Audit Independence and Expectation Gap: Empirical Evidences from Iran

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Abstract
This paper discusses about auditor independence and audit expectation gap. An independent auditor is essential because of the separation of ownership from the management; the independent factor is the foundation of the public accounting profession and upon its maintenance depend the profession’s strength and its stature. Independence is fundamental to the reliability of auditors’ reports. The causes for reducing independence are economic dependence of the auditor on the client; audit market competition; the provision of non-audit services (NAS); the regulatory framework. Due to these causes auditors are not able to produce a fair report. Therefore “auditor independence is a key element of the audit expectation gap”. If auditors are independent it reduces the expectation gap.

Keywords: Audit, Auditor independence, Iran, Audit expectation gap

1. Introduction
The concept of auditor independence changed during the late 19th and early 20th centuries. Because there was a large shift from capital coming from some sources to capital deriving primarily from domestic sources, noted economic sectors means articulated this change that large corporations were based on the separation of ownership from management, which they also emphasized the growing importance and role of accounting and auditing. The auditors’ primary duty was to serve the needs of proprietary interest, which comprises of shareholders and general public. The creation of SEC laid emphasis on standards for financial reporting and auditing. The concept of auditor independence shifted in favor of objectivity and neutrality in reporting.

The audit of accounts in the corporate sector by an independent auditor is obligatory by statute, which defines his duties, rights and powers. It is essential because of the separation of ownership from the management in the corporate sector as the former needs someone who can keep a professional watch on the latter and to whom they can trust for the reliability of accounts as the preparation of financial statement is the prerogative of the management. The auditor has not much to suggest on the form and adequacy of financial statement and independent auditor is responsible for his report. Independence is fundamental to the reliability of auditors’ reports. Those reports would not be credible, and investors and creditors would have little confidence in them, if auditors were not independent in both fact and appearance, which it expressed by Council of the American Institute of Certified Public Accountants (AICPA) in a statement adopted in 1947. Auditor independence is considered the hallmark of auditing profession. Independence is viewed as the most essential factor in business sector in protecting the interest of several parties.

Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depend the profession’s strength and its stature (Carey, 1970).
2. Independence

Gill and Cosseral (1996) have emphasized that independence is the cornerstone of the auditing profession. Without independence the auditor’s opinion is suspect. In addition the third parties believe that without independence there is no need for external auditors. Third parties’ acceptance implies that the role of the external auditors is that of an independent instrument of social control within the corporate accountability process. To maintain independence under the many pressures of practice, an auditor must be alert to any deleterious influences on his planning, investigative, or reporting independence.

The public perception of auditor independence is important because the apparent independence depends on society’s perception of what could impair actual independence. The external auditors must strive to ensure that audit quality will not be compromised and that auditor performance.

2.1 Definitions of auditor independence

The concept of independence has proved difficult to define precisely (Schutze, 1994), however representative definitions are:

‘The conditional probability of reporting a discovered breach’ (DeAngelo, 1981);
‘The ability to resist client pressure’ (Knapp 1985);
‘A function of character, with the attributes of integrity and trustworthiness being key’ (Magill and Previts 1991);
‘An absence of interest that create an unacceptable risk of bias’ (AICPA 1985);
“Independence is the main means by which the auditor demonstrates that he can perform his task in an objective manner” (FEE 1995) and
‘Freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditor ability to make unbiased audit decisions’ (ISB, 2000).

There respective definitions all reflect the importance of objectivity and integrity as the two key aspects of auditor independence (Dunmore and Falk, 2001).

2.2 Factors affecting auditor independence

The auditor’s independence may be influenced by conscious inaccuracy or by unconscious inaccuracy in the reported information. The conscious inaccuracy may arise out of several factors like,

a) Close to his client;
b) Dependency on the client for his livelihood;
c) Driven by a desire of economic and social success;
d) Close relationship with the client’s executive;
e) Blood relationship or marriage relationship with his clients;
f) Acceptances of goods or services from clients directly or through his employees at confessional basis or free basis;
g) Beholden to the Board of Directors for his re-appointment; and
h) Competitive in audit market (Sucher and Macullich, 2004).

