An empirical study of Canadian companies to determine clients' preferred relationship approach with their financial auditor.

The purpose of our research is to determine the relationship approach that clients (buyers) prefer to have with their auditors (sellers). The success of the audit service depends on clients' relational interactions with their auditors, yet we know very little about the client's relationship perspective. The results of a nationwide study of Canadian corporations show that clients prefer a relational approach rather than a transactional approach with their auditor. In addition, surprisingly, clients not only want a relational approach, but they also want to remain at arm's length, as required by audit regulators.

Keywords: Relational, transactional, auditing, auditor, accounting, buyer-seller, client-auditor relationship, marketing, arm's length, audit service.

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Introduction and objectives

The relationship between clients (buyers) and auditors (sellers) is different from other typical buyer-seller relationships studied in the marketing literature. The client pays for the audit service, but does not use (consume) it. Those that use the audit service are referred to as third-party financial statement users (CICA, 2006, 5025.07), such as creditors or investors. Therefore, the client-auditor relationship is not a dyadic but rather a triadic relationship, and the presence of the third-party user has been given as a reason for potential conflict between clients and their auditors, referred to as *Role Strain* (Kleinman and Palmon, 2000).

It is important that we increase our understanding of client-auditor relationships from the client perspective since the success of the audit service requires client involvement and cooperation. Clients' cooperation is necessary since they possess information that the auditor needs: information asymmetry in favour of the client (Beattie *et al.*, 2001).

Despite the importance of better understanding the client's relationship perspective with the auditor, very little direct evidence is available in the academic literature. Client-auditor relationships have been studied from the auditor's perspective (Saltario and Koonce, 1997), and researchers have called for additional studies to capture the client's perspective (Gibbens *et al.*, 2001; Iyer and Rama, 2004). In addition, Beattie *et al.* (2001) stress the importance of additional research to improve our understanding of the audit client's relationship behaviour using marketing and psychology theory, given the limitations of economic theory. Therefore, the objective of this research is to determine the client's preferred relational approach with their auditor.

After pre-testing multi-item relationship marketing variables for their relevant use in the audit context, we conduct a Canadian wide mailing, where we survey financial professionals from 990 corporations to measure their relationship preferences with their auditors. The results suggest that the audit client prefers more of a relational approach to a transactional approach with their auditor. In addition, individual item results suggest that clients prefer a cooperative and trusting relationship. Moreover, clients want value-added information from their auditor. However, clients do not want to exercise their power to influence clients, which has been suggested in past audit research. Additionally, clients want to remain at arm's length, respecting audit regulations, which has been an on-going concern among audit regulators.

Our results contribute to the audit literature by contradicting power models and resource dependency theory. In addition, our results contribute to marketing theory and practice by providing a new triadic model, different from the traditional buyer-seller relationships studied in the marketing literature.

We structure our research as follows. We present an audit and marketing literature review, followed by a conceptual framework, which leads to our hypothesis. We explain our method used to analyze our hypothesis, and we then present the findings of our study. We conclude by discussing our overall results, the study's limitations, and opportunities for future research.

Literature review

Audit

The duration of the client-auditor relationship has sparked debate in the audit literature and the results are mixed. Calls for the mandatory rotation of audit firms have triggered opposing views by auditing academics and regulators. The central question surrounding the debate is whether long-term client-auditor relationships reduce the quality of the audit service. Auditors have been blamed for acquiescing to client demands in long-term relationships and therefore not acting as independent auditors, as required by audit regulations (Arel *et al.*, 2005; George, 2004; Shafer *et al.*, 2004).

The opposing argument is that close, long-term relationships, between auditors and their clients, improve the audit service, since auditors are better able to understand their client's business (George, 2004). A close relationship between the auditor and the client results in knowledge sharing, which is critical to the audit process (Arel *et al.*, 2005). Evidence from the client is considered an important source and a good starting point for the audit planning and process (Arens *et al.*, 2007; Kopp *et al.*, 2003); therefore, the auditor is dependent on client involvement (Arel *et al.*, 2005; Kopp *et al.*, 2003; Rennie *et al.*, 2006). Moreover, client cooperation and management provided evidence have been shown to increase audit effectiveness (Comunale *et al.*, 2003).

The conflict over the auditor having a close working relationship with the client and remaining independent has created what Beattie *et al.* (2000) refer to as a paradox: is the auditor able to establish a close relationship with clients in order to understand the business and be able to maintain a certain distance to remain independent in accordance with audit regulations ?

