Auditor Independence Threats and Factors Affecting Independence

Gana Kafiya Wakil, Mohd Norfian Alifiah, Alhaji Ali Tijjani

Abstract: In various professional standards and regulations, the accounting profession has generally described independence as a lack of specific interests and relationships that are presumed to affect auditor objectivity. An auditor must be watchful to any harmful impacts on his planning, investigation, or reporting to preserve independence under the numerous pressures from clients. This article reviews auditor independence literature and factors affecting independence in order to determine the effects of the factors on independence. The method employed for the research is a desk system of research design, in which data were collected through secondary sources such as journals, books and internet materials. The finding of the review indicates that the most mentioned threats to auditor independence are non-audit services, audit tenure, auditor-client relationship and client importance. Independence continues to be a problem when it comes to finding out how accurate and credible investor financial statements are. The leading factor of the independence of the auditor was not evident, but other researchers ranked them based on importance because of their belief that they chose to experiment.

Keywords: Agency theory, Audit, Auditor independence, Threats.

I. INTRODUCTION

The objective of this paper is to critically review the literature and theories related to the present study. It will also review several important concepts related to auditors’ independence as well as empirical studies that explain the relationships between auditor’s independence and factors affecting the independence of auditors. Independent auditing is a key characteristic of effective capital markets and regulatory authorities have been worried with potential threats to audit independence for a very long time (Defond, Raghunandan, and Subramanyam, 2002). The independence of the auditor is often defined as the possibility that the auditor will report a found breach in the financial reports (Watts and Zimmerman, 1983).

II. PROBLEM STATEMENT

Independence of auditors relates to the capacity of external auditors during their audit to behave with integrity and impartiality (Akpor and Dimkpah, 2013; Gul, 1991; Said and Khasharmeh, 2018). An independent auditor is required to audit accounts of the body corpores by statute, which defines his responsibilities, rights and powers. Due to the separation of ownership from leadership in the organisations, it is crucial as the owners requires someone who can maintain a professional watch on the management and to whom they can trust the accuracy of accounts as the preparation of financial statements is the prerogative of the management. The auditor has little to suggest about the form and adequacy of the financial statement, and his report is the responsibility of the independent auditor. Independence is essential to auditors reports reliability (Salehi, Mansoury, and Azary, 2009).

However, the corporate scandals of the 2006 confirmed the significance of the autonomy of the auditor, and there is steady pressure from the press, shareholders, investors, regulators and all other stakeholders to improve their credibility. As many company giants such as Enron, WorldCom in the developed economy as well as Cadbury Nigeria plc and Lever Brothers plc in Nigeria have been associated with auditor independence problems (Abdul-Rahman, Benjamin, and Olayinka, 2017; Ruddock, Taylor, and Taylor, 2006), auditors independence is now more than ever a problem for stakeholders. This paper tries to review literature on auditor independence to come up with a finding. It is on this note that the researcher considers it possible to review appropriate literature to determine possible threats that may have any impact on the auditor’s independence.

III. OBJECTIVE OF THE STUDY

This study’s primary goal is to examine auditor independence literature to identify major prominent threats to auditors’ independence as documented by different researchers using diverse techniques.

IV. RESEARCH METHODOLOGY

This article reviews empirical studies to evaluate what researchers have done about problems linked to auditor independence and identify literature gaps where further research is required. The method employed for the research is a desk system of research design, in which data are collected through secondary sources such as journals, books and internet materials.

V. THEORETICAL FRAMEWORK

The underpinning theory adopted in explaining the present study framework can be justified based on the agency theory.
The theory was adopted to provide the required theoretical foundation and explanation on the salient role of auditor’s independence.

VI. AGENCY THEORY

Agency theory, in the views of De Angelo (1981), Jensen and Meckling (1976), José and Almeida (2014) and Panda and Leepsa (2017) suggest that, information asymmetries and conflict of interest between the agents and the principals should theoretically be able to regulate behavior in an organization through directing and rewarding system. In other words, agency theory postulates that information asymmetry influences subjective scrutiny of financial statements and agency problems. The principal-agent relationship is illustrated in agency theory which stipulates that the principal- lack reasons to believe their agents because of information asymmetries and conflicting interest. Thus, information asymmetry during decisions making occurs when one party is more informed than the other party. The agency theory provides the theoretical underpinnings to support the position of auditors’ independence in bridging information asymmetry gap between principal and agent.

