The Relationship Between Social Trust and Client Importance and Auditor Independence: A Global Perspective.

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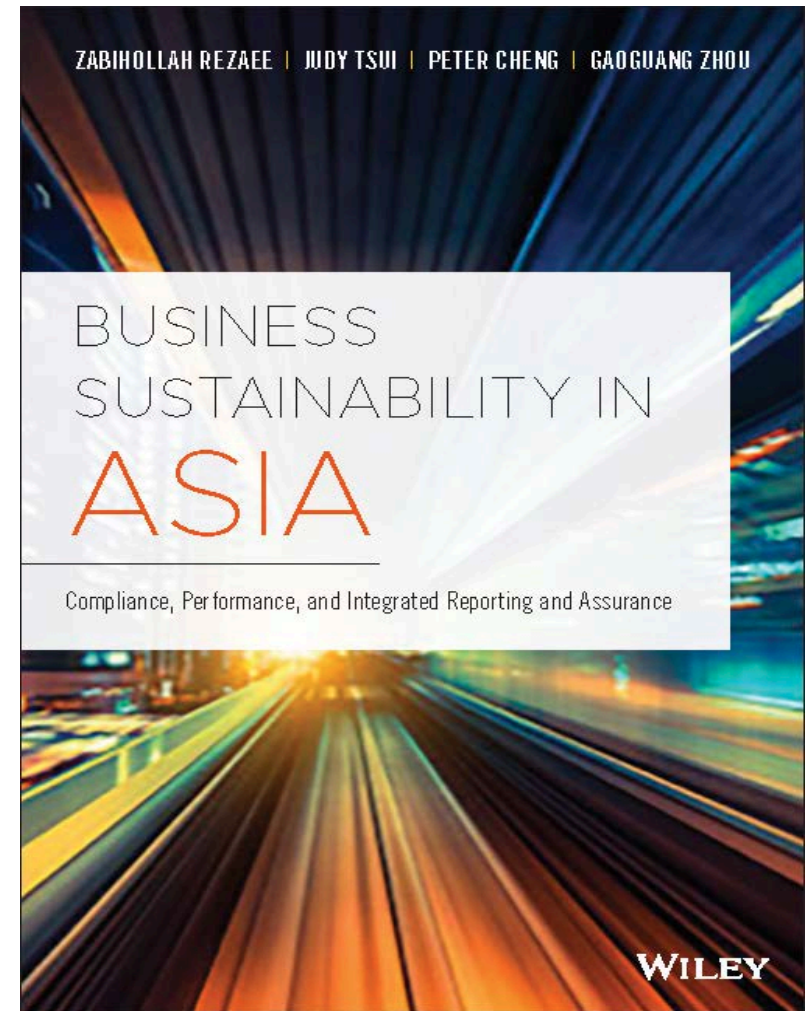**Atlanta, Georgia,** Monday August 10, 2020 - 4:00 pm-5:30 pm

Introduction

- Independent audits add value to the capital market by lending more credibility to the audited financial statements and thus increasing investor confidence and public trust in financial information that facilitates efficient capital allocation.

- Auditors are likely to be tempted to compromise their independence to their economically important clients (e.g., Mautz and Sharaf 1961; AICPA 1978).

- Regulators worldwide have taken various regulatory measures to preserve auditor independence (e.g., the Sarbanes-Oxley Act (SOX) 2002; EU 2002; EU 2010; 2014; IFAC 2012).

- However, prior studies do not adequately examine whether and how informal institutions such as social trust affect auditor independence, despite the growing recognition of the governance role of informal institutions, which is addressed in our study.

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THE GLOBAL MOVE TO SUSTAINABILITY HAS ARRIVED IN ASIA
In Asia, sustainability practices have grown substantially over the past decade, and the continent's business leaders are poised to become global leaders in sustainability initiatives. Following the global trend, Asian businesses focus on economic, governance, social, ethical, and environmental (EGSEE) sustainability dimensions. Business Sustainability in Asia applies this paradigm to the economic powerhouses in Asia, from Japan and Mainland China to India and Vietnam. For each jurisdiction, the authors consider:
• Global, regional, and local sustainability requirements and expectations
• Best practices for maximizing firm value by improving sustainability
• Balancing short-, medium-, and long-term sustainable performance
• The interrelated nature of financial performance and long-range sustainability.

