Importance of auditor independance

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INTRODUCTION

Independence has been always a huge concern in the auditing profession. Scandals like the failure of Enron has raised the importance of independence of auditing. According to Akpom and Dimkpah, audit independence refers to the ability of the external auditor's behaviour in terms of integrity and impartiality during the auditing, (Akpom and Dimkpah, 2013) also can be described as having an unbiased point of view while performing audit tasks such as analysing the results and confirming the audit report.

Auditor independence increases " the effectiveness of the audit by ensuring that the auditor plans and carries out the audit objectively" (Chepkorir, 2013, p. 2). Recent challenges of the audit independence assumption have forced the accounting profession to consider ways of improving the audit report's credibility (Shockley, 1981, p. 785). As the result, the accounting profession has found a new ways to improve and defend the independence of audits. The quality of auditing report has been constantly facing pressure from the media, stakeholders and investors to minimize the risk of compromising audit independence, especially after 2002. According to Shockley (1981, p. 785), " the value of auditing services depends upon the fundamental assumption that certified public accountants (CPA) are independent of their clients". Some researchers argue that auditing has three different parts, first is to monitor the actions of managers, second is to enhance information environment and third is to provide a source of insurance against corporate failures (Fernando, Abdel-Meguid, and Elder, 2010). Corporate collapses and bankrupts such as Enron and WorldCom is highly correlated to the audit independent quality. It is believed that once auditors has failed to identify or

misstate information on financial statements such like income statement and balance sheet, it can challenge the value of the audit and the firm's reputation may be damaged (Fearnley, Beattie and Brandt, 2005).

1. ROLE OF AUDITOR

The role of auditors should be a key to attest the quality of financial performance of an organisation, in terms of reducing the risks of misstatements and to ensure that the financial statements are compiled according to current laws and regulations. The lower the risks on misstatements the more increase confidence in the capital markets (Heil, 2012). The investors and shareholder's confidence in the auditor depends on the auditor's credibility to assess the financial statements. As the result, auditors have to maintain and appear to maintain their independence at all times.

However, the key factor is the relationship between an auditor and the clients. (Hardies, K., Breesch, D. and Branson, J. (2009) in C. O. Mgbame, C. O., Izedonmi, F. I. O. and Enofe A. (2012)) argued that audit quality is not simply a linear function of Auditor competence and auditor independence, but also on the factors such like their managers and the clients perspective and values.

Since audit quality in this case refers to credibility and quality of the audit to the financial statements which is the degree to measuring the confidence of a business. However this becomes difficult, because managers in the firm are responsible for hiring and firing the auditor under their own authority. This allows the auditor's view and value to be influenced because of conflict

of interest, and this may lead to lose their independence, as result this gave rise to the principal -agent relationship where owners (principals) entrusted the duty of running the day-to-day affairs of their businesses into the hands of professional managers hence, agents theory.

Furthermore audit quality in recent times has become a source effect of auditor independence on audit quality, many studies shows of worry from the shareholders, investors locally, nationally and globally as most auditors seem to be not acting independently. Clients appear to be deciding for the auditor's opinion and approach. This is the factor for the failure for massive corporate. Companies like Enron and WorldCom, amongst others, have disclosed improprieties in their financial statements amounting to billions of dollars (Cullinan, 2004).

2. AGENCY THEORY AND AUDITING

Agency theory (Watts and Zimmerman 1978, 1986a, 1986b) suggests that the auditor is assign in the interests of both the third party as well as the management. In these relationships, management is the agent, which tries to gain contributions from the client, shareholders, employees. In the recent days the most widely used audit theory is the agency theory.

Since the shareholders cannot focusing on day-to-day administration, management and policy making, therefore this type of work is trusted to managers (agents). An agency relationship raised up when a " principal" engages another person as their agent to provide a service on their behalf. As the result of information lack of equality or equivalence between the agent and the principal and of their different thought of motivations, the

principal lacks trust in the agent and may therefore need to put in place some monitoring mechanisms, such as the providing audit service, to reinforce this trust. Jensen and Meckling (1979) define an agency relationship " as a contract under which one or more person engage with another person (agent) to perform some service on their behalf which involves delegating some decision making authority to the agent". Since the agents may have personal interests which are different from that of the principal, the principal needs to establish appropriate incentives for the agent and incur monitoring costs to limit the divergence of interests by the agent.

3. TREATS

According to IBS (Independence Standards Board, 2000) the threats to auditor's independence are the sources of possible bias that may compromise, an auditor's ability to make unbiased audit performance. Because of the possible compromise of the audit performance, decisions makers should identify and analyse the effects of threats that are sources of potential bias.