Similarly, contradictory aspects such as financial rewards, market opportunities, and associations with other parties, that are not directly related to principals can drive agents to be more optimistic about the economic performance of an entity, rather than the performance of the whole organization. Information asymmetries and opposing motivations decrease dependability of information, which resulted in the principals’ lack of trust on their agents. Therefore, auditors, as a third party, should try to align the interests of agents with principals, to let principals to measure and control the behavior of their agents and to increase principals’ confidence on agents that may negatively influence auditors independent (Colbert and Jahera 2017).

VII. AUDIT

Audit refers to an activity to address information asymmetry and the gap between different parties and an organisation. It also plays a very crucial role in reducing agency costs, as well as in increasing shareholders and third parties’ confidence to the reliability of the financial information provided by the financial statements (Watts and Zimmerman 1983). Auditing is mainly about bringing transparency and accountability in the public and private sector (Oyebisi, Wisdom, Lawrence, Bibiana and Dorcas, 2017). Furthermore, it performs the function of administering appropriate confidence towards the credibility and dependability of an organisation’s financial statements among the stakeholders (Gipper, Leuz and Maffett, 2015). To achieve these objectives, independence of the auditor is key. Through exhibiting the principle of independence “in fact” and “in appearance”, the opinion expressed in the financial statement will be valued by its users (Wilson, 2017). Moreover, an audit serves as a tool to ensure that public and private entities take responsibility and accountability in their duties. In short, an audit could enhance the accountability, transparency, equity and integrity in the activities of an organisation (Masood and Azfal 2016).

VIII. AUDITOR INDEPENDENCE

Auditor independence is the foundation of the auditing profession (Abu Bakar and Ahmad, 2009). Also, according to Independence Standard Board (2000) auditors independence is the freedom from those pressures and other variables that compromise an auditor’s capacity to make unbiased audit choices or can reasonably be anticipated to compromise.

Opinion express by an Independent auditor boosts the confidence of investors in the reporting system, and further translate to an improved in capital markets efficiency (Naslmosavi, Sofian, and Saat, 2013). It has been globally acknowledged that auditors’ independence is the key in bridging information asymmetry gap between owners of entities and their agents (John and Chukwumerije, 2014; Mardiah and Erlina, 2012; Panda and Leepsa, 2017). Auditors’ independence will ensure that auditor expresses independent opinions that are true and fair about the financial statements prepared by the management. Ndubuisi, Okeke, and Chinyere (2017) opine that, auditors’ independence reflects unbiased mental attitude in reporting a financial statement while other scholars argued that independence is the distinctive feature of the profession (Albeksh, 2017). Ali and Nersrine (2017) mentioned that auditors’ independence is based on two features, in fact, and in appearance.

Furthermore, Tepalagul and Lin (2015), Patrick et al. (2017) and Salawu (2017) opined that the main threats to auditors’ independence are client importance, non-audit services, auditor tenure, and client affiliation with audit firms. Chen, Li and Chi, (2016) and Rickett, Maggina and Alam (2016) suggested that auditor-client relationship could impair auditors’ independence. Similarly, Kyrkakou and Dimitras (2018) and Quick and Schmidt (2018) revealed audit tenure as the threats to auditors’ independence. Moreover, in the views of Alnawaiseh and Mahmoud (2015), threats to auditors’ independence include self-interest threat, self-review threat, advocacy threat, familiarity threat and intimidation threat.

Similarly, empirical research conducted by John and Chukwumerije (2012) on the perception of accountants on factors affecting auditor’s independence in Nigeria has shown evidence on the significant relationship between auditor’s independence and audit firm size, market competition, audit tenure, audit fees and non-audit services. Albeksh (2017) opined that independence could be categorised into objective and personal factors. Objective factors consist of audit size, audit market competition, audit firm tenure and non-audit services while the personal factors are qualification, integrity and secretariat, as well as objectivity and independence.

In contrast to the views of Kyrkakou and Dimitras (2018) on mandatory audit firm rotation, Aschauer and Quick (2018) did not identify any significant effect of audit rotation on auditor independence. Their findings indicated that mandatory audit rotation does not have any significant negative influence on the level of perceived auditor’s independence. However, they agree with Tepalagul and Lin (2015) that the provision of non-audit services can impair auditors’ independence.
According to Roy and Saha (2016), auditors’ independence reflects the lack of personal interest by the auditor in the auditing engagement, and this can keep auditor away from any material bias which may affect the reliability and credibility of the financial statements for decision making. Thus, auditors’ independence is important because it could impact quality of reporting (Tepalagul and Lin, 2015).

