The Impact of Guanxi on Auditor Independence: Perceptions of Auditors and CFOs in Hong Kong.

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Abstract

Auditor independence has long been referred to as the cornerstone of the auditing profession. Guanxi refers to the networks of informal relationships and exchanges of favors that dominate all business and social activities that occur throughout China. This research will analyse the impact of guanxi and client size on the perceived independence of auditors in the setting of Hong Kong.

Survey data is obtained from 524 questionnaire responses from Chief Financial Officers (CFOs), Big 4 and Non-Big 4 auditors. Two within-subjects independent variables: “guanxi” and the “client size”, and one between-subject independent variable: auditors versus CFOs, are employed.

Results indicate guanxi is a significant factor influencing perceived auditor independence in Chinese society, which has largely been neglected in the accounting literature. Independence is severely impaired when the duration of guanxi with clients reaches five years or more. Large client size has a negative influence on the perceived independence of auditors and this result contradicts an earlier U.S. study. The results indicate that the longer the guanxi when the auditor is associated a with large audit client, the greater the decrease in their perceived independence and this has implications for audit legislation.

CFOs generate the lowest mean scores (greatest threat to auditor independence) for the perceived effects of all levels (durations) of guanxi among the three groups. This result supports the stewardship theory that asserts stewards (CFOs) motives are aligned with the objectives of their principals. CFOs consider the increasing levels of guanxi associated with the auditors are not in the best interests of their principals, and hence affect the reliability of the audited accounts.
Though this study is conducted in the Asia Pacific region, western counterparts will find the results useful. Multinational corporations which have subsidiaries or headquarters established globally, should be aware that guanxi has implications for their Asian operations and their consolidated audited accounts. In view of the critical importance of the guanxi factor on the perceived auditor independence, standard setters in this region should consider devising ethical guidelines requiring mandatory rotation of public accounting firms.

*Keywords*: guanxi, auditor independence, client size, stewardship theory, rotation of audit firm
1. Introduction

Auditor independence is regarded as one of the cornerstones in auditing theory (Mautz and Sharaf, 1961). The AICPA (2008) in its Principles of Professional Conduct sets down the following for auditors to observe:

“For a member in public practice, the maintenance of objectivity and independence requires a continuing assessment of client relationships and public responsibility. Such a member who provides auditing and other attestation services should be independent in fact and appearance.”

Perceived independence of auditors is of critical importance both for the Profession and in auditing research. In view of the importance of perceptions of auditors’ independence, researchers worldwide have been investigating dimensions of this issue over a considerable period of time (Ashton, 1974; Firth, 1980; Shockley, 1981; Johnson and Pany, 1984; Knapp, 1985; Pany and Reckers, 1987; Gul, 1989; Bartlett, 1993; Teoh and Lim, 1996; Beattie et al., 1999; Majid et al., 2001; Goodwin and Seow, 2002; Umar and Anandarajan, 2004; Lindberg and Beck, 2004; Lin and Chen, 2004; Jones and Chen, 2005; Cooper et al., 2006; Law, 2008b; Daniels and Booker, 2009; Law and Yuen, 2010).

Many researchers have concentrated their effort in examining whether the influence of provision of non audit services (NAS) have had a negative influence on perceptions of auditors’ independence, and this has particular relevance especially after the Enron debacle (Shockley, 1981; Hillison and Kennelley, 1988; Teoh and Lim, 1996; Beattie et al., 1999; Gendron et al., 2004; Lindberg and Beck, 2004; Alleyne et al., 2006; Carey et al., 2006; Richard, 2006; Law, 2008b), or whether it positively enhances independence (Bartlett, 1993; Emby and Davidson, 1998; Windmoller, 2000). Additionally, some researchers reveal NASs provisions have no influence on perceptions of independence (Sucher and Bychkova, 2001; DeFond et al., 2002; Ashbaugh et al., 2003; Chung and Kallapur, 2003; Quick and Rasmussen, 2005).
These studies had as a focus the monetary impact (provisions of non audit services) on auditor independence, however, considering the importance of guanxi in doing business in Chinese society this non-monetary dimension has considerable importance. Scant attention has been given however to research examining the human impact on auditor independence, like guanxi.

The research issue of guanxi is interesting and such a study can be of significant practical relevance to regulators and practitioners in addition to researchers in both accounting and management. In Western society, because of the close or strong ties in the network relations of organisations (Podolny & Page, 1998) a form of guanxi exits. This research takes the opportunity to extend the empirical study of these relations to the Eastern society, particularly in Hong Kong. The only prior research similar to this has been conducted by Hwang et al., (2008) using Taiwanese data.

Hong Kong was under the sovereignty of Britain for over 100 years until 1997 and western culture and accounting practice is understood in the region (Law and Hung, 2009). However it is appropriate to conduct an empirical study such as this in Hong Kong, because Confucian culture is still deeply ingrained in the Hong Kong society. Cohen et al., (1995) has indicated that there are international differences in auditors’ ethical perceptions, and in an increasingly global environment accounting ethics and cross-cultural behavioral research is strongly recommended (Umar and Anandarajan, 2004; Cooper et al., 2006). This study is the first study in the Asia Pacific region using empirical survey data to examine the impact of guanxi on perceived auditor independence.

Three sample groups of are drawn: Big 4 auditors, non big 4 auditors and Chief Financial Officers (CFOs) from Hong Kong. Two within-subjects independent variables – the guanxi factor (duration) and the client size factor – and one between-subject independent variable – “auditors versus CFOs from Hong Kong – are examined. Given the lack of any theory used to explain the impact of guanxi on auditor independence, this research draws attention to stewardship theory in
considering the goal convergence of shared collective interests with the contracted steward, i.e., the CFOs of corporations.