The unconscious inaccuracy may also arise from several factors as below:

a) The auditor may rely on branch manager;
b) Rely on external confirmation while making his opinion on accounts such as confirmation from debtors, creditors, bankers etc; and
c) Rely on the management for verification and valuation of assets to a greater extent.

Normally auditors bother for their re-appointment as shareholders in the annual general meeting appoint them but in practice they are dependent on the board for their reappointment because of controlling power of the board arising out of its domination of the management by a few family blocks.

Sometimes the possibility of varying interpretations of financial accounting practices may adversely affect Auditor independence

Battie et al. (1999) identified four themes as impediments to independence. They are:

1. Economic dependence of the auditor on the client;
2. Audit market competition;
3. The provision of non-audit services (NAS); and
4. The regulatory framework.

3. Audit expectation gap

Audit is essentially entrusted with the task of reporting reality in financial statements and this reality is what the users of accounting information expect. However, the auditors may not check out the reality and this reality may fall short of user expectations. This shortfall in audit effectiveness is broadly labeled as audit expectation gap. Most of the time financial statement users consider an auditor’s report to be a clean bill of health. Thus most users’ expectation toward auditors is far more than what they should be. The expectation gap occurs when there are differences between what the public expects from the auditor and what the auditor actually provides. To guarantee on efficient control to the shareholders and to the general public, the auditors have to meet stringent requirements both with regard to their professional knowledge and their independence.

One of the first discussions of an expectation gap in financial statements was by Liggio (1974). He was concerned that since the late 1960 the accidentally profession had been under attack regarding the quality of its professional performance. He suggested two reasons for this: ‘a greater willingness to hold others-especially professionals-accountable for perceived misconduct and the expectations gap as ‘a factor of the levels of expected performance as envisioned by both the independent accountant and by the user of financial statements. The difference between these levels of expected performance is the expectation gap’.

This definition was extended a little in the Cohen Commission’s (1978) terms of reference. The commission was charged, inter alia, to consider whether a gap might exist between what the public expected or needed and what auditor could and should reasonably should. They did not allow for substandard performance. It is submitted that gap which gives rise to criticism of auditors is that between what society expects from auditors and what is perceives its receives from them. It is therefore proposed that the gap more appropriately entitled “the audit expectation performance gap” may be defined as the gap between society’s expectation of auditors and auditors’ performance as perceived by society. Given this definition, the analysis indicates that the gap has two major components:

1. A Gap between what society expects auditors to achieve and what they can reasonably be expected to accomplish (designated the reasonableness gap).

2. A gap between what society can reasonably expect auditors to accomplish and what they are perceived to achieve (designated the performance gap).

This may be subdivided into 2:1 a gap between the auditor that can reasonably be expected of auditors and auditors existing duties as defined by the law and professional promulgations (deficient standards) and 2.2 a gap between the expected standard of performance of auditors existing duties and auditors perceived performance, as expected and perceived by society (deficient performance).

Sikka et. al., (1992) identified the independence is the main cause to reduce the expectation gap. He stated “as a first step towards reducing the expectation gap, auditing standards and hence audit objectives should be shaped by open, democratic, accountable bodies, independent of the accountability profession and the DTI”\(^{\dagger}\). Continuing arguments on reducing audit expectation gap, he recommends one of the steps to be taken by the profession to reduce the expectation gap is reform relating to auditor independence. Directly related to the independence issue is auditor appointment and the role of directors and senior management in that appointment.

Different underlying explanations have been offered for the continuing presence of the expectations problem. Tricker (1982) viewed the expectation gap as the result of a natural time lag in the auditing profession identifying and responding to continually evolving and expanding public expectations. Other authors argued that it was the consequence of the contradictions in a self-regulated audit system operating with minimal government intervention as evidenced in Hopwood (1990); Humphrey (1991).

Much has been written about the possibility of an audit expectations gap. Concerns over ambiguities in the role and responsibilities of auditors have led to the establishment of several government and professional investigations, which form an important part of the expectation gap literature. These include the Cohen Commission (1978); Metcalf Committee (1976); and Treadway Commission (1987); in the United States, the Cross Committee (1977); and Greenside Committee (1978); in the United Kingdom and the Adams Committee (1977) and MacDonald Commission (1988) in Canada. A common finding in all these investigations is that a gap between audit performance and expectations exists.

