Are auditors likely to represent the interests of small investors?

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Abstract

This study aims to understand the power relations that exist between auditors and various stakeholders of audited financial statements of New Zealand Securities Exchange (NZX) listed companies. To this end, this study examines auditors' perceptions of various stakeholders' ability to influence them, and the level of interest these groups have on audited financial statements. Using the stakeholder salience theory developed by Mitchell, et al. (1997), various stakeholder groups of audited financial statements in terms of their salience is classified. Next, the hypothesis that auditors have few incentives to protect the interests of less powerful stakeholders such as small investors is explored using a survey. Of the four stakeholder groups examined in the survey – institutional investors, financial analysts, NZX, and small investors – auditors seem to recognise institutional investors as the dominant stakeholder group. As expected, the results show that auditors consider small investors as neither influential nor highly interested in the NZX listed company financial statements. A major concern exists about auditors' ability to provide adequate protection to less sophisticated users of financial statements, although arguably they seem to require the greatest protection and have a legitimate claim to protection by auditors. Considering the complex power relations that exist between auditors and various stakeholders of financial statements, the tightening of auditor independence rules are unlikely to provide adequate protection to the interests of less sophisticated stakeholders. Therefore, it may be more ethical to provide adequate warnings that financial statements are specialist documents thus allowing less powerful stakeholders to exercise caution when they use financial statements.

Key words: auditors; information disclosure; NZX listed companies; power relations; small investors; stakeholder salience

Introduction

In search for solutions to the auditor independence problem, policy makers appear to focus heavily on the appointment and tenure of auditors. This presumes that auditor independence is impaired and, as a consequence, the public interest is compromised when there are conflicts of interest between corporate management and auditors. Accordingly, noteworthy measures – audit firm rotation, audit lead partner rotation, and prohibition of auditors to undertake management consultancy work – aim to reduce conflicts of interest between corporations and their auditors. In contrast, this paper argues that the issue of auditor independence involves complex power relations including the power relations that exist between auditors and clients on one hand, and auditors and different types of stakeholders and regulators on the other. The existing measures to improve auditor independence therefore would be of little help since auditors have incentives to protect important power relations (e.g., institutional investors) yet undervalue those that are less important (e.g., small investors, special interest groups, etc.). Arguably, the interest of small investors is at the highest risk and requires the greatest protection by independent audits, as these shareholders are relatively less informed, less sophisticated, and have little power to demand and obtain information from corporations. The responsibility to provide information to groups other than investors and creditors (e.g., employees, the government, customers, suppliers, and the general public) who have a legitimate claim to corporate information has been long recognised (Accounting Standards Steering Committee, 1975; cited in Ryan, et al., 1992, pp.70-71). Therefore, auditors are expected to ensure that the corporate financial statements they certify meet the information needs of wider stakeholder groups and not just a powerful few. Added to this is the fact that company financial statements are general-purpose statements and in some jurisdictions (e.g., New Zealand) they are certified as *true and fair* by *independent* auditors, thus clearly inviting small investors and other less sophisticated stakeholders to use them with confidence.

Using the stakeholder salience theory developed by Mitchell, et al. (1997), which recognises power-dependency relations within various stakeholders, this study hypothesises that when conducting audits of New Zealand Securities Exchange (NZX) listed companies, auditors have reasons to undervalue the interests of small shareholders more so than the interests of powerful investors and regulators. To explore this hypothesis, this study examined audit managers’ and partners’ views on different types of stakeholder-interest in the published financial statements of NZX listed companies, and these stakeholders’ ability to influence the auditors. The remainder of the paper is organised as follows. The stakeholder salience theory and its relevance to the auditor independence problem are briefly discussed next. The research method, sample and participants are described in section three. Results are presented and discussed in section four, and finally, conclusions are drawn in section five.

