

The factors affecting auditor independence accounting essay



**ASSIGN
BUSTER**

The issue of auditor independence is a crucial element and very important for the audit profession. This concept has been discussed widely and many definitions have been presented in literature. Independence refers to the auditor's ability to present his opinion about the reliability of financial statements honestly and impartially away from his interest or the pressure of clients[1](Ahmad, 1985).

Literature has contemplated two standards for assessing auditor independence. Mautz & Sharaf(1961), who are among the pioneers in the study on auditors independence have developed a concept of independence with two components: practitioner-independence (independence in fact) and profession-independence (independence in appearance). The Public Oversight Board emphasized that the members of Certified Public Accountant firms should protect the profession by being independence both 'in fact' and in 'appearance' (Lowe et al, 1999). Independence in fact refers to the mental attitude of the auditor characterized by the integrity and the objective approach to the audit process. Also, the practitioner independence requires the auditor to be free from personal interest and susceptibility to excessive pressure[2](Moizer & Sutton, 1997).

However, since this mental process is unobservable and auditors also have incentives to violate their independence through satisfying their clients so as to maintain the economic bonding to the client[3](DeAngelo, 1981), there is a need for the auditors to be perceived as independent(named independence in appearance) from the management team who prepares the financial statements. Orren (1997) states that independence in fact refers to the actual, objective relationship between auditing firms and their clients

whereas independence in appearance is the subjective stated of that relationship as perceived by the clients and the third parties. Church and Zhang, (2002) argue that independence in fact is necessary to enhance the reliability of financial statements. On other hand, independence in appearance is necessary to promote public confidence such that users will rely on audited financial statements.

Securities and Exchange Commission, 1979 asserts:

“ The [auditor independence] issue is both one of appearance and of fact; if public confidence in the integrity of financial reporting is to be maintained, it is of the utmost importance that public confidence in the objectivity of independent auditors be similarly maintained”.

American Institute of Certified Public Accountants (Public Oversight Board, 1979):

“ While it is, of course, essential that an auditor preserve his objectivity and integrity from his own viewpoint, commonly called “ independence in fact,” it is also important that the auditor appear independent to all users of the financial information he provides. This latter concept is an essential ingredient to the value of the audit function because users of audit reports must be able to rely on the independent auditor.”

The need for Auditor’s independence

Independence is an important auditing standard because the auditor adds justification and credibility to financial statement even when there are no material misstatements or omissions in the financial statements prepared by

management (okolie 2007). The author Gupta (1999) is of opinion that is auditor is not independent of management; his opinion would mean nothing to shareholders, prospective investors, bankers, government agencies, and others who are concerned with the financial statements of a company.

The author Ezeipe(2004) describes the concept of auditor's independence in three dimensions[4]:

Programme independence: Sometimes client manager have the intention to restrict or modify the procedures that the auditor want to perform. Thus auditors should always remain free from interference of client managers.

Reporting Independence: The auditor should never let any feelings of loyalty towards the client to affect his work. He must fully and fairly disclose his obligations. Management are never allowed to pressurize the auditor.

Investigative Independence: The auditor should have access to all necessary materials required on the content of an audit. For example, the auditor must have access to books and records; also active co-operation from management personnel during audit examination is required (salehi 2009).

Factors affecting auditor independence

In theory, there are many factors that affect independence of an auditor and these factors which have been studied can be:

The effects of gifts

The purchase of discounts arrangement

The audit firm size

The provision of management advisory services by the audit firm

The client financial condition

The nature of conflict issue

The audit firm's tenure

The degree of competition in the audit services market

The size of the audit fees

The audit committee

Practising non-audit services by auditors

In this study, only factors such as the provision of non audit services, the audit firm size, the audit firm's tenure, the degree of competition in the audit services market, the size of audit fees and non audit fees and the audit committee will be analysed and whether these factors will impair or enhance auditor's independence.

The provision of non audit services by auditors

Audit failures[5]reported in the past have affected the profession of auditor worldwide because the interests of shareholders and stockholders have not been safeguarded. This problem has arisen as a result of the provision of non-audit services (Salehi and Moradi 2010).

