THE AUDITOR-MANAGEMENT RELATIONSHIP IN A MICROSTATE PERSPECTIVE

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ABSTRACT

The main objective of this thesis is to examine the relationship problems that exist between external auditors and managers in the microstate of Malta. Such problems are discussed with twenty audit practitioners and an equal number of senior financial executives on the island. Issues in communication and independence are studied, followed by a focus on the complications of management fraud , a small company environment , and government control. In general, auditors are seen to exert a positive influence on managers, but the study points out in particular that:

(i) A lack of communication skill training, management education in accounting and time pressures on both sides appear behind various barriers between the parties. Besides, existing written communications are not seen as constructive enough, and managers view even the statutory report itself as potentially more meaningful and useful. Both sides also see certain report qualifications as leading to the replacement of auditors, and the law needs to be more protective in this regard.

(ii) While psychological and economic factors influence auditor independence, one problem more typical of a small country is that of close relationships. The implementation of ethics and professional standards also appears difficult. Both sides agree that the provision of accounting services in non-small companies is a threat to independence , and see as minimal the influence of third parties, beyond shareholders, on the auditor-management rapport.

(iii) While, on his part, the auditor is also perceived as little able to give protection to outside third parties as regards management fraud, increased managerial duties are felt necessary as to the maintenance of internal controls.

(iv) Relationships appear even closer in small companies, where a tax evasion mentality seems prevalent among managers, and changes in small company auditing are wanted by both sides.

(v) As regards government-controlled enterprises, these seem to require more controls on the audit process, such as audit committees and auditor rotation.

Clearly, there is ample room for improvement in the relationship, and, as one manager said, much more is needed than merely copying what has been done elsewhere.

PREFACE

When, as a University lecturer, I was given the opportunity to undertake postgraduate research in an accountancy area, it seemed only natural to choose a topic related to auditing and financial management, my two lecturing subjects. However, the motivation for this study is to be traced back in years. In 1973/1983 , I had spent years relating, in practice, with auditors in my financial executive positions in different Maltese organizations. At the time, I had felt the need to know more about the man and his team whom, as a student accountant, I had been warned by a superior to treat carefully as " *they speak softly and carry a big stick.*" As I progressed in my career to become a young member of a growing accountancy profession, I increasingly felt the need to improve my understanding of auditors and their relationship with management.

Yet, defining the research problem and developing the research design in a way that yields worthwhile data was no easy task, especially given the traditional shroud of secrecy surrounding both the area of auditing and the location of the research, an island microstate. In this connection, I would like to thank my supervisor, Dr Andrew Higson, for his guidance, invaluable suggestions and encouragement over the last few years.

This thesis was made possible by the financial support of my employer, the University of Malta, for which I am grateful.

A word of special thanks must also be given to Prof J. Sizer, my Director of Studies, for his practical and continuous help; Prof D. Darmanin, Dean, Faculty of Economics, Management and Accountancy, University of Malta, and my colleagues at the Department of Accountancy, for their tolerance and support; the Institute of Chartered Accountants in England and Wales, for permitting access to their library and the help of their staff; Dr David Coates, Lecturer in Statistics at the Loughborough Business School for his advice; the Burgess family of Loughborough for their hospitality. I would also like to thank all survey participants, both auditors and managers, for giving their time despite many competing pressures.

Finally, but certainly not least, a profound thanks to my wife Elsie and children Mariana and James for their encouragement and continuous support throughout the whole project.

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LIST OF ABBREVIATIONS

A	Auditor/s
AAA	American Accounting Association
AICPA	American Institute of Certified Public Accountants
App	Appendix
APA	Accountancy Profession Act, Cap. 281 (Malta)
APB	Auditing Practices Board (UK)
APC	Auditing Practices Committee (UK)
Art	Article
ASB	Auditing Standards Board (USA)
ASR	Accounting Series Release (SEC)
CA	Companies Act (UK)
C&AG	Comptroller and Auditor General (UK)
CAR	Commission on Auditors' Responsibilities (USA)
CBM	Central Bank of Malta
CPA	Certified Public Accountant
CPAA	Certified Public Accountant and Auditor
CPO	Commercial Partnerships Ordinance, Cap.168 (Malta)
Def	Definition/s
DIR	Department of Inland Revenue (Malta)
EC	European Community
ed/s	Editor/s
edn	edition
ff	and the following pages
Fig	Figure
GAAS	Generally Accepted Auditing Standards (USA)
GNP	Gross National Product
IAG	International Auditing Guideline
IAPC	International Auditing Practices Committee
IASC	International Accounting Standards Committee
IASS	Indicative Average Scale Score
ICAEW	Institute of Chartered Accountants in England and Wales
IFAC	International Federation of Accountants
IMF	International Monetary Fund
ISA	International Statement on Auditing
ITA	Income Tax Act, Cap. 123
Qn/s	Question/s
M	Manager/s
MIA	Malta Institute of Accountants
NCFFR	National Commission on Fraudulent Financial Reporting (USA)
Para/s	Paragraph/s
SAS	Statement On Auditing Standards (by ASB)
S/Ss	Section/Sections
SEC	Securities and Exchange Commission (USA)
SSARS	Statement on Standards For Accounting and Review Services
UEC	Union Europeenne des Experts Comptables, Economiques et Financiers
VFM	Value-for-money

CHAPTER ONE

GENERAL INTRODUCTION

1.1 The Research Objectives and Question

An auditor is an individual, firm or organization carrying out the audit of an enterprise. On its part, the term *"audit"*, as defined by the Auditing Practices Committee of the UK, is *"the independent examination of, and expression of opinion on, the financial statements of an enterprise"* (APC, 1989a: para 2). There are different types of audit, and this study is concerned with the external or statutory type, which the same APC pronouncement describes as one *"where there is a statutory requirement for the auditor to express an opinion in terms of whether the financial statements give a true and fair view"* [ibid.: para 3(a)].

In formulating his opinion on the financial statements of an enterprise, such an external auditor needs to interact frequently with the management of his client companies in the course of formulating his opinion on the financial statements. By *"management"* one here means the Board of Directors or equivalent in a company and also the executives of such a company acting within the delegated authority of the Board. This relationship between auditors and client management affects the whole nature of auditing and problems arising in it can render auditing difficult. In this connection, Mautz and Sharaf (1961) even stated that *"from a practical standpoint an audit without the co-operation of management becomes virtually an impossibility" (p 68).*

As will be seen later (S2.2), academic researchers in auditing dedicate considerable effort to the auditor-client relationship, and even accounting policy makers, such as IFAC and AICPA, show concern in this direction in their promulgation of auditing and ethical statements. However, emphasis has traditionally been placed on the maintenance by the auditor of his independence of management, and on the problems that arise in this connection. Communication problems have been largely ignored, while more delicate issues such as those arising from the possibility of management fraud have started to receive importance mostly in the past few years.

The objective of this research project is to examine such relationship issues. However, because of the environmental differences among countries , it will need to adopt a particular perspective, and this project is concerned with that of the microstate of Malta. Although the Maltese regulatory framework has been basically adopted from the UK one, Malta has its own microstate characteristics that may bear further influences on the auditor-management rapport. For example, its small-size economy not only lacks an advanced industrial base and a sophisticated financial system, but seems to allow a significant role to be played by the prevailing number of small companies and government-controlled enterprises.

This project is therefore an attempt at bringing an awareness of the particular problems arising between the two parties to the relationship in such a microstate environment. It will also assess, as far as practicable, how both sides of the relationship want to respond to such problems .

It deals with the following research question: **What relationship problems exist between auditors and managers in the microstate of Malta, and what can be done about them?**

As outlined in Fig 1.1, this question is investigated under the main headings of communications, independence, management fraud, small companies and other issues. The actual investigative questions are the following:

Communication Issues: What major communication issues arise during the audit, and in the final report?

Independence Issues: What factors are perceived by both auditors and managers to influence the independence of auditors from management?

Management Fraud: What role do both parties consider the auditor is playing and should play in respect of management fraud?

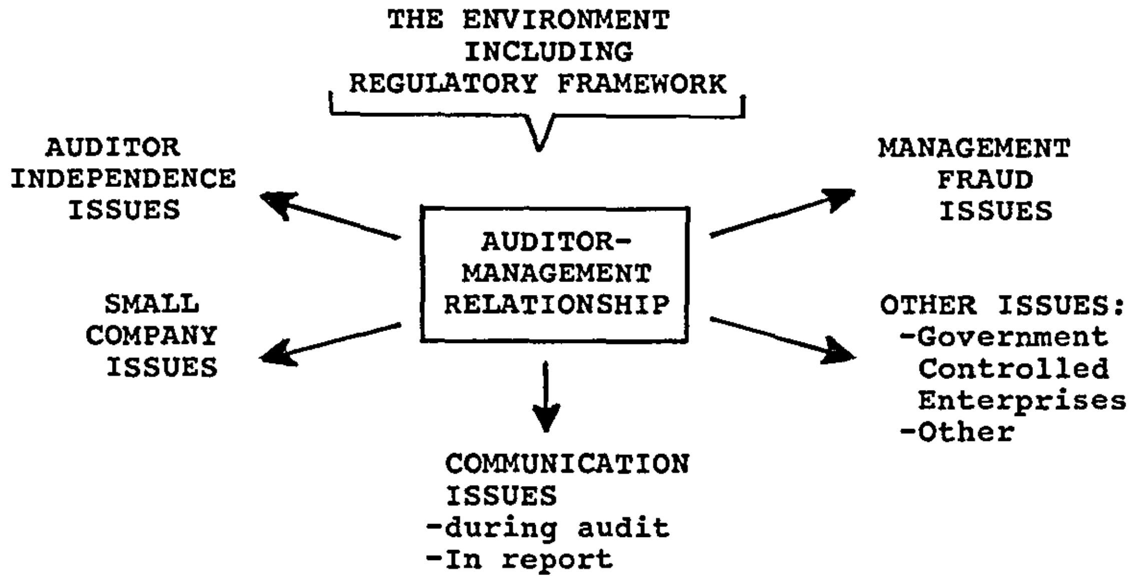
Small Companies: What are the problems of auditing small companies and what role does the auditor need to play in such entities?

Other Issues: What other issues of relevance to the relationship are there, particularly in government-controlled enterprises?

The project will consider also the impact of the regulatory framework on the above issues, and even the attitude of both parties toward relevant changes in such a framework.

FIGURE 1.1

THE AUDITOR-MANAGEMENT RELATIONSHIP ISSUES



1.2 General Background Information

In order to put the purpose of this project in proper perspective, microstates in general and the need of microstate-related studies are now first introduced, followed by basic information on Malta.

1.2.1 Microstates and Related Studies

(a) Microstates Unfortunately, there is no generally agreed definition in the economic literature of either what constitutes a *"microstate"* or even a *"small"* state. Srinivasan (1986: p 206), for example, referred to the traditional theory of international trade which defines size by using the country's market power or its ability to affect its terms of trade by changing its volume of exports and imports. However, he dismissed such a definition as not operationally useful since, among other reasons, it cannot be applied to a whole economy. Other factors that have been identified include the country's energy consumption (Hein, 1989), land area and the gross national product (see, for example, Jalan, 1982).

While it is agreed that a single variable for this purpose is too narrow a conception, there is one common factor used by most studies on the concept of small countries (or small islands) in economic and social terms. This is the size of the country's population. However, there is still much difference on where the cut-off point is as regards population size. The World Bank, for example, in its World Development Report, annually publishes separate tables for United Nations/ World Bank members identified as *"small countries"* and defined as those with a population of less than one million. Authors like Chenery and Taylor (1968) and Chenery and Syrquin (1975) give a higher cut-off point, going up to 15 million, while the Commonwealth Secretariat (1983) defines mini-states as having populations of less than half a million. Jalan (1982) mentions microstates as a sub-classification of small states with a cut-off point relating to a population of 400,000. What is certain is that Malta, with a population of about 350,000, can be conveniently classified as a microstate under most definitions.

There is an apparent neglect on the common characteristics of microstates in the economic literature, and this is probably due to the lack of available data on truly small countries and territories. However, Hein (1989) claims that interest in the study of microstates has recently grown in Commonwealth circles owing to the fact that a large number of small countries decolonized in the last few decades were within the former British Empire.

A further distinction can be made between *"landlocked"* microstates and *"island"* ones. The latter will probably suffer more from their sense of isolation. Hein also points out that in UNCTAD (United Nations Conference on Trade and Development), resolutions since 1972 have dealt with island developing countries and identified handicaps such as smallness, remoteness, heavy financial burdens, communication constraints including transport, great distances from market centres, highly limited internal markets, a lack of natural resources, heavy dependence on a few commodities for their exchange earnings, a shortage of administrative personnel and a lack of monetary expertise. Several of these are clearly the direct consequence of small size.

(b) The Significance of Microstate-related Studies Studies related to microstates are probably worth pursuing in themselves in order to understand better their mechanisms and the options open to them. But a second important reason is that such a study may require in many ways *"an entirely different approach to problems of social, environmental, political and economic management"* (Ibid.,p 8). In fact Hein concludes that not only in economics but also in several other fields such studies would require a departure from standard approaches and even the forging of new concepts. *"Theories and concepts thus developed could throw light not only on the problems of microstates themselves, but help in the understanding of issues applicable to the whole range of countries which lie somewhere between the extreme archetypes of microstates on the one hand, and the large countries of the world, on the other" (p 9).*

1.2.2 The Microstate of Malta

Malta is a miniature archipelago in the Mediterranean Sea south of Sicily, an ex-British colony which gained its independence in 1964, with a system of Government very similar to that found in the UK. Its population is just over one-third of a million, and its official languages are Maltese and English. More details on its geography, history, population and government are given in Appendix I and on its economic, financial and taxation systems in Chapter Three.

1.3 The Need for Research on Maltese Auditing

The majority of auditing research to date has taken place in the USA, and, until relatively recently, little research on this topic was carried out elsewhere. In the case of the UK, for example, Professor Bryan Carsberg stated in 1987 that *"although auditing represents one of the principal activities of many members of the accounting profession, relatively little attention has been given to research in this area of professional life"* (Gwilliam, 1987a: p vii). Problems claimed to be contributing to this dearth of research include not only the difficulty of conducting experimental research in the area, but also the lack of access to researchers of confidential audit data (ibid.: p 15).

It is no surprise, therefore, that this situation still prevails today to an even larger extent in microstates, like Malta, with traditional UK influence in the field and also with the added problem of more scant research resources. However, such research is important not only from the viewpoint of the auditing profession, but also from that of the corporate auditees, and of society as a whole.

1.4 Scope of the Study

In its treatment of the auditor-management relationship, this research project will limit itself to those aspects that are more relevant to a microstate like Malta. For instance, it will go into detail on issues such as the problems of small companies, while omitting, say, the effects on the relationship of security market reactions when the audit report is qualified.

The work will take into account applicable auditing literature, particularly that in the UK and the US. As to professional literature, IFAC pronouncements will be given priority to APC ones, but the latter will also be referred to where felt significant. The project will also consider important findings in previous Maltese studies which may have touched on individual aspects of this relationship.

Coverage of relationship considerations in specialized audits such as banks, insurance companies and co-operatives, will be limited to cases where lessons can be drawn from the particular onto the general.

The study is also limited in its coverage to companies operating under normal circumstances, that is, it excludes those facing particular difficulties such as going concern or bankruptcy, and those in the process of effecting material changes to their ownership and management.

On the other hand, it includes within its scope public sector companies and corporations , but, as explained more fully in S2.7, only insofar as it considers issues relating to commercial rather than public sector auditing.

Internal auditing is in itself a managerial control that can make a difference to the work of the external auditor. Nonetheless, discussion on internal and also management auditing is limited as far as possible in order to retain the focus of management's relationship with the external, rather than internal, auditor.

Laws and regulations stated in this study are, as far as possible, up-dated to 1 January, 1992.

1.5 Approach To the Study

The overall outline of the study can be seen in Figure 1.2.

Chapter Two will give a theoretical background to the auditor-management relationship, reviewing and evaluating the relevant literature on this relationship.

Chapter Three will then present a profile of the environment in which the auditor-management relationship exists in Malta. This chapter will also include a review of previous preliminary studies carried out in Malta concerning this relationship.

Chapter Four will then describe the research methodology used in this project. Interviews are to be conducted with audit practitioners and company financial executives. This chapter will deal with the general methodology, the actual survey design and the nature of the limitations.

Research findings from the survey response are then analysed in Chapter Five. Such analysis provides detailed answers to the five investigative questions listed in S1.1.

Finally, Chapter Six presents the major conclusions and implications of this study , and suggests areas for further research.

Figure 1.2

OUTLINE OF THE THESIS

CHAPTER TWO	Theoretical Aspects of the Relationship
	↓
CHAPTER THREE	The Maltese Environment of Auditors and Managers
	↓
CHAPTER FOUR	Research Methodology
	↓
CHAPTER FIVE	Survey Findings
	↓
CHAPTER SIX	Conclusions

1.6 Importance of the Study

This chapter has introduced the subject of this thesis, reported on the need for research in the area, and set out its outline.

It is hoped that this project on Malta will be of value to auditors, managers, and even to the public , not only in Malta, but also in other microstates and even larger countries, particularly the UK on whose regulatory framework the Maltese one is based. It is also hoped that it will serve as a stimulus to further research projects in the area.

CHAPTER TWO

THE AUDITOR-MANAGEMENT RELATIONSHIP: THEORETICAL ASPECTS

2.1 Introduction

The objective of this chapter is to examine the auditor-management relationship theory and review and evaluate relevant literature on this relationship.

The next section, 2.2, will give a general background and include an explanation of how the various aspects of the relationship are to be classified for the purpose of this review. The main issues will then follow in the different sections.

Section 2.3 will deal with independence issues, which are fundamental to the relationship.

Section 2.4 will then consider general communication and reporting issues.

This will be followed by Section 2.5, which will treat the question of the auditor and management fraud.

Section 2.6 will then deal with small company issues affecting the relationship.

Finally, Section 2.7 will cover other issues mostly relating to government-controlled enterprises.

2.2 The Auditor's Relationship To Management: The Background

Turley (1985) identified auditor-client relationships as a main aspect of auditing research, and distinguished it from other aspects such as the audit process, the auditing profession and the role and usefulness of the audit. However, he limited this aspect to *"research into the nature of auditor independence."* While, indeed, auditor independence is a main attribute of auditor-client relationships, Gwilliam (1987a) included, in his more detailed survey of auditing research, topic areas that can easily be inserted within this aspect, such as audit reporting, auditors' responsibility for fraud detection of and auditors' liability.

This study concerns auditor-*management* relationships and therefore it is appropriate to distinguish between the two words *"client"* and *"management"*. In the literature (eg Goldman and Barlev, 1974) *"client"* signifies the reporting entity itself, and this is not identical to, although commonly represented by, management: it denotes a wider class of persons than management. As a result, not all attributes in auditor-client relationships are necessarily applicable in auditor-management ones. In fact, this study will focus on the issues of independence, reporting and communication, and management fraud, but not on auditors' liability to shareholders and other third parties. In addition, other issues concerning the auditor-management relationship in a microstate, such as those relating to small company audits and government-controlled enterprises are also separately treated.

2.2.1 A Complex Relationship

The Commission on Auditors' Responsibilities (CAR, 1978: p 8) described the auditor's relationship to management as " *the most complex of the auditor's relationships."* Mautz and Sharaf (1961) made the point that this relationship is such that the auditor is closely associated with management and that he attempts to serve management's interests in as many legitimate ways as possible:

> *"the management of the client company is the only interest with whom the auditor has any direct dealings. He discusses the proposed audit report with representatives of management; he appears at stockholders' meetings along with management to explain any questions raised about the report; he works closely with management in planning the annual report and in working the necessary disclosures for regulatory agencies" (p 212).*

The auditor has even more crucial ties with management: it is the latter which normally engages him, negotiates his fee, and even takes the initiative to dismiss him. These aspects may be traditionally associated with the direct contractual relationship a professional has with a client. However, management does not operate as an independent contractor for the auditor's services, but acts only as a representative of the entity audited. In fact, it is the entity's resources which are used to compensate the auditor, and its shareholders who ratify his appointment.

2.2.2 The Distinct Roles of Auditor and Management

The roles of management and auditor in the issue of audited financial statements are kept distinct. For example, International Auditing Guideline (IAG) No:1 (IAPC, 1980a) states that *"while the auditor is responsible for forming and expressing his opinion on the financial statements, the responsibility for their preparation is that of the management of the entity" (para 4).*

The management is not therefore relieved of any of its duties by the auditor. In the USA, such division of responsibility was examined by the Commission on Auditors' Responsibilities (1978), which concluded that this made sense and that the rationale of the relationship was sound. The argument went that it was best for judgments to be made by management because this had more familiarity and experience with the entity than the auditor and was continuously involved in its entity's operations.

In any case, shifts, or even apparent shifts, in responsibility between the auditor and management may face heavy user opposition. For example, Carmichael and Winters (1982) suggested that the unprecedented opposition, in 1978, to a new audit report wording attempted by the American Accounting Standards Board was because the changes were seen as attributing more responsibility for the financial statements to the management and less to the auditor.

2.2.3 Incentives For Continuing Established Auditor-Management Relationships

The economic interests of managers and auditors provide an incentive for both to continue an established relationship.

For example, Arens and Loebbecke (1980) compared initial and repeat engagements and identified a number of areas in which it is necessary to perform more audit procedures for an initial engagement than for a repeat audit. These include procedures involved in becoming familiar with the clients' business operations and in determining opening account balances . Therefore, as De Angelo (1981) suggested, clients' economic interest in their auditors is due to some extent to the significant economic start-up costs involved in first audits.

Company legislation further induces the continuity of such relationships. For example, in the UK, the CA 1985 (S392) obliges a company to disseminate to members representations by a retiring auditor. An auditor switch may therefore easily lead to adverse outsider reaction.

Outsiders may in fact view an auditor switch as *"an information signal of changing economic conditions for the company"* (Fried and Schiff, 1981). After all, terminating an existing relationship will only lead to the managers' problem of finding a new, more compliant auditor. On the auditors' part, then, such a termination will mean that the specialized knowledge which they have acquired in respect of their client will probably not bear its economic reward.

2.2.4 Advocate or Adversary?

Despite retaining the distinction between the duties of management and those of auditors, the latter find it difficult to achieve a balanced attitude toward management in practice. *"The auditor should be neither an advocate on management's behalf nor an* *adversary"* (CAR, 1978: p 9). The question arises : where is one to draw the line between these two extremes ?

On the one hand, in order not to impose an enormous cost, the auditor cannot take the attitude of an adversary of management, but needs to maintain a co-operative and confidential relationship with it in order to be able to see whether the financial statements reflect the realities of the particular company. Owing to the need for this attitude of co-operation, in its Interpretations of the Rules of Conduct, the AICPA (1991) precludes an auditor from acting when management has started or intends to start litigation proceedings against the auditor. It insists that *"the relationship between the management of the client and the auditor must be characterized by complete candor and full disclosure regarding all aspects of the client's business operations" (para 101-6)*.

In this respect, Mautz and Sharaf (1961) stated that the auditor will not assume that management is dishonest, but take as a basic postulate in his work that there is no necessary conflict of interest with it. Conducting the work on the basis of a contrary assumption, the auditor would not be able to rely on explanations from management about the way its goals have affected the financial statements. The audit would therefore have to be extremely extensive and detailed : auditing would become impracticable and uneconomical.

On the other hand, the CAR (1978) said that being in frequent contact with management and settling most problems solely with it,

> *"can lead an auditor incorrectly to look on the interests of management as if they are the same as the interests of the company. This relationship ... is a potential threat to the auditor's ability to remain independent" (p 12).*

Waller (1990) stated that accountants have to recognise that there needs to be

> *"a less cosy relationship between client and auditor...*

Talk about accountants' skills in managing potential conflicts of interest is not enough to sooth outsiders' fears" (p 9).

Auditor independence is needed because of the inherent potential conflict of management with other users of financial statements. In this connection, Mautz and Sharaf (1961) referred to the close relationship of public accounting, and with it auditing, and business, including the maintenance of the confidential relationship between auditors and their client companies. They claimed that this raises the suspicions of outsiders:

"Does it seem likely to one who does not understand the full nature of the auditor-client relationship that a confidant could also be completely independent of the one who reposes confidence in him? In the simplest terms, secrets imply a considerable degree of intimacy" (p 212).

In effect, auditors may actually often be treating directors as their real clients but at the same time managing to maintain their appearance of independence. For example, Waters (1987) stated that in the UK

"the fact that most auditors have not visibly lost their independence indicates the strength of their moral fibre. The fiction of company law is that shareholders appoint auditors: the reality is that directors are seen by auditors as their real clients" (p IV).

Also, in the USA, according to Stevens (1985), Certified Public Accountants enjoy an enviable position as trusted, thoroughly professional confidants and advisers whose honesty and integrity are generally held beyond reproach.

Goldman and Barlev (1974) showed that there is a threat to the auditor's independence built into the structure of the auditor's role and that pressures on auditors not to perform according to professional standards are constantly created. To understand the relationship, there is therefore the overriding need to analyze independence issues. This will now follow.

2.3 Independence Issues

This section will first introduce the nature and significance of auditor independence. Then it will discuss the factors affecting independence and, finally, the related question of non-audit relationships.

2.3.1 Nature and Significance

The concept of independence has been the focus of heavy controversy, debate and analysis for many years. Many have also stated this concept to be the cornerstone of the auditing profession (eg Mautz and Sharaf, 1961; Berryman, 1974). Researchers such as Sherer and Kent (1983) have even included independence standards as behavioural postulates of auditing, and Gwilliam (1987a: pp 46,103) while arguing against this, still held that in the real world it is likely correct to assert that independence is a fundamental aspect of the audit process; one has to count on it because the actions of an auditor failing in his duties are not always observable and it is therefore difficult in practice to make him accountable for his actions.

Yet, as pointed out by Antle (1984), the phrase *"auditor independence"* traditionally has no agreed meaning. The rules of AICPA, SEC and even UK professional bodies have in fact abandoned attempts to provide a concise definition, while the academic literature has also associated various meanings to the concept.

One common meaning is that of an attitude and approach of not being subordinate to clients, and this refers to professional qualities like honesty, integrity and expertise. Mautz and Sharaf (1961) put this as *"a combination of self-reliance, freedom from client control, expert skill and ability and considered judgment based on training and experience not available to those who are not members of the profession"* (p 231).

Yet another meaning, more specific to *auditor* independence, is the absence of any self-interest which may warp one's judgment, or what Carey and Doherty (1966) referred to as " *the avoidance of any relationships which would be likely, even subconsciously, to impair the CPA's objectivity as auditor*" (p 41). Mautz and Sharaf (1961) referred to this as a second phase of independence, consisting of "*freedom from bias and prejudice*" (p 231). Lee (1986), for example, tried to combine further both meanings by defining auditor independence as "***an attitude of mind*** *which does not allow the viewpoints and conclusions of its possessor to become reliant on or subordinate to the influences and pressures of conflicting interests*" (p 8).

A third meaning to independence concerns appearance: it is what Carey and Doherty (1964) also termed as "*the avoidance of any relationships which to a reasonable observer would suggest a conflict of interest*" (p 42). This leads to considerations such as the provision of non-audit services, and independence in this context , has not only been the subject of several research studies but also the basis of many professional rules or codes of conduct.

Related to the multiple meanings given to the concept, there is the added question of from whom the auditor needs to be independent. This work is concerned with independence from management, and the need for this becomes clear if we accept the stewardship/agency theories (see S2.4.2) that the auditor's main role is to ensure the truthful reporting of the activities of the business to shareholders. However, as pointed out by Goldman and Barlev (1974), there may also be the need for independence from existing shareholders and this extension is due to the possibility of conflict between existing and potential shareholders: after all both management and present shareholders at least have one common interest: to make a good impression on third parties such as investors, lenders and creditors.

2.3.2 Factors Influencing Independence

Much research on auditor independence to date has focused on investors' and other users' perceptions of audit independence when potentially incompatible functions are performed, eg Knapp (1985), Imhoff (1978) and Shockley (1981). Other research has dealt with whether perceptions of independence influence user decision-making, eg Lavin and Libby (1977) and Firth (1980). Most of the findings in these studies relate to outside users rather than to managers and auditors and are therefore not directly relevant to this project. Nevertheless, it is worthwhile to point out that many of these studies have shown that the intended users of audits, such as bankers and investment analysts, appear to have a more rigorous and wide-ranging view of factors which could threaten independence than has been recognized in professional recommendations (Turley, 1985). For example, in Firth (1980), users of accounts expressed concern on the proportion of total fee income derived from one client that could be a threat to independence: for them , it was difficult for auditors to maintain independence at much lower levels of fee income than those permitted by the UK ethical guidelines.

The main factors perceived to influence auditor independence of management are now analysed. These can in fact be classified into psychological and economic factors, the technical competence factor, influences of the profession, and those of other third parties.

(a) Psychological Factors These are the internal factors affecting the attitude of a practitioner. One is what Farmer, Rittenberg and Trompeter (1987) called objectivity or, more generally, "*an independent mental attitude.*" This attitude in itself attempts to view events on a purely factual basis without the influence of one's personal feelings, opinions or interests. Another related attitudinal factor that may be separately identified is that of the integrity of the practitioner, in the sense already referred to in S2.3.1 of intellectual honesty and non-subordination of one's judgment to that of others.

Farmer et al (1987) examined auditor independence from the viewpoint of practising auditors and auditing students, and found that all categories of auditors and students gave priority to an independent mental attitude over any other factor. These findings went against the indications in previous social research (Becker and Greer, 1958 and Kelman, 1972) that the more experienced auditors would be influenced by more practice-oriented factors such as economic ones.

A third psychological influences that may be separately considered is the auditors' sense of idealism. Farmer et al (1987) also included this in their study and defined it as *"the nature of the auditor to determine what the appropriate treatment or procedures are, and to pursue those judgments without regard to potential client impact."* They found that audit partners, but not other respondents, also ranked this after an independent mental attitude, but above other factors.

(b) Economic Pressures These are often asserted to be a a major factor (eg, in Previts, 1985). Commonly, such pressures will be made in order to retain a client. These may derive from the size of the total fee already referred to, or other factors such as the many examples provided by Turley (1985): the provision of accountancy and management consultancy services to audit clients (see S2.3.3 below); the existence of a financial relationship, such as loans, between the auditor and his client, the relative size of the audit firm, and the degree of competition in the environment of the audit firm. Furthermore, particularly in larger audit firms, even if the total fee from a client may not be too large, an individual auditor may still have to depend on such a client for his or her economic success in the firm. In addition, auditors, especially those below the rank of partners in audit firms, may have to face economic pressures to subordinate judgments to their superiors in the audit firm.

Farmer et al (1987) found that audit managers and partners attached less importance to economic factors than audit seniors and staff. In addition, managers and partners agreed less often with the clients' position than did seniors and staff. In fact Farmer et al concluded that there may be too much of a tendency of the staff group to believe that retaining and pleasing a client is more important than partners themselves believed, and that this perhaps led the staff to be more influenced by a client's position.

(c) The Technical Competence Factor A technically competent auditor was described by Moizer (1991) as one who *" will have the necessary expertise to discover all the significant errors and omissions present in a set of financial statements."* (p 35). The ability to reach independent judgments is also dependent on such expertise: as other research indicates (eg Rittenberg, 1977), without adequate competence in accounting and auditing, the auditor would be in the danger of having to rely on the management's judgment instead of forming his own independent opinions.

(d) Professional Influences: Standards and Ethical Codes Opinion shopping, or management seeking an auditor willing to support an accounting treatment wanted by it irrespective of how reliable it is, is cited as raising serious questions about audit independence (eg Hendrickson and Espahbodi, 1991). By defining accounting choices, accounting standards leave less area for judgment disagreements between management and the auditor. On the other hand, auditing standards and codes of ethics aim at a minimum level of professional performance that may, among other things, make client abuse much more difficult. Reaching consensus in these areas removes the individual auditor from the need to defend positions different from those of a client (Connor, 1986).

(e) Other third Party Influences This represents the potential strength of organizational and societal action in maintaining auditor independence. Farmer et al (1987) breaks this down into the public servant attitude, the existence of legal liability, and, in large companies, the existence of an audit committee made up of outside directors. The public servant attitude means the sense of being a public servant, that is, not being an agent for anyone including management, the controlling authority, investors, lenders or the general public. Existence of legal liability means the knowledge that the courts will make auditors accountable for their actions and reports. In view of these third party influences, the auditor considers himself as part of the public information system. Besides Farmer et al (1987), researchers such as Lavin (1977), Shockley (1981), and Knapp (1985), also recognised similar influences on auditor independence.

2.3.3 The Question of Non-audit Relationships

It has been seen in S2.2 that the actual auditor-management relationship is asymmetrical, where management dominates because of its effective control on the appointment , remuneration and removal of the auditor. While managements may indeed voluntarily be hiring auditors reputed for their independence to observe and vouch for managements' actions, Antle (1984) has shown that there often exist financial incentives, such as profitable management advisory contracts, for auditors to be involved in non-independent activity by their co-operation or even direct collusion with management. In fact, he delineates *"collusion"* and *"no co-operation"* as extremes in a continuum, and puts the crucial question to be confronted by the auditor as the finding of the point where the line is to be drawn between behaviour that is merely self-interested and that which is collusive:

> *"At the very least an independent auditor would not collude with the manager to the detriment of the owner. On the other hand, even an independent auditor would not be expected to act against his/her own best interests in carrying out his/her duties for the owner. But this self-interested behaviour must stop short of collusion" (p 15).*

In fact, in a pure audit environment, that is in the absence of non-audit relationships such as management advisory services or personal and other relationships between auditor and client, users appear to be happy that auditors can and do maintain their independence (Gwilliam, 1987: p 104). As a result, research to date has concentrated on the effect of the presence of such mentioned factors on the perceptions of auditor independence.

Most research work to date suggests that many of these relationships do appear to weaken somewhat user confidence in auditor independence. Gwilliam (1987a: p 105) stated that it appears easy enough to devise a set of independence requirements which would remove the *"undesirable"* relationships as tested by the various surveys. This might include the prohibition of the provision of many non-audit services, and, in fact, the AICPA did take steps to prohibit members of the SEC Practice Section from offering questionable services such as executive recruitment, public opinion polls, merger and acquisition service (for a finder's fee), psychological testing and actuarial services for insurance companies (AICPA, 1981). However, research carried out by Pany and Reckers (1984) showed that there was little evidence that such services were seen as significantly more damaging to perceptions of independence than other non-audit services.

(a) The Total Prohibition of Non-audit Services In order to eliminate any question about an auditor's conflict of interest, one may consider the total prohibition of non-audit services. At first sight, prohibition may seem beneficial because it should increase user confidence in financial reports. However, research carried out by McKinley, Pany and Reckers (1985) indicated that one cost of prohibition may actually be a loss of confidence in the reliability of financial statements. They identified economic benefits in non-independence, such as a signalling of confidence when an auditor provided non-audit services that the financial statements were free from material fraud.

In any case, the accountancy profession would probably not welcome such total prohibition. For example, in the UK the ICAEW (1987) took a definite stand against this, citing in support a survey of the Commission on Auditors' Responsibilities (CAR,1978), which had found no evidence that the provision of such services had caused problems of independence. More recently, a survey undertaken by the ICAEW's Board for Chartered Accountants in Business (Accountancy, 1991a) showed that Institute members thought that business people opposed an embargo on accountancy firms undertaking other work in addition to an audit.

It is perhaps understandable that the profession would not welcome such total prohibition : after all, these services provide a large proportion of the income of the audit firms. For example, Bernstein (1985) stated that non-audit fees of the top US CPA firms averaged about forty percent of total fees collected in 1985, and that the percentage could even increase. In addition, such services may even have a greater profit margin than audit services, particularly in view of the competitive market for audit services resulting in price cutting. Audit firms therefore seize the growth opportunities provided by non-audit services , and are keen on their reputation for their ability to offer a well-developed package of ancillary services. King and Carver (1984) also provided evidence that in meeting client demands, it was important for the reputation of accounting firms to be able to offer a diversity of services.

Hillison and Kennelley (1988) mentioned two other factors that may be encouraging audit firms to expand these services: one is their increased ability to attract to the profession creative new staff that has traditionally migrated to clients ; the other is the awareness of the risky legal environment faced in auditing, making the attempt to diversify into such services more attractive.

Furthermore, there is evidence that non-audit fees are important because they appear to recur (Simunic, 1984 and Beck, Frecka and Solomon, 1988). Given also an increasingly regulated auditing environment, total prohibition might therefore drive many professional practices to consider, rather, discontinuing auditing altogether.

(b) The Restriction or Disclosure of Non-audit Services Two alternative approaches have therefore been put forward by Hillison and Kennelley (1988) in the USA to this question of provision of audit services. One is to provide these to non-audit clients only. This is already being carried out to a limited extent in the UK, where the preparation of accounting records is not normally provided to public company clients. Kaplan (1987) suggested that such a restriction of services may actually improve the quality of some audits: the interest of the audit firm could be more aligned with that of the financial statement users. But a potential disadvantage is that the potential cost savings from the combination of audit and non-audit services are definitely lost.

The second recommendation by Hillison and Kennelley, is that all types of non-audit work be allowed but that full disclosure be made of these in the financial reports. In this way, it is projected that audit firms will become reluctant to provide certain types and quantities of service that might create questions of concern in the minds of users. The sale of non-audit services would thus be monitored by the market, without the need for any intervention by any regulatory body. However, following a similar reporting requirement by the American SEC in 1979 in ASR 250, Scheiner (1984) concluded that the disclosure requirement did not appear to have a substantial impact on the amount of non-audit services provided by independent auditors to their clients.

A main problem is that research efforts, spanning more than twenty years, to empirically determine what services are compatible with auditing are still inconclusive and that it is doubtful whether such efforts can be totally successful: practitioners will probably continue to contest the results of research which suggests that certain services are not compatible with auditing, at least until evidence is conclusive, which, in the least, is a far-off prospect.

2.4 Communication and Reporting Issues

This section will now examine communication and reporting issues insofar as they are relevant to the auditor-management relationship. It will first introduce the communication process, and the role of auditing in accounting communication. Communication barriers identified in the literature between auditors and management will then be reviewed. A discussion will then follow of the communications during the audit, and in the audit report itself. Finally, one will treat auditor-management disagreements on audit reports and auditor switching .

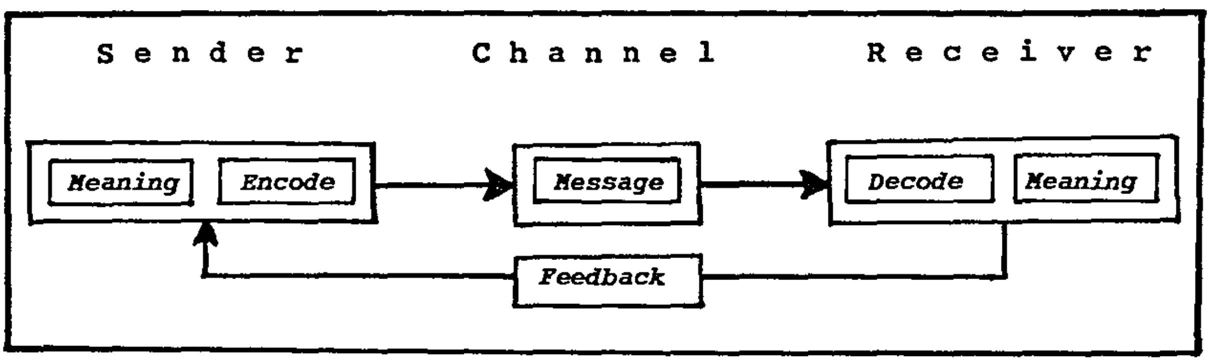
2.4.1 The Communication Process

The communication process itself is quite simple. As can be noted from Figure 2.1, there must be a message to be sent, and the process involves a sender, a receiver, a channel for sending such a message, and feedback. In effect, communication means sending a message to someone in such a way as to allow the receiver of that message to understand exactly what the sender means.

The message must be coded according to the channel of communication used, and for the message to be complete the receiver needs to signal that the message has been received in the form intended - that is, he must have feedback.

