

# A Literature Review on the Auditor's Independence Between Threats and Safeguards

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## Abstract

*The paper aims to identify the threats to the auditor's independence and to discuss this subject from a theoretically point of view. Auditor independence is one of the seven principles of professional ethics, necessary to perform a fair and professional audit engagement. In this paper, I have reviewed the literature and analyzed some of the most relevant scientific articles that have researched this topic. For the case study, I chose to analyze the most relevant papers in this area taking into account the objective pursued by the author, the research methodology, the selected sample, the variables and the category of threats to auditor independence. Subsequently, were split the discovered threats into groups and identified a series of safeguards to limit the threats to the auditor's independence. The main conclusion is that an in-depth knowledge, the exercise of the procedures for mitigating the effects of threats to the auditor's independence and compliance with professional and ethical rules are factors that ensure the successful performance of an audit process.*

**Key terms:** auditor independence, ethics, threats, safeguards

**JEL Classification:** M40, M42

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## 1. Introduction

Auditor independence is a cornerstone of the audit profession, a crucial element in the legal process of financial reporting that contributes to increasing the added value of the audited financial statements.

However, the financial crises and the corporate collapses at the beginning of the 21st century have caused many changes to the audit process and, indirectly, even to the auditor's independence. Especially, the economic dependence resulting from the provision of non-audit services by audit firms, the familiarity resulting from the auditor's experience and personal relationships built through employees were considered factors that led to the erosion of auditor independence.

An external auditor faces many threats that could affect his independence. If his independence is impaired, he becomes unable to issue a correct report that indicates the accuracy of the audited financial statements in accordance with the requirements of international audit standards. The auditor's career can be affected and the future acceptance by another client will be lowered, thus reducing the users' confidence in the services provided by the auditor.

The objective of the article is to identify the most important information and concepts in the case of auditor independence and the practical implications based on literature and the Code of ethics for professional auditors.

## 2. Theoretical considerations

In order to highlight the current state of knowledge in the chosen subject area, the most important concepts, elements and factors that influence the research topic will be presented.

In recent years, especially following the great financial scandals (in which the role of auditors has not always been neutral), there has been an increase of concerns for the study of factors that influence audit quality, one of these factors being the auditor's independence.

Starting from DeAngelo's (1981) definition that defines audit quality as a double probability through which the auditor can detect significant misstatements, the main factors that can be identified as influencing audit quality are: the auditor's ability to identify misstatements, the procedures used and the sample size, all of which depend significantly on the auditor's competence and endowment with appropriate technologies. This definition also refers to the auditor's competence and independence, two important characteristics, especially when they are discovered as the causes of fraud or accounting errors. The lack of effort or competence prevents an auditor from detecting problems that need to be resolved, and the lack of independence prevents an auditor from correcting the problems identified in the client's pre-audit financial statements.

The Code of ethics for professional auditors defines independence as a state of mind that allows the auditor to issue an opinion without being affected by influences that could compromise his professional judgment, to act with integrity and to exercise objectivity and professional skepticism.

According to the authors Pittman *et al.* (2020), the characteristics of the individual auditor play an important role in audit quality. Assessing the implications of audit quality on the risk tolerance of partners is a common test used to determine their risk profiles that affect their performance and manifest in the audit results.

Al-Nawaiseh and Alnawaiseh (2015) are of the opinion that independence refers to the fact that an auditor must express his opinion about the financial statements without being influenced by any threat from any source, but also to an auditor's ability to avoid the influence of any threat from any source.

Ghosh *et al.* (2016) consider that an auditor's independence is also reflected in the duty to obtain sufficient appropriate audit evidence on which to base his opinion.

Tahir *et al.* (2014) have developed a model in which an auditor decides on an optimal model on the level of independence applicable on the bond market. This decision is influenced by the level of fees charged to diminish the independence of the costs that arise when the quality of the reports is poorly monitored or fraud detection is less efficient. Capital costs are inversely proportional to the auditor's independence.