Most of the client-auditor relationship studies present the auditor perspective (Beattie *et al.*, 2004; Gibbens et al., 2001; 2005; Saltario and Koonce, 1997), and there are still requests for further empirical investigations of the client's perspective (Iyer and Rama, 2004). In addition, Beattie *et al.* (2000) argue that most research into client-auditor relationships is abstract or indirect, which draws inferences from public company information due to the difficulty of gaining access to real life information (Beattie *et al.*, 2000; Dye, 1991). Kleinman and Palmon (2000) stress the need for further empirical research of the client-auditor relationship because the relationship is becoming more intensive and extensive.

One of the challenges, however, in studying client-auditor relationships is determining the appropriate definitions and measures of relationship constructs and variables. Therefore, we draw on a field of study that has defined and operationalized relationship variables. For this reason, we present the following relationship marketing review that provides our study with a method to define and measure a relationship. To the best of our knowledge, relationship marketing is the only field where relationships between buyers and sellers are theoretically defined and empirically studied.

Marketing

In the relationship marketing literature, clients have been found to prefer more of a transactional approach or more of a relational approach (Gronroos, 1991; 1994; 1997; 2000; Gummesson, 2002; Paulin *et al.*, 1997; 2000; Pels *et al.*, 2000). On a continuum, the relational approach is considered by marketing scholars to be at the opposing end of the transactional approach (Dwyer *et al.*, 1987; Macneil, 1974; 1978; 1980; Paulin *et al.*, 1997; 2000; Pels *et al.*, 2000).

The relational approach reflects an ongoing process (Dwyer *et al.*, 1987; Morgan and Hunt 1994), based on interdependence rather than independence of choice and cooperation rather than competition (Sheth and Parvatiyar, 1995). In contrast to the relational approach, the transactional approach is discrete, which has a distinct beginning, short duration, and ends by the delivery of performance (Dwyer *et al.*, 1987; Morgan and Hunt, 1994). The transactional approach is a perspective based on the premise that competition and self-interest results in an arm's length relationship (Morgan and Hunt, 1994).

The relationship approaches are further conceptualized and empirically tested showing that buyers and sellers are either more transactional or more relational based on where they are positioned on a transactional-relational continuum (Dwyer *et al.*, 1987; Ferguson *et al.*, 2005; Fink *et al.*, 2007; Kaufmann and Dant 1992; Paulin *et al.*, 1997; 2000; Morgan and Hunt, 1994; Rokkan and Haugland, 2000).

Conceptual framework

Client-Auditor Relationship

To the best of our knowledge, most of the traditional buyer-seller relationships, studied in the academic marketing literature (Christopher et al., 1991; Dwyer *et al.*, 1987; Gronroos, 1994; 1997; 2000; Gummesson, 1994; 2002; Heide and John, 1992; Kotler, 1992; Morgan and Hunt, 1994; Sheth and Parvatiyar, 1995; 2000) are different from the client-auditor relationship.

This difference is because the client who pays for the audit service is not the intended user. In addition, the client-auditor relationship is heavily regulated, which requires the auditor to be at an arm's length distance from the client (CICA, 2006).

As a foundation of our conceptual framework, we present the client-audit relationship as defined in the audit standards (CICA, 2006 5025.07) (see Figure 1).

Figure 1: Three parties involved in an audit service.
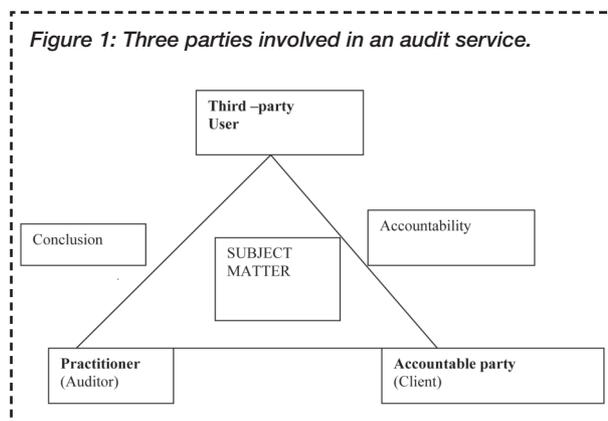
We use this framework (see Figure 1) because it is a standard that applies to all Canadian accounting practitioners who perform audit services (CICA, 2006, 5025.01). In Figure 1, the Accountable party is the Client and the Practitioner is the Auditor (CICA, 2006 5025.07). In addition to the Client and the Auditor, Figure 1 highlights the presence of a Third-party User, such as shareholders, creditors, customers, the board of directors, the audit committee, and the legislators or regulators (CICA, 2006 5025.06). There is an accountability relationship between the Client and the Third-party User, where the Client is responsible to the Third-party User (CICA, 2006 5025.04). We argue that it is this accountability to a Third-party User that differentiates the client-auditor relationship from other traditional buyer-seller relationships.

