

# The Impact Of Auditor's Independence On Audit Quality: A Theoretical Approach

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**Abstract:** Audit Quality is an audit conducted in accordance with auditing standards generally acceptable that can detect and report material misstatements in the financial statements include disclosure relating either caused by an error / fault or fraud, is able to provide assurance of internal control, and is able to provide going concern warnings. audit quality is affected by the auditor's independence. The more independent an auditor then increasing audit quality.

**Keywords:** Audit Quality, Auditor's Independence

## 1. Introduction

Globalization in general carries significant influence on the development of the world economy, especially with the free trade as part of the globalization in the economic field. Free trade causes the flow of products and services, both for the real sector and financial sector, the consequences to the company as the main actors in the economy. Related to this, both states and businesses obliged to prepare themselves as well to be able to adapt to the changes caused by globalization. This change is a change in the external business environment that is pressing the company to be able to produce strong competitiveness so as to receive the benefits of globalization. Free flow of goods and services as well as various other production factors in the era of globalization led to the country demographic boundaries become irrelevant. Investors from various countries can invest in other countries that provide better returns by studying and analyzing the relevant information before making an investment decision. One of the information used is the financial report is the product of a process of accounting. In this case the financial statements that can be trusted by investors absolutely necessary. In order for those statements to be believed, then the audit of financial statements is necessary especially for a company incorporated in the form of a limited liability company that is open. The management company appointed by the shareholders held accountable in the form of financial statements for the funds that have been submitted to the management of company. According to Arens, et.al (2012: 4), "Auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. The same thing was also stated by Messier (2008: 11) states that "Auditing is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users.

Bahram Soltani (2007: 444) asserts that "to carry out an audit in a manner that meets the reasonable expectations of users of audited financial statements, it is essential that work is performed with due regard for audit quality. The audit firm must not compromise quality to achieve financial benefits. In developing quality control policy and processes, and to preserve audit quality, management structures within audit firms are designed to prevent commercial considerations taking precedence over the quality of audit work. Further explanation put forward by Bahram Soltani (2007: 445) that the background of the reforms in audit quality control lies in the decline in confidence in financial reporting and auditing arising from corporate collapses and accountants' failures in a number of countries. The consequence of this has been greater regulation of the profession in many countries in an attempt to restore public and investor confidence in corporate financial reporting. While the financial failures have not occurred in all countries, they have significantly influenced the international regulatory environment in a way that requires a response. Audit quality depends on auditor's independence as proposed by Arens, et.al (2014: 134) that the value of auditing depends heavily on the public's perception of the independence of auditors. The same thing also expressed by Enofe, et.al (2013: 131) based on the results of research that as auditors' independence increase, the quality of the audit also improves.

## Literature Review

### Auditor's Independence

Bahram Soltani (2007: 196) describes the notion of auditor's independence is as follows : "auditor independence refers to the auditor's ability to maintain an objective and impartial mental attitude throughout the audit". Furthermore Rick Hayes, et.al (2004: 85) defines the independence of the auditor is as follows: "Independence is described as having a position to take an unbiased viewpoint in the performance of audit tests, analysis of results, and attestation in the audit report". Next Arens, et.al (2012: 131) explains that : "Independence requires an attitude of responsibility separate from the client's interest. The auditor must maintain an attitude of healthy professional skepticism". Based on the above understanding can be concluded that the independence of the auditor is the auditor's ability to maintain mental attitude objectively and impartially in the interests of the client in conducting the audit, analyzing the results, and attestation in the audit report. Arens et.al (2012: 34) explains that the independence of the auditor is divided into two parts as follows: "Independence as consisting of two

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components : independence in mind and independence in appearance. Independence of mind reflects the auditor's state of mind that permit the audit to be performed with an unbiased attitude. Independence of mind reflects a long-standing requirement that members be independent in fact. Independence in appearance is the result of others' interpretations of this independence. If auditors are independent in fact but users believe them to be advocates for client, most of the value of audit function is lost" Furthermore Mautz and Sharaf (1993: 249) explains that the independence of auditors is composed of three dimensions with the following statement: We have advocated recognition of three dimensions of independence as follows:

- 1) Programming independence : freedom from control or undue influence in the selection of audit techniques and procedures and in the extent of their application. This requires that the auditor have freedom to develop his own program, both as to steps to be included and the amount of work to be performed, within the over all bounds of the engagement.
- 2) Investigative independence : freedom from control or undue influence in the selections of areas, activities, personal relationships, and managerial policies to be examined. This requires that no legitimate source of information to be closed to the auditor.
- 3) Reporting independence : freedom from control or undue influence in the statement of facts revealed by the examination or in the expression of recommendations or opinions as a result of the examination.