FIGURE 2.1

A MODEL OF THE COMMUNICATION PROCESS



Source: Bamber, Bamber and Vincent (1985)

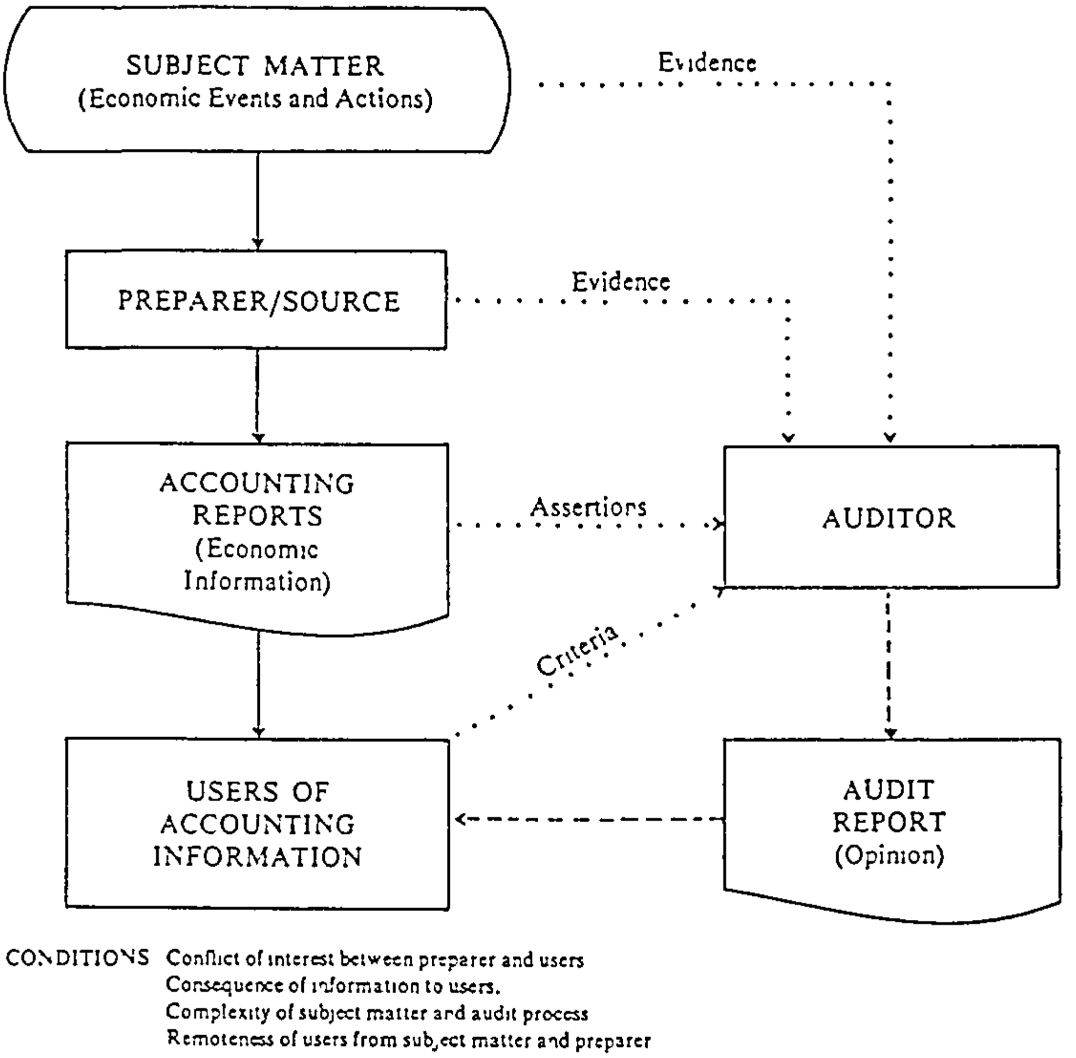
2.4.2 The Role of Auditing in the Accounting Communication Process

Accounting information reaches users by means of a communication process. The primary purpose of this process is to convert and send information from the preparer or source of the information to a second party, the user of the information.

As shown in Figure 2.2, the role of the auditor is not to change this process linking the user to the subject matter (indicated by the solid lines); it adds to it. What is added is a secondary communication process between the auditor and users (shown by the broken lines). The Committee on Basic Auditing Concepts (1973: p 12) stated that the role of the auditor is to assist the user in determining the quality of the information being received. As shown at the bottom

FIGURE 2.2

THE COMMUNICATION OF ACCOUNTING INFORMATION AND THE ROLE OF THE AUDIT FUNCTION



Source: Committee on Basic Auditing Concepts (1973: p 12)

of Figure 2.2, there are *"conditions"* creating this demand by the user: there may be bias inserted in it by the preparer owing to a conflict of interest, the information may be important and complex, and the user may be too far removed to conclude on his own on the quality of the information.

Gwilliam (1987a: pp 49-58) stated that in auditing literature the auditor can be seen to be serving many purposes. Most of these can be interpreted by the diagram above of the Committee on Basic Auditing Concepts. If *"users of accounting information"* are taken to be shareholders, then the reason for the auditor's check of the quality of information can be taken to be that of monitoring the performance of management on their behalf - the *"stewardship"* or *"agency"* theory. If users include other third parties, then the auditor can be seen as providing third party protection against financial collapse - the *"insurance"* or *"deep pocket"* theory. Related to this is the third viewpoint that the auditor improves investor decision making by adding credibility to the financial reporting of companies - the *"information theory"* viewpoint. Gwilliam also mentioned another purpose of auditing that, he stated, had received little attention to date in the literature - the *"behavioural theory"* viewpoint that the auditor can bring beneficial effects in terms of its influence on the behaviour and actions of all personnel, including the management, of the organization.

2.4.3 Communication Barriers between Auditors and Management

A communication barrier may be taken to be anything that prevents or restricts the conveyance of meaning of a message. In any communication, various barriers may exist. Brown (1975: pp 24-29 and 1976: 15-21) distinguishes between macrobarriers and microbarriers. Macrobarriers are concerned with the environment within which the communication takes place - the increasing load and need for information with the variety of languages and media making the communication difficult to succeed. Important examples in auditor-management communication include the complexity of the subject-matter, the technical language which managers may need to know, and the pressures on auditors and managers that make it difficult to talk and listen.

Microbarriers are those barriers encountered in the immediate communication situation - the individual message, its transmission and receipt. Examples include the views which auditors and managers have towards each other and towards the situation, the feedback each party obtains, as well as the meaning attached to the messages themselves.

Golen, Looney and White (1988) found that American practising CPA's viewed four communication barrier dimensions between them and their clients : the most serious was the attitudinal dimension, which had the following highly rated barriers (in descending order of average rating): a hostile attitude, a tendency not to listen, a lack of trust and credibility, too many intermediate receivers and personality conflicts.

The other barrier dimensions which they worked out were defensive (such as resistance to change), accounting background (such as lack of understanding of technical accounting jargon) and also, although less importantly, other personal and physical barriers (such as poor timing of message and speaking too loudly).

They also found a few serious barriers not included under any of the above dimensions, the most serious of which was a lack of feedback.

The important barriers found in the first three dimensions have, in fact, also been identified as serious barriers in the non-accounting area. For example, a hostile attitude was identified by Tafoya (1976), listening barriers by Tacey (1960), Lee and Lee (1957) and Lundstein (1971), lack of trust by Allen (1977) and Argyris (1966), credibility by Allen (1977), Burton (1977) and Stieglitz (1958), personality conflicts by Sigband (1977), resistance to change by Allen (1977), Blagdon and Spataro (1973), Burton (1977), Lee and Lee (1957), and Tacey (1960).

Golen et al (1988) showed that the communication dimensions developed by them can be compared with others developed in the non-accounting area by Berlo (1960), Thayer (1968) and Tafoya (1976). Although labels may be different, the components of the barrier dimensions are similar.

In addition, several accounting studies have found that communication skills are perceived as being needed to achieve a successful career in accounting. For example, Ingram and Frazier (1980) indicated the need felt by most practitioners, public and private, and by educators for staff accountants and auditors to have more communication skills. In addition, Blocher, Moffie and Tower (1983) constructed five job dimensions among internal auditors and found that *"having decision-making, communications and social responsibility"* was rated as most important, with personal contact and other communication skills most highly rated within this dimension.

2.4.4 Communications during the Audit

As stated in the literature (eg Bamber et al, 1985 and Committee on Basic Auditing Concepts, 1973), oral communications take place in the course of an audit for the exchange of ideas or concepts, or where elaboration or feedback is required. For example, auditors may decide to give management the necessary feedback on their findings by attending the meetings of the board of directors. Oral communications are also useful because they permit more openness, and therefore, if auditors want to persuade rather than inform, they can be more conducive to attitude change.

Yet, the importance of written communications during the audit cannot be over-emphasized. Bamber et al (1985) stated that such communications are particularly effective when sender and receiver have different vocabularies or problem orientation, such as when non-routine information or work is requested from the client - and it is probable that auditors and management do often have such differences. A widely dispersed audience also gives rise to the use of written communications (Committee on Basic Auditing Concepts, 1973) : however such an audience is more often the case of the audit report at the end of the audit.

An examination will now follow of the three main written communications during the audit between the auditor and management - the letter of engagement, the letter of weakness and the management representations.

International Auditing Guideline No: 2 (IAPC, 1980b) describes a letter of engagement of an auditor to his client as one that *"documents and confirms his acceptance of the appointment, the objective and scope of the audit, the extent of his responsibilities to the client and the form of any reports"* (para 1). According to the same paragraph, this letter also helps to avoid misunderstandings with respect to the engagement. Summers, White and Clay (1987) conducted a study in the USA on the frequency and extensiveness of the use of engagement letters and the results refuted the belief that most auditors used engagement letters for all their services. Although responses for national firms indicated a high level of usage, the responses also indicated that many smaller-firm auditors did not always use engagement letters and that use became less prevalent with lesser assurance levels. The main reason that the letter was not used was that it was not considered necessary, particularly for lower levels of service, or was only needed for new clients or when existing circumstances changed. They also found that where engagement letters were not used, the engagement specifics were frequently communicated to the client.

Letters of weakness are also known as management letters, reports to management, post audit letters and letters of weakness. Such letters, as stated by the relevant UK guideline (APC, 1986: para 3), are mainly for the auditor to give his comments on areas of weakness, and to provide management with constructive advice. IAG No: 6 (IAPC, 1981: para 28) indicates that weaknesses are not always communicated in writing, and even the APC guideline more clearly states that *"given the volume or nature of his comments, a written report may be unnecessary, inappropriate or not cost-effective"* (para 21). In such circumstances, the report may take the form of *"a written record of a discussion held with management, to be included preferably in the auditor's working papers."* A relevant US development (ASB, 1988d) in this connection is that the auditor reports not only control weaknesses but also deficiencies in the control environment itself. Such an environment consists of the overall attitude, awareness and actions of management and others concerning the importance of control. Two examples of items subject to the wider report include management's philosophy and operating style, and the functioning of the board of directors.

As regards representations by management, and in accordance with IAPC (1985), the auditor normally requires these as a source of evidence in the course of his audit. They are obtained in writing so as to reduce the possibility of misunderstandings. This is usually the case where the auditor is unable to obtain independent supporting evidence and could not reasonably expect it to be available. The APC (1983) gives two clear examples of this as *"where knowledge of the facts is confined to management or where the matter is principally one of judgement and opinion"* (para 4).

In this connection, Gwilliam (1987b) referred to the statement by Lord Lindley in the London and General Bank (1895) case that there is little doubt that uncertain acceptance by the auditor of all management representations would result in little more than idle farce.

In fact, the trend in decided case law has been to extend those areas where the auditor is expected to make enquiry and observation, obtain third party evidence, and carry out specific audit tests and reduce management explanations. In Dominion Freeholders v. Aird (1966), the judge stated that auditors must not rely or depend on company officers in respect of matters where they are to conclude independently, and, if they do rely, they cannot shed their responsibility by casting the liability on to the company officer/s concerned. All this point to the need for caution in the use of these representations.

2.4.5 Communications in the Audit Report

Communication problems may also arise between auditors and managers because of their different interpretations of the audit report and its message. Such problems arise not only between these two parties; for example, Higson (1991) found differences of opinion even among auditors themselves as to what the report was trying to say. In this connection, the Committee on Basic Auditing Concepts (1973) listed three different levels at which auditors might face communication problems with readers of the report - technical, semantic and effectiveness problems.

Technical problems arise in the transfer of messages from sender to receiver and relate to the accuracy of symbols transmitted and efficiency of *"coding." "Noise"* or interference, not intended by the sender, distorts the signal and therefore readers its effectiveness. In the audit report, this problem may arise because of unusual alterations of its form. In fact, in an effort to overcome this *"noise"*, many standard-setting bodies recommend specific formats to the report that include several standardized coded messages. However, there is controversy as to how far a technically worded report is in fact superior. For example, Hatherly and Skuse (1991) argued for a *"free-standing"* audit report that would include words in their natural, not technical sense, while still using standardized language whenever possible.

Semantic problems relate to the congruency of meaning as interpreted by receiver with that intended by sender. This has previously (S2.4.3) been referred to as a microbarrier. As stated by the Committee on Basic Auditing Concepts (1973),

> *"the meaning of any message... is not in the message itself. Rather, it is in the sender and the receiver" (p 46).*

In fact, since no two minds are alike, nor are the meanings which they attribute to the same message. Symbols are therefore used to evoke similar meanings, and the message effectiveness of the auditor depends on his ability to choose those meanings which bring the intended meanings in the audit report reader. These usually take the form of standardized language. However, one danger is that as a reader becomes familiar with these chosen symbols, particularly in the case of the standardized unqualified report, he tends to treat the whole report as a single, although complex symbol that is no longer read (Seidler, 1976). Reader impression of what it means depends on his memory of what it says. He merely glances to see that the report is included and that it does not contain a departure from the usual language. Moreover, as stated in the CAR (1978) report, as a reader becomes more familiar with the standard language, *"he might easily overlook minor modifications in the standardized language in a report that appears to be about the standard length " (p 73).*

One possible way to avoid this is to issue a more expanded report, and an attempt in this direction was the release in 1988 of SAS No: 58 by the Auditing Statements Board of the AICPA (ASB,1988c). This contained changes, mostly expansions, to a report that had not been substantially revised since 1948. Kelly and Mohrweis (1989) found that this SAS in fact significantly increased reader understandability regarding the purposes of the audit and the responsibility of management for the financial statements. In the UK, Hatherly, Innes and Brown (1991) also concluded, following an experimental study, that reader perceptions of the audit report would probably be significantly improved if the report was expanded on the lines, although in somewhat more detail, of the SAS 58 requirements, and, in fact, a consultative paper issued by the APB (1991) made proposals on similar lines. Perhaps, one advantage of using more expanded reports is that the auditor no longer over-relies on words such as "*true and fair*" which can mean differently to different persons. For example, two recent UK studies (Nobes and Parker, 1991 and Parker and Nobes,1991) analyzed surveys on auditors and financial directors, and , found that this phrase was regarded differently by both parties. Auditors were even using this phrase to obtain quick support for views which were as yet uncovered by accounting standards.

Finally, a third level of communication problem is the effectiveness level. Effectiveness means that the received meaning of the report affects the conduct of the reader in the desired way. As stated by the Committee on Basic Auditing Concepts (1973), in order to be effective with readers of the report, the auditor needs to understand his audience , and to relate to their knowledge, interests, attitudes and communication skills. In other words, the auditor is to use all possible applications to auditing of modern communications theory. After all,

> *"Communication is not neutral. It does have an impact and can change behaviour" (p 52).*

2.4.6 Auditor-Management Disagreements On Audit Reports and Auditor Switching

It has already been pointed out in S2.2.3 that the respective economic interests of managers and auditors provide an incentive for them to continue their relationship. Where a disagreement between them occurs, auditors and managers may therefore compromise, especially where a planned qualification is not in an extreme form.

If compromise cannot be reached, and the qualification or intended one is serious enough, managers may attempt to change auditors. This was and is still possible in the UK and other countries such as Malta despite the fact that the statutory obligation to appoint auditors rests with shareholders. In practice, executive and other directors, that is, the managers of the company, often have effective power through their nomination of the auditor and their control over the general meeting. An example of management's attempt to dismiss the auditor following qualification of the accounts happened was in England in 1963. The directors of the City of London R.P. Company Ltd did not, however, proceed with their plans following public criticism of their proposed action.

Several authors (eg Burton and Roberts, 1967, Carpenter and Strawser, 1971, Chow and Rice, 1982 and Craswell, 1988) have discussed the role of accounting disputes and audit qualifications in firms' choice of auditors. Yet, in discussing those that have produced systematic evidence in this regard, it is pertinent to note that management surveys such as Burton and Roberts (1967) and Carpenter and Strawser (1971) consistently indicated other reasons than these in auditor switches. However, since it does not seem in the interest of the surveyed company management to reveal such reasons, the results may not be surprising.

Using a sample from SEC-registrants, Chow and Rice (1982) found that firms tended to switch auditors more frequently after receiving qualified opinions. This was confirmed in Australia by Craswell (1988), who found in an Australian survey that there was evidence that managers were switching auditors more frequently following qualification, with *"new"* auditors giving unqualified opinions, irrespective of the type of previous qualification and of whether the audit firm was a Big Eight one or not. He stated that

> *"if managers change auditors following qualification, regulators may be concerned about the threat of dismissal on auditors' independence. If managers can avoid subsequent qualifications as a result of changing auditors, regulators may be concerned about auditors satisfying their legal and professional obligations" (p 23).*

In fact, in recent years there has been much media discussion, especially in the USA, as to whether auditors can fulfil their duties if managers can avoid later qualifications by changing auditors. For example, Knapp and Elikai (1988) included, in their list of references, articles on so-called *"opinion shopping"* in the Wall Street Journal, Business Week and the New York Times.

2.5 The Auditor and Management Fraud

Management fraud and even its possibility raises important issues for the management's relationship with the external auditor. After defining its nature, this section will discuss the circumstances leading to it and to its detection, the relationship between fraud and the internal control structure, and finally, the responsibility of the auditor for its detection and reporting.

2.5.1 The Nature of Management Fraud

Fraud in the auditing environment is described as *"the use of deception to obtain an unjust or illegal financial advantage" (APC, 1990: para 1)*. The IAG (IAPC, 1982: para 2) describes it widely as involving not only the intentional distortion of financial information, but also the misappropriation of assets.

However, management fraud, unlike that of non-management employees, will probably not involve direct theft: the CAR (1978) referred rather to intentional misrepresentations leading to improper selection of accounting principles or inclusion of false amounts in, or the omission of amounts from, financial statements. *"Such fraud is often accompanied by acts of concealment, such as omission or manipulation of entries or documents (including forgery) or collusion among individuals inside or outside the company" (p 32)*. Johnston (1986: p 12) stated that such misrepresentations happen for a variety of reasons, such as because of the wish of the perpetrators to enhance their remuneration or position, or, on occasions, to buy time for sick companies.

In defining fraud, there is a problem in that, as stated by the Lord Benson Report (ICAEW, 1985), fraud is only finally established by a verdict in the Courts. An important on-going problem is therefore that the auditor will be concerned not with an established fraud, but with a suspicion of it.

2.5.2 Circumstances Leading to Fraud and Its Detection

Wells (1990) quoted a noted criminologist, who pioneered the study of embezzlement in the 1950's, that in most frauds there is a combination of three factors : a motive or *"hidden need"*, a perceived opportunity to commit fraud without being detected usually caused by weak internal controls, and a defective set of values resulting in an ability to rationalize the theft. While fraud mostly occurs when these three factors are present at the same time, this is not necessarily of comfort to the auditors: in fact, doubts have been expressed as to the suitability or effectiveness of auditing to detect such fraud. For example, Comer (1985:p 10) reported the results of a USA study by the *"Computer Fraud and Security "* Bulletin : this showed that most cases of fraud were detected by accident (51 %), and only a minority detected by auditors (19 %) and management controls (10 %).

2.5.3 Internal Controls and Fraud

It has already been stated in the previous section that often weak internal controls are a main factor leading to fraud. The establishment and maintenance of a proper internal control structure are therefore relevant to fraud prevention and detection. In the USA, following the recommendation of the National Commission on Fraudulent Financial Reporting, or NCFFR (1987), to extend the concept of control beyond accounting controls, the ASB (1988b) defined such a structure as including not only the accounting system, but also control procedures and the control environment. The latter has already been referred to in S2.4.4. In addition, the ASB in the same statement required an assessment by auditors of such a structure in all audits, whether or not they intended to rely on such controls. This was therefore an attempt to enhance audit effectiveness by increasing the auditor's responsibility to obtain knowledge about a company's internal control structure.

A related controversy is whether it is beneficial to have legal requirements on companies with respect to internal controls. Unlike the situation in the UK, public companies in the USA have, since 1977, been expressly required by the Foreign Corrupt Services Act to maintain such controls. This was a useful first step in the prevention and detection of fraud.

Yet, given that what are required to be kept are primarily internal accounting controls, this is no longer being considered sufficient. An additional NCFFR (1987) recommendation, taken up for consideration by the Securities and Exchange Commission, or SEC (1988) is to require public companies to assess the effectiveness of their control structures and report the results to the public. The proposal is for a *"Report of Management Responsibilities"* to contain this assessment along with the company's response to significant internal control recommendations by the company's auditors. In addition, management would acknowledge its responsibilities for preparing the financial statements and maintaining a proper system of internal control related to financial reporting. Proposals for a management report in the USA go back at least to the CAR in 1978, and the idea , which has been so long in gestation, may be one " *whose time has come*" (Solomon and Cooper, 1990), at least on that side of the Atlantic.

2.5.4 The Auditor's Responsibility for the Detection of Fraud

Various writers, eg Flint (1971), Lee (1986), and Gwilliam (1987) have suggested that over time the responsibility of auditors for the detection of fraud has shifted a great deal. Early in the twentieth century, the detection of fraud was seen as a major objective of an audit in its own right. This role was by time taken by the need for the auditor to attest to the overall truth and fairness of a company's financial statements. As stated by Gwilliam (1987a: p 161), the profession in the UK and the USA for many years sought to abrogate any responsibility for the detection of fraud.

However, since the sixties, the shift began to be reversed. A professional statement at the time (AICPA, 1960) specified that auditor responsibility for fraud arose when this resulted from the auditor's failure to comply with GAAS's. In 1977, the ASB issued SAS 16 which, while still stressing the inherent limitations of an audit, effectively required the auditor to plan his audit to *search for* material errors and irregularities. However, according to Carmichael (1988), many auditors believed that this meant that they could assume that management was honest unless information came to their attention that specifically contradicted that assumption. The new SAS (ASB, 1988a) requires auditors to be more sensitive to the possibility of material irregularities: the auditor is now to design the audit to *provide reasonable assurance* of detecting errors and irregularities material to the financial statements. Very similar guidance is also provided by the IAPC (1982) and the APC (1990).

However, the American statement goes further: it imposes a duty on auditors to be aware of the existence of *"red flag"* characteristics. *"Red flags"* are indicators that fraudulent activity is in fact taking place. As stated by Cosserat (1990), the presence of red flags means that *"the auditor must revise the normal presumption of neutrality towards management integrity and approach the audit with a greater degree of professional scepticism"* (p 2). Several red flag lists have actually been developed by the accounting profession, eg SAS No: 6 (ASB, 1975), Touche Ross and Co (1974) and Coopers and Lybrand (1977). Also, a number of research studies have been directed at this approach, eg Albrecht and Romney (1986) and Sorensen, Grove and Selto (1982).

2.5.5 Due Audit Care and Fraud Detection

The concept of *"reasonable assurance"* of detecting errors, fraud and other irregularities in financial statements seems to be developing on the lines suggested by Mautz and Sharaf in 1961. They proposed the development of a concept of professional care under which *"practitioners are expected..to make a reasonable search for irregularities, to provide their clients and business generally with an important service and some effective protection ; they are not held for an examination unreasonably extensive or rigorous "* (p 131).

Thus an auditor cannot be expected to detect all frauds. For example, he cannot be made necessarily to detect fraud involving the participation of top management, or where such fraud is highly sophisticated. Indeed, as stated by the CAR (1978),

> *"the need to provide audits at a rational cost imposes limits. Society does not require perfect performance of any professional"* (p 37).

Nevertheless, as stated by Gwilliam (1987a: pp 162-167), the courts will go into the merits of each particular case, and their interpretation may even go beyond what many in the profession may expect to be normal audit boundaries.

2.5.6 The Reporting of Management Fraud

An auditor will seek to establish a normal professional relationship with his client. He expects to win his clients' confidence and vice-versa. The client wishes to have full freedom in his discussions with the auditor and have his confidence respected. Otherwise, the relationship will become difficult because in the course of his work the auditor needs to obtain knowledge of impending matters such as mergers, dividend prospects, trade secrets, future developments and so on. Therefore, it is no surprise that professional pronouncements, such as the Guideline on Ethics for Professional Accountants (IFAC, 1990) emphasize the need for the auditor to observe such confidentiality. *"Confidentiality should always be observed by a professional accountant unless specific authority has been given to disclose information or there is a legal or professional duty to disclose"* (para 4.2).

On the other hand, IAG 11 of IAPC (1982: paras 13-19) states that the auditor will try to confirm or dispel a suspicion of fraud, and, if suspicion is confirmed, will see that it is *"properly reflected"* (para 14) in the financial information. The auditor will also need to consider the possible impact of any unconfirmed suspicion of fraud on the financial information and on his audit report. *"He may wish to obtain legal advice before rendering any report on the financial information or withdrawing from the engagement"* (para 15). As regards reporting to management itself, the IAG also states that the auditor should normally report fraud on a timely basis to a higher level of management than that implicated in the fraud. Furthermore, if those in overall direction of the entity are doubted, the auditor would again *"seek legal advice to assist him in the determination of the procedures to follow"* (para 19). In any case, the auditor is told to consider his reporting responsibilities to regulatory authorities if fraud *"is actually found to exist"* (para 18).

The UK Guideline on the subject (APC, 1990) is even more specific. First, if, as a result of the fraud, the financial statements do not give a true and fair view, the auditor should qualify his opinion (para 25). In extreme circumstances, such as where the entity refuses to issue the financial statements, or the auditor has considerable doubts about management's integrity and there is no immediate occasion for reporting to members, he should resign so that use can be made of the existing legal provisions designed to keep members informed of the prevailing circumstances [paras 28-29, see also S5.3.4 (a)].

Another question dealt in more detail by the same APC Guideline is that of reporting to outside third parties. As stated by Tweedie (1991), attitudes towards fraud have recently hardened in the UK. Since the mid-eighties, three Acts were passed - the Financial Services Act 1986, the Building Societies Act, 1986, and the Banking Act, 1987 - which, among the increased powers to regulatory bodies in the financial sector, gave the statutory right to the auditor to report to such bodies when the auditor suspected that fraud had been committed by senior management. Overall, the changing attitudes have led to *"a gradual evolution of the auditor's general right to report senior management fraud to third parties" (p 32).*

Thus, only in 1985, the Benson Report (ICAEW, 1985) spoke against pressures being put on the auditor *"which cause him to be regarded as a possible mole or informer, with the result that he takes action without his client's knowledge, or when there is no duty to do so."* However, following more controversies on the subject and even questionnaires to interested persons, such as the APC one analyzed in an audit brief (Allan and Fforde, 1986), the 1990 APC guideline placed more emphasis on the need to *"weigh the public interest in maintaining confidential client relationships against the public interest in disclosure to the proper authority" (para 3)*.

In effect, while it may still be in the interest of the auditor to take legal advice before taking a decision, the guideline indicates that the auditor is protected from the risk of breach of confidence or defamation if:

- information is disclosed to one who has a proper interest to receive information (para 35)
- the suspicion of fraud or other irregularity is reasonable (para 30)
- disclosure is made in the public interest (para 34).

Probably the latter is most difficult to determine, because the *"public interest"* is an undefined legal concept. Yet, even where one decides in favour of disclosure, according to the APC guideline, normally the auditor should first request management to report to the proper authority within a specified time. An exception occurs where there is no confidence in the integrity of senior management, or the management, when so requested, fails to do this or to provide evidence of such action: in this case, the auditor should report directly to the proper authority (paras 37-38).

2.6 Small Company Issues

This section will first define and bring out the characteristics of a small company. It will then deal with the effect of these characteristics on internal controls; the consequences on the work and reporting of the auditor and, finally, the relevance of the audit to management-owners.

2.6.1 Definition and Characteristics of a Small Company

A *"small company"* is difficult to define. In a UK survey among auditors, Carsberg, Page, Sindall, and Waring (1985) found that most respondents preferred a definition based either on turnover, or on number of employees or on the proprietoral nature of such companies. It is worthwhile noting that the definition of a small company in UK company law (S246 CA 1985), and following the EEC 4th Directive of 1978 as amended (see Appendix IV) is any one which can meet any two or more of the following conditions: turnover does not exceed GBP2.8 million, total assets do not exceed GBP 1.4 million and average number of employees do not exceed 50.

Following the IAPC (1989) Statement, the phrase is used here to refer to companies that

> *"have few employees or a low turnover or total assets. Such businesses usually display either or both of the following characteristics*
> - *limited segregation of duties*
> - *domination by the senior management over all essential aspects of the business" (para 2).*

The first characteristic will be due to the small number of accounting and administrative personnel employed by such a company. The full division of responsibilities attainable in larger companies is simply not practicable. One possible consequence of this is that

> *"record-keeping may be informal or inadequate. There is therefore a greater risk that financial statements will be inaccurate or incomplete" (ibid., para 5).*

The second characteristic, the domination by senior management on all the vital aspects of the company, often happens because members of management and their families own all or a large part of the enterprise, and therefore need to act in their dual capacity of owner-managers. Even where this is not the case, that is, the manager is not the owner, the company is still composed of a sole or few persons who will therefore be necessarily involved in many of the day-to-day operations.

The small company management will combine all or most of the key functions of purchasing, manufacturing, personnel, finance and accounting.

2.6.2 Effect on Controls

Professional literature such as the IAPC (1989) statement on the audit of small businesses and a related statement by the UEC (1985) refer to the effect of small size characteristics on the existing accounting system and controls. In all entities, even small companies, the accounting system needs to be designed in such a manner as to provide reasonable assurance of the completeness and accuracy of the accounting records. However, one difference is that in small businesses the limited number of employees makes it impossible to operate complex, formal systems that will prevent company personnel from having, say, an easy access to assets. Therefore, simple controls are often adopted, such as supervisory controls, for which there is little or no record of actual operation. In addition, management, consisting of a sole or a few dominant persons, is often in a position to override all controls operated by staff, and such controls may only be effective as a check for management's use.

In fact, the usually close involvement by the management or owners in the day-to-day running of small companies has both its advantages and disadvantages. For example, the senior management or owner may be able to personally sign all cheques, in cases where there is a limited segregation of duties in the area of purchasing and cash disbursements. This in itself will reduce the risk of employee fraud or error. However, in such a situation, there may be an opportunity for senior management to override prescribed procedures, and to direct personnel to make disbursements that they would not otherwise make in the absence of supporting documentation.

The above can give rise to particular difficulties for the auditor both as regards the audit work and the actual audit report.

2.6.3 Consequences on the Audit Work

The auditor needs to face the increased risk made up of the above-mentioned lack of controls or of insufficient documentation of their operation. There are particular difficulties relating to the profit and loss account - the possible overstatement of expenses and understatement of income (IAPC, 1989: para 18). For example, the personal expenses of the proprietor may be included with the business expenses as little distinction may be made by him between business and personal transactions [APC, 1991 para 9(b)]. In particular, omissions of sales transactions may be difficult for the auditor to find out, especially where they are mostly for cash, or where there is no regular pattern of margins or volumes of turnover. Furthermore, an owner-manager may be particularly motivated to cause the reported profit of the business to be materially misstated and his involvement in the business may make this easy to achieve [ibid., 1991: para 9(d)].

It may be that, owing to many of these problems, the auditor decides not to rely on the system of controls in expressing his opinion. Additionally, as stated by the IAPC (1991: para 19), it may appear more efficient for the auditor to confine audit procedures to those of a substantive nature even where there appears to be effective controls.

Extensive substantive tests, such as the full review of costs and margins, may still need to be supplemented by management representations. For this reason, as stated by BPP Publishing (1990), the auditor needs to:

> *"form an opinion as to the honesty and reliability of management, based on previous experience and having due regard to the prevailing circumstances. Reliance on*

management assurances must be justified, and should be supported by written representations where appropriate" (p 340).

The requirement in the USA, referred to in a previous section (S2.5.3), for auditors to consider the control environment as part of the internal control structure is also relevant here. Monk and Tatum (1988) claim that, prior to the introduction of SAS no: 55 (ASB, 1988b), many American auditors failed to consider the significance of this environment when placing reliance on management representations.

One important aspect of this environment is management's philosophy and operating style. For example, if management is absent from the business or neglects the exercise of day-to-day control, its representations will probably not be dependable ; also, if the auditor knows that the owner-manager places emphasis on minimizing income taxes, the auditor will be more cautious about the possibility of material misstatements in stock.

Another problem faced by the small company situation is that greater reliance may need to be placed on auditors to assist in the preparation of accounting records and financial statements. One danger of this is that, as a result, *"the managers of small businesses may incorrectly assume that they have been relieved of their responsibility for accurate financial reporting"* (IAPC, 1989: para 5). Instead, they may concentrate their efforts on operational areas such as sales and marketing. The IAPC Statement attaches importance to the roles of the letter of engagement (in para 15) and the letter of representation (in para 20) in clarifying such a misunderstanding.

2.6.4 Audit Reporting Consequences

The UK accountancy profession's response to the mentioned problems relating to small company audits was the use, in the eighties, of a special small company qualified audit report known as *"Example 6."* This was originally an example given in an auditing guideline (APC, 1980) as an illustration of meeting the auditing standards, but throughout the eighties it was adopted widely by practitioners. Keasey, Watson and Wyarnczyk (1988) found that between 1980 to 1982 about a quarter of small company reports had the small company qualification. This proportion was again quoted by the Certified Accountant (1989: p 5). Also, according to the APC (1987), *"More than half of the qualified audit reports issued on the financial statements of limited companies are in the form of Example 6"* (para 2.1).

There was therefore the tendency for this report to become regarded as a standard small company qualification, and this was beyond the APC's original intention. Such a report qualified the auditor's opinion on the grounds of uncertainty, subject to the acceptance of management representations. It included the controversial wording *"where independent confirmation of the completeness of the accounting records was therefore not available we have accepted assurances from the directors/managing director that all the company's transactions have been reflected in the records"* (APC, 1980).

The APC (1987), in drafting a revised audit reporting standard, argued against this report, mainly because there was some internal inconsistency in this wording. After all, if the auditor considered it fit to accept the representations of management, this acceptance could not justify a qualified opinion in unspecific terms. This example was therefore omitted from the subsequent revised auditing standard (APC, 1989b), and opinions similar to the old form *"Example 6"* report are now expected to be issued only in exceptional cases. The current normal requirement for the auditor is either to support the management representations and not qualify, or to qualify in specific terms, referring to the areas and amounts in the financial statements affected by the uncertainty. In this connection, the IAPC (1989) issued an ISA recommending a similar type of report except for using - more in line with American practice - an *"except"* rather than a *"subject to"* opinion.

2.6.5 The Relevance of the Audit

In the UK there has been a long-standing debate concerning the relevance or otherwise of independent audits for small companies. For example, prior to the implementation of the Fourth Directive in the Companies Act, 1981, the APC (1979) issued the audit brief *"Small Companies -The Need for Audit."* This was in response to a Government Green Paper (Department of Trade, 1979) deliberating the possibility of change. The brief put forward arguments for and against change from the viewpoint of various users, including management and shareholders. It was argued, among other things, that the audit provides management with a useful independent check on the accuracy of the accounting systems and that the auditor is frequently able to recommend improvements in the systems.

However, arguments against the audit are particularly strong where all the shareholders are also executive directors or closely related to them; the benefit gained from an audit may not be worth its cost. For example, Woolf (1986: p 13) argues that there is *"something ludicrous"* about directors supplying information to the auditor so that the latter reports back to them as shareholders. Furthermore, in mid-1985 the UK Department of Trade and Industry again issued a consultative document suggesting, among other things, that the audit was not essential in such circumstances. Yet, it still acknowledged that the interests of other investors such as banks and trade creditors required protection and that such parties could demand their own independent audit in the absence of any statutory requirements. Although the controversy was raised again, the small audit requirement was unchanged.

Nevertheless, although the small company is subject to statutory audit only in a few countries, such as Belgium, Denmark, Sweden and Switzerland, there is still strong support to it in the UK. For example, a 1991 survey by the Manchester Business School showed that the vast majority of 2,000 UK small businesses agreed that the benefits of an audit outweighed the costs (Accountancy, 1991b).

It may be argued that a review accompanied by a management consultancy report would represent a greater benefit for a similar cost. While supporters of the review have often failed to define its nature and scope, the 1979 APC audit brief mentioned above described it as *"a procedure whereby an accountant, relying upon the assumption that his client has made a full and fair disclosure of all the relevant information, satisfies himself (after completing work in accordance with an approved review standard) that on the basis of the information and explanations so provided the financial statements give a true and fair view"* (para 43). According to the brief, the review is substantially less in scope than an audit, excluding the collection of independent evidence or the carrying out of any examination of internal control, but including at least a limited examination of the accounting system, in case the information provided by management is not as accurate or as complete as management believed. As explained by Gemell (1977), a review consists primarily of *"enquiry, comparison and discussion of financial statements, and of the information and explanations supplied."* A comparable idea is found in American literature: in their GAAS Guide, Miller and Bailey (1991) state that a review performed under the SSARS's of the AICPA

> *"is a level of service lower than an audit of financial performance...The more prominent auditing procedures not required by a review are*
> *-an evaluation of internal control structure;*

-tests that the internal controls are as represented and are properly functioning
-observation of inventories
-confirmation of accounts receivable" (para 40.26).

No opinion is therefore expressed in a review performed according to American standards; rather, such a review results in a negative expression of *"limited assurance."* The limited assurance is contained in a report by the accountant stating that he is *"not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles"* (Miller and Bailey, 1991: para 40.65) .

The APC (1980) audit brief referred to above states that review procedures are similar to those already being carried out in respect of unaudited financial statements. However, by contrast, the American review places the review on a higher level than a preparation of unaudited financial statements or *"compilation"*, because this latter service simply means that the financial statements are appropriate in form for the client and the industry in which it operates and are free from obvious material errors (Miller and Bailey, 1991: para 40.19). More importantly, here the auditor expresses no assurance at all.

However, even the review has its opponents. A common argument against it is that it would not be sufficiently distanced from the audit to avoid the danger of confusion (Page, 1991). Moreover, Shaw (1978) argues that the review procedure *"requires the reviewer to make manifestly clear by his unambiguous disclaimer that his review was to all purposes worthless."*

Probably a less contentious remedy to the small company audit problem is to take up the suggestion made by the UK Department of Trade (1979) Green Paper: that is, that of *"developing further standards setting out the different approach and methods appropriate to the* *circumstances of smaller companies"* (Chapter 2: para 14). An audit can still be carried out, but, as stated by Page (1991), one may decide to adopt *"lower auditing standards of evidential support"* (p 218). After all, small company audits are relatively uneconomical in comparison with large companies:

> *"there are economies of scale in auditing: it does not cost twice to audit one company which is twice as big as another.. there is an element of fixed cost in many audit procedures (such as compliance with the Companies Acts and accounting standards, audit planning, audit review"* (Ibid.: p 217).

Auditing standards or guidelines may therefore be developed to make the small company audit more cost-beneficial, such as by allowing the scope of such an audit to be reduced and its procedures simplified.

2.7 Other Issues Relating To Government-controlled Enterprises

States often intervene in a large, and diverse, number of trading and quasi-trading activities. This intervention normally materializes through the creation of new entities such as companies or corporations with their own special statutes or by the acquisition of part of the equity share capital in private sector companies. Although the UK and other countries have effected major privatizations in the 1980's, the significance of entities remaining in public sector control will probably continue for a long time.

This work is concerned with the relationship between management and statutory, not public sector auditors. Auditing in the public sector is a vast and separate area in itself and this part will therefore focus on the particular issues affecting the statutory auditor-management relationship in business enterprises - companies and corporations - where the state has a majority stake or complete ownership.

Common examples of such enterprises include energy utilities, communication services and national railways. The International Public Sector Guideline No:1 (International Public Sector Committee, 1989), states that *"government business enterprises are normally required to operate commercially, that is, to make profits or to recoup, through user charges, a substantial proportion of their operating costs"* (para 5). Such businesses *"usually take the same legal form as private sector business enterprises"* (para 7). However, some may be subject to specific legislation giving them a different legal form, such as that of a public corporation. Their main difference from other entities within the public sector is that they *"have the financial and operating authority to carry on business, usually including the power to contract in their own name, and some are able to raise finance from non-government sources"* (para 6).