In Hong Kong, there is currently no mandatory enforcing of Auditing Standards to monitor the impact of guanxi or other perceived risks to independence. With increasing globalization, this study has practical implications for multinational corporations that have business in Chinese societies. It is hoped that the results of the research can assist regulators and standard setters in devising auditing standards and ethical guidelines in Hong Kong and their international counterparts.

Following this introduction the paper proceeds with a literature review, namely, importance of auditor independence, stewardship theory and guanxi from which hypotheses are developed. The data collection method of this research experiment is then discussed. This is followed by the presentation of results, discussion and finally a conclusion.

2. Literature review and hypothesis development

Importance of auditor independence

Auditor independence is an alleged factor attending recent corporate collapses and corporate scandals across the world, for example, Enron, WorldCom, and Sunbeam in the US (Bakar et al., 2005), HIH and OneTel in Australia, and Parmalat in Italy. Auditor independence has long been referred to as an essential component of the auditing profession (Mautz and Sharaf, 1961), and been seen as crucial to the validity of external audit (Sucher and Bychkova, 2001). It has been observed by the Chairman of the American Institute of Certified Public Accountants (AICPA) and embraced by the Hong Kong Institute of Certified Public Accountants (HKICPA) as indeed the cornerstone of the accounting profession and one of its most precious values. Actual independence and the appearance of auditor independence have thus been heralded within the major worldwide professional accounting bodies as matters of primary importance. The requirement for CPA auditors’ independence from audit clients is well established in the professional standards of the accounting bodies such as the Institute of Chartered Accountants of England and Wales (ICAEW), American
Institute of Certified Public Accountants (AICPA), The Institute of Chartered Accountants in Australia (ICAA), and CPA Australia. The Code of Professional Conduct (ICAA and CPA Australia, 2005) explicitly requires not only actual independence from audit clients, but also the maintenance of the appearance of independence to third parties.

In that context the International Standards on Auditing (ISA) 200 states that the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. If outside parties doubt the independence of the reporting auditors, then a number of possibilities could arise. Firth (1980) mentions the following three impacts:

1) Audits may be perceived to be valueless. Audit work and audit fees would disappear.
2) The Government may become more involved in auditing matters and could move towards a state-controlled audit board.
3) Other regulatory bodies such as Stock Exchanges may become more concerned with auditing matters. This may result in lower earnings for auditors and lessen the powers of the professional accounting bodies and CPAs.

Thus, it is generally argued as vital that auditors maintain their independence, to ensure high quality of audits are maintained at all times, and that without auditors’ independence, the credibility of the audited financial statements would be reduced to the detriment of interested parties and, indeed, to the accounting and auditing profession generally (Bakar et al., 2005).

Overall the pervading rhetoric appears to be that, when auditors discharge their responsibilities, independence both in fact and in appearance should always be present (Mautz and Sharaf, 1961; Firth, 1980; Shockley, 1981; EFAA, October 1998; Hussey and Lan, 2001). Indeed, in the wake of Enron and the subsequent demise of
Arthur Andersen the future of the auditing profession was argued to be dependent upon the perceptions of auditor independence. In other words, once an auditor is perceived to lack independence, the audit work loses credibility and the value of the auditing function is severely impaired, if not lost (Firth, 1980; Koh and Mahathevan, 1993; DeFond et al., 2002; Law, 2008b); an audit report is only beneficial if it contains reliable and unbiased information. When users of the audit report do not believe that the auditor is independent, reduced confidence is applied to the auditor’s opinion in the audit report (Quick and Rasmussen, 2005; Law, 2008b).

**Stewardship theory**
Stewardship theory examines relationships and behaviors often discounted in organizational economic theories, emphasizing collective and contractual behavior in which a higher value is placed on goal convergence than on agent self interest (Slyke, 2006). Stewardship theory defines situations in which managers are not motivated by individual goals, but rather are stewards whose motives are aligned with the objectives of their principals (Davis et al., 1997a). In contrast to agency theory, a steward places greater value on collective rather than individual goals, makes decisions he/she perceives to be in the best interests of his/her principals (Davis et al., 1997b). Stewards are motivated by intrinsic rewards such as trust, job satisfaction and mission alignment (Mayer et al., 1995). The disposition of both the principal and the contracted steward is towards trust and the realization of collective interest, and this differs significantly from that of agency theory which is more distrusting of the intentions of the agent (Slyke, 2006). Hence, there is much less of a clear divergence between managerial and shareholder interests under the assumptions of stewardship theory. Though the accounting literature has attempted to use the stewardship theory to examine corporate competitiveness (Ho, 2005), the theory remains acknowledged but largely neglected and untested (Slyke, 2006; Pirie and McCuddy, 2007), particularly in application to auditor independence.
**Guanxi**

*Guanxi* describes the basic dynamic in the complex network of personal influence and social relationships, and is a central concept in Chinese society. China is often described as being a relational society involving mutual obligations’ a long-term perspective and cooperative behaviour. By contrast, Western society and business environment is characterised by the short-term immediate benefit, highly transactional behaviour (Tsang et. Al., 1998).

In the Chinese language, "guanxi" is the term for a personal relationship. It refers to the network of informal relationships and exchanges of favors that dominate all business and social activities that occur throughout China (Lovett *et al.*, 1999; Hwang and Baker, 2000). Sociologists have linked guanxi with the concept of social capital and it has been exhaustively described in studies of Chinese economic and political behavior (Wellman *et al.*, 2002). *Guanxi* has been critically important to Chinese society since the time of Confucius (Hwang and Staley, 2005). Confucius promulgated five sets of healthy relationships with society: ruler/subject, parents/children, older/younger brothers, husband/wife, and friends (Hwang and Baker, 2003; Lovett *et al.*, 1999). Researchers observe that business people cannot achieve their goals alone and thus must rely on social networking or guanxi with others, particularity in Chinese society (Hwang *et al.*, 2008; Groen *et al.*, 2008). In the Mao era, China emphasized collectivistic values like the alignment of individual and organizational interests, when performing well for the individual means performing well for the organization. Conflicts of interest are removed because of this collective interest.