In the face of a growing expectation gap between auditors and the public, the accounting profession has attempted to narrow, if not eliminate, the gap and counteracts the negative consequences. Efforts to this end have included changes in accounting/auditing standards, revising the audit report and conducting official investigation as evidenced in the studies of Guy and Sullivan (1988); Hille (1993); Pound and Fensome (1993); Chenok (1994); ICAA (1994); and Koh (2000). The most relevant studies are delineated here. However, these evidences prompt a serious concern to the auditing profession as the proven existence of the expectation gap lead to severely tarnished reputation and negative perception towards the value of independent audit (Fadzly and Ahmad, 2003).
4. Empirical evidence on independence and audit expectation gap

The expectation gap stems from the differing expectations of the function of independent audit between the auditors and the public. Sweeney (1997) listed out the areas where difference in expectations mostly arises: going concern, fraud and illegal acts, independence, and duty of care.

The empirical study by Humphrey (1991) with reference to England is an extension of first studies and the main conclusions include expectations gap in auditors’ role in fraud detection; the extent of auditors’ responsibility to this party; the nature of balance sheet valuation; threats to auditors’ independence; and auditors’ ability to cope up with risk and uncertainty. He also adds “If any topic can be classified as going to the heart of the audit expectations debate, it is the issue of auditor independence.” Humphrey et al. (1992) stated that the “auditor independence as a key element of the audit expectation gap”.

Garcia-Benau and Humphrey (1992) investigated the expectation gap in both the UK and Spain. Auditors, finance directors and users were asked, inter alia, whether audit firms should not provide NAS to their audit clients. In both countries, the average response was close to neutral for all groups except UK auditors who expressed strong disagreement.

The Beattie et al., (1988; 1999) study examined a large set of 45 economic and regulatory factors that could impair or enhance auditor independence, using questionnaire surveys of UK audit partners, finance directors and financial journalists. At a level of 50 per cent of audit fee, the corresponding threat rankings were firth, tenth and seventeenth and at the level of 25 per cent of audit fee they dropped to fourteenth, eighteenth and twentieth ranks. NAS fees also increased economic dependence generally, and all groups ranked various measures of economic dependence among the top threat factors.

A survey taken up by Lin (2004) in China with respect to audit objectives, auditor's obligation to detect and reporting frauds and third party liability of auditors. The study evidenced the emergence of the expectation gap in China and the majority of audit independence by reducing governmental control or intervention and moving towards self-regulation of the profession. This study has a limitation in the sense that it should cast light on understanding of the institutional setting and updated development of independent audits in China and may also serve as an annotation to the recent accounting reform debates in the western world. This study investigated the views of natural shareholders regarding the role of the effects on independence due to the audit firm also providing non-audit services to their audit client. A total of 615 questionnaires were received with an overall response rate of 37.50 per cent. Shareholders were asked whether they agreed that the independent audit enabled them to rely on financial information of profits, dividend yield/payout ratios and assets/liabilities. The responses of shareholders generally confirmed that the independent audit was important in their use of financial accounting information. Similarly, the reliability factors for the audit report of the independence of auditors and audit firm reputation were tested. Both were believed to add credibility to the auditors’ report. Further discussion involved shareholder perception of audit independence in three separate instances: audit firm receiving substantial consultancy fees; the auditor holding shares in the audit client and the same auditor had been retained for over seven years. Shareholder opinions revealed that auditor independence was perceived to have been impaired by the substantial consultancy fees paid, but to a lesser extent by share ownership. Long-term audit contracts were not perceived to impair auditor independence. This study also refutes the idea that auditors could maintain their independence when receiving substantial consultancy fees. Overall, the findings of this research suggest that natural shareholders place a strong reliance on regulatory matters such as the accounting standards and the corporation’s law for accounting information.