Threats are posed by all different types of activities, relationships, and other circumstances, to identifying the types of threats can give more understanding of the nature of those threats and their potential impact on audit independence to the independent decision maker. The following list provides examples of the types of threats that may create pressures and other factors that can lead to biased audit performance. It illustrates the wide variety of threat types that independence decision makers need to

consider when analysing auditor independence issues. IBS identified five main treats as follow:

a. self-interest threats—threats that arise from auditors acting in their own interest. Self-interests include auditors' emotional factors, financial factors, or other personal interests. Auditors may favour either consciously or subconsciously to those self-interests over their interest in performing a quality audit. For example, auditors' relationships with auditees (Clients) can create a financial self-interest because auditees pay the auditors huge amount of fees. Auditors also have a financial self-interest if they are the shareholder or investor in an auditee's company, this may have an emotional factor or financial factor, and leads to bias audit decision.

b. Self-review threats—threats that arise from auditors reviewing their own work or the work done by others in their firm. It may be more difficult to evaluate quality without bias when people are reviewing their own work, or of one's firm, than the work of someone else or of some other firm. Therefore, a self-review threat may arise when auditors review and decisions they, or others in their firm, have made.

c. Advocacy threats—threats that arise from auditors or others in their firm promoting or advocating for or against an auditee's position or opinion rather than serving as unbiased attesters of the auditees' financial information. Such a threat may be present, for example, if an auditor or others in the auditor's firm promote an auditee's securities.

d. Familiarity (or trust) threats—threats that arise from auditor's judgement being influenced and affected by a close relationship with an auditee.

Independence may compromise if auditors are not sufficiently sceptical of an auditee's assertions and, as a result, too readily accept an auditee's viewpoint because of their familiarity or emotionally with in the auditee. For example, a familiarity threat may arise when an auditor has a particularly close or long-term personal or professional relationship with an auditee, this can be same auditor serving the same client for a long period of time.

e. Intimidation threats—threats that arise from auditors being, or believing that they are being, overtly or covertly coerced by auditees or by other interested parties. Such a threat may arise, for example, if an auditor or an auditing firm is threatened with replacement over a disagreement with an auditee's application of an accounting principle.

4. FACTORS CAN AFFECT THE INDEPENDENCE

There are many factors can affect auditor's independence; however, in this case, we are looking into the factors such as the audit firm size, the firm's tenure, the level of competition in the market, the size of the audit fee, the audit committee and provisions for non-audit services will be discussed.

4. 1 AUDIT TENURE

An audit firm's tenure can be defined as the length of time of an auditor performs the audit services for a client. The risk associated with the compromising of independence are increased once client relationships are maintained for a long period of time. However, other individuals believe having a lasting relationship will increase independence. For example, " long tenure is beneficial as auditors gain expertise in the field that they audit and

may reduce the auditor's ability to detect irregularities or material misstatements" (UKEssays). The SEC stating that partners should not remain with a client for no more than five years, to eliminate the possible familiarity. Shockley (1981, p. 789) explained how " complacency, lack of innovation, less rigorous audit procedures and a learned confidence in the client may arise after long association with the client." A recommendation to rotate auditors was introduced by the Metcalf subcommittee in order to avoid this familiarity issue (Shockley, 1981). Many research has proven that there are more unsuccessful audits in the beginning of auditor-client relationships in addition to lower earnings with audits who have shorter time frames. Apparently, investors reward long auditor-client relationships with lower cost of debt (Mansi et al, 2004).

4. 2 SIZE OF THE AUDITING FIRMS

The audit firm size is another factor that impacts auditor independence. What distinguishes a large audit firm from a small audit firm? There are many differences between the two firms which include the amount of responsibility, the number and reputation of the clients and the calibre of employees. Larger audit firms are more likely to provide a better-quality audit due to better research facilities, technology, financial resources, and skilled labour because they can conduct audits from bigger firms. Pressures from management will affect smaller firms while larger firms are able to resist since they have different variations for client exposure. Since larger firms receives more publicity from the media, smaller firms are less noticeable by shareholders, " implying less information and weaker monitoring" (Fernando, Abdel-Meguid, and Elder, 2010, p. 367). A study was

conducted where researchers studied the impact of auditor firm size. It was comprised of larger firms such as the Big 4 and national and local firms. Everything was measured using the “ collateral bond” by DeAngelo (Saat et al, 2013). The results of the study showed that, although the relationship between audit firm size and independence is unclear and insignificant, audit’s firm size can moderate the relationship of moral reasoning and independence (Saat et al. 2013, p. 244). In addition, there was a difference in the way large and small firms chose to document their disclosures in financial statements. For instance, national firms would leave comments for any adjustments that were made on the disclosure while local firms preferred a footnote.

These factors may affect the auditing quality of the auditors, therefore without given any thought of avoiding the treats from ISB or consider the factors that can compromised the auditing independence, company and auditing firms may put them self into a scandal risk.

5. SCANDALS IN THE US HISTORY

There are few scandals in the US history such like Worldcom, Enron and Tyco, however Enron is the most famous and well known scandal of the all.

