Importance of the independence of the external auditor essay example

Business, Company

Why is it important for external auditors to be independent? Relate your answer to the primary role of external auditors. Give examples of specific ways the lack of auditor independence may impact adversely on an audit.

Introduction:

Generally Accepted Auditing Standards /GAAS (Business Accent, 2009) define Audit as;

" Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users".

Basically there are two types of auditing, external audit and internal audit. The focus of internal audit is on reviewing the control and operational effectiveness of an organization. External audit however aims on the clarity and authenticity of the financial statements. External audit is also called independent audit as the purpose of this audit is to check any errors or fabrications being done by the internal auditors. The external auditor's job is to analyze and form an opinion whether the financial statements prepared by an entity present fairly in every aspect that is in compliance with standards that are applicable to the organization. In this paper External auditor and the importance of his independence has been discussed in detail.

External Audit:

A review of the financial reports or statements of any business entity is called an external audit. This review is carried out by a person who is not in any way affiliated with the agency or the company that is being audited. The purpose of conducting an external audit is to check the accuracy and transparency of the financial statements that are been prepared by company's own auditors. External audits are generally carried out on regular basis and are normally required yearly.

(Ojo, Marianne, 2006) " The primary aim of the audit today is the verification of financial statements"

External Auditors and their importance:

The accountants who work independently and are not affiliated to any company are the external auditors. Companies hire the external auditors in order to examine company operations and records to ensure the accuracy of their financial statements. The primary role of the external auditors is to ensure the compliance of a business with the tax laws as well as with the internal revenue service rules. As the external auditor has no affiliations with the company he can fearlessly reveal any discrepancies, forgeries, any kind of false information that could be done to decorate the financial statements. An external auditor's report can impact significantly on the organization that is being audited. He is an independent service provider who can comment on the discrepancies found in the accounting records providing a statistical analysis on the effectiveness and clarity of the accounting policies being practiced by the company. The external auditors also may guide the management about evidence that may cause substantial harm to the company in future. They can give advice on developing internal control trough recommendations n discussions or audit notes. Constructive and positive criticism and suggestions can contribute to improved procedures that are more ethical, efficient, fair and presentable.

The basic purpose of an audit is to verify the company's financial statements after thoroughly reviewing them. The external auditors have to give an opinion extracted from the analysis. They may give an adverse opinion or a qualified, unqualified or may be a disclaimer depending upon the results. These opinions commented by the auditor are vital for any company. These opinions translate whether the financial information was fairly represented, false, fabricated, insufficient enough or incomplete to be decisive. The auditor report should be trustworthy as the Stakeholders are greatly influenced by this report. In case of an unqualified or a report with objections, the company may have to face difficulties on getting bank loans or attracting investment capital. These reports or statements are information to the public about the truthfulness and clarity of the financial information. The public would definitely rely on these reports for their investments. It can be said that the external auditors play the role of police and judges of the financial public affairs. The objective is a clear and authentic set of financial statements tin order to safeguard public and private investment.

Why is Auditor Independence Important?

Independence of the auditor is often misunderstood (Business Competence, 2013)

“ The term ‘ independent’ and the concept of auditor independence are often referred to in connection with both internal and external auditors. However, there is a considerably different meaning, degree and context regarding independence for each”.

A cornerstone of the difference in an external auditor and an internal auditor is independence. An external auditor should have independence. When reviewing and analyzing a company's financials he cannot have any ties with the organization. This means that he cannot have stocks or shares in the company, even his close relatives shall not have stocks in the company, no ties with the stockholders or company's management. The purpose of this policy is to ensure completely objective reviews where the influences do not impact the outcome of the audit. The independence of an external auditor cannot be compromised at any cost, if so the purpose of carrying out an external audit would be lost. Reliability and credibility of the financial information, value for money and threats to the professional standards are few of the important factors that are at stake if the independence of the external auditor is compromised.

The independent auditors' report and comments are reliable, and reliability if the financial information is one of the primary aspects of the corporate governance. Also the stakeholders require a trustworthy management as they are the care takers of their money, if they will fabricate the financials and do not present and independent auditors' report the company's trust would be lost. Assurance provided by the external auditors is however a key to quality control on the presentation of the reliable information.

Credibility of the auditor and his opinion are the most important reason for an auditor's independence, (OICU-IOSCO, 2002)

" The external auditor plays a critical role in lending independent credibility to published financial statements used by investors".

A credible audit report is what expected from an external auditor. Any qualified or unqualified report would portray the company’s performance and policy. The external auditor needs to be independent in order to reproduce such reports. He must not be compelled to follow certain instructions or be liable to any kind of company policy restrictions because what at stake is the credibility of the financial statements.

A good sum of funds are allocated for audit, if the external auditor’s independence is questionable, it simply depicts that the share holders are not getting value for the money they have been charged for audit. In addition to this a lack of independence of the external auditor may result in the failure in the fulfillment of the professional procedures and legal requirements. If there is no independence to the auditor, he may not be able to get substantial evidence to produce any opinion. In such case the outcomes would be questionable that will undermine the credibility of the accountants and the profession as well as its policies and standards.

Part of an external auditor's job is to serve and defend the company's stakeholders. In the current business environment the economic downturns and companies found with scandals and frauds have affected the auditors’ credibility quite badly, yet such case have also provided a positive insight of how can people cheat and what may go wrong when the employees do not perform up to the standards or get in to unethical practices.

(Institute of Chartered Accountants Australia, 2011)“ Auditor Independence is an overarching principal”

Conclusion

The job description of external and internal auditors may be common when practicing certain rules. They also do differ in certain comparisons yet the major difference is the authenticity of the reports which is reliable and credible. The independent auditor’s report can combat the frauds that put adverse impacts on businesses and might save investment decisions, jobs or may be a family's future. The term ‘ independent’ is often confused when defining it for external or internal auditors. There is however, a considerable different degree, meaning, and context regarding the independence for both.

(Word count 1257)

Reference List

GAAS (Generally Accepted Auditing Standards) 2009. (www. http://businessaccent. com)

[Accessed 03/02/2013].

Auditor independence n. d. http://www. business-competence. com/auditor-independence. html [Accessed 03/02/2013].

Auditor independence. 2012. http://www. cmvm. pt/CMVM/Cooperacao %20Internacional/Docs%20Iosco/Documents/Principles_Auditor_Independence. pdf[Accessed 03/02/2013].

Audit Independence : Its Importance to the External Auditor's. 2006. http://mpra. ub. uni-muenchen. de/231/1/MPRA_paper_231. pdf[Accessed 03/02/2013].

Auditor Independence. 2011. http://www. charteredaccountants. com. au/Industry-Topics/Audit-and-assurance/External-Auditors/Auditor-independence[Accessed 03/02/2013].

Independent External Audit. 2013. http://www. stcu.

int/cis/activepr/audit/[Accessed 03/02/2013].