Auditor independence affects the capital costs in two ways. Firstly, a greater independence leads to better monitoring of the firm's net assets by external auditors and to higher fraud detection rates. Better monitoring by auditors allows investors to opt out of their expensive monitoring activities aimed at reducing the risk of expropriation by managers.

Mohamed and Habib (2013) have studied the issue of the auditor's lack of independence in the Egyptian context and how this topic affects audit quality based on a questionnaire distributed among the audit practitioners within the Big Four audit companies operating in Egypt. The main reason for the lack of independence is the weak structure of closely held corporations. It has also been found that the voluntary switching of auditors aims to improve quality, suggesting that the rotation of auditors as an optimal solution.

Cordoș and Fulop (2013) consider that the auditor's rotation is not necessary to increase audit quality, because a specialist's knowledge of a client is proportional to the duration of the period in which he is an auditor. In addition to this, imposing the obligation to change the auditor would restrict the investor's freedom to choose an auditor according to their needs and those of the company.

### 3. Research methodology

The research method is a qualitative one, taking into account that the article aims to be more of a theoretical documentation, respectively a descriptive-explanatory study of the most relevant scientific articles. For this purpose, I have analyzed and synthesized the information identified in the mentioned articles in Table 1.

To highlight this aspect, I have summarized the information obtained after analyzing the articles included in the sample in Table 1. The articles were selected mostly from international business administration databases, in order to identify research at international level, but also from Romanian publications. The chosen period is 2006-2019 and the selection criterion was the existence of the words “audit”, “independence”, or the phrase “auditor independence”. An initial number of 47 articles were obtained, out of which the 15 most representative ones were selected.

### 4. Results

I analyzed the objective of each article, the main results, the chosen sample, the research methodology and whether there were any independent or dependent variables in the case of a quantitative methods. The most significant results are presented in the first table.

Table 1. Studies on the threats to the auditor’s independence

Author/s and year	Objective	Results	Sample	Research methodology	Variables	Threat category
Yustina and Gonadi (2019)	Examine whether time pressure affects professional skepticism and whether the effect is mediated by the auditor’s independence.	Auditor independence mediates the relationship between the variables. It is recommended to increase the number of members of the audit team and the presence of a supervisor.	163 external auditors from Jakarta (Big Four)	Survey Empirical model based on two hypotheses	Independent: time pressure Dependent: professional skepticism	Intimidation
Tănase and Ștefănescu (2020)	Tracking rotation practices within banking institutions in Romania.	Most banks have adopted their own rotation policy for partners or audit firms.	29 banks on the Romanian market	Qualitative study	Not necessary	Familiarity
Chang <i>et al.</i> (2019)	Examine whether audit partners can compromise their independence for economically important clients of affiliated business groups.	Audit partners are more likely to compromise their independence for economically important clients. The independence of audit partners in the Big Four is more significant than that of the non-Big Four audit partners.	Clients of audit partners	Empirical model based on three hypotheses	Independent: total assets Dependent: earnings and cash flow	Self-interest