Mautz and Sharaf (1993: 249) states that the independence of auditors is composed of three dimensions: the independence of the audit program, the investigative independence, and the independence of the audit reporting. Mautz and Sharaf (1993: 249) adds indicators to assess the independence of auditors as follows:

#### **Programming independence indicators:**

- a. Freedom from managerial interference or friction intended to eliminate, specify, or modify any portion of the audit
- b. Freedom from interference with or an uncooperative attitude respecting the application selected procedures.
- c. Freedom from any outside attempts to subject the audit work to review other than that provided for in the audit process.

#### **Investigative independence indicators:**

- a. Direct and free access to all company books, records, officers and employee, and other source of information with respect to business activities, obligations, and resources.
- b. Active cooperation from managerial personnel during the course of the auditor's examination.
- c. Freedom from any managerial attempt to assign or specify the activities to be examined or to establish the acceptability of evidential matter
- d. Freedom from personal interests or relationships leading to exclusion from or limitation of the examination of any activity, record, or person that otherwise would have been included in the audit

#### **Reporting independence indicators:**

- a. Freedom from any feeling of loyalty or obligation to modify the impact of reported facts on any party
- b. Avoidance of the practice of excluding significant matters from the formal report on favor of their inclusion in an informal report of any kind.
- c. Avoidance of intentional or unintentional use of ambiguous language in the statement of facts, opinions, and recommendations and in their interpretation.
- d. Freedom from any attempt to overrule the auditor's judgment as to appropriate content of the audit report either factual matter or his opinion.

Furthermore Rick Hayes, et.al (2004: 85) states that the independence of auditors consists of two dimensions as follows: "Independence is described as: independent in fact: accountant's ability to maintain an unbiased attitude throughout the audit, so being objective and impartial; independent in appearance: the result of others' interpretations of this independence".

#### **Audit Quality**

Arens et. Al (2011: 105) defines the quality of the audit are as follows:

*"Audit quality means how well an audit detects and report material misstatements in financial statements, the detection aspects are a reflection of auditor competence, while reporting is a reflection of ethics or auditor integrity, particularly independence".*

Furthermore, The US Government Accountability Office ("GAO") (2015: 10) explains the notion of quality of the audit are as follows:

*"A quality audit is an audit conducted in accordance with generally accepted auditing standards (GAAS) to provide reasonable assurance that the audited financial statements and related disclosures are (1) presented in conformity with GAAP and (2) are not materially misstated whether due to errors or fraud".*

Next DeAngelo (1981: 186) confirms the definition of quality of the audit are as follows: "The quality of audit services is defined to be the market-assessed joint probability that a given auditor will both (a) discover a breach in the client's accounting system, and (b) report the breach". Public Company Accounting Oversight Board (PCAOB) (2015: 3) defines audit quality as follows: "we define audit quality as meeting investors' needs for independent and reliable audits and robust audit committee communications". Australian Public Policy Committee (2014: 3) defines audit quality as follows: "Meeting investors' needs for independent and reliable audits and robust audit committee communications on: Financial statements, including related disclosures; Assurance about internal control; and Going concern warnings". Based on the above understanding can be concluded that the quality of the audit is an audit conducted in accordance with auditing standards generally acceptable that can detect and report material misstatements in the financial statements include disclosure relating either caused by an error / fault or fraud, is able to provide assurance of internal controls, and capable to provide going concern warnings. IFAC (2015: 20-23) in the statement of "a framework for audit quality indicator" describes

the dimensions and indicators to assess the quality of audit as follows: Values, Ethics, and Attitudes

### 1.1 Engagement Level

- ✦ The engagement team recognizes that the audit is performed in the wider public interest.
- ✦ The engagement team exhibits objectivity and integrity.
- ✦ The engagement team is independent.
- ✦ The engagement team exhibits professional competence and due care.
- ✦ The engagement team exhibits professional skepticism.

