**Auditor Independence**

**Background**

Auditor independence is one of the fundamental reasons for auditors in a capital market economy. It is considered as a core feature of auditor performance and the success of the public accounting system in financial markets. It inevitably adds credibility to published financial information and value for the various interested parties. Auditor independence is easy to understand, yet extremely difficult to create. The corporate failures that have occurred in certain financial markets have demonstrated the need for greater transparency and trust. The violations of auditor independence rules associated with the high-profile financial failures of recent years, and a changing audit and business environment have led regulators and practitioners to question the ability of the existing rules to maintain public confidence. The particularities of the collapses and perceived accountability deficiencies have caused some to argue that there has been a loss of confidence in the securities market. In recent years, there have been calls to prohibit joint provision of audit and non-audit services, and to mandate the rotation of audit committees and auditors. Standards of independence for auditors of listed entities should be designed to promote an environment in which the auditor is free of any influence, interest or relationship that might impair professional judgement or objectivity or, in the view of a reasonable investor, might impair professional judgement or objectivity.

**What is Independence?**

Independence means that management can place full reliance on audit findings and recommendations. The auditor’s independence contributes to the reliability and credibility of the financial information and this furthers the ability of investors to make rational decisions and so underpins the efficient functioning of capital markets. Poor quality of information in terms of bias and misrepresentation will therefore act as an obstacle to achieving optimal resource allocation and will harm the interests of individual economic actors, particularly shareholders. There are many positive images that are conjured up by this concept of independence:

**1. Objectivity**

Behind this word is a whole multitude of issues that together form a complex maze. The main problem is that the whole basis of objectivity stems from a human condition of correctness and fair play. Any models that involve a consideration of the human condition have to deal with many psychological matters, and at times irrational behaviour. Although objectivity is located in the mind, it is heavily influenced by the procedures and practices adopted.

**2. Impartiality**

Objectivity may be seen as not being influenced by improper motives while impartiality is not taking sides. The question of impartiality is important because there is a view that internal audit, like all other units, will work in a politically advantageous way. This may result in audit taking the side of the most powerful party in any work that impact on the political balances within an organization. If this is allowed to occur unchecked then the audit evidence that supports any audit report may be secured with a view to assisting one side only.

**3. Unbiased views**

When an audit report states that ‘the audit view is *. . .*’ this should provide a comment on the state of internal controls. Where used to provide an advantage for the audit function, credibility is risked. The other aspect of audit bias is where certain officers/sections have been earmarked as ‘poor, uncooperative or suspect *. . .*’ we go into an audit looking for any material that supports our original contentions. If taken to the extreme, the audit function will become a hit squad, conjuring up cases against people it does not like. It is difficult to build professional audit standards using this model.

**4. Valid opinion**

Readers of audit reports require the auditors to complete work to professional standards with the audit opinion properly derived from this work. This opinion must make sense having reference to all relevant factors. The audit role is not to please nominated parties or simply maintain the status quo; it is to present audit work in a professional and objective manner.

**5. No spying for management**

Professional objectivity means that audit does not fall into the trap of acting as spies for management, particularly where managers feel that their staffs are not performing.

**6. No ‘no-go’ areas**

There are senior managers who adopt a particularly aggressive stance to managing their areas of responsibility. All outsiders are treated with great suspicion. In fact there is a correlation between professional incompetence and this threatening posture, i.e. the less able the manager the more aggressive he/she becomes. If this results in certain areas being deemed out of bounds to internal audit then this means that audit’s independence is impaired and they will have a lesser role. If audit can be kept away from certain areas then this restricts the audit field, and if this trend is allowed to continue it could set a damaging precedent. The net result may be that the audit field becomes relegated to defined parts of the organization only. This is playing at auditing far removed from the demands of any professionally based audit practice.

**7. Sensitive areas audited**

To achieve its full status internal audit must be able to audit sensitive areas. Unlike the no-go areas, this potential barrier arises where the necessary skills and techniques are not available to the audit unit thus making it impossible to cover high-level areas. Where the audit scope is set within basic accounting systems for low-level checking, little important work can be undertaken and audit independence will not have been secured.

**8. Senior management audited**

There is a view that system controls are primarily located within the management processes that underpin the operations. Where audit fails to incorporate this factor into the scope of audit work, a great deal will be missed. The problem is that managers may not wish to be audited, particularly where this exposes gaps in their responsibility to establish

**9. No backing-off**

We do not expect auditors to back down without a valid reason when confronted by an assertive manager. This is not to say that auditors march unchecked across the organization, unaware of any disruption they might be causing to front line operations. It does, however, mean that they will pursue audit objectives to the full in a diplomatic and professional manner. If this is not the case then audit will be vulnerable to criticism from all sides. Audit reports would then reflect what managers allowed the auditor to do rather than the work required to discharge the terms of reference for the audit. In this instance audit can claim very little real independence.

**Auditor independence and non-audit services**

Market regulators’ principles of independence with respect to services provided by auditors are largely predicated on three principles, violation of which would weaken the auditor’s independence:

■ an auditor cannot play the role of company’s management;

■ an auditor cannot audit his or her own work; and

■ an auditor cannot serve in an advocacy role for his or her client.

Some commentators have stated that regulatory bodies should prohibit the audit firm from performing most, if not all, non-audit services. Others support a less strict approach. The general opinion is that the scope of prohibited services should be clarified. Auditors are generally prohibited from the following non audit services are;

■Book-keeping or other services related to the accounting records or financial statements of the audit client

■ Financial information systems design and implementation

■ Appraisal or valuation services, fairness opinions, or contribution-in-kind reports

■ Actuarial services

■ Internal audit outsourcing services

■ Management functions or human resources

■ Broker or dealer, investment adviser, or investment banking services

■ Legal services and expert services unrelated to the audit

■ Any other service that the regulator determines, by regulation, is impermissible

**Definitions of threats and risks to auditor independence (Situations that impair auditor’s independence)**

In conducting the audit of financial statements, an external auditor may face different types of threats affecting audit performance. The main types of threats to the auditors’ objectivity and independence are:

■ **Self-interest threat**.