Author/s and year	Objective	Results	Sample	Research methodology	Variables	Threat category
Honigsberg (2019)	Investigates whether an audit company's reputation influences the accountants and determines optimal levels of attitudes regarding the audit of the company.	Marketing of individual auditors could increase industry competition without the need for aggressive rules.	PCAOB inspections issued for the period 2005-2016	Qualitative study	Not necessary	Advocacy
Sori and Karbhari (2017)	Investigate the impact of the auditor's reputation on the auditor's independence.	Most of the auditors, loan officers and superior managers of listed companies agreed that auditors in the Big Four companies are superior to their counterparts in non-Big Four companies in all the reputational issues presented to them.	Mangers of audit companies, banks and listed companies	Survey	Not necessary	Self-review
Azibi <i>et al.</i> (2017)	Studied whether the auditor's independence increases as a result of the regulation of the H3C act. (The regulation of the audit profession in France.)	Independence increased after the establishment of H3C. Contrary to this result, the independence of auditors did not change significantly after the inspection process was announced.	140 companies included in international databases	Empirical model	Independent: auditor independence Dependent: audit fees and total assets	Advocacy
Huiying and Ying (2016)	Offering prospects for achieving auditor independence in the economic and cultural policy field	Auditors who work under pressure tend to reduce audit fees, avoid issuing qualified opinions, and offer additional advice and assistance on financial reporting.	Seven managers, five independent chairmen, five auditors and four academics	E-mail or phone interview	Not necessary	Self-interest
Junaidi <i>et al.</i> (2016)	Empirical testing of the effects of auditor rotation on auditor independence	The long tenure of an auditor can have negative effects on the auditor independence. The rotation of the auditors has a significant influence effects on auditor independence.	Listed companies from Indonesia in the period 2002-2010	Regression	Independent: auditor independence Dependent: auditor rotation and reputation	Self-review

Author/s and year	Objective	Results	Sample	Research methodology	Variables	Threat category
Ahmed (2015)	Examines whether the practice of hiring ex-auditors affects the perspective of financial statements users on auditor independence.	A cooling period of two years could reduce the negative impact on independence from the practices of previous auditors.	Corporate and loan officers and professional investors from Malaysia	Survey	Not necessary	Self-review
Austin and Herath (2014)	Research the specialized literature on auditor independence	A wide range of areas has been discussed and these issues can be incorporated into the revision of curricula related to auditor independence.	Research papers published in 1992-2010	Survey	Not necessary	Advocacy
Kamau <i>et al.</i> (2014)	Established the independence status of internal auditors	The involvement level of internal auditors in management activities affects their professional independence significantly.	Social media groups for accountants and auditors (Kenya)	Empirical model based on four hypotheses	Independent: internal auditor implication Dependent: auditor independence	Self-interest
Cordoş and Fulop (2013)	Study how the duration of the auditor-client relationship affects the auditor's independence.	The sampled companies tend to choose a Big Four auditor as their audit partner.	25 companies listed on the London Stock Exchange and companies listed on the Bucharest Stock Exchange in the 1st category	A deductive approach from general to private which combines quantitative and qualitative studies	Not necessary	Familiarity
Dogui <i>et al.</i> (2013)	The way in which auditor independence is built within the network of persons involved in the fulfillment of the ISO 14001 audit commitments	Practitioners use a range of strategies to build and maintain the belief that ISO 14001 audits meet the professional requirements of auditor independence.	Canadian practitioners, including ISO auditors, certification body managers, accreditation inspectors, consultants and managers	Descriptive-explanatory study	Not necessary	Familiarity
Suseno (2013)	Investigate the influence of auditor independence and audit fees on audit quality	Auditor independence significantly influenced audit quality and audit fees, thus changing the quality of the audit.	73 public accounting offices from the capital market of Indonesia	Interview	Independent: auditor independence Dependent: audit team size, risks	Intimidation

Author/s and year	Objective	Results	Sample	Research methodology	Variables	Threat category
Gul <i>et al.</i> (2007)	Examines the impact of non-audit fees on auditor independence.	The association between non-audit fees and auditor independence is conditioned by the auditor's tenure and has an impact on auditor independence when the audit duration is short and the client's size is small.	4,720 USA companies from the period 2000-2001	Empirical model	Independent: audit fees Dependent: ROA, total assets	Self-review
Alleyne <i>et al.</i> (2006)	Investigate the perceptions of users from Barbados on auditor independence.	Auditor's economic dependence in relation with the client, the high competition, a long period of time and the size of the audit firm negatively affected the auditor's independence.	66 auditors and 148 users	Survey	Not necessary	Familiarity

Source: Own projection.

One may notice the repetitiveness of some factors that can threaten the auditor's independence, such as: legal rules in this area (three cases), followed by auditor rotation and reputation, the relationship between auditors and clients, and also the audit fees. Less frequent factors are time pressure, professional skepticism, and other aspect from literature.