According to Lapsley (1988), who surveyed academic research on public sector accounting, one aspect of audits in the public sector in general which attracted the attention of accounting researchers was that of the regulation of the external auditor. In the UK, the role of the Secretary of State in such audit regulation of nationalised industries was questioned by Glynn (1987). Each year, the relevant Secretary of State of each nationalized industry appoints a firm of auditors to carry out financial and regulatory audits. The audited accounts and accompanying audit report are sent to him , and he, in turn, presents them to Parliament. Glynn suggested that to improve matters private audit firm reports should be presented to the Comptroller and Auditor General (C & AG) rather than to the respective Secretary of State, whose government can regulate many of the activities of such industries. He further suggested that the C & AG appoints the auditors of each nationalized industry, and thus strengthen their independence *"not only in relation to an industry's sponsoring department but also with respect to the potential pressures of overbearing industry chairmen"* (p 108).

Another area in which there has been a high degree of academic and professional interest in recent years is the extension of statutory auditing to include value-for-money (VFM) auditing, or, as is commonly known, the three E's audit: economy, efficiency and effectiveness. For example, in an ICAEW-sponsored research report, Glynn (1985), has documented the institutional background to the development of this concept in six countries. As stated by Hepworth (1990) , with VFM, both the financial manager and the auditor experience a changed role in the delivery of public services:

> *"The auditor must understand the business and be able to assess its performance. His reports should inform the politician about the performance of the manager. He must be able to mobilize public opinion* "(p 4).

On the other hand, the financial manager/ accountant *"must produce reports for the politician, consumer (elector) and regulator to allow judgments to be made about performance"* (p 4). A related question arising in the context of VFM auditing is the extent to which the auditor should consider policy aspects in satisfying himself as to the VFM achieved. For example, as pointed out by Gwilliam (1987a: p 85), in the UK public sector, the VFM audit is yet restricted to the execution of policies alone, and the auditor is unable to call into question policy decisions themselves: it is not his duty to consider political merits as part of his work. Yet, such a distinction may not be clear enough in practice, particularly when policy aims are less than clearly defined. In addition, restricting the VFM auditor in this manner may make his end-product less than satisfactory to users of his report. In this connection, Tomkins (1986) found that there existed difficulties of identifying and measuring the attainment of policy objectives. The same study also supported a previous finding by Grimwood and Tomkins (1986) that little *"effectiveness"* audit was undertaken on two public sector audit engagements which they examined.

2.8 Conclusion

This chapter has attempted to outline the main issues in the literature that concern the complex auditor-management relationship. The auditor's independence from client management was seen to be affected by various factors, but one issue as yet much subject to debate, despite considerable research effort, is the desirability of the provision by the auditor of non-audit services to client companies. Furthermore, while the auditor was seen as playing diverse roles in the accounting communication process, difficulties in auditor-management communications were pointed out both during the audit and in the statutory audit report. With regard to the latter, research studies have indicated that disagreements between the two parties contribute to managers switching their auditors. The chapter has then shown that the possibility of management fraud, and the fact that companies may be small or government-controlled, may bring further complications to the relationship and, in particular, controversies concerning auditor responsibilities.

This project now intends to introduce the environment of the Maltese microstate to such relationship issues, as a preliminary to studying how these issues evolve within such an environment.

CHAPTER THREE

THE MALTESE ENVIRONMENT OF AUDITORS AND MANAGERS: A PROFILE

3.1 Introduction

The objective of this chapter is to present the Maltese environment in which auditors and managers relate to each other.

Section 3.2 will introduce environmental factors - economic, professional and legal - that have a bearing on Maltese auditing and the auditor-management relationship.

This will be followed by Section 3.3 which will give an overview of the Maltese economic and financial systems and of limited liability companies.

An outline of the regulatory - professional and legal - framework related to the relationship will follow in Section 3.4, and Section 3.5 will then point out the possible effects on this regulatory framework of a changing European environment.

Finally, Section 3.6 will examine any exploratory studies in Malta concerning this relationship.

3.2 Environmental Influences on Accounting and Auditing Practices

Environmental differences give rise to different accounting and auditing practices and can explain groupings of countries (Frank, 1979 and Nair and Frank, 1980). Different groupings have been made by various authors on account of these differences.

For example, Mueller (1967) classified international accounting practices into four groups: (1) systems that emphasize macro-economic uses of accounting data, such as Sweden; (2) systems with microeconomic uses that focus on measuring the economic net worth of firms, such as the Netherlands; (3) systems of accounting based on existing business practices such as the UK and the USA, and (4) systems that require the use of a uniform code, such as France.

On the other hand, Seidler (1967) developed a classification based on spheres of influence of certain countries identifying three models: the British, the American and the Continental European.

Furthermore, the AAA International Accounting Committee (AAA, 1977) identified five zones of influence: British, Franco-Spanish, Portuguese, Germanic-Dutch, US and communistic.

Environmental factors influencing accounting and auditing practices are relevant also to the auditor-management relationship. They can be divided into three categories: economic, legal and professional (Choi and Mueller, 1984: p 41).

3.2.1 Economic Factors

Following the classification used by the World Development Report of the World Bank, Malta can be classified as an upper-middle-income developing country (Briguglio, 1989: p 33). Now, Hussein et al (1986) stated that in developing countries most of the accounting practices laid out during colonial times are still in use: the majority of such countries are economically closely linked to their former colonial power or to a major economic power on whom they depend for capital and technical knowledge; and most of them train their professionals in Europe or the US. British and French accounting, existing at the turn of the 20th century, was exported to other British Commonwealth countries and to French possessions in Africa and Asia.

Therefore, it is no surprise that Malta uses many of the accounting practices of the United Kingdom, of which it was a colony for one hundred and sixty-four years of its recent history (1800/1964). Malta now remains a Commonwealth country and is still closely linked economically to the UK: for example, the UK is one of Malta's major trading partners, and, by the end of 1990, most of the tourists to Malta were still coming from there (CBM, 1991a). Additionally, many professional practitioners, such as medical specialists and even accountants are UK trained. In addition, Malta has systems of accounting based on existing business practices, as in the UK and the USA.

However, one economic factor that should bear out differences between the UK and Malta is the nature of business ownership. Choi and Mueller (1984: p 42) asserted that widespread ownership of corporate securities as in the USA or the UK suggests financial reporting and disclosure requirements which are different from those applicable to predominantly family or bank-owned corporate interests, as in Germany: for example, the German audit report is much shorter than that of the USA. While the existing small Maltese economy, the financial system and the available company information will be overviewed later (S3.3), it seems clear that in Malta the situation is different from that in the UK. Thus, for example, the number of traded stocks is as yet negligible, and the financial community is less sophisticated.

3.2.2 Professional Factors

The level of development of the accounting profession has been cited as having a significant impact on accounting and auditing practices (Hussein, Bavishi and Gangolly, 1986). Factors that indicate this are the presence of codified auditing standards, the number of professional accountants per 100,000 of the population, licensing, education requirements and certification through examination. The presence of codified accounting and auditing standards in the UK and the fact that there are as yet none applicable for the whole accountancy profession in Malta might be taken as evidence that the Maltese profession is less mature. The number of professional accountants per capita in Malta is also less than in the UK: Hussein et al (1986) give the UK figures in

1986 as 235 per 100,000 of the population, while the Maltese ratio, although on the increase, was still far away from this by the end of 1990: the Malta Government Gazette (1991) gave the total number as 439, which comes to about 125 per 100,000 of the population. In both countries, certification by examination exists, although in Malta licensing and education requirements are somewhat different (see S3.4).

3.2.3 Legal Factors

Although civil law is largely based on the Napoleonic Code, and the Criminal Code is Italian in origin, existing commercial and company legislation is modelled on its British counterpart. Insofar as is relevant to auditor-management relationships, this is outlined in S3.4. Unlike countries with company legislation based on Roman law, there is not so much rigidity in legislation, although, owing to the process of European Directive harmonization, this situation on the British side has been changing in the eighties. On the Maltese side, legislation is outdated and includes provisions modelled on the Companies Act 1948 that have since long been amended in the UK itself, such as, for example, lower accounting disclosure requirements for private exempt companies.

3.3 Economic and Financial Systems and Auditee Companies: An Overview

3.3.1 The Economy

Until early 1979, Malta was used as a naval base for the British Mediterranean fleet, and received in return a rent, which, together with other revenue indirectly generated from such use, accounted for a substantial portion of the country's total income.

The loss of such revenue was offset by increased emphasis on manufacturing and tourism industries. Manufacturing became the leading gross domestic product contributor. The main industries in the manufacturing sectors are the clothing, food and beverages, machinery and transport, equipment and furniture ones. In these sectors, subsidiaries of foreign-owned companies which export their production are prevalent. One disadvantage of being a microstate is, as Briguglio (1989) put it, *"the concentration on a few categories of products and services in export trade"* (p 35). This has shown itself in the Maltese textile and clothing industry, which makes up a very high percentage of exported goods.

Malta's Gross National product also rose from 423 million Maltese liri in 1980 to 790 million liri in 1990. (CBM, 1991b: p 85). This meant a per capita income of over Lm2,200 or GBP3,800. In fact, among the countries annually classified by the World Development Report of the World Bank, Malta is one of the richest in terms of GNP per capita, much higher than that of many countries in Asia, Africa and Latin America.

One distinguishing feature in Malta's economy is its very small size. As a microstate, Malta tends to lack natural resources, and the import bill tends to be large. For example, in 1990, total imports totalled Lm620 million compared to total exports of Lm 357 million (ibid.: p 87). The substantial visible trade deficit is bridged by heavy dependence on the tourism industry, a volatile and therefore risky industry, and also by earnings deriving from shipbuilding, ship repairs and other services.

In addition , the Maltese public sector is significant in size. For example, Briguglio (1989: pp 51-2) pointed out that in mid-1989, this sector employed about 38% of the work-force, of which 16% worked in public corporations and companies controlled by government or its agencies. He maintained that this sector had a particular problem of low labour productivity, which gave rise to an inefficient use of resources. With regard to the accountability of corporations and companies, as pointed out by the Financial Secretary (Wadge, 1990: pp 13-15), the Boards of such entities are probably still not subject to sufficient controls by Parliament or government authorities.

3.3.2 The Financial System

The Maltese financial system is not as yet much sophisticated and one indicator of this is the key role still played by government in controlling it. The main financial institutions are the Central Bank of Malta and the four local commercial banks. As regards the former bank, this not only carries out perennial central bank functions such as the issuing of currency and the maintenance of the external reserves, but also, by virtue of the Exchange Control Act, 1972, administers rigorous controls on foreign exchange dealings and the export of domestic currency from Malta. With regard to the commercial banks, the three main ones are government-controlled and, while they offer a range of banking and commercial services, they neither have to face stiff competition among themselves nor do they have to differ substantially in their banking products. In addition, interest rates on bank deposits, loans and advances are fixed by government, which thus even controls the banks' profit margins. The commercial banks are also the major shareholders in three specialist financial institutions furnishing long-term finance to the business sector as well as home mortgages.

In addition, it was only as recently as 1990 that the Malta Stock Exchange Act was passed to provide for the establishment of a local stock exchange. This was in fact established and started limited operations in government securities in January 1992. However, the number of local public companies is very limited, and it will probably take a number of years before this institution can start playing any significant role in the local financial system.

3.3.3 The Taxation System and the Underground Economy

The main tax in Malta is income tax. Other taxes include death and donation duty, customs duty, and stamp duty, but there is no capital gains tax. An expenditure levy was introduced in 1990 on overseas travel and sales in catering establishments, and this was probably the first in a series of consumption taxes planned to implement the value added tax system found in the European Community, which Malta intends to join.

Income tax on company profits went up from 32.5% in the eighties to 35% in 1990. The tax is charged on accounting profits as disclosed in the audited accounts and as adjusted to take account of capital allowances and certain other items.

Tax on individuals is calculated on the taxable income of individuals. The top rate was reduced from 65% to 35% in 1990, bringing it to the same level of tax as that charged on company profits. One of the main reasons for this change, as stated by Zarb and Fiott (1989), was to eliminate the exaggerated use of companies just because companies were taxed at a lower rate than individuals.

An indication of Malta's black economy is the ratio of currency in circulation to the Gross National Product. In Malta, this tends to be extremely high when compared to the same ratio in other countries. For example, using the 1986 IMF Yearbook Financial Statistics, Briguglio (1988) showed that

> *"Maltese currency in circulation in 1985 amounted to over 50% of GNP, whereas in many other countries this ratio ranged from 5% to 10% during the same year. In Cyprus, which is a small Mediterranean island like Malta, the ratio for 1985 was just 7%"* (p 94).

He put forward a reason for holding cash related to the underground economy, in which transactions are settled in currency so as to evade taxation. He also put this excessive currency in circulation as evidence that marginal tax rates in the personal sector were relatively high.

Indeed, as further indicated by Zarb and Fiott (1989), the previous top income tax rate of 65% was a threshold which many taxpayers found unacceptable. It created a disincentive to work coupled with an incentive to cheat.

Although it is as yet too early to reliably assess its effect, the 1990 lowering of the maximum income tax rate will therefore probably prove to be a contributor to the reduction of Malta's black economy.

3.3.4 Limited Liability Companies in Malta

There are three main types of registered commercial partnerships in Malta, the partnership *"en nom collectif"* (ordinary limited partnership), that *"en commandite"* (with some but not all partners enjoying limited liability), and the limited liability company, or partnership *"en anonyme."* In addition, there are overseas companies and partnerships, and offshore companies registered also under the Malta International Business Activities Act of 1988. No statutory audit is required of partnerships *"en nom collectif"*, partnerships *"en commandite"*, overseas partnerships and offshore companies. Furthermore, overseas companies are often subject to audits in accordance with the law of their place of incorporation or registration. Therefore, Maltese auditing is mainly applicable to limited liability companies. However, there are special undertakings also subject to auditing on the same lines. Examples of such undertakings are co-operatives, with their particular provisions under the Co-operative Societies Act, 1978, government-owned public corporations with provisions very similar to the CPO in their founding Act, insurances subject to the Insurance Business Act, 1981 and banks subject to the Banking Act, 1970.

As regards limited liability companies, these may be public or private. Private companies are those which(i) restrict the transfer rights on their shares, and may offer shares for sale to the public; (ii) limit the number of their shareholders to fifty (CPO: S147).

Private companies may attain private exempt status mainly if there are no more than fifty persons holding debentures in such companies, they do not have any company as their director, none of their shareholders or debenture holders is a company (unless a private exempt company subject to conditions), and there is no arrangement whereby persons other than directors, members or debenture holders are capable of determining the policy of the company [CPO: S149(2)]. According to statistics supplied to author by the Registrar of Commercial Partnerships, as at 31 December, 1989, the Registry contained a total of 8,800 limited liability companies, excluding companies that had gone into liquidation. Of these, 7,679 were private exempt, 1,080 were private non-exempt and 41 were public companies. As can be calculated from Table 3.1, new limited liability companies were being registered at an average rate of about under 88 per month. The majority of companies therefore benefited from the exemptions available to private exempt companies, and enjoyed financial statement secrecy in that they did not have to file such

TABLE 3.1

PARTNERSHIPS REGISTERED DURING 1989

1,051	Limited Liability Companies
5	Partnerships *"en nom collectif"*
3	Overseas Companies
37	Offshore Companies
1,096	Total Number of Partnerships

Source: Unpublished Statistics, Registrar of Commercial Partnerships statements or the auditors' or directors' reports with the Registrar [CPO: S149(1)]. However, as in all other companies, they had to file their accounts with the Inland Department each year together with their tax return.

The number of companies with their respective share capital as at 31 December, 1989 was as shown in Table 3.2. It can easily be seen that more than half the companies had a share capital below Lm1,000 and that 97% of them had a share capital less than Lm100,000. The preponderance of low-capital companies may be due to the taxation advantages of incorporation up to 1989 that have already been referred to in S3.3.3.

Further statistics supplied by the Registrar showed that the country with the largest number of companies with foreign participation was the UK, while Libya had the largest investment of all countries.

TABLE 3.2

NUMBER OF COMPANIES WITH RESPECTIVE SHARE CAPITAL AS AT 31 DECEMBER, 1989

Issued Capital	Number of Companies	Total Issued Capital
Lm		Lm
Under 1,000	4,678	2,411,956
1,000 and under 5,000	1,927	3,518,740
5,000 " " 10,000	837	4,786,468
10,000 " " 20,000	473	5,613,722
20,000 " " 50,000	399	11,514,220
50,000 " " 100,000	202	12,839,968
100,000 " " 200,000	140	18,575,429
200,000 " " 300,000	45	10,547,817
300,000 " " 400,000	25	8,652,998
400,000 " " 500,000	16	6,721,514
500,000 " " 750,000	18	10,073,419
750,000 " " 1,000,000	8	7,217,214
Over 1,000,000	32	116,149,915
TOTAL	8,800	Lm218,623,380

Source: Unpublished Statistics, Registrar of Commercial Partnerships

The number of employees in an organization is an indicator of its size. There were no available statistics at the Registrar on the number of employees in companies, and statistics available in another Government Department were obtained to arrive at this additional indicator of size. These are shown in Table 3.3. The figures excluded self-employed persons, government departments, and the Armed Forces but included parastatal companies. They were not directly comparable to the statistics already given because they were not all limited liability companies, although most were so, and the figures related to an earlier date in 1989. One may note that the big majority of firms are small ones employing less than ten employees.

TABLE 3.3

FIRMS BY NUMBER OF EMPLOYEES
AS AT 30 APRIL,1989

No of Employees In Firms	No of Firms	Percentages (%)	Private Sector
1 - 10	7,698	91	7,688
11 - 49	602	7	582
50 - 99	100	1	84
100 - 499	91	1	74
500 - 1,000	4	-	4
Over 1,000	9	-	1
	8,504	100%	8,433

Source: Department of Labour and Social Services - Unpublished Statistics - Number of Employers by Industry Group and Range of Employees excluding Self-employed, Government Departments, Armed Forces and Dejma, April, 1989

3.4 The Regulatory Framework of the Maltese Auditor-Management Relationship: An Outline

The framework regulating the Maltese auditor-management relationship contains two major pieces of legislation: the Commercial Partnerships Ordinance, Cap. 168 (CPO) and the Accountancy Profession Act, Cap.281 (APA). The CPO requires the audit of a company's accounts, and lays down the rights and duties of auditors in this respect. On the other hand, the APA regulates the accountancy profession. Besides the law, there are no official standards or guidelines for the whole Maltese profession. However, the local professional accountancy body, the Malta Institute of Accountants, requires its members to adhere in their audits to its Code of Ethics and to the International Auditing Guidelines (IAG's) of the International Federation of Accountants (IFAC).

The auditor is the holder of a warrant of Certified Public Accountant and Auditor (CPAA) given by a government-appointed Accountancy Board to proper persons who, among other things, have obtained an accountancy degree or an equivalent professional qualification, and have attained proper experience in accounting and auditing. Practitioners need also to be covered by professional indemnity insurance (APA: Ss3,5 and 11).

The auditor is normally appointed at each annual general meeting of a company to carry out an examination of its financial statements, establish compliance with the CPO and give an opinion on whether such statements give a true and fair view. The audit report is required by law to state also whether auditors have obtained all the information and explanations which they believed were necessary, whether proper books of account have been kept, whether proper returns were received by the auditors from branches not visited by them, and whether the financial statements agree with the books of account and returns (CPO, Ss140, 142). Although no standard format of audit report for the whole profession is as yet applied in Malta, a model of an unqualified Maltese audit report drawn up in compliance with the regulations is given in Appendix II.

The auditor is also given a right of access at all times to his company's books, accounts and vouchers, and the right to acquire from the officers of the company such information and explanations as he thinks necessary. He is also entitled to receive, like any shareholder, the notices and other communications on any general meeting held during his tenure of office. Furthermore, in any general meeting which he attends, he has the right to be heard on any business concerning him as auditor (CPO: S143).

The auditor cannot act as auditor in a company where he is an officer or servant. Additionally, except where a company is private exempt, he cannot be a partner or in the employment of an officer or servant of such company. Furthermore, with the same exception, he or his partner cannot be related by consanguinity or affinity up to the third degree to any officer of the company [CPO: S141 and 149(4)].

Accountancy Profession Regulations issued by virtue of the APA (Malta Government Gazette, 1987) also preclude an auditor from acting where he or his partner or employee performed or had the power to perform executive decisions in respect of his client's affairs within the previous two years. Moreover, the auditor is not allowed to act if he holds a direct or indirect interest in the affairs of his client. The MIA also has a code of ethics applicable only to its own members (MIA, 1986a). Subjects covered are professional independence, confidentiality, limits on advertising, obtaining professional work, the determination of fee levels and clients' accounts and monies. It is a short code based mainly on the UK model, and is not much restrictive to auditors beyond detailing a procedure to use when there is a change of audit practitioner in a company.

As regards discipline, both the Accountancy Board and the MIA are empowered to take the necessary measures , and commonly this follows any complaint in writing against a defaulting practitioner [Malta Government Gazette, 1987: Schedule 1, S4 and MIA, 1986b: S6.02].

An auditor is not an officer of a company (CPO: S196), but, according to Cremona (1989: p 120) may be considered to be the mandatary of its members. As such , he has the right to resign and the members, as mandators, have the right to remove him at any time. However, the CPO provides no specific safeguards in these circumstances of termination of office.

Furthermore, in accordance with the general law of mandate, the auditor is to exercise a reasonable standard of care. *"If he acts negligently, or if he deliberately fails to reveal inaccuracies in the company's accounts, he is liable to the company in damages"* (ibid.: p 120). However, his position as regards legal liability towards third parties is unclear. There are no local cases on the matter, and there appears legal dissent as to how far third parties have any right of action to claim damages against the auditor.

Regarding the auditors' responsibility for the detection of fraud, local law is silent on the matter. However, some guidance is given to MIA members by IAPC (1982), already referred to in S2.5.4. As for the reporting of fraud outside the company, the MIA Code (MIA, 1986a) states that *"information required in the course of professional work should not be disclosed except where consent has been obtained from the client, employer or other proper source or where there is a public duty to disclose or where there is a legal or professional right or duty to disclose"* (para 4). However, the code does not detail when such duties or rights may arise in the local context. There is in fact no general provision in Maltese law obliging the auditor to reveal client offences and unless compelled by a specific law or by the order of a judge, the auditor faces a legal problem if he wants to divulge that information. Yet, even if he decides not to, he often still needs legal help so as to avoid the danger of becoming deemed an accomplice to crimes by clients.

A company is managed by two organs, the general meeting of shareholders and the board of directors. The general meeting normally has the power to appoint and remove the board and determine its conditions, but undoubtedly the board of directors is the more important of the two because it is responsible for the day-to-day running of the company. Company directors owe a fiduciary duty towards their companies derived both from the various duties prescribed by the CPO and from the general principles of the laws of agency and mandate. In their external dealings with third parties, directors are agents of the company, while in their internal dealings with the company they are its mandataries. Prof Cremona (1989) encapsulates their management responsibilities under the guiding principles of diligence and honesty. Each director *"acts with that reasonable care and skill an ordinary man might be expected to take in the same circumstances on his behalf"* (p 113). The required standard of care and skill of an ordinary director is therefore not that of what might be expected of a more professional man such as an auditor.

Regarding the annual audit, the directors have a specific duty to see that proper books of account are kept and that audited accounts giving a true and fair view are laid before the company (CPO: Ss 133 to 136 and 139). They are also to attach with the annual accounts a directors' report containing the amount of recommended dividend and the amount proposed to be carried out to reserves (CPO: S137). However, the

Maltese auditor is not required to check this report for consistency with the financial statements.

3.5 A Microstate in a Changing European Environment: Possible Effects on the Regulatory Framework

An important factor to consider in studying the various issues relating to the Maltese auditor-management relationship is that Malta is a European microstate, and is at present re-assessing its relationship the European Community (EC), which is its main economic partner. While Malta has enjoyed an association agreement with the Community since 1970, in 1990 it applied for full membership, and the European Community is still considering such an application.

With this membership in perspective, Malta is now in the long process of harmonizing its laws with those of the Community. The latter in fact has a set of Directives - the EC Council Directives on Company Law Harmonization - aimed at creating a unified business area in which all Member States apply harmonized rules relating to the structure, accounting and auditing of companies.

A list of the current issued and proposed Directives relevant to this study is found in Appendix IV. Here the main possible implications of the implementation in Malta of these Directives on the relevant regulatory framework will be pointed out.

3.5.1 Independence Issues

Article 23 of the Eighth Directive (see App IV) provides that member states are required to prescribe that duly qualified statutory auditors must carry out audits with professional integrity, and Article 24 requires that auditors are to be independent in accordance with their national laws. In addition, Article 26 states that member states must ensure appropriate sanctions in the case of persons not carrying out the audit with professional integrity and independence. However, there are no further details on how these broad requirements are to be implemented. For example, this Directive is silent on the provision or not of other services by the auditor of a company.

Additionally, the controversial Fifth Directive (see App IV), makes further significant proposals which may bear effect on auditors' independence. They mainly concern the legal status of the auditor.

Regarding appointment, the Fifth Directive (Art 56) proposes that the auditor would be appointed for a period not exceeding six years, but not less than three. At the end of this period, the same auditor could be re-appointed, and thus the maximum appointment would not exceed twelve years. This would represent a major change the Maltese CPO requirement for annual re-appointment referred to earlier in this Chapter.

There are also related dismissal provisions to the effect that only if there are proper grounds, members in general meeting can dismiss the auditor before the end of their period in office (Art 61).

Besides, the courts, or perhaps, the Registrar of Commercial Partnerships (*"the judicial or administrative authority"*) would have the power to dismiss the auditor, again on proper grounds if an application had been made either by a director or by shareholders [Art 55 (3)]. Currently the Maltese auditor can be dismissed for any reason because there are no specific provisions in the local law.

For the UK, on whose 1948 company law Maltese legislation is modelled, some of these provisions may still not go far enough. Malta can therefore easily opt also to adopt current UK provisions. It can, say, enable the auditor threatened with dismissal to have written representations distributed to members (CA 1985: Ss 386-388,391-393). Similarly, it can introduce resignation provisions on UK lines (CA 1985: Ss 390 (2), 394).

3.5.2 Other Related Issues

(a) Detailed Report To Non-Executive Directors The proposed Fifth Directive also requires auditors to prepare a detailed report relating to the results of their work and containing observations concerning *"any infringements of law or of the memorandum or articles which have been found in the company's accounts, annual accounts or annual (directors') report in the course of the audit"* and concerning also *"any facts noted in the course of the audit which constitute a serious danger to the financial position of the company"*(Art 60(b) and (c). The Commission explained, in this respect, that the purpose of the latter observations by the auditor would be to serve as an *"alarm bell."* It wanted this report to be addressed to the shareholders in general meeting. However, the European Parliament has suggested that this detailed report should be made exclusively for the benefit of the non-executive directors of the board of a company, or its equivalent in a two-tier system of management (Commission of the European Communities, 1983: p 18).

(b) The Directors' Report A new duty for Malta proposed by the Fifth Directive is for auditors to verify the consistency of the directors' report with the annual accounts for the same financial year [Art 58(1)]. The application of such a proposal would also bring the auditors' duties in line with the existing UK law [CA, 1985: S235(c)].

(c) Small Companies The Fourth Directive (Art 51) gives the option to member states as to whether or not to require the statutory audit of the accounts of small companies. An attempt by the EC Commission to abolish the small company audit failed in November 1990 as it was not accepted by the Council, and the question of the role of the statutory auditor in such companies remains largely an open issue.

(d) The Regulation of Auditors As stated by Borg (1988: pp 343-347), as regards the regulation of auditors required by the 8th Directive, the necessary framework already exists in the Accountancy Profession Act, Cap. 281, and some changes thereon will suffice. For example, the Accountancy Board or the MIA may, after proper study, adopt regulations to carry out monitoring of auditors on lines similar to the Joint Monitoring Unit of the UK's Chartered Institutes. As from October, 1991, this has carried inspections on practising units of members in order to ensure that the objectives of audit regulation are met. These are encapsulated in the UK Companies Act 1989 (S24) and, as described by Woolf (1991), their broad intention is that *"audits should be carried out by qualified and supervised auditors whose work should be conducted properly, with integrity and the requisite degree of independence"* (p 112).

(e) Other Changes Further changes to be brought about are mostly of an accounting nature, and bear only remote influence on the auditor-management relationship. Foremost among these are the financial reporting changes due to both the Fourth and Seventh Directives. In practice, owing to the heavy British influence, many companies already probably draw up accounts in a manner that is similar to the Directives as adopted in the UK. For example, both the Source and Application of Funds and the Notes on the accounts have probably been normal practices for a number of years, despite the fact that they are not required by the CPO. Therefore, much of the exercise with respect to financial reporting would probably involve the enshrining of current practices into law. However, a noteworthy change is that a new classification of companies by size would come into effect that would do away with the commonest type of company - the private exempt one - that at present does not file its accounts at the Registrar of Partnerships. In addition, the abridged forms of filing for small and medium-sized companies may take some time to adjust to. Again, with respect to the

Seventh Directive, many groups of companies probably already prepare consolidated accounts although these are not required by the CPO.

3.6 Preliminary Studies in Malta Related To the Auditor-Management Relationship: A Review

Academic projects related to Maltese accountancy were virtually unknown until 1983, when the first B.A. (Hons) Accountancy students graduated at the University of Malta. A requirement of that degree course, which covers the academic content for the granting of a warrant of a certified public accountant, is to present a dissertation relevant to Malta. Topics covered up to December, 1991 related to accounting, taxation, company law, auditing and financial management. As a university lecturer since 1983 in the latter two subjects, the author has been involved in the promotion and supervision of most studies related to these two areas. Although these short, unpublished works were also of an undergraduate and exploratory nature, a review is now presented of the findings in these studies that are of relevance to this study. This review follows the same topic order of the literature review in Chapter Two.

3.6.1 Independence Issues

Borg (1983) posted questionnaires on auditor independence to thirty-two auditors and forty companies, but received a reply from only about one-half of them. Company respondents were mostly against auditor rotation. Additional services appeared mainly related to tax advice and financial accounting services. Factors taken into consideration in choosing an auditor included the time the latter promised to finish the audit, and the additional services which he might offer free of charge.

Practitioner respondents considered independence important and most indicated agreement to a limitation of fees to be received from individual clients. However, most of these, too, were against the rotation of audit firms, and also thought it appropriate for auditors to participate in the preparation of the accounts of a company. Moreover, they were divided on whether audit committees would alleviate the problem of audit independence.

Sciortino (1983) mailed a questionnaire to the 119 auditors at the time about auditing standards in Malta. He received a reply from about one-third of them. Regarding independence, respondents suggested that a standard on independence was to be given priority. However, many did not want such a standard to include the regulation of the type and extent of other services, such as accountancy and management consultancy, given by the auditor to his clients.

3.6.2 Communication and Reporting Issues - Communications

Mercieca (1986) interviewed eleven audit firm partners and nine sole practitioners on the audit evidence process in Malta. He found that practitioners felt that their work was not yet understood or sufficiently appreciated by client companies or the Inland Revenue Department. Both tended to view the auditor with some distrust, and as a result, the auditor frequently had to defend himself against the attitudes of both parties:

> *"On the one hand, the client at times may regard the auditor as an agent of the tax people. On the other hand, the Inland Revenue may grow suspicious of an auditor-client alliance for the evasion, and not mere avoidance, of tax"* (p 65).

This contrasted with findings by Vella (1988) in a later questionnaire survey on the auditor-client letters of communication with fifteen audit practitioners - nine audit firm partners and six sole practitioners. Most stated that they enjoyed both a professional and friendly relationship with their clients (p 75) and agreed that effective communication with their clients was essential in the conduct of their audit (p 74). They added that in fact the client was frequently communicating effectively with them in the sense that they understood exactly what he meant (p 75). They also all considered that their relationships with their clients were at least frequently based on *"mutual respect that perhaps permits a frank and straightforward discussion of differences of opinion"* (p 76).

According to the latter study, the contents incorporated in engagement letters (pp 77-81) were often uniform, mostly modelled on APC auditing standards or on a particular version of the practitioner's firm that did not follow any specific APC or IAPC pronouncements. Most respondents did not send these letters every year in repeat engagements when the terms of engagement remained the same, but very often when extra duties were required of the auditor, or where there was a significant change in auditing standards. Clients also appeared to have rarely reacted negatively to such letters.

Regarding weakness letters (pp 61-2, 82-86) respondents considered them as an important tool whereby matters otherwise leading to qualification could be corrected in time. However, clients were apparently not keen to feed the auditor with written follow-up on such weaknesses, and, although they took such letters seriously, many of the same weaknesses seemed to recur from year to year.

With respect to representation letters (pp 87-90) respondents considered them very important where other evidence was difficult or impossible, and to confirm oral statements made by management. Clients often lacked the necessary knowledge to participate in drafting such letters, which were in fact drawn up by auditors for client signature. However, respondents could normally obtain the required representations.

3.6.3 Communication and Reporting Issues - Reporting

Mugliette (1988) carried out a mailed questionnaire with eighteen audit practitioners, and backed this by an interview with twelve of them. She found that they mostly favoured brief and standardized reports. Nevertheless, they wanted the report to continue to refer in every instance to the duties stipulated by the law such as to whether proper books had been kept, and whether accounts were in agreement with the books. Practitioners also indicated that qualifications were on the increase, and that the small company audit qualification was the commonest audit qualification in Malta at the time. They considered the *'subject to'* opinion as both necessary and useful, and that dropping it, as suggested at the time and since effected in the USA was too revolutionary. They were also mostly against the local implementation of other changes suggested in the USA, such as the addition of the word *'independent'* in the report title. Additionally, most auditors indicated that they had had instances where their appointment had been terminated after the issue of a qualified audit report.

3.6.4 Small Company Issues

Farrugia (1984) carried out a questionnaire survey with twelve audit firms and six sole practitioners on the audit of small firms. According to these respondents, in the majority of small companies, management had little accounting knowledge, and the staff was inexperienced (p 76). In such cases auditors appeared undecided on how far to rely on management (p 79). Farrugia also claimed that, while small company auditors often felt management representations were unsupported, some were unwilling to state this explicitly to clients for fear of being misunderstood by them. They were therefore using *"subject to"* qualifications referring to *"limited internal control procedures"* (p 59).

Magri (1991), in a concurrent study with this project on the possibility of introducing reviews and compilations for the small firm, interviewed, besides other groups mentioned later, six auditors and six management accountants, and she found that most respondents agreed only mildly to the introduction reviews, and did not want compilations at all. They were afraid not only of a resulting distorted picture to users, but also of the undermining of the auditors' profession because such reviews could be carried out by accountants (p 90). Local auditors were seen to rely for most of their work on substantive testing mainly based on personal knowledge, and experience with, the client. Internal control systems in small companies were often poor or non-existent, and therefore rarely resorted to. Management representations were considered important, although not easily attainable from management.

Sciortino (1983: p 26), already referred to above, also indicated, in relation to this topic, that auditors seemed concerned with the possibility of tax evasion in those companies which had limited segregation of duties in relevant accounting functions, or where most shareholders were directors or in management. However, he noted that, despite the fact that income tax legislation [ITA: S51 (4)] required audited accounts for tax assessment purposes, the audit report remained one of stewardship aimed at the members of the company, and not for the specific use of the Commissioner of Inland Revenue.

It is not within the scope of this thesis to analyze the perceptions or expectations held by financial statement users of auditing in general. Nonetheless, it is felt important to refer here to indications on the small company audit given in preliminary studies on users' perceptions of such an audit. In such a small country, audit report users found in larger economies like the United Kingdom, such as, for example, creditors, employees and investment analysts, do not seem powerful or interested enough to make regular use of financial statements. Therefore the users who are really important appear to be the banks and the Inland Revenue Department. However, while both the latter users require the audited financial information for their own purposes, they have both shown that they are often diffident of small company audit reports.

An illustration of this were the findings of Saliba (1987). She worked on the banks' role in small business finance, interviewed 25 managers of the main local banks, and found that in the opinion of 24 of them, small company audited accounts were produced primarily *"for the Inland Revenue."* This implied that such accounts understated profits for tax purposes and therefore did not really portray a true and fair view.

Further insight on the matter was given by two studies by Galea St John (1990) and Magri (1991), both carried out simultaneously with this study. Galea St John (1990) interviewed bankers (15), income tax assessors (5) and trade creditors (4) on the small audit report. She found that users did not perceive much independence on the part of the small company auditor, and often lacked confidence in his reports, which they considered frequently to be lacking in clarity, detail and uniformity. For example, nine out of fifteen bankers stated that they did not believe that the auditor's report added to the credibility of the financial statements of a small enterprise (p 93), and three out of five bankers also found little or no increased credibility. Furthermore, Galea St John found that a local version of the UK small company qualification or *"Example 6"* report was in extensive use. App III reproduces a typical report of this kind included by Galea St John. Such a report was often regarded by users as more a form of protection for auditors who did not perform sufficient audit work, and therefore as virtually adding no credibility to the accounts.

Magri (1991) carried out another interview with the same respondents of Galea St John on the possibility of introducing compilations and reviews for the Maltese small firm. She found that compilations were generally seen as unprofessional, but that an in-between level of attestation such as a review was acceptable to most of them as an alternative to an audit. About users, she found further that

- banks insisted on getting an audit from small companies. However, it was not the basic factor in a loan decision. The reputation of, and their relationship with, the client as well as the loan size appeared to be the main considerations.
- the Inland Revenue Department required an audit from small companies, but again, an audit qualification was not the fulcrum of the assessment, and detailed information, mainly a breakdown of sales and expenses, was often requested. It also seemed that an unqualified audit report often did not in itself reduce the chances of a tax investigation.
- trade creditors stated that they were unaffected by the audit report, and for some the access itself to the audited accounts was not possible.

3.6.5 Government-controlled Enterprise Issues

Scott (1989) carried out a preliminary study on the external audit function in government-controlled enterprises. She interviewed senior representatives in eleven audit firms and four employed CPAA's. Moreover, she posted a questionnaire to a further forty-six CPAA's not employed in audit firms, of whom thirteen responded.

She found agreement that, for the sake of more public accountability, the scope of auditing needed to be extended in these enterprises. She therefore recommended the introduction of value-for-money and financial propriety and regularity audits. While in the long run these could be performed by state and internal auditors respectively, at present this appeared to be inhibited by severe limitations claimed at the Government Audit Department. Scott therefore suggested the immediate utilization of private sector auditors to fulfil such extended responsibilities for the time being.

Scott (p 68) also found that managers in government-controlled enterprises often seemed to lack the necessary resources and autonomy to effect the required internal control improvements on which they had been advised by their external auditors.

3.7 Conclusion

This chapter has introduced a Maltese background to the major issues concerning the auditor-management relationship. As an island microstate, Malta has its own environmental characteristics. Although Maltese accountants and auditors are clearly influenced by their UK counterparts, the Maltese profession seems as yet not as developed as the UK one. Thus, for example, there are no local auditing standards applicable to all Maltese practitioners.

Overall, the Maltese economy is very small and its financial sector is still unsophisticated and controlled, while a strong black economy exists, apparently as a reaction to the taxation system. Furthermore, government-controlled enterprises and small, private exempt companies have an important role in the economy, and these probably create their own special difficulties in professional practices.

The present Maltese regulatory framework of auditors and managers is partly modelled on the Companies Act, 1948, on which, in fact, Maltese company law (the CPO) is still mostly based. The other major component of this framework is the local Accountancy Profession Act, Cap. 281 (APA), which regulates Maltese auditors by means of a government-appointed accountancy board.

As Malta intends to up-date its laws in line with EC legislation, the chapter has also pointed out possible applicable changes in this direction, relating to independence and other issues.

Finally, Maltese preliminary studies relevant to this project have also been reviewed. Yet, this project intends to go beyond these and find more empirical evidence on how the auditor-management relationship issues are evolving within this Maltese environment. It will therefore next go into the research methodology adopted so as to carry this out.

CHAPTER FOUR

RESEARCH METHODOLOGY

4.1 Introduction

The objective of this chapter is to explain the research methodology used in this project, and in particular to discuss the sources and means of collecting and analysing the empirical data. It deals with the general methodology, the actual survey design and the nature of the limitations.

First, the next section (S4.2) discusses the research methodology in general and goes into the choice of research design, the survey approach and the technique of question structure.

Then, Section 4.3 goes into the details of the survey design, dealing with both the construction of the actual questionnaire, and the selection of the two groups of respondents.

Finally, the limitations in data collection and other possible research approaches are expounded in Sections 4.4 and 4.5 respectively.

4.2 The General Methodology

4.2.1 The Research Design

A research design comprises the methods and procedures for the collection, measurement, and analysis of data. It may be considered from different points of view (Emory, 1985: p 59 ff).

One point of view is the distinction between exploratory and formalized research design. Exploration, including methods such as literature searches, is indeed a first major step in any research study. However, a formalized study, like the present one, goes beyond this: it is typically structured with a research question or hypothesis.