Most of the empirical investigations on auditors’ independence falls within the four threats to independence of the auditor. These threats are, client’s importance, client’s affiliation with auditor firm, auditor tenure and non-audit services. Ali and Nesrine (2015) and Tepalagul and Lin (2015) categorized auditors’ independence into independence in fact and appearance. Independence in fact means that an auditor will act with integrity and exercise objectivity and demonstrate professional scepticism by not giving room for undue influence. Moreover, independence in appearance has to do with preventing third parties from reasonably conclude that the integrity, objectivity or professional scepticism of a firm or a member of the audit team have been compromised. Hence, it can be concluded that, in order to influence investment decision making, the provision of high quality financial reporting is essential (Albaqali and Kukreja 2017).

IX. EMPIRICAL REVIEW

Al Nawaisheh and Alnawaisheh (2015), examined the effect of the threats on the auditors independence of mind and appearance, using descriptive statistics measurement and analytical statistics (paired samples test and one way ANOVA test to analyse the responses of 65 respondents representing 37% of auditors who are registered in 189 auditing firms in Jordan to test the hypothesis of the study. The research found that, self-interest threats, self-review threats, familiarity or intimacy threats, advocacy threats and intimidation threats affect the auditor independence in mind and appearance.

Tepalagul and Lin (2015) carried out a comprehensive review of academic research pertaining to auditor’s independence and audit quality. Based on their review, concluded that, there is a limited evidence that auditors independence is compromised in the presence of client importance. Financial statement users generally perceive non-audit services as a threat to auditor independence. Their finding also conclude that auditing tenure does not impair independence. Furthermore, their findings show that only a few studies have examined the client affiliation threat and the evidence is mixed.

Patrick, Vitalis, and Mdoom (2017) reviewed literature on effect of auditor independence on audit quality. The review is ex post facto in nature where secondary data was employed. Their findings also revealed four threats to auditor independence, client importance, non-audit services, audit tenure and client’s affiliation with CPA firms. Furthermore, their findings discovered that some findings indicated a positive relationship while others showed contrary due to the type of study design employed, sample size, data collection instruments and analysis techniques used.

Salawu (2017) examined factors influencing auditor independence among listed companies in Nigeria using generalized method of movements (GMM) approach, with a sample of 65 firms out of the 194 listed on the Nigeria Stock Exchange. These comprises of 14 money deposit banks, one mortgage bank and 50 non-financial firms. Secondary data was employed for the study and were sources from the audited financial reports of sample companies and fact book of the Nigerian Stock Exchange between the period of 2006 to 2013. Data were analysed using descriptive statistics and generalized method of movements. The study revealed that Big4, audit tenure, profitability, leverage and inventory account receivable had negative significant impact, which can impair auditor independence. Furthermore, size of the firms and loss had positive influence on auditor independence in Nigeria.

Enofe, Nbgame and Ediae (2013) examined the relationship between audit quality and auditors’ independence in Nigeria. A cross sectional study analysis of companies listed on the Nigerian Stock Exchange was carried out. A sample of twenty (20) audited financial reports of these companies for the period ending 2011 was selected using the simple random sampling technique. The data collected for the variables were subjected to the ordinary least square (OLS) regression analysis. Findings indicated that as auditors’ independence increases, the quality of audit also improves and as the independence of the board and ownership structure increases, the quality of audit reduces.

Kyrakoul and Dimitras (2018) studied impact of auditor tenure on audit quality in four European countries of Germany, France, Italy and Spain, using generalized method of movements (GMM) model during the period from 2005 to 2013. Two GMM methods are used with two alternative definitions of crises-the main and the robustness method. The findings show that the impact of Spanish auditors’ long-tenure on discretionary accruals, affecting auditors’ quality and independence indirectly.

Quick Schmidt (2018) investigated whether perceptions of auditor independence and audit quality are influence by audit firm rotation, auditor retention and joint audits by conducting an experiment with bank directors and institutional investors in Germany. The result indicates a negative main effect for joint audit on perceived auditor independence. Also, beside the main effects, planned contrast tests suggest a negative interaction between rotation and joint audit on participant perceptions of auditor independence. Furthermore, the study could not identify a positive impact of the regulatory measures taken or supported by the European Commission on perceptions of auditor independence and audit quality.

John and Chukwumerije (2012) examined factors affecting auditors independence in Nigeria. The study employed survey research design and data were collected using Likert-rated questionnaire, sampling 150 chartered accountants in 15 audit firms in Lagos, by random sampling. Analysis was carried out using descriptive statistics and chi-square in testing the hypothesis. Their finding shows that each of the factors of size of audit firm, audit market competition, audit firm tenure, size of audit fees and non-audit services has significant relationship with auditor’s independence.