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Purposes

- Two steams of research suggest that institutions define the expected benefits of auditors' independence and social trust that affect financial reporting and auditing practices

- Motivated by the anecdotal evidence and prior research, we examine whether and how social trust affects auditor independence, thus contributing to the nascent literature on social norms and audits.

- Social trust is one of the most important concepts in sociology, which is commonly defined as, "the subjective probability with which an agent assesses that another agent or group of agents will perform a particular action" (Gambetta 2000, p. 217).

- Trust means exercising integrity, fairness, honesty, and reliability in the relationship with others.

- A high level of trust is associated with greater economic growth (Fukuyama 1995; La Porta et al. 1997; Knack and Keefer 1997; Zak and Knack 2001) and financial market development (Guiso, Sapienza, and Zingales 2004, 2008).

- In corporate settings, trust mitigates agency conflicts and affects corporate governance practices (Al-Najjar and Casadesus-Masanell 2002; Chami and Fullenkamp 2002; Hilary and Huang 2015).

- Social trust is expected to play a more important role in the corporate setting because of the emerging sustainability.

Synopsis:

- **What did we do in the paper?** We examine the role of social trust in the relationship between client importance and auditor independence. Trust mitigates conflicts of interest and enables auditors to exercise integrity, fairness, honesty, and reliability.

- **Why did we do?** Prior research and authoritative reports suggest that independent audits add value to the capital market by lending more credibility to the audited financial statements and the public and investors expect auditors to act independently, auditors are likely to be tempted to compromise their independence to their economically important clients. Rules and regulations (SOX, SEC, PCAOB) are intended to preserve auditor independence and monitor auditors incentives to compromise their independence. However, prior studies do not adequately examine whether and how informal institutions such as social trust affect auditor independence, despite the growing recognition of the governance role of informal institutions.

- **How did we do?** we use modified audit opinion to directly capture auditors' assessments as to whether client firms have faithfully complied with generally accepted accounting principles (GAAP) as a proxy for auditor independence. To measure client importance, we use the percentage of a client's total assets to the sum of total assets of all clients audited by the auditors. We use a country-level trust score based on a questionnaire from the World Value Survey to measure the degree of trust in others.

Synopsis (continued)

- **What did we find?** Based on a sample of more than 55,000 firm-year observations from 20 countries for the 1995-2017 period, we find a significantly positive association between trust and the likelihood of issuing modified audit opinions to important clients, supporting the notion that as an important social norm, trust can deter auditors from compromising their independence to satisfy important clients. Our subsequent analyses show that this effect is more pronounced in the Big N sub-samples, suggesting that Big N auditors may prioritize independence to economic benefits in anticipating greater reputation loss risks in high-trust societies. Finally, we reveal that the association between trust and auditor independence is stronger in countries with weak investor protection, supporting the substitution hypothesis for formal and informal institutions.

- **What is our Contribution:** Our results have implications for policymakers, regulators, and corporations as they are currently paying attention to auditors role in the aftermath of COVID-19 pandemic. By identifying social trust as another important country-level determinant of auditor independence, this study also answers the call for more studies on social or cultural factors in audit quality globally (Simnett et al. 2016). Second, our study adds to the emerging literature on the accounting consequences of social trust (Jha and Chen 2015; Pevzner et al. 2015; Knechel et al. 2019). Recent studies find that trust increases investors' and auditors' confidence in the quality of corporate financial statements (e.g., Jha and Chen 2015; Pevzner et al. 2015), and affects the demand for audit services (Knechel et al. 2019).

Literature Review

The economics literature views trust as an important institution and shows that trust affects economic agents' incentives (e.g. Arrow 1974; La Porta et al. 1997; Fukayama 1995; Knack and Keefer 1997; Zak and Knack 2001; Guiso et al. 2004, 2006, 2008, 2009). In a corporate setting, trust is modeled as being an effective tool to mitigate agency problems between the principals (shareholders) and agents (management) (Chami and Fullenkamp 2002).

