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Perceived Independence of Auditors in Least Developing Audit Market: A Literature Review and Study Framework

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Abstract
Compromised quality of audit practice do have a devastating impact on the development and sustainability of an economy, as the professional accounting and auditing service is subject to adherence to professional standards and legal provisions; however literatures indicated that there exist situations in which the audit found to underserved its purpose as it was found that companies that reported an unqualified audit report demonstrated performance contradictory to the report and resulted the consecutive failure of the auditors in the recent past.(Anlop &Chandla, 2003). This has been repeatedly mentioned as the underpinning rational for examining the effectiveness of auditors' independence from different perspectives. Studies on auditors' independence and its effect of actual audit quality and users expectation gap are useful to inform regulatory bodies and the accounting profession in devising ways to enhance auditors' independence and the role in corporate governance. The purpose of this exploratory study is to review existing empirical studies on auditors independence to developed a theoretical framework that facilitate further studies in least underdeveloped audit market. The study is conducted based up on review of literatures and identified the factors that possibly influenced perceived independence of auditor.
Keywords: Audit, Independence of Auditors, Perceived Independence, Factors, Study Framework

Introduction

Following the accounting scandals and failure of large companies in the developed counties like Enron in the USA and others (Anlop &Chandla, 2003), the issue of auditors' independence has become the concern of regulatory bodies, investors and the accounting profession itself. It is not arguable that weak or lack of auditors' independence impairers the quality of the audit profession and diminishes the public trust on auditor's assurance.

The professional code of conduct at international and local levels as well as the commercial codes that govern the business and economic endeavors stated that professional accountants must be competent and independent to undertake an audit and assurance services. Independence takes the central place in audit profession as lack of independence is interpreted as "[….] *the auditor is hardly likely to report breach of the contract between principals (shareholders and lenders) and agents (managers)*" (Fearnley and Page, 1994, p. 7; as cited on Roger and George, 2001). Further, weaken independence of external auditor is a serious challenge for the government bodies that make tax liability assessment and regulatory duties on the basis of audited financial reports.

In general the purpose of external auditors in society is to give reasonable assurance on fairnes the truthfulness of financial statements. As stated by Lavin (1977:237), in order to perform their role, it is essential that, auditors are independent of the client company and are not seen to have any motive for none disclosure of misleading information.

The concept of independence is very important in enhancing the contributions of the audit profession to the sustainable development of the overall economy and the issue has becoming a discourse of academics, professional and regulators in developed and emerging economies, studies addressing the issue in Ethiopian and other least developing countries audit market context are scantly available.

Unlike studies in developed countries, few of the previous studies in developing countries were not motivated by notable failure of companies and audit firm scandals, but they indicated that there is a frequent appeal of major financial statement users such as taxing authorities and banks that are in a difficult situation of accepting audited financial reports as a credible and dependable for financial and economic decisions. In this regard Delu (2007) who studied audit expectation gap in Ethiopia found that there was agreement between auditors and users of financial statements that the auditor must act independently; however, both also expressed their doubts on the practical applicability of independence. The underdevelopment in the audit infrastructure was also mentioned by police makers at Ministry of trade and Industry among the possible challenges speeding up investment and economic development in Ethiopia (MOI, 2005). The current momentum to establish publicly owned companies in Ethiopia is also considered as the need for examining auditors' independence. However, there is no publicly known corporate failure and audit scandal in Ethiopia, the possible lack of independence may bring it into existence to hamper the ongoing private sector development and economic growth that has been registered in the recent two decades. Hence it is found imperative to examine the factors affecting external auditors' independence in Ethiopian context and suggest possible actions to enhance the contribution of independent on one hand, and to drop a piece of information in the literature about the context of Ethiopia. In this respect the current study is intended to conduct a review of research and develop a theoretical framework to pave the ways for future research in Ethiopia and other LDCs with similar underdeveloped audit market. The study is believed to contribute on literatures on auditor independence in least developing countries by showing the gap and future study areas.