*Guanxi* is embedded in the mindset of the Chinese and in their personal and organisational relationships (Park and Luo, 2001). Thus it ties in business partners by reciprocal exchanges of favours and obligations regularly and voluntarily (Alston, 1989). Once it is established between partners, one can ask a favour of the other, who can also expect it to be repaid in the future, in some way.
As China integrates herself into the world economy, managers in Chinese organizations are now facing the challenge of having to compete with outsiders. They will have to come to terms with operating under a non-guanxi based environment. Similarly managers from the west with have to confront Chinese managers where a more Confucian environment prevails. This may be either inside or outside their corporate boundary, for example, managers operating a Division of a large corporation in China or in dealings with an external supplier from Asia.

In the Chinese business environment, it is unavoidable that an auditing firm will be exposed to guanxi (Hwang and Staley, 2005; Taormina and Lao, 2007; Law and Hung, 2009). The potential audit risk and violation of ethical standards that would impact audit firms when operating in a society of guanxi should not be overlooked (Hwang and Staley, 2005). As a result, guanxi has been widely used in the Chinese society; it is a strong social cultural concept. Individuals can obtain legitimate benefits from organizations but guanxi may also carry negative consequence including cronyism, corruption, violation of organizational procedures, erosion of trust and independence (Khatri et al. 2006; Hwang et al., 2008), hence, favour exchanges between close guanxi parties within an organization may negatively affect the welfare of the others (the non-guanxi parties).

Western and Eastern approaches to guanxi are quite different. Law and Hung (2009) found that the social networking factor is a key factor that influences CPAs to become entrepreneurial start-ups in Hong Kong. Chinese business people often rely on guanxi for business information, advice and problem solving (Hwang and Staley, 2005; Taormina and Lao, 2007; Hwang et al., 2008). Hwang and Staley (2005) observe that in China, business people first strive to build guanxi with a potential customer, and business development follows afterwards. It was also found that once guanxi has been established, marketing costs and bad debt expense are lowered (Hwang and Baker, 2000). Yeung and Tung (1996) noted in their research that guanxi
was the only item consistently chosen as a key factor that contributes to business success in China. Likewise, Au and Wong (2000) indicated that the ethical judgments of Chinese CPAs are negatively affected by *guanxi*. From a western research perspective, Wright and Booker (2005) comment that a former auditor’s prior relationship with the audit client would likely impair auditor independence. Another US study conducted by Bowlin et al., (2009) show that there are concerns when auditors become managers of their audited clients. In a qualitative study in Poland, MacLullich and Sucher (2005) found that ethical issues were thus presented to be a likely problem for Polish auditors. Auditors may be over familiar with clients for their built-in relationships, and thus the degree of thoroughness in the audit investigations may be lower, affecting the independence of the auditors. Auditor independence is further threatened by the very nature of the relationship between client management and the auditor (Windsor and Ashkanasy, 1995). Furthermore, prior studies have indicated that perceived auditor independence may differ very much in different countries (Cooper et al., 1994; Cooper et al., 1996; Patel and Psaros, 2000; Umar and Anandarajan, 2004; Cooper et al., 2006), therefore the importance of *guanxi* in Chinese society is worthy for our research. Hence in the context of the stewardship function and the above literature review leads to the following hypothesis:

**H1: Guanxi has a negative influence on the perceived independence of auditors.**

**Client size**

Generally though, studies which have investigated the association between client size and auditor independence have been infrequent. Shockley (1981) commented that in a highly competitive environment, competition for audit clients increased and this gave clients greater opportunities and incentives to replace incumbent auditors. Auditors’ dependence on their clients may increase. Emby and Davidson (1998) commented that auditors were in a relatively weak position in disputes with their clients, compared to other professionals groups in society, that the existence of the competing audit firms in the audit market can provide a major source of power to clients. Reynolds and Francis (2005) agree that economic dependence clearly exists for large
clients. This dependence is greater when a client is large relative to other clients in the accounting firm. They further comment that could lead to preferential treatment and favourable reporting by auditors. DeAngelo (1981) further found that economic consequences create strong incentives for accounting firms to be lenient and report favourably in order to retain large clients. Miller (1992) also reported that economic dependence could lead to favorably reporting for large clients. A subsequent study conducted in the U.S. found the impact of client size has a negative influence on the auditor independence (Carcello et al., 2000).

In order to make a classification of the definition of client size in this study, corporations which are constituents stocks of the Hong Kong Hang Seng Stock Index are classified as large corporations, while those not in the constituents stocks of the Hang Seng Stock Index are classified as small corporations. Thus the classification is consistent with the grouping categories in prior studies (Pany and Reckers, 1980; Knapp, 1985; Gul, 1989). In considering the impact of client size on the perceived independence of auditors, the above literature review leads to the following hypothesis

**H2: Large client size has a negative influence on the perceived independence of auditors.**

To determine the interaction effects between the independent variables of *guanxi* and the client size factors, the alternative hypothesis H3 is proposed.