Jha and Chen (2015) provide first evidence that auditors charge lower audit fees to clients in high-trust regions. Pevzner et al. (2015) argue that investors perceive financial statements provided by firms in high-trust countries as more credible by finding that investors react more strongly to corporate earnings announcements in countries with higher levels of trust than in those with lower levels of trust.

In an international setting, Knechel et al. (2019) report that firms are more likely to hire Big N auditors in high-trust countries, because the audit function is highly valued in these societies and further find that trust is significantly positively associated with audit fees.

To our knowledge, no prior studies examine whether and how trust affects auditors' behaviors.

Hypothesis Development

- Motivated by prior studies, we propose two competing views that explain the relation between social trust and auditor independence.

- On the one hand, social trust as an important social norm and a set of rigorous networks can play a governance role and deter auditors from surrendering their independence (Fukuyama (1995) .

- On the other hand, deviating from this social norm entails various costs of negative reputation and disgrace (Hosmer, 1995). For example, clients are more likely to switch to other audit firms when the incumbent auditor is suspected of breaching social expectations (Barton 2005; Cahan, Emanuel, and Sun 2009). As such, the social norm view of trust suggests that trust could induce auditors not to give up their independence.

- Given these two competing views, we state our first hypothesis as non-directional.

  H1: Social trust affects auditors' tendency to compromise their independence to important clients.

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Hypothesis Development

- Globalization has enabled Big N auditors to become major players in the international audit market. Given their uniform quality control and service in international settings, Big N auditors are more likely than non-Big N auditors to provide globally consistent audit quality (Francis and Wang 2008).

- There is ample empirical evidence that Big N auditors are associated with high earnings quality (e.g., Teoh and Wong 1993; Becker, DeFond, Jiambalyo, and Subramanyam 1998; Francis, Maydew, and Sparks 1999; Krishnan 2003; Francis and Krishnan 1999, 2002) and they are more independent (e.g., DeAngelo 1981; Li 2009; Fung et al. 2016)

- Given Big N auditors' effective control systems in place and great reputation capital, the effect of trust in enforcing independence is unclear *ex ante*. The monitoring hypothesis of trust predicts that Big N firms are less likely to give up independence in high trust societies due to greater reputation loss after detection in such societies. However, it is also plausible that the effect of trust in upholding independence is limited for Big N auditors due to their effective control systems. Due to these competing views, our second hypothesis is non-directional.

  > *H2: The relation between social trust and auditors' tendency to compromise their independence to important clients differs between Big N and non-Big N auditors.*

Hypothesis Development

- We argue that investor protection can supplement or replace trust to affect auditor independence.
- On the one hand, prior research suggests that trust and formal institutions can be substitutes for influencing economic and regulating activities (e.g., Williamson 1993).
- On the other hand, trust and formal institutions can complement one another to preserve auditor independence.
- The institutional complementarity hypothesis (Wysocki 2011) suggests that different institutions can complement one another to improve their effectiveness in regulating auditor independence.
- For example, Francis and Wang (2008) show that high-quality audits are the product of a high-quality micro-institution, such as Big N auditors, and strong investor protection.
- We expect strong investor protection to complement social trust in affecting auditor independence. Based on these arguments, we state our third hypothesis as follows:

    H3: The relation between social trust and auditors' tendency to compromise their independence to important clients varies with investor protection.

Empirical Model

Our empirical model to test our first hypothesis is as follows:

$$Prob.(OP = 1) = \alpha_0 + \alpha_1 CIMP + \alpha_2 TRUST + \alpha_3 CIMP \times TRUST + Controls + FixedEffects + \varepsilon$$

Where: *OP* is an indicator variable that equals 1 if the audit client receives a modified audit opinion, and 0 otherwise. *CIMP* is the country-year median adjusted ratio of the firm's total assets (in natural logarithm form) to the sum of total assets (in natural logarithm form) of each client audited by the firm's auditor in a given country-year. *TRUST* is the country-level trust score (Pevzner et al. 2015).