Stakeholder salience theory

Mitchell, et al. (1997, p. 854) propose a “theory of stakeholder salience that can explain to whom and to what managers actually pay attention”. Beginning with a broad definition of stakeholders to capture any and all stakeholder groups, Mitchell, et al., recognize three criteria for identifying stakeholder salience – the power to influence; the legitimacy of the stakeholder relationship; and the urgency of a claim of stakeholders on the firm (Mitchell, et al., 1997, p. 854). Explaining the dynamic nature of their theory, and hence, its ability to explain stakeholder salience in a variety of situations, Mitchell, et al., state that:

> “Power and legitimacy, then, are necessary core attributes of a comprehensive stakeholder identification model. We argue that when these attributes are evaluated in light of the compelling demands of urgency, a systematic, comprehensive, and dynamic model is the result” (Mitchell, et al., 1997, p. 863).

Mitchell, et al. (1997) recognise several assumptions that underlie their definition of stakeholder salience. For example, the principle of salience assumes that one who wants to achieve certain ends pays attention to various stakeholders. It is one's perception that determines stakeholder salience, and various stakeholders can be identified using the three main attributes of the theory – power, legitimacy and urgency (Mitchell, et al., 1997, p. 872). Specifically, stakeholder salience theory recognises the presence of different classes of stakeholders (Figure 1). Stakeholders vary from one to another in terms of their power, legitimacy, and urgency.

Qualitative Classes of Stakeholders (Mitchell, et al., 1997, p. 872)

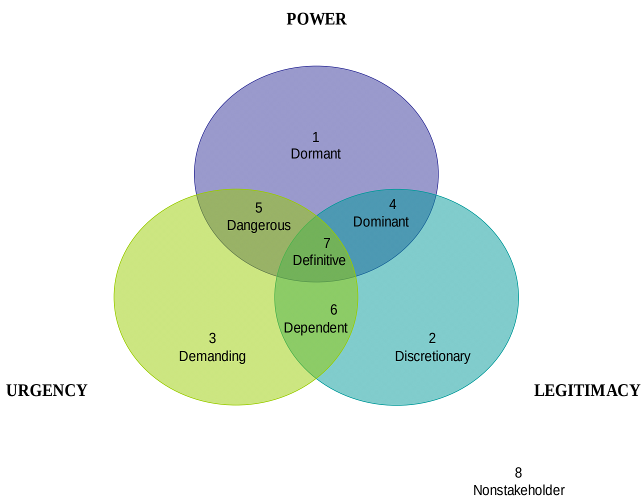

Figure 1

A dormant stakeholder, for example, may possess a high degree of power but may not be in a position to easily exert that power to command a high level of urgency. Equally, a discretionary stakeholder, even though, is high in legitimacy may not benefit from it as they lack power. Only a stakeholder that is high in terms of all three attributes – power, legitimacy, and urgency is best positioned to be so important that its concerns are difficult to ignore. Stakeholder salience theory is therefore useful to understand the complex power relations that exist between auditors and different types of shareholders (e.g., institutional and small investors) and auditors and other stakeholders (e.g., management, NZX, financial analysts, employees, special interest groups, etc.,) whose positions vary in terms of power, legitimacy, and urgency. In turn, this increased understanding is useful to expose the danger of making strong claims to improved auditor independence under the existing and arguably strengthened independence rules, which may be of little effect in providing adequate protection by the auditors to certain stakeholders affected by corporate activities.

Following the stakeholder typology proposed by Mitchell, et al. (1997), Figure 2 classifies various stakeholders of audited financial statements of NZX listed companies.