The existence of the Third-party User could give rise to non-cooperative behaviour (Beattie *et al.*, 2001; Kleinman and Palmon, 2001). For example, the auditor could want to protect the Third-party User and assure that financial information is accurate according to audit regulations; whereas, the client's objective could be to assure that the financial information is favourable and attractive to the Third-party User, regardless of regulations. These conflicting objectives are referred to as "role strain" (Kleinman and Poleman, 2000; 2001). Therefore, given role strain, these authors ask the question: "Given all these outside interests: What motivates the parties to seek accommodation or conflict?" (Kleinman and Poleman, 2000, 25). In other words, given the multiple users, other than themselves, why would audit clients want to enter into a cooperative relationship (relational approach) with their auditor?
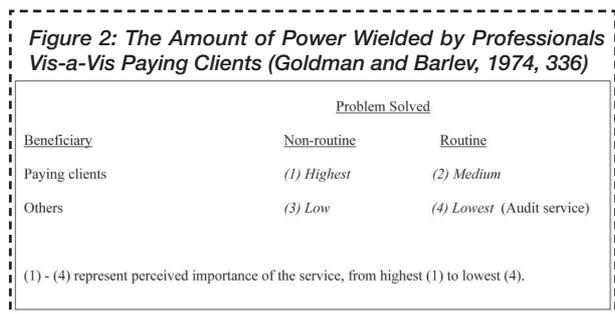
Research in relationship marketing shows that clients are either transactional or relational, given a specific exchange situation (Gronroos, 1991; 1997; Pels *et al.* 2000; Sheth and Parvitayar, 1995). Berry (1995) argues that the clients of services with the following characteris-

tics will benefit from a relational approach: personally important, variable in quality, and/or complex and high involvement (e.g. medical, banking, insurance and hair-styling). The reason for this is that "the heterogeneity of labour-intensive services encourages customer loyalty when excellent service is experienced" (Sheth and Parvatiyar, 2000, 153).

In addition, Pels et al. (2000) propose a dynamic model which shows that clients each have a specific need structure and they will be in a relational mode or transactional mode based on how they perceive the service offering. If the service offering is perceived as unique, the client will prefer a relational approach with their service firm. If the service offering is perceived as generic, the client will prefer a transactional approach with their service firm (Pels *et al.*, 2000; Ravald and Gronroos, 1996). Therefore, to determine a hypothesis as to the audit client's relationship preference, we further explore theory that would help predict how the client perceives the audit service, unique (important) or generic (not important).

Transactional Approach Preference

Goldman and Barlev (G&B) (1974) argue that the client has power over the auditor, since the audit is an easily attainable commodity (generic) and perceived as not important by the client. This perception of non-importance gives the client power. Two dimensions explain importance in the G&B power model: 1) the nature of the problem solved and 2) the party benefiting from the service (see Figure 2). This model is also referenced by Kleinman and Palmon (2001), Beattie et al. (2001), Nichols and Price (1976), Green (2006) and Iyer and Rama (2004).

Figure 2: The Amount of Power Wielded by Professionals Vis-a-Vis Paying Clients (Goldman and Barlev, 1974, 336)

	Problem Solved	
Beneficiary	Non-routine	Routine
Paying clients	*(1) Highest*	*(2) Medium*
Others	*(3) Low*	*(4) Lowest* (Audit service)

(1) - (4) represent perceived importance of the service, from highest (1) to lowest (4).

In their model (see Figure 2), Goldman and Barlev (1974) explain how even though the auditor is asked time to time to handle non-routine problems (unique), many audit issues are routine and do not benefit the paying party. Because of routine problems solved and the client not benefiting from the service, the audit is perceived by the client as the lowest level of importance; therefore, the power of the relationship is asymmetric in favour of the client.

