

Research proposal on threat to auditors independence accounting essay



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History reveals that audit is a Latin word meaning “ he hears”. Auditing originated in those years when individuals entrusted with public funds were required to give an oral account of their handling of those funds. Porter (1997)

An opinion of an independent chartered accountant is needed to give the public rest of mind that the sets of accounts presented were true and fair and also conform to lay down standards.

Independence is the cornerstone of auditing; Stewart (1977) quoted by Porter. In carrying out the audit assignment, the auditors must be independent i. e. the sense of being self reliant and his/her professional judgement not being subordinated by the opinion of others. (Porter, 1997, p. 65)

It is very important for the auditors to be independent otherwise the audit report will be undermined and lose its value. In order to make the users of information to have faith and rely on the audited account, they must be sure that the audited accounts are independent of entity, its management and other interested party.

This is reflected in the fundamental principles of external auditing- objectivity and independence which state that auditors are objective and they express opinion independently of the entity and its directors. As the guide to professional ethics statement (GPES) 1: 201: integrity objectivity and independence explains, objectivity is essential for any professional person exercising professional judgement. Objectivity is sometimes described as independence of mind (Dunlea, A. & Maclochlainn, N. p. 19).

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However, it is possible to identify some threats to auditors' independence. The provision of non-audit services by auditors to their client is referred to as a self-review threat to auditors' independence. This is so because once an auditor of a company starts to provide non-audit services to its client e. g. computation of corporation tax matters and other financial services the auditor and the directors tend to develop a relationship and this may jeopardise the objectivity of the auditor (Woolf, E. 1997, p. 11-14).

The provision of non-audit service by auditors to their client is still a topical issue. The New Standards on Ethics issued in October, 2004 by Auditing Practices Board (APB), gave some exemptions to small companies on the provision of non-audit services. These exemptions can be found on APB's website- www.frc.org.org/apb. (Accountancy, 2005)

My interest in auditing as my best subject and my future aspiration to become an auditor made me to choose this topic to assess the threats to auditor's independence.

RESEARCH OBJECTIVES

1. To carry out a critical literature review to identify and assess the key threats to auditors' independence.

To examine the controversies on the provision of non-audit service.

To carry out empirical research to establish the opinions of auditors on the provision of non-audit service, to know whether it can pose can a threat to auditors' independence and objectivity.

To draw a conclusion on the extent to which the provision of non-audit service does and is perceived to weaken the independence of auditors.

1. 3 METHOD

1. Conduct a review of literature on auditing in relation to auditors

independence and threat to auditors' independence in order to develop research question.

2. A questionnaire will be developed with question based on the background and objective of the research. The questions in the questionnaire will seek to test the research question; does the provision of non-audit service, pose a threat to auditors' independence?

The questionnaire will be distributed to a sample of 20 auditing firms and 20 small sized businesses within Bolton, United Kingdom: In order to find out whether the how provision of non audit service poses a threat to auditors' independence.

Data analysis that will be used is percentage method and chart, to evaluate the effect of non audit service on auditor's independence.

3. If required, conduct interviews with some auditors after the collation of questionnaire.

TIMESCALE

February 2005 Week 1-3, lectures on how to write good project and

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selection of research topic.

March 1, 2005 Draft research proposal and individual tutorials.

March 4, 2005 Submission of research proposal.

March 2005 Literature review and clarification of research objectives.

April 2005 Agree formal access to 20 auditing firms and businesses.

April 2005 First draft of literature review, clarification of methodology and compilation, piloting and revision of questionnaire.

April-May 2005 Administer questionnaires and collection of questionnaires. If required, conduct interviews.

June 17, 2005 Submission of draft literature review, methodology and related documentation.

July-September Analysis of primary/secondary data.

2005

October 2005 Further writing up and analysis.

November 25, 2005 Draft completed including bibliography.

January 13, 2006 Submission of final project report and logbook.

(England, J. (2005)

RESOURCES

I have access to computer hardware and software. Access to auditing firms and businesses has been negotiated, subject to confirmation. I also have the finance required to pay all incidental cost as part of my course expenses.

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LITERATURE REVIEW

LITERATURE REVIEW

2. 1 INTRODUCTION

Since the introduction of the auditing standard on independence, which requires auditors to be independent of the clients being audited, the maintenance of independence has become a critical issue for the accounting profession. Bartlett, R. W (1993, Online)

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The author sees independence in auditing as able to maintain an unbiased mental attitude in making decisions about audit work that one is to report upon.