**H3: The influence of guanxi on the perceived independence of auditors depends on client size.**

**Between-subject independent variables: types of respondent groups**

There have been several calls for cross-cultural behavioral and accounting ethics research (Umar and Anandarajan, 2004; Cooper et al., 2006). Cohen et al., (1995) suggest there is a need to explore international differences in auditors’ ethical
perceptions. Cooper et al., (1996) in their research found that there are differences in the ethical perceptions and operational practices of auditors in Hong Kong and those in Australia. Hong Kong was under British rule for over 100 years. Although it was handed back to China in 1997, Western culture and accounting practice remains prevalent through various channels, in television, movies, lifestyle, social activities, and the educational system (Law and Hung, 2009). The power of the West has been, and still is, rooted in the forms of social, economic and cultural patterns that prevail in the society (Schaper & Volery, 2004). Hence, both Chinese and Western culture in the Hong Kong environment create a unique environment for the study of guanxi. The study of perceived national cultural differences and the impact of these cultural differences on commercial behavior justify the selection of auditors and CFOs in Hong Kong as respondents for this research (Patel and Psaros, 2000).

Hence H4 and H5 are proposed:

H4: The influence of the guanxi factor on the perceived independence of auditors depends on the respondent sample groups.

H5: The influence of the client size factor on the perceived independence of auditors depends on the respondent sample groups.

The final hypothesis is formed to examine whether there are differences in the perceptions of auditor independence among the three groups.

H6: There are differences in the perceptions of auditor independence among the three respondent groups.
3. Data collection method

Given the exploratory nature of the research an experimental approach has been taken. Respondents are familiarized with the topic of the research through small vignettes of two Hong Kong companies one small and one large. Their views are then sought, through closed questions of the impact of guanxi on auditor independence. Different durations of guanxi are then posed (1, 3, 5 and over 5 years) in order to explore the different possible impact of timescale.

250 Big 4 auditors, 250 non Big 4 auditors and 250 CFOs were randomly selected from the Directory of CPAs booklet (Dijk, 2000). Research assistants were employed to make phone calls to the selected participants, requesting their participation before sending off the questionnaires to them (Law, 2008b). The respondents were assured of anonymity and of the voluntary nature of their cooperation in the survey. The survey package together with a prepaid envelope was then sent to those who agreed to participate. The package consisted of a copy of vignettes, the questionnaire and a cover letter signed by the researchers. Prior evidence in Australia and Netherlands supports contacting the respondents before sending off the questionnaires and suggests response rates of 70% to 80% might be expected (Roberts, 1999; Dijk, 2000). Baruch (1999) observes an average response rate of 59% for surveys of professionals and that this is an acceptable level. Thus similar techniques were used in this study in the expectation of a satisfactory response rate (Sekaran, 2000; Desira and Baldacchino, 2005). Collis and Hussey (2009) suggest that the response rate would be increased by keeping the questionnaire as short as possible and using closed questions of a non-sensitive nature.

Measurement

The term ‘guanxi’ was defined to the respondents and their attention focused on the relationship between auditor and client for the hypothetical small company, not registered on the HKSE. Attention was then turned to a larger size company which was registered on the HKSE. The respondents were asked to rate their perceptions of auditor independence in the vignettes on a five-point Likert scale ranging from 1 “guanxi seriously undermines independence” to 5 “guanxi strongly enhances independence.”
These perceptions dealt with the existence of and duration of *guanxi* between the auditor and client for each of one year, three years, five years and finally above five years.

Responses such as those required in this research are not unfamiliar to auditors. Pany and Reckers (1987) point out auditors often make repeated judgments in their daily work. Auditors are generally working on similar aspects of more than one audit during their daily work and repeated judgments are often required (Bamber, 1983). Therefore, these audit judgments are likely to be *like* within subject responses. Some researchers have commented there exists a possible ‘demand’ effect in the within-subjects repeated measures (Pany and Reckers, 1987; Chang et al., 2002). Demand effect implies instructions may induce the participants attention in a certain direction and this may occur especially in experimental design studies. Findings in psychological research suggest however, that there is little evidence to show the experimental demand effect actually exists (Weber and Cook, 1972; Berkowitz and Donnerstern, 1982).

Moreover, in this research, possible bias due to learning effects from the subjects are controlled for by printing the order of the vignettes and questions in the questionnaire in a random manner (Gul, 1987; Gul, 1989; Dijk, 2000; Chung and Monroe, 2000; Law, 2008b). Gul (1989) further concludes that based on his extensive reviews of the literature there is no *clear-cut* evidence on the existence of “demand effects” in the repeated measures design. Fuller and Kaplan (2004) state that the advantages of the within subjects design in the mixed ANOVA far outweigh the disadvantages.

A mixed ANOVA (within subjects and between subjects ANOVA) is conducted for analyzing the main and interaction effects. Shannon and Davenport (2001) point out that the mixed ANOVA entails a most useful analysis. In the auditing literature, the uses of within subjects repeated ANOVA analysis techniques are commonly used in examining behavioral issues, and in researching auditors’ perceptions of independence (Ashton and
To recap the experiment the two independent variables are:

1) existence and duration of *guanxi* with four levels, 1 year, 3 years, 5 years and more than 5 years relationships with the client, and

2) client size with two levels, large and small client.

The dependent variable is the perceived independence of the auditor in the auditor - client relationship, and the between-subjects independent variables are CFOs, Big 4 auditors and Non Big 4 auditors.

### 4.0 Results

There were 193 responses from the CFOs, 178 responses from the Big 4 auditors and 153 responses from the non Big 4 auditors, giving response rates of 77%, 71%, and 61% respectively. The items in the survey showed satisfactory levels of reliability, with a Cronbach’s alpha of 0.84 and a normal data distribution. A test for non-response bias was carried out by comparing the first 30 responses and the last 30 responses of the second requests for the three groups respectively (Oppenheimer, 1976), but no significant differences in perceptions of independence were found and hence non-response bias was not considered a problem. For the CFOs sample, 69% of the respondents had 11-15 years of experience and 19% had more than 15 years of experience. Whereas for the auditors groups, 62% had 6-10 years of experience, 21% had 1-5 years of experience and 15% had 11-15 years of experience. The descriptive statistics for the means and standard deviations of the scores for the dependent variable, perceived auditor independence, are shown in Table 1.