OBJECTIVE AND Research METHOD

The study is an exploratory study and its primary purpose is to develop a study framework on auditors' independence in Ethiopia. AI can be vied from actual independence (independence in fact) and perceived independence, but the scope of this paper is limited to perceived independence. Secondary data obtained from a review of literature and researchers' personal observation of the external audit market in Ethiopia, which represent the context of list developing countries in sub Saharan Africa were used as a main source of data analysed qualitatively.

The concept of independence

Despite the fact that there are a number of professional and legal requirements to audit, the issue of independence takes attention as to(Aranes & lobeck,1999) it is very important on public's confidence in using audited financial reports. Independence of auditor, as stated by Nick A &et.al (2008) GAAS requires that an auditor be impartial and act without bias toward the client. This will ensure that the public maintains confidence in the profession. In order to be independent, an auditor must be intellectually honest. This is commonly known as independence in fact. An auditor must also be recognized as independent. This is commonly known as independence in appearance. Theoretical literatures in audit and accounting loudly pronounce the need for auditors' independency in making financial statement credible and useful to stakeholders in financial condition and performance of a firm (for example see, Millichamp, 2002; Arens & Lobeck 1999) . On their study Backer, Rahman & Reshid (2005) stated that auditor independence is fundamental to public confidence in financial reporting and the auditing profession. To remain independent auditor is expected to be independent in fact as well as independent in appearance. The differences between the two requirements of independence are clearly presented by Ahmed and Abu Baker (2005) who cited (Mautz & Sharaf, 1961) defined Independence in fact …… *as the auditor's state of mind and his ability to maintain a proper attitude in the planning of his audit program the performance of his verification work, and the preparation of his report. On the other hand, independence in appearance refers to the public's or others' perceptions of the auditor's independence.*

However it is the case that much is known about independence and it is well explained in theoretical literatures as well as on national and international professional accountants' code of ethics and even in national company and commercial lows, the stock of empirical evidence across time and place reveled that it is not as such easy to the auditor to strictly adhere to all criterions to independence to ensure that the public can get at most confidence on the credibility of audited financial statements.

Factors Affecting Auditors Independence

Different empirical studies on threats to auditors' independency were identified at varied temporal and special contexts. Out of the stock of empirical evidences on auditors' independence we synthesized and presented those focused on identifying the threats to independence.

Rahman & Reshid (2005) attempted to determine the factors affecting auditors' independence in Malaysia by taking the perception of 86 sample selected loan officers who were considered as a complicated financial statement user. It is identified in this study, that audit firms size, level of audit firms' competition to market share, serving a given client over a long period (audit tenure), the size of audit fees, offering non audit service and absence of audit committee from in client company are identified as explanatory variable to independence of auditors. According to the study smaller audit firms, firms working in highly competitive environment, and firms offering managerial consultancy are found to be in relatively high risk of losing their independency. The finding of Rahman & Reshid also provided different factors and that good insight on the factors to be considered in studies focusing on auditors' independence. Their study considered different variables as explanatory variable to independence, albeit they generalized only from the users' perspective.

Ahmad and Abu Baker (2008) who explored the perception of Malaysian Certified Public Accountants (CPAs) on the factors affecting independence of external auditor narrowed the gaps of the preceding study by considering similar issue form the view of the practicing auditors. In their study they identified and prioritized independent variables on the basis of their relative impact on impairing auditors' independence, as viewed by the professional accountants. According their ranking, the size of audit fees, the level of competition among audit firms, audit firm size, tenure of an audit firm, the provision of management advisory services, and existence of an audit committee are the factors affecting independence of external auditors.

Peter & Dwayne (2006) also conducted study on the perceived independence of auditors in Barbados with the sample of 66 auditors and 148 users and found with similar factors explaining independence of auditors. This study showed that economic dependence of auditor on the client, the provision of non-audit service to audit client, high competition among audit firms, small audit firm size, being a sole practitioner, lengthy tenure found to have a negatively effect on perceived independency of auditors in Barbados; which makes us to infer that the explanatory variables to perceived independence of audit independence have a relatively similar nature in deferent developing country setting.