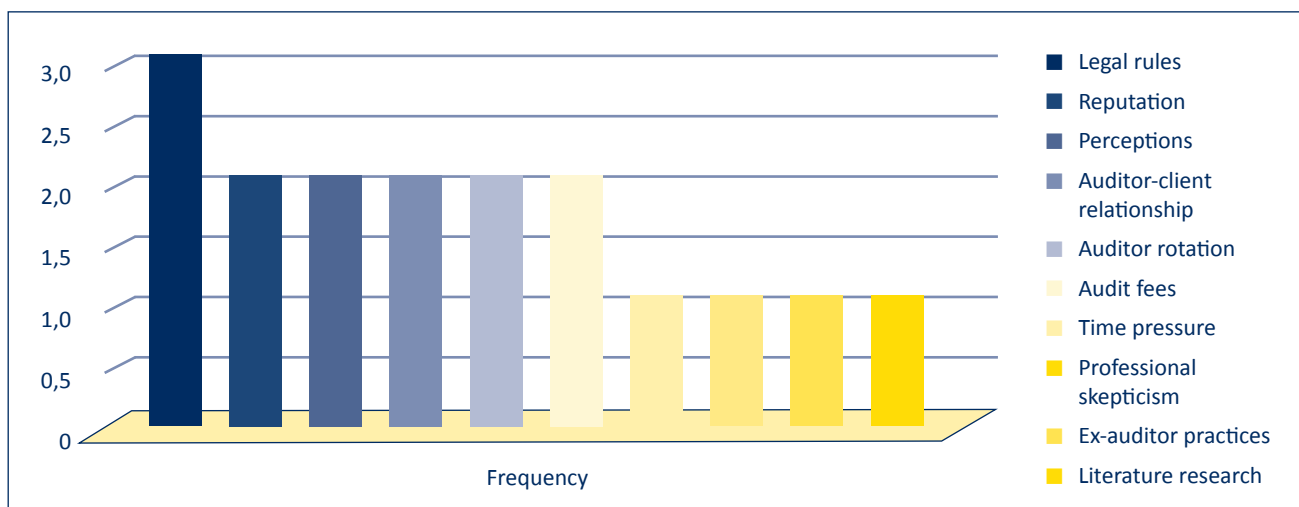


Figure 1. Threats frequency

Source: Own projection.

The main research methods used by the authors focused on the quantitative empirical model (based on several hypotheses), followed by qualitative studies such as explanatory studies (27%), surveys (27%) and phone or email interviews (13%).