Another point of view concerns data collection methods. An observational approach is contrasted with a survey, which involves the questioning of subjects, the approach adopted here. In the survey, the researcher has no control of independent variables as in an experimental study, but aims at giving a report of a state of affairs, all other factors being equal. In other words, where true experimentation is not possible, controlled enquiry is (Kerlinger, 1986: p 359). Advantages of the survey, both large and small-scale, include its wide scope and its accuracy - within sampling error - and drawbacks may be its lack of depth and its demands on the investigator's time, money and research knowledge (ibid.: p 387) .

The objective of a study distinguishes between a descriptive study, which finds out essential aspects of a situation, and a causal one, which seeks to explain the effects of one variable on others. Although the causal study is more idealized, the descriptive study can be just as demanding of research skills. As implied in Chapter One, the aim of the present study is descriptive of the relationship problems between financial auditors and managers in Malta.

Moreover, research design may be either cross-sectional, which is carried out at one point in time, or longitudinal, that is the research is repeated to find out what changes occur over time. The time dimension of this project is cross-sectional, set in 1990-91.

Research studies may also be basically qualitative or quantitative. The present study is essentially qualitative. According to Patton (1980), one main distinction is that in quantitative studies , samples of data are typically large so as to enable various statistical techniques to be used while qualitative techniques, on the contrary, do not emphasize on the size of the sample but more on depth and detail, so that one may understand the subject's point of view. Lofland (1971) states that in qualitative studies the researcher needs to get close to the people or situation at the centre of the study, and record accurately what is said or what happens, with data consisting of direct quotations. He also needs to obtain pure descriptions of people, activities and interactions.

The researcher also needs to consider the quality of the research results. Two major considerations are validity and reliability. The term validity refers to the extent to which any measuring instrument is measuring what it is intended to measure. An important type of validity is face or content validity. This is the extent to which the instrument covers the topic under study. As stated by Emory (1985: p 95), the determination of such validity is judgmental. However, he adds that such validity can be determined by the researcher by the adoption, in the formulation of his measuring instrument, of the research question hierarchy referred to later (S4.2.3). This is because this has as its aim the orderly fractionation of the major research question into the detailed specific questions. While for descriptive studies, the establishment of such face validity is normally sufficient, one may also refer, if possible, to other forms of validity requiring more information, such as construct validity and criterion-related validity (Bailey, 1982: pp 72, 327).

Reliability is concerned with the degree to which a measurement gives consistent results (Emory,1985, p 98). It can be improved by standardizing, as far as possible, the conditions under which the measurement takes place. Reliability has two main perspectives: equivalence and stability. While equivalence is concerned with variations at one point in time among investigators and even samples of items, stability is concerned with personal and situational fluctuations from one time to another. The measurement of stability is usually more difficult in survey studies and interest has centered on the improvement of equivalence (ibid.: pp 98-99). In this project, equivalence has been particularly enhanced by the use of only one motivated investigator, the author himself, to conduct the whole survey.

4.2.2 The Survey Approach

A survey may be conducted by a mailed questionnaire, a telephone interview or a personal interview.

A mailed questionnaire is low-cost and allows the respondent time to consider and check his responses, but the percentage of non-response or incomplete response can cripple the findings (Bailey, 1982 : pp 156-7). A telephone interview is also relatively economical in time and money and ensures the respondent's anonymity as in the mailed survey but he may be distrustful or uncooperative and terminate it prematurely. Moreover, the busy executive might not find the timing of the telephone call convenient. The interviewer has no control over the situation and is unable to gather the detailed information or even relevant non-verbal data (ibid.: pp 207-8).

(a) The Personal Interview *"The personal interview far overshadows the other [methods] as perhaps the most powerful and useful tool of social scientific research"* (Kerlinger, 1986: p 379). The face-to-face interview ensures accuracy in the interpretation of the questions and adequate thought and attention on the part of the respondent (Moser, 1971). Interviewing allows flexibility as well as opportunity for probing and more specific answers and the obtaining of supplementary information. The interviewer can repeat or re-phrase a question according to the respondent's needs, thus making sure that the answer given contains the information sought; moreover, he can motivate the respondent to cooperate (Emory, 1985: pp 160-1). Disadvantages of interviewing include the time and cost required and the possibility of bias and errors in the sampling and questionnaire designs. The interviewer himself can be a source of bias by his conduct of the interview, his personal characteristics or errors in recording the response. On the part of the respondent, he has no anonymity and his response may contain deliberate or accidental mistakes. He has inadequate time to ponder his reply and his reasoning ability might be affected by inconveniences cropping up unexpectedly during the interview (Bailey, 1982: p 183 ff).

The management of an interview involves establishing a friendly relationship, gathering information and recording it accurately. The rapport between interviewer and respondent is enhanced if the interviewer's appearance and behaviour, both verbal and non-verbal, are acceptable to the respondent. It is up to the interviewer to ensure the adequacy of the setting and the time of the interview and to establish a relationship of confidence and understanding. He must clearly give the facts, define vital terms and provide the right context so that the respondent's interest is aroused, his memory aided , his experience and qualifications acknowledged and he feels no threat to his ego (Gordon, 1987: p 313 ff).

To gather information which is relevant, complete and clear, the interviewer needs to direct the respondent's train of thought by probing. A probe is a verbal or non-verbal reinforcement such as a neutral question or comment, a request for clarification or elaboration, the repetition of the question or the respondent's reply, the indication of understanding and interest or even an anticipatory pause.

The interviewer must decide which method to adopt to record the interview so that the data collected will be reliable and valid and the analysis efficient. Unless the information is anticipated and the interviewer is simply expected to tick a box or circle or number, note-taking may lengthen the interview session, distract the interviewer from listening and probing, interrupt the respondent's flow of thought and will obviously also demand a subsequent thorough review of the notes to ensure clarity and logic and eliminate possible recording errors.

Tape- or cassette- recording an interview has the advantage that the relevance of the response can be decided later, so that the interviewer can concentrate on the exchange and achieve a favourable inter-personal relationship. Though the use of a cassette recorder increases the expenses, and the playback and coding task is time-consuming and delays the analysis stage, it promotes the collection of complete and accurate information. However, loss of data may still occur through poor recording or even power breakdown. To guard against this, the operator must know how to operate the machine well, position it properly, and also maintain the power source, say, by regularly replacing the batteries. Taking some notes is an additional safeguard. If the interviewer treats the cassette recorder as a routine part of the interview and assures the respondent that once the relevant information is transcribed, the tape will be re-used so that anonymity is kept, he is unlikely to meet with objections to its use.

(b) Typology of Interviews Studies on interviewing, for example, Cannell and Kahn (1957, 1968), Richardson, Dohrenwend and Klein (1965) and Gordon (1987) give a typology of interviews using different dimensions.

One dimension is the distinction between standardized and non-standardized interviews, which is a variation between a closed and open situation. The standardized or structured interview involves a fixed set of questions which are asked in a fixed order to each respondent to obtain information relevant to the research problem. The non-standardized or unstructured interview covers a set of topics but the actual questions and their order depend on the flow of the exchange with the respondent. Such an interview may give rise to data which, although seemingly unquantifiable, provide powerful insights.

Another dimension of interview style involves the extent of control of the variables of content, wording, sequence and actual number of questions asked. Thus an interview may be scheduled or non-scheduled. A completely scheduled interview uses fixed questions in a fixed sequence, which facilitates data analysis. However, this straitjacket means the loss of data which do not fit into formal categories. A non-scheduled interview allows flexibility in the phrasing of the questions and their sequence, and, in addition, the questions need not all be asked because the respondents are allowed to talk freely and the topics are covered to different extents by different respondents. The analysis of such data is difficult and time-consuming.

A non-standardized, non-scheduled interview is sometimes only used in the initial, exploratory stage of the study before determining the relevant questions, their wording and their order.

An interviewing experience may contain all sorts of compromises between the given idealized poles, having different degrees of structure in different parts of it. For ease of reference the term *"semi-structured"* or *"semi-scheduled"* is used. In such an interview, it is still possible for the interviewer to structure the answers and to record the responses on a multiple-choice code sheet. This eliminates having to convert verbatim notes into code categories. Also, if the correct category for the answer is unclear, the interviewer can probe for further clarification (Gordon, 1987: p 329).

4.2.3 Question Structure Technique

Where the interview is the main tool of the research , the interview schedule includes questions which, apart from being information-gathering devices, are intended to measure the variables of the study (Kerlinger, 1986: p 440).

The research question, which guides the direction of the study, is broken down into subsidiary investigative questions to delineate further the scope of the study. These need to be further broken down into more specific measurement questions which are actually asked to the respondents. The questions are checked for content, wording, response form and sequence (Emory, 1985: p 207).

(a) Content and wording Each question must seek information which is relevant, not too wide in coverage, and which the respondents are able and willing to give. Since bias in question content distorts responses by suggesting possible answers or excluding other possible answers, it is important to examine carefully the wording of questions and avoid words with strong emotional connotations. Leading questions, whose phrasing hints to the respondent that the interviewer prefers or expects a particular answer, are only justified if they obtain more valid information than neutral questions.

(b) Response Form Question design involves the degree of response structure to be adopted or how far to use closed and open-ended response items. A combination of both is found to achieve optimum results.

Closed-ended or fixed-alternative questions, which can be dichotomous or multiple-choice, give uniformity of measurement and thus greater reliability, but the alternatives suggested may not be exhaustive and may show the designer's bias while random answering is not ruled out. Open-ended questions have the advantage of discovering the respondent's opinion, his frame of reference or his amount of knowledge and perhaps providing unanticipated data. The non-restrictive approach gives the respondent the possibility of thinking over a reply and reduces ego threat as regards sensitive areas. Disadvantages of open-ended questions include the non-standardization of data and the difficulty of coding it.

A third type of response is the scale item.

"A scale is a set of verbal items to each of which an individual responds by expressing degrees of agreement or disagreement or some other mode of response. Scale items have fixed alternatives and place the responding individual at some point on the scale" (Kerlinger, 1986: p 443).

Scale items can improve the usefulness of the interview because they supply scores for each respondent and these can be checked against data obtained by open-ended questions (ibid.: p 444). Therefore the use of these items in combination with open-ended questions can be a way to retain the above advantages of closed-ended questions.

A convenient measuring instrument is the rating scale which is used to judge properties of objects or variables by assigning them to categories. There are different types of rating scales with different numbers of points, usually ranging from three to seven. In a graphic rating scale the respondent assigns his response or evaluation along a continuum with numerals assigned to it. This scale is clear and easy to understand and use because of the continuum and equal intervals fixed in the respondent's mind. But his tendency to make errors cannot be ignored. In fact, constant rating error takes such forms as *"errors of leniency, central tendency, and halo effect"* (Emory, 1985: p 247).

The error of leniency, the tendency to rate too high , and its opposite, the error of severity, occur mostly when the persons rated are known. The error of central tendency, the avoidance of extreme judgments, is seen when the persons are unfamiliar. The halo effect is the tendency to give a biased rating to sustain a general impression of the subject, as in the case of judging a well-behaved student to be intelligent. Coping with these errors involves the designing of the rating scales to anticipate them by adjusting the descriptive phrases and the intervals between them or avoiding the rating of different traits in close sequence.

Rating scales are widely used in behavioural research. Kerlinger

(1986) points out that

> *"they can be used as adjuncts to other methods. That is , they can be used as instruments to aid behavioural observations , and they can be used in conjunction with other objective instruments, with interviews, and even with projective measures" (p 496).*

(c) Sequence A final consideration in question design is the sequence of the questions. A logical order is to be kept and change in subject matter and frame of reference should be minimal since respondents are apt to interpret questions without changing their perspective. To motivate the respondents to participate, the introductory question of the interview should be broad and non-threatening, and sensitive questions left to the later part of the meeting. Within any subtopic, the questions may move from the simple and general to the more complex and specific, or vice-versa. The latter case, called *"inverted funnel"* sequence by Cannell and Kahn (1957: p 160), may serve to help the respondent formulate a judgment when he does not have one or prevent him from stating a hastily formulated judgment based upon prejudice , which he later tries to maintain to save his face.

Once the interview schedule has been drafted, it must be tested on a small number of persons typical of the proposed respondents, if the survey is to be scientific and produce valid results. Such a pilot-scheme is necessary to check how effective the questions are. While the respondents must not be told of the testing stage, they should afterwards be asked about their understanding and interpretation of the questions and ease of answering. In the present study, the proposed respondents are representative in that they form a sample of individuals with similar characteristics who can give information directly relevant to the objectives of the interview.

4.3 The Survey Design

4.3.1 The Construction of the Questionnaire

The study required the carrying out of a number of personal interviews. These would gauge the opinion and attitude prevalent among auditors and managers regarding the major issues affecting their relationship. The interview questions were to be framed in such a manner so as not to restrict discussion as far as possible and to obtain adequate coverage of the issues.

On the other hand, a balance needed to be found so that respondent opinions would also, as far as possible, be given with sufficient clarity to satisfy later analysis and with the least possible inconvenience being created to the respondent through over-lengthy discussion.

It was therefore decided to hand to the respondents a discussion schedule to be used as the basis for a personal interview (see App VI). Such an interview was to be semi-structured in the sense that, in order to allow the response to flow more freely, the questions did not have to follow a strict numerical sequence. In addition, all questions were open-ended and therefore did not contain any formal response categories. The same questions except one (Qn B.3a in Appendix VI) were set to all respondents so as to facilitate comparisons. However, the interviewer's copy included five-point scale items that were to be used in conjunction with many of the above questions, as referred to in discussing response form in S4.2.3 (b). At the beginning of the interview, it was emphasized that the respondent's free comments were being primarily sought and not his marks to questions, but that such marks were also to be a concluding point in several instances. To help the respondent award a mark for the relevant question, a separate sheet showing either the vertical (*"intensity"* or *"frequency"*) score scale or the horizontal (*"opinion"*) score scale, as shown in Appendix VII was presented after each relevant response, and the response recorded by the interviewer on his copy of the interview schedule. Respondents would therefore concentrate on thinking on the issue involved and elaborating on it to a point when they felt clear enough to clinch their position on the five-point mark scale.

As an interviewer, the author concentrated not on taking notes of the response, which was being taped, but on seeing that respondents did cover the scope of each question, and also on prompting them at the end to crystallize their views on such a scale. Thus the ultimate marking for most questions did not cut short the actual discussions, while it still tried to ensure that the gist was tackled.

With the attention given to the background discussion to each question, together with the rapport established, respondents were not inclined to give a random reply on the issues, nor were their answers prompted as in a questionnaire that emphasized formal response categories. At the same time, the mark given enabled a comparison of the response between the groups, and in addition, indicative average scale scores for both groups and overall, referred to as IASS's in the next chapter, could be worked out for most questions to help further in the analysis.

Questions asked varied considerably. Some attempted to establish the facts in the microstate while many others necessitated the respondent's objective evaluation and the submission of an opinion. Other questions required the respondent to describe his probable reaction to possible changes in legislation.

The questions varied in type and length to help maintain the respondent's interest, and were divided into five main areas in line with the five investigative questions of the study (see S1.2). The questions were tested in November and December 1990 by means of five pilot interviews, and the necessary amendments carried out. The justification of the questions as amended is given in the introduction to the analysis of each section in Chapter Five. The final interview schedule is given in Appendix VI.

4.3.2 The Selection of Respondents

In order to analyse the opinions and attitudes on both sides of the relationship, respondents were to be selected both from financial auditing and management.

In November, 1990 the following alphabetical lists were obtained as at 31 October, 1990 from the Accountancy Board :

(i) A list of the seventeen audit firms registered with it.

(ii) A list of 230 Certified Public Accountants and Auditors, which included the partners of all firms listed in (i).

(iii) A list of 209 Certified Public Accountants.

All three lists were later published in the Malta Government Gazette (1991).

(a) The Selection of Audit Respondents In the selection of audit respondents, the main aim was to obtain the views of the more influential persons in as many different practising entities as was feasible. List (ii) above contained the total population of auditor warrant holders, but an unknown number of these was concentrated in the audit firms included in List (i). It was therefore considered best to interview all the available senior or technical audit partners of the firms in (i), and a corresponding number of warrant holders who were sole practitioners.

A practical problem was the identification of the sole practitioners in (ii). Upon further contact with the Accountancy Board, it was found that such identification could, and, in fact, was made from their records of current holders of compulsory indemnity insurance cover for the year 1990. A list of sixty-one such holders was supplied in confidence to the author from such files. Upon checking this list, it was found to include warrant holders who were partners in two of the seventeen audit firms listed in (i). By personal contact with their partners, it was confirmed that these firms were new and not in effective operation as their partners were still working as sole practitioners. It was therefore decided to treat them as such for the purpose of selection of respondents.

Piloting was carried out with a senior partner of one of the remaining fifteen audit firms and with a sole practitioner. After appropriate amendments to the interview discussion schedule, the respondents were then selected.

A preliminary contact was established with fourteen audit firms by telephone. This secured immediate success with seven of these audit firms, and an appointment was fixed for interviews with their representatives. At this stage, one audit firm informed the author that it was unavailable for interview as it was in the process of amalgamating with another of the audit firms being contacted. The remaining six audit firms, who did not give a definite reply within a week, were contacted in writing. The communication included two letters: a general introductory letter by the supervisor and the other by the author himself explaining briefly the subject of the research studies and asking for participation (see Appendix V). This brought a favourable reply from a further three audit firms. Two of the remaining firms, known by the author to employ less than ten audit employees, did not accept to be interviewed citing pressure of time, while another firm again failed to reply. Thus a total of ten final interviews were secured with audit firm partners. This included all representatives

TABLE 4.1

SIZE OF RESPONDENT AUDIT FIRMS

Indicated Number of Audit Employees	Number of Respondent Audit Firms
1 - 9	1
10 - 19	4
20 - 29	-
30 - 39	1
40 - 49	-
50 - 59	3
60 - 69	-
70 - 79	1
	10

of *"Big Six"* firms and also three representatives of other international firms. Table 4.1 indicates the size range in terms of audit employees of the firms whose partners responded, based on information supplied by such partners themselves during the interviews.

As regards the sole practitioners, random selections were made from the warrant holders identified as such from List (ii) mentioned above. In order to arrive at a corresponding number of sole practitioners, a total of thirteen random selections needed to be made, as three were unsuccessfully contacted. The same contact procedure as with audit firms was used. In eight cases, appointments were fixed by the preliminary telephone contact, while in two cases appointments were fixed after written communications. Of the three unsuccessful contacts, two refused to be interviewed, citing pressure of time, while one was known to be away from the island for an extended period of time.

All twenty-two personal interviews, including the two pilot ones, were held in respondents' offices with the senior or technical partner in each audit firm, or with the sole practitioner concerned. The interviews took two sessions each, typically one session following the other within a week, and each session was about one-and-a-half hour duration. They were all cassette-taped and the interviews took place as follows:

Pilot interviews: November and December 1990

Final interviews: December 1990 to April 1991

(b) Selection of the Management Respondents Management respondents needed to be able to go deeply into the more technical aspects of auditing, and also possibly to beyond the commoner small company auditing issues. As importantly, however, they still needed to give a faithful and representative picture of the management relationships with external auditors.

Senior financial executives, who were possibly but not necessarily CPA's, and who could not work as auditors, would fit into this picture provided that they were either directors or participated in the board meetings related to auditors, and felt that they could themselves give the above required picture of the existent auditor-management relationships in their companies.

At the piloting stage, it was decided to interview three such senior financial executives, two CPA's and one a non-CPA. For the final interviews List (iii) of CPA's referred to at the beginning of this section was utilized. A practical problem regarding this list was that not all the listed persons were employed in relevant management positions and that there were other senior financial executives who were non-CPA's and therefore not included. Given that there were no other more suitable lists to refer to, the following approach was adopted to tackle this limitation:

(i) Initially, an exercise was carried out where the name of any person known reliably not to be employed in a company management position was removed from the list. For the scope of this exercise, enquiries were held with the local audit firms, the Government Finance Section, Audit and Inland Revenue Departments, and also with the Department of Accountancy, University of Malta. In this manner, thirty-nine persons were removed from the list, most of whom were recent University graduates, often employed with audit firms or still in Government service. The list, now totalling 170, was used to select randomly twenty managers - a number corresponding to that of auditor respondents. In all, twenty-six managers were contacted for the final interview, and of these six were unsuccessful. Three could not be contacted, of which two were on extended leave abroad, and one could not be traced. A further three declined to be interviewed, two citing pressure of work and the other giving no specific reason.

Seven of the CPA's contacted referred the author to a more senior financial executive within their company. In these referred cases, the higher executive was a non-CPA, and the interview was held with him instead.

Six of the twenty management respondents were executives in small companies as defined in the interview discussion schedule (Def G.1 in App VI), while another nine were also senior financial executives in smaller companies besides their main one. In addition, ten of the respondents were engaged or had previous experience in government-controlled enterprises. The job titles of the management respondents were as follows:

Chairman and financial director	1
Financial Directors	4
Financial Secretary	1
Financial Controllers	9
General Managers - Finance	5

4.4 Data Collection Limitations

(a) The Views of Unqualified Managers The use of the CPA list for selecting management respondents that was referred to in the previous section meant that the final sample could not include unqualified senior financial executives whose companies did not engage CPA's, at least part-time. One possible result of this was the under-representation, in the final sample, of managers in smaller companies, because such companies probably tended not to engage qualified accountants as financial executives, as larger companies did.

However, in mitigation of this limitation, it is to be noted that, as stated in the previous section, the final sample, as selected, still had fifteen of its twenty respondents who were connected in one way or other with small companies. Therefore the problems in such companies were still reflected in these managers' replies. Furthermore, even if a list including non-CPA financial managers were available (which was not), a sample using such a list would probably have had an opposed limitation: it would not have gone so much beyond the commoner small company auditing issues, and therefore treated too little on the larger company ones.

(b) The Non-recording of More Sensitive Information The response was in a few instances not cassette-recorded where the respondent considered the part of the interview as too sensitive to be put on cassette. In these cases, data was recorded from memory after the interview, and this rendered it more subject to error.

(c) Interview Interruptions In view of their high status in their firm or company, many respondents were subject to repeated interruptions during these interviews held in their own work environment. These consisted mainly of urgent staff intrusions or telephone calls, and have probably resulted in a lack of depth in some of the replies.

(d) The Lack of Anonymity Despite the introductory assurances given by the author to the respondents as to the confidentiality of their replies, the lack of anonymity ensuing from face-to-face interviews still rendered a few respondents from both groups reluctant to open up and elaborate in some of their replies. Yet, this was the exception, rather than the rule.

(e) Respondent Treatment of Score Scales Most respondents did not treat the score scales referred to in S4.3.1 and Appendix VII as interval. One indication of this is that, except or a few responses in the intensity score scales, which were half-way between allotted number values (eg 1 1/2), there was no indication of continuous data. In addition large scale score differences were noted between adjacent scale categories in some cases. For this reason, no parametric tests like the "*t*" test were used in the analysis of the data. Instead, for each relevant question, chi-squared tests were used to compare each group's IASS's for significance. However, as stated earlier (S4.2.1), the study remains essentially qualitative, not quantitative in nature, and this scale score analysis must therefore be seen as of an indicative, secondary significance. The details of these tests are explained in Appendix VII.

4.5 Other Possible Research Approaches

Alternative approaches for the collection of data for the project were considered, but, unlike the selected approach, were discarded because they were found either impracticable or not eliciting the right type of response. One that was particularly considered was the adoption of a case study approach of a few specific relationships: this would have involved an even more qualitative approach than that actually adopted and already described. However, given both the confidential nature of individual relationships and the smallness of the country, the practical difficulty lay in finding subjects who were willing to furnish the required detailed information.

4.6 Conclusion

This chapter was mainly concerned with the research method designed in order to obtain the relevant data for this project and with the data collection limitations. The study has a formalized, descriptive, cross-sectional, essentially qualitative and survey design. The adopted strategy of the survey consists of an examination of the auditor-management relationship issues by means of semi-structured personal interviews held with representatives on either side of the relationship, that is, with both senior audit practitioners and senior financial executives in local companies. The response to these interviews will now be analysed in detail.

CHAPTER FIVE

RESEARCH FINDINGS

5.1 Introduction

The objective of this chapter is to examine the survey, the methodology and design of which were described in Chapter Four, and to analyse the response to it. The survey questions will treat the major issues in the relationship set out in Fig 1.1 in Chapter One, and their analysis will also, as far as possible, follow the same section sequence of the discussion based on the literature in Chapter Two.

The next section, 5.2, will analyze the introductory question and questions relating to communication and reporting issues. Section 5.3 will then consider independence issues, and this will be followed by management fraud issues in Section 5.4. Section 5.5 will then treat small company issues affecting the relationship, while other relationship issues including government-controlled enterprises will be dealt with in Section 5.6.

The analysis of the questions will follow the order of the interview discussion schedule shown in Appendix VI. It is to be noted that, unlike the section order in Chapter Two, independence issues are in fact treated after communication and reporting issues. This is because in the interviews independence issues were considered too delicate to be raised towards the beginning. In presenting the analysis it was also considered helpful to give, either directly in the text or in brackets, the number of audit practitioners and managers subscribing to any statement or opinion.

5.2 Communication and Reporting Issues

The main purpose of this section in the interview discussion schedule was to answer the investigative question: What major communication issues arise during the audit, and in the final report?

An introductory question was asked to find the need perceived by audit practitioners and managers of the auditor in the accounting communication process. This was followed by a question on the barriers to auditor-management communication, questions on written communications during the audit and on the audit report itself, and, finally, a question on disagreements on audit reports and auditor switching.

5.2.1 The Need for the Maltese Financial Audit

In response to the first question (A.1, see App VI) on whether respondents found a real need for the financial audit of companies, all auditors and managers interviewed saw at least some need for it. The overall intensity IASS (or indicative average scale score, see S4.3.1) was 3.8, with auditors reaching 3.7 and managers 3.9. The question contained no check-list of content categories, but replies could and in fact were analyzed into four different types of need. These were

- to play a co-operative influence on management and staff;
- to monitor management on behalf of shareholders;
- to protect the interest of third parties;
- to help investors in their decision-making.

(a) Influence on Management and Staff A number of auditors (9) and managers (10) saw that a main need for auditing was to help and influence the management and even the staff of the company. Auditors emphasized that the audit assisted managers to maintain the company's reporting standards (5), had a deterrent value on staff against errors and fraud (3) and also afforded management an opportunity to discuss new ideas affecting accounting staff (3). On their part, managers saw it as giving them access to financial expertise (4), and helping them to improve their systems and controls (5). One managing director stated,

"We spend good money on auditing because we believe in

it...There are always points which auditors extract from the reports for us, such as production wastage figures."

Some managers (3) also believed in the deterrent value of the audit against staff default, although one manager's contrary view was that *"they may be spending too short a time in our company for this."*

(b) Shareholders' Need To Monitor A number of auditors (7) and also managers (9) saw a further need for an audit to provide a service to shareholders controlling management, and some [4 Auditors(A), 4 Managers (M)] added that this was especially so where there was a spread of shareholdings and owner-management divorce. Three of these auditors, however, emphasized an equal need in the prevalent family companies, because it was common there for one family member to control the financial information, and the auditor was needed to mediate in shareholder-director disputes .

(c) Third Party Protection Again, an almost equal number of auditors (6) and managers (7) saw the further need for an audit to protect the interest of third parties. Here, more auditors (6) than managers (3) referred to the needs of the Inland Revenue Department, while managers (7) referred more than auditors (3) to the interest of banks.

(d) Help To Investors A few (3A, 1M) of the interviewees expressed the need for an audit to help investors in their decision-making. Perhaps this was no surprise, in view of the largely undeveloped financial markets in this microstate. Most of these (2A,1M) added that this need was expected to increase in view of the new Malta Stock Exchange, which was expected to start operating within a short time. In fact, the Malta Stock Exchange did start operations, although on a small scale, in January, 1992.

(e) Alternative viewpoints Unlike managers, four auditors, three of whom sole practitioners, saw only little need for an audit. Most local companies were owner-managed, and audit results did not add much new information to the proprietors as it mostly involved reporting to them what they themselves did. One audit firm partner concluded that *"were the audit not compulsory most companies would not do it, as managers consider us parasites!"*

However, judging from the managers' responses, the facts seemed otherwise. There seemed to be not just a demand for auditing from the traditional agency theory viewpoint of the auditor performing a monitoring role for shareholders, or from the insurance theory viewpoint of the auditor providing protection for third parties (see S2.4.2 for both viewpoints in literature): the above indicated that the need in Malta was even more pronounced from the behavioural theory viewpoint of the auditor influencing staff at all levels - including executives in the organization.

5.2.2 Communication Barriers between Auditors and Managers

Ten items, mainly selected from the literature, were then listed (Question B.1) so that respondents would pinpoint and discuss their barriers to auditor-management communication. A barrier is here taken to be, as already described in S2.4.3, anything that prevents or restricts the conveyance of meaning of a message. Seven of these items (a tendency not to listen, a lack of feedback, personality conflicts, resistance to change, a lack of trust, too many intermediate receivers, a hostile attitude) were barriers identified by Golen et al (1988) study as most serious (see S2.4.3). To these were added three other barriers: one to represent another dimension identified by Golen - that of accounting background - for which the barrier of a lack of understanding of meaning of accounting terminology was included; a barrier arising from the level of standardization of audit reports, which piloting indicated might be important; and a general *"other"* category that could include the *"personal and physical"* dimension

TABLE 5.1

RANKING OF BARRIERS TO AUDITOR-MANAGEMENT COMMUNICATION

Ranking Order Number	Barrier	Total Number of Respondents With Barriers	Auditors With Barriers	Managers With Barriers	Chi-squared Test of Significance (5% Level)	Indicative Average Scale Score
1	*A Tendency not to listen*	33	18	15	No	2.45
1	*A Lack of Understanding of Meaning of Accounting Terminology*	33	20	13	Not Reliable	2.30
1	*A Lack of Feedback*	33	18	15	No	2.30
1	*Personality Conflicts*	33	20	13	Not Reliable	2.08
5	*A Lack of Trust*	29	16	13	No	1.95
6	*Resistance To Change*	26	18	8	Yes	1.99
7	*A Hostile Attitude*	23	8	15	Yes	1.69
8	*Too Many Intermediate Receivers*	22	11	11	Unnecessary	1.74
9	*The Level of Standardization of Audit Reports*	20	11	9	No	1.73

identified by Golen et al as well as any other barriers. This last item contained no rating score and is separately considered later. However, taking the other nine items, these were ranked as shown in Table 5.1, which includes not only the number from each group of respondents finding that item a barrier, but also the overall intensity IASS for each item as well as whether there are significant differences between each group (see S4.3.1 and App VII). A synthesis of the findings on each of the above items now follows in descending order of importance. In this connection, one can also refer to Appendix VIII, which gives a further breakdown of the scale scores by group.

(a) A Tendency Not to Listen As can be seen from Table 5.1, 33 respondents (18A,15M) stated that a tendency not to listen was a barrier to them, with no significant difference between the groups. This was therefore one of the four highest barriers. The overall intensity IASS was highest at 2.45, being 2.63 for auditors and 2.28 for managers. The significance of this attitudinal barrier was not surprising, in that even in the Golen et al (1988) study mentioned in S2.4.3, U.S. auditors ranked it only below one out of 33 barriers.

Listening, as distinguished from hearing, is a mental rather than physical activity. It is the means by which the receiver decodes the message of the speaker, or, as defined by Lundstein (1971) *"the process by which the spoken language is converted to meaning by the mind"* (p 1).

Both auditors and managers found this a relatively high barrier. On their part, auditors were almost divided in attributing this problem to managers (10) and to themselves (8). On the other hand, almost all managers finding this item a barrier (14) attributed it to auditors.

Most (8) of the auditors pointing a finger at managers gave one of two reasons. A few (2) argued that managers were too much in a hurry.

However, the commonest argument (6) was that many managers did not listen carefully, and distorted the message or over-simplified it because they lacked basic accounting knowledge. This rendered them unable (1A) or unwilling (2A) to accept the reality of their company's financial situation, such as (2A) their need to implement change.

Interestingly, four auditors referred to blocking tactics used by managers in exchanges with them. Managers tended to shift topics to more convenient ones, or to stop communication at the outset - saying that they were in a rush (2). Others resorted to postponing tactics - *"will see this later on"* (2).

Three auditors emphasized the listening barriers of managers in government-controlled enterprises. Some of these were not *"expert"* or *"competent"* enough to listen fruitfully (2), while others simply rejected involvement in any discussions, *"passing the buck from one to another"* (1). One practitioner contrasted their *"low motivation to listen"* with that of managers in private industry, particularly in local subsidiaries of German companies, where *"even a slight remark to a manager will suffice."*

On the other hand, most (12) of the managers pointing a finger at auditors gave almost similar views: auditors had too limited a period of time, and therefore could not get involved in lengthy dialogues with managers. Two managers attributed this to auditors having more jobs than they could reasonably do. Another said, *"Where I would like half a day of discussions, it typically boils down to fifteen minutes of talk, with very little listening by my auditor."*

A few (3M) pointed out that auditors may be working so hurriedly because the fees were too low, while others (2M) claimed that because of their rush, auditors ignored the complexities of their clients' business, and continued to report *"at a superficial level"*, or *"within* *established patterns"*, without rising to the occasion.

A number of respondents (8A,1M) maintained that it was their own group that created listening barriers. One manager confirmed the viewpoint of some auditors (6), stated above, that managers tended not to listen because they often did not have enough accounting knowledge to understand the reality of the situation. On the other hand, two auditors confirmed what some managers (3) have already been quoted as saying: many auditors could not afford the time to listen to their clients. Other audit practitioners (5) stated that managers would not listen because their auditors lacked communication skills. Auditors had not been trained to *"put themselves into managers' shoes"*, or empathize with them so as to be able to understand fully their circumstances (3A). *"This had to include serious efforts to understand the daily environment of the manager , such as the factory floor"* (1A). Owing to this lack of empathy, auditors were also unclear in some of their advice (2A). One partner also claimed that managers' listening attitudes were adversely influenced by the inadequate image as professionals some auditors were building with managers.

In summary, many managers seemed to be seeing in the tendency not to listen the symptom of an audit professional with too many demands on his time. But for several auditors this tendency in one or the other of the two parties to the relationship meant something deeper, or, as stated by one auditor, *"just the obvious tip of an iceberg."* For most, it indicated problems due either to deficiencies in the auditors' communication approach or to the managers' lack of accounting knowledge.

(b) A Lack of Understanding of Meaning of Accounting Terminology The accounting terminology was taken to be the set of technical terms or jargon used in accounting which, as in other professions, varies from general usage.

This lack of understanding ranked overall as one of the highest overall of all barriers, with 33 respondents (20A,13M) finding this a barrier to them. The overall intensity IASS was second highest at 2.30, being 2.80 for auditors and only 1.80 for managers. The chi-squared test of significance could not be relied on here, because of the smallness of the sample (see App VII regarding the use of Intensity Scales in the analysis), but it is still clear from the different number of respondents in each group finding this item a barrier that auditors found more difficulty in this than managers. The high ranking of this item is particularly significant in that in the Golen et al (1988) study, US auditors ranked it well below other barriers.

The main auditor argument was that the problem was due to managers' lack of a high enough level of education (6) or of at least a working knowledge of accounting (10), especially in very small companies (4). In such companies, auditors needed to explain terminology in everyday terms (4). In the case of non-English speaking directors, there was an added difficulty, in that the technical jargon had no Maltese language equivalent (1).

Many managers (10) said that they met similar problems due to lack of education in their companies, both large and small, and personally needed at times to explain in laymen terms the auditor's jargon. A number (4) saw the technical communications to Boards of large and small companies as an unnecessary time-waster. As one manager said, *"In companies of different sizes, financial managers at times even have to re-draft such communications, in an attempt to simplify to their Boards who cannot understand them."* However, a number (5) of managers emphasized, in agreement with the auditors mentioned above, that the problem was particularly acute for auditors in very small companies.

Such companies often had no financial executive or only a part-time one, and auditors themselves frequently needed to explain the terminology to accounting-illiterate directors.

Yet, the existence of this communication problem even in larger companies indicated the need for more emphasis on the accounting education of management.

(c) A Lack of Feedback Feedback was defined as *"the information which the other party gives you on your work, so that you can make the necessary adjustments or modifications in the future."* This definition was adapted from the one given in the Penguin Dictionary of Psychology (Reber, 1985: p 27). At the piloting stage, it was decided to limit the question to feedback to respondent and not by him, as both managers and auditors did not comment much on feedback given by them, except, typically, that thought that they always gave the necessary feedback whether orally or by letter.

Table 5.1 shows this lack of feedback ranked as highest overall, at par with the previously discussed barrier, at 33 respondents. There was no significant difference between auditors (18) and managers (15) finding this a barrier. In addition, the overall intensity IASS of 2.30, with auditors 2.20 and managers 2.40. Interestingly, the ranking of this factor by Maltese auditors was approximately similar to that by US auditors in the Golen et al (1988) study. However, the latter study did not contain a definition of this barrier, and therefore comparisons are necessarily limited.

Respondents from both groups claimed that the other party did not give them enough feedback. A common problem (13A,10M) was that they were not given what they wanted in time, most (11A, 10M) adding that the other party seemed too pressed for time to forward the feedback more quickly. Some (3A,4M) claimed that it took the other party even *"up to* *the following year's audit" (1A,2M)* to give the information.

Auditor and manager respondents also seemed to differ on the nature of the desired feedback. Many auditors (12) wanted more formal feedback on their weakness suggestions: *"Too often we have to read between the lines in managers' comments for this" (1A).*

In contrast, a number of managers (8) indicated that, beyond the weakness suggestions, auditors needed to give them more feedback on the financial performance of their companies, with a few (2) adding that auditors should go beyond what managers happened to ask for. On such information, one public company respondent stated,

> *"Auditors already have it in their files. I cannot see why they are not passing it on to management."*

However, auditors seemed to treat different companies differently in this respect. One large company respondent, in fact, expressed satisfaction on *"A Report on Comparative Financial Performance"* on his company which he received as part of his annual audit service: this report compared in detail the performance of his company with that of the previous year. There were indications that the level of feedback actually varied with the fees which clients were prepared to pay. For example, one small company manager stated that he received no feedback at all, adding that *"probably this is because the fees are too cheap."* One auditor was equally clear: *"I cannot be expected to give much feedback on the reduced fees I have to charge."* Significantly, two managers stated that they did not want any feedback at all - they did not believe it was useful enough.

A number in each group (4A,4M) pointed out the problem of the informal meetings held during the audit. They were unscheduled and too informal (2A,1M), and both parties seemed too busy to render them more useful (1A,1M). One audit partner spoke of different corporate cultures on this, varying with company size.

"In large companies, feedback is clearer than in small ones, and does not depend so much on makeshift meetings. Managers come back, often in writing, after receiving the management letter, and tell us what they felt was right or not... they will also spell out the action they have taken, and that is useful for us to consider in giving our audit opinion."

Another problem that emerged was the question of feedback to auditors on their general approach. There seemed to be a dilemma on this: seven auditors declared that they did not encourage such feedback, with one adding that probably managers did not know how to give it. On the contrary, a number of practitioners (8) wanted more feedback on better liaising with staff (4), audit timing (2), and even on audit efficiency (2).

Other comments included small and government-controlled companies. As regards small companies, both parties seemed to face more problems. Some auditors (3) had to apply more pressure than in other companies to obtain feedback on their weakness suggestions, while a few managers (2) thought that genuine feedback on performance was impossible.

"Here the real accounting figures, particularly stocks and sales may easily be understated for tax evasion reasons. Most auditors will have little idea of the real figures" (1M).

As regards government-controlled companies, a number of audit practitioners (3) stated that in these entities, they had to press more for feedback than in other companies, as financial managers were less motivated to act.

Overall, each party seemed as yet unsatisfied with the feedback being forwarded from the other, but especially with the delay in its being received and its nature. Therefore, more attention to this factor seemed warranted for the sake of improving the relationship. This may include tackling the time pressures leading to such delay, and to the use of communication skills to identify and pass on the needed feedback.

(d) Personality Conflicts Personality is defined as *"a compendium of one's traits or characteristic ways of behaving, thinking, feeling, reacting etc" (Reber, 1985: p 533)*. Personality conflicts are therefore taken to be those conflicts arising from such traits. Table 5.1 shows that this factor was ranked one of the highest four barriers, with 33 respondents (20A,13M) considering it a barrier. The overall intensity IASS was 2.08, with auditors 2.25 and managers 1.90. As in the case of the analysis of the accounting terminology barrier [(b) above], the chi-squared test of significance could not be relied on here because of the smallness of the sample (see App VII). However, it is still clear from the difference in the number of respondents in each group finding this item a barrier, that auditors found it more difficult than managers. The high ranking of this item is significant in that in the Golen et al (1988) study, American auditors ranked it below six other barriers. Yet, again, comparisons are limited in that the term '*personality*' was not defined in the latter study.