Independence in auditing context according to Bartlett, R. W. (1993), is the auditor's ability to resist client pressure or/and the auditor's ability to act with integrity and objectivity.

Dunn, J. (1991, p. 19), described independence " as an attitude of mind characterised by integrity and an objective approach to professional work".

Whittington and Pany, (1998, p. 34) sees independence as, " the ability to maintain an objective and impartial mental attitude throughout the audit assignment/ engagement".

There is a general agreement that independence is an attitude of mind, which does not allow the viewpoints or conclusion of the corporate auditor to become reliant on or subordinate to the influence of pressures of conflicting interests; Lee (1993, p. 98) quoted by Sherer, M. and Turley, S. (1997).

For purposes of this research, independence will be separated into two related concepts of independence, which are; independence in fact and in appearance.

Independence in fact is when an auditor displays independence in mental attitude when carrying out his statutory audit assignment. While independence in appearance simply means that the auditor should be seen as been independent in the public's view (shareholders, Potential investors).

Public confidence would be impaired by evidence that independence was lacking, and/or when there is the existence of circumstances, which the public might believe, is likely to influence independence. The relationship that exists between the auditor and their client should be such that appears independent to the third party, Bartlett, R. W (1993).

Whittington and Pany (1998, p. 35) further state that,

The requirement by the third party from the auditor is to give credibility to the audited financial statement.

The concept of appearance of independence has been primarily concerned with identifying those situations in which a qualified Chartered Accountant might not be perceived to be independent. The mere perception that an auditor is not independent renders his report useless to the shareholders who wish to rely on it for decision-making purpose.

Beattie, V. et al. (1999) stated that,

The reality and perception of auditor independence is fundamental to public confidence in financial reporting.

This work will identify and assess the key threat to auditor's independence and concentrate on the provision of non-audit services. It will examine the controversies on the provision of non-audit services and establish the opinions of the public and auditors on such provisions. Finally a conclusion will be drawn on the extent to which provision of non-audit service does and is perceived to weaken the auditors' independence.

2. 1 ANALYSIS OF PRESENT SYSTEM

A number of factors have been identified in textbooks, journals, articles, auditing standards and the public's view, which does affect auditors' independence.

Hussey, R. and Lan, G. (2001), identified some of the factors such as: the nature of the auditor-client relationship (Goldman and Barley, 1974), lack of strict auditing regulations, and competitive pressures leading to what has been termed predatory pricing or lowballing and the provision of non-audit services. Beattie and Fearnley, (1994), quoted by Hussey, R. and Lan, G. (2001), (Online).

The auditing practice board(n. d) categories these threat as follows: Self interest threat, self review threat, management threat, advocacy threat, familiarity threat, and intimidation threat.

Woolf, E. (1997, p. 13), lists examples of " threat to Auditors' independence" as follows:

Undue dependence on a single audit client, overdue fees, litigation, external pressure or influence, family and other personal relationship, beneficial interest in shares (other investment) and trust, trustee investment in audit clients, voting on audit appointment, loans to and from client, receipt of hospitality or goods and services on preferential terms, and provision of non audit services to audit clients etc.

Beattie, V. et al. (1999), stated the principal threat factors to independence relate to economic dependence and non-audit service provision. I have <https://assignbuster.com/research-proposal-on-threat-to-auditors-independence-accounting-essay/>

chosen to concentrate on how the provision of non-audit poses a threat to auditors' independence, (Online).

According to the Auditing standards guidelines (online, n. d.), " non audit services" comprises:

Any engagement in which an audit firm provides professional services to an audit client other than pursuant to:

the audit of financial statements; and

those other roles which legislation or regulation specify can be performed by the auditors of the entity.

An online source (n. d.) defined, non-audit service as,

Those services that are permissible under applicable legislation and that are routine and recurring, do not impair the independence of the auditor, and are consistent with APB rules on external auditor independence.

