A literature review on auditor independence

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Auditor Independence, Competition, Credibility, Literature Review

Abstract

Purpose: The purpose of the current research is to review literature related to auditor independence. More specifically, this review will examine whether the size of the audit firm, the size audit fees, the auditor's duration with the client, competition among other firms and the availability of non-audit services will compromise auditor independence.

Design/methodology: This paper reviews empirical studies to assess what researchers have done about auditor independence related issues and identify gaps in the literature where further research is needed.

Findings: 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.

Practical implications: This study highlights the importance of auditor independence attributes and this research is expected to serve as a guide in understanding the importance of auditor independence and the challenges auditors face.

Originality: This paper provides valuable insights for researchers and practitioners of auditor independence attributes.

1. Introduction

Independence is a major concern in the auditing profession. Corporate scandals like Enron failure confirmed the importance of credulity of audits. Audit independence refers to the ability of the external auditor to act with integrity and impartiality during his/her auditing functions (Akpom and Dimkpah, 2013). *Recent challenges* of the *audit independence assumption have* impelled the accounting *profession* to consider *ways of improving* the *credibility* of *audit* reports (Shockley, 1981, p.785). As a result, the accounting profession has considered new ways to improve the credibility of audits. It is constantly facing pressure from the media, stakeholders and investors to minimize.

According to Shockley (1981, p.785), "the value of auditing services depends upon the fundamental assumption that certified public accountants are independent of their clients". What is auditor independence? It can be described as having an unbiased viewpoint while performing audit test, analyzing 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). Researchers argue auditing has three different functions: monitor the actions of managers, enhance the information environment and provide a source of insurance against corporate failures (Fernando, Abdel-Meguid, and Elder, 2010). Corporate collapses such as Enron and WorldCom contributed to the impairment of auditor independence. It is believed that once auditors fail to report or identify incorrect information on financial statements, it can challenge the value of the audit and possibly damage the reputation of the firm (Fearnley, Beattie and Brandt, 2005). This review will examine whether the size of the audit firm, the size audit fees, the auditor's duration with the client, competition among other firms and the availability of non-audit services will compromise auditor independence.

During major accounting scandals, auditors received criticism for increasing their non-audit services. During the Enron and other accounting scandals, in which auditors were often suspected of complicity, auditors and clients were criticized for, among other things, substantial increases in nonaudit services (NAS), including tax services provided by external auditors (Lassila et al, 2010, p. 79).

In the aftermath of a downward economy, the public's concern for auditor independence became heightened as companies wanted to ensure a company's adherence to professional accounting standards and principles (Austin and Herath, 2014, p.63). Auditors were not allowed to provide certain types of non-audit services to their clients after the Sarbanes-Oxley Act (SOX) was passed (Gul et al, 2007, p.122). Revised rules were published by the Securities Exchange and Commission to address the circumstances for non-audit services. Audit firms must now create separate categories that discloses all the fees that were paid to the firm so that investors are aware about the types of fees (Gul et al, 2007, p.120). The relationship between auditor tenure and auditor independence is another aspect that the poplar literature examines. Tenure is the length of time it takes to complete an audit. Section 203 of the SOX explains how the reviewing audit partner or external lead must complete a five-year cycle rotation (Gul et al, 2007, p.119). Research evidence shows that higher quality earnings are associated with longer audit tenure than shorter audit tenure. Further, research suggests that auditors and client firms have a stronger economic bound once auditors have been employed for a long period of time which leads to personal connections and familiarity. Gul et al (2007) conclude that non-audit fees are likely to affect auditor independence for firms with shorter auditor tenure, but not for firms with longer audit tenure.

2. Auditor independence framework

The Independent Standards Board (ISB) established a framework for Auditor Independence due to the lack of inconsistent rules and regulations. The framework contains various principles and concepts to help assist the board with writing the standards. This framework defines auditor independence as "freedom from the factors that compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions" (McGrath et al 2001). Standards are based on a model that involves three key steps: identify threats to the auditor's independence and analyze their significance, evaluate the effectiveness of potential safeguards and determine an acceptable level of independence risk. According to researchers, "the definition of independence does not require the auditor to be completely free of all the factors that affect the ability to make an unbiased audit decision, but only free from those that rise to the level of compromising that ability" (McGrath et al 2001). The overall goal with independence is to ensure financial reports are reliable and improve capital markets efficiency.

The role of appearance continues to remain a controversial topic in auditor independence. Challenges are faced when individuals uncover the meaning of "appearance" as well as selecting the right perceptions. Previous writings establish an auditor to consider whether an investor can determine how an audit will be affected based on the relationship between the auditor and the client. Researchers found difficulties when determining how to assess appearance because there was a "probable" lack of consensus about the circumstances likely to affect auditor's independence" (McGrath et al 2001). Although the debate over "appearance" fail to cease, there are three ways it can be incorporated in the standards if the auditors goal is to enhance credibility and reliability for financial statements. The methods include creating independence standards based of requested views from different parties, obtain information from a hypothetical group and develop standards based on the board's judgment.