Both groups identified character traits in the other group which they found causing conflicts. The commonest traits mentioned were different for each group: auditors claimed that managers were careless and secretive, while managers claimed auditors had tactless and impractical audit staff.

The question of managers' carelessness was raised by a number of auditors (6), who found this a barrier in all accounting-related work, particularly in small companies. Other auditors (5) stated that many managers also were not completely open with them, especially in the auditors' first years of engagement. Auditors also referred to other *"troublesome"* traits of managers: a lack of financial prudence (3); undependability, with auditors having access to press managers to keep their promises (2); and managers' tendency to dominate the less assertive audit staff (2). Some small owner-managers, such as building contractors, seemed particularly *"unrefined"* in their treatment of auditors (2A). *"They think we are no more than their calculating machines"* (1A).

On the other hand, according to many managers (8), the tactlessness of some audit staff was evident in their dealings with company management and staff. They treated unqualified staff in a demeaning way (3M), or *hankered constantly for more information, without any indication why they needed it"* (1M). Company staff often retaliated to similar treatment by withdrawing their co-operation (4M). Some audit staff were also found impractical, concentrating on trivialities (3M) or taking *"too theoretical"* a viewpoint (3M).

A few respondents (3A,2M) blamed their own side. Auditors found some audit staff breaking confidentiality rules or not practical enough (3A), while some managers transmitted to their staff the feeling that auditors were a nuisance (2M).

In order to avoid conflicts, a number of auditors (8) stated that they took pains to match a suitable member of staff, or, at least, adapt themselves, to the *"more difficult"* or *" incompatible"* managers. In contrast, no manager spoke of such self-adaptation. Probably it is true that, as stated by one audit partner, *"auditor-client relationships will not improve unless auditors take the initiative to deal with problems of this type originating not only from their staff, but also from their client managers."*

(e) A Lack of Trust This was taken to mean as lack of mutual trust - that is, both respondents' lack of trust in the other party and the other party's lack of trust in them. Table 5.1 shows that this factor ranked as the fifth highest barrier, with 29 respondents considering it a barrier, and no significant difference between the groups

(16A,13M). The overall intensity IASS was 1.95, with auditors 2.05 and managers 1.85. The ranking here was lower than that by US auditors in the Golen et al (1988) study, where U.S. auditors ranked it only below two other barriers. However, again, it is unknown whether a different meaning was attached to trust in the latter study.

Managers' lack of trust in auditors will be examined first, followed by the examination of auditors' lack of trust in managers, as the two were attributed to different factors.

Managers' Lack of Trust In Auditors Both auditors and managers attributed this mostly to a lack of accounting education, but also to the non-involvement by the auditor of other services, and to auditors' conflicts of interest.

Lack of accounting education to management led to misunderstandings as to the auditor's function (8A,6M). For instance, one manager stated that in his company most directors viewed the auditor suspiciously as *"the tax inspector whom we have to pay for."*

On the other hand, the non-involvement of the auditor in other services was also claimed (5A,3M) to be the cause of lack of trust, mainly (3A,3M) because it kept the relationship at a *"superficial"* level, as auditors were often *"indifferent"* or even *"ignorant"* towards what was really being done by the management of the company. According to one auditor,

> *"Without such services there is too little contact and chance of using our expertise. The relationship cannot be that intense."*

There were also problems of conflicts of interest. According to some auditors (3), managers mistrusted fieldwork audit staff who in Malta could easily be blood related to their company's competitors. Management respondents (2) also claimed instances of the same audit firm which was doing their company audit while working also for main competitors, and giving advice to both. Such conflicts led managers to doubt even auditors who had had a long-standing engagement with their company.

Two managers in government-controlled enterprises complained of their trust being shaken by the charging of excessive fees for accounting services. They claimed that auditors were doing this to make up for the originally agreed audit fee, that had often been set too low in view of an over-competitive tender system.

> *"Take one recent case brought to my notice. Additional charges amounted to twice the audit fee, and simply related to thirteen journal entries!"* (1M).

Auditors' Lack of Trust in Managers Auditors' lack of trust seems to relate mainly to the lack of openness of small company managers, and also to fears of over-friendliness by managers, and dilemmas concerning the auditors' relationship with the financial controller.

As in the response to the lack of feedback barrier [(c) above], a number (8A,4M) of respondents again referred to the fact that small company managers were often not open enough to reveal all relevant information to auditors and that therefore the latter had to be more cautious. A few (1A,2M) added that management took this attitude because it wanted to evade taxation.

In addition, a number of auditors (5A) said that they were afraid that managers would become over-friendly and too familiar with them, exerting too much influence on auditors and their staff.

There also appeared dilemmas as to how far auditors could trust financial controllers at board level. One audit partner stressed the importance of such trust: controllers were his main point of reference on the management's side and communications needed to be channelled through them. However, another partner thought differently: he often by-passed some financial controllers at board level because he did not consider them *"strong enough."* According to a number of managers (3), some auditors, in fact, did not let financial managers take the lead in finance-related matters at board level, and this caused mistrust. *"A few auditors communicate at Board level in a way that implies that their presence is essential and that there is nobody in finance to refer to"* (1M). This is one area where guidance by the accountancy profession may create a better image for both auditors and accountants.

(f) Resistance To Change Table 5.1 shows that this factor ranked as the sixth highest barrier, with 26 respondents considering it a barrier, and with significantly more auditors (18) finding it so than managers (8). The overall intensity IASS was 1.99, with auditors 2.38 and managers 1.6. The overall ranking here was a little higher than that by US auditors in the Golen et al (1988) study, where it was ranked below six other barriers. Again, however, caution needs to be exercised in making comparisons because of the possibility of differences in the meanings attached to the terms used in the two studies.

The question here related both to resistance of respondents to changes proposed by the other party, and also to the resistance of the other party to the proposed changes of respondents. Some managers (6), but no auditors, commented on the first type of resistance. The latter resistance of managers concerned auditors' proposed changes which they considered not cost-beneficial (5). *"Auditors are too theoretical, trying to close all system loopholes at any cost."* Regarding changes proposed by respondents, two managers and almost all auditors (18) stated that they met with problems from the other party.

The two managers found auditors too inflexible to accept quick changes that were unlike those of other companies. One of these managers in fact stated that he did away with such resistance simply by implementing changes without informing the auditor.

On the other hand, the auditors meeting with resistance from management on proposed changes were divided as to whether this was attributable to managers (9) or to auditors themselves (8), with only one attributing it to both. Those pointing at managers stated that these resisted because in their cost-benefit considerations they were unwilling to pay for the cost of the change (7), or under-estimated its benefits (2), such as that *"of not going into deterioration and decline."* A few (3) stated also that many managers resisted owing to their self-interest. *"They are obsessed with the problems that could be created for themselves"* (1A). One auditor illustrated this: in annual general meetings of family companies, arguments easily arose between close relatives, and in self-protection managers opposed any auditor's ideas of more accounting disclosure.

Auditors attributing this managerial resistance to auditors themselves mainly blamed this on the undue use of the threat to qualify the audit report (2), and on the lack of general communication skills, specifying presentation ones (4), and a lack of the powers of persuasion (2).

A few respondents from both groups stated that in small (3A,2M) and government-controlled (1A,1M) companies, problems seemed even more acute (3A,2M). In small companies, the level of accounting education was even lower than was the case in other companies, and as a result change was less appreciated than in larger companies (2A). Managers resisted change to the point of inhibiting growth, preventing delegation to accounting staff, and often dismissing suggestions for formal procedures as unnecessary paperwork. In government-controlled companies, managers particularly resisted change simply because they were afraid of them (2A) - *"it may work against their easy non-accountable position"* (1A).

In summary, this barrier seemed to emerge as much from the auditors' lack of communication skills as from managers' lack of accounting education and narrow self-interests.

(g) A Hostile Attitude *"Hostile"*, according to the Chambers' 20th Century Dictionary (1983), means *"pertaining to an enemy, showing enmity or unfriendliness" (p 607)*. A hostile attitude is here taken to mean one between the two parties showing such characteristics.

Table 5.1 shows this factor ranked the seventh highest barrier, with 23 respondents considering it a barrier, and with significantly more managers (15) finding it so than auditors (8). The overall intensity IASS was 1.69, with managers 1.98 as against auditors 1.40. The low overall ranking was surprising, taking into account that in the Golen et al (1988) study, U.S. auditors ranked it highest of 33 barriers. Even after considering the possibility of slight differences in meaning attached to the term in the two studies, the contrast is still noticeable.

Respondents not finding this factor a barrier (12A,5M) described their relationships with managers as *"friendly"*, *"helpful"* or simply *"not hostile."* Furthermore, of all respondents, only a few (4) managers referred to the possibility of direct hostility between auditors and higher management. Two of these stated that this happened when such managers tried to exert pressures on their auditors on accounting treatments and met with opposition from them. Additionally, according to two other managers, in small, family-controlled companies, problems were arising with managers because they were often controlled not by one, but by at least two competing families. In order to avoid hostile attitudes, the auditor needed to *"walk on a tight-rope"* because of the existing power-sharing in management.

"If related closely to one side or not tactful enough to keep

or even appear neutral, he will easily find himself embroiled in the family feuds that flare up. This happens particularly in the annual general meetings of these companies" (1M).

As to the respondents finding such a barrier, many of these (5A,10M) emphasized that this mainly existed between auditors and lower levels of management and staff, in particular storekeepers. A number (3A,5M) again raised here the audit staff problem, discussed previously in personality conflicts [(d) above], of tactlessness.

However, some managers (4) found staff hostility *"natural"*, and one said that he positively encouraged such an attitude among his staff so that the auditor would remain an effective deterrent. One sole practitioner confirmed this managerial viewpoint: *"This attitude is generated by the inspector image given of us by financial executives themselves."*

The low emphasis on this item, particularly on the auditors' side, indicated that many Maltese auditors considered themselves friendlier in their relationship with the management of local companies than the managers themselves, and even more their client staff, considered them so.

(h) Too Many Intermediate Receivers Intermediate receivers are here taken to be persons who go between the sender and the ultimate receiver; in other words , those through whom the message is passed. As shown in Table 5.1, this ranked the eighth highest barrier, with 22 respondents considering it so, being equally auditors and managers (11A,11M). The overall intensity IASS was 1.74, being 1.75 auditors and 1.73 managers. The relatively low ranking for this factor was lower than that obtained in the Golen et al (1988) study, where it was ranked below only three other barriers. A possible reason for this was that forwarded by a number of respondents (6A,4M): companies and even audit firms in this microstate were smaller and therefore had fewer tiers of management.

Three main issues emerged: the need to build auditor-management relationships at different levels, the problem of audit staff changes, and the accessibility of audit firm partners.

A number of auditors (8) stated that, in large companies, messages could be distorted when passing through the various intermediaries unless auditors were particularly cautious. In order to tackle this, they tried to build matching relationships at different levels between auditors and managers, but this took them time (3). Two sole practitioners found this particularly difficult to achieve because they had few members of staff. Most of these auditors (6) often also resorted to written communications, so as to reduce the distortions.

Moreover, both auditors and managers (6A,9M) were finding difficulties because of the frequent changes in fieldwork audit staff. This was due both to the firm's internal rotation policy, and to the high levels of turnover in audit staff (4M). As a result, new staff often misunderstood company staff (3M) and information had to be repeated (9M). *"This year (1991), all audit staff has been changed except for the partner and audit manager ; it is a waste for us."*

A final issue raised was that audit firm partners were not always accessible to small company managers: this led to misunderstandings with other members of audit staff (4M).

In conclusion, all three issues seemed to point to the need for auditors to better liaise with company managers in the formulation of their audit management strategy.

(i) The Level of Standardization of Audit Reports As shown in Table 5.1 this was the lowest ranked of nine barriers, with 20 respondents considering it so, with no significant difference between auditors (11) and managers (9). The overall intensity IASS was 1.73, being 1.85 auditors and 1.60 managers.

As stated in S3.4 , in Malta there is no standardized audit report but auditors follow the legal requirements, and, if members of the local Institute, the relevant IAG's. Appendix II gives a model report abiding with both, to which, however, there may be several variations in practice.

About half of the few respondents finding this factor a barrier, mostly auditors (8A,3M), considered the report not standardized enough, and, as a result, at times confusing to management, users or subsequent auditors. Many of these (5A,2M) pointed out that new auditors often changed the report wording of a previous auditor, and that this raised problems with management, who required explanations. Three (2A,1M) also pointed out that particular problems were raised when an audit report qualification became necessary in small companies. They felt that in order to avoid confusion in such circumstances, there was a particular need for *"more applicable standards."*

On the other hand, the few other respondents finding this factor a barrier, mostly managers (3A,6M), saw the report as already not sufficiently freeflowing. As a result, they did not find it *"meaningful"* or *"communicative"* enough. This message of the audit report was taken up further in a later question [see S5.2.4 (a) for Qn B.4].

Finally, given that all the previous barriers discussed in this question were found to be higher than this one for this purpose,it may be true that, as stated by one manager, *"for the sake of improving auditor-management communications, the auditing profession should be giving those other factors at least as much, if not more, consideration as report standard-setting, although the latter factor may appear more useful to outside users."*

(j) Other Barriers (Lack of Other Communication Skills including Personal and Physical, any Other) Very little emphasis was made on personal and physical skills such as physical appearance (1A) and manner of speaking (2M). This was not unexpected as in the American study referred to previously (Golen et al, 1988) these barriers ranked below other barriers.

However, comments expressed by six managers again emphasized, as in the previous discussion on personality conflicts, the lack of general communication skills among fieldwork audit staff, often repeating what had already been stated in discussing the personality conflicts barrier. One typical comment was *"the further down the line you go the more problems you will find in auditors' communication skills."* Most (4) of these managers thought that audit staff needed more training, especially for meetings with management. One group controller explained that fieldwork auditors, including audit managers, seemed *"overtaken by the details in their audit file, and unable to make a proper presentation case."* This lack of communication skills in audit staff tallies with what was found by Ingram and Frazier (1980) in the USA (see S2.4.3).

Four audit partners stated that presentation skills for meetings with managers were much more important than they were made out to be by the traditional training and education of auditors. This was because these skills determined whether auditor-management relationships thrived or not. One partner added an example of this: his firm placed particular attention to the skilful presentation of the end-of-year results of their client companies, using audio-visual aids and putting the right man to help the partner in his delivery: *"We even try to match the age and personality of managers with someone on our part."*

Finally, three of these partners also pointed out that, in order to sustain the relationship with management, auditors needed also to give importance to a proper location where to discuss their difficulties with management. They felt that, wherever possible, their usual preference was their own office. As stated by one of them, *"misunderstandings are less likely to ensue in a warm environment with cosy seats, potted plants, gentle lighting and fitting decor!"*

5.2.3 Communications During the Audit

The next set of questions concerned the normal communications recommended by the profession through the IAG's - the letter of engagement, the management letter and the representations required of management. The aim was to see the significance of these letters in the overall relationship, and to gauge respondents' views on the implementation of changes in this area.

(a) Usefulness of Engagement Letter The first part of the next question (B.2i) asked about the usefulness of the engagement letter. Twenty-four respondents found this letter useful, and there was also a significant difference in the response between auditors (16) and managers (8). The overall intensity IASS was 2.74, auditors reaching 3.35 and managers 2.13.

Most auditors finding the letter useful stated that it safeguarded the interests of both parties, especially in the case of disputes with clients (10), and also clarified matters (6), *"enshrining the right concept of an audit"*(1). Different views were expressed on its use: some (3) said that they used it in every engagement, while others (4) never used it because they did not consider that it offered them any protection and that they never needed to refer to it. Even more (8) stated that they did not use it in small companies, except as a precautionary measure when the previous auditor had been dismissed (4). Personal contact was such in small companies that this letter was turned into a mere formality (3), given that not even the distinction between auditing and other services was necessary, as the services needed in a small company were not that specialized (2).

On the other hand, many managers (10) had never referred to such a letter and some (4) saw no point in it except as a protective device for the auditor if he wanted to charge for additional services. Interestingly, three managers in large companies stated that they had never even seen such a letter. Most (6) of the managers who found this letter useful stated that they found it so only in the first year of engagement of an auditor, before the relationship became established. After that, the letter was forgotten (2) or became a formality (4). Often it was unclear and not up-to-date even about the charging of fees for other services (4). Two managers also confirmed the above view of auditors that in small companies the letter turned out to be a mere formality.

In summary, despite the aim of the accountancy profession to use this letter to *"avoid misunderstandings in respect of the engagement"* (see S2.4.4), this letter seemed to be playing a minor role in this respect, particularly in small companies or after the first year.

(b) Usefulness of the Management Letter The second part of the same question (B.2ii) asked about the usefulness of the management letter. All respondents (20A,20M) found this letter useful. The overall intensity IASS was 3.41 in terms of usefulness, auditors reaching 3.6 and managers 3.23.

The main use of this letter as seen by most respondents (16A,15M) was to advise management to take action on company deficiencies, and both parties agreed that managers generally appreciated this.

"As auditors, we sit down and discuss this letter with

managers, often after the accounts are signed by the directors. They come to expect it from year to year" (1A).

Respondents, but more auditors (15A,8M), also stated that the letter helped their relationship with managers from decaying and enabled auditors to be helpful and use their expertise. A number (6A,9M) also saw it much more important than the statutory audit report for the auditors' relationship with management, because the report was primarily made up for third parties, not managers.

However, a problem conceded by a number of auditors (8) was that management letters might contain trivialities, at least from the point of view of managers. This was, perhaps, because, as one practitioner added, *"it was difficult to retain a good letter year after year."* Many managers (10) also referred to such trivialities, and some (3) stated that these were more common when a new auditor was on his first-year audit with a client company.

Many managers (9) also stated that at least some of the auditors' suggestions were often impracticable; to make matters worse, according to some of these managers (4), auditors often insisted on repeating these suggestions year after year. A few (4M) attributed such suggestions to insufficient insight of client companies, or to audits being carried out superficially. Some (5M) were also annoyed by the fact that reports included points or facts which managers themselves had passed on to auditors, and that these appeared in such reports in a way that led readers to believe that they were new and unknown to financial executives.

On the other hand, a few auditors (3) lamented that some managers did react adversely to constructive criticism. Special reference was made to government-controlled enterprises, where it seemed to these auditors that even pointing out system loopholes often met with more resistance than in private companies. One auditor even suspected that, in one particular recent case, he had not been re-appointed following and in consequence of a particularly strong management letter.

Clearly, most audit respondents (12A,14M) did not normally send this report in writing to managers of small companies and preferred oral discussions on the subject with them. Respondents from both sides (5A,4M) felt that way communications were much more frank and genuine. As one auditor put it, *"Small size means having to do away with such formalities."*

A few auditors (3) felt irritated by other practitioners who were abusing of this report as a protective device; it was claimed that on the pretext of advising managers, such auditors included in the letter very serious matters that warranted an audit report qualification. In this context, one manager wryly observed that *"probably the true rationale for the management letter is that some problems are too sensitive for audit report readers."*

One point of difference that emerged among respondents was the extent to which auditors consulted with managers and staff before finalizing this letter. Fifteen respondents (8A,7M) said that managers received the report in draft form first, and that this was subject to discussion and amendment. However, a further seven managers lamented that they received such a report only in its final form . It seems that such consultancy varied with the trust built up between auditors and the particular financial managers in question.

Overall, the letter did therefore seem to matter for both parties. Probably, as stated by one manager, *"One sure hallmark of a growing auditor-management relationship is a high quality report that is used by management."*

(c) The Letter of Representation Two preliminary local studies (see Vella, 1988 and Farrugia, 1984 in Ss 3.6.2, 3.6.4) had already delved into the issue of the usefulness or importance of the letter of representation, and indicated that most auditors found this letter useful. Therefore, in this study, a question was asked in two parts on this letter: the first part was made to managers so as to gauge their attitude towards auditors on it, and the other to both groups, so as to compare their frame of mind about the introduction of legal safeguards on representations in Maltese company legislation.

Auditors and Shifting Responsibility To Management. The first part (B.3a) asked managers whether they felt that their auditors were trying to shift their responsibility on to them by means of this letter. Just over half the managers (11) responded that they felt so, while the others (9) did not agree, and the opinion IASS averaged 2.60.

It seemed that the response was divided because some, but not all, auditors were asking for comprehensive letters that were seen as too detailed. In fact most of the managers in agreement referred to the undue length (6), or excessive routine details(4) asked for inclusion in this letter. They were also mostly convinced that auditors were demanding these as a *"self-protective device"* (6) or because they were *"risk-averse"*(2). Some (3) added that the letter clearly indicated that auditors were not sufficiently self-confident.

> *"I feel that auditors should act more responsibly here. There should be no need for us to certify practically anything which they have to use to build their opinion on the accounts."*

On the other hand, most (6) of those who did not see the letters as an attempt by auditors at shifting their responsibility claimed that the letters which they were asked to sign were generally concise and to the point. They viewed requests for such letters as only *"fair"*(4) or *"to be expected"* (3). After all, as most (5) of these managers added, they could understand that audit tests were limited in scope.

"Auditors cannot possibly go beyond sampling in their job, and I can see that there will be some important areas where they need to rely on us."

Overall, therefore, the response pointed to the unfavourable perceptions of managers on auditors when the latter asked too much from these letters.

Legislation on Misleading Representations To the Auditor Both groups were then asked (Qn B.3b) whether they thought that it was important to have legislation specifying that it was a criminal offence to give misleading representations to the auditor. This change would make company law in this respect at par with the United Kingdom legislation (CA 1985: S393). This fact was not mentioned to respondents.

Generally, respondents (16A,12M) considered such a change in local legislation as important, with no significant difference between the groups. The overall intensity IASS was 3, with auditors reaching 3.25 as against a score of 2.75 by managers.

The main argument in favour put forward by both groups (9A,8M) was that this would lead to more attention or seriousness on the part of Boards of Directors in dealing with the auditor. Many (6A,6M) also emphasized that this was important because these assertions were the basis of the financial reports. The change would also lead to more awareness of the possibility of omissions that could make a difference to the results (3A,2M), and of the directors' legal responsibilities (7A). Another related argument was that such legislation clarified the current position, in that there would be no need to refer to the general laws of the country (4A,3M).

However, there was a marked difference in the arguments put against such legislation by both groups. Some managers (6) stated that such a law would tend to reinforce the self-protective mentality of auditors.

For them, it was more a matter of trust than law. On the other hand, most auditors (5) seeing such legislation as unimportant doubted how far this would really be effective in making management take this letter more seriously. Three of these auditors added that the difficulty lay in proving that mangers were trying to mislead, and that the change would not make that any easier.

The overall frame of mind was perhaps best summed up by one chairman:

> *"Such a change will hopefully make management more aware that we are signing this letter not for the auditor's sake, but because we owe it to users to produce reliable financial statements. However, auditors will still have to be careful on how much detail to ask for."*

5.2.4 Communications In The Audit Report

This section treated with communications as seen by both parties in the audit report itself. One question sought to compare the meaning given to the message of the audit report, while the other sought the two parties' views towards changes in the normal contents of the audit report. The objective was to identify and compare the different perceptions and opinions which they held towards this statutory end-product and how relevant it was to the auditor-management relationship.

(a) Message Conveyed By an Audit Report The first question (B.4) asked both parties what message they saw being conveyed by an audit report. The meaning to both groups can probably best be summarized in two typical sentences, that are almost the exact words used by some respondents (1A,2M). To audit practitioners the auditor normally seemed to be saying, ***"I have found that you can believe and rely on this set of accounts."*** On the other hand, to managers the auditor is mainly saying something similar, though not identical: ***"I have not found anything to bother you in this set of accounts."*** An analysis of both messages now follows.

"I" Respondents in both groups emphasized on who was *"the man passing the accounts in their professional test"* (2A,1M). A number (4A,7M) emphasized that the credibility of the report varied with the reputation of the auditor. A few managers (3) added that both the local banks and the Department of Inland Revenue (DIR) seemed to give less weight, unofficially, to the opinions of certain practitioners. One auditor added that the Banks and the DIR knew who the *"black sheep"* of the audit profession were, and, apparently because they were bound by their own secrecy rules, they did not do anything about it. Another senior partner added on this that, *"this situation has been like that throughout my long career."*

"You" As to who was the receiver of the message, a number (16A,15M) of managers and auditors specified these in their reply as one or more of the shareholders (7A,8M), in particular those not involved in management (3A,3M) , the DIR (8A,5M), and the banks (6A,5M). A few of these (3A,2M) added prospective investors, and fewer still (1A,1M), creditors.

Some (2A,4M) remarked the DIR was not important as a user. Two managers, one of whom claiming strong contacts with small companies, said that, unless it was qualified, a small company audit report did not normally mean much to the DIR : the latter often assumed that profits were understated for tax reasons. A few auditors (3) doubted how much expertise existed at the Department to interpret the audit report properly. However, the distrust held by the DIR was justified by one audit partner who mentioned that his firm had recently come across three instances of companies with clean audit reports and gross understatement of profits.

Other respondents (3A,3M) claimed that the message was less important to bankers because they used criteria other than audited financial statements for granting financial facilities to clients, such as their personal knowledge of them.

The above views regarding the limited weight given on the audit report by bankers and the DIR was confirmed in respect of small companies by what Galea St John (1990) and Magri (1991) found the same users were themselves saying with respect to such company audit reports (see S3.6.4).

Managers: "I have not found" Many managers (12) emphasized that the message in an unqualified auditors' report was a negative one. This negativity persisted despite the additional statements required to be inserted by the CPO: the report did not detail what the auditor actually found in order to come to his true and fair view (1). For this reason some managers stated that the message looked like *"a short conclusion to an undisclosed long essay"(1), "a seal" (7),* or even *"a clean sheet"(1).* For these respondents, in order to place any meaning to the message, one had to examine the accounts themselves.

However, many (10) saw the report was more than this when it was in fact qualified. Then the message often became more explicit (5) or stronger (6), although wording controversies persisted, particularly, as also referred to in the literature (S2.6.4), on the small company audit report.

A few managers (3) also complained that audit reports failed to warn users by signalling important issues in time, such as system or performance weaknesses. *"The report will carry a red flag only when the company has already burnt its fingers: it is then too late for everybody"* (1M).

Auditors: "I have found that" In contrast to managers, no auditor referred to the negativity of the clean report, and it seemed that the current way of reporting was taken far more for granted. A few (3A) even emphasized that the message of the report, both if qualified and not, was *"clear enough"*.

Managers:"...anything to bother you" Most managers (14) also saw the message in an unqualified report as that of releasing users from their worry, and putting them more at ease. For many (9), this did not mean that users could become complacent but that they could go ahead with their enquiries about the company. As one manager put it,

> *"The auditor informs users that the picture is reasonably as depicted and not substantially distorted. But these still carry out their enquiries before judging these accounts."*

This interpretation of the auditors' message differed significantly from that of the auditors themselves.

Auditors:"... you can believe and rely" In fact, many auditors talked of the report doing more than this: for them, it revealed the truth on the accounts and increased their reliability.

Many (11) talked of the auditor showing the *"true"* or *"right"* or even *"correct"* position. Furthermore, as two put it, it was a question of *"having faith"* or *"believing"* in *"a report of a professional man."* Most auditors (15) also referred to the report as increasing the reliability of the accounts: the message was that users could rely on the fairness of those accounts.

Therefore there was an assurance that the financial results and position were as shown and that users could act on the accounts: *"Once he puts his name on them, the auditor makes himself responsible for any question or figure in the financial statements"* (1A).

In summary, managers saw the report as more limited in influencing users than auditors seemed to expect.

"..On/in this set of accounts" Both groups also saw the audit opinion as restricted to a set of accounts prepared by management. Therefore a clean report signified to management that it had done a good preparatory job (7A,9M). This was important for its image or reputation with all users (3A,5M).

A number of respondents (2A,8M) still emphasized that other aspects of the audit were of more significance and had more value to them than an unqualified audit report in their ***internal*** dealings of their company. They gave as examples areas discussed in earlier questions such as the management letter, and the auditor's deterrent effects on staff.

Therefore, the audit report was significant in the auditor-management relationship mostly in so far as it helped managers in their ***external*** communications with the main Maltese users - banks, the DIR and shareholders. However, particularly in small companies, the report seemed not to be succeeding much in building the bridge of trust and reliability with such users as professed by auditors: in fact, it seemed little more than a starting-point towards that end.

(b) Changes in the Audit Report The second question (B.5) suggested two changes in the audit report and sought the opinions of both groups on them so as to see their attitude towards change in this area. It asked respondents whether they would agree to an audit report being requested by the auditing profession

i - to distinguish between the responsibilities of auditors and managers ;

ii - to explain that an audit is planned and performed to obtain reasonable assurance that financial statements are free of material misstatements.

These suggestions were in fact two of the more important changes carried out in the USA by the issue of SAS 58 (ASB, 1988c).

Distinction Between Responsibilities The distinction between the responsibilities of auditors and managers was marginally favoured by respondents, but there was a marked difference between the groups, with managers (17) being significantly more in agreement with the suggested change than auditors (5) . This was also indicated by the each group's opinion IASS, which was 2.92 overall - auditors having 3.50 as against managers' score of 2.35.

According to a number of respondents in agreement (3A,9M), this change could help to clarify matters with users, but particularly with management. This was because, as some (3) added, managers were often not sufficiently aware of where their duties lay, especially in small companies, where auditors were often also employed in other capacities, such as to do accounting work. However, a number of these respondents (2A,5M) cautioned that for the sake of increasing the understanding of the more unsophisticated user, the distinction would probably have to be a detailed one. Otherwise, some (2A,1M) claimed that it might have the opposite effect of increasing their mistrust .

On the contrary, many (10A,2M) of those not in agreement, particularly auditors, said that such insertions would not add much to the understanding of anyone and would therefore render the report unnecessarily longer. A few (3A,2M) felt that management should include such a distinction elsewhere, such as in the notes to the accounts (1A,1M) or in the directors' report (2A,1M). Some auditors (4) even stated that the current report had stood the test of time, and that therefore they found its format *"hard to question."*

Overall, the response to this part indicated that many auditors found it more difficult than managers to consider changing the audit report - it was harder for them to question its usefulness as a means of communication.

Explanation of an Audit The second suggested change, that of explaining the nature of an audit, was almost as controversial. Over half the respondents (7A,14M) were in favour, and again there was a significant difference between the two groups, with only 7 auditors as against 14 managers being in agreement. The overall opinion IASS was 2.83, auditors being 3.3 and managers 2.35.

Most of the respondents agreeing with the wording (5A,10M) did so because it clarified the position of the auditor. As one manager stated:

> *"Such an explanation goes beyond the mere statement of the true and fair view. Not all users are sophisticated, and it would certainly have an impact in the local environment."*

Another manager added that it would *"destroy the myth that auditors eliminate all bias from the accounts: the words* ***'reasonable'*** *and* ***'material'*** *speak for themselves"*. A few respondents (2A,3M) stated that, given this explanation, many managers would understand better the function of the auditor.

Most (9) of the auditors opposing this addition again brought the argument that there was no need to change the traditional report for this purpose, as it would not add much to the understanding of anyone. The report was not a place to educate users on the meaning of an audit (2A). In addition, this change might make outside unsophisticated users more distrustful because it would bring more into focus the subjectivity of the audit process (2A).

On the contrary, many (3) of the managers opposing this saw some need for explanations but stated that they were afraid that some auditors would indeed seek to derive advantages from this. *"Auditors might easily exploit such explanatory statements to seek further reduction of their responsibility, such as in case they do not detect gross frauds"* (1M).

The response to this part continued to indicate that changes in the audit report seemed not as important to auditors as to managers, and that auditors seemed to take their current way of reporting more for granted.

It is probably true that, as stated by a manager,

> *"for many auditors, the report, rather than a live message, is more of a traditional formula, whose origins appear to have been lost time ago. They do not consider the wording of their report as really open to question."*

5.2.5 Auditor-Management Disagreements on Audit Reports and Auditor Switching

Reference has already been made in the literature (S2.4.6) to evidence in other countries that auditors qualifying their opinions were more likely to face dismissal. In addition, it was stated in S3.6.3 that in a preliminary local study (Mugliette, 1988) a number of audit respondents referred to instances where their appointment had been terminated after the issue of a qualified audit report. The next question (B.6) focused on this important issue to the auditor-management relationship, asking both auditor and management respondents whether auditors were being replaced by clients as a result of auditors qualifying their audit report.

All respondents (20A,20M) stated that Maltese auditors were being replaced by clients, at least rarely, as a result of report qualifications. The frequency IASS was 2.95, indicating that on average respondents thought that auditors were being replaced almost half the time they made a qualification. This indicative assessment, however, varied from 2.65 for auditor respondents to 3.25 for management ones.

Many respondents claimed that some qualifications were often taken by management to imply an end to the auditor-management relationship (11A,12M). As a result, management tended to use its influence with owners to engineer an auditor change as soon as possible (9A,8A). A number (7A,6M) of these respondents emphasized that change occurred more frequently in small companies. Most of them (4A,3M) implied that the managers in such companies, who were often also their owners, were much more sensitive than others to the tax implications of certain qualifications: some would even try to have their auditors removed as soon as the latter indicated that they were determined to qualify. One large company manager typically claimed that small company managers *"will go to any length to find auditors to accommodate them by dropping such qualifications."* In any case, particularly in small companies, there seemed to be a lack of that mutual respect that practitioners in Vella (1988, see S3.6.2) claimed to exist when differences of opinion arose. It seemed that fears of having to pay more tax were here overriding any good intentions.

A number of respondents (9A,8M) emphasized that not all types of qualifications were leading to this state of affairs. Qualification types that were in fact specified as often leading to auditor change were those relating to specific control weaknesses in areas such as turnover (2A,3M), stock-taking (2A,2M), and current assets and liabilities (1A,3M). On the other hand, one qualification most commonly mentioned (5A,6M) as not having such effect at all was the small audit qualification based on the old UK *"Example 6"* model referred to in the literature (see Ss 2.6.4, 3.6.4). It seemed that such a report was treated like an unqualified one. As one auditor stated, *"It is so much in use, no-one sees much of a difference from the unqualified report."* Another qualification that seemed to be treated in similar fashion was that of going concern. According to some auditors (5), this interested more bankers than the Inland Revenue, and although common enough was often issued too late to be of any practical significance.

Many respondents (8A,12M) added that change normally took place after several attempts at some type of compromise. However, there were also factors preventing change from happening too often. One was that the DIR and even the banks often demanded to know the reasons for the change (6A,7M). It was also not always easy, in the circumstances, to find new auditors ready to replace the old ones (7A,4M). Furthermore, management disliked disclosing its private matters to a new auditor and tried to avoid need (3A,2M).

Finally, a number (5A,4M) also referred to the preventive effect of the Code of Ethics of the MIA (1986: S8), which required the incoming auditor to communicate with the old one. However, even more respondents (4A,9M) questioned the effectiveness of this latter code: in order to practice one did not need to be an MIA member and therefore not everybody was subject to it. As one manager added, *"In our small financial and business community, we need much more monitoring and discipline than at present."* Perhaps even more importantly, the outgoing auditor was often unwilling to pass on to the new one many helpful comments (3A,4M), or, at times, even in violation of the code, the new auditor did not communicate at all (2A,3M).

It is probably also true that in this microstate, *"practitioners know each other too well to lodge official complaints against each other"* (1A) and that this causes difficulties to the MIA in exerting its discipline. An even more serious example of the consequences of this was given by some respondents (3A,2M) to this question. They claimed that a very small number of practitioners were repeatedly not fulfilling their proper duties: for an uncompetitively cheap fee, they were at times signing accounts without even examining them at all, and nobody seemed able to discipline such ethic busters.

In conclusion, therefore, Maltese auditors did seem to be facing a substantial real threat from management in several circumstances that called for qualifications of their reports. This was particularly so in the case of small companies, apparently because of more management sensitivity to the tax consequences of the qualifications.

5.2.6 Summary

This section attempted to tackle the major communication issues between auditors and managers as seen by both parties.

(a) The Need Both saw the auditor as needed, because, among other reasons, he exerted a positive influence on management and staff.

(b) The Barriers Various communication barriers were identified, of which the highest overall were four: a tendency of both parties not to listen, the managers' lack of understanding of the meaning of accounting terminology, a mutual lack of feedback, and personality conflicts. Two other barriers were found significantly higher by one of the parties: these were the resistance to change by managers according to auditors, and the managers' view of auditors having a hostile attitude, particularly towards company staff. Most of the barriers indicated the need for more training in communication skills to both parties, while others pointed to the need for more emphasis on accounting education to management, or betrayed undue time pressures on both sides.

(c) The Letters As for the three written communication letters, their usefulness could be definitely enhanced. However, while management letters already seemed helpful in the relationship, engagement ones appeared not effective enough in reducing misunderstandings. Furthermore, detailed representation letters seemed to cause adverse reactions in management.

(d) The Report As for the statutory audit report itself, the auditor-management relationship banked on it mostly insofar as it expressed a message to outside users that helped the position of management with them. However, managers seemed to see the existing report as having a more limited role than auditors did, and saw the latter as taking their current way of reporting too much for granted.

(e) Disagreements and Switching Finally, some audit report qualifications often threatened, and even signalled an end to the auditor-management relationship: the real possibility of replacement often needed to be faced by auditors in such circumstances. This seemed more so where management feared that the qualifications had adverse tax implications.

5.3 Independence Issues

The main purpose of this section in the interview discussion schedule was to answer the investigative question: What factors are perceived by both auditors and managers to influence the independence of auditors from management?

The interviewees were first asked for the views of respondents on listed factors which could be considered influential on auditor independence. This was followed by four other questions: one on the provision of non-audit services by the auditor, one on audit committees, while the final two enquired on new legislation to protect independence, the first question concerning the statement of circumstances, and the second concerning auditor rotation and dismissal on proper grounds as proposed by the Fifth EC Directive.

5.3.1 Factors Influencing Independence

Ten items were first listed (Qn C.1) so that both parties would select and discuss those factors which they considered influential on independence. Nine of these consisted, with a few modifications after

TABLE 5.2

RANKING OF FACTORS INFLUENTIAL ON INDEPENDENCE

Ranking Order Number	Factor	Total Number of Respondents Finding Factor Influential	Auditors Finding Factor Influential	Managers Finding Factor Influential	Chi-squared Test of Significance (5% Level)	Indicative Average Scale Score
1	*Integrity*	40	20	20	Unnecessary	4.90
1	*Objectivity*	40	20	20	Unnecessary	4.38
3	*Economic Pressures*	38	19	19	Unnecessary	4.02
4	*Tact*	36	18	18	Unnecessary	3.99
5	*Technical Competence and Experience*	28	15	13	No	3.20
6	*Standards and Ethical Codes*	26	17	9	Yes	2.65
7	*A Sense of Idealism*	23	15	8	Yes	2.43
8	*Existence of Legal Liability*	16	8	8	No	1.73
9	*A Public Servant Attitude*	11	8	3	No	1.50

piloting, of the more pertinent attributes found to be associated with auditor independence in the literature review (S2.3.2 and S3.6.1). A tenth category was also inserted in the question to encourage discussion of any other factors considered influential; this contained no rating score and is separately considered later. However, taking the other nine items, these were ranked as shown in Table 5.2, which includes not only the number from each group of respondents finding that factor influential, but also the overall IASS for each item as well as whether there were significant differences between each group. A synthesis of the findings on each of the above items now follows, in descending order of influence. In this connection, one can also refer to Appendix IX, which gives a further breakdown of the scale scores by group.

(a) Integrity In the interview discussion schedule, this factor was defined, after piloting, as *"intellectual honesty and non-subordination of one's judgment to that of others."* As can be seen from Table 5.2, all respondents stated that integrity was a factor influential on audit independence, and it was one of the two highest ranked factors. The overall intensity IASS was 4.90, being the same for both auditors and managers.

Respondents stressed that audit practitioners, above all, needed this quality. Most of them (16A,15M) also remarked that they considered Maltese auditors persons of integrity, although there were some who were not: a few auditors added that this was *"as in any other profession."*

Many, particularly auditors (11A, 4M) stated that for them the influence of this factor meant that practitioners would not give in to fraudulent, misleading, or even meaningless reporting or to agree to self-interested management viewpoints which they knew to be dishonest. A number, mostly managers (2A,6M), thought that most auditors, as persons of integrity, would not change their opinions or judgments too easily, but only where reasonable or justifiable.

Overall, therefore, the personal integrity of the practitioners seemed the most important positive influence on independence from client pressure.