Other services that are rendered by auditors apart from auditing are:

bookkeeping or other services related to the accounting records or financial statement, financial information systems design and implementation, actuarial services, internal audit outsourcing services, management functions, human resources, broker-dealer, investment adviser, legal services just to mention a few. (Online)

The Authors' research as indicated that over the years, there as been a growing dissatisfaction among investors and other users of financial

statements about auditors' provision of non-audit service. These services are perceived to weaken auditors' independence when both audit work and non audit work are performed by the same audit firm to the same audit client.

Barkess and Simnett, (1994), disagreed with the view, that the provision of non-audit service does impair auditors' independence. They argued that there is no relationship between the level of other services and the type of audit report issued; hence they concluded that, the provision of other services by the external auditors to their clients does not compromise the independence of the external auditors.

The accounting profession also disagreed about whether non-audit services impaired the performance of the audit and financial reporting process.

Several auditors are of the opinion that, when they understand the factors that influence and improve the entity's performance, that they will be able to focus their audit on those critical issues.

Others view provision of non audit service, as an impediment to independence because, in some cases, the fees from the provision of non-audit services are more than that of audit fees. If the income earned from provision of non audit service, is more than that of audit service, auditors have naturally tendencies to lose their independence, considering the cost of losing a client can be considerably more than simply the audit fees.

The Securities Exchange Commission, in the United States of America, carried out a research in 1999 and discovered that:

4. 6% of Big Five SEC audit client paid consulting fees in excess of audit fees. The SEC is concerned that the more the auditor has at stake in its dealing with the audit client, the greater the cost to the auditor should he or she displease the client, particularly when the non-audit service relationship has potential to generate significant revenue on top of the audit management.

The SEC concluded that issue that impairs auditor's objectivity are subtle and that certain non-audit services, when provided by the auditor do create inherent conflicts, (Online).

In a situation where an auditor assists an audit client with their bookkeeping services, this places the auditor in the position of later having to audit his or her own work. It is rather unprofessional for the person who prepared the account to also audit the account. When such happen it is practically impossible to expect the auditor to be able to audit those same records with an objective eye.

In the same vein, when an auditor performs certain valuation services for the audit client, can such auditor raise questions in line with valuation of assets at the end when auditing that same audit client? An auditor who has appraised an important client asset at a period during the year is less likely to question his or her own work at year-end.

Various examples can be used to see how the provision of non-audit service will impair audit independence.

An auditor who provides services in a way that is tantamount to accepting an appointment as an officer or employee of the audit client cannot be expected

to be independent in auditing the financial consequences of management's decisions. An auditor who has also helped an audit client to negotiate the terms of employment for a new chief financial officer is less likely to bring quickly to the audit committee questions about the new CFO's performance.

Considering the following examples of non audit services rendered by auditors to their audit client, it would be seen that such services not only impair auditors' independence but also shows that the accounting profession is not prepared to provide the reasonable assurance that the public expects.

Graeme, W. (1994), carried out a further investigation on whether there is the potential for an appearance of auditor independence impairment when higher levels of non-audit services are provided to audit clients. He investigated this, by analyzing the audit reports for a sample of publicly listed companies over a 10 years period. The results of his analysis revealed that the auditors of companies not receiving an audit qualification of any type over the period derived a significantly higher proportion of their remuneration from non-audit services fees than the auditors of companies receiving at least one audit qualification, (Online)

The result of his findings could suggest that auditors are less likely to qualify a given company's financial statements when higher levels of non-audit services fees are derived.

Firth M. (1997) in his write up concluded that, the provision of non-audit services to audit clients does increase the economic bond between the auditor and client. This bond, he said, is perceived as impaired auditor

independence (Beck, Frecka, and Solomon 1988b; DeBerg, Kaplan, and Pany 1991; Pany and Reckers 1983, 1984), quoted by Firth, M.

Firth, M. further affirms this by given two reasons to believe that such service impair independence:

The audit firm is unwilling to ' criticize' the work done by its consultancy division, and secondly, the audit firm does not want to lose lucrative consultancy services provided to the audit client and is, therefore, more reluctant to disagree with management's interpretations of accounting matters.

He concluded that, auditors disagreements with management could lead to a change of auditor, a move which implies not only a loss of audit fees but, in all probability, a loss of consultancy fees as well. (Online)

On one hand, many practitioners (auditors) are adamant that their auditing firms are able to wear both the hats of auditor and consultant without reducing the effectiveness of either service (Burton, 1980; Carey and Doherty, 1966; Klion, 1978; Mednick, 1990) quoted by Bartlett, R. W. (1993).