Table 1 about here
4.1 Within subject analysis

For hypothesis 1, the multivariate test reported in Table 2 relates to the first within-subject independent variable – guanxi. Green and Salkind (2001) recommend reporting the familiar Wilks’ lambda value. The variable for guanxi has an F value of 996 at p < 0.05 and hence the result is statistically significant. As the variable is significant and has four levels, pairwise comparisons were undertaken using the Bonferroni comparison (Green and Salkind, 2001) to reveal where the differences exist. The pairwise comparison (Table 4) shows that all four levels of guanxi are significantly different from each other at a p value < 0.05. The mean score for guanxi with 1 year of relationship drops from 4.18 to 1.76 for guanxi after a relationship of more than 5 years (see Table 3) and therefore H1 is supported.

Table 2-4 about here

For Hypothesis 2, the client size variable has an F value of 92 at p < 0.05 (Table 2) and the result is significant. The means and pairwise comparisons (Tables 5 and 6) show that both levels of the variable are significantly different from each other at a p value of < 0.05. The mean score for large client size (2.54) is significantly lower than that of small client (2.97), implying the larger client size has a negative influence on the perceived independence of auditors, thus H2 is supported.

Table 5 and 6 about here

For hypothesis 3, Client*Guanxi has an F value of 11 at p < 0.05 (Table 2). The result is statistically significant, and thus H3 is supported. The mean scores of the interactions is shown in Table 7. Tests of within subject contrasts (Table 8) show that the difference lays in level 2 versus level 3. That is the mean score drops significantly from 3 years guanxi (2.85) to 5 years guanxi (1.83) (Table 7), indicating perceived independence is
significantly impaired when duration of guanxi increases from 3 years of relationships with clients to 5 years of relationships in a large client environment.

Table 7 and 8 about here

4.2 Between-subject analysis

For hypothesis 4 the (Guanxi* TYPESAMP) interaction has an F value of 16 at p < 0.05 (Table 2). The result is statistically significant, and thus H4 is supported. Test of within-subject contrasts (Table 8) show that the four levels (durations) of guanxi are significantly different from each other for the three groups.

It is interesting to note that the CFOs have the lowest mean scores (that guanxi more seriously undermines independence) for all levels among the groups, while non Big 4 auditors have the highest mean scores for all levels among the groups (Table 9). Overall CFOs consider the independence of auditors would be impaired under the different levels of guanxi relationships to a greater extent than the auditors. These results support the stewardship theory that the CFOs are concerned (as stewards) to give due regard to the the resources entrusted to the corporation under their control (Davis et al., 1997a; Slyke, 2006). This will be elaborated further in the following section.

Table 9 about here

For hypothesis 5, the (Client * TYPESAMP) interaction has an F value of 0.08 at p > 0.05 (Table 2). Thus H5 is rejected. There is no significant difference between the respondent groups concerning the influence of client size on the independence of auditors. This is perhaps not surprising and indeed a somewhat reassuring dimension of the study, that there is some commonality of thinking between the different samples on this point.

For hypothesis 6, the between-subject ANOVA reveals that there are significant differences in the means among the three groups, F value of 140 at p < 0.05 (Table 10). Post Hoc tests
also confirm the results (Table 12). The mean scores of the CFOs (2.2) are the lowest among the groups while non Big 4 auditors have the highest (3.2) (Table 11). Hence, H6 is supported. This confirms the impression created earlier (see Table 1) that the lowest score for ‘undermining independence’ are awarded by CFOs. Big 4 auditors and to a greater extent non-Big 4 auditors do not report as much concern about the undermining of independence.

Table 10-12 about here

5. Discussion and implications
This empirical study makes several contributions. First, the result in H1 indicates that guanxi has a negative influence on the perceived independence of auditors. Independence is severely impaired when the guanxi with the client reaches five years or more. In Hong Kong, there is currently no mandatory rule enforcing Auditing Standards or monitoring of the impact of guanxi or other perceived familiarity risks to independence. Likewise, Section 203 of the U.S. Sarbanes Oxley Act (2002) only requires the reviewing partner of the public accounting firm to be rotated off of the audit every five years. However, the impacts of guanxi on the perceived independence of other auditors in the audit firm are ignored in the Sarbanes Oxley Act (2002). Several bills with provisions dealing with audit firm rotation were heavily debated in the U.S., however nothing was enacted into law because the U.S. Congress decided further study was needed (Daniels and Booker, 2009). Though this empirical finding originated from Hong Kong, Umar and Anandarajan (2004) point out that many corporations (MNC) have operations globally. The unique Confucian culture ingrained in the Chinese society could have a significant influence on the perceived independence of auditors, and the fairness of the consolidated audited financial statements that emerge from regional operations. Standard setters could seriously consider drafting ethical guidelines requiring the mandatory rotation of public accounting firms when the duration of guanxi with clients reaches a certain number of years relationship. Though that may incur increased transaction costs (Williamson, 1981), the benefits could nevertheless outweigh the costs in the long run.
Second, the result in H2 reveals that large client size has a negative influence on the perceived independence of auditors. This result contradicts an early study conducted by Pany and Reckers (1980) in the U.S. Since this study is conducted in a society of Chinese Confucian culture, further research is recommended to validate this finding. H3 indicates that the longer the guanxi between the auditor and the large audit client, the greater the undermining of their perceived independence. The result in H3 reinforces the finding in H1, and confirms that guanxi is a significant factor influencing auditor independence particularly in Chinese society. Hence it is surprising that the effect of guanxi on auditor independence has largely been neglected in the accounting literature thus far.