(b) Objectivity Objectivity was defined in the discussion schedule as *"a mental attitude that views events on a purely factual basis without the influence of one's personal feelings, opinions or interests."* This definition was adapted from the Concise Oxford Dictionary (1990). There was again no question as to the influence of this factor: all agreed to the influence of such an attitude. The overall intensity IASS was also high at 4.38, reaching 4.43 for auditors and 4.33 for managers.

However, most (12A,12M) commented that, in their experience, it was not possible for the auditor to be completely objective, and some (6A,2M) attributed this to insufficient evidence independent of management, particularly in small companies. There, *"the facts were blurred or known only to management."*

Some (4A,6M) even thought that auditors tended to become too attached to some clients, a few (3A,3M) referring here to the fact that, particularly in smaller companies, friendly or close relations hindered them from retaining their sense of detachment. One manager even felt that *"the question is really how long before it takes auditors in such companies to lose their objectivity."*

Overall, this psychological factor seemed also as unquestionably important as the previous one of integrity, in relation to auditor independence.

(c) Economic Pressures As can be seen from Table 5.2, 38 respondents (19A, 19M) saw this factor as influential on independence, and there was no difference in response between auditors and managers. It was ranked third highest, and the overall intensity IASS was 4.02, being 4.1 for auditors and 3.93 for managers.

The two respondents (1A,1M) seeing this factor as not influential held that independence was a question of integrity, and had no economic aspects. However, the majority (16A,15M) took a different viewpoint: they stated that there were important pressures on auditors to retain particular clients when the audit fees coming from them were too large: the possible loss of such fees could become threatening to a practice. This emphasis on client fees in fact agreed to what had been indicated by some audit practitioners in a preliminary survey by Borg (1983, see S3.6.1). Some respondents from both groups (4A,3M) here added that there was the real danger for company management to dominate such auditors: *"they may start treating auditors as their employees"* (1M). Most respondents (12A,11M) wanted some limits in this connection to be set for the whole local profession. Emphasis was laid on the need for not only for the profession to set these, but for it to see also that they were effectively implemented (6A,5M). Some (4A,5M) also pointed to the need to treat differently in this respect new practices that were still in the process of establishing themselves: some (2A,2M) wanted these to be given more allowances, while others (2A,3M) emphasized the need to monitor them even more closely. Probably, it is a question of both.

A few (2A,3M) referred also to another economic factor, the added competition from the increasing number of auditors in the local market: they claimed that this was in itself making it harder for practitioners to remain independent of their clients.

In general, however, it seems that economic pressures due to the size of the fees were considered to be only a little less influential on independence than the previously discussed psychological factor.

(d) Tact According to the Chambers' 20th Century Dictionary (1983), this means *"adroitness in managing the feelings of persons dealt with: nice perception in seeing and doing exactly what is best in the circumstances"* (p 1316). Tactlessness has already been referred to in the communications section [S5.2.2 (d)]. However, following the emphasis placed on it by the piloted respondents, tact was included here as an additional psychological factor to be tested for its influence on independence .

Tact ranked the fourth influential factor: thirty-six respondents (18A,18M) agreed to its influence, with equal response from each group. The overall intensity IASS was also high at 3.99, reaching 4.05 for auditors and 3.92 for managers.

Many (12A,13M) emphasized that auditors had in practice to exercise much tact in order to remain independent. For them, it was essential in healthy interactions with management.

> *"The right auditor tactics at the right time mean that the auditor is not overpowered by managers, but is, just as importantly, not alienated to them"* (1A).

> *"Tactfully, many managers can often be persuaded to improve their attitudes towards auditors and fair financial reporting"*. (1M)

A number (2A,4M) referred to the need to exercise tact in view of the particular challenges placed by a clients in a small country where there was a higher possibility of close or friendly relationships. Such relationships have already been mentioned in discussing objectivity in (b) above, and will be taken up more in (j) below (other factors).

There were also a few respondents (2A,2M) who did not see any relevance of tact to independence. In the opinion of three of them (2A,1M), independence was a question of fact, rather than tact. *"Diplomacy plays no part in it"* (1M).

Clearly, however, the majority disagreed: they recognized it as a necessary ingredient in keeping the right balance or distance in the Maltese auditor's relationship with management.

(e) Technical Competence and Experience Technical competence was defined, on the lines described by Moizer (1985, 1991) in the literature [S2.3.2 (c)], as *"the possession by an individual of the necessary expertise to discover all the significant errors and omissions present in a set of unaudited annual accounts"*. Following the piloting stage, this item was combined with *"experience"* because respondents were reserving practically identical comments and scores to both.

The factor ranked the fifth most influential factor: twenty-eight respondents agreed to its influence, with no significant difference between the groups (15A,13M). The overall intensity IASS was also high at 3.20, reaching 3.40 for auditors and 3 for managers.

As expected from the literature [S2.3.2(c)], most auditors (10A,12M) stated that they believed that the lack of this factor was in fact making some auditors dependent on the expertise of management. However, most of these (5A,8M) also argued that the presence of this factor could not by itself make auditors necessarily independent: they also had to have personal integrity.

A minority of respondents (5A,7M) saw no relevance of this factor to independence. Most of them (3A,4M) believed that the latter was influenced solely by other factors, because all warranted auditors had the minimum level of expertise not to have to over-rely on management: if they needed, they could consult other auditors.

However, some (1A, 2M) of those seeing technical competence as relevant showed their scepticism of the safety of a warrant or of the possibility of auditors consulting others. For example, as for the latter possibility, one audit partner remarked, *"If you need technical competence and experience in the field, you will far more likely seek help from your client than from other auditors."*

Overall, therefore, technical competence was another influence to consider in assessing a practitioner's independence.

(f) Standards and Ethical Codes This factor ranked the sixth in influence out of the nine listed factors. Twenty-six respondents found this factor influential, with auditors (17) finding it significantly more so than managers (9). The overall intensity IASS was also high at 2.65 , reaching 3.30 for auditors and 2 for managers.

Most respondents (14A,5M) in favour stated that they viewed any professional pronouncements influential, and referred in particular to those issued or adopted locally by the Malta Institute of Accountants. However, many of these (11A,4M) added that the influence of the current MIA pronouncements could be much higher if they were made to apply to the whole Maltese profession, not just Institute members. Some of these respondents (5A,3M) even referred to insufficient or ineffective monitoring by the Institute.

On the other hand, many managers (11) and a few auditors (3) were more pessimistic: they saw standards and ethics as not influential at all. Most of them (2A,10M) thought that this was so because, in their experience, practitioners who wanted to ignore them could not be effectively monitored in practice; similar problems have already been discussed in S5.2.5 with reference to the Institute's Code of Ethics. Additionally, a few managers (3) thought that this lack of influence was rather due to the MIA's approach towards the issue of such standards and codes. They stated that all IFAC/IASC statements were adopted by it *"practically wholesale"*, and that was the root of the problem.

> *"Why are these assumed to be suitable in the local context? I believe that, before being issued, they need first to be carefully studied and adapted for their applicability to the local context"* (1M).

In any case, the experience to date appears to render managers less impressed than auditors at the influence of standards and ethics on audit independence.

(g) A Sense of Idealism Sense of idealism was defined as *"the nature of the auditor to pursue the appropriate judgments without regard to potential client loss."* This definition was adapted from the Farmer et al (1987) study referred to in the literature (S2.3.2).

This factor ranked seventh in its influence on independence, much behind the related psychological concept of integrity discussed above [in (a)]. The response to this factor was divided with most respondents (23) finding it influential on independence. The difference between auditors (15) and managers (8) finding it so was statistically significant, and the overall intensity IASS was 2.43, auditors reaching 3.30 and managers only 1.55.

Respondents finding a sense of idealism influential stated mainly that to be independent, auditors needed to uphold their principles whatever the circumstances. However, some (5A,5M) declared that, in practice, this could be difficult to do and were convinced that not all auditors were in fact ready to go on pursuing judgments to the point of sacrificing clients for the sake of principles.

On the other hand, most (3A,11M) of the managers and auditors who saw this factor not influential stated that, in their experience, most auditors did their best not to lose clients. They were *"practical, not idealistic"* in their approach (3M), ready to *"discuss and revise their views"* with management (3M) especially in areas where management *"knew best"* (2M), and also to change their views where *"sensible"* to do so (4M). *"To be independent does not mean that an auditor needs to* *remain in a world of his own making"* (1A).

Moreover, most (2A,9M) of these respondents stated that a few auditors were known to be clearly ready to forsake all principles as long as they retained their clients, although two (1A,1M) acknowledged that *"after all, in the long run, that does not pay"*.

Interestingly, one auditor even admitted that, in his work,

> *"I have to accommodate some clients. This is a small place, and people can make life difficult to survive."*

It is worth noting the difference in response to this item, from the one to integrity as discussed in (a) above, and which all respondents, including managers, found influential on independence. It seems that managers want their auditors to retain their integrity, and yet see managerial influence on the auditor's judgment as justifiable. As one manager opposed to the influence of sense of idealism put it,

> *"We expect our auditors to take seriously into account what we are saying and if necessary change their judgment - and that is really no compromise to their integrity. After all, with proper discussion, even our own views may change" (1M).*

However, it could be that managers are really attempting to rationalize their influence on auditors, refusing to admit that they may actually be pressing auditors towards a compromise with their integrity.

(h) The Existence of Legal liability This factor was taken to mean the knowledge that the court system will make auditors accountable for their actions and representations. Overall, it ranked penultimate in its influence on independence and only a minority (16) found it influential, with no difference between the groups (8A,8M). The overall intensity IASS was 1.73, auditors reaching 1.65 and managers 1.80.

Most (8A,10M) of those not seeing this factor as influential stated that few, if any, auditors were concerned with the possibility of legal liability. A typical comment was that *"it seems that no-one as yet believes that one will possibly be sued."* Some (3A,5M) suggested that the probable reason for this attitude was that there had been no decided court cases to date that tested auditors' liability to third parties. Some respondents (3A,2M) added that in fact little resort was made to the courts as far as professional work in general was involved, even in the case of other more traditional professions; this situation did not change noticeably as a result of compulsory indemnity insurance cover being required by the APA (Section 11) for auditors in 1986 (2A,2M).

In contrast, most (4A,5M) of those respondents finding this factor influential argued that they felt that there were risks involved and that these bore some practical influence: as a few (2A,2M) added, auditors still retained these risks at the back of their mind because they feared being discredited, particularly with the banks and the DIR.

However, generally treating legal liability as little influential on independence was much in line with the response to the item of public servant attitude, discussed next.

(i) A Public Servant Attitude This factor was defined as *"the auditor's sense of serving all interested parties and not anyone in particular."* It ranked the last of nine items in its influence on independence, with only eleven (8A,3M) finding this attitude as influential, and no statistical difference in response between the groups. The overall intensity IASS was 1.50, auditors reaching 1.70 and managers 1.30.

The main argument of both groups (14A, 11M) was that this attitude was largely irrelevant and that it did not affect independence because auditors could not possibly cater equally in their work for the needs of all potential users of their reports. Most of these respondents

(10A,9M) emphasized that auditors in fact often kept in mind serving the company itself and its shareholders who appointed them. A typical comment was that *"such an attitude does not exist: other parties besides the company are served only indirectly, and you do not feel as if you are working on their behalf at all"* (1A).

However, eight auditors and three managers were of a different opinion. They felt that auditors needed to balance the shareholders' interests with those of the other users, and that this need was a factor pressing them not to be unduly influenced by their client. Two auditors emphasized that this was the rationale of a public warrant. However, some of these (4A), all auditors, added that they felt that although users were not yet insisting enough for their rights, the situation was changing and that they therefore felt that this attitude would become much more influential in future years.

As yet, however, other external parties beyond shareholders seemed to be exerting minimal influence on the auditor's independence.

(j) Other influential factors Other factors were also included by respondents as influencing independence.

One negative influence that was commonly mentioned by respondents here, besides being already referred to in (b) objectivity and (e) tact above, was that of close relationships. Most respondents (11A,14M) referred to the fact that, in a small country like Malta, there was more probability that clients knew their auditors on a personal, business or social level, and that this was therefore a potential threat to independence (5A,10M). This was more particularly so in small companies, where sole practitioners often performed all the work. (6A,4M)

A particular problem referred to here was that of blood relationships. As previously stated in S3.4, there were no blood relationship restrictions applicable to private exempt companies: here, a number of respondents (11A,10M) referred to the existence of such relationships as a widespread problem affecting independence, and wanted the law to be more restrictive. Some auditors (3), audit firm partners (2) and a sole practitioner, thought that it was a particular problem among sole practitioners, particularly in their initial years, and two added that their audit firm could and did tackle such a problem by seeing to it that no partner or staff connected with any client job was related to any official of that client, even if that was a private exempt company.

A few respondents (2A,1M) also referred to fear of loss of reputation as an added factor affecting independence: they claimed that the more reputable firms avoided over-dependence on management so as not to incur such a loss either among clients (1A) and report users (1A,1M). However, two of these respondents (1A,1M) also indicated that auditor reputation was not generally a priority concern, at least in the context of independence.

5.3.2 The Provision of Non-audit Services

The next question (C.2) related to the provision of non-audit services by the auditor. The few specific limitations in this respect in Malta have already been described in S3.4, and this question was placed here in order to find out whether this factor was felt locally to affect auditor independence from management. Respondents were first asked for their general views on the provision of non-audit services (C.2a). This was followed by a request for views in respect of particular services (Qn C.2b). The final part of the question (C.2c) was then aimed at identifying steps that could be taken in this area - it sought respondents' views on proposed new requirements.

(a) General Views on the Provision of Non-audit Services Many respondents (13A,12M) were not in favour of the auditor providing all kinds of non-audit services, and there was no significant difference between respondents in this regard. The overall opinion IASS was 2.7, being 2.75 for auditors and 2.65 for managers.

Many (8A,6M) of those not in favour were of the opinion that the provision of certain services could cause the auditor particular problems. He might become too complacent (2A,1M) or find himself in conflicting situations, where the auditor would have to *"act as his own judge"(5A,4M)*, or would have to *"conceal his own incompetence" (1A,1M)*. However, while restrictions in the provisions of some services were essential, this was often uneconomical or impracticable in smaller companies (4A,2M).

In contrast, many of the respondents in favour of the provision of all kinds of other services, mostly managers (5A,7M), felt that auditors were trustworthy or competent enough to remain independent when they performed such services. A few (2A,1M) reiterated what had been stated in S5.2.2 (e) that they felt that the provision of such services in fact helped to establish more trust between auditors and managers. Moreover, most auditors in favour (4A) also stated that companies in Malta were not that large, and that therefore such a separation of functions would probably be too expensive to clients. A number of audit firm partners (3A) added that the fact that they had offshoot companies owned by them that offered services to audit clients was enough of a Chinese wall to safeguard independence, because these companies acted separately of the audit firm and had different employees. However, other respondents (2A,1M), including both an audit firm partner and a sole practitioner, referred to such an arrangement as *"artificial"* or *"merely cosmetic."* The two auditors stated that if future regulations would still allow such arrangements, the sole practitioner, who often had no offshoot companies, would be discriminated against.

At this stage, it appeared overall that, while the issue of non-audit services was controversial even locally, preference would be given by the majority towards restrictions in some services only. However, it was as yet unclear where such restrictions were mostly preferred, and this was taken up by the next part of the question.

(b) Views on Particular Services Respondents were asked for their views on the provision of particular services: two of these had been those indicated in a preliminary study to be mainly provided in Malta (see Borg, 1983 in S3.6.1), that is, tax advice and financial accounting services, while another - executive recruitment for clients - was claimed by two pilot respondents as a relatively new service the provision of which was particularly controversial with respect to auditor independence. In addition to comments on these services, respondents were asked to comment on any other particular services they wanted to.

The Provision of Tax Advice Almost all respondents (20A,19M) found no objection to the provision of tax advice by the auditor, and the overall opinion IASS and the average one of each group was 1.75. Most (15A,14M) added that an auditor was usually the most suitable person to give such advice, because he already knew much about the company in his work: *"After all, he is normally the best man around to provide an effective and cost-efficient service" (1A)*. The general attitude by auditors themselves seemed to be, as one auditor put it, *"to give good tax avoidance advice in order to help client as much as possible, while remaining on the right side of the law."* A number of auditors (9) also claimed that this service by the auditor was a spur for clients to be *"persuaded"* or *"influenced"* to abide with the tax law. As one auditor said, *"Were it not for the auditor acting as a tax consultant, most clients would be evading tax."*

Only one manager disagreed with auditors providing tax advice, and he disagreed only where sole practitioners did such work .

> *"Sole practitioners tend more to adopt the mentality of a client's advocate and this easily spills over to the auditing work itself. Moreover, unlike audit firms, they often find it more difficult to have somebody else doing the tax work for them."*

However, in general, tax advice seemed to be taken as a service to be expected by both parties out of all auditors.

The Provision of Financial Accounting Services Most respondents (13A,12M) were not in favour of auditors providing financial accounting services, and there was no significant difference between the groups in this view. The overall opinion IASS was 3.3, being 3.4 for auditors and 3.2 for managers.

Those not in favour were mostly emphatic on the need for an independent *"second opinion"* (5A,4M) or for the auditor not to be *"his own judge"*(4A,6M): they also felt that such an opinion was not possible unless accounting and auditing functions were given to different practitioners. Various conflicts of interest would remain possible unless such restrictions were made (2A,1M). Two (1A,1M) also saw particular dangers to auditor independence where practitioners sought regular accounting work from audit clients simply to keep staff busy at a time of year when the audit work was at a low.

However, some respondents not in favour (2A,1M) still emphasized that financial accounting services should be allowed on a temporary basis where the company's accountant has left and not yet been replaced (2A,1M). Others, also not in favour (6A,3M), reiterated, as in the response to Part (a) of the question, that in case of smaller companies, exceptions could be made to allow even such services, as this was clearly more economical or practicable.

On the contrary, most (5A,6M) of those who agreed to the provision of such services found it unnecessary to have it abolished. A number (5A,6M) referred, as a few auditors had done in Part (a) of the question, to the fact that many auditors were already ensuring any necessary internal controls in their practices, such as avoiding conflicts of interest by segregating staff that was doing accounting from that doing auditing work. Some (5A,2M) felt that the provision of accounting services gave auditors invaluable insight for audit work, while for a few others (3A,1M) it was often much more economical to leave both functions in the same professional firm.

Nonetheless, overall practitioners seemed more willing to accept restriction on this service than in others, and therefore this area is probably the least controversial to start from if any form of regulation were to occur. Given the contrary previous indications by audit practitioners in Borg (1983, see S3.6.1) that it was appropriate for auditors to participate in the preparation of the accounting records of their clients, it also seemed that practitioners were even more willing to accept this than before. However, as will become more evident later [S5.5.4 (a)], an exception still needed to be made in the case of small companies. Perhaps even here the influence of UK practices was evident, as in the UK the preparation of a company's accounting records was restricted in public companies as described in the literature [S2.3.3 (b)].

Executive Recruitment For Clients Many respondents (14A,14M) found nothing wrong with the provision of such a service. The overall opinion IASS was 2.58, and there was no significant difference between the groups, auditors being 2.7 and managers 2.45. Many managers (12) thought that often auditors were most *"fit"*, *"trustworthy"*, *"expert"* or *"competent"* for this, a few (5M) adding that the company reduced its risks when it relied on them. Many auditors (9A) also thought that there was nothing wrong in auditors doing this, as long as the top management continued to take the final decision. They were trustworthy enough (5A), or had sufficient integrity (4A).

Many of the respondents (6A,6M) who disagreed stated that they viewed such work concerning managerial positions as leading to a reduction in auditor independence. Only a few (3A,1M) expanded on this, saying that they felt that with such a service there was a greater possibility of too close relationships being established.

However, response indicated that both parties were not generally so concerned with independence considerations: for many, auditors were trustworthy enough to be in a position to help managers in taking such important decisions.

Other Services Provided By Auditors Services opposed by some respondents were in fact financial advisory services (2A,1M) and secretarial services (2A,2M). Provision of financial advisory services could deter the auditor from commenting on the adverse performance of the company in the area covered by the advice (2A,1M), while secretarial services could result in auditors adopting a *"dependent"* or *"employee"* mentality (1A,1M). In contrast , many respondents did not list any services at all, with some adding that they felt it *"natural"* or *"cost-effective"* for auditors to offer services which did not tantamount to their taking executive decisions in the company (3A,4M), or which auditors were competent enough to offer (2A,3M).

Overall, there was no other service opposed by more than any four respondents, and this continued to indicate that, with the exception of financial accounting services, no non-audit services currently provided seemed to be of much concern to respondents with respect to independence from clients.

(c) Restriction or Disclosure of Non-audit Services The final part of the question proposed two alternative requirements on non-audit services, that were proposals made in recent American literature [see S2.3.3 (b)], with some adaptations following the piloting. Respondents' views were sought on these requirements.

Restriction of Other Services To Non-audit Clients This alternative would restrict non-audit services to non-audit clients in the case of public companies and those with a significant public interest. The latter companies were defined in the interview discussion schedule (see App VI) as *"fiduciary companies and government-controlled companies and corporations."* On their part, *"fiduciary companies"* were defined in the same schedule as *"those to which third party or public funds are entrusted, such as banks."*

Most respondents (12A,16M) did not agree to such a restriction of non-audit services, with no significant difference between auditors and managers. The overall opinion IASS was 3.10, being 3.05 for auditors and 3.15 for managers.

Most (8A,10M) of those not in favour saw such a restriction as unnecessary. A number of them (3A,5M) repeated the reasons given earlier, mostly in respect to the provision of accounting services in (b) above, that there were good internal controls within the practices themselves or that such services gave useful insights to auditors. A few (4A,2M) emphasized that such a general restriction was not cost-effective, even in larger companies. Some others (4A,5M) pointed out that they would be ready to accept such a restriction if it was limited to the provision of accounting services, already discussed in (b) above.

Most (7A,3M) of those in favour of carrying out restrictions saw this as necessary for the appearance of independence or to help maintain the necessary standards. However, a few also pointed out that they were still concerned as to the cost-effectiveness of such restrictions.

Disclosure of Non-audit Services The second alternative proposed not placing any restrictions as in (i) but requiring, instead, full financial statement disclosure of such services by the auditor. Most respondents again disagreed (12A,13M), with no significant difference between the groups. The overall opinion IASS was 3.15, being 3 for auditors and 3.3 for managers.

Of the auditors who disagreed to such a disclosure, most (9) were afraid that users of financial statements would interpret this wrongly and that this would *"reduce the credibility"* or make them *"doubt the integrity"* of the auditor. Additionally, many (8) of the managers who disagreed saw no need to provide auditor-related information to users, two adding that anyone really interested could enquire directly with company management, as banks sometimes did. In contrast, a few other managers (3) disagreed because they saw the measure as not strong enough to effect independence in fact.

On the other hand, most respondents (6A,4M) who agreed stated that disclosure satisfied users' right to know without placing too many restrictions: *"it is a practicable non-restrictive system "* (1M). A few managers (3) added that this would make auditors more aware of the need to retain their independence if they wanted to remain reputable. Others (3A,3M) saw this as a minimum in small companies where it was often not practicable for these non-audit services to be carried out by someone other than an auditor.

In summary, neither auditors nor managers seemed to see much need for either a general restriction or a disclosure on non-audit services, even though such measures are limited to public and public interest companies. This is in line with the response to the earlier parts of the question: overall, for many respondents, the provision of most non-audit services scarcely seems to beckon change, as it has little relevance to auditor independence.

5.3.3 The Introduction of Audit Committees

In the literature [S2.3.2 (e)], audit committees were described by Farmer et al (1987) as a third party influence on auditor independence. Such committees are as yet not introduced in Malta, this potential influence was therefore treated separately by the next question (C.3), which asked for respondents' reaction if such committees, as defined in the interview discussion schedule (App VI), were introduced as financial reporting watchdogs and buffer between auditors and management in the case of public companies and those with a significant public interest.

The views of both auditors and managers showed no significant difference: most respondents (11A,14M) were favourable to the introduction of such committees, and the overall opinion IASS was 2.58, being 2.7 for auditors and 2.45 for managers. However, the almost divided response on the part of auditors was consistent with what Borg had indicated in 1983 (S3.6.1).

Most of those favourable to the introduction of committees (10A,11M) thought that these would lead to a more independent audit. Such committees could act as a check against pressures on auditors by managers, particularly by those with a dominating personality (6A,3M). Reference was commonly made to the fact that such committees could review and even recommend action to the Board of Directors on matters related to the auditor's appointment or its termination, such as on remuneration (3A,2M), services to be provided (4A,1M), disagreements particularly with the main executives (5A,4M), and on a lack of cooperation with auditors on the part of management and staff (3A,1M). Such non-executives committees could therefore also improve the auditor-management communication (2A,3M). *"Auditors would not have to deal with too many directors on the main board who are often at present too busy doing other business"* (1M). Here a number (8A,4M) also referred to the implementation of the letter of weakness: it stood a much higher chance of being quickly implemented with the presence of such a watchdog.

However, many (7A,6M) of the respondents in favour stated that such committees would yield positive results only if the persons appointed in them had sufficient professional expertise. A few (2A,2M) doubted whether enough persons of the right calibre could be available locally.

Most (7A,2M) of those who did not agree to such committees felt that such an idea would not be implemented well, particularly in government-controlled companies, because the appointed people would probably not be of the right calibre. A number (6A,3M) felt sceptical of committees in general, stating that these would end up being bureaucratic - wasting too much time (5A,1M), or even splitting the board (1A,2M). A number (4A,3M) felt that there would be better results if, instead, internal audit sections were established that would help external auditors by reporting more frequently to the Board of Directors. Finally, a few (3A,1M) felt that a priority was the appointment of a higher calibre of directors to the Boards in the first place.

It is to be noted that, although no respondent referred to such a possibility, this committee made up of non-executive directors would probably be the optimal venue for proper action on the detailed report by auditors proposed by the Fifth Directive. This report, which has already been referred to in S3.5.2 (a), relates to the results of the auditors' work and their important observations on the company.

In conclusion, most respondents considered that the appointment of such committees could be a positive step towards improving auditor independence, but that their projected success seemed to hinge on whether suitable people would be found and asked to join such committees. The Maltese accountancy profession, particularly the MIA, will probably do well to foster member interest in this direction.

5.3.4 Legislation Protecting Independence

The next two questions (C.4 and C.5) gave examples of legislation that may be considered protective of auditor independence and asked respondents on their opinion as to their introduction. The objective was to see how far both groups wanted such tighter laws in order to enhance auditor independence.

(a) A Statement of Circumstances The first question (C.4) specifically asked whether an auditor should be required to make a British-type statement of circumstances, as defined in the interview discussion schedule (App VI), to his client company, the Registrar of Commercial Partnerships and, if considered necessary by him, to company shareholders, irrespective of whether he resigned, was dismissed or did not seek re-appointment.

Most respondents (14A,16M) agreed to such a requirement, and there was no significant difference between the groups. The overall opinion IASS was 2.24, with auditors being 2.28 and managers 2.2. Many (8A,10M) felt that this would strengthen the position of the auditor as regards independence; a number (7A,7M) specified that the auditor would be protected against unfair dismissal. Some, mostly auditors (7A,4M) saw this new provision as important because they considered insufficiently effective the letter of etiquette or *"clearance letter"* required by the Code of Ethics of the MIA (1986: S8). Many (5A,4M) here repeated what has been already laid out in S5.2.5, that the Institute could not effectively monitor defaulting members. Other respondents (4A,3M) stated that with such a statement management would probably exert less pressures on the company to dismiss auditors. Unfair dismissals would become more easily known outside the company (2A,2M), and even new potential auditors would think more seriously before accepting appointment in such circumstances (1A,1M).

On the other hand, most (6A,1M) of those not agreeing to this statement feared increased court action by client managements for claimed defamatory matter, or the difficulty of ensuring a clear, non-controversial statement. Some (4A,3M) saw no need to send such information outside the company, and were mostly (3A,2M) afraid that this would lead management to mistrust because of the possibility of auditors disclosing to outside parties.

The overall response to this question indicated that most respondents wanted to tighten the legal framework in such a way as to bring the regulation of the termination of the auditor's appointment more in line with the UK one.

(b) Auditor Rotation and Dismissal on Proper Grounds The next question (C.5) asked respondents on the introduction of the proposals in the draft Fifth European Directive on Company Law Harmonization (see S3.5.1) that:

i - the auditor be appointed for a 3-to-6 year period, subject to re-appointment and therefore a maximum period of 12 years;

ii - his dismissal within his period of appointment to be only on *"proper grounds"* either in general meeting or by the Commercial Court or similar administrative authority (eg Registrar of Commercial Partnerships) on application by the board of directors, a director or one or more shareholders.

As regards proposal (i), respondents mostly (13A,12M) did not agree to such a rotation system, with no significant difference between auditors and managers. The overall opinion IASS was 3.03, being 3.10 for auditors and 2.95 for managers. This overall unfavourable reply confirmed the indications given by Borg in 1983 (see S3.6.1).

Most were against such a system because this would commit auditors and managers unnecessarily to the termination of sound relationships, often built on trust over the years.

> *"Once you know the history of an enterprise, you can give it good advice. It takes years for an auditor to build up the experience"* (1A).

The lack of familiarity of new auditors with the company led to several disadvantages, including extra costs in the search for evidence (2A,1M), and much more emphasis on trivialities (2A,3M). A number (6A,3M) of respondents stated that they preferred that the audit partner or, at least manager, on the job would be changed. Also, according to a few auditors (2A), most private company managers did not like having to divulge their affairs to different, transient auditors.

On the contrary, those in favour mostly spoke of the need to eliminate auditor complacency (4A,3M), or to make easier for the maintenance of a standard of independence (2A,3M). Some (4) managers were of the opinion that *"a new broom will sweep clean."*

As regards proposal (ii), respondents (13A,9M) were marginally in favour that dismissal should occur in such a manner, with no significant difference between auditors and managers. The overall agreement IASS was 2.78, auditors being 2.65 and managers 2.9.

Most respondents in favour thought that such a provision would reduce management pressures on auditors, particularly where the auditor's opinion was in conflict with that of management. Such a provision would help dismissal to be done for serious reasons, and even reduce inter-auditor *"poaching."*

Most of those not in favour felt that the client freedom to change to auditors who give the best possible service was more important (4A,6M), or that large problems would arise in interpreting what were *"proper grounds."*(2A,3M). Others (1A,3M) said revealing reasons to the person or body who needed to decide would often worsen any existing tensions and animosities between auditors and managers. Examples given were personality problems on the part of the auditor or his staff (2A), and even professional incompetence (1A).

The overall response to both proposals indicated that, although, as shown also in the previous question (C.4), most respondents were in favour of a tighter legal framework so as to improve auditor independence, they found such proposals, going beyond existing UK requirements, more controversial.

5.3.5 Summary

This section studied the factors perceived by both parties to influence auditor independence of management.

(a) The Main Influential Factors The independence of auditors was seen to be most highly influenced by their integrity and objectivity and, to a lesser extent, by the economic pressure of large fees coming from particular clients.

Tact, technical competence and experience were also important for independence, but other factors - standards and ethical codes , and a sense of idealism - were considered significantly less influential in practice by managers than by auditors. Managers particularly considered the local monitoring of standards and codes as largely ineffective, and perceived some practitioners ready to forsake principles for the sake of retaining their clients.

The relatively low influence of third party factors - the public servant attitude and the existence of legal liability - also indicated that, except perhaps for shareholders, parties external to the auditor-management relationship were exerting minimal influence on independence.

Finally, the influences of close, friendly relationships particularly in small companies, including blood relationships in private exempt ones, were also identified as peculiar factors in this microstate.

(b) Non-Audit Services The provision of such service was not considered a particular problem for independence with the exception of accounting services, unless the latter was provided on a temporary basis or for small companies. Other non-audit services, including executive recruitment for clients, were generally unopposed. As for tax advice, auditors were even *expected* to provide this service. In general, regulating non-audit services was therefore generally seen as unnecessary or even harmful.

(c) Audit Committees The appointment of such committees was seen as positively helping auditor independence provided that suitable persons could be found to run them.

(d) Legislation Respondents wanted to tighten up the law relating to independence by the introduction of the UK-style Statement of Circumstances. However, going beyond the UK model appeared more controversial: auditor rotation was opposed and the proposal for companies to forward proper reasons for their auditors' dismissal, was only marginally accepted.

5.4 Management Fraud Issues

The objective of the questions in this section was to examine the major issues faced by the auditor in most cases where management deliberately acts irregularly. From the initial piloting it was thought that many respondents would probably be unwilling to divulge details on specific fraud cases which they had experienced, and therefore the interview questions were drawn up to answer generally the investigative question: What role do both parties consider the auditor is playing and should play in respect of management fraud?

In order not to impair discussion, fraud was defined widely as *"the use of deception to obtain an unjust or illegal advantage, including the intentional distortion of financial statements and the misappropriation of assets"* (App VI).

5.4.1 The Detection of Fraud and Auditing

The first question (D.1) asked what led to the detection of management fraud. This question sought to find out whether auditing was considered important in management fraud detection, particularly since doubts had been expressed in the literature as to how effective auditing was in this respect (see S2.5.2).

Most managers and also a number of auditors (9A,14M), in fact, said that fraud detection came only rarely through the auditor [*"revealing the tip of the iceberg"* (3M)] while a few respondents (3) even claimed that the auditor was never a source of fraud detection, but only its deterrent. Some, mostly managers (2A,6M), claimed that when auditors discovered fraud, this was generally accidental:

> *"It is not from his tests that an auditor at times detects such frauds. It is rather from unexpected events occurring when on the client's premises or from unusual information given by mistake by managers themselves when interacting with him"* (1M).

Auditors did not emphasize fraud because they were not bloodhounds (5A,4M) and normally took a neutral attitude particularly as regards management honesty (3A,4M). A few respondents (2A, 3M) even added that auditors could not carry out deeper investigations because they either did not understand enough about the company's business (2A) or did not have sufficient time to carry out such investigations (3M). Not being present throughout the year, they often missed out important clues in small companies (2M) such as *"telling family disputes" (1M)*. Some respondents (2A,3M) added that, in any case, auditors were often in too close a relationship with management, and, as a result, found it difficult to take *"rigid"*, *"firm"*, *"clear"* or *"uncompromising"* stands when management wanted, for example, to misstate financial statements.

Many respondents, but more managers (10A,18M), stressed that, after all, most frauds were discovered accidentally. Commonly, many managers (13) stated that it was the case of one manager casually following up some query from outside the company, often in the absence of the manager perpetrating the fraud (13M). Respondents from both groups (12A,9M) also stated that detection was brought about as a result of inter-management dissension, particularly (2A,6M) if the collusive circle became too large.

Interestingly, many managers (12M), as against only a few auditors (2A), stated that good internal controls, particularly management ones, also played a role in the detection of management fraud, although most of these managers (7) added that such controls were far more important for the prevention of such fraud. Two stated ,as an example, that an inappropriate segregation of duties often made it easier for a senior manager to override procedures and commit fraud. Finally, a small number of respondents (2A,2M) thought that employees often came to suspect senior management fraud and spread rumours within their company, putting auditors (2A) or other managers (2M) on the enquiry. As one manager emphasised, *"one common difference in a small country is that indicators like extravagant lifestyles of those committing the fraud are easier to find out."*

Overall, however, no respondent attached much importance to the existing role of the auditor in management fraud detection.

5.4.2 Internal Controls and Fraud

The next question (D.2) treated the need for legal requirements relating to internal controls and an increased role for the auditor in this respect. Its objective was to see, beyond the attitude of both parties towards changes in this area, whether such changes were considered important and beneficial as against management fraud. The question concentrated on those companies which were of direct interest to the public and therefore more subject to outside concern, that is, public companies and those with a significant public interest.

(a) A Proper System of Controls Part a.i of the question asked whether in such companies management needed to be specifically required by law to maintain a proper system of internal controls in addition to proper books of account. There was no significant difference in the response of auditors and managers - most respondents in both groups (12A,17M) agreed to such a requirement and the overall opinion IASS was 1.95, being 2.30 for auditors and 1.65 for managers.

Many of those in favour thought that such controls would be *"effective in preventing fraud"* (9A,11M), or would *"lead management to be more careful"* (2A,5M), or *"increase public trust"* (3A,4M). However, they often (8A,10M) mentioned the need for the law to clarify what was meant by *"proper"* internal controls; a few (3A,4M), although agreeing in principle, felt that the law could not achieve such a clarification. Additionally, some (5A,2M) of these respondents thought that it would also be helpful if the law was more stringent on what were proper books of account, which were previously referred to in S3.4. They wanted the law to require that records and details be kept even of the end-of-year stocks held by the company.

On the other hand, those not in agreement (8A,3M) saw no need for legislation, mostly (6A,2M) because they felt that the management in such companies already generally felt that it was in its interest to install internal controls and that there was no need to impose this.

Nonetheless, in general, such a legal requirement was considered worthwhile for the prevention of fraud.

(b) Additional Management Statements Part a.ii of the question then asked for the opinion of both groups as to requiring the following statements in the directors' report or in a separate additional report

(i) an acknowledgement by management of its responsibility for preparing the financial statements and maintaining a proper system of internal controls.

(ii) an assessment of the effectiveness of internal controls and how management responded to any material weaknesses identified by the auditor.

These proposed requirements were substantially similar to the proposal by an American Commission (NCFFR, 1987) already referred to in S2.5.3.

Management's Acknowledgement of Responsibility This first statement had 21 respondents in its favour, but there was a significant difference between the response of managers and auditors. Most managers (14), as against only a few auditors (7) were in favour and the opinion IASS was 2.82 overall, with 3.25 for auditors and 2.4 for managers.

Those in favour argued that such an acknowledgment clarified matters and made directors more aware and careful of their duties. However, most (12A,6M) of those not in favour claimed that such statements would be misunderstood by users as an indication that financial statements were not reliable, or that the auditor was not taking full responsibility for his opinion on the accounts.

In addition, a number of respondents (9A,5M), while seeing such a new requirement as beneficial, stated that, for clarity purposes both to management and to outside users, this needed to be accompanied by another requirement already discussed [S5.3.2 (b)]: the prohibition of the provision of financial accounting services by the auditors of such companies.

Overall, however, auditors were here clearly more pessimistic than managers that such an acknowledgement would indeed be of overall benefit.

Effectiveness of Internal controls and Response To Auditors This second statement assessing the internal controls and management's response to any material weaknesses identified by the auditor was also a controversial question. Just over half the respondents (11A,11M), were in favour of this requirement, with no response difference between the groups. The overall opinion IASS was 2.8, auditors showing slightly more disagreement at 2.95 as against managers' 2.65.

On the one hand, most respondents in favour (6A,10M) thought that this would help prevent the incidence of errors and fraudulent activities, mostly (4A,6M) because the management team would feel pressures to devote more attention towards improving internal controls, once it knew that such information was to be more in the public eye. As one auditor put it, *"it made management more accountable."*

On the other hand, most (8A,6M) of those not in favour did not refer to such positive effects but were concerned that, as in the case of the previous statement, this would give rise to user misunderstandings (3A,4M) and even harmful shareholder over-reactions (3A,2M). Some managers (3) even felt that by pointing out the weaker control areas one might actually help to generate new employee irregularities.

Interestingly, in their reply, most respondents in favour (8A,10M) also indicated that they wanted the directors' report to be expanded beyond the present requirements to include, besides the information referred to in the question, that at present being provided optionally by a few interested companies. Common examples included an outline of the year's events (5A,4M) and the prospects for the following year (6A,3M).

In general, while both the required statements in Part a of the question were marginally considered beneficial, the fact that no similar changes had been made in the UK seemed to render them as yet too new to be readily acceptable to respondents.

(c) The Role of the Auditor Part b of this question then asked respondents about the role which they saw for the auditor if the requirements in the preceding parts were to become law, with the required statements in a.ii forming part of an enlarged directors' report.

Regarding the requirement in Part a.i, most respondents (12A,14M) felt that such a specific legal provision on internal controls did not need to be accompanied by any changes to the auditor's present practice - that of not testing in detail the system of internal controls unless this was intended to be relied on. A common comment (9A,7M) was that the auditor was already doing sufficient reporting at present in this area by means of his letter of weakness to senior management. A few (4A,3M) thought that auditors should present this letter to the annual meeting of shareholders, but others (2A,2M) feared that this could be a source of unnecessary controversies at such a meeting.

As for the required statements in Part a.ii and their forming part of an enlarged directors' report, most respondents (12A,15M) felt that, particularly if in any way enlarged, the directors' report needed to be reviewed by the auditor for consistency in the areas relating to financial statements. This would bring the auditors' duties in line with existing UK law and EC Directives [see S3.5.2 (b)].

However, most (10A,9M) emphasized that if those particular statements required in Part a.ii came into effect, the auditor should not actually extend his current level of tests because of them. They were clearly willing to effect change only up to the point of bringing the local position in line with the existing UK one.

