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Corporate Governance and Auditor Independence in Small Economies

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Abstract: Corporate governance and auditor independence can be viewed as two sides of a coin. They are thus intertwined to a significant extent, with one (auditing) lending support to the other (corporate governance). Corporate governance is a topical issue worldwide, while auditor independence is a topic that has attracted considerable interest from research scholars over a period spanning many decades to-date. Various aspects of auditor independence have been studied yielding interesting outcomes. However, there has not been a significant amount of interest in researching this topic with regard to small economies such as that of Botswana, to establish if there are any unique auditor independence issues that arise as a result of that phenomenon. This study attempts to fill that void and has yielded results that call for further inquiry to establish if indeed there are no factors emanating from the size of the economy or the size of the population of a country that impact auditor independence, and thus compromise corporate governance. The study is based on Botswana, but it is presented here that its outcomes would most likely apply to other small economies with similar characteristics to those of Botswana.

Keywords: Corporate governance, Auditor independence, Small economy, Small population, Ethics, Botswana

1. A Concise Examination of Corporate Governance

The Business Dictionary (2017) defines corporate governance as the framework of rules and practices by which a board of directors ensures accountability, fairness, and transparency in a company's relationship with all its stakeholders (financiers, customers, management, employees, government, and the community). It adds that the corporate governance framework consists of (1) explicit and implicit contracts between the company and the stakeholders for distribution of responsibilities, rights, and rewards, (2) procedures for reconciling the sometimes conflicting interests of stakeholders in accordance with their duties, privileges, and roles, and (3) procedures for proper supervision, control, and information-flows to serve as a system of checks-and-balances (ibid).

TechTarget also defines corporate governance as a term that refers broadly to the rules, processes, or laws by which businesses are operated, regulated, and controlled. Further, that "a well-defined and enforced corporate governance provides a structure that, at least in theory, works for the benefit of everyone concerned by ensuring that the enterprise adheres to accepted ethical standards and best practices as well as to formal laws."

2. A Summary Review of Auditor Independence

External audit is an attest function carried out by an unbiased and independent person, aimed at providing comfort to users of audited financial statements of organisations, that those

statements can be relied upon. The attest function ties in very well with the dictates of corporate governance as discussed above, as auditing is one of the safeguards against unethical conduct of those running organisations (management and boards). As Zulkarnain et al. (2015) noted, it is a fact that auditor independence plays an important role in ensuring good corporate governance and is a prerequisite for the expected ethical behaviour of institutions. For investors to rely on the opinion of the auditor, it goes without saying that the auditor must not only be independent in fact, but must also be seen and believed to be independent of the client that they audited. As Zulkarnain et al. (2015) rightly pointed out, a review of the Asian financial crisis in 1997/1998 and the Global Financial Crisis of 2007, it is evident that proper corporate governance practice is essential in mitigating adverse eventualities such as those alluded to in the foregoing situations. The more recent episode concerning KPMG in South Africa, which is still evolving, will likely add yet another dimension of how compromised auditor independence can harm corporate governance.

Key to the function of auditing is the independence of the auditor from those running the entities that they audit. What then does it mean for an auditor to be independent? The International Federation of Accountants (IFAC) defines independence in two parts and these being 'independence in mind' and 'independence in appearance.' IFAC (2005) explains independence in mind as the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional scepticism. On the other hand, independence in appearance is the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional scepticism had been compromised.

IFAC (ibid) does clarify that auditor independence should not be taken to the extreme as every individual does relate to others in society, and this at times may even involve elements of economic or financial relationships. What is important is that any economic, financial or other relationships should be considered in terms of what an informed third party having knowledge of all relevant information would reasonably conclude to be unacceptable.

3. Background of the Study and Hypothesis Development

As Shockley (1981) points out, the value of auditing services is dependent upon the fundamental assumption that auditors are independent of their clients. Numerous factors weigh in on the independence of an auditor. Windmöller (2000) has astutely summarised the factors and drivers, actual and perceived, that have the effect of compromising auditor independence as:

- Auditors holding shares and other direct or indirect financial interests in audit clients
- Key audit clients personnel being family members or having a close relationship with the auditor.
- Auditors forming joint ventures or alliance with audit clients.
- The provision by auditors of non-audit services to audit clients.

3.1 Problem Statement

The motivation behind this study stems from the fact that in small economies such as that of Botswana, with much of the economic and audit activities concentrated in one area, usually the capital city, the major players in the economy and the major accounting firms mostly locate their head offices in and around the capital city. The audit partners and the company executives are generally very well acquainted with each other from a business perspective and in some instances, from a social perspective. The question is, in this setup, are the auditors perceived

to be independent of their clients, and are the steps that the auditors take to assure the public that indeed they are independent, really working? If the responses to the preceding are in the negative, then corporate governance is compromised since external auditing is an integral part of assurance in the corporate governance system.