These two studies conducted in the same environment, but with the view of different groups: users of financial reports and professional accountants and auditors concluded with relatively similar result on the factors affecting perceived independence of external auditors. The result from other countries summarized hereunder also showed relatively similar explanatory variables to independence of auditors.

The Effect of Specific Explanatory Variables on Perceived Independence of Auditors

There are empirical studies that focused either only on one or two variables identified in the above section. On the following sub section we presented a synthesis of findings that tried to show how far specific variable affected independence. This serves for the development of hypothesis as to the possible effect of each independent variable to be studied on forthcoming studies in other audit market settings.

Offering Audit and Non Audit Service to the Same Client

Audit firms may involve in offering other non-audit services (NAS) to their audit clients. In this regard there are two views. Some argued that NAS to audit client can contribute to audit quality for the fact the auditor may have possibility to have an in depth knowledge and understanding about the client business and system which is an advantage to devising better audit program and undertake a rigor subsequent test. On the other hand the other wing argued that NAS creates familiarity threat to auditors' independence because of the fact that the audit team and the management relationship may limit the strict applicability of audit program. What do empirical studies taking NAS as primary concern showed on the issue?

Canning & William (1999**)** studied people's perception towards auditors independence in Irish commercial environment with a primarily emphasis on the impact of offering non audit service (NAS). The principal findings of the study were that perceptions of auditor independence were significantly diminished when non audit service were provided to audit clients by personnel involved in the audit rather than by either a separate department within the audit firm or to non-audit clients only. The study highlighted that users of financial statements were willing to accept some reduction in auditor independence consequent upon the provision of NAS if this resulted in firms obtaining better or more cost-effective advice or if it resulted in a higher standard of audit. Flaming (2002**)** indicated that providing non audit service to audit client basically benefits the audit quality by providing a deeper knowledge of clients business, but in the audit the perceived independence is found to be very low as compared to firms that don't offer non audit service to audit client. Salehi & Rostami (2009**)** who studied the same topic in the context of Iran argued that their finding showed significant negative impact of non audit services to audit client on the degree of auditors' independence. Similarly, Michael (2011**)** also confirmed that non audit service to the same client can threaten auditor independence.

Although There an argument that offering NAS can enhance the financial capacity and earning of the audit firm as well as the auditors knowledge acquired during the NAS do have a spillover effect in the audit service and enable auditor to conduct the audit in efficient and effective manner. And such as, management consultancy, tax planning and advisory and other non audit service has become a lucrative business of professional accounting firms the issue requires a further investigation and clear cut suggestion for the professional bodies and/or regulators having mandate on reconsidering the standards rules on non audit and audit service in a ways that independence of auditor can properly defended for the fact the negative effect of NAS on independence has empirical evidences. This is off course a potential research area with potential policy implication.

The Audit Firm Size and Independence

The size of audit firms also considered as having effect on auditors independence (Rahman & Reshid (2005), Ahmad and Abu Baker (2008), Peter & Dwayne (2006)). The following studies on size and independence also presents a further evidences.

Zulkarnain & Yusuf (2006) studied the opinion of auditors, bank managers, loan officers and Chief executive officers (CEOS) of listed companies in on the impact of audit firm size on auditors in Malaysia and obtained that the audit firm size affects peoples' attitude on auditors' independence. Their finding suggests that big audit firms are effective at identifying client's business continuity; they are also more risk averse and less likely to be influenced by the client and/or management in maintaining their independence. In general the study of Zulkamain & Yosuf showed that the big the firm sizes it is perceived as having high independency. This is consistent with the findings of Rahman & Reshid (2005) in firms with smaller size was presented as having greater risk to independence threats. On the same vein Sori Mohammed& Karbhari also examined the impact of auditor reputation (i.e. size of audit firm) on auditor independence taking the perceptions of senior managers of Malaysian audit firms, banks and public listed companies as study subject. Consistent with the documented evidence, the Big Four firms were perceived to be superior compared to the non-Big four firms in all aspects relating to independence from their clients.