On the contrary, a minority of managers (5M) wanted the auditor to assume more duties in respect of all requirements in Part a.ii. These felt that, in order that the auditor in these companies may become more *"successful"* or *"effective"* against management fraud, he should be made, as part of his work, always to test those controls, and report his findings on their strength to the shareholders.

In conclusion from both parts of this question, respondents marginally accepted the importance of most of the proposed legislative changes related to management's duties on internal controls, and most of those accepting them appeared to do so for the sake of fraud prevention. However, respondents still did not really want any significant change in the auditor's current role in this area, and, in particular, any change taking the Maltese auditor beyond the existing role in the UK.

5.4.3 The Auditor's Responsibility for the Detection of Fraud

The next question (D.3) dealt with the auditor's responsibility in respect of the detection of fraud. It asked for the opinion of respondents as to whether the auditor should have a wider responsibility for such detection than he had at present. Neither group agreed to any extension of responsibility, and there was no statistical difference in each group's response, with only one auditor and six managers agreeing to it (1A,6M). The IASS opinion score was 3.65 for auditors and 3.2

for managers.

Most respondents (14A,11M) started by stating what they understood to be the existing position: this was approximately that the auditor had a duty to express an opinion on the accounts and therefore, to perform this duty properly, he had the resultant duty to work in such a way as to detect any fraud that was material to such an opinion.

Many (8A,8M) of those not in favour of extending responsibilities beyond this added that such an extension was not normally desirable, because it was harmful to the relationship with management. The reason for this was that the auditor would have to take up the role, unwanted by management, of the policeman (2A, 2M) or internal auditor (2M) or would be doing the job which management felt belonged to itself (1A,4M). If the company really needed this, then it could engage the auditor to do an extra service in this connection (4A,3M). An exercise combined with the annual audit could have undesirable consequences: *"With a combined exercise auditors could be bogged down by details and made to tone down their current role of rendering reliability to financial statements"* (1M).

Others thought that it was impracticable to go beyond the present level of responsibilities (10A,6M) and the main reasons given were that most local companies would find such an audit too expensive (6A,3M) and that auditors had not evolved enough techniques or expertise for this, particularly in respect of fraud not relating directly to financial statements (4A,2M). There were also those (2A,3M) who claimed that it was too difficult, except perhaps for owner-managers themselves in small companies, to discover most management frauds: *"Even if auditors watch management closely throughout the year, such an exercise will probably still prove inconclusive"* (1A).

The few respondents, mostly managers, (1A,6M) in favour of extending responsibilities to auditors stated that auditors were too risk-averse as a profession and that shareholders and users demanded more of them than what they were currently delivering.

However, it seems from the above that extension of auditor responsibilities is generally opposed by both auditors and managers. Perhaps what is really needed is what a number of managers (4) termed a *"tougher"* attitude on the part of auditors in dealing with management. As one manager typically put it:

> *"The auditor needs to be more 'pushy', asking more questions and less of a passive watchdog when dealing with management. He cannot simply assume that management is honest or reliable."*

One practical way of implementing this is to recommend, and, eventually require, Maltese auditors to be on the lookout for the existence of *"red flag characteristics"* as referred to in the literature (see S2.5.4).

5.4.4 The Reporting of Management Fraud

The next question (D.4) dealt with the reporting of management fraud. It presented the case of the auditor uncovering material fraud, in which management was implicated, and asked for respondents' views on a suggested procedure that mainly followed the recommendations in the relevant UK auditing guideline (APC, 1990); these have already been described in the literature (see S2.5.6). It was suggested, in the first place, that unless the auditor had no confidence in the integrity of senior management, the latter should be informed by the auditor and requested to deliver an adequate company report within a specified time to persons or bodies with a *"proper interest"* to receive such information. In addition, the question suggested that the auditor should be empowered by law, in case of management not complying with this, to override his duty of confidentiality and report directly to the persons concerned. Shareholders were also included with the these interested persons particularly because, as already discussed in S5.3.4(a), unlike the existing position in the UK, where on termination of appointment, the auditor is required to send a statement of circumstances that he may choose to pass on to shareholders, the Maltese auditor has no similar provisions enabling communication.

A minority of respondents (10A,6M) agreed to this procedure without reservation and the opinion IASS score in this regard was 3.1 for auditors and 3.3 for managers, with no significant difference between the groups in their overall acceptance of the proposal.

In the first instance, most respondents (15A,18M) stated that they knew of no case to date where the auditor had reported management fraud to parties beyond shareholders.

Those in favour then indicated that they saw it useful to protect all those concerned - auditors, shareholders and outside third parties. Some (3A,3M) added that this extension of reporting rights would enable the auditor to fulfil better his current role.

On the contrary, most respondents (10A,12M) were ready to accept that the auditor be required to request senior management to deliver a report to all concerned, but were still of the opinion that if management did not act accordingly, the auditor should not report himself to the interested parties, but should resign (6A,5M) or simply consider resigning (4A,7M), some adding that, in the latter case, if he stayed on he would at least ensure that the financial statements showed a true and fair view (4A,5M).

Many of the respondents not in agreement (9A,8M) also stated that the whole procedure could be made to apply to shareholders only, but not to outside persons or bodies. A number of these (5A,4M) emphasized that such information needed to be so given without being made public, while others (4A,3M) added that it was to be given even to shareholders only as a last resort. Some added that this would commonly be when the routine annual reports, such as the directors' or auditors' reports were not seen enough for this purpose (3A,3M) or, in the case of an auditor terminating his appointment, as long as there was no newly required statement of circumstances, as already mentioned above (2A,1M).

A common reference by most respondents (9A,12M) not in agreement was to the importance of professional secrecy for the auditor to retain the trust of senior company management. Some (5A,2M) were particularly afraid that if the auditor was *"empowered"* to override easily his duty of confidentiality, this right would soon give way to a duty expected out of him from users and particularly from the public authorities. One view (4A,2M) was that the auditors would finish off as a *"government inspector"*, mistrusted by the company appointing him, and often, as a result, becoming much less informed on what was really happening. The overall frame of mind of those particularly opposed to giving the auditor such power is probably best reflected in the comments of two respondents:

> *"In our small community , the mentality is that if you roll over stones in the end you will hurt your toes. So most auditors will prefer the authorities to find any irregularities for themselves"* (1A).

> *"People in a small place like Malta often know much more than they dare inform the authorities.If auditors are required to blow the whistle, management will start keeping them in the dark"* (1M).

Probably, rather than legislating for wider reporting responsibilities for auditors, a better start may be for the relevant outside bodies or authorities to be empowered to perform a *"direct"* or *"more effective"* monitoring role themselves. In fact, a repeated example given by respondents (6A,4M) was that of *"giving teeth"* to the

Registrar of Commercial Partnerships by amending the CPO to allow for the appointment of inspectors to carry out investigations on companies. Nonetheless, the Malta Stock Exchange Bye-Laws (Malta Stock Exchange, 1991: para 4.12) issued recently , although relating to a specialized audit, may be indicating the writing on the wall: in the audit of stockbroking firms, the auditor was required to lodge a report in writing to the Chairman of the Stock Exchange (with a copy to the firm itself) *"as soon as practicable"* after becoming aware of any matter which in his opinion adversely affected the financial position of the firm *"to a material extent"*, or after discovering evidence of a contravention by the stockbroking firm of the regulations. Therefore, although they may not like it, both auditors and managers probably need to accept fast change in this direction. After all, as seen in the literature (S2.5.6), something similar has already happened in the UK.

5.4.5 Common Management Fraud Areas and the Overall Relationship with Auditors

Respondents were finally asked (Qn D.5) whether they could mention any cases of management fraud encountered , their views on auditors' responsibility thereon, and for any further comments on how this type of fraud affected the overall auditor-management relationship.

(a) Fraud Cases Nine respondents (3A,6M) opted not to refer to specific cases, while another ten (6A,4M) stated that they had never personally encountered management fraud. Response was in general concise, and cases referred were as follows; kickbacks from suppliers inflating purchase prices (4A,3M), collusive purchasing or selling (2A,3M), favours for friends and relations (2A,3M), including the award of uncompetitive contracts detrimental to the company (2A,3M), income tax evasion (2A,4M) and customs duty evasion (1A,1M).

(b) Auditors' Responsibility in the Cases Many of these respondents (8A,9M) claimed that no auditors were personally implicated in these frauds. Furthermore, many (8A,6M) stated that most of these *"frauds"* were no more than *"reasonable"* suspicions to company auditors, most (7A,5M) adding that the auditors had not reported any such frauds to third parties beyond shareholders. Furthermore, some (1A,4M) said that they knew auditors who were implicated in tax evasion, but only two managers elaborated here, adding that some auditors would unfortunately close an eye to what was happening, often, as one stated, *"opting not to bite the hand that they fed on."* As regards pressures by management to minimize tax, this subject is taken up again in another section (S5.5.3).

(c) Overall Effect on the Relationship In a final comment on how respondents saw management fraud as reflecting on the overall relationship with the auditor, many (10A,14M) stated that the fact that this could occur without being detected or reported showed, more than anything else, that auditors provided *"little or no protection"* against bad managers: the latter could be *"much stronger"* (4M) or *"more powerful"* (3A,2M) and were able to render auditors *"largely impotent"*(6A,5M). Some respondents (6A,5M) also indicated that, for the same reason, in the eyes of users the financial audit was therefore likely to remain a restricted exercise, not worth emphasizing. As two respondents put it,

> *"Users know that management can manipulate the situation to a large extent and that this can render auditors subject to the dictates of less scrupulous directors. One cannot do much about that"* (1M).

> *"Management can forego proper behaviour and easily get away with it as regards company outsiders. The auditor is really limited in his work by how honest management is"* (1A).

In other words, not only was the auditor-management relationship adversely affected when management acted fraudulently because it rendered the auditor largely impotent, but even the possibility itself of such frauds seemed to be devaluing the whole worth of auditing to users.

5.4.6 Summary

This section attempted to examine the major issues faced between auditors and managers regarding management fraud .

(a) Auditor's Role in Detection The auditor did not seem to play an important part in management fraud detection: this was claimed to be occurring mostly by accident.

(b) Internal Controls and the Auditor The need was mostly agreed for legal changes on controls in public or public interest companies in order to prevent, rather than detect, such fraud. These would specify management duties towards internal controls and also require, possibly in the directors' report, management to acknowledge such duties and to disclose information on the controls. Yet, the auditor's role in this control area was not felt as needing change, except for the related adoption of the existing UK auditor requirement of reviewing the directors' report for its consistency with the financial statements.

(c) Extension of Detection Responsibility The auditor was not known to be reporting management fraud to third parties beyond shareholders, and the extension of his responsibility for the detection of fraud was generally unwanted by both parties, as this was seen undesirable and harmful to the relationship, or even impracticable.

(d) Extension of Reporting Responsibility Both parties were also mostly opposed to reporting such fraud to outside parties, but not to shareholders. They felt that the existing secrecy fostered auditor-management trust. Outside bodies or authorities wanting such information probably need to be empowered to effect their own supervision on companies.

(e) Common Frauds and Overall Effect on the Relationship In the mentioned fraud cases, auditor involvement was claimed, by a few, in client evasion of income tax. Furthermore, despite being generally against change, both parties agreed that the fact that auditors could leave management fraud undetected or even unreported showed that he served little or no protection as against managers abusing their powers.

5.5 Small Company Issues

The main purpose of this section in the interview discussion schedule was to answer the investigative question: What are the problems of auditing small companies and what role does the auditor need to play in such entities?

The interview discussion schedule (see App VI) gave the meaning of a *"small company"* as *"one having the following characteristics: (i) only a few employees in relevant accounting and administrative functions leading to a limited or inexistent segregation of duties; and (ii) with domination by the senior management or owner over all essential aspects of the business."* This was a version, amended during piloting, of the IAPC (1989) definition given in the review of the literature (S2.6.1).

The first question asked respondents whether they saw the need for the small company audit, how far such an audit should be different from that of larger companies, and for any complications seen by respondents in such an audit. The second question sought to find whether management pressures to minimize tax liabilities were an increasing problem in the presentation of small company financial statements. A further question sought respondents' views on a few suggested small audit requirements, if such were to be introduced by auditing standards set specifically for small companies. The final question related to private exempt companies, as many small companies probably are, and asked for respondents' views on abolishing the permitted secrecy in respect of the financial statements and the auditors' and directors' reports of such companies.

5.5.1 The Need For the Small Company Audit

On the need for the audit of small companies (Qn E.1a), there was no significant difference between the response of auditors and managers. Only eleven respondents (4A,7M) saw no need for the small company audit. The overall intensity IASS was 3.03, with auditors reaching 3.22 and managers 2.85.

Many respondents (8A, 10M) mostly reiterated what they had stated in Question A.1 [see S5.2.1 (a)] for all companies, stating that even more in the case of a small company, an audit was a positive influence on management in running its company.

> *"For small companies, the audit is often the only chance in practice for managers to meet financial professionals and benefit from their expertise"* (1M).

> *"It settles inter-management disputes on how the company is really doing"* (1A).

> *"It is a psychological deterrent, a positive discipline for management and staff"* (1A).

However, most (8A,7M) of these respondents added that such help in itself was often not enough to justify its statutory cost: a number (5A,5M) felt that there was little need for such an audit where the management of the company involved all the owners (4A, 3M) and/or the company had no bank or similar loan finance (3A,2M). In such cases there was *"little need to pay such a price for limited liability"* (1M). There was no need for shareholders to monitor what was going on, and not even a main normal user, the bank, was interested. However, a number (2A,2M) stated that there was often another interested party, the Department of Inland Revenue, to whom an audit would probably be more suitable in the small company case.

A further number of respondents (8A,3M) stated that a small company audit was needed for other reasons. Besides a few again referring to the needs of the Inland Revenue (1A,1M) and the banks (2A), in the opinion of others it was a mistake not to require it, because that was how investors (3A,1M) and even owner-managers themselves (2A,1M) were informed of how their investment was really faring.

All those who found no need for an audit (4A,7M) thought that the question of the small company audit should become a voluntary one to the shareholders of each individual company. Many (3A,6M) also added that these companies were mostly proprietary or owner-managed, and that the outside users of their financial statements were strong enough to require an audit from them if they wanted to. In the experience of these respondents, users did not on fact find the audit report as an *"important"* or *"reliable"* product, and the audit only amounted to an unnecessary cost.

From the above analysis, there seemed to be a case for allowing small, owner-managed companies to decide whether they wanted an audit or not, particularly if they had no bank or similar loan finance. However, for this to occur, changes needed to be made not only to the requirements of the CPO but also those of the Income Tax Act, Cap 123. An alternative taken up in a subsequent question (E.3) involved having an audit tailor-made for the small company.

5.5.2 The Difference between Large and Small Audits

The second part of the first question (E.1b) started by asking for respondents' views on how far a small company audit was different from the audit of larger companies. Almost all respondents (18A,20M), with no statistical difference between the groups, said that there were differences. The overall intensity IASS was 3.76 with auditors reaching 3.72, and managers 3.8. The general reply (14A,16M) was that it involved the same basic *"principles"* or *"objectives"* as that of a larger audit, but required a different *"approach"*, *"methods"* or *"techniques."* Most (11A,13M) added that the relationship with managers was necessarily more *"intense"* or *"close."* Many added that this occurred because auditors needed to rely more on them (10A,11M).

> *"Here you really have to know better the manager - often the owner-manager. That is how you will manage to extract out of him the relevant information which often only he knows"* (1A).

> *"The difference is that auditors* do have *to establish a closer relationship with managers. Otherwise, what will there be to help them decide on what managers are telling them? Unlike the situation in large companies, they often cannot obtain independent sources of information"* (1M).

However, here a few (3A,2M) referred again to barriers against the development of the desired level of closer relationships, which were already mentioned in discussing auditors' lack of trust in managers [Qn B.1 see S5.2.2 (e)] : in short, the auditors' fear of over-familiarity by managers and the lack of openness by managers.

Moreover, many respondents (11A, 9M) also stated that, more often than in large companies, auditors still found it more difficult to assess how far management representations were reliable. Most (9A,8M) added that it was particularly difficult to be sure that the recorded transactions were complete, and to rely on such records, as in most larger companies: *"after all, given its strong domination and the small number of employees, management could always be tempted to manipulate records or controls"* (1M).

Therefore, it seemed that while getting closer to managers was helping auditors to assess better their reliability, they still often remained doubtful on whether to rely on managers' representations, particularly as regards completeness of records.

Other mentioned differences between large and small audits were that a system-based approach relying on controls was often impracticable (6A,7M), and that much more vouching work was needed (5A,3M).

5.5.3 Management Pressures To Minimize Tax Liabilities

References to the understatement of profits and to the possibility of tax evasion in local small companies were already made in the review of preliminary studies [Sciortino (1983) and Saliba (1987) in S3.6.4]. Furthermore, various references to tax evasion have already been made earlier in this survey itself [see S5.2.2 (e), S5.2.5 and S5.4.5 (b)]. The next question (E.2) took up this issue in respect of small companies with both parties, enquiring whether *"management pressures to minimize tax liabilities"* were an increasing problem in the presentation of small company financial statements. The views of both groups of respondents were very similar, and only five respondents (3A,2M) agreed that this was an increasing problem. Additionally, the overall opinion IASS was 3.35, with auditors being 3.55 and managers 3.15.

Most respondents (16A,14M) stated that management pressures to minimise tax were *"constant"* or *"fixed."* In fact, they did not appear to vary to any noticeable degree even following cuts in tax rates a short time before (11A,8M). Most (13A,11M) added that tax evasion attempts on the part of the small businessman were common because they originated from an *attitude"* or *"mentality"* that could only change in the long term. In this connection, the chairman of one small company openly admitted that *"few small companies consistently declare all their income, and my company is not among them."* One manager emphasized that *"the way a small businessman looks at an auditor is that he is good as much as he can tolerate tax dodging."* A few (2A,1M) gave as the probable reason for the existing local *"low fiscal morality"* that taxation was still thought to be excessive. Some respondents (8A,5M) pointed to the high level of cash transactions in small, owner-managed companies as a symptom of such tax evasion.

> *"Many owner-managers are wary of the possibility of an Inland Revenue investigation, that often includes requests for bank statements. So they ask for or pay in cash so as to leave no trace of their hidden extra income"* (1A).

About auditors' role in tax evasion, a few managers (4M), mostly the same as in S5.4.5 (b), stated that some auditors often gave in to such pressures in smaller companies.

> *"Where they come to know about management misstating financial statements so as to evade tax, auditors are rarely able to put their foot down and stop it "* (1M).

> *"My experience has been that if small company profit figures are seen too high by management, some auditors will be prepared to reach a compromise and accept lower figures"* (1M).

On the other hand, a number of auditors (8A) said that it was difficult for them to know when small company management was understating profits, and a few audit firm partners (3A) also emphasized that they made no compromise in this respect, and would simply resign from their audit job if their clients continued to press them.

A few respondents (2A,2M) were also of the opinion that management pressures to minimize tax liabilities were in fact decreasing because, over time, more managers were realizing that the understatement of profits inhibited their company's growth, mostly (1A,1M) because it resulted in the portrayal of too adverse a picture to outside potential lenders, particularly banks.

However, as seen, the majority saw it as a practically static problem.

5.5.4 Changes To the Small Company Audit

The next question (E.3) asked for respondents' views on suggested changes in the audit small companies through the issue of auditing standards for small companies. The objective of the question was to see how far both groups of respondents felt that changes in this type of audit would be beneficial.

(a) Allowing Both Compilation and Audit The first part of the question (E.3i) asked for the views of respondents if, in the case of small companies, new standards would still expect management to retain responsibility for financial statements, but allow audit practitioners both to compile them on its behalf and to audit them. In a previous question [see S5.3.2 (b)], it was stated that while most respondents (13A,12M) were not in favour of the provision of financial accounting services by the auditor, a number of them (6A,3M) referred immediately, though unasked, to exceptions which they wanted to be made in small companies. In comparison, response here showed that most respondents (19A,15M), with no significant difference between the groups, agreed that, in the case of such companies, auditors would be allowed also to compile the financial statements. The overall opinion IASS was 2.09, 1.82 for auditors and 2.35 for managers.

The common (15A, 13M) argument of respondents in favour was that for the auditor to do financial accounting services was often cost-beneficial in this case: *"following contact with the auditor for accounting purposes, the small audit will remain efficient and less costly"* (1M). Requiring different practitioners for compilation and audit was therefore considered a *"waste"* (8A,6M) or *"a luxury"* (1A,3M) because the engagement of a separate financial statement compiler gave rise to costs that small companies could not afford. On the other hand, those against mostly (1A,3M) maintained that the audit was useless if it did not render a second opinion on what the compilers did. A few (2M) were even afraid that, if this was generally accepted, some auditors would actually do no work beyond the compilation of the financial state-financial statements of the company.

(b) Changing the Audit Report It was found in the literature (S2.6.3) that auditors may find particular difficulties in placing reliance on small company internal controls, and in her study Magri (1991, see S3.6.4) confirmed that this situation in fact existed locally. In addition, some of the piloted respondents (1A,1M) stated that auditors were at a loss on how to refer to such a lack of reliance on controls attributable to company size. One of these piloted respondents, an auditor, suggested that some new standard report was needed for use in such common cases that was to be more suitable than the *"notorious Example 6 report of the UK."* This latter report and developments thereon were already referred to in reviewing the literature (Ss 2.6.4, 3.6.4 and App III).

Therefore, the next part of the question (E.3ii) enquired whether respondents agreed with a proposal on the small company audit report, aimed at making it tailor-made to the situation. It was suggested that small company audit standards would stipulate that a lack of reliance on internal controls would be taken as normal and that therefore the auditor would not have to refer to this fact in his reports relating to such companies; if, then, the auditor did rely on such controls, he would have to disclose the extent of such reliance.

Three-quarters (15A,15M) of the respondents agreed with this proposal, with no difference between the groups. The overall opinion IASS was 2.30, auditors being 2.25, and managers 2.35.

Respondents who agreed added that such a report would be more *"positive"* (2A,5M), *"useful"*(3A,4M) or *"meaningful"*(1A,4M) to readers than existing reports or that it would encourage management to improve controls so that the auditor could report increased reliance (9A,5M).

"I agree to this. You can see the progress in the company's

systems by it.. It makes sense where there is growth involved, and encourages management to improve" (1A).

"Stating in which control areas the auditor is actually trusting management enables the user to compare with the previous year: he can obtain an idea on how the company and its management are improving its control areas" (1M).

Some managers emphasized that such a *"small company report"* needed also to explain, more clearly than in existing practice, the general circumstances of the small company (5M) or the meaning of *"internal controls"* for this purpose (2A).

It is relevant to point out that only a minority (4A,2M) of these respondents who agreed showed that they were aware of the 1989 UK audit report standard that practically dropped the *"Example 6"* report (see S2.6.4). Given the influence of existing UK practice, it is probable, as becomes clearer below, that some respondents would have changed their opinions had they known this.

In fact , auditors (5A) not agreeing to the change suggested by the question all indicated awareness of the UK changes. Most (4) of them stated that they did not want to adopt a new report on the proposed lines which was *"very different"* from the new one prescribed by the UK audit report standard. Three of these even added that they would even still prefer to continue to use, although *"exceptionally"*, or, *"only where necessary"*, the *"Example 6"* report.

On the other hand, the managers who were not in agreement with the question proposal (5) did not indicate any awareness of UK changes. Most (4) stated that they were satisfied with the current way of reporting for small companies, and that they simply saw no reason for changes in this area.

Overall , there appears to be a case for introducing the proposal in this part of the question. However, before deciding on this, it seems that auditors need to solve what seems to be a repeatedly resurfacing dilemma: how far to continue to follow UK auditing standards and guidelines.

If this proposal is indeed taken up, the auditor would still need to evaluate the control systems in order to be in a position to decide whether to rely on them or not. Therefore, his level of attestation would always remain higher than that of a review as described in the American literature (see S2.6.5), which does not require such an evaluation.

(c) Adopting A Different Testing Approach However, the remaining part of the question put forward proposals, which, if taken up, would further change the nature of the small company audit from that of the normal audit: the former would definitely have more of the characteristics of a review (see S2.6.5). This part (E.3iii) proposed that while analytical review procedures and internal substantive tests (transaction tests, inspections etc) would be the main audit tests, external verification procedures, such as the observation of stocks and the confirmation of debtors, would not normally need to be carried out.

Almost all respondents (17A,18M) agreed that analytical review procedures and internal substantive tests would be the main audit tests, and most stated that this was already existing practice. However the issue of whether or not the auditor should carry out external verification in small companies was much more controversial. As a result, there was a significant difference between the number of auditors and managers in overall agreement with the proposal in the question: in fact, only a few auditors (6) as against most managers (17) were in agreement. The overall opinion IASS was 2.68, being 3.15 for auditors and 2.2 for managers.

Most (5A,13M) of the respondents agreeing that such external verification procedures should not normally be carried out stated that such work was not cost-beneficial because completeness could not be ensured in this type of audit.

> *"There is a stronger possibility of omissions in small companies. External verification will, in most cases, need to be limited to the places indicated by the one manager"* (1A).

Some auditors (4) referred in particular to debtor circularization and said that response rates in small company audits were often low, because the debtors contacted were often themselves small and disorganized companies.

However, most (13A, 2M) of those against change emphasized that they felt that, despite the limitations of external verification procedures, their omission would lead to an inferior type of exercise and opinion, because new relevant information could possibly be gained by such procedures.

This was an area where auditors significantly saw much more point in their existing practices than managers, and where the former were, as a result, clearly less inclined to change them.

5.5.5 Financial Statement Secrecy

The final question in this section (E.4) asked respondents whether they agreed that the secrecy permitted by Maltese law [CPO: S149(1), see S3.3.4] to private exempt companies in respect of financial statements, and including the auditors' and directors' reports, should be removed. Most respondents (12A,14M), agreed to the removal of such secrecy, and there was no significant difference between the groups in this respect. The overall opinion IASS was 2.42, auditors being 2.45 and managers 2.40.

The main argument in favour (8A,10M) was that both auditors and managers often felt the need to have more access to basic financial information on the majority of Maltese companies, who were private exempt.

> *"At the moment you can hardly know anything about the company you are dealing with"* (1M).
>
> *"Too often nothing is officially available for inter-firm comparisons, and you are unable to gauge one company's performance against that of competitors"* (1A).

Some (5A,7M) added that such a new requirement would put the auditor-management relationship in the small company on a *"more formal"* and *"sounder"* basis, as public access to the figures would be a new deterrent for auditors not to accept their misstatement. Three of these respondents (1A,2M) added also that having such financial information on public record by far reduced the possibility of management issuing more than one set of financial statements for the same period to different users.

A number (5A,3M) considered the removal of secrecy as part of the price of the company of having limited liability, a few (2A,3M) adding that this step was particularly important for the protection of trade creditors.

On the other hand, most (6A,4M) of those who did not agree to the removal of secrecy stated that this would frequently result in the provision of information on a small company that would be useful to its larger and more powerful competitors, and that therefore this would be detrimental to it. A number (3A,2M) also felt that access to the public of these accounts led to unwanted misunderstandings, publicity or pressures.

Nonetheless, it seems that in general the removal of financial statement secrecy would be generally viewed positively by both groups of respondents.

5.5.6 Summary

This section attempted to tackle the particular issues related to small company audits.

(a) The Need While appreciated for their positive influence on management, statutory small company audits were in question as regards their cost benefit, particularly where all shareholders were in the management team and no outside loan finance was used.

(b) The Difference between Large and Small Audits While having the same objectives of large audits, small audits needed a different treatment and required more intense or close auditor-management relationships. However, even given such relationships, auditor doubts often seemed to persist concerning the management representations.

(c) Tax Minimization Pressures Most respondents saw management pressures on auditors to minimize tax liabilities in the presentation of small company financial statements as coming from a static evasion attitude, capable of improvement only in the long run.

(d) Changes Changes were wanted by both parties:

Compilation and Audit Compilations and audits by the same practitioners were agreed as often cost-beneficial for small companies.

Audit report Changes Many agreed to a suggested small company audit report positively disclosing, where applicable, the extent of any auditor reliance on internal controls rather than negatively referring to any lack of reliance on them.

A Different Testing Approach Managers were significantly more inclined to change existing practices particularly as regards external verification procedures: they saw these procedures not normally cost-beneficial for the auditor to go on carrying them out in small companies.

(e) Financial Statement Secrecy Both groups viewed positively the removal of such secrecy in private exempt companies, mainly so that both auditors and managers would have access to more information.

5.6 Other Auditor-Management Relationship Issues

The purpose of this section in the interview discussion schedule was to answer the investigative question: What other issues of relevance to the relationship are there, particularly in government-controlled enterprises?

The first three questions concerned specific issues in the latter enterprises, while the last question asked for other necessary changes to enhance the auditor-management relationship.

Sixteen respondents (6A,10M) did not reply to the first three questions because they felt that they did not have sufficient experience of the sector, but all replied to the fourth question.

5.6.1 Issues Relating to Government-controlled Enterprises

(a) A Public Watchdog and Its Powers The first question (F.1) was placed to probe ways of strengthening the independence of the private auditor in these enterprises. It enquired, in three parts, on the need for a watchdog in this area and on whether this function and specific powers with it could be given to the Director of Audit, who is the auditor of the Government according to the Constitution of the Republic of Malta [S108(1)], but whose regular work does not extend to such enterprises.

The Need For A Public Watchdog The first part of the question (F.1a) asked for respondents' views on the need for a public watchdog to monitor the appointment and removal of auditors. Most respondents, with no significant difference in response between groups (10A out of 14, 7M out of 10) agreed to such a watchdog, and the opinion IASS was 2.33, auditors being 2.36 and managers 2.30. The commonest (8A,4M) reason given was that the management of such enterprises could often exercise a major practical influence on the appointment and removal of auditors and that, added to this, a number of such companies carried substantial audit fees.

Furthermore, some (4A,3M) argued that since there were public funds involved, additional safeguards were felt necessary to ensure that management did not exercise undue pressures on their auditors. One auditor clarified that this was because *"it is more difficult for companies with public funds to exercise proper accountability than those in the private sector - the ultimate owner is not that clear "* (1M).

Many of these respondents (7A,3M) emphasized that such a watchdog would not actually itself end up exercising the power of appointment or removal of auditors. This was better left to the ultimate authority within each individual entity: the watchdog would need to remain truly an overseer of what happened. Reference was also made to giving it the power to *"enquire whatever it considered necessary"* (3A,4M), including consideration of how proper were the reasons for any auditor changes (2A,2M), and that proper rotation was maintained, if that was to be a policy (1A,1M). Additionally, it was suggested that this watchdog should report to Parliament (2A,3M). One manager also added that, if such reporting is not done, *"as a minimum this watchdog should publish its findings to create public awareness and pressures on what is going on."*

Some (2A,3M) felt that such a guardian was even more necessary in those entities, such as Telemalta Corporation, where no shareholders' meeting was provided for in statute, but appointment was made directly by the Minister responsible.

On the other hand, most (3A,2M) of those who did not agree to the need for a public watchdog felt that this would not solve any problems faced in this type of enterprise because such a person or body would not manage to remain *"independent of the Government,"* or *"free of interference by politicians"* in his monitoring and reporting.

Nonetheless, overall respondents felt this need for a watchdog . After all, it is probably true that, as one auditor agreeing to it stated, *"a watchdog can remain serious and independent if it is of the right breed."* The question of *who* could act as such a watchdog was in fact the subject of the next part of the question (F.1b).

However, before analyzing this next part, it is relevant to compare the response here with the reaction of the same 24 experienced respondents to the formation of audit committees in companies *"with a significant public interest,"* that included such enterprises (Qn C.3 in S5.3.3). Response to that question was almost similar, with most (7A,6M) of these respondents agreeing to the formation of such committees. However, only two of the respondents (1A,1M) did not agree to at least one of the two suggestions for some form of watchdog. Most (9A,5M) were in favour of either one or the other, with eight (4A,4M) respondents wanting both forms. This brings more into focus the perceived need for some type of overseer to improve the auditor-management relationship in these enterprises.

The Director of Audit As A Public Watchdog The next part (F.1b) presented a statement suggesting that the public watchdog could be the Director of Audit and his staff *"provided that the position of Director of Audit is filled only by a qualified accountant of recognized standing and experience".* Those respondents in (a) who did not want a public watchdog at all (4A,3M) did not reply to this part, and therefore 17 respondents (10A,7M), experienced in this sector, replied. Many of these (6A,4M) were in favour of the statement, and again there was no significant difference in response between the groups. The overall opinion IASS was 2.71, auditors being 2.70 and managers 2.71. Respondents were in favour mostly (3A,2M) on the ground that the position of Director of Audit was safeguarded by the Constitution of the

Republic of Malta. This provided that removal from office could only be effected by a two-thirds majority vote in Parliament *"on the ground of proved inability to perform the functions of his Office (whether arising from infirmity of mind or any other cause) or proved misbehaviour"* [S98(2)]. These respondents pointed out that because of the security of his position, a *"proper"* Director would easily carry out monitoring without bias. Moreover, almost all respondents (10A,6M), even those who did not agree that the Director should act as a watchdog, felt the need, as yet not required by law, for a Director to be professionally qualified as an accountant and to be of recognized standing and experience.

Other respondents (4A,3M) did not agree to giving the Director of Audit the role of a watchdog. They stated that the work of the Director and his staff should be restricted to Government departments, because, as most (3A,2M) of them added, he was unlikely to be strong enough as a monitor to government-controlled enterprises - he could easily become subject to political pressures, particularly on what to disclose. Some (2A,2M) preferred responsibility to be given to a committee that would include in it not only the Director of Audit as chairman or member but also other interested parties such as the Commissioner of Inland Revenue (2A,1M) and the local banks (2A,2M). A few auditors (2) suggested that monitoring in these enterprises should be done directly by the Malta Institute of Accountants representing the local accountancy profession.

Other Powers to the Director of Audit The third part of the question (F.1c) suggested further powers to the Director of Audit to strengthen its monitoring role on behalf of Government: that he would be empowered to receive and examine the annual audited accounts of such companies before passing them on with any necessary comments to Parliament or to a financial committee appointed by it from its members, such as a public accounts committee. It was suggested that these powers would include that of recommending a second audit, if necessary.

As in the previous part, only the 17 respondents (10A,7M) who were experienced in this sector and who agreed to a public watchdog replied to this part. Most of these (6A,4M) again agreed to the suggestion of the mentioned further powers to the Director of Audit, and there was no significant difference in response between the groups. The overall opinion IASS was 2.82, with auditors being 2.80 and managers 2.86. Respondents in agreement thought that these powers would induce more action by management on the auditors' recommendations so as to improve the financial reports to be presented. Some auditors (3A) suggested that even letters of weakness should become compulsory in this sector and be passed on to this watchdog, so that the latter would be in a better position to evaluate the situation. The right to recommend a second audit to Parliament or to a committee representing it was considered important so as to give the Director the necessary *"tools"* or *"teeth"* (3A,2M). Some auditors (3A) thought that, in addition, in their function they should be allowed to communicate freely and as they felt necessary with the Director of Audit.

Many (2A,2M) of those respondents who did not agree to such powers being given felt that this would be attaching too much weight to a public office holder. Some doubted whether such a Director could build the right expertise to use these powers. One auditor was particularly pessimistic: *" These (powers) could lead to more bureaucracy, rather than to rendering the auditor more independent of management."*

In conclusion, the overall response to all three parts of this question indicates that respondents agreed on the need for some type of watchdog, and that they mostly saw the appointment of a public one as an alternative to that of an audit committee to each enterprise. Yet, it seems that opting for the first alternative of public watchdog would give rise to additional controversy as to whether the Director of Audit should act in such a capacity and be given extended powers of monitoring. Therefore, given also that the introduction of audit committees could be made applicable to other public companies besides government-controlled ones, this second option seems simpler and, in the end, probably more acceptable to respondents.

(b) The Rotation of Auditors Rotation in public sector enterprises was the subject of the next question (F.2), as piloting had indicated that respondents could view its introduction in this context differently from the case in respect of all companies [Qn C.5 in S5.3.4 (b)] .

Of those replying to this question (14A,10M), most (9A,7M) were in fact in favour, and there was no significant difference between the groups ; the overall opinion IASS was 2.46, being 2.50 for auditors and 2.40 for managers.

Most respondents in favour (7A,5M) wanted auditor to be appointed between five and six years, while a few (2A,2M) wanted a longer period for up to ten years. Furthermore, most respondents in favour (6A,5M) thought that rotation would serve as a check or deterrent on auditors that was particularly important or needed in these enterprises in view of the involvement of taxpayer funds. As one manager typically put it,

> *"In practice, no pressure is exerted on auditors by the final shareholder, the taxpayer. Executives and their politician superiors are less accountable and more powerful on the auditor than in other companies. Rotation will help press auditors to remain independent."*

A number of auditors (3A) added that, with rotation in view, auditors would also be less willing to quote cheap initial fees in their tenders for the audits of these enterprises - a malpractice that was claimed to be resulting in these auditors being awarded the job but then having to sacrifice audit quality and independence. Some respondents (3A,2M) also emphasized that such a rotation needed to take place without having a public watchdog to oversee the procedure: they felt that it was best to leave it to the individual enterprises concerned, or, better, if appointed, to their audit committees.

On the contrary, most (3A,2M) of those against thought that the auditor should be changed only if there were serious enough reasons, because new auditors were relatively weak or ineffective for the first few years.

Two auditors saw a better alternative to rotation: the creation of a consortium of audit firms that would be in charge of all work in such enterprises, so that this would be strong enough to countervail the power yielded by their management.

In summary, however, rotation in this enterprises was seen as needed as a safeguard to auditor independence.

(c) Government-controlled Enterprises: Value-for-Money Auditing By Private Statutory Auditors The next question (F.3) asked for respondents' views on a suggestion made in a preliminary study (Scott, 1989, see S3.6.5) with regard to extended work to be done by private auditors in respect of government-controlled enterprises. Scott had suggested that auditors needed to carry out value-for-money audits in such enterprises until such time as the Department of Audit had adequate resources to perform it. Value-for-money auditing was defined in the interview discussion schedule as *"an objective examination of a government-controlled enterprise in order to determine whether it is achieving economy (or that a programme of activity is performed at the lowest cost), efficiency (or that the optimum output is being achieved), and effectiveness (or that the intended objectives or goals are being achieved)."* This definition was adapted from Millichamp (1990: p 329).

Of those replying to this question (14A,10M), most (8A,7M) were in favour of VFM audits by audit firms, with no significant difference between the groups, and the overall opinion IASS was 2.56, being 2.75 for auditors and 2.30 for managers.

Almost all respondents (12A,8M) stated that they saw a real need for extended exercises on economy, efficiency and effectiveness. For many of them (10A, 9M), the existence in these enterprises of the statutory audit, even with its management letter, was often insufficient, mostly because of the strong possibility of waste of public funds (4A,2M) or of an inefficient level of services (3A,3M).

However, whether private auditors should themselves perform this function was more controversial. Many (6A,6M) of those in favour of this commented that there was no real alternative: unless private auditors did such exercises, these could not be done in the near future as the Department of Audit was indeed not properly equipped. Some (3A,2M) also emphasized that the auditor-management relationship would become more relevant and useful with such an additional exercise: as one manager put it, *"auditing would be considered much less of a formality"* (1M).

On the other hand, most of those against (4A,2M) stated that although they agreed that the Department of Audit at the time lacked the necessary resources, they felt that it was better that staff there (3A) or in a newly formed Government unit (1A,2M) would be trained immediately to carry out such exercises. Most (3A,2M) of them added that hiring local private auditors to fulfil this need would be a mistake because Government would never manage to build up its own audit team. A few (2A,1M) of these respondents felt also that private auditors were not yet specialized enough to do such exercises, and themselves needed long-term training. In addition, two auditors thought that the effectiveness aspect of VFM reporting could easily involve statutory auditors in political controversy, and so this new service would be harmful to the reputation of the audit practitioners.

Yet, despite the latter arguments, an extended role for private auditors was favoured by respondents to this question.

5.6.2 Further Comments on Enhancing Auditor-Management Relationships

The final question (F.4) was a winding-up one asking for any other comments on ways of enhancing auditor-management relationships. Most respondents (17A,18M) had some other comments to make.

(a) The Lack of Discipline and Its Effects A common comment (7A,9M) again concerned, as referred to elsewhere [Ss 5.2.5 and 5.3.1(f)], the existing lack of discipline among some audit practitioners. Most of these respondents (5A,6M) emphasized the need for more initiative towards disciplinary measures by the Institute or even the Accountancy Board to ensure observance of laws and regulations.

> *"A thousand laws will be to no avail unless, as is often happening, the right action is not taken or not seen to be taken when such laws are broken"* (1M).