3.2 Hypothesis Development

The opinion issued by an auditor ought to give users of financial statements, be they investors, lenders, creditors and others, the confidence to rely on those financial statements in decision making relating to the particular entity. The audit opinion provides users with reasonable assurance that the audited financial statements give a true and fair view of its financial position, results of operations and changes in financial position in conformity with accounting standards applicable in that jurisdiction. It also gives users of financial statements a fair level of comfort that the statements are not likely to contain material error and fraud. (Institute of Chartered Accountants in Australia, 2008).

As indicated above, auditors should not only be independent in fact, but should also be seen and believed to be independent by those relying on their opinion. According to Elliot & Jacobson (1998) audit independence has been guided by detailed rules, common sense and conservatism. What is still vague to the public is what exact measures do these auditors and audit firms take to substantiate to the bankers, creditors, investors and others that truly and indeed these measures they take mitigate their independence. While there is ample literature that has been undertaken that links the independence of auditors with other factors, such as Magee & Tseng (1990), Reynolds & Francis (2001) and DeFond, Raghunandan & Subramanyam (2002) and many others, there is not much evidence of a significant amount of research that has considered measures auditors take to substantiate their independence. It can be suggested that if users of audited financial reports had the knowledgeable of measures taken by auditors to substantiate their independence, their confidence would more likely be boosted, easing their concerns about the reliability of audited financial statements.

Auditors' independence has been a major issue and needless to say, cases such as that of Enron and others have intensified the concerns of the public. Over the years the profession has come under increasing scrutiny, with calls for measures to be instituted to minimise any potential for non-independence (Shockley, 1981). In the US, the Independence Standard Board came up with a model for standard setters based on three key steps (ISB, 2001):

- Identify threats to the auditor's independence and analyse their significance.
- Evaluate the potential safeguards, including restrictions.
- Determine an acceptable level of independence risk, the risk that the independence of the auditor will be compromised.

Auditor independence is often referred to as the cornerstone of the auditing profession as the public's trust in the attest function stems from it (Lindberg, 2004). There are numerous factors that may easily lead the public to believe that the auditor does not appear independent. These may include economic dependence, competition and provision of non-audit services, among others. When one or more of such factors occur, needless to say, the users of audited financial statements begin to doubt if they should rely on those financial statements at all.

As the Institute of Chartered Accountants in Australia (2008) rightly pointed out, the auditor's responsibility is to express an opinion on whether management has fairly presented the information in the financial statement. The auditor has to satisfy himself that the amounts and disclosures in the financial statements are free from material misstatement. The auditor also evaluates whether there are any threats to the client's ability to continue as a going concern in the foreseeable future. The issuance of a qualified audit opinion can have far reaching consequences for the client, including whether the client can continue as a going concern. An

auditor whose independence from the client is compromised in any way, is at the risk of not releasing a truthful audit opinion. When that happens, the risks faced by the client transfer to all those who may rely on the audited financial statements in their dealings with the client.

It has been argued that auditor independence depends on the relative importance of clients and not the services it provides (Cote, 2002). Further that disagreements between auditor and client may at times severely disrupt the professional relationship. A disgruntled client may make it difficult for auditors to attain information or pressure them to conduct cover-ups. Auditors know that clients can easily take away the auditors business if they are unhappy with the results of the audit, and this therefore gives clients the upper hand in this professional relationship. The ability to resist this pressure depends on the auditing firm's dependence on the client, with smaller firms having greater dependence. Cote (ibid) mentions that auditor independence heavily relies on the healthy legal and professional relationship between the auditor and the client. Ideally, none should have the upper hand to provide a balance and neutral environment to perform the audit impartially. As indicated above, the notion of a neutral and impartial environment is hardly realistic.

As Nichols & Price (1976) have stated, the power of the client is his ability to pressure the auditor, and thus influence the auditor's behaviour and decision making. Alongside economic dependency, another factor that has the potential to pressure auditors to compromise their integrity is the increasing competition for audit business. Shockley (1981) found that competition was perceived as the most important factor that affected auditors' independence. O'Leary (1998) also argued that increased competition results in declining audit fees, thus putting additional pressure on auditors to find alternative strategies for both conducting their audits and finding new sources of revenue. Competition puts more pressure on the independence of the auditor, making it more likely for the auditor to compromise with the client in challenging circumstances.