Marketing scholars have theorized that services that are not perceived important by the client and which are perceived as routine and commodity-like with little added

value will result in the customer preferring more of a transactional approach over a relational approach (Berry, 1995; Gronroos, 1995; 2000; Gummesson, 2001; Pels *et al.*, 2000; Sheth and Parvatiyar, 2000). Therefore, if the G&B (1974) model (see Figure 2) is assumed a theoretical representation of the audit service, the audit client would prefer more of a transactional approach to a relational approach, given that the audit service is considered not important and routine. However, additional theory offers an alternative explanation of why an audit client would perceive the audit service as a value-added, important service.

Relational Approach preference

In the relationship marketing literature, an added-value service is an important component of the relational approach, which allows companies to differentiate themselves from the competition and sustain a competitive advantage (Gronroos, 1997). The value of the auditor beyond the core audit service is shown by the auditor being a source of support and advice for the client, resulting in cooperative efforts, as clients increasingly rely on advice from their auditors (Beattie *et al.*, 2000).

Empirically, Beattie et al. (2000) found that clients desire, from their auditor, more than auditing services, such as guidance on accounting principles, advice on internal controls, and general business advice. These authors also found that when auditors did not provide enough advice, they were replaced. Advice is part of the "added-value audit[1]". Audit regulations recommend that the auditor's main objective, when conducting an audit, is to provide an opinion on the financial statements taken as a whole (CICA 2006 5750.03). However, while conducting the audit service, the auditor "may identify certain matters that may be of interest to management" (CICA 2006 5750.03).

The value-added component of the audit has been shown to be important for the client (Beattie et al., 2000), and the value-added information is a key component of the relational approach (Gronroos, 1991; 1997; Ravald and Gronroos, 1996). Therefore, the added-value source of support and advice provides a theoretical explanation of why the audit would be perceived as a non-routine, unique, and important service by the audit client.

Hypothesis Development

Given the existence of conflicting theory, the audit service could be perceived as a unique (important) or

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[1] *"There is some confusion over the term 'added-value'. Audit practitioners use it to mean audits that are performed in such a way that the findings can be interpreted and communicated to the client and form part of the business decision taking activity and add real value to the corporate entity (personal communication with Gerry Acher, senior partner in KPMG UK, Chair of the ICAEW Audit Faculty and formerly chair of KPMG's world wide auditing committee). Some commentators have however, taken the term to mean consultancy-related services" (Beattie et al., 2000, 200).*

generic (not important) service. We argue that there is more convincing theory leading towards the perception of the audit service as unique (important) and value-added. Even though the audit service does not provide a direct benefit to the paying client, the client does benefit from other additional advice offered by the auditor. Therefore, if the client perceives the audit service as important and value-added, according to relationship marketing theory, the client would prefer more of a relational approach to a transactional approach with their auditor.

H1: The audit client will prefer more of a relational approach to a transactional approach with their auditor.

Method

After an extensive literature review, we chose the survey measurement instrument used by Kaufmann and Dant (1992), which is an appropriate model for two reasons: it is an instrument that applies to both buyers and sellers, and the measurement scales are not industry specific (Kaufmann and Dant, 1992; Paulin *et al.*, 1997). Consequently, the Kaufman and Dant (1992) measurement instrument is appropriate for our study, since it can apply to various industries such as the audit industry and apply to the client (buyer) of audit services. Moreover, Nevin (1995) considers that this model provides the most comprehensive conceptual context for understanding business-to-business relationships.

The Kaufmann and Dant (1992) model includes six contractual dimensions: Relational Focus, Solidarity, Restraint, Role Integrity, Flexibility, and Mutuality. Twenty individual items are derived from these six dimensions.

Since the objective of our study is to determine if audit clients prefer more of a relational or transactional approach, we determined a single mean score from the 20 items. The 20 items met the conditions for unidimentionality; therefore, the items were summed to arrive at a single mean score, referred to as Relationalism.

Findings

We surveyed 990 financial executives across Canada and we received 306 completed questionnaires, resulting in a response rate of 30,91%. We removed two variables: one that approached a zero correlation (Solpref3), and one that was negatively correlated (Mutpref3). Removing low and negatively correlated variables increases the reliability of a scale (Churchill, 1979).

After dropping the two items, we conducted Confirmatory Factor Analysis with 18 items and six dimensions. A similar approach was used by Noordewier et al. (1990), who modeled their relational items using a second-order factor model, arguing that relational factors arise from a single second-order factor (Relationlism). After running a

second-order factor analysis using the CALIS procedure in SAS, we dropped the Mutuality dimension (which includes two items) due to a negative eigen value. Therefore our final measure includes 16 items (see Table 1).