Non-audit services can be any services other than audit that an auditor provides to an audit client. Over the late 20th century, demand for business expert services has increased, Watlington and Pany (2001) identified the different range of services which are offered by auditors to private and public sectors and these non-audit services include: training, services for payroll, risk management advice, mergers and acquisition, taxation, public offering, portfolio monitoring, recruitment and human resources and corporate governance. An auditor needs to pay much attention when both audit and non-audit services are provided to the same client, because these non-audit services may threaten the independence of auditor.

Although there are market-based incentives for auditors to remain independent, there are also forces that potentially threaten auditor independence. Specifically, the SEC is concerned about two effects of non-audit services. One is a fear that non-audit service fees make auditors financially dependent on their clients, and hence less willing to stand up to management pressure for fear of losing their business[6]. The other is that the consulting nature of many non-audit services puts auditors in managerial roles, potentially threatening their objectivity about the transactions they audit.

Auditor's services relationship raises two types of independence concerns. First, the more the auditor has at stake in its dealing with the audit client, particularly when the non-audit services relationship has the potential to generate significant revenues on top of the audit relationship. Second, certain types of non-audit services, when provided by the auditor, create inherent conflicts that are incompatible with objectivity.

<https://assignbuster.com/the-factors-affecting-auditor-independence-accounting-essay/>

In the United States, the Sarbanes Oxley Act of 2002 implemented a ban on nine non-audit services which include:

Bookkeeping and other services related to the audit client's accounting records or financial statements.

Financial information systems design and implementation

Appraisal or valuation services and fairness opinions

Actuarial services

Internal audit services

Management functions

Human resources

Broker-dealer services

Legal services

Ojo (2009) suggested that the provision of non-audit services by audit firms does not necessarily affect auditor independence. However, where the fees generated from non-audit services are relatively high (in proportion to the audit fees earned by such accounting firms), this creates a situation whereby the auditor's independence is likely to be compromised since the auditor may be denied profitable contracts[7] where he gives a qualified opinion on the financial statement being audited.

Proponents of the provision of audit services argue that synergies of knowledge spill over and audit efficiency arise from providing both audit and non-audit services. Nevertheless, following the collapses, auditing profession as a whole has been affected and changes were proposed to ensure that audit firms reduce their over-reliance on NAS (The Star, 2002). In order to ensure the independence of auditors and to protect the interest of investors, the accounting profession in most countries has come up with a code of ethics that spells out guidelines for auditors' competency and independence.

Audit committee

An audit committee consists of a selected number of members of a company's board of directors whose main duties are to help auditors remain independent of management (Arens et al, 1999), that is, committee should support the auditor instead of management in different audit disputes.

Braiotta (1999) and Goldman (1974) maintained that audit committees could monitor the financial reporting process and provide recommendations in the selection of auditors, negotiation of fees and termination of external auditors, which would ultimately diminish management's power over the auditor. Thus, the audit committee is anticipated to ensure that the firm has sufficient internal controls, proper accounting policies, and independent external auditors that will prevent the incidence of fraud and promote high quality and timely financial statements.

The members who participate in the audit committee can be non-executive directors, corporate managers, academicians and retired partners of CPA

firms (Knapp, 1987). In the U. S., the Securities and Exchange Commission (SEC) chairman, Levitt (2000) pointed out that, "...qualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest"

SEC requires Audit Committees to evaluate the independence of the company's external auditor when deciding whether or not to hire the auditor for providing non-audit services. In so doing, Audit Committees also are encouraged to consider how the auditor provided non-audit services may improve audit quality and enhance auditor independence.

Size of audit firm[8]

The size of audit firm is an essential characteristic that reflects auditor independence. Auditor reputation is directly associated with audit quality. Large audit firms will make sure to provide an independent quality audit service as the larger audit firms tend to have better research facilities and efficient financial resources, more advanced technology and more skilled employees who will be able to undertake large company audits compare to smaller audit firms. Large audit firms have larger client portfolios which enable them to resist management pressures whereas small firms provide personalised services as their client portfolios are limited and they have to succumb to management requirements (Lys and Watts, 1994).