Most (5A,6M) of these respondents added that, in view of this situation, while most auditor-management relationships were sound enough, those where such auditors were involved were being repeatedly dominated by managers, and this affected adversely the image held by users of the whole profession.

A smaller number of respondents (3A,4M) seemed somewhat defeatist. While even they maintained that most auditor-management relationships were *"sound"* or *"healthy"*, they saw little possibility of bringing to book those who lacked the necessary self-discipline: this was a problem that these respondents had learned to live with. A few maintained that this was evident not only within the profession, but also among audit report users themselves, and even with some public authorities.

Finally, two (1A,1M) maintained that this was a *"very difficult small country malaise"*:

> *"In this small community, strong pressures can be exercised on any person in authority to refrain from taking the proper disciplinary steps: he will be easily accessed through family or social contacts. Unfortunately, the institutions are often too small to withstand such manipulations"* (1A).

> *"In a small place like this there may be too much hat-changing in the positions of power for discipline to be effective. The various institutions become helpless against unscrupulous persons exercising their pressures in the different places"* (1M).

However, no practitioner referred to the possibility of the Institute or the Accountancy Board setting up a monitoring unit to carry out quality control inspections on audit practitioners. Such a unit has been referred to in S3.5.2 (d): it seemed that no-one was as yet thinking in such terms.

(b) Other Comments These mostly repeated arguments already made by more other respondents earlier on in the interview.

One comment was that by a number of respondents (3A,4M) who emphasized that auditors should not be allowed to perform accounting duties, except, in the view of most of these respondents (1A,3M), in small companies. All these stated that by the virtue of their warrant auditors should be prohibited from performing such services, and such duties be instead given to the other warrant holders, the CPA's.

A final re-emphasis (5A,4M) was made on the need for both parties in the relationship to be educated, particularly in communication skills .

5.6.3 Summary

This section attempted to tackle other relevant issues between auditors and managers, particularly as regards government enterprises.

(a) Audits in Government-Controlled Enterprises

A Public Watchdog Respondents agreed to the need for some type of watchdog, and the appointment of a public one was mostly seen as an alternative to that of an audit committee to each enterprise. However, appointing the Director of Audit in such a capacity and giving him extended powers of monitoring was controversial.

Rotation Most respondents saw the need for rotation to protect independence, and a 5-to-6 year rotation period was commonly suggested.

Value-For-Money Auditing By Private Auditors An extended role for the statutory auditor in value-for-money auditing was favoured until Government auditors would have the resources to perform this themselves.

(b) Further Comments The need was also expressed for more disciplinary action to be taken on defaulting practitioners.

5.7 Concluding Note

This chapter has presented the response to the various sections of a research survey that investigated the chief relationship issues arising between Maltese auditors and the managers of client companies. The findings have been analysed and a synthesis also included at the end of each section.

The final conclusions of the research study will now be presented in the next chapter.

CHAPTER SIX:

SUMMARY AND CONCLUSIONS

6.1 Summary

The main objective of this project as stated in Chapter One was to examine the major issues affecting the auditor-management relationship from the particular perspective of the microstate of Malta. It sought to bring an awareness of the existing problems between the two parties and to assess, as far as practicable, how they want to respond to such problems. The various issues were investigated under the aspects of communications and reporting, independence, management fraud, small companies and a general one concerning particularly government-controlled enterprises.

The research approach consisted of interviews with audit practitioners in different Maltese practices and also with local senior financial executives. Following five pilot interviews, twenty respondents were interviewed on each side of the relationship. The response of both parties has already been analyzed in the preceding chapter. This one now presents the major conclusions and implications of this study, takes a further look at the study limitations, and suggests areas for further research.

6.2 Conclusions and Implications

This study concludes that while auditors are often perceived to exert a positive influence on the management of their client companies, there is much room for improvement in this professional relationship.

6.2.1 Communication Barriers

Various communication barriers were identified between the parties that point to the need for both sides to change existing defensive or negative attitudes. Two examples of high barriers met by both sides in this connection were a tendency of the other party not to listen and personality conflicts. Auditors also felt that they met with managerial resistance to change, while managers referred to auditors' hostile attitude, coming in particular from the audit staff.

Both parties seem to need increased training in general communication skills in order to help them to change such attitudes and to interact more effectively. This implies that an increased emphasis on such skills is to be borne particularly in mind by Maltese professional and educational institutions in accountancy and management. This concerns both the further training of existing professionals and the planning of their educational curricula for future ones. After all, the possession by auditors and managers of such skills is probably at least as important as their having expert knowledge in their field.

Related to this, managers also seem to have insufficient education in accounting and this appears to contribute to other barriers such as their tendency not to listen, their lack of understanding of accounting terminology, their lack of trust in auditors and even their resistance to change. It is suggested that managers can no longer afford to operate without, at least, a basic knowledge of this important language of business, and that management training and degree courses need to increasingly acknowledge the need for a proper accounting background.

Finally, undue time pressures also seem to be leading to barriers such as listening problems by auditors, and to feedback delays on both sides. This area needs further study, and is taken up further in S6.4.

6.2.2 Auditor-Management Letters and the Audit Report

It has also emerged that written letters of communication between auditors and managers can play a more useful or positive role to the relationship than at present. In particular, the letter of representation seems to be causing adverse reactions in management because some auditors are using it to obtain unnecessary details. Therefore auditors need to take particular care to avoid this.

As regards the audit report itself, this seems to be taken for granted by auditors, but is seen by managers as little more than a start in helping them to communicate with the external users. Many managers see it as negatively worded, and not as influential on such users as auditors seem to expect. The implications of this are that auditors cannot remain complacent with the present wording of the report but must look at ways to render it more meaningful both to management and to outside users. This is also further taken up in S6.4.

As for qualifications in the report, when serious qualifications are made or perhaps even considered, management frequently seems to be building up pressures on auditors and these too often have to face a real threat of being replaced. This seems particularly so in small companies, in view of the feared tax implications of the qualifications.

A clearly implication of this is that the auditor is not sufficiently legally protected. Both auditors and managers agree on the introduction of a UK-style Statement of Circumstances on termination of appointment. However, perhaps more importantly, there is the need to take disciplinary action against a small minority of practitioners claimed to be defaulting ethically and not being effectively checked. This matter is again raised in the next section.

6.2.3 Influences on Independence

As to factors influencing the independence of auditors from managers, psychological factors are clearly significant: in fact, the integrity and objectivity of auditors are seen to exert the highest influence, while importance is also attached to their exercise of tact. Therefore, as in the communication barriers area, a main question is how far individual auditors are able to adopt an appropriate mental attitude, in this case one reflecting intellectual honesty and objectivity, while still allowing a tactful approach. The implication here is that such an influence is not simply a matter of detailed regulation and codes but, perhaps more importantly, one involving the development of one's personality and character traits. In other words, the local accountancy profession, in particular, needs to ensure that its members have the appropriate moral fibre to enable them to maintain the right balance in a complex relationship. Admittedly, this is difficult to achieve in practice, but here is another reason why increased emphasis is needed on inter-personal and communication skills in student education programmes (eg assertiveness training). Moreover, it is equally important for this purpose to instil into accountancy and even management students a serious sense of professional ethics.

Two other important influences on independence were economic factors and close relationships.

As to economic factors, many respondents pointed out the pressures of retaining clients when the audit fees are large. In this regard, regulations are needed to bind all local practitioners, and not MIA members only. Such regulations will, however, have to take special consideration of audit firms which are in their initial years of operation.

Another influence on independence commonly referred to was the stronger possibility of close relationships in such an island microstate. In Malta clients have more tendency to know their auditors on a personal, business or social level, and this is considered a potential threat in itself, particularly in smaller companies. Included in this factor is the problem of blood relationships, which cannot be dismissed lightly. In this respect, it is clear that more monitoring needs to be exercised by the accountancy profession or its regulator, the Accountancy Board. It is recommended that the current legal restrictions as to blood relationships (see S3.4) be made applicable even to private exempt companies. In addition, if one removes the benefit of financial statement secrecy enjoyed by the latter (see S3.3.4), similar relationships would be further discouraged. The removal of such a benefit was in fact agreed to by both parties, and would bring the added advantage of more access to the financial information of companies.

The implementation of ethical rules and standards also seems difficult to monitor, particularly in the eyes of managers, and this detracts the influence of such professional pronouncements on independence. Claims of practitioners defaulting without being effectively checked have already been referred to, but when such claims include allegations of practitioners helping clients to evade tax [see S5.4.5 (b)], the urgent need for stronger disciplinary action becomes clearer. Yet, even taking action after the event is probably not enough. It is suggested that the MIA or the Accountancy Board should consider the monitoring of audit practitioners through quality control inspections, say on lines similar to that carried out by the Joint Monitoring Board of the UK, as already described in S3.5.2 (d).

A further problem that emerged with regard to independence concerns the provision of financial accounting services by the auditor. Unlike the provision of other existing services, restriction on this is favoured, except in small companies where it is not considered cost-beneficial. While such a restriction may not be enough in the eyes of external users of financial statements, it is useful to know about these views among auditors and managers, because this implies that if any form of regulation is to occur, this is probably the least controversial area from which to start.

Finally, the relatively low influence of third party factors indicates that, except perhaps for shareholders, third parties are exerting minimal influence on auditors to remain independent: the latter often seem to have in mind serving nobody beyond shareholders, and to be mostly unconcerned with any legal liability to other persons or bodies. Thus, main users such as the DIR and the banks seem to need to exert more influence. Probably, the problem is that, as stated by Baldacchino (1991), such users are too hampered from exerting their influence by their own rules: in fact, the requirements of secrecy of both banks and the DIR statutorily bar them from lodging complaints against offending accountants and auditors. Such restrictions therefore need to be relaxed.

6.2.4 The Auditor and Management Fraud

This study has found that the detection of fraud rarely occurs through the auditor, and that no fraud discovered by the auditor is known to be reported by him to outside third parties. Therefore, the protection which auditors provide to third parties against fraudulent management is clearly negligible: auditors seem largely powerless as against management in such situations. Yet, any extension of auditor responsibilities for the detection or reporting of fraud to such parties is opposed by both sides, because it is thought to affect negatively the auditor-management relationship, placing auditors in an undesirable inspection role.

An implication of this is that outside third parties, such as supervisory bodies, who want such information need to press for the legal powers to perform a direct monitoring role themselves. Following the UK pattern, some (eg the Registrar of Commercial Partnerships) may, for example, be empowered to send their own inspectors for the needed information. More controversially, they may even want to go further and to press for auditors to be required to lodge special reports to them. In fact, as mentioned in S5.4.4, this is already happening in the audit of stock-broking firms, where the auditor is exceptionally required to report to the recently set-up Malta Stock Exchange.

In any case, both parties to the relationship will have to recognize much more the increasing need to balance their traditional duty of confidentiality to the client against the opposing need to open up to the interested parties. However, it is felt that at present auditors should at least begin to give more information on management fraud to shareholders on the lines suggested in S5.4.4 : this is a start to which both sides seem to agree.

In addition, the introduction of legal provisions, mostly agreed to by both parties, on the internal controls in public or public interest companies can also be helpful in the prevention of management fraud. Such provisions specify the duties of management towards internal controls and also require management, possibly in the directors' report, to acknowledge such duties and to disclose information on the controls. The auditor needs also to review the directors' report for its consistency with the financial statements.

6.2.5 Small Company Audits

Small company audits are also seen to be generally needed for their positive influence on management. However, their statutory requirement seems unjustified where all shareholders are in management and no outside loan finance is used. In cases like this, there seems to be a need to relax legislation and make the audit voluntary. In addition, the small audit differs from the large one not only in approach but also in its demand for a more intense or closer auditor-management relationship. In the small company case, auditors often need to rely more on managers because of the insufficiency of independent data. This implies that the auditor needs to be even more careful here not to compromise his independence.

A tax evasion mentality seems prevalent among small company managers, and both parties think that such a mentality can only change in the long run. It is therefore a constant additional source of pressure on the small company auditor. Given the allegations stated previously of some practitioners helping clients to evade tax, such pressure is no surprise and it becomes even more apparent that the accountancy profession needs to put its house in order.

The study also indicated the need for changes in small company auditing through the issue of small company auditing standards. Interestingly, both sides disagree on how far to go with such changes, with auditors seeing more sense in their existing practices and less inclination to change. Yet, both sides see the need for an audit report that better reflects the extent of auditor reliance on internal controls. In view of the prevalence of small companies in the economy, this is an area to which the Maltese accountancy profession needs to devote particular importance in its auditing standard setting.

6.2.6 Further Issues

This study further concludes that government-controlled companies, in particular, need more controls on the audit process, and that these may include the introduction of audit committees, auditor rotation , and value-for-money auditing.

While in all public and public interest companies audit committees are seen by both auditors and managers as helpful to the independence of the auditor, such committees are particularly worth consideration in government-controlled enterprises, because their introduction probably obviates the need to have a public watchdog to monitor auditing activities. However, wherever such committees are appointed , care must be taken to appoint the persons properly qualified for the job. Again, with respect to government-controlled enterprises, periodic auditor rotation is also seen as a necessary additional safeguard to auditor independence - the public interest seems to take precedence. Furthermore, in these enterprises, an extended role for the statutory auditor is also favoured to cover value-for-money auditing, at least until Government auditors have the resources to perform such an audit.

Finally, in their response, both auditors and managers seemed uncertain as to how far to vary from their known UK model in law and professional pronouncements. On the one hand, in several suggested changes to the regulatory framework (eg in considering protective legislation on auditor dismissal, and in the regulation of non-audit services), the influence of UK pronouncements and developments became evident. On the other hand, in other suggested changes (eg the appointment of audit committees, the disclosure of information on controls in the directors' report), they were even willing to venture beyond the UK pattern. Thus, the continued applicability of the traditional model as to company laws and professional standards has therefore been shown to be in question. Again , it is not enough merely to adopt international pronouncements such as those of IFAC and IASC as national standards and guidelines. Therefore, further research into other foreign models and their possible adaptation to Malta will be helpful in deciding on the fine details of the changes to be made to the regulatory framework relevant to the auditor-management relationship. Other areas of research resulting from this study are discussed in S6.4.

6.3 A Note on the Study Limitations

This study has provided new evidence in an area that as yet needing much empirical research. Yet, its limitations must be borne in mind.

While its scope limitations have already been pointed out in S1.5, and also its data collection ones in S4.4, a final word of caution is felt needed on the limited applicability of the findings to the population as a whole, as is always the case of any research that uses samples. The depicted picture of the views and behaviour of both Maltese auditors and managers was necessarily limited by the respondents' personal bias, experience and perceptions. While the high influence in the local community of many of the respondents was undisputed, it can only be hoped that the given picture approximates, rather than coincides, to the overall existing situation.

In addition, the approach taken in the examination of the auditor-management relationship included some amount of subjectivity (eg the areas to concentrate upon, and the importance given to the different areas). Another researcher might have concentrated differently, and even drawn different conclusions. Nonetheless, having said this, clear indications have , in any case, emerged concerning the major problems in this relationship.

6.4 Suggestions for Further Research

In Chapter One (S1.6) the hope was expressed that this project will stimulate further research studies, and the need for a particular line of research on the adaptation of foreign models has already been referred to. The following further suggestions come to light as a result of undertaking this study:

1) Research seems particularly warranted on the potential roles of the MIA and educational institutions such as the University of Malta, in helping to improve the communication skills of both auditors and managers, and in the accounting education of management. Such a project may include a study of how the efforts of the individual institutions may be coordinated.

2) Also, S5.2.2 (e) referred to the possibility of guidance to auditors by the accountancy profession relating to apparent dilemmas brought out by some of the practitioners on how far to trust financial controllers at board level. Specific research on detailed communications in this direction may also be helpful.

3) As stated earlier when concluding on communication barriers, time pressures on both auditors and managers are apparently affecting negatively their mutual communications. Research needs to be undertaken in order to find the specific reasons for such pressures, in particular whether there is some relationship between such pressures and cheap audit fees, as claimed by a few respondents in S5.2.2 (a). A longitudinal study in this connection would also reveal whether such pressures are becoming more serious over time.

3) Furthermore, the need has already been pointed out, particularly with regard to influences on independence, for the improvement of the existing disciplinary machinery of the local profession, and the possibility of monitoring auditors by quality control inspections was raised. This is another useful area to devote more detailed attention to in research studies and, in this respect, backing may be particularly sought from the local Accountancy Board or the MIA itself.

4) Accent is clearly further needed in future research on the statutory report itself. Here, two separate areas can be identified, the audit report in general and also its detailed modified wording in the common small company case. Finding how to render the statutory end-product more meaningful both to managers and to other users is an area that deserves to be given priority in studies aimed at the local application of foreign models suggested earlier (S6.2.6).

5) Further studies may also compare the points of view of auditors and managers with those of the various users of the financial statements.

Such studies could point out the differences in views and perceptions and seek the reasons behind them. In particular, these studies may go into the views of the individual users concerning the changes in the regulatory framework suggested in this project.

6.5 A Final Remark

This study has shown that there is much room for improvement in the auditor-management relationship in Malta and has discussed various suggestions in this direction. However, if one keeps in perspective the desired results, difficulties arising in their implementation need not be discouraging : after all, as Richard Hooker was quoted as saying long ago, *"change is not made without inconvenience, even from worse to better"* (Collins Gem Dictionary of Quotations, 1985: p 193).

APPENDIX I:

BACKGROUND NON-ECONOMIC INFORMATION ON MALTA

Geography and Population Malta is not a single island but a miniature archipelago consisting of Malta, Gozo, Comino and two other small uninhabited islands. The total area of the islands is 315 square kilometres and they are strategically situated in the middle of the Mediterranean Sea, 96 kilometres from Sicily and 290 kilometres from North Africa. The main island, Malta, is 27 kilometres long and its widest point measures 14 kilometres. Gozo, the other important island, is about one-third the size of Malta. Comino lies in the Gozo Channel between Malta and Gozo, and has few permanent residents.

Valletta, the capital city faces the Grand Harbour, the main Harbour, and is the administrative, commercial and shopping centre. It is surrounded by a number of towns grown together, forming the large urban agglomeration that is the modern centre of Malta.

With a population of 352,000 in 1989 (Demographic Review of the Maltese Islands, 1991), Malta is, in terms of land area, one of the most densely populated countries in the world. However, this does not necessarily mean that Malta is *"overpopulated"*, taking into account that it enjoys a respectable Gross National Product per capita by international standards (see S3.3.1). Maltese and English are official languages in Malta, both are given equal status and use, but business correspondence is normally in English.

History Malta's strategic position and its harbours have often made it an object of contest among competing powers. The island has been occupied through the ages by different races including the Phoenicians, Carthaginians, Romans, Arabs, French and British. Malta is also known for its links with the Knights of St John who were based in the country for a considerable period and left an indelible mark on its history and architecture.

Malta was a British colony from 1801 until 1964 when it became an independent state within the British Commonwealth. With its predominantly European culture, it enjoys close links with the European Community, to which it applied for accession in July, 1990.

Government Malta is an independent republic within the British Commonwealth. Its titular head of state is the President who is appointed by the House of Representatives. Legislative power lies in the hands of this House which has sixty-five members drawn from the two major political parties (the Nationalist Party and the Malta Labour Party). Elections are held every five years and the party at present in Government is the Nationalist Party.

Executive power is exercised by the Prime Minister and the Cabinet, the system of Government being very similar to that found in the United Kingdom. The Prime Minister is usually the Party leader commanding the greater support of the house.

APPENDIX II:

A MALTESE UNQUALIFIED AUDIT REPORT

The following report is modelled on the Commercial Partnerships Ordinance, Cap 168: S143 and on International Auditing Guideline No: 13 (IAPC, 1983):

Auditor's Report to the Members of.....

We have examined the accounts of....... on pages.......to.......in accordance with the International Auditing Guidelines. We have obtained all the information and explanations which, to the best of our knowledge and belief, were necessary for the purposes of our audit. In our opinion, proper books of account have been kept by the company, so far as appears from the examination of the books, and proper returns adequate for the purposes of our audit have been received from branches not visited by us. The company's accounts are in agreement with the books of account and returns.

In our opinion, and to the best of our knowledge and according to the explanations given to us, the said accounts give the information required by the Commercial Partnerships Ordinance, Cap. 168 in the manner as required and give, in accordance with the International Accounting Standards, a true and fair view of the state of affairs of..... as at..... and of the profit and source and application of funds for the financial year ended on that date.

(signed)
Auditors' Name and Address
Date

APPENDIX III:

AN "*EXAMPLE 6*" REPORT ISSUED IN MALTA

Auditor's Report to the Members of....

We have audited the financial statements on pages... to...The accounts are in agreement with the books, which, in our opinion, have been properly kept. Having regard to the matters referred to below, we have received all the information and explanations which were necessity for the purposes of our audit.

In common with many businesses of similar size and organization, the company's system of control is dependent upon the close involvement of directors. Where independent confirmation of the completeness of accounting records was not available, we have accepted assurances from the directors that all the company's transactions have been reflected in the records.

Subject to the foregoing, in our opinion the financial statements give a true and fair view of the state of the company's affairs as at 31 December, 19.. and of its source and application of funds for the year then ended and comply with the Commercial Partnerships Ordinance, Cap. 168.

(signed)
Auditor's Name and Address
Date

Source: Galea St John (1990, p.83) as extracted in August 1990 from the recent accounts (date not given) of a non-exempt private company filed at the Registrar of Commercial; Partnerships, Valletta.

APPENDIX IV:

RELEVANT DIRECTIVES OF THE COUNCIL OF THE EUROPEAN COMMUNITIES AND THEIR STATUS

DIRECTIVE	**STATUS** AS AT 31 DECEMBER,1991	**SCOPE**
Fourth	Issued 25. 7.78 (78/660/EEC)	based on Article 54(3)g on the annual accounts of certain types of enterprises
	Amendments a.issued 27.11.84 (84/569/EEC) b.issued 8.11.90 (90/604/EEC and 90/604/EEC)	
Fifth	Proposed 13.12.72 Amended Proposals 19.8.83 11.1.91 and 20.9.91	on company structures and the power and obligations of company organs
Seventh	Issued 83/349/EEC (13.6.83)	based on Article 54(3)g of the Treaty on on consolidated accounts
Eighth	Issued 10.4.84 (84/253/EEC)	based on article 54(3)g of the Treaty on the approval of persons responsible for carrying out statutory audits of accounting documents

APPENDIX V:

THE TWO INTRODUCTORY LETTERS

The attached two letters were sent as an introduction to potential participants who did not respond to an initial telephone contact.

Loughborough University

LOUGHBOROUGH, LEICESTERSHIRE, LE11 3TU
Telephone 0509 263171 Telex 34319

LOUGHBOROUGH UNIVERSITY BUSINESS SCHOOL

Fax 0509 210232

Tel Ext 3124

TO WHOM IT MAY CONCERN

This is to introduce Mr Peter J Baldacchino of Msida, Malta who is a full-time Lecturer in Accountancy and Finance at the University of Malta

Mr Baldacchino is a post-graduate research (MPhil) student registered with this University and his subject area relates mainly to external auditing.

It would be appreciated, therefore, if you and/or your institution could be helpful to him in any way you can for the purposes of his research studies

Yours sincerely

A Higson BSc, PhD, ACA
Supervisor

UNIVERSITY OF MALTA
Msida – Malta

FACULTY OF ECONOMICS,
MANAGEMENT AND ACCOUNTANCY

TELEPHONE 336451
CABLES UNIVERSITY-MALTA
TELEX 407 HEDUC MW

OUR REF YOUR REF

Dear Sir/s,

AUDIT RESEARCH WORK

I am at present carrying out interviews with audit firms/practitioners and corporate executives in connection with my postgraduate research studies, and I would appreciate your (firm's) co-operation in this work.

The object of my project is to examine the type of relationship between Maltese external auditors and management. It therefore takes into account major issues that are of current interest to the Maltese accountancy profession, particularly in view of the expected changes in financial reporting and auditing legislation.

I would therefore be most grateful if you (or a representative of your technical department/ corporate management) would be prepared to meet me for a discussion. This will be conducted at a time and date of mutual convenience.

Summarized results of the ensuing research paper will be sent to all participants.

Yours faithfully,

P J BALDACCHINO, F.C.C.A, F.I.A
Lecturer in Accounting and Finance

APPENDIX VI:

THE INTERVIEW DISCUSSION SCHEDULE

"THE AUDITOR-MANAGEMENT RELATIONSHIP

IN A MICROSTATE PERSPECTIVE"

*SECTION A : **INTRODUCTION** (ONE QUESTION)*

*SECTION B : **COMMUNICATION ISSUES** (SIX QUESTIONS)*

*SECTION C : **INDEPENDENCE QUESTIONS** (FIVE QUESTIONS)*

*SECTION D : **MANAGEMENT FRAUD** (FIVE QUESTIONS)*

*SECTION E : **SMALL COMPANY AUDIT ISSUES** (FOUR QUESTIONS)*

*SECTION F : **OTHER ISSUES** (FOUR QUESTIONS)*

*SECTION G : **DEFINITIONS***

*SECTION H : **RESPONDENT CLASSIFICATION INFORMATION***

(TOTAL: TWENTY-FIVE QUESTIONS)

PETER J. BALDACCHINO

SECTION A: INTRODUCTION

A.1 Do you find a real need for the financial audit of companies?

SECTION B: COMMUNICATION ISSUES

B.1 What, if any, do you consider barriers to auditor-management communication?

i. - a lack of understanding of meaning of accounting terminology*(eg true and fair view)*
ii. - the level of standardization of audit reports
iii. - resistance to change
iv. - a lack of trust
v. - a lack of feedback *(Def G.2)*
vi. - personality conflicts *(Def G.3)*
vii. - a tendency not to listen
viii. - too many intermediate receivers
ix. - a hostile attitude
x. - other barriers (lack of other communication skills including personal and physical, any other, *please specify*)

B.2 How far do you find the following letters useful:

i. letters of engagement?
ii. management letters?

B.3a *(Management Respondents only)*
Do you feel that auditors are trying to shift responsibility onto you by the letter of representation?

b Do you think that it is important to have legislation specifying that it is a criminal offence for management to give misleading representations to the auditor?

B.4 What message do you see being conveyed by an audit report?

B.5 Would you agree to an audit report being required by the accountancy profession

i - to distinguish between auditor and management responsibilities?

ii - to explain that an audit is planned and performed to obtain reasonable assurance that financial statements are free of material misstatements?

B.6 Do you think that auditors are being replaced by clients as a result of qualifying the audit report?

SECTION C: INDEPENDENCE ISSUES

C.1 What factors, if any, do you consider influential on auditor independence?

i. - integrity *(Def G.9)*
ii. - sense of idealism *(Def G.5)*
iii. - public servant attitude *(Def G.7)*
iv. - technical competence *(Def G.8)* and experience
v. - standards and ethical codes
vi. - the legal liability towards third parties
vii. - size of fee income coming from one client
viii. - tact
ix. - objectivity *(Def G.10)*
x. - other (eg lack of other communication skills including personal and physical, any other: *please specify*)

C.2a What are your general views on the provision of all kinds of non-audit services by the auditor?

b What do you think in particular of:

i. the provision of tax advice?
ii. financial accounting services?
iii. executive recruitment for clients?
iv. other services *(please specify)*?

c i. One may restrict non-audit services to non-audit clients in the case of public companies and those with a significant public interest *(Def G.6)*.

ii. Alternatively one may think of placing no such restrictions but requiring, instead, full financial statement disclosure of such services by the auditor.

What do you think of such courses of action?

C.3 What would your reaction be if audit committees *(Def G.11)* were introduced as financial reporting watchdogs and buffer between auditors and management in the case of public companies and those with a significant public interest?

C.4 In your view, should an auditor be required to make a Statement of Circumstances *(Def G.12)* to his client company, the Registrar of Commercial Partnerships and, if considered necessary by him, to company shareholders, irrespective of whether he resigns, is dismissed or does not seek reappointment?

C.5 The draft Fifth European Directive on company law harmonization proposes that:

i. the auditor be appointed for a 3-to-6 year period, subject to re-appointment and therefore a maximum period of 12 years;

ii. his dismissal within his period of appointment to be only on *" proper grounds"* either in general meeting or by the Commercial Court or similar administrative authority (eg Registrar of Commercial Partnerships) on application by the Board of Directors, a director or one or more shareholders.

What are your views about the above proposals?

SECTION D: MANAGEMENT FRAUD

D.1 What do you think leads to the detection of management fraud *(Def G.14)*?

D.2a Do you think that in public companies or companies with a significant public interest *(Def G.6)* management needs to be specifically required by law:

i. to maintain a proper system of internal controls in addition to proper books of account?

ii. to include in the directors' report or a separate additional report in the financial statements:

- an acknowledgment of its responsibility for preparing the financial statements and maintaining a proper system of internal controls?

- an assessment of the effectiveness of internal controls and how it responded to any material weaknesses identified by the auditor?

b If the requirements in a.i became law and those in a.ii were included in an enlarged directors' report, what role do you see for the auditor in this respect?

D.3 Should the auditor have a wider responsibility for the detection of fraud than he has at present?

D.4 The case may arise of the auditor uncovering material fraud in which management is implicated. Do you think that in such cases:

- unless the auditor has no confidence in the integrity of senior management, he should inform it and request it to deliver an adequate company report within a specified time to persons or bodies with a *"proper interest"* to receive such information: these are to include, as the case may be, shareholders and regulatory bodies and public authorities according to the nature of the fraud, eg the Registrar of Commercial Partnerships or Central Bank of Malta?

- the auditor should be specifically empowered by law, in case of management failure to do this, to override his duty of confidentiality and report directly to the persons or bodies concerned?

D.5a Were there, in your experience, any cases of management fraud which you would like to refer to?

b What are your views on the auditors' responsibility in the cases referred to in (a), if any?

c Are there any other comments you wish to make on how management fraud affects the auditor-management relationship?

SECTION E: THE SMALL COMPANY AUDIT

E.1a In your view , is there a need for the audit of small companies *(Def G.1)*?

b How far do you think such an audit should be different from that of larger companies and what complications, if any, do you see in such an audit?

E.2 Do you think that management pressures to minimize tax liabilities are an increasing problem in the presentation of small company financial statements?

E.3 What are your views on the following suggested changes for small company audits through the issue of auditing standards for small companies?

i - management still retains responsibility financial statements but audit practitioners may both compile them on its behalf and audit them.

ii - normally the auditor will not rely on internal control systems: if he does so rely he needs to disclose the extent of reliance in his audit report.

iii- analytical review procedures and internal substantive tests (transaction tests, inspections etc) will be the main audit tests, and external verification procedures (e.g. circularization of debtors, bank letter) need not normally be carried out.

E.4 Do you agree that the secrecy permitted by Maltese law *[CPO: S149 (1)]* to private exempt companies in respect of Maltese financial statements, including the auditors' and directors reports, should be removed?

SECTION F: OTHER AUDITOR-MANAGEMENT RELATIONSHIP ISSUES

F.1a Do you agree that in government-controlled entities there is the need for a public watchdog to monitor the appointment and removal of all private auditors in the sector?

b *"Provided that the position of Director of Audit is filled only by a qualified accountant of recognized understanding and experience, such a Director and his staff may act as the public watchdog in (a)."* What do you think of this statement?

c *"Such a Director may be further empowered to receive all audited financial statements of government- controlled enterprises, and to examine such accounts on behalf of the government as shareholder. He would then pass them on with any necessary comments to Parliament or to a financial committee appointed by it from its members (eg a public accounts committee). These powers would include that of recommending a second audit, if necessary."* What are your views?

F.2 What is your opinion on the general rotation of auditors of government-owned enterprises, and on its frequency?

F.3 *"Value-for-money auditing* (Def G.13) *needs to be carried out in government-controlled enterprises by the private statutory auditors until such time as the Department of Audit has adequate resources to perform it."* What are your views?

F.4 Do you have any other comments on ways of enhancing auditor-management relationships?

SECTION G: DEFINITIONS

G.1 ***"A SMALL COMPANY"*** is *"one having the following characteristics:*

(i) only a few employees in relevant accounting and administrative functions leading to a limited or inexistent segregation of duties; and

(ii) with domination by the senior management or owner over all essential aspects of the business."

G.2 ***"FEEDBACK"*** is *"the information which the other party gives you on your work, so that you can make the necessary adjustments or modifications in the future."*

G.3 ***"PERSONALITY"*** is *"a compendium of one's traits or characteristic ways of thinking, feeling, reacting etc."*

G.4 ***"FIDUCIARY COMPANIES"*** are *"those to which third party or public funds are entrusted, such as banks."*

G.5 ***"SENSE OF IDEALISM"*** is *"the nature of the auditor to pursue the appropriate judgments without regard to potential client loss."*

G.6 ***"COMPANIES WITH A SIGNIFICANT PUBLIC INTEREST"*** are taken to include *"fiduciary companies* (see Def G.4) *and government-controlled companies and corporations."*

G.7 ***"AUDITOR'S PUBLIC SERVANT ATTITUDE"*** is *"the auditor's sense of serving all interested parties and not anyone in particular."*

G.8 ***"TECHNICAL COMPETENCE"*** means the *"possession by an individual of the necessary expertise to discover all the significant errors or omissions present in set of unaudited annual accounts."*

G.9 ***"INTEGRITY"*** is *"intellectual honesty and non-subordination of one's judgment to that of others."*

G.10 ***"OBJECTIVITY"*** is *"a mental attitude that views events on a purely factual basis without the influence of one's personal feelings, opinions or interests."*

G.11 ***"AUDIT COMMITTEES"*** are *"committees that are composed of non-executive directors and whose objective is that of monitoring a company's auditing activities."*

G.12 ***"A STATEMENT OF CIRCUMSTANCES"*** is *"a statement required in British Statute [CA 1989: S123(1), CA 1985: S.394] to be delivered by the auditor when he ceases to hold office for whatever reason. This will be deposited at the company's registered office and, unless the Court decides otherwise, a copy of it is given to the Registrar of Companies and also, if required by the auditor to every person entitled to receive copies of the accounts. This statement points out the circumstances, if any, of which the auditor feels such person or company creditors should be aware of connected with his ceasing to hold office."*

G.13 ***"VALUE-FOR-MONEY AUDITING"*** is used here to refer to *"an objective examination of a government-controlled enterprise in order to determine whether it is achieving economy, (or that a programme of activity is performed at the lowest cost), efficiency (or that the optimum output is being achieved), and effectiveness (or that the intended objectives or goals are being achieved)."*

G.14 ***"FRAUD"*** is used to refer to *"the use of deception to obtain an unjust or illegal advantage, including the intentional distortion of financial statements and the misappropriation of assets."*

SECTION H: RESPONDENT CLASSIFICATION INFORMATION

STATUS

i. if auditor *(please specify):*
- Senior Partner
- Technical Partner
- Sole Practitioner
- Other...........

ii. if senior financial executive (please specify):
- Financial Director
- Financial Controller
- Other ....

AUDIT PRACTICE

Number of audit employees ......

Foreign Correspondent
or Associate Yes/No
Detail ......

"Big Six" Correspondent ......

COMPANY OF WHICH MAIN SENIOR FINANCIAL EXECUTIVE:

Small (Def G.1) Yes/ No
No of Employees:
Total ......

In Accounting/Administrative Functions......

Government-Controlled Enterprise Yes/No

FOR AUDIT PRACTITIONERS:

Audit Experience (Years)

General .....

In Government-controlled Enterprises .....

FOR SENIOR FINANCIAL EXECUTIVES:

CPA/ Non-CPA .....

Previous Experience In
Government-Controlled
Enterprises: Yes/No .....

No of Years .....

Also Financial Executive in Smaller Company/ies Yes/No

Experience in Finance-related Functions.....

OTHER RELEVANT DETAILS:

APPENDIX VII:

SCORE SCALES USED IN THE INTERVIEW DISCUSSION

AND THEIR USE IN THE ANALYSIS

(a) The Score Scales

In the interview discussion, two score scales were used and these were referred to as (1) *"Opinion"* Score Scales and (2)*"Intensity* or *"Frequency"* Score Scales.

(1) The *Opinion* Score Scale

1	2	3	4	5
SA	A	U	D	SD

SA (1) = Strongly Agree
A (2) = Agree
U (3) = Undecided
D (4) = Disagree
SD (5) = Strongly Disagree

These opinion scales were used for the following questions in the interview discussion schedule:

B.3a, B.5i,ii, C.2a, C.2bi,ii,iii, C.2ci, ii, C.3, C.4, C.5i, ii, D.2ai,ii (two parts in ii), D.3, D.4 , E.2, E.3i,ii,iii, E.4, F.1a,b,c, F.2, F.3

(2) The *Intensity* or *Frequency* Score Scale

High . (5)
. (4)
. (3)
. (2)
No . (1)

The following variations of the Frequency Score Scale were used in the questions of the interview discussion schedule as indicated:

Variation	Questions Used
No barrier (1).... High barrier (5)	B.1
No need (1)....... High need (5)	A.1, E.1a
Not Important (1)..Very Important (5)	B.3b
Not Useful (1).....Very Useful (5)	B.2(i) and (ii)
Not Influential(1).....Very Influential(5)	C.1
Not Different (1)..... Very Different (5)	E.1b
N(1)...R(2)...50/50 (3)...O (4)...A (5) N = Never R = Rarely 50/50 = Equal Chance O = Often A = Always	B.6

(b) Scale Score Use in the Analysis

The way in which the marks given by the respondents were grouped depended on whether the scale was intensity or opinion. Generally, the marks given by the respondents were grouped so that the chi-squared test could be used.

(a) Intensity Scales In the case of intensity scales, the number of respondents with a scale of one was compared with the total number of respondents with a scale above one to five. This was done both for auditors and managers, and for all the respondents. A chi-squared test was made with the null hypothesis of no response difference between the groups at the 0.05 significance level. However, this test was not considered in the analysis in a few cases (questions B.1i and vi) where there was the possibility of the results being biased because of the smallness of the sample, which was where any expected class category was less than 5 and the test rejected the null hypothesis.

In a few further cases (questions A.1, B.6, and C.1i and ix) where no scores at all were made on point one of the scale, it was also checked whether any significant difference between the groups would be ascertained by the same test if the number of respondents with scales marks up to two were compared against those above two to five, and in no case was any significant difference found.

(b) Opinion Scales A similar chi-squared test was used to find out whether there was any significant difference between the number of auditors and managers agreeing to the various opinion questions. The only difference here was that in all cases the number of respondents in each group and overall with a scale of up to two one was compared with the number of respondents with a scale above two to five. The test could be used for all the opinion questions.

Finally, in view of the limitations stated in S4.4(e), in the case of both types of scale scores the arithmetic average of the scale scores was used only as a secondary indicator in the analysis. These scores are referred to as IASS's (Indicative Average Scale Scores) in this thesis.

APPENDIX VIII:

BARRIERS TO AUDITOR-MANAGEMENT COMMUNICATION - SCALE SCORE AVERAGES AND RESPONDENTS WITH BARRIERS BY GROUP

Barrier	Auditor Average Scale Scores	Number of Auditors With Barriers	Manager Average Scale Scores	Number of Managers With Barriers
a. A Tendency Not To Listen	2.63	18	2.28	15
b. Understanding of Meaning of Accounting Terminology	2.80	20	1.80	13
c. A Lack of Feedback	2.20	18	2.40	15
d. Personality Conflicts	2.25	20	1.90	13
e. A Lack of Trust	2.05	16	1.85	13
f. Resistance To Change	2.38	18	1.60	8
g. A Hostile Attitude	1.40	8	1.98	15
h. Too Many Intermediate Receivers	1.75	11	1.73	11
i. The Level of Standardisation of Audit Reports	1.85	11	1.60	9

APPENDIX IX:

FACTORS INFLUENCING INDEPENDENCE - SCALE SCORE AVERAGES AND RESPONDENTS BY GROUP

Factor	Auditor Average Scale Scores	Number of Auditors Finding Factor Influential	Manager Average Scale Scores	Number of Managers Finding Factor Influential
a. Integrity	4.90	20	4.90	20
b. Objectivity	4.43	20	4.33	20
c. Economic Pressures	4.10	19	3.93	19
d. Tact	4.05	18	3.92	18
e. Technical Competence and Experience	3.40	15	3.00	13
f. Standards and Ethical Codes	3.30	17	2.00	9
g. A Sense of Idealism	3.30	15	1.55	8
h. Existence of Legal Liability	1.65	8	1.80	8
i. A Public Servant Attitude	1.70	8	1.30	3

APPENDIX X:

LEGAL CASES CITED

	Section Where Cited
London and General Bank 1895) No 2, 2 2 Chapter 673	2.4.4
Dominion Freeholders v. Aird (1966) 67 S.R. N.S.W. 150	2.4.4

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