Table 2   Social Trust, Client Importance and Auditors' Propensity to Issue Modified Opinions

Column	(1) Full sample		(2) Above-median *TRUST*		(3) Below-median *TRUST*	
Variables of interest	coef.	z-value	coef.	z-value	coef.	z-value
CIMP	1.689	1.51	4.965***	2.87	2.213**	2.19
TRUST	-3.993***	-6.51				
CIMP*TRUST	5.911**	2.03				
Client-level variables						
BIGN	-0.268***	-2.90	-0.143**	-2.37	-0.393**	-2.19
LAG(OP)	2.511***	26.95	2.061***	25.67	2.952***	24.99
TENURE	-0.018***	-2.81	-0.012*	-1.75	-0.020**	-2.55
LOSS	0.378***	9.37	0.502***	9.79	0.363***	6.14
ZSCORE	0.123***	10.42	0.125***	12.63	0.103***	3.89
CFO	-1.604***	-6.85	-1.304***	-4.26	-1.443***	-6.41
AGE	-0.001	-0.32	-0.001	-0.15	-0.005	-1.24
RET	-0.161***	-5.92	-0.287***	-6.02	0.023	0.55
BETA	0.156***	3.13	0.040	0.83	0.207***	3.42
STDRET	10.818***	6.42	11.408***	6.37	4.138**	2.31
LEV	0.113*	1.82	0.174	1.24	0.412***	2.73
CLEV	0.789***	5.71	0.422	1.53	1.153***	2.83
RPLAG	-0.105**	-2.45	-0.433*	-1.93	-0.010	-0.21
ABACC	0.110	0.65	0.360	1.53	-0.144	-0.99
SIZE	-0.098***	-6.38	-0.167***	-9.08	-0.059***	-3.73
FISSUE	0.025	0.82	-0.013	-0.31	0.077**	2.10
INVEST	-1.119***	-6.31	-1.639***	-8.21	-0.567***	-2.82
QUICK	-0.022***	-4.13	-0.030***	-4.30	-0.000	-0.06
ARINV	0.008*	1.68	0.002	0.30	0.009*	1.96
TURNOVER	-0.325***	-4.95	-0.299***	-4.49	-0.315***	-4.03
MB	0.004	1.33	0.008	1.44	-0.026***	-2.70
Country-level variables						
PROT	-0.003	-0.03	0.137*	1.69	-0.109	-0.81
IFRS	-0.715***	-9.78	-0.491***	-5.50	-1.264***	-13.16
CULTURE	-0.053***	-5.37	0.023	1.34	-0.098***	-14.59
GDP	0.274***	9.21	0.307***	3.94	0.161***	4.42
GDPPC	-0.100**	-2.53	-0.717***	-10.86	-0.311***	-4.15
GDPGR	1.024	1.57	0.860	1.28	0.406	1.18
Difference in Coef. of *CIMP*			2.751**			
			p-value =0.050			
Intercept	Included		Included		Included	
Year fixed effects	Included		Included		Included	
Industry fixed effects	Included		Included		Included	
N	55,974		26,816		29,158	
Pseudo R-square	0.374		0.390		0.396	

The full sample contains 55,974 firm -year observations from 20 countries for the period 1995 -2017. Definitions of all variables are provided in Appendix I. z-statistics are calculated based on robust standard errors clustered at the auditor level.[*], [**] and [***] represent two-tailed significance at level of 10%, 5% and 1% respectively

Table 3   Social Trust, Client Importance and Auditors' Propensity to Issue Modified Opinions: Big N vs. Non-Big N Auditors