A stakeholder typology of audited financial statements

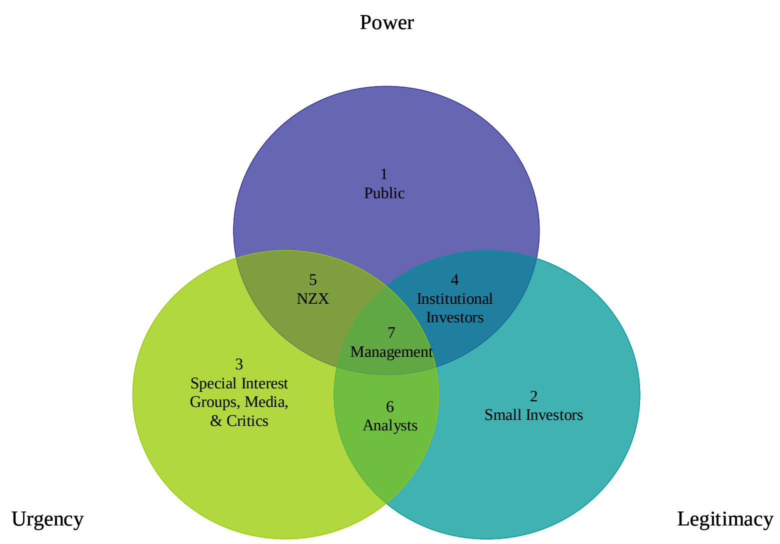

Figure 2

Figure 2 shows corporate management as the most salient stakeholder group among the stakeholders of audited financial statements. Management is a definitive stakeholder as it is best endowed with all three attributes identified in the stakeholder salience theory of Mitchell, et al. (1997). There may be instances where large institutional investors could also be considered as the most salient. But that is likely to happen under exceptional circumstances (e.g., a financially distressed company). In contrast, small investors can be viewed as a discretionary stakeholder as they are high in legitimacy but low with respect to urgency and power *vis-à-vis* other stakeholders. Although such stakeholders have a highly legitimate claim in the affairs of audited financial statements, they may not be able to exert high influence on auditors due to lack of power, resources, and legal avenues. For example, unlike in the US and Australia, New Zealand has legal barriers against taking class actions by small shareholders (Scherer, 2009, p. 16). Institutional investors can be classified as a dominant stakeholder for they can exert power (e.g., demand information) and are high in legitimacy. In comparison, the NZX is a dangerous stakeholder due to its ability to exert power and urgency to any concern it has over audited financial statements of listed companies. Although public has power it is best classified as a dormant stakeholder. This is because public rarely mobilises this power to influence the affairs concerning audited financial statements. Special interest groups and media, on the other hand, are demanding stakeholders whose concerns need to be met with some urgency. However, they have relatively little power or legitimacy *vis-à-vis* other stakeholders in the typology of listed-companies' audited financial statements.

Method

The questionnaire survey method was used. A questionnaire was developed by the authors and it was subjected to a pilot-test by several highly experienced auditors in practice. Minor improvements were made to the questionnaire as a result of the pilot-test's findings, to make the questionnaire easier to understand and to respond.

Sample

Participants for the survey were audit managers and partners employed in New Zealand Big-4 audit firms. It was necessary to focus on Big-4 firms as most of the NZX listed-company audits are conducted by these firms. Given the small population of partners and managers in New Zealand Big-4 firms (a total of 166 auditors), a random sample was not obtained. Instead, all 166 names of these partners and managers received on request from the New Zealand Institute of Chartered Accountants (NZICA, formerly ICANZ) were included in the study. A total of 42 responses was received (25% response rate). The participants' average experience was 13.5 years with a high level of involvement in their firms when determining audit scope (85.8% indicating high/very high involvement), risk assessment (85.7% indicating high/very high involvement) and information disclosure issues (95% indicating high/very high involvement). Accordingly, the participants were highly knowledgeable and experienced in dealing with the issues covered in the survey.

Results & Discussion

Stakeholders' interest in financial statements

The survey examined auditors' views on the level of interest various parties have on the listed company financial statements and different stakeholders' ability or power to influence auditors. Table 1 shows a summary of auditors' views on the level of interest various user groups have on the NZX listed company financial statements.