Third, the result in H4 is interesting and contributing to the existing body of literature related to stewardship. It is promising to note that CFOs have the lowest mean scores for all levels of guanxi among the three groups. That is, they believe that guanxi more seriously undermines auditor independence. Results support the stewardship theory that asserts stewards’ (CFOs) motives are aligned with the objectives of their principals (Davis et al., 1997a). CFOs perceive that the utility gained from contractually aligned behavior is higher than the utility that can be gained through individualistic self serving behaviors, which are undertaken at the expense of the principal’s goals (Davis et al., 1997a). The stewards (CFOs) place greater value on collective rather than individual goals, and consider the increasing levels of guanxi associated with the auditors are not in the best interests of their principals, and hence affect the reliability and fairness of the audited accounts. Further, H6 also indicates that there are significant differences for the impact of guanxi on the perceived independence of auditors among the three groups. The mean scores of the CFOs (2.2) are the lowest among the groups while non Big 4 auditors have the highest (3.2) (Table 11). Apparently CFOs give due regard to the resources entrusted to the corporation and this may result in lower perceptions of auditor independence than the auditors group. Nevertheless, there may be some other variables that contribute to the variation of perceived auditor independence between the groups and further research is recommended to explore this result. Such research may be based on interview, or case study and perhaps be of a longitudinal nature in the future.
Finally, whilst the sample groups held significantly different views on the effects of guanxi on auditor independence, they do not hold significantly different views on the impact of client size on auditor independence. Hence hypothesis 5 was not supported.

6. Conclusion
This empirical study draws data from Hong Kong to examine the impact of guanxi on auditor independence. It makes several contributions to further our understanding and the results are consistent with stewardship theory. Given the lack of prior empirical research using stewardship theory to examine the impact of guanxi on perceived independence, this research contributes to the existing literature. Though this study is conducted in the Asia Pacific region, western counterparts in the U.S or U.K. should also find the results beneficial. For example, MNCs nowadays have subsidiaries or headquarters established globally, the impacts of guanxi have possible implications for their Far East operations, the fairness of their regional financial statements and ultimately affecting the consolidated audited accounts. With the increasing globalization of doing business, this study contributes some practical implications for multinational corporations that have business in Chinese societies.

In view of the critical importance of the guanxi factor on the perceived auditor independence, standard setters should consider devising ethical guidelines requiring mandatory rotation of public accounting firms. Though that may involve transaction costs (Williamson, 1981), the benefits would nevertheless outweigh the costs in the long run. Guanxi is grounded in the Chinese community and the interpersonal relationships between friends and family members are not necessarily in terms of money. In Hong Kong, life and getting work done is all about connections. The impact of guanxi will determine the success of the business or what lengths a person must go to help the others. Hence, the non Chinese auditors working with Chinese managers should become accustomed to the practice of guanxi, if not this may result in misunderstanding, distrust, anger and even the end of a business relationship. No matter how much experience the non-Chinese management possess, the right guanxi can remove barriers when they encounter difficulties.
Western auditors and CFOs have to consider the impact of *guanxi* on auditor independence, as we take this subject forward.

This research was exploratory in dealing with the impact of *guanxi* in a Chinese environment which are familiar with a Western notion of auditor independence. It sought the opinions of major players (subjects) in the audit process. *Guanxi* will be familiar to all respondents and in this research a single item variable was used to identify *guanxi* to the respondents and this has been used successfully in previous research (Lee and Humphreys 2007). However future research could attempt to deconstruct the *guanxi* characteristic into distinct elements. Additionally, case studies could be adopted to explain further the impact of *guanxi* using interviews and research of a longitudinal nature could occur to discover more about how it is founded, how it grows and its consequent impact.
Table 1. Descriptive statistics – perceived Auditor Independence by client size and Guanxi duration

| Clients / Duration                        | Subjects (Types of samples) | Mean  | Std. Deviation | N  |
|-------------------------------------------|-----------------------------|-------|----------------|----|
| Large clients, Guanxi with 1 year relationship | CFOs                        | 3.01  | 1.34           | 193|
|                                           | Big 4 auditors              | 4.57  | .73            | 178|
|                                           | Non Big 4 auditors          | 4.65  | .77            | 153|
|                                           | Total                       | 4.02  | 1.27           | 524|
| Large clients, Guanxi with 3 year relationships | CFOs                        | 2.29  | 1.25           | 193|
|                                           | Big 4 auditors              | 2.90  | 1.73           | 178|
|                                           | Non Big 4 auditors          | 3.35  | 1.52           | 153|
|                                           | Total                       | 2.81  | 1.57           | 524|
| Large clients, Guanxi with 5 year relationships | CFOs                        | 1.58  | 1.13           | 193|
|                                           | Big 4 auditors              | 1.63  | 1.05           | 178|
|                                           | Non Big 4 auditors          | 2.28  | 1.24           | 153|
|                                           | Total                       | 1.80  | 1.18           | 524|
| Large clients, Guanxi with more than 5 year relationships | CFOs                        | 1.11  | .33            | 193|
|                                           | Big 4 auditors              | 1.44  | .93            | 178|
|                                           | Non Big 4 auditors          | 1.71  | 1.09           | 153|
|                                           | Total                       | 1.40  | .86            | 524|
| Small clients, Guanxi with 1 year relationship | CFOs                        | 3.61  | 1.16           | 193|
|                                           | Big 4 auditors              | 4.61  | .80            | 178|
|                                           | Non Big 4 auditors          | 4.63  | .72            | 153|
|                                           | Total                       | 4.25  | 1.05           | 524|
| Small clients, Guanxi with 3 year relationships | CFOs                        | 2.55  | 1.30           | 193|
|                                           | Big 4 auditors              | 3.10  | 1.87           | 178|
|                                           | Non Big 4 auditors          | 3.65  | 1.66           | 153|
|                                           | Total                       | 3.06  | 1.67           | 524|
| Small clients, Guanxi with 5 year relationships | CFOs                        | 2.16  | 1.28           | 193|
|                                           | Big 4 auditors              | 2.41  | 1.46           | 178|
Scores are from 1 guanxi seriously undermines independence to 5 guanxi strongly enhances independence