It ought to be borne in mind that while there are factors that have the potential of compromising auditor independence, there also exists a set of incentives for auditors to remain independent. As DeFond et al. (2002) pointed out, a large body of theoretical and empirical research exists that suggests that auditors have market-based institutional incentives to act independently. They give examples of Benston [1975] who conjectures that reputation concerns are likely to create incentives for independence, and Watts and Zimmerman [1983] documented several historical examples of auditors taking costly actions to protect their reputation capital. Therefore in difficult circumstances, auditors may be torn between yielding to the pressures from the client and guarding their integrity steadfastly. DeFond et al. (2002) indicate further that although there are market-based incentives for auditors to remain independent, the forces that potentially threaten auditor independence are real. For instance, even regulators are said to be concerned about two effects of non-audit services, being the fear that non-audit service fees make auditors financially dependent on their clients, and hence less willing to stand up to management pressure for fear of losing their business, and that the consulting nature of many non-audit services puts auditors in managerial roles, potentially threatening their objectivity about the transactions they audit (ibid). The obvious concern from the point of view of users of audited financial reports would be the likelihood of auditors becoming financially dependent on their clients. Potentially, the auditors may view the benefits retained from clients with lucrative non-audit service fees as outweighing the expected costs of sacrificing their independence.

In Botswana, the Big Four accounting firms would, however, not audit clients where they have provided non-audit services that create a threat to their independence or would not provide these services to their audit clients, in compliance with the code of ethics that the Botswana Institute of Accountants (BICA) has adopted. This is consistent with the relevant provisions of the code of ethics developed by the International Ethics Standards Board for Accountants,

which BICA has adopted. In any case, the expected costs of sacrificing independence that includes cost of reputation and litigation costs associated with audit failure weigh heavily against sacrificing auditor independence for any perceived benefits of doing so.

The numerous abundant literature on issues relating to auditor independence and the challenges thereto has more-or-less excluded the scenario that prevails in small economies such as that of Botswana, where the likelihood of auditors and their clients' executives being acquainted with each other socially is very high. This, it is believed, brings in another dimension of threats to auditor independence not evident in large economies. This leads to the one hypothesis for this study as shown below. The study aims to establish the measures taken by auditors to substantiate their independence in this environment. It also seeks to establish whether some of the principal institutional users of audited financial statements have any concerns about auditor independence as a consequence of this factor of the size of the economy.

According to Buthali (2012), the last population census in Botswana recorded a population of 2 024 904 people, with Gaborone, the capital city, at just over 230 000. With much of the business activity concentrated in Gaborone, where the head offices of nearly all companies listed in the domestic stock exchange, the major private companies and the Big Four accounting firms are located, Botswana is by any measure a small economy (small population size). The partners of accounting firms and the executives of the companies audited by these firms must have become well acquainted with each over the years, both from their business and social interactions in the small city of Gaborone.

3.3 Hypothesis

The small size of the economy poses a challenge to auditor independence in Botswana.

3.4 Objectives of the Study

To find out:

- The measures are taken by auditors to substantiate their independence;
- The views of the auditors as to whether they believe the small size of the economy of Botswana does impact their auditor independence;
- The opinions of key institutional users of financial information on auditor independence in Botswana

4. Scope of Study

This study primarily focuses on the big four auditing firms in Botswana. The purpose of this study is to get insights on the independence of these audit firms and to establish the steps that they have taken to assure auditor independence in the face of possible suspicion that they may not be truly independent of their clients.

5. Research Approach and Research Design

This research paper is largely based on the descriptive research approach. The main focus was on the identification of the state of affairs as far as auditor independence issues are concerned along the lines indicated in the objectives outlined above.

5.1 Sampling Scheme

There are three sample groups entailed in this study. The first being the big four audit firms namely, KPMG, Ernst and Young, Deloitte and PricewaterhouseCoopers (PwC). These firms are known for their global footprint in more than 150 countries (Scannell, 2016). The second sample group consists of Botswana's largest and oldest three commercial banks, Barclays Bank Botswana, Standard Charted Bank Botswana and First National Bank Botswana, as well as one

of the more recently established commercial banks, Stanbic Bank. The third and last group compromises of the Botswana Stock Exchange and four randomly selected stock brokers, namely Stockbrokers Botswana, Motswedi Securities, Imara Capital Securities and African Alliance.

5.2 Data Collection Methods

Two different sets of questionnaires were administered, one for the accounting firms and the other for the commercial banks, the stock brokerage firms and the Botswana Stock Exchange. Thus the first sample group had a separate questionnaire, as the main subjects of the study, from that of the second and third sample group, which had the same questionnaire as representatives of institutions that often place reliance on audited financial statements for decision making.

6. Summary of the Research Findings

6.1 Introduction

The three sample groups consisted of a total of thirteen (13) organizations altogether, four (4) audit firms, four (4) commercial banks, four (4) stock brokerage firms and the stock exchange. A total of eight (8) these completed and returned the questionnaires administered. The feedback was received from three (3) audit firms, one (1) commercial bank, and all four (4) stock brokerage firms, resulting in a 61% response rate.
Auditor independence is not a new phenomenon as indicated by the abundance of literature on the subject dating back to the 1970s and beyond. It is no secret that after the Enron case auditors independence has posed a question mark in the public's mind.