Column	(1) BIGN = 1		(2) BIGN = 0	
Variables of interest	coef.	z-value	coef.	z-value
CIMP	3.222**	2.44	1.123	0.52
TRUST	-4.164***	-20.97	-3.839***	-6.73
CIMP*TRUST	6.702*	1.70	-2.967	-0.44
Client-level variables				
LAG(OP)	2.597***	55.91	2.207***	30.52
TENURE	-0.016***	-3.73	-0.024***	-3.22
LOSS	0.363***	8.04	0.354***	4.46
ZSCORE	0.145***	10.13	0.106***	6.73
CFO	-1.748***	-7.28	-1.235***	-3.85
AGE	-0.001	-0.26	-0.001	-0.17
RET	-0.107***	-2.67	-0.163***	-3.55
BETA	0.124***	3.71	0.256***	2.79
STDRET	12.159***	10.01	5.738***	4.13
LEV	0.119	0.86	0.042	0.22
CLEV	0.915***	3.93	0.495*	1.95
RPLAG	-0.081*	-1.66	-0.083	-0.81
ABACC	0.255	1.15	0.007	0.03
SIZE	-0.081***	-6.17	-0.134***	-5.18
FISSUE	0.040	0.98	0.017	0.23
INVEST	-0.708***	-5.66	-1.764***	-11.57
QUICK	-0.013*	-1.67	-0.035***	-4.38
ARINV	0.005	1.11	-0.006	-0.28
TURNOVER	-0.289***	-8.71	-0.382***	-6.64
MB	0.010	1.21	-0.001	-0.19
Country-level variables				
PROT	0.036	1.11	-0.017	-0.17
IFRS	-0.763***	-12.05	-0.886***	-4.41
CULTURE	-0.060***	-14.70	-0.026**	-2.15
GDP	0.329***	12.67	0.088	1.31
GDPPC	-0.185***	-6.07	0.312***	3.80
GDPGR	0.825***	3.13	3.259***	3.27
Difference in Coef. of *CIMP*TRUST*	9.669**			
	p-value =0.035			
Intercept	Included		Included	
Year fixed effects	Included		Included	
Industry fixed effects	Included		Included	
N	45,566		10,408	
Pseudo R-square	0.368		0.354	

The full sample contains 55,974 firm -year observations from 20 countries for the period 1995 -2017. Definitions of all variables are provided in Appendix I. z-statistics are calculated based on robust standard errors clustered at the auditor level.*, ** and *** represent two-tailed significance at level of 10%, 5% and 1% respectively.

Table 4 Social Trust, Client Importance and Auditors' Propensity to Issue Modified Opinions: Strong vs. Wea k Investor Protection Countries

Column	(1)		(2)	
	Above-median *PROT*		Below-median *PROT*	
Variables of interest	*coef.*	*z-value*	*coef.*	*z-value*
CIMP	2.630**	2.01	-4.292	-0.92
TRUST	-2.219***	-3.82	-2.368***	-20.37
CIMP*TRUST	-1.506	-0.61	2.958**	2.21
Client-level variables				
BIGN	-0.274***	-3.67	0.415	1.09
LAG(OP)	2.449***	22.66	2.350***	20.68
TENURE	-0.018***	-2.70	-0.010	-0.88
LOSS	0.441***	9.90	0.241***	2.82
ZSCORE	0.120***	10.37	0.210***	3.12
CFO	-1.398***	-4.27	-2.258***	-8.23
AGE	0.002	0.31	-0.005*	-1.94
RET	-0.179***	-7.85	0.080	0.82
BETA	0.130**	2.34	0.099	1.33
STDRET	9.136***	6.34	3.785	0.36
LEV	0.150**	2.18	-0.615*	-1.89
CLEV	0.689***	5.05	1.657***	4.12
RPLAG	-0.056	-1.60	-3.633	.
ABACC	0.213	1.29	-1.750***	-6.42
SIZE	-0.124***	-5.12	-0.015	-0.31
FISSUE	0.009	0.28	0.112	1.26
INVEST	-1.256***	-7.62	-0.519*	-1.68
QUICK	-0.024***	-4.46	0.027*	1.94
ARINV	0.005**	2.12	0.011	0.69
TURNOVER	-0.334***	-6.77	-0.088	-1.06
MB	-0.000	-0.08	0.031	0.87
Country-level variables				
IFRS	-0.861***	-10.04	-0.168	-0.30
CULTURE	-0.014*	-1.76	0.024	0.79
GDP	-0.008	-0.19	-0.437***	-3.96
GDPPC	-0.076	-1.55	-0.884***	-5.41
GDPGR	-0.260	-0.39	2.615***	2.89
Difference in Coef. of *CIMP*TRUST*	-31.086***			
	p-value < 0.01			
Intercept	Included		Included	
Year fixed effects	Included		Included	
Industry fixed effects	Included		Included	
N	47,367		8,607	
Pseudo R-square	0.373		0.456	

The full sample contains 55,974 firm -year observations from 20 countries for the period 1995 -2017. Definitions of all variables are provided in Appendix I. z-statistics are calculated based on robust standard errors clustered at the auditor level.*, ** and *** represent two-tailed significance at level of 10%, 5% and 1% respectively.