Table 1: Relational Preference (16 item score)

Variable (item)	Valid N	Scale Range	Scale Mean	Characteristic	Result
Focpref 1	306	0-1585	961,39	Audit service	Significantly higher than midpoint
Focpref2	306	0-1585	836,47	Audit service	**Not significantly higher than midpoint**
Focpref3	306	0-1585	807,01	Audit service	**Not significantly higher than midpoint**
Solpref1	306	0-1585	1238,24	Information sharing	Significantly higher than midpoint
Solpref2	306	0-1585	1389,26	Trust	Significantly higher than midpoint
Solpref3	*306*	*0-1585*	*246,37[2]*	*Arm's Length.*	*Significantly lower than midpoint. Not retained in overall score because of low correlation*
Solpref4	306	0-1585	1231,44	Long-term relationship	Significantly higher than midpoint
Solpref5	306	0-1585	1291,60	Not one-shot dealings	Significantly higher than midpoint
Solpref6	306	0-1585	1298,53	Cooperation	Significantly higher than midpoint
Powpref1	306	0-1585	1255,21	Pressure tactics	Significantly higher than midpoint
Powpref2	306	0-1585	1087,68	Pressure tactics	Significantly higher than midpoint
Rolpref1	306	0-1585	1111,93	Expectations beyond audit	Significantly higher than midpoint
Rolpref2	306	0-1585	1055,64	Non-audit issues	Significantly higher than midpoint
Rolpref3	306	0-1585	830,52	Expectations audit service	**Not significantly higher than midpoint**
Flepref1	306	0-1585	1244,93	Modifications	Significantly higher than midpoint
Flepref2	306	0-1585	1132,58	Renegotiable	Significantly higher than midpoint
Flepref3	306	0-1585	1131,99	Give and take	Significantly higher than midpoint
Relpref	**306**	**0-1585**	**1119,03**		

[2] This is a reverse item. The score of 274,46 represents a high preference for an arm's length relationship. This item is not included in the overall Relational Preference score. It was removed since it did not correlate positively with the overall score. We list it here because the item score is important for our discussion.

Our second-order factor analysis model shows a reasonable fit (GFI = 0.93, AGFI = 0,90). Moreover, the higher order model shows reasonable reliability of 0,75 based on Joreskog's formula (Roussel *et al.*, 2002), further adding support for a unidimensional measure (Hair *et al.'s* 2006).

We further test for the validity of our second-order model. Factor Loadings, Variance Extracted (VE) and reliability are all indicators of Convergent Validity. Among the five Factor Loadings of the single order construct, four are over 0,5, which is considered a good rule of thumb (Hair *et al.*, 2006). The VE of the second order model is close to 0,5 (0,4633, to be exact) which is considered adequate convergence (Hair *et al.*, 2006). Therefore, due to the result of Factor Loadings, VE and reliability we confirm adequate validity.

With our theoretical justification, unidimensionality, reliability, and validity confirmed, we meet the four conditions for a summated scale highlighted by Hair *et al.* (2006). The summated single mean score of 16 items, making up the Relational Preference score, is 1119,03 (Relpref) on a scale of 0-1585 (see Table 1).

Hypothesis validation

Using the Kolmogorov-Smirnov Test, we determined that the distribution of our Relational Preference variable

(Relpref) is normal; therefore, to verify the hypothesis H1 we used a dependent t-test (parametric test). In addition, to validate further our hypothesis we used the Wilcoxon signed rank test (the non-parametric equivalent of the dependent t-test). The scale used for the relational preference items has a range of zero (transactional) to 1585 (relational), with a midpoint of 792,50. Therefore, for levels significantly greater than the 792,50 mid-point we conclude that the audit client's preference is more relational than transactional. For levels significantly less than the 792,50 midpoint we conclude that the audit client's preference is more transactional than relational. Other similar studies used scale midpoints as a point of reference for determining relational (high Relationalism) or transactional (low Relationalism) relationships (Paulin et al., 1997; 2000).

For the 306 participants, the single mean overall Relational Preference (Relpref) score is 1119,03 (on a scale of 0-1585). The minimum mean score is 807,01 (Audit service) and the maximum mean score is 1389,26 (Trust) (see Table 1). Therefore, with a midpoint of 792,50 units and a mean score of 1119,03, we conduct a parametric paired-sample T-test to see if there is a significant difference between the mean single score and the midpoint on our relational scale. The results of the test show that the Relational Preference mean score (1119,03) is significantly higher than the midpoint (792,50) $(t = -34,526, p = 0,000)$. Therefore, the main hypothesis (H1) is supported.