The supporters of the opinion that non-audit service does not impair auditors' independence argue that independence is a quality of auditor professionalism which can have a range of values:

...like all attributes of professionalism, independence is a matter of degree.

Those arguing that independence is impaired by combining consulting and auditing have assumed that independence must be absolute, while their

opponents have recognized that independence is a matter of degree and <https://assignbuster.com/research-proposal-on-threat-to-auditors-independence-accounting-essay/>

have decided that the auditor can achieve the necessary degree of independence and act in the dual capacity of auditor and consultant.

Carmichael and Swieringa (1968) quoted by Bartlett, R. W. (1993).

Auditing Practice Board under the Accounting Standard Board maintained its stand that the provision of non-audit services to audit clients does reduce the public confidence in the independence of the auditor, Bartlett, R. W (1993).

However, consideration was given to small entities. A small entity is defined for the purposes of ES-PASE as;

“ As a company which is not a UK listed company or an affiliate thereof that meets two out of the following three criteria: turnover below £5. 6 million, balance sheet total below £2. 8 million and employees below 50.

ES-PASE:

Provides auditors of Small Entities with procedures as an alternative to the safeguards described in Ethical Standards 1- 5, in relation to threats to independence created when the auditors have a degree of economic dependence or where they provide non-audit services to their audit clients;

Makes available exemptions to the auditors of Small Entities in relation to:

The prohibition on auditors representing their clients at tax tribunals;

The prohibition on auditors providing non-audit services, including tax and accountancy services, unless management is sufficiently ‘ informed’ to make

independent judgements and decisions in relation to them. (APB, 2005 Online)

<http://www.frc.org.uk/apb/publications/pub0685.html>

2. 3 STRATEGY AND TECHNOLOGY

In the USA, the General Accounting Officer (G. A. O.) did a graphical representation of both the permitted and prohibited audit work to audit client:

The standard for non-audit services was said to employ two overarching principles:

Audit organizations should not provide non-audit services that involve performing management functions or making management decisions; and

Audit organizations should not audit their own work or provide non-audit services in situations where the non-audit services are significant to the subject matter of the audits.

SEE the APPENDICE 2. 3. 1 for table of permitted & Prohibited non- audit service

TABLE 2. 3. 1

2. 4 CONCEPTUAL FRAME WORK

The contention on the provision of non-audit service has been critically analysed. Different views of all stakeholders concerned with the provision of non-audit services to audit client have been examined. A logical conclusion

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has been drawn, as to the extent to which provision of non-audit service does and is perceived to weaken the auditors' independence. The accounting profession has also reviewed the statement of Auditing Standard on auditors' independence, knowing fully well that, without value in the auditor opinion, there would be no demand for audit service.

Various proposals have been propounded for protecting auditors from the undue influence of directors and regarding the provision of non audit services. There have been many similarities with the proposals of Institute of Chartered Accountants of Scotland and the Board for Chartered Accountants in Business, in considering possible mechanisms to remedy the perceived weaknesses of regulations, practises on other audit services.

They concern is to whether there should be a prohibition on firms undertaking work other than audit for their audit clients or whether there should be compulsory rotation of audit firms, after a fixed period of say anything between 5 and 12 years or whether the responsibility for the development of auditing standards and guidelines be distanced from the Institute of Chartered Accountants in England and Wales?

The conclusions it reached were that to prohibit additional work or require compulsory rotation of audit firms would increase clients' costs, reduce efficiency and place restrictions on the freedom of the client to make decisions on the services they desired. The Board was also opposed to the establishment of another body to control auditing practices. It argued that this would lead to a bureaucratic, inflexible framework without the advantage of the accumulated experience of the accounting profession.

They came out with these conclusions as regards non-audit service that;

Auditors should no more be allowed to undertake work other than audit work for the same client. They recommended that there should be compulsory rotation of audit firm after a fixed number of years. This will break any relation that might exist between auditor and company management and would also make the auditor to perform his job without been biased knowing that other auditor (firm) will come in after him (them).

“ An audit can only be effective if the auditor is independent and is believed to be likely to report breaches of the contract between principals (shareholders and lenders) and agents (managers)”

(Fearnley & Page, (1994), quoted by Hussey, R. and Lan, G. (2001)

I agreed with what the accounting profession did by has establishing the categories of ethical standards by which the auditors must abide in order to avoid impairment of independence, Spindel, F. S. stated.