The issue of audit firm size and independence in the context of least developed countries where small firms dominate the market, the issue requires a further research aimed identifying the prevailing relationship between size and independence on hand and devising ways to improve audit firm sizes or alternative ways to ensure independence.

Audit Firm Tenure and Independence

Chia-Ah & Karlsson (2010) examined the relationship between audit tenure and independence in a view that the extended audit still remained open. As mentioned on their research some countries stipulated the threshold level for the period of audit tenure to preserve auditors' independence and in other places it is left open. The result of their study conducted using data from 2500 Swedish professional accountants showed that there is an association between audit tenure and independence. When the same auditor served for the same client auditors' familiarity and self interest may threaten their independence.

In the context of Ethiopia the commercial code provided that the audit tenure should be 3 years, however there is no empirical evidence showing the nature of audit tenure and its effect on independence and other aspects of audit quality. Hence it seems the factor to be considered as a potential explanatory variable to auditors' independence.

Competition and Independence

The American Institute of Certified Public Accountants' (AICPA) Special Committee on Financial Reporting (1994) stated that users of financial statements are concerned that competitive pressures could erode the external auditor's independence (Fran M. & et al, 1999). The issue is also empirically proved by Abu Bakar & et.al (2005) in their study of factors affecting auditors' independence on the bases of Malaysian bank loan officers where Auditors independence is found to be hampered when the auditor works in a highly competitive environment.

Audit Committee in Client organization and Independence

Philmore & et.al (2006) stated about audit committee formation and purpose in a ways that one can easily relate audit committee and independence of auditors. According to these researchers, a company's audit committee is appointed by the Board of Directors and is responsible for recommending the selection of external auditors to the Board, receiving, reviewing, and forwarding to the Board the annual financial report of the external auditors, and generally dealing with other financial matters that arise. Felix, (1997) also explained the term as, "The audit committee represents a standing committee of the board of directors which is charged with dealing with audit-related concerns". With respect to enhancing the independence of auditor an effective audit committee members do have their own expected role in which they independently mediate the conflict between management and auditor as to the audit findings. The need for having a qualified, experienced and independent audit committee members in the board is a highly recommended by authoritative bodies in the realm of professional accounting bodies. In this respect Rocco(1994) pointed out that the American Institute of public Accountants (AICPA) Special Committee on Audit Committees provided a clear recommendation on 1997 which emphasizes the need for audit committee in enhancing the quality of financial reporting and overall governance of a corporation which vital for the management as well as the Public. The results of Rahman & Reshid (2005), Ahmad and Abu Baker (2008) and Peter & Dwayne (2006) identified existence of audit committee as a factor with positive contribution to independence, but studies with primary emphasis on audit committee and independence of auditors are limited though it appears important to examine.

The Audit Market in Ethiopia and Some observation

Currently independent audit service is provided by state owned audit Service Corporation established during the socialist government to audit state controlled enterprises and 52 private audit firms (OFAG, 2010). These firms are playing a significant role in the nave, but growing private sector in the country through enhancing financial reporting quality. however due to low level of profession development, lack of appropriate standard and enforcement mechanism (ROSC,2007, Miherat, 2012) as well as professional misconducts of auditors (Beyene,2007) their contribution are losing poplar public support. For instance Dilu (2008) reveled that users of financial statements in financial institutions are not comfortable to use audit reports for financial analysis and credit decision. The understanding and expectation of users on the role of auditor is significantly different from what auditors perceive. Audit expectation gap as explained by growing number of litterateurs is a main challenge of audit quality.

