accounting frauds allegedly perpetrated by managers (Enron, WorldCom). The definition of corporate differs depending on one’s view of the world. Many existing studies in good corporate governance have focused on: the roles of non-executive versus executive members of the board (Pass, 2004), the independence of the board of directors (Zandstra, 2002), the role, independence and disclosure of audit committee (Rezaee et al., 2003), the enforcement of compliance and role of internal auditors (Vinten, 1998, 2000, 2002). They are altogether grouped into under mentioned values of corporate governance perspectives:

- Accountability (Spira, 2001);
- Integrity (Grant, 2003);
- Efficiency (Walker and Fox, 2002); and
- Transparency (Rezaee et al., 2003).

To explain the primary impediments to good governance, the International Swaps and Derivatives Association (ISDA) (2002) reminds us that modern economic theory has established an approach to construct corporate governance through the separation of two main functions in firms, which are:

1) **Principals:** The owners of the companies who hold claims over the net income of the company’s business, no matter whether it is positive or negative, who then appoint the agent; and

2) **Agents:** Agents are those who execute duties and responsibilities in the companies on behalf of the principals.

This separation is however, linked and governed through proper “agency relationship” at various levels, among others “between shareholders and boards of directors, between boards and senior management, between senior and subordinate levels of management” (ISDA, 2002, p. 4). In such a principal-agent relationship, there is always “inherent potential for conflicts within a firm because the economic incentives faced by the agents are often different from those faced by the principals” (ISDA, 2002, p. 5). According to ISDA (2002), all companies are exposed to agency problems, and to some extent develop action plans to deal with them. These include establishing such measures as: “controls on the actions of agents, monitoring the actions of agents, financial incentives to encourage agents to act in the interest of the principals, and separation of risk taking functions from control functions” (ISDA, 2002, pp. 5). It is safe to say that, corporate governance covers all aspects of firms; therefore the existence of good corporate governance wills great effect firms. Furthermore, now a day’s firms should think in interdisciplinary way; it means they have to accept new conditions. According to Wilson (2000), new rules of corporate conduct could be considered as follows:
a) **Legitimacy:** To earn and retain social legitimacy, the corporation must define its basic mission in terms of the social purpose it is designed to serve rather than as the maximization of profit;

b) **Governance:** The Corporation must be thought of, managed, and governed more as a community of stakeholders and less as the property of investors;

c) **Equity:** The corporation must strive to achieve greater perceived fairness in the distribution of economic wealth and in its treatment of all stakeholder interests;

d) **Environment:** The corporation must integrate the practices of restorative economics and sustainable development into the mainstream of its business strategy;

e) **Employment:** The Corporation must rewrite the social contract of work to reflect the values of the new workforce and increase both the effectiveness and loyalty of employees and the corporation;

f) **Public/private-sector relationships:** To ensure the success of the power shift, corporations must work closely with governments to achieve a viable and publicly accepted redefinition of the roles and responsibilities of the public and private sectors; and

g) **Ethics:** The Corporation must elevate and monitor the level of ethical performance in all its operations in order to build the trust that is the foundation of sound relationships with all stakeholder groups.

In accounting and auditing dimensions, the corporate governance may play vital role, because good corporate governance leads to more audit independence; in other words there is a positive relationship between corporate governance and audit independence. One of the key elements of audit practice is independence as explained hereunder.

8. **RESEARCH METHODOLOGY OF THE STUDY**

This study gives emphasis on the perceptions of auditors and bankers on auditor independence. It is usually held that economic considerations basically influence the level of auditor independence leading to effectiveness or effectiveness of audit process. The influence of economic considerations on auditor independence was considered through eight variables given in the ensuing table. The study has focused on the perception of 120 private commercial bankers and 15 professional chartered accountants of Bangladesh. The questionnaire consisted of five variables, which were held to decrease audit independence and four variables, which were held to increase audit independence in Bangladesh. All these variables were to be rated by the sample respondents on 5-point Likert scale having the ratings of “strongly disagree” (1) and “strongly agree” (5). The statistical tools used in the study included mean value, median value, standard deviation, Mann-Whitney test and Z value for the purpose of analysis and interpretation.