6.2 Findings

There are three aims this research sought to conclude, the first being the measures taken by auditors to substantiate their independence. Auditors do in fact have measures they take to substantiate their independence. The table below illustrates some of the important measures audit firms have taken, based on submissions from three of the four firms that responded to the questionnaire.

Table 1: Important measures taken by audit firms

Audit Firm 1	Audit Firm 2	Audit Firm 3
Not being too friendly with clients.	Check for independence of the firm.	Team members sign an independence form before each engagement.
Disclosing any interests in restricted entities well in time.	Ensure independence by engagement teams	The firm checks for its independence before taking on an engagement.
Declaration of the firm's independence.	Expect professionalism from audit teams.	

Furthermore, auditors do take steps to try and ensure that the public is made aware of the measures that they implement. It must be noted, however, that not all institutional users of financial information are aware of these measures yet they do believe auditors are independent. There are, on the other hand, institutions that do know the measures taken by auditors. This illustrates that auditors still have a lot of room to educate much of the public of the measures they employ with the view to assure their independence. The measure taken by the audit firms to substantiate their independence are broadly similar and are aligned to those other auditor firms would take in many other countries around the world, to achieve the same objectives of assuring the independence of the auditor. It is not clear, however, as to how audit firms would ensure that they are not too friendly with their clients in an environment that must definitely lead to frequent interaction with senior officials of client organisations in

formal and social occasions. There is also no evidence that the Big Four audit firms in Botswana have taken any unique measures to assure their independence from the clients, beyond what is standard practice internationally.

The second aim was to establish the opinions of key institutional users of financial information on auditor independence in Botswana. These financial institutions consider the auditor's report important because they take into account the audit information when transacting with their clients. The importance of auditor independence to these institutions is reflected by the extent to which they rely on auditors' reports when making decisions that require financial data and information.

While the audit firms assert that they are independent of their clients, how does the public view them? Lindberg (2004) states that auditor independence is often referred to as a cornerstone of the auditing profession, because it is the foundation for the public's trust in the attest function. For the public to trust the auditors, there must be steps that auditors take to make the public aware of the measures they take to substantiate their independence. According to the research findings, auditors do take steps to make the public aware of the important measures they take to substantiate their independence. The table below summaries steps taken, as indicated by the three audit firms that provided responses, to create public awareness of the measures auditors have in place to assure their independence.

Table 2: Steps taken to ensure public awareness of measures

Audit Firm 1	Audit Firm 2	Audit Firm 3
Always explaining to them about the importance of being independent.	Auditing standards issued to public by relevant authorities.	Include statement on auditor independence in the audit report.
Always trying to avoid situations that would impair independence.	Botswana Institute of Chartered Accountants (BICA) regulatory requirements.	Refer to set policies that require each employee to update independence on a yearly basis and before engaging with a client.
	Information on Professional standards to be adhered to by practitioners.	Disclosure of measures in the engagement letters and the auditing financial system (AFS).
		Inclusion of these measures in the annual reports made to the public in the case of listed companies

The foregoing measures are taken either at audit firm level, profession level or both.

The last aim was to find out the views of the respondents with regard to whether, in their opinion, the small population size of Botswana impacts auditor independence. That is, given the small size of the economy of Botswana, are auditors able to maintain their independence regardless? Financial information users do believe auditors are able to maintain their independence in Botswana. This finding suggests that the size of the economy or the size of the population of a country does not appear to impact auditor independence.

7. Conclusion

The hypothesis for this study was that the small size of the economy poses a challenge to auditor independence in Botswana. The study did not reveal any evidence to show that the

small size of the economy and the centralisation of business activity in one small city has necessarily compromised auditor independence and consequently affected good corporate governance. On the basis of the findings of this study, the hypothesis has thus been rejected as no strong evidence was found to support it.

8. Future Research

Despite auditors including the measures they take to substantiate their independence in audit reports, engagement letters, annual reports, and even taking the time to explain the importance of auditor independence, as well as the relevant authorities issuing audit standards to the public, there seems to still be a lack of knowledge in terms of how exactly auditors can be said to be independent in fact. Further inquiry into this area is necessary to add to knowledge in the broad topic of auditor independence, and consequently, corporate governance. The small audit market in small economies with the Big Four accounting firms represented in the market alongside smaller indigenous firms, must mean that there is intense competition for clients that is not evident to members of the public. The concentration of business ownership in the hands of the few, as is often evident in small economies, must also have an impact on auditor independence, albeit to unknown proportions. If auditor independence is compromised in any manner, the same will apply to corporate governance.

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