A comprehensive survey on accounting and audit service on Ethiopian corporate sector were also conducted by World Bank. This "*REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC)*" pointed out the need for enhancing existing accounting, audit and finical reporting infrastructures in order to facilitate the economic growth and private sector development aspired in Ethiopia. The result of this study showed that accounting and auditing is not supported by adequate regulatory framework. Confirmed latter by Mihret(2012) the result of ROSC suggested that the commercial code of Ethiopia 1960 that guides accounting and audit service requires revisions. Further adoption of international financial reporting and audit standards are recommended for the fact that the commercial code refers GAAP and GASS without a clear definition as to the source tough there is no a local accounting and audit standards. (ROSC, 2007)

Studies on financial reporting and audit in Ethiopia show that financial reporting audit infrastructure in the country are at low level of development and requires many assignment by government and professional bodies in the country. Among the major problem lack of clear legal frame work on consistent application of professional standards is the major one. It was also recommended on the need for adopting international standards and revision of the commercial code in light of the current business and economic scenario. (Miheret, 2012) Moreover, the statuses of professional associations (EPPA and ASE) are not strong enough to support in regulating accounting and audit profession (Mengesha, 2006; Miheret, 2012)

Concerning audit practice in Ethiopia, there are some studies showing problem in reporting audit expectations gap. For instance Beyne(2007) pointed out situations in which auditors issued reports that are different from what has been shown on the financial statement. Dilu(2008) on his part showed that there is misconception among users of financial statement as to responsibility of auditor. He also indicates that users lack confidence on the quality of audited financial reports. Further on the study of Kinfu(2009) it is mentioned that auditors in Ethiopia issued a short version of audit report which is prone to expectations gap. Kinfu also indicated that audit reports are silent on director's statement on business operation, risk, governance and other qualitative matters as to whether they are in line with the financial statement or not. (ibid)

Thus studies in auditors' independence, the determinant factors and ways forward are relevant to strengthen the role of audit in corporate governance and private sector development aspired in the country.

Summary and Conclusion

As pointed out by the stock of theoretical and empirical studies cited above lack of auditors' independence hamper the popular public confidence on using audit finical statements and off course negatively affects the development in the financial market, investment and overall growth and sustainability of an economy . As explained by (Faraj & Akbar, 2010) *[….it can also be argued that lack of independence would lead auditors to collaborate with the management of firms and would produce misleading accounting information*]. This really difficult for investors, creditors, government as well as to the general public who primarily relied on the firms audited financial information in making various financial, socio economical and political decisions in relation to a given entity. In simple terms it would be very difficult to carry out ordinary business in the absence public confidence in auditors' independence and quality of audit findings.

Form the review of related literatures; it is understood that exploring the various factors possessing risk on auditor independence is essential for the government and professional bodies who are working to enhance the quality of audit service and service and enhancing corporate governance to protect corporate failures and the repercussions on the entire economy. Therefore in this exploratory study we tried to identify the factors theoretically viewed as a threat to auditors' independence and the empirical evidences as to how they affect auditors' independence.

Studies on perceived independence of auditors can be studied from the perspectives of users and practicing auditors and considering the following e explanatory variables is suggested on the bases of the review**.** As to the framework Perceived independence of auditors is subject to non audit service, audit fee, audit firm size, audit tenure competitive environment, and existence of audit committee on the audit client. To make the framework suit the situation of Ethiopia we incorporated:

- Non Audit Service to audit client
- Audit Firm Size
- Audit Tenures
- Competition on Audit Market
- Existence of Audit committee in Client organization
- Audit Fee

Moreover, in the context of underdeveloped audit market in LDCs including Ethiopia, the educational qualification and experience of practicing auditors, No. of certified public accountants (competence), strength of regulatory frame work and nonexistence of strong professional association, nonexistence of legally adopted Standard (ROSC, 2007) on existence of international audit firm could be a potential factor to affect audit quality including perceived independence.

Future studies on perceived independence of independent auditors in Ethiopia and other least developing countries need to consider, not only the common explanatory variables on audit independence, but also include variables unique to the context of developing audit market.

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