Alleyne et al., (2006) investigated the appearance standard by empirically exploring both auditors’ and users’ perceptions of auditor independence in Barbados. Firstly, the study contributed to the existing body of knowledge in terms of providing a better understanding of the nature of auditor independence in small developing countries. Secondly, this study could inform policy makers, governments and professional accounting bodies as to how auditor independence policies and frameworks could be structured to ensure adequate regulation of the capital market. Thirdly, their study would serve to educate users and auditors about the contextual factors surrounding the role of auditor as well as the possible threats and enhancements factors affecting auditor independence. The survey instrument was divided into two sections: section one dealt with demographic factors and section two focused on 39 audit-related issues categorized under a number of generic factors. The sampling respondents identified comprised several groups such as auditors, financial directors, credit managers, investment analysts, fund managers, shareholders and government departments. The sample respondents comprised 66 auditors and 148 users. The findings of the study revealed that economic dependence of auditor on the client, the provision of non audit services, high competition, small firm size, being a sole practitioner, lengthy tenure and the size and closeness of Barbadian society were found to negatively affect perceptions of auditor independence.
5. Research methodology

The main objectives of this research are measured whether there is expectation gap between auditors and investors regarding to status of auditor independence in Iran. So far accurate answer to this question, the authors design and developed a questionnaire based on method used in Best et al (2001) in Singapore, Nazri Fadzly and Ahmad (2004) in Malaysia and Chowdhury et al (2005) in Bangladesh.

The questionnaire contain two parts namely (A) bio-data and some questions about importance of audit, importance of financial reports, importance of company profile and importance of Directors profile, which totally this section has 10 tables and (B) this section includes 9 questions regarding to the level of audit independence in Iran, which this section of questionnaire contain two parts; first contain shows on Table No.11, 9 questions which show actual level of auditor independence in Iran and second part shows on Table No.12 contains the same questions which assert investors expectation regarding to auditor independence in Iran. The measure instrument of the statements is a Five-Point Likert type scale anchored “strongly disagree” (1) and “strongly agree” (5). To test for the significant expectation gap between two parties of respondent, Mann-Whitney U test is used which is non-parametric equivalent to the t-test, considered appropriate for ordinal measurements, such as the Likert scales employed in this study. It tests whether two independent samples are from the same population.

6. Results of study

Parts (A) contain Table No. 1 for descriptive analysis which shows below:

The table shows that related information collected from 214 Iranian investors and 227 Chartered Accountants. Total 441 useable questionnaires collected from both sides.

Part (B) contains 2 tables which show status of real and expectation levels of auditor independence and perceptual level of independence in Iran.

As Table No. 1 shows, investors got more than 91% bachelor degree and less than 8% master degree, whereas more than 78% of Chartered Accountant have bachelor, more than 20% of them have master and only less than 2% have PhD in accounting qualification. As shows in the table less than 44% of investors have not any auditing information as well as knowledge; approximately 56% of them have same knowledge.

Furthermore, the table revealed status of invested in corporate which in addition of investors more than 23% of Chartered are invested in corporate sectors. However it is incredible that Chartered Accountants this much investing in corporate sectors.

Insert Table 1

Above table shows amount of reading habits in both participants, which according to this table approximately 72% of investors reading financial statements occasionally and 28% of them looking to financial statements regularly. Whereas more than 48% of auditors reading financial statements occasionally and 52% of them reading financial statements regularly and also the table presents the distribution of respondents from the viewpoint of high importance of audit of audit report and low importance, which exact 50% investors believes that the auditor report is very important and 50% of them have idea that the audit report is not important. 26.5% of auditors have this perception that audit report is not important and 73.5% of them strongly believe that audit report is very important. In addition it is shows that 35% investors have this idea that financial statements are not very important, while 17.6 auditors have same idea. 65% investors and 82.4% auditors believes that the financial statements are very important.

Analysis of statement No.1, Table No.2 about actual level of audit independence revealed that there is significant difference between investors and auditor regarding to actual level of economic dependence of the auditor on the client which 39% investors agree with this statement, while only 10% of auditors have a same idea; in this position, may be auditors want to reluctant to reveal real position of this statement.

Analysis of statement No.2 show that there is a significant gap between two parties which 36% investors believe that audit market competition impair independence, whereas only 10% of auditors agree with this idea in other words Iranian investors strongly agree that audit market competitions impair independence of external auditors.

In relation to statement No.3 results show that there is no significant gap between two parties, in other words both investors and auditors strongly believe that receiving payment for non-audit services impair independence, it my because of practicing non audit services by auditors, while there is no complete regulation with respect to that.