9. **HYPOTHESES OF THE STUDY**

In carrying out the study, the following hypotheses were identified:

a) Audit independence is lower due to self-interest of the auditors;

b) The self-interest reducing the audit independence is perceived with higher weighted points by the bankers than the auditors; and

c) Auditors perceive lower actual values for economic consideration than the bankers.
10. FINDINGS AND ANALYSIS OF THE STUDY

Table 1 highlights the results of respondents’ perceptions comprising of auditors and bankers on economic and regulatory considerations affecting the independence of auditors and eight factors are included to study of these factors on auditor independence. It is interesting to note that both the auditors and bankers recognize that these factors influence auditor independence. Furthermore, according to the Mann-Whitney test there is a significant difference between two parties on all eight factors (p<0.05). In the other words, there is a significant perception gaps in all factors between auditors and private commercial bankers in Bangladesh. The auditors perceived the independence level by assigning the mean value of 3.559 implying that these factors reduced independence of auditors. However, the bankers expected more from auditors in eight dimensions and they expected that the ill effects of these factors affecting independence should be reduced and they assigned the mean value of 3.708.

Table 1. Factors effecting to independence.

<table>
<thead>
<tr>
<th>Statements</th>
<th>Auditors</th>
<th>Bankers</th>
<th>Significance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic dependence of the auditor on the client</td>
<td>3.168 3 1.116</td>
<td>3.789 4 0.945</td>
<td>-8.415 0.000</td>
</tr>
<tr>
<td>Audit market competition</td>
<td>3.609 4 1.026</td>
<td>3.465 3 1.665</td>
<td>-8.676 0.000</td>
</tr>
<tr>
<td>Receiving payment from non-audit services</td>
<td>2.799 3 0.981</td>
<td>4.014 4 0.945</td>
<td>-7.578 0.000</td>
</tr>
<tr>
<td>Receiving gifts and presentations from management</td>
<td>2.970 3 0.810</td>
<td>4.401 4 0.855</td>
<td>-6.822 0.000</td>
</tr>
<tr>
<td>The regularity of frame work</td>
<td>3.852 4 0.900</td>
<td>3.402 3 1.125</td>
<td>-8.505 0.000</td>
</tr>
<tr>
<td>The corporate governance system</td>
<td>4.059 3 1.026</td>
<td>3.537 4 1.123</td>
<td>-8.685 0.000</td>
</tr>
<tr>
<td>The great use of audit committees</td>
<td>3.888 4 0.981</td>
<td>3.789 4 1.521</td>
<td>-7.875 0.000</td>
</tr>
<tr>
<td>Professional ethic guidance</td>
<td>1.311 4 0.810</td>
<td>3.447 3 0.801</td>
<td>-9.395 0.000</td>
</tr>
<tr>
<td>Total</td>
<td>3.559 - -</td>
<td>3.708 - -</td>
<td>- -</td>
</tr>
</tbody>
</table>

Further, the auditors’ perceptions of the economic and considerations like client’s economic worth, receiving gifts and presentations from management, in the executive function at a higher level rather than bankers, while the perceptions regarding audit market competition, the regularity of framework, the corporate governance, the great use of audit committees and professional ethic guidance are higher than bankers’. It is interesting to note that the auditors believe the corporate governance effects on audit independence. In other words the well-corporate governance increase audit independence. The auditors also believe audit market competition reduces audit independence and audit committees of private commercial banks and professional ethic guidance increase audit independence. However, private commercial bankers do not agree on these matters with auditors. The private commercial bankers believe the economic dependence of the auditor on the client, receiving payment from non-audit services, receiving gifts and presentations from management and receiving gifts and presentations from management do seriously affect audit independence and impair independence of Bangladeshi auditors.
11. CONCLUSIONS

The new concept of auditor independence requires one that specifically incorporates the propositions that auditors should not be advocates for their clients, and management should not be able to influence the audit fee and the scope of the audit. Without a transition to this concept, auditor independence standards will most likely be primarily cosmetic and will not provide sufficient assurance that auditor is in fact independent from client management. The primary purpose of an independent audit is not the detection of fraudulent financial reporting, as long as the public's perceptions remain the way they are. The auditor's best protection against empty pockets is to look for fraudulent financial reporting with each and every independent audit regardless of whether it will have a material effect on the statements. Audit opinion on financial statements renders the level of truth and fairness in preparing and presenting financial statements and also of representational faithfulness of corporate governance. The auditors strongly believe that corporate governance in Bangladesh will increase audit independence, therefore, it is crucial to Bangladeshi finance sectors to well-establish corporate governance according to business requirements. In addition, the present study reveals a low level of auditor independence and this level indicates the pathetic situation in the ineffective audit process. If auditors eulogize audit as the sacred act of them, private commercial bankers and third parties condemn it as a perfunctory legal duty devoid of any credibility. Recognizing this failure of audit process, it has been embarked upon cleansing the corporate Bangladesh through the much hyped corporate governance, the effectiveness of which is still under doubt needing proactive institutional framework in Bangladeshi private commercial bankers.

References


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(Received 08 November 2014; accepted 16 November 2014)