Table 1: Different stakeholders' interest in financial statements

Financial community	**Level of Interest**					
	Very Low	***Low***	***Moderate***	***High***	***Very High***	***Rank****
Small Investors	10%	51%	16%	18%	5%	*4*
Financial Analysts	3%	5%	5%	49%	38%	*2*
Institutional Investors	0%	5%	3%	51%	41%	*1*
NZX	3%	18%	23%	41%	15%	*3*

* Note: Rank 1=highest and 4=lowest. Ranks are based on the sum of percentages shown in the high and very high columns. For example, the institutional investors were perceived to have the highest level of interest = 92% in the financial statements and small investors the lowest = 23%.

These results suggest that a majority of participants believe that institutional investors have the highest level of interest in the listed company financial statements (Table 1: 51% indicated high and 41% indicated very high level of interest), thus leading them to be ranked as the most interested group. By contrast, fewer participants believe small investors have a high level of interest in the listed company financial statements (Table 1: 18% and 5% for high and very high level of interest respectively). While the level of interest NZX has in the listed company financial statements is high (Table 1: 41% and 15% high and very high respectively), this is lower than the financial analysts' interest in the financial statements (Table 1: 49% indicated high and 38% indicated very high level of interest). Based on the responses of the participants in this survey, the level of interest in financial statements of NZX listed companies could be ranked from highest to lowest as: (i) institutional investors; (ii) financial analysts; (iii) NZX; and (iv) small investors (Table 1).

Stakeholders' ability to influence auditors

Table 2 shows a summary of the participants' views on the ability of various groups in the financial community to influence auditors. Participants indicated that while NZX had the largest influence (Table 2: 42%), small investors had the smallest influence on auditors. Next to NZX, institutional investors were being identified by the participants as the group having the greatest influence on auditors (Table 2: 29% and 3%, indicated high and very high influence respectively).

Table 2: Different stakeholders' ability to influence auditors

Financial community	**Ability to Influence**					
	Very Low	***Low***	***Moderate***	***High***	***Very High***	***Rank****
Small Investors	51%	33%	13%	3%	0%	*4*
Financial Analysts	28%	57%	10%	5%	0%	*3*
Institutional Investors	5%	21%	42%	29%	3%	*2*
NZX	3%	29%	26%	42%	0%	*1*

* Note: Rank 1=highest and 4=lowest. Ranks are based on the sum of percentages shown in the high and very high columns. For example, NZX was perceived to have the strongest ability to influence auditors = 42%, and Small Investors the lowest = 3%.

Although slightly higher than the ability of small investors, financial analysts too did not have much influence on auditors (Table 2: 5% and 0%, high and very high respectively). Accordingly, in terms of their ability to influence auditors, NZX could be ranked number 1 (the highest influence), and institutional investors, analysts, and small investors respectively as 2^{nd}, 3^{rd}, and 4^{th} (the lowest influence). Table 3 shows a matrix of interest *versus* influence (or power) that may be helpful in understanding auditors' perception of interest and power relations that seem to exist in the New Zealand audit environment. From the perspective of stakeholder salience theory, the institutional investors appear to be the dominant stakeholder in New Zealand audit environment. Although NZX has regulatory power and is therefore in a position to censure auditors directly, auditors who participated in the survey seem to recognise its interest in financial statements less than that of the institutional investors. This is understandable as

NZX's interest is about compliance with rules, not about corporate activities and their effects on others.

Table 3: A matrix of auditors' perception of Interest and Power

Interest / Power	High	Low
High	Institutional Investors (Rank: Interest = 1 & Power = 2)	NZX (Rank: Interest = 3 & Power = 1)
Low	Financial Analysts (Rank: Interest = 2 & Power = 3)	Small Investors (Rank: Interest = 4 & Power = 4)

While financial analysts are perceived as having high interest and low power, among the four stakeholder groups examined in this study, small investors appear to be the group with the lowest level of interest and power over auditors.