Insert Table 2

Analysis of statement No.4 on Table No.2 shows that there is significant gap between auditors and investors; namely 81% auditors emphasize the regulatory framework will be effected on independence of auditors but 26% investors have same perception. It could be arise from investors’ unawareness regarding auditor regulatory framework.
With regard to statement No.5 result shows that there is a significant difference between auditors and investors in relation to the corporate governance system. In other words, 79% auditors strongly agree that corporate governance system influence on independence of auditors, while 19% investors have the same believe.

Analysis statement No. 6 shows that significant gap between two parties, in other words, 8% auditors disagree that the greater use of audit committees influence to independence while, 29% investors strongly agree that the greater use of audit commits influence to auditor independence.

With regard to statement No.7 result shows that there is wide gap between two parties with regard to professional ethics guidance; 20% investors agree with this statement, while 76% auditors strongly believes that the professional ethics guidance has a direct affect to auditor independence.

Analysis statement No. 8 shows that also there is significant difference between auditors and investors in relation to receiving gifts and presentations from management; 87% auditors strongly disagree with this statement, while 37% investors strongly agree that receiving gifts and presentations from management deeply influence on auditor independence.

Analysis the last statement shows there is gap between to parties. 77% auditor strongly disagree with the statement “Prospects of reappointment impair audit independence,” whereas 38% investors strongly agree with statement.

Table 3 shows expected level of audit independence in Iran, which the same above questions are repeated here for measuring expected level of independence from the viewpoint of auditors and investors.

According to Table No. 3 about the statement No. 1 there is a significant expectation gap between auditors and investors; 42% investors have same perception that the economic dependence of the auditor on the client, while 4% auditors agree with this statement.

Result of analysis statement No. 2 shows that there is a significant gap between two parties with regard to that the audit competition may affect to independence. 81% auditors have same perception that audit competition may independence, while, 30 investors disagree with this perception.

Analysis of the statement No.3, Table 3 shows that there is also expectation gap between two parties; 78% auditors expect that receiving payment for non-audit services will be affect on independence, while 47% investors thinking that receiving payment for non-audit service will not be affected on audit independence.

Result of statement No.4 shows that there is a significant difference between two participants. 91% auditors expecting that the regulatory framework will impair independence, whereas the investors not expecting that the regulatory framework impairs independence.

Insert Table 3

With regard to Table No. 3 about statement No.5 result shows there is expectation gap between auditors and investors in respect to the corporate governance system and independence.

87% auditors expect that corporate governance system will be affect on audit independence, while 18% investors not expecting in this manner.

Result of statement No.6 shows there is no expectation gap between two parties, in other words 84% auditors and 67% investors strongly expecting that the greater use of audit committees have positive affect on independence, in this condition audit committees plying very important role to audit independence.

Result of statement No.7 shows that there is a significant gap between two parties; 84% auditors have expectation that Professional ethics guidance has positive affect on audit independence, but 13% investors expecting that the professional ethics guidance has not positive affect on independence.

With regard to result of statement No.8 found that there is no significant expectation gap between two parties with regard to receiving gifts and presentations from management; both parties strongly expecting that receiving any gifts and presentations from management impair audit independence.

Result of statement No. 9 at Table No. 3 shows that there is a expectation gap between two parties; 41% investor expecting that Prospects of reappointment for next yeas strongly impair audit independence, whereas only 8% auditors have the same expectation.

7. Conclusion

In conclusion, the maintenance of auditor independence is very important for the users of the financial statements. The more independent an auditor seems to the greater will be the confidence in his work and opinion. Independent audit is an important factor to reduce audit expectation gap, because the investor and others are expecting more from auditor. In conclusion, the maintenance of auditor independence is very important for the users of the financial statements. The
more independent an auditor seems to the greater will be the confidence in his work and opinion. Independent audit is an important factor to reduce audit expectation gap, because the investor and others are expecting more from auditor. This study found significant expectation gaps between auditors and investors on actual level of audit independence in Iran. As mentioned earlier, according to Table No.2 except statement No.3 there are significant differences on other statements. It seems that the auditors believe the external factors (i.e. the regularity framework, and corporate governance) are more effective on depend or independent of auditors rather than eternal factors (i.e. prospects of reappointment), while investors believe the internal factors impair audit independence rather than external factors.