Table 2.
Multivariate Tests of client size and guanxi duration

| Effect               | F          | Hypothesis | Sig. |
|----------------------|------------|------------|------|
| CLIENT               |            |            |      |
| Pillai's Trace       | 91.503(a)  | 1.000      | .000 |
| Wilks' Lambda        | 91.503(a)  | 1.000      | .000 |
| CLIENT * TYPESAMP    |            |            |      |
| Pillai's Trace       | .082(a)    | 2.000      | .921 |
| Wilks' Lambda        | .082(a)    | 2.000      | .921 |
| GUANXI               |            |            |      |
| Pillai's Trace       | 996.578(a) | 3.000      | .000 |
| Wilks' Lambda        | 996.578(a) | 3.000      | .000 |
| GUANXI * TYPESAMP    |            |            |      |
| Pillai's Trace       | 15.466(a)  | 6.000      | .000 |
| Wilks' Lambda        | 16.087(a)  | 6.000      | .000 |
| CLIENT * GUANXI      |            |            |      |
| Pillai's Trace       | 11.049(a)  | 3.000      | .000 |
| Wilks' Lambda        | 11.049(a)  | 3.000      | .000 |

a  Exact statistic
The statistic is an upper bound on F that yields a lower bound on the significance level. Design: Intercept+TYPESAMP  Within Subjects Design: CLIENT+GUANXI+CLIENT*GUANXI
### Table 3

Mean values of influence of *guanxi* on Auditor Independence by *guanxi* duration

| GUANXI         | Mean | Std. Error | 95% Confidence Interval | Lower Bound | Upper Bound |
|----------------|------|------------|-------------------------|-------------|-------------|
| 1 year         | 4.179| .033       |                         | 4.113       | 4.244       |
| 3 years        | 2.975| .052       |                         | 2.874       | 3.076       |
| 5 years        | 2.123| .042       |                         | 2.042       | 2.205       |
| More than 5 years | 1.757| .033       |                         | 1.692       | 1.822       |

### Table 4.

Pairwise comparisons of influence of *guanxi* on Auditor Independence by *guanxi* duration

| (I) GUANXI | (J) GUANXI | Mean Difference (I-J) | Std. Error | Sig.(a) | 95% Confidence Interval for Difference(a) | Lower Bound | Upper Bound |
|------------|------------|-----------------------|------------|---------|----------------------------------------|-------------|-------------|
| 1 year     | 3 years    | 1.204(*)              | .055       | .000    | 1.057                                 | 1.351       |             |
| 5 years    | >5 years   | 2.055(*)              | .052       | .000    | 1.919                                 | 2.192       |             |
| 3 years    | 1 year     | -1.204(*)             | .055       | .000    | -1.351                                | -1.057      |             |
| 5 years    | >5 years   | 1.218(*)              | .063       | .000    | 1.060                                 | 1.376       |             |
| >5 years   | 1 year     | -2.055(*)             | .052       | .000    | -2.192                                | -1.919      |             |
| 3 years    | >5 years   | -8.52(*)              | .063       | .000    | -1.019                                | -6.84       |             |
| >5 years   | 1 year     | -2.422(*)             | .045       | .000    | -2.540                                | -2.303      |             |
| 3 years    | >5 years   | -1.218(*)             | .060       | .000    | -1.376                                | -1.060      |             |
| 5 years    | >5 years   | -3.366(*)             | .042       | .000    | -4.76                                 | -2.56       |             |

Based on estimated marginal means.

* The mean difference is significant at the .05 level.

(a) Adjustment for multiple comparisons: Bonferroni.
Table 5.
Mean values of influence of *guanxi* on Auditor Independence by client size

| CLIENT | Mean | Std. Error | 95% Confidence Interval | 95% Confidence Interval Lower Bound | 95% Confidence Interval Upper Bound |
|--------|------|------------|-------------------------|------------------------------------|-------------------------------------|
|        |      |            |                         |                                    |                                     |
| Large  | 2.543| .028       | 2.488                  | 2.599                              |                                     |
| Small  | 2.974| .037       | 2.901                  | 3.047                              |                                     |

Table 6.
Pairwise comparisons of influence of *guanxi* on Auditor Independence by client size

| (I) CLIENT | (J) CLIENT | Mean Difference (I-J) | Std. Error | Sig.(a) | 95% Confidence Interval for Difference(a) | Lower Bound | Upper Bound |
|------------|------------|-----------------------|------------|---------|----------------------------------------|-------------|-------------|
| Large      | Small      | -.430(*)              | .045       | .000    | -.519                                  | -.342       | .342        |
| Small      | Large      | .430(*)               | .045       | .000    | .342                                  | .519        |             |

Based on estimated marginal means
* The mean difference is significant at the .05 level.
(a) Adjustment for multiple comparisons: Bonferroni.