An auditor’s independence may be threatened by a financial or other self-interest conflict (e.g. direct or indirect financial interest in the client, overdependence on the client’s audit or non-audit fees, the desire to collect outstanding fees, fear of losing the client). The self-interest threat might cause the auditors to be reluctant to take actions that would be adverse to the interests of the audit firm or any individual in a position to influence the conduct or outcome of the audit.

■ **Self-review threat**.

This relates to the difficulty of maintaining objectivity in conducting self-review procedures (e.g. where the audit firm has been involved in maintaining the accounting records, or undertaking valuations that are incorporated in the financial statements; or when any outcome or judgement of a previous audit or non-audit assignment performed by the auditor or his firm needs to be challenged or re-evaluated to reach a conclusion on the current audit). In such circumstances, the auditor may be (or may be perceived to be) unable to take an impartial view of relevant aspects of those financial statements.

■ **Management threat**.

A management threat arises when an audit firm undertakes work that involves making judgements and taking decisions (or taking part in decisions) that should be taken wholly by the audit client’s management (for example, where it has been involved in the design, selection and implementation of financial information technology systems). In such work, the audit firm may become closely aligned with the views and interests of management and the auditors’ objectivity and independence may be impaired, or may be perceived to be, impaired.

■ **Advocacy threat**.

Independence may be threatened if an auditor becomes an advocate for, or against, the client’s position in any adversarial proceedings or situations (e.g. dealing in or promoting shares or securities in the audited company; acting on behalf of the audit client in litigation; or when the client litigates against the auditor). To act in an advocacy role, the audit firm has to adopt a position closely aligned to that of management. This creates both actual and perceived threats to the auditors’ objectivity and independence.

■ **Familiarity (or trust) threat**.

A familiarity (or trust) threat arises when the auditors are predisposed to accept or are insufficiently questioning of the client’s point of view. In such cases, the auditor may be over-influenced by the client’s personality and qualities, and consequently become too sympathetic to the client’s interest through, for example, a too long and too close relationship with client personnel, which may result in excessive trust in the audit client and insufficient objective testing of his representations.

■ **Intimidation threat**.

This relates to the possibility that an auditor may be deterred from acting objectively by threats or by fear (for example, where the auditor encounters an aggressive and dominating individual and/or an influential client).

**Suggestions to improve auditor independence**

Auditors should identify and assess the circumstances, which could adversely affect the auditors’ objectivity (‘threats’), including any perceived loss of independence, and apply procedures (‘safeguards’), which will either eliminate the threat or reduce the threat to an acceptable level. The safeguards include;

1. Accept audit assignment s in businesses where the auditor has no conflicts of interest in terms of owning shares either directly or indirectly, business relationships or employment relationships.
2. Regular rotate auditors or audit partners.
3. Not conduct non audit assignments that impair independence.
4. Avoid over reliance on one audit client in terms of revenue of the auditor.
5. To avoid replacement of a ‘strong’ auditor and to safeguard auditor independence, it is extremely important that the auditor in such situations is protected from being dismissed by the executive management of the audited company. Thus auditors can only be replaced by shareholders at an AGM.
6. An auditor not auditing/ reviewing his or her own work; and
7. An auditor not serving in an advocacy role for his or her client.
8. Requiring that each engagement of the accountant to perform audit or non-audit services for the company be pre-approved by the audit committee, which serves as the representative of investors.

Auditors’ independence is the accounting profession’s main means of demonstrating to the public and regulators that statutory auditors and audit firms are performing their task to a standard that meets established ethical principles, in particular those of integrity and objectivity.

**The audit committee**

The audit committee (AC) is a standing committee of the main board and tends to consist of a minimum of three non-executive directors (NEDs). Most audit committees meet quarterly and they are now found in all business and government sectors for larger organizations. The format is normally that the NEDs sit on the audit committee and the CFO, external audit, and CEO attend whenever required. The committee will have delegated authority to act in accordance with its set terms of reference and also investigate areas that again fit with their agenda.

**The Role of the Audit Committee**

An audit committee will be established by the main board to perform those duties that the board decides should be properly allocated to this specialist forum. The role of the audit committee may therefore incorporate some the following components in its terms of reference.

1. ***The external audit process*** To review the external audit process and make recommendations to the board where appropriate.

***2. The final accounts*** To consider the annual accounts and the external audit report that attached to these accounts.

***3. Systems of internal control*** To consider the adequacy of systems of internal controls. The current move to require directors to report on their systems of internal control means that this is starting to assume a higher profile.

***4. Internal audit*** Involvement in the appointment of the internal auditors and ensuring that the internal audit function operates to professional standards and performs well and discharges its responsibilities under the audit plan and strategy.

***5. Risk management*** The audit committee will ensure that there is an effective system of risk management within the organization and that this system supports the controls which, in turn, provide a reasonable expectation of achieving organizational objectives.

***6. Compliance and propriety*** An oversight of systems and procedures is in place to ensure compliance with regulations, policies, laws and procedures and the organization’s code of conduct. Also ensure that the organization is able to prevent, detect and respond to fraud and allegations of fraud.

1. ***Financial management*** To consider the finances and expenditure of the organization and ensure that there is a good financial reporting and budgeting system in place and that this feeds properly into the process for preparing the annual accounts.
2. ***Special investigations*** The audit committee may request special investigation from the internal audit, compliance officer, external auditor and external specialists where there is a need to probe into sensitive problems that fall within its remit.