Discussion

The results of our study show that clients have a preference for a relational approach rather than a transactional approach with their auditor, providing indirect evidence of the importance of the audit service, as perceived by the client.

A theoretical model suggests that the audit service does not benefit the client; therefore, the audit service will be perceived as unimportant (Goldman and Barlev, 1974; Nichols and Price, 1976). Therefore, given the unimportance of the audit service for clients, they should prefer a more transactional approach with their auditors (Pels *et al.*, 2000). However, in our conceptual framework, we hypothesize that the audit service is important to clients, and that they would prefer a relational approach. Our argument is based on the theory of an added-value service (Beattie *et al.*, 2000; Gronroos, 1997).

The results of our study support our hypothesis. The client sees the auditor as a source of information (Solpref1 = 1238,24) and has expectations from auditors that go beyond the audit service (Rolpref1 = 1111,93). Our results are consistent with Beattie *et al.* (2000) and Eilifsen *et al.* (2001) who argue that the value of the auditor is the added-value service beyond the core audit service, which

results in cooperative efforts from the customer. Beattie et al. (2000) found that clients desire, from their auditors, services such as guidance on accounting principles, advice on internal controls, and general business advice.

In addition, clients prefer cooperating with their auditors (Solpref6 = 1298,53), and, surprisingly, clients also desire to remain at arm's length (Solpref3 = 246,37). We defined the arm's length item (Solpref3) in our questionnaire as "relating in such a way as to avoid familiarity and prevent direct influence by any of the parties over the other or others".

No documented marketing relationship, to our knowledge, models a buyer-seller relationship that is both cooperative and at arm's length. In documented buyer-seller relationships, when a buyer and seller are at arm's length, the relationship is transactional; whereas, when a buyer and seller are cooperative (opposite to being at arm's length) the relationship is relational (Dwyer *et al.*, 1987; Ferguson *et al.*, 2005; Gronroos, 2000; Gummeson, 2002). Therefore, our client-auditor, triadic relationship (given the presence of a third-party user) introduces to the marketing literature an original, triadic, relationship framework.

Managerial implications

This study has important implications for marketing managers of financial auditing services. We provide evidence that a relationship can be relational (supported with relational variables such as cooperation, trust, information sharing, and power restraint) and also be conducted at a certain distance (at arm's length).

In popular terms, relationship marketing by service or product providers is often referred to as getting as close as possible to customers. For example, service providers often encourage recreational activities such as lunches or golf to reinforce business relationships. However, as our model shows, customers could desire many important relational variables, yet prefer to maintain a certain distance from the service provider: maintaining a professional business relationship but avoiding a compromising friendship (by remaining at arm's length). In addition, the results of our study provide evidence that clients want their auditors to be cooperative and trustworthy as well as to share information.

The results of our study could encourage marketing managers of auditing services to invest in activities such as information sessions to inform customers and build trust instead of investing resources in business lunches or social events (unless the time is spent on added-value business issues). Moreover, it may not be necessary to use only extraverted sales and marketing professionals to build relationships with clients, but also technical or operational experts that can build credible trust with clients and provide valuable information.

Limitations

Our study has certain limitations. The studies from which we borrowed our measures represent different industries and different respondent populations. This might explain why items in our results did not load under the same dimensions as our borrowed research models. In addition, the multi-items used to measure the client's relational preference that we borrowed from the marketing studies, mentioned above, had to be slightly modified following our two pre-tests. In our first test, we used 24 questions with the exact wording of our borrowed items. The pre-test candidates found some of the questions confusing and found our questionnaire too long; therefore, we made a few modifications.. We were concerned about the clarity and length of the question-naire, which has been shown to reduce response rates (Dillman, 2006).

Future research

Given the various definitions of relationships that exist in the relationship marketing literature, it would important to replicate this research in the audit industry, to see if the multi-item measures could give similar results. This replication study would also help us see if the measures that we borrowed from different industries are applicable in the audit industry.

In addition, it would be important to continue a study that would measure the relationship preferences between the client and the auditor but from the perspective of the user. In the case of private companies, the user would most likely be the bank or other creditors. Since the third-party is the ultimate user of the audit and who can influence regulations, it would be important to investigate if the third party user would prefer a transactional or relational approach between clients and their auditors.

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