The issue of maintaining auditor independence is more crucial for smaller firms than larger firms. Pearson (1980) found the larger size of audit firms will enhance auditor's independence, because, smaller firms would experience more difficulty in resisting client pressures in situations of

conflict. As a result, the information content of audit reports certified by large firms is considered to be more and reliable than those of smaller audit firms[9](Titman and Trueman, 1986).

However, as pointed out by Goldman & Barlev (1974), it cannot be concluded that large CPA firms are more resistant to pressures from their clients. This is so because the few court cases which challenge the assumption that CPA firms acted independently indicate that there is no guarantee that large CPA firm has the ability to resist pressures from clients, as happened with Arthur Andersen and Enron[10].

Level of competition in audit service industry

Competition[11]has been identified as an external factor affecting auditor independence (Shockley 1981). Many firms which operate in an intensely competitive environment may have difficulty remaining independent as the client can easily acquire services of another auditor. The[12]AICP Cohen Commission (1978) in its report affirms that there are excessive competitions among public accounting firms and this excessive competition among different firms has been consistently identified as a factor threatening auditor independence[13](Farmer et al., 1987). .

Shockley (1981) had found that audit firms operating in an environment characterized by a high level of competition for audit clients would have a greater risk of decreasing their audit independence than where audit firms operated in a low-competition environment. However as suggested by Linberg and Beck (2004), Competition in the audit market makes the auditor more careful and concerned with the audit assurance level in their services.

Tenure of an audit firm serving the needs of a given client

An audit firm's tenure refers to the length of time required to fill the audit needs of a given client. A lengthy association between a company and an accounting firm is likely to result a close identification of the firm with the interests of its clients, thus an independent action by the accounting firm become difficult. (U. S. Senate 1976).

The author Mautz & Sharaf (1961) added that after a long association, less rigorous audit actions, complacency and confidence in the client may arise. However, long auditor tenure may lead to a cozy relationship between the client and the auditor and this may impair auditor independence due to a decrease in the auditor's due-diligence and also becomes more prepared to "turn a blind eye" to inappropriate managerial actions. On the other hand, long auditor tenure is beneficial as auditors gain expertise in the field they audit and may reduce the auditor's ability to detect irregularities or material misstatements (Gul et al., 2009)

Size of audit and non audit fees

The IFAC's Code of Ethics for Professional Accountants (1996, para 8. 7) propose that client size which is measured from size of fees could raise doubts as independence of auditor is concerned. The EFAA (October, 1998, p. 4) clearly states that," the (total) fee from one client should not exceed a certain percentage of the total turnover of the audit firm". In cases of accounting scandals (for example Enron and WorldCom), the audit firm appeared to be in collusion with the management in hiding fraudulent activities. The major factor behind such reservation was the amount that the auditors received as non-audit fees from these clients. Anderson, the auditor
<https://assignbuster.com/the-factors-affecting-auditor-independence-accounting-essay/>

for Enron, received US dollar 27 million as non audit fees in addition to US dollar 23 million as audit fees. The fact that the accounting firm received more than half of its Enron revenue from NAS gives an appearance of a lack of independence in the audit (Flaming 2002).

In addition, the fees for non-audit services has also increased substantially and are more profitable than fees from audit services, thus strengthening the economic bond and substantially lead to impairment of AI . The regulatory bodies in the U. S. like the SEC, the POB and the AICPA emphasized that significant high non audit fees can negatively affect auditor independence and also impair auditor decision-making, when those decisions involve a substantial amount of professional judgment.

In Malaysia the MIA By-Law (Section B-1. 98 on Professional Independence) has emphasized that “ if the total fees (arising from assurance and non-assurance services) generated by one assurance client or its related entities exceed 15% of the firm’s total fees in each year over two consecutive financial periods, financial dependency shall be considered to exist, in which case, a self-interest threat to independence is created. In such event, the only course of action is to refuse to perform or withdraw from the assurance engagement”. This 15% criterion has also been the level generally used by the ICAEW and Australia at which auditors have to consider their independent position.