Enron is one of the most famous financial scandals that this generation has seen. In order to satisfy the credit rating agencies, the leadership of Enron lobbied to raise Enron’s credit rating, but without any success. They were interested in lowering their debt ratio through reducing hard assets and increasing Enron’s return on assets (ROA). This deduction would then make the company look more attractive to investors and the credit rating

agencies. Many companies used ‘ special purpose entities’ (SPE) to access capital and hedge risk. By using these they are able to increase leverage and ROA without having debt on its balance sheets. The SPE then can borrow a large amount of money from financial institutions to purchase assets or conduct other business without the debt or assets showing up on their financial statements. They can also sell leveraged SPE’s and book a profit, and through FASB (Financial Accounting Standards Board) guidelines, they were able to avoid classifying them as a subsidiary and would not have to report the SPE’s financial position on their financial statements. (Thomas, 2002)

Enron took the use of SPEs to a new level and they were able to take advantage of this loophole. Enron began using these SPE’s in many of their business deals and compounded a management fee of 3 30 million dollars, which went straight into Andrew Fastow’s, former Enron CFO, pocket. In addition, by capitalization of Raptor Vehicles, one of their SPEs, they were able to record a note receivable and the corresponding increase in shareholder’s equity for $1. 2 billion when they issued common stock. Through odd footnotes and disclosures on their financial statements, Enron began to crumble and thus started one of the largest financial busts we have seen. (Thomas, 2002)

Enron, Worldcom and Tyco are just a few of the cases seen in the early 2000’s that caused the United States Congress to pass the Sarbanes Oxley Act (SOX) 2002 and tighten the regulations on internal accounting practices and increase the accuracy in financial reporting. One of the common issues around all of these scandals is 4 that they all suffered from or exhibited

corrupt internal controls in regards to reporting their financial statements. This is the reason Section 404 of the Sarbanes Oxley Act is so important and worth dissecting and looking into in more detail. This study will address what the Sarbanes Oxley Act consists of and how the most controversial section of it operates (Section 404). The study will also, examine the different trends in financial misstatements and internal control financial reporting weaknesses.

6. SARBANES OXLEY ACT

After the events described above occurred, the United States Congress decided something must be done in order to stop these terrible acts from happening again. Their response was the Sarbanes Oxley Act; this was aimed to restore the public confidence in financial information. SOX was introduced by Senator Paul Sarbanes and Representative Michael Oxley. Representative Oxley created a bill, which was referred to as the " Corporate and Auditing Accountability, Responsibility and Transparency Act", which was passed by the House of Representatives and was sent over to the Senate to be reviewed by the Banking Committee. At this time, Senator Sarbanes, chairman of the Banking Committee, was working on his own proposal focusing on the same issue. Congress created a Conference Committee to join these two proposals and created what we now know as the Sarbanes-Oxley Act.

SOX contains eleven titles targeted to strengthen corporate accountability and public accounting responsibilities. The first title creates and organizes the Public Company Accounting Oversight Board (PCAOB). This board is directed by the Securities and Exchange Commission and has various

responsibilities. They have the responsibility of (1) registering public accounting firms that prepare audit reports, (2) establishing auditing ethics, independence and other regulatory rules and audit standards, (3) conducting inspections, investigations and disciplinary proceedings and (4) imposing sanctions. (Grey & Ehoff 2015)

7. THE IMPORTANTCE OF AUDIT INDEPENDENCE

Independence is an essential attribute for audits because it determines how credible and reliable financial statements will be to investors. Independence has been the focus of almost constant controversy, debate and analysis (Law, 2008, p. 917). After corporate failures and scandals, regulators began to question how independent and competent auditors were during engagements (Bakar et al, 2005, p. 805). According to Fearnley, Beattie and Brandt (2005, p. 40), “ the restatement of the Enron accounts and the collapse of Anderson…shows the devastating effect of loss of confidence in the integrity of an audit firm.” The media remains critical of the auditing profession. Actual and perceived independence are the two types of auditor independence. The perceptions of the auditor independence will determine the future of the auditing profession (Fearnley et al, 2005, 41).

CONCLUSION

In conclusion, auditor independence remains an important element when individuals are conducting an audit. Auditor independence ensures an unbiased perspective and allows financial statements to be more reliable. Firms face the risk of damaging their reputation once auditors fail to report mistakes in their audits. Independence became an issue after corporate

scandals such as Enron. Also, the International Standards board began to establish different frameworks to help provide rules and standards for auditor independence. However, the meaning of “ appearance” continues to remain a challenge for researchers. The question of whether investors can truly understand the relationship between the client and auditor to determine how the audit will be affected is still unanswered.

In conclusion, the top determinant of auditor independence was not clear; however, other researches ranked them based off importance because of their hypothesis that they chose to test. It is evident that independence remains a going concern when discovering how reliable and credible financial statements are to investors.

REFERENCES

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