As expected, the responses of auditors are consistent with the stakeholder typology of audited financial statements presented earlier in Figure 2. The results of the survey suggest that highly experienced auditors in New Zealand think that small investors have comparatively little interest in the NZX listed company financial statements and they have little power to influence auditors. The information needs of small investors therefore may not receive high priority, and to an extent this may raise the question as to whether auditors are willing to judge financial statements on the basis of principles or on higher order criteria such as corporate transparency. Also, it is unclear whether in fact small investors have little interest in the NZX company financial statements. In addition, the results suggest that auditors are more likely to respond to the demands of institutional investors than those come from small investors. The problem is that institutional investors may be in a position to demand information from companies. This is a privilege that is unavailable to small investors. Therefore, it is important to represent the interests of small investors fairly since they are more vulnerable to poor corporate reporting than their *more powerful* counterparts. Given the limited results available from this survey further research is needed to examine whether auditors tend to mainly satisfy the demands and expectations of more powerful investors (e.g., institutional investors) and interested parties (e.g., NZX and analysts) leaving those of small investors in the periphery.

Auditors' willingness to make financial statements more transparent

Many accounting practitioners seem to believe that the disclosure of information is unnecessary if it is not specifically called for in the respective accounting standards or regulations (Lont, 2002; Liyanarachchi, 2006). A related issue is the belief that it is the responsibility of companies to disclose more information than what is required by regulations, and hence, accounting practitioners cannot persuade clients to do so. For example, empirical research shows that New Zealand financial statements do not disclose important information related to environmental impact (Milne, et al., 2001), and intellectual capital (Whiting and Miller, 2008). These disclosures may be useful for a proper dialogue to be maintained between the role of corporations and societies in which they operate (Liyanarachchi, 2008). Auditors' bias towards clients' interests (Shafer, et al., 2004) could be one explanation for their lack of action to seek more information. Another explanation may come from auditors' belief that small investors and other less-powerful stakeholder groups are not highly interested in financial statements, thus allowing them to rule out easily the need for such disclosure leaving clients to make such disclosure decisions. Given auditors' views that small investors have relatively little power to influence auditors there may be inadequate incentives for them to consider information demands of such stakeholders.

To shed some light into the disclosure adequacy, the participants' views related to the NZX listed company financial statements' ability to meet regulatory requirements, true and fair criterion, and corporate transparency were examined.

Views were measured using a scale that varied from 1 (strongly disagree) to 5 (strongly agree). The results are presented in Table 4.

Table 4: Auditors' views on the adequacy of NZX listed company disclosure [a]

Statement	Median	Mean
1. Financial reports are transparent	3.0	3.40
2. Forthcoming with important information	3.0	3.34
3. Disclosures meet the accounting and regulatory requirements	4.0	4.10
4. Disclosures meet the true and fair criterion	4.0	3.97
5. Voluntarily discloses important information	3.0	2.89
6. Voluntarily discloses beneficial information	3.0	3.33
7. Discloses beyond legally required minimum if auditors insist on such disclosure	3.0	3.32
8. Easy for auditors to persuade companies to disclose beyond what is legally required	3.0	2.59
9. Disclosures satisfy the company obligations to owners and interested parties	4.0	3.41

a. Views were measured using a scale that varies from 1 (strongly disagree) to 5 (strongly agree).

Table 4 shows that the survey participants moderately agree that NZX listed companies are forthcoming with important information to meet higher requirements such as corporate transparency (see Table 4: statements 1, 2, & 5). Yet they agree that the NZX companies disclose adequate information to meet the 'regulatory requirements' and 'true and fair criterion' (see Table 4: statements 3 & 4). More importantly, the survey participants do not seem to agree strongly that greater levels of disclosure will result if auditors insist on or attempt to persuade companies to make these disclosures when they are beyond the needs for complying with the regulatory requirements (see Table 4: statements 7 & 8). Overall, however, the survey participants seem to be confident that disclosures are adequate to meet the information needs of interested parties (see Table 4: statement 9, median = 4). These results may suggest that auditors think companies are less likely to voluntarily disclose information to make financial statements more transparent than what these statements reveal by complying with standards and regulations.