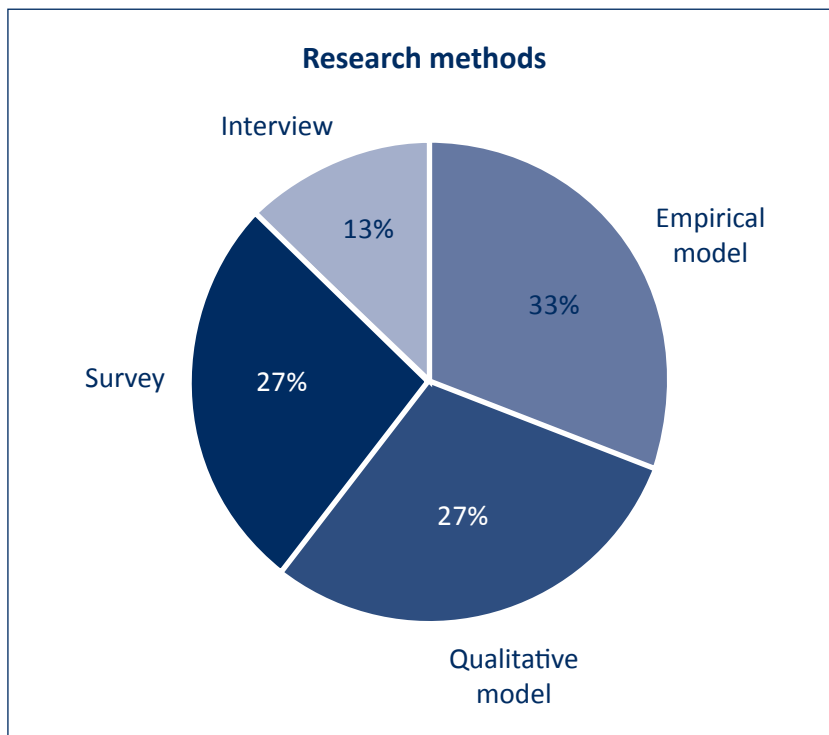


Figure 2. Research methods used by the authors

Source: Own projection.

I have identified the drivers for each category of threat to the auditor’s independence and proposed a few safeguards that can prevent their influence on auditor independence, based on articles which studied the effects of these drivers.

Table 2. Threats to auditor independence and safeguards

Category	Self-interest	Self-review	Advocacy	Familiarity	Intimidation
<b>Factors</b>	<ul style="list-style-type: none"> <li>• Dependence on fees</li> <li>• Financial interests</li> <li>• Loans or guarantees from the client</li> </ul>	<ul style="list-style-type: none"> <li>• Contribution to the preparation of financial statements</li> <li>• A close business relationship with the client</li> <li>• Previously performed audit tasks</li> </ul>	<ul style="list-style-type: none"> <li>• Legal requirements</li> </ul>	<ul style="list-style-type: none"> <li>• Habit</li> <li>• Nepotism</li> <li>• Favoritism</li> </ul>	<ul style="list-style-type: none"> <li>• Audit fees</li> <li>• Pressure</li> </ul>

Category	Self-interest	Self-review	Advocacy	Familiarity	Intimidation
<b>Safeguards</b>	<ul style="list-style-type: none"> <li>• Continuous professional training</li> <li>• Professional certification and experience requirements to gain access to the profession</li> <li>• Monitoring the activity and applying disciplinary measures</li> <li>• Implementation of the audit standards</li> </ul>	<ul style="list-style-type: none"> <li>• Review of the quality control system</li> <li>• Independence policies regarding the identification of threats to independence</li> <li>• Identification and application of safeguards in order to eliminate or reduce threats to an acceptable level</li> </ul>	<ul style="list-style-type: none"> <li>• Employees capable of making competent managerial decisions</li> <li>• Implementation of the necessary policies and procedures for the correct reporting of the financial statements</li> </ul>	<ul style="list-style-type: none"> <li>• Auditor management's emphasis on the importance of independence</li> <li>• Policies and procedures for implementing and monitoring the quality of audit commitments</li> <li>• Applying a disciplinary mechanism to promote compliance with audit procedures and policies</li> </ul>	<ul style="list-style-type: none"> <li>• Internal procedures that ensure the objective setting of fees for works that do not concern audit commitments</li> <li>• Corporate governance structures such as an insurance committee that provides an adequate overview and communications regarding the services offered by the company</li> </ul>

Source: Own projection.

## 5. Conclusions

Regardless of the factors that influence auditor independence, the appropriate judgment and ethical actions can lead to a quality audit. For this, however, an auditor must have a high level of professional knowledge and skills and assimilate the ethical behavior required by professional rules and society. Consequently, without the threat to auditor independence, there should not be any deterioration in the audit quality in the next tenure years. However, the binding effect can erode the audit quality over time, as the close personal relationship between the auditor and the client will certainly and slowly affect the auditor's judgment over time.

The developed confidence in the client activity over time adds confidence and hinders the auditor's ability to design creative and rigorous audit programs and to exercise the necessary professional skepticism.

The limitations of the research consisted of the fact that the number of analyzed articles has been reduced, as the data has been collected manually. Future research directions can materialize into the expansion of the number of articles and in the quantitative research based on collected data or even on a sample.

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