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RESEARCH METHODOLOGY

CHAPTER THREE

RESEARCH METHODOLOGY.

3. 1 INTRODUCTION

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England, J. (2005) defined Research Methodology as,

“ A precise statement of how a researcher intends to achieve his research objectives and rationale for his choice of method”.

Research on the other hand, can be defined as an investigation into a matter to get a solution or answer to a particular subject matter or issue.

Kumar, R. (1999) defined research as

An undertaking within a framework of a set of philosophies using procedures, methods and techniques that have been tested valid and reliable and has been designed to be unbiased and objective to find out answers to a question.

Research is a systematic investigation to find out answers to problems, Burns (1994; p. 2) quoted by Kumar R defines research as,

A systematic investigation into the study of materials, sources etc in order to establish facts and reach new conclusions. It is also an endeavour to discover new or collate old facts by the scientific study of a subject or by a course of critical investigation, Oxford English Language quoted by England, J.

Research, according to Alison et al. (2001) is a systematic enquiry, which is reported in a form, which allow the research methods and the outcomes accessible to others.

3. 2 RESEARCH OBJECTIVES

After carrying out a literature review to collate data on the views of different authors on issue of provision of non audit services to audit client and how this is viewed to threaten auditors independence, a set of questions will be prepared. This is necessary so as to be able to have a wide range of auditors and entrepreneurs view on the subject matter.

In order to obtain relevant information needed to achieve the objectives stated below, questionnaires will be delivered (sent) to twenty auditing firms and twenty small business entities:

To carry out a critical literature review to identify and assess the key threats to auditors' independence.

To examine the controversies on the provision of non-audit service.

To carry out empirical research to establish the opinions of auditors on the provision of non-audit service, to know whether it can pose a threat to auditors' independence and objectivity.

To draw a conclusion on the extent to which the provision of non-audit service does and is perceived to weaken the independence of auditors.

3. 3 RESEARCH APPROACH

3. 3. 1 RESEARCH PHILOSOPHY

Blaikie, N. (2003) defined positivism as, " the research that assumes that social reality is external to people involved and only the aspect that can be measured are regarded as relevant to research".

Jackson, W. (1995) stated that research just like positivism relies on experiments, survey and secondary data, therefore my research philosophy is positivism based. The author will be using questionnaire which comes under the Survey category.

3. 4 RESEARCH STRATEGY

The deductive approach or research strategy will be used for this research because, sufficient materials (journals, articles, periodicals) are available to carry out a test on how the provision of non-audit service does and is perceived to weaken the independence of auditors.

The approach involves what?

There are different researches strategies ranging from Experiment, Survey, Case Study, Ethnography and Action Research but the Survey strategy will be used for this research.

Survey strategy and questionnaire option are chosen under this category leaving behind the structured interview and observation.

Kumar, R (1999, p. 104) stated that sometimes information required to carry out a research are readily available but needed to be gathered / collected from different sources to get the clue to what one is trying to find out or achieve.

To achieve the objective of this research as earlier stated above, questions will be tailored to answer the Research Objectives.

Questionnaire was chosen because it allows the collection of data from a sizeable population i. e. twenty auditing firms and twenty small business entities as stated in the literature review.

The delivery and collection questionnaire method is considered appropriate for this research. The questionnaire will be delivered in person to selected auditing firms and small business entities, asking them of a possible date of collection. This is chosen to be the best form of questionnaire method necessary to achieve the aim of the research, Saunders et al (2001)

The author considered interview as another option to this research, but realised that time may be a limiting factor. It may be impossible to interview twenty auditing firms and small business entities because of time.

The author also considered the convenience of answering the structured interview as respondents may be busy with other business matters on the day of interview. This may cause lack of concentration or simply not getting the best from the person interviewed.

If time permits, additional information through interview would be gathered. This will be done by carefully selecting respondents from the questionnaire who are willing to supply more information on the subject matter and are ready to be interviewed, to assist in achieving the objective of the research.

A question will be in the questionnaire asking whether respondent are willing to give further information to help achieve the research objective (Interview).

Other research strategy or methods are considered in appropriate for this kind of research.

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ADVANTAGES OF QUESTIONNAIRE <