Table 5 shows some data about the difficulty of relying on disclosure without explicitly requiring them through standards. The participants responded to the likelihood of disclosure of certain information when a client is against that disclosure and the relevant accounting standard requires disclosure, is silent or the need for disclosure is subject to interpretation. When a client is against a particular disclosure, 92.5% of participants indicate that the likelihood of that disclosure is high only if it is explicitly required by a standard. But they think the disclosure is unlikely (Table 5: 85%) if the standard is silent on the disclosure requirement. Also, when a standard requirement is subject to interpretation, many participants rate the likelihood of disclosure against the wishes of directors to be moderate (Table 5: 60%) or low (Table 5: 25%).

Table 5: The impact of clients' preference and the wording of standard on disclosure

	Directors are against the disclosure And		
	The standard **requires** disclosure	The standard is **silent** on disclosure	The standard is **subject to interpretation**
The likelihood of disclosure is:			
Low	0.0%	85.0%	25.0%
Moderate	7.5%	12.5%	60.0%
High	92.5%	2.5%	15.0%

These results may suggest that the information disclosure is largely dependent on either the explicit requirements of standards or clients' willingness to disclose. The role of auditors may be one which attempts to ensure more strict compliance of financial statements with existing standards. However, compliance with standards alone is insufficient to make financial statements *true and fair* (Vinten,

2002) or *transparent*. Indeed, as Clarke and Dean (2007) have demonstrated, attempts of companies and their auditors to ensure stricter compliance with rules, while ignoring the effects such compliance may have on fair presentation, could lead to misleading financial reports.

Conclusion

The results reported in this paper need to be interpreted bearing in mind some of its limitations. Firstly, a large proportion of the sample did not respond to the survey. The views of the non-respondents may be different from those reported in this paper. Secondly, whilst the participants responded to the survey questions, an opportunity was not available to them to explain or clarify their view points in detail. To overcome these limitations future research may focus on conducting in-depth interviews to better understand auditors' views on the issues discussed in this study.

Based on the results of the study, several conclusions can be drawn. Firstly, auditors have little reason to anticipate information needs of less powerful stakeholders of NZX listed company financial statements. Power relations that exist between external auditors and various stakeholders of audited financial statements are such that small investors are least powerful *vis-à-vis* other stakeholders. Additionally, because auditors believe small investors have little interest in financial statements, they are less likely to pay much attention to the needs of such users when they deliberate information disclosure issues. Without adequate regulatory intervention to protect the interests of less powerful stakeholders, corporate financial reporting practices may continue to cater for the needs of more powerful stakeholders irrespective of the presence of mandatory audits. Secondly, although NZX listed company financial statements are labelled *general purpose* and they constitute a significant part of corporate information available in the public domain, auditors seem to focus on regulatory compliance of such statements perhaps hoping that this will automatically make financial statements true and fair. This is problematic as compliance with standards may not necessarily make financial statements either true and fair or transparent. Consequently, questions arise in relation to the use of higher order claims such as “true and fair” and “transparent” financial statements by companies, their auditors, and even by the New Zealand accounting profession (ICANZ, 2002; 2003). Perhaps it is timely to start declaring that financial statements are merely in compliance with accounting standards and reporting regulations. This may be of help to less powerful stakeholders, as they may then focus on financial statements with some caution. We would however like to go further and suggest that NZX listed company financial statements should carry a clear warning that such financial statements are specialist documents thereby signalling the need to seek advice before placing reliance on published financial statements. This seems to be ethical and also in the interests of the public, given that auditors have little reason to represent the interests of less powerful stakeholders such as the small investors of NZX listed company financial statements.

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