Albevks (2017) conducted research on factors affecting the independence of the external auditor within the auditing profession.
The findings revealed that the most important of the findings are auditing standards and professional behavior are the most impact factors on the independence of the auditor and that the integrity, honesty and truthfulness of the qualities that must be provided by the independent auditor.

Causholli, Chambers and Payne (2015) investigated the effect of selling non-audit services on auditor independence in America. Findings obtained from statistical regressions of abnormal accruals found strong evidence that the anticipated future provision of non-audit services does represent a source of impaired independence in the current year.

Aschauer and Quick (2018) examined mandatory audit firm rotation and prohibition of audit firm-provided tax services: evidence from investment consultants’ perception. Their study provides experimental evidence on effects of rotation system, the impact of non-audit services (auditor-provided tax services) and the interaction between both regulatory issues. Based on the assessment of 140 professional investment consultants from credit institutions, their result shows that the provision of tax services by the audit firm decreases independence.

Roy and Saha (2016) studied statutory auditors’ independence in India: an empirical analysis from the stakeholders’ interest perspective. Their findings indicate that statutory auditors fail to detect irregularities in financial books due to their lack of independence and professional skepticism. Additionally, a long association between a statutory auditor and a client is one of the major reasons behind statutory auditors’ lack of independence.

Ali and Nesrine (2015) examined factors affecting auditors independence in Tunisia: the perceptions of financial analysts. Their study investigates the impact of 49 independence enhancing and threatening factors on the perceptions of 54 financial analysts using questionnaire instrument. Their findings revealed that, the principal threats to independence are, provision of non-audit services and existence of personal and financial relationships.

X. FACTORS AFFECTING THE INDEPENDENCE OF AUDITORS

From the reviewed literature, the most prominent threats to auditor independence are, non-audit services, audit tenure, auditor-client relationship and client importance. Though there are others, but not as prominent as these ones that are single out.

A. Non-Audit Services

Auditors are attracted by the economic benefits to provide non-audit services to their audit clients as non-audit services are perceived to be more profitable (Tepalagul and Lin, 2015). However, the provision of non-audit services, such as tax services by auditors to client create high tendency for them to compromise their independence (Aschauer and Quick 2018; Tepalagul and Lin 2015). Causholli et al. (2015) argued that auditors’ provision of non-audit services to their clients will create economic ties between them. In turn, this could decrease auditor’s independence. Similarly, Ye et al. (2006) are of the view that, the economic dependence occasioning from the provision of non-audit services (NAS) have been assumed to contribute to this attrition of auditor independence.

On the other hand, Aschauer and Quick (2018) stated that the provision of non-audit services to client by an auditor can be beneficial to the clients. Similarly, Causholli et al. (2015) believe that, the provision of non-audit services by auditors to their clients could increase auditors’ understanding of the client’s business, resulting in the desired audit outcome. Past studies also did not find any correlation between non-audit services and auditors’ tendency to issue a going concern, indicating that there is no conclusive link between the provision of non-audit services and the decrease in auditors’ independence (DeFond nd Zhang, 2014). Surprisingly, there is still no conclusive evidence to show that auditors’ provision of non-audit service to client can impair auditor independence. This is mostly because auditor’s desire to maintain their reputation and litigation cost outweighs the economic dependency on the clients. Loss of reputation and litigation costs, overshadowing the expected benefits from compromising auditor independence (DeFond et al. 2002).

B. Audit Tenure

The proponent of mandatory rotation argues that short audit firm tenure can strengthen auditor independence due to the avoidance of close personal relationship between the auditors and the client’s management (Dada 2018). Similarly, in a study carried out on audit firm rotation by Corbella et al. (2015), several countries presently have mandatory audit firm rotation guideline; Italy has required audit firm rotation since 1975, Brazil since 1999, and Singapore has required audit firm rotation for local banks since 2002. Various other countries comprising Austria, Canada, Greece, Spain and Slovakia hitherto necessitated mandatory audit firm rotation. Similarly, there are growing demands for audit committees to contemplate voluntary firm rotation as a means of improving audit quality. These calls for voluntary audit firm rotation presume that audit quality upsurges when a new audit firm is engaged (Türel et al. 2015).

However, Tepalagul and Lin (2015) argued that long tenure generally does not impair auditor independence, rather, the auditors will gain client-specific expertise as a result of the non-audit services provided, which mitigates the loss of knowledge due to audit firm rotation, and at the same time, minimises the economic incentives. Another study by Kyriakou and Dimitras (2018), which involved auditors in four European Union countries, had also fail to discover any statistically significant relationship between long term tenure and auditors’ independence. This shows that non-rotation of auditors has no statistically significant influence on the audit quality as well as the auditor’s independence.