Table 5   Social Trust, Client Importance and Auditors' Propensity to Issue Modified Opinions: 2SLS Approach

Column	(1) First-stage		(2) Second-stage	
Dependent Variable =	*TRUST*		*Prob (OP = 1)*	
Variables of interest	*coef.*	*z-value*	*coef.*	*z-value*
CIMP	-0.105***	-3.24	1.253	1.60
PTRUST			-5.427***	-7.56
CIMP*PTRUST			6.780***	2.76
Instrumental variables				
PROTEST	0.013	0.43		
CATHOLIC	-0.097***	-3.26		
BUDDHIST	-0.209***	-15.65		
MUSLIM	-0.119***	-3.79		
Client-level variables				
BIGN	0.003	0.74	-0.283***	-2.96
LAG(OP)	-0.012***	-6.16	2.464***	27.46
TENURE	0.000	0.38	-0.017***	-2.74
LOSS	0.000	0.24	0.370***	9.65
ZSCORE	0.001***	3.02	0.127***	10.02
CFO	0.001	0.16	-1.618***	-6.72
AGE	0.000*	1.78	-0.000	-0.05
RET	-0.004***	-7.29	-0.162***	-6.21
BETA	-0.000	-0.13	0.140***	2.77
STDRET	-0.018	-0.83	11.106***	6.58
LEV	-0.012***	-3.40	0.055	0.82
CLEV	-0.004	-1.55	0.789***	5.48
RPLAG	0.010**	2.27	-0.108**	-2.45
ABACC	-0.005***	-4.05	0.100	0.59
SIZE	-0.005***	-8.71	-0.102***	-7.71
FISSUE	-0.000	-0.06	0.028	0.91
INVEST	-0.021***	-4.90	-1.162***	-6.68
QUICK	0.001***	7.76	-0.021***	-4.33
ARINV	0.001***	3.25	0.009	1.57
TURNOVER	-0.002**	-2.12	-0.320***	-4.91
MB	0.002***	5.41	0.008***	2.61
Country-level variables				
PROT	0.022	1.15	0.014	0.23
IFRS	-0.075***	-5.13	-0.766***	-8.19
CULTURE	-0.016***	-8.15	-0.072***	-8.98
GDP	0.001	0.27	0.277***	8.19
GDPPC	0.069***	4.64	0.061	1.02
GDPGR	0.161*	1.96	0.803*	1.71
Intercept	Included		Included	
Year fixed effects	Included		Included	
Industry fixed effects	Included		Included	
N	55,974		55,974	
Adj. R-square/Pseudo R-square	0.771		0.370	

The full sample contains 55,974 firm-year observations from 20 countries for the period 1995-2017. Definitions of all variables are provided in Appendix I. z-statistics are calculated based on robust standard errors clustered at the auditor level. *, ** and *** represent two-tailed significance at level of 10%, 5% and 1% respectively.

Conclusion

- Auditor independence is an important precondition for high-quality audits, but it is possible that auditors compromise their independence in exchange for financial benefits from important clients.

- This study extends the discussions on how to oversee and monitor auditor independence by focusing on how auditors consider social trust when making audit decisions for clients that are important.

- Based on a sample from cross-country data, our results reveal that auditors in high-trust countries are less likely to compromise their independence to important clients, consistent with the notion that trust is an effective mechanism to deter auditors from losing independence.

- Further analyses show that the effect of trust on auditor independence is more significant for Big N auditors, as Big N auditors have more to lose in the events of detected misconducts in high-trust environment.

- Finally, we find that the effect of trust on auditor independence is stronger in countries with weak investor protection regimes, supporting a substitution effect between formal and informal institutions in affecting auditor independence.

Questions?

Thank you for your attention