3. The importance of auditor 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).

4. Factors that affect auditor independence

There are many factors that affect auditor's independence; however, in this study, 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. The level of competition in the market

Competitive markets make it more difficult for firms to remain independent solely because clients can choose from a handful of other auditors to conduct their service. Other incentives or opportunities are available as the number of audit clients rises. Studies have shown that audit firms remain less independent when competition is high. According to Shockley (1981), if an audit firm allows competition to affect the nature of its audit dangerously close to nonindependence." However, some argue, auditors are more independent once they realize the competition level so they do not jeopardize their clientele (Chepkorir, 2013). The Cohen Commission expressed their concern about too much competition in the accounting profession. "It is not the lack of competition that, however, but possible excessive competition that appears to present a problem to the public accounting profession today" (Shockley, 1981, p.787). In response to the increase in pressures from competition, audit firms began to change their behavior by reducing audit fees in real terms and "there were prima facie cases of low balling, where incoming auditors were believed to have secured their appointment by offering significant fee reductions" (Beattie and Fearnley, 1998). Houghton and Jubb (2003) offer a solution to create a "market-observable audit independence quality control process" as a result of market competition. In the proposed models they focused on having regular reviews on independence and ensuring that individuals selected on the Independence Control Board for firms who have audit engagements that are traded publicly are knowledgeable and free from receiving any benefits from decisions made from the Board. (Houghton and Jubb, 2003, p. 213.)

4.2. Audit firm size

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 caliber of employees. Larger audit firms are more likely to provide a better-quality audit due to better research facilities, technology, financial resources, and skilled labor 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.

4.3 Audit tenure

An audit firm's tenure can be defined as the length of time an auditor performs services for a client. Risk associated with the loss of independence are increased once client relationships are maintained for a long period of time. On the other hand, other individuals believe having a lasting and faithful relationship will augment 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 released a regulation stating that partners should not remain with a client for no more than five years. 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 advised by the Metclaf subcommittee to avoid this issue (Shockley, 1981). Academic 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).

4.4. Size of audit fee and non-audit services

Many concerns are centered around auditors providing Non-Audit Services (NAS) because they are likely to risk their independence in return for more NAS earnings. It is assumed that auditors may try to sacrifice their independence in exchange for retaining the audit clients from which they might accrue large NASs revenues (Law 2008; DeFond, Raghunandan, and Subramanyam, 2002). Examples of non-auditing services include appraisal services, actuarial services, bookkeeping, internal audit services, various modes of management consulting, financial information design services, taxation services and legal advice (Austin and Herath, 2014). Studies have shown that NASs has impacted auditor independence negatively. Rules have been established by the Sarbanes-Oxley Act to limit the services auditors can provide for client. In addition, the SEC required firms that were traded publicly to reveal the amount of fees paid to auditors in their annual proxy statements as they were investigating the relationship between non-audit services and auditor independence (SEC, 2000). On the contrary, a few researchers discussed how utilizing NASs can help increase knowledge about the client.

Audit Fee can be defined as the amount charged to a client to conduct specific services by the accountant. The fee may vary by size or based off the type of service provided but there have been many questions from researchers whether it affects audit quality. "The amount of audit fee can vary depending on the assignment risk, the service complexity, the level of expertise required, the cost structure of Public Accountant Firm and other professional considerations" (Rahmina and Agoes, 2014, p.326). "Large diversified with extensive receivables and inventories, pay higher fees" (Turpen, 1995). Studies have shown that larger firms tend to charge higher fees because of the idea that they may provide better quality for audits. Audit quality is challenging to measure and explain due to the lack of concept detail. According to Rahmina and Agoes (2014), there are nine elements firms should implement to meet quality control expectations. They include: independence, assignment of personnel, consultation, supervision, employment, professional development, promotion, acceptance and sustainable clients and inspection.

5. 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 this literature review, we examined several determinants that influence auditor independence. The first factor that we examined was the level of competition in the market. As the competition rises, it is easier for clients to find other auditors to conduct their services. On the other hand, some auditors choose to remain loyal to their clients because they do not want to lose their clientele. The excessive competition changes the behavior of firms. The second, factor audit firm size, distinguished the difference between a large firm (Big 4) and a small firm. For example, individuals should take into consideration the number of employees or how large are their clients. According to research, large firms have more access to resources to produce a quality audit and media attention. Smaller firms face pressures within their working environment due minimum client exposure.

Tenure was another concern that influenced auditor independence. Before the Sarbanes-Oxley Act was passed to require auditors to rotate clients every five years, auditors would stay with clients for long periods of time. As a result, questions began to arise about the connection and closeness of their relationship and what affect it would have on the audit. However, some believe auditors become experts in their field once they are very familiar with their client. Research has proven that higher earnings and a decrease in debt are directly associated with firms that have longer relationships with clients. Non-audit services have a risk of impacting auditor independence because individuals are willing to compromise their independence to gain more income for other services. An example of a non-audit service would be consulting. A firm cannot audit and consult a company at the same time because of a conflict in interest. Rules and regulations have been established to limit the amount of non-audit services. Audit fee size varies based off the diversity of the company, the size of the firm and so on. Drawing inferences about audit fees can be challenging because firms have different practices and limited access to data about costs and rates.

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.

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