With regard to Table No.3 difference perceptions were found between two parties, except statements No.6 and 8 in other statements there were difference perceptions on audit independence.

For reducing such gaps at first, Iranian accounting and auditing regulators should develop scope of audit independence and show clear picture of that, second investors should aware about responsibilities as well as limitations of audit independence. In this position better communication between two parties may reduce such gaps.

References


Table 1. Profile analysis

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<thead>
<tr>
<th>Statements</th>
<th>Investors</th>
<th>Auditors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Qualification:</td>
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<tr>
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<tr>
<td>Master</td>
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<tr>
<td>PhD</td>
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<tr>
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<tr>
<td>Yes</td>
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<td>227</td>
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<td>Invested in corporate:</td>
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<td>Yes</td>
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<td>121</td>
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<tr>
<td>Reading financial statements:</td>
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</tr>
<tr>
<td>Occasionally</td>
<td>154</td>
<td>110</td>
</tr>
<tr>
<td>Regularly</td>
<td>60</td>
<td>117</td>
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<td>Low</td>
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<tr>
<td>High</td>
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<td>Importance of financial statements:</td>
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<td>High</td>
<td>139</td>
<td>187</td>
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</table>

Table 2. Actual Level of Independence

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<th>Investors</th>
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<td></td>
<td>Mean</td>
<td>Median</td>
<td>Std</td>
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<tr>
<td>1   Economic dependence of the auditor on the client.</td>
<td>2.17</td>
<td>2</td>
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<td>-6.56</td>
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<td>2   Audit market competition.</td>
<td>2.95</td>
<td>3</td>
<td>0.74</td>
<td>-2.29</td>
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<td>3   Receiving payment for Non-audit services.</td>
<td>1.95</td>
<td>2</td>
<td>0.71</td>
<td>-1.55</td>
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<td>4   The regulatory framework.</td>
<td>3.70</td>
<td>4</td>
<td>0.83</td>
<td>-10.77</td>
</tr>
<tr>
<td>5   The corporate governance system.</td>
<td>4.29</td>
<td>5</td>
<td>1.28</td>
<td>-13.51</td>
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<td>6   The greater use of audit committees.</td>
<td>2.85</td>
<td>3</td>
<td>0.87</td>
<td>-2.25</td>
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<td>7   Professional ethics guidance.</td>
<td>4.34</td>
<td>5</td>
<td>1.04</td>
<td>-12.98</td>
</tr>
<tr>
<td>8   Receiving gifts and presentations from management</td>
<td>1.33</td>
<td>1</td>
<td>0.99</td>
<td>-7.88</td>
</tr>
<tr>
<td>9   Prospects of reappointment</td>
<td>2.35</td>
<td>2</td>
<td>0.98</td>
<td>-3.14</td>
</tr>
</tbody>
</table>

Note:* Significantly different from Auditors at P≤0.01
Table 3. Expected Level of Independence

<table>
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<th>Auditors</th>
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<td>Median</td>
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<td>Mean</td>
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<td>Std</td>
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<td>3</td>
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<td>3</td>
<td>1.62</td>
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<td>1.72</td>
<td>-6.92</td>
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<td>4</td>
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<td>1.14</td>
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<td>4</td>
<td>1.58</td>
<td>-9.79</td>
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<tr>
<td>The greater use of audit committees</td>
<td>3.64</td>
<td>4</td>
<td>1.09</td>
<td></td>
<td>3.49</td>
<td>4</td>
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<td>Professional ethics guidance</td>
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<td></td>
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<td>Receiving gifts and presentations from management</td>
<td>1.81</td>
<td>2</td>
<td>0.78</td>
<td></td>
<td>2.06</td>
<td>1</td>
<td>1.76</td>
<td>-0.60</td>
</tr>
<tr>
<td>Prospects of reappointment</td>
<td>2.06</td>
<td>2</td>
<td>0.94</td>
<td></td>
<td>2.60</td>
<td>3</td>
<td>1.70</td>
<td>-3.14</td>
</tr>
</tbody>
</table>

Note:* Significantly different from Auditors at \( P \leq 0.01 \)