In a research conducted by Tobi et al. (2016) state that, audit firm rotation does not necessarily improve auditor independence in Nigeria. This could be due to the unity of professional stance among auditors and similarity in cultural bias and alignment may have momentous effect on the audit quality. Mandating audit firm rotation at the expense of other determining factors of audit quality would be a bad policy and may impair auditor independence, weaken audit expertise, undermine corporate governance and impair audit quality (Odia, 2015).
The reasons for abandoning the requirements for mandatory audit firm rotation in Spain and Canada were related to its lack of cost-effectiveness, cost, and having achieved the objective of increased competition for audit services (Odia, 2015).

C. Auditor-Client Relationship

Kachelmeier and Van Landuyt (2017) suggested that, measurement uncertainty alone does not influence auditor adjustments in the absence of social bonding. One way to ensure more conservative auditor evaluations of accounts with measurement uncertainty is to limit auditors’ social-bonding opportunities with their clients. Similarly, Tobi et al. (2016), applying the logistic regression model, their study findings shows that long-term auditor-client relationships is positively related with the increased likelihood of the auditor issuing an unqualified opinion. Furthermore, Aamir and Farooq (2011) suggested that, long-term auditor-client relationship is essential for both the audit and the audit quality because auditor desires time so as to get to understand the client firm, its processes, its risks, and other procedures. This could be a good reason why an audit is challenging during the first year as compared to the successive years.

On the contrary, Wilson et al. (2018) observed that too much familiarity could retrogressively impact the performance of the audit team which in turn negatively affect auditor’s independence. According to Tobi et al. (2016), a long audit-client relationship could lead to an alignment of the auditor’s interest and that of its client which makes truly independent behaviour of the auditor a probability. Similarly, the auditor-client relationship poses a risk to the objectivity and auditor independence that might lead to weakening audit quality, this is because auditor becomes more familiar, and closer to the client. Other opinions favour the view of diminishing audit quality because auditor becomes closer to clients and resulted in weakening the objectivity and auditor independence (Boone et al. 2008). This is because longer audit tenure leads to closer relationship between auditors and clients. The closer relationship may cause the auditor and the client to compromise their opinions concerning auditing and reporting method.

Importantly, Kachelmeier and Van Landuyt (2016) observed that, the social bond involves a relatively harmless aspect of auditor-client relationships, comparable to the casual interactions that real-world auditors and their clients experience on a day-to-day basis. That is, social bonds do not enforce economic burdens such as client retention or other conflicts of interest that would be akin to abuses of regulatory auditor independence rules. Herda and Lavelle (2013) suggest that auditors’ perceptions of client fairness are crucial in making robust auditor-client relationships. Deeper relationships generate more levels of service that go beyond the main audit requirements.

D. Client importance

As economically important clients carry greater weight in an auditor’s portfolio, an auditor may have a higher incentive to yield to pressure from larger clients, thereby compromising independence (Tepalagul and Lin 2015). Similarly, Chen et al. (2016) states that, client importance is negatively associated with audit quality. Furthermore, Cahan and Sun (2015) carried out research on personal characteristics of audit partners by considering the incremental effects of client importance among others after controlling for overall audit experience. The results suggest that the auditors’ personal characteristics may serve as a signal of the level of care that will be exercised during the audit process. Also among the threats to auditors independence in a study conducted on effect of auditors independence on audit quality by Patrick et al. (2017) is client importance.

Chen et al. (2016) state that, after selecting sampling 8551 firm-year observations discovered that client importance is negatively significant with incidences of audit adjustment, suggesting that greater client importance is connected with fewer audit adjustments, i.e. compromised audit quality. Likewise, economically a one-unit increase in client importance is correlated with a 1.3% decrease in the possibility of an audit adjustment, thus indicating that client importance has a negative impact on audit quality. Specifically, increased client importance means a decreased likelihood of adjusting for management bias on financial reports. These findings indicate that auditors may compromise their independence and sacrifice audit quality if it means retaining the client Chen et al. (2016).

XI. CONCLUSION

Findings from the reviewed literature shows that, though there are quite a number of factors impairs auditor’s independence, the most mentioned among researchers are non-audit services, audit tenure, auditor-client relationship and client importance. Independence of auditors is very crucial to financial statement users. The more independent an auditor seems to be, the more confident investors and other stakeholders will have in his work and opinion.

REFERENCES


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Retrieval Number: C125310838219/20190/BEJESP
DOI:10.35940/ijrte.C1253.10838219

Published By:
Blue Eyes Intelligence Engineering & Sciences Publication
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