Table 7.
Mean values – client *guanxi*

| CLIENT | GUANXI | Mean | Std. Error | 95% Confidence Interval | 95% Confidence Interval Lower Bound | 95% Confidence Interval Upper Bound |
|--------|--------|------|------------|-------------------------|------------------------------------|-------------------------------------|
|        |        |      |            |                         |                                    |                                     |
| Large  | 1 year | 4.073| .044       | 3.986                  | 4.160                              |                                     |
|        | 3 years| 2.849| .066       | 2.719                  | 2.979                              |                                     |
|        | 5 years| 1.832| .050       | 1.734                  | 1.930                              |                                     |
|        | >5 years| 1.419| .036       | 1.348                  | 1.490                              |                                     |
| Small  | 1 year | 4.284| .041       | 4.204                  | 4.364                              |                                     |
|        | 3 years| 3.101| .071       | 2.962                  | 3.240                              |                                     |
|        | 5 years| 2.415| .062       | 2.294                  | 2.536                              |                                     |
|        | >5 years| 2.095| .058       | 1.981                  | 2.208                              |                                     |
Table 8  
Tests of within-subject contrasts

| Source         | Client        | Guanxi       | Type III Sum of Squares | F     | Sig.  |
|----------------|---------------|--------------|-------------------------|-------|-------|
| Client         | Level 1 vs. Level 2 | 96.082       | 91.503                  | .000  |       |
| Client * typesamp | Level 1 vs. Level 2 | .173         | .082                    | .921  |       |
| Guanxi         | Level 1 vs. Level 2 | 752.193      | 471.163                 | .000  |       |
|                | Level 2 vs. Level 3 | 376.582      | 182.031                 | .000  |       |
|                | Level 3 vs. Level 4 | 69.628       | 77.794                 |       |       |
| Guanxi * typesamp | Level 1 vs. Level 2 | 46.551       | 14.579                 | .000  |       |
|                | Level 2 vs. Level 3 | 24.638       | 5.955                   | .003  |       |
|                | Level 3 vs. Level 4 | 11.630       | 6.497                   | .002  |       |
| Client * Guanxi | Level 1 vs. Level 2 | .860         | .189                   | .664  |       |
|                | Level 2 vs. Level 3 | 56.853       | 9.722                   | .002  |       |
|                | Level 3 vs. Level 4 | 4.488        | 1.348                   | .246  |       |

Client level relates to large and small company clients  
Guanxi level relates to duration 1, 3 5 and >5 years duration

Table 9.  
Mean values - Types of samples *guanxi

| Types of samples | GUANXI | Mean | Std. Error | 95% Confidence Interval |
|------------------|--------|------|------------|-------------------------|
|                  |        |      |            | Lower Bound            | Upper Bound |
| CFOs             |        |      |            |                         |             |
| 1 year           | 3.306  | .055 | 3.198      | 3.413                   |
| 3 years          | 2.422  | .085 | 2.256      | 2.589                   |
| 5 years          | 1.870  | .068 | 1.736      | 2.005                   |
| >5 years         | 1.301  | .054 | 1.194      | 1.407                   |
| Big 4 auditors   |        |      |            |                         |             |
| 1 year           | 4.590  | .057 | 4.478      | 4.702                   |
| 3 years          | 3.003  | .088 | 2.830      | 3.176                   |
| 5 years          | 2.022  | .071 | 1.883      | 2.162                   |
| >5 years         | 1.778  | .056 | 1.667      | 1.889                   |
| Non Big 4 auditors |      |      |            |                         |             |
| 1 year           | 4.641  | .062 | 4.519      | 4.762                   |
| 3 years          | 3.500  | .095 | 3.313      | 3.687                   |
| 5 years          | 2.477  | .077 | 2.326      | 2.628                   |
| >5 years         | 2.193  | .061 | 2.073      | 2.312                   |
Table 10.
Tests of Between-Subjects Effects

| Source       | Type III Sum of Squares | df | Mean Square | F       | Sig. |
|--------------|-------------------------|----|-------------|---------|------|
| Intercept    | 3950.715                | 1  | 3950.715    | 12926.344 | .000 |
| Typesamp     | 85.904                  | 2  | 42.952      | 140.535 | .000 |
| Error        | 159.235                 | 521| .306        |         |      |

significant at the .05 level

Table 11.
Mean values of Auditor Independence by subject

| Types of samples    | Mean  | Std. Error | 95% Confidence Interval |
|---------------------|-------|------------|-------------------------|
| CFOs                | 2.225 | .040       | 2.147 2.303             |
| Big 4 auditors      | 2.848 | .041       | 2.767 2.929             |
| Non Big 4 auditors  | 3.203 | .045       | 3.115 3.290             |
Table 12. Post Hoc tests

| Types of samples | Mean Difference (I-J) | Std. Error | Sig.   |
|------------------|-----------------------|------------|--------|
| (I) Types of samples | (J) Types of samples |            |        |
| CFOs             | Big 4 auditors        | -.6236(*)  | .05745 | .000  |
|                  | Non Big 4 auditors    | -.9779(*)  | .05984 | .000  |
| Big 4 auditors   | CFOs                  | .6236(*)   | .05745 | .000  |
|                  | Non Big 4 auditors    | -.3543(*)  | .06095 | .000  |
| Non Big 4 auditors| CFOs                  | .9779(*)   | .05984 | .000  |
|                  | Big 4 auditors        | .3543(*)   | .06095 | .000  |
| CFOs             | Big 4 auditors        | -.6236(*)  | .05745 | .000  |
|                  | Non Big 4 auditors    | -.9779(*)  | .05984 | .000  |
| Big 4 auditors   | CFOs                  | .6236(*)   | .05745 | .000  |
|                  | Non Big 4 auditors    | -.3543(*)  | .06095 | .000  |
| Non Big 4 auditors| CFOs                  | .9779(*)   | .05984 | .000  |
|                  | Big 4 auditors        | .3543(*)   | .06095 | .000  |
| CFOs             | Big 4 auditors        | -.6236(*)  | .05681 | .000  |
|                  | Non Big 4 auditors    | -.9779(*)  | .05847 | .000  |
| Big 4 auditors   | CFOs                  | .6236(*)   | .05681 | .000  |
|                  | Non Big 4 auditors    | -.3543(*)  | .06455 | .000  |
| Non Big 4 auditors| CFOs                  | .9779(*)   | .05847 | .000  |
|                  | Big 4 auditors        | .3543(*)   | .06455 | .000  |

*Based on observed means. *The mean difference is significant at the .05 level.*

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