### 1.2 Firm Level

- ✦ Governance arrangements are in place that establish independence and the appropriate “tone at the top.”
- ✦ The firm promotes the personal characteristics essential to audit quality.
- ✦ Financial considerations do not drive actions and decisions that may have a negative effect on audit quality.
- ✦ The firm emphasizes the importance of providing partners and staff access to high-quality technical support.
- ✦ The firm promotes a culture of consultation on difficult issues.
- ✦ Robust systems exist for making client acceptance and continuance decisions.

### 1.3 National Level

- ✦ Ethics requirements are promulgated that make clear both the underlying ethics principles and the specific requirements that apply.
- ✦ Regulators and professional accountancy organizations are active in ensuring that the ethics principles are understood and the requirements are consistently applied.
- ✦ Information relevant to client acceptance decisions is shared between audit firms.

## Knowledge, Experience and Time

### 1.4 Engagement Level

- ✦ Partners and staff have the necessary competences.
- ✦ Partners and staff understand the entity’s business.
- ✦ Partners and staff make reasonable judgments.
- ✦ The audit engagement partner is actively involved in risk assessment, planning, supervising, and reviewing the work performed.
- ✦ Staff performing detailed “on-site” audit work have sufficient experience, their work is appropriately directed, supervised and reviewed, and there is a reasonable degree of staff continuity.
- ✦ Partners and staff have sufficient time to undertake the audit in an effective manner.
- ✦ The audit engagement partner and other experienced members of the audit team are accessible to management and those charged with governance.

### 1.5 Firm Level

- ✦ Partners and staff have sufficient time to deal with difficult issues as they arise.
- ✦ Engagement teams are properly structured.

- ✦ Partners and more senior staff provide less experienced staff with timely appraisals and appropriate coaching or “on-the-job” training.

- ✦ Sufficient training is given to audit partners and staff on audit, accounting and, where appropriate, specialized industry issues.

### 1.6 National Level

- ✦ Robust arrangements exist for licensing audit firms/individual auditors.
- ✦ Education requirements are clearly defined and training is adequately resourced.
- ✦ Arrangements exist for briefing auditors on current issues and for providing training to them in new accounting, auditing or regulatory requirements.
- ✦ The auditing profession is well-positioned to attract and retain high-quality individuals.

## Audit Process and Quality Control Procedures

### 1.7 Engagement Level

- ✦ The engagement team complies with auditing standards, relevant laws and regulations, and the audit firm’s quality control procedures.
- ✦ The engagement team makes appropriate use of information technology.
- ✦ There is effective interaction with others involved in the audit including, where applicable, internal auditors.
- ✦ There are appropriate arrangements with management so as to achieve audit efficiency.
- ✦ There is appropriate audit documentation.

### 1.8 Firm Level

- ✦ The audit methodology is adapted to developments in professional standards and to findings from internal quality control reviews and external inspections.
- ✦ The audit methodology encourages individual team members to apply professional skepticism and exercise appropriate professional judgment.
- ✦ The methodology requires effective supervision and review of audit work.
- ✦ The methodology requires appropriate audit documentation.
- ✦ Rigorous quality control procedures are established and audit quality is monitored and appropriate consequential action is taken.
- ✦ Where required, effective engagement quality control reviews are undertaken.

### 1.9 National Level

- ✦ Auditing standards are promulgated that make clear the underlying objectives as well as the specific requirements that apply.
- ✦ Bodies responsible for external audit inspections consider relevant attributes of audit quality, both within audit firms and on individual audit engagements.
- ✦ Effective systems exist for investigating allegations of audit failure and taking disciplinary action when appropriate.

## OUTPUTS

### The value and timeliness of:

#### Engagement Level

#### From the Auditors

- ✦ Auditor's reports to users of audited financial statements
- ✦ Auditor's reports to those charged with governance
- ✦ Auditor's reports to management
- ✦ Auditor's reports to financial and prudential regulators

#### From the Entity

- ✦ The audited financial statements
- ✦ Reports from those charged with governance, including audit committees
- ✦ From Audit Regulators
- ✦ Providing information on individual audits

### 2.2 Firm and National Levels

#### From the Audit Firm

- ✦ Transparency reports
- ✦ Annual reports

#### From Audit Regulators

- ✦ Providing an aggregate view on the results of audit firm inspections

## INTERACTIONS

### Effective Interactions Between:

- ✦ Auditors and management, those charged with governance, users, regulators
- ✦ Management and those charged with governance, regulators, users
- ✦ Those charged with governance and regulators, users
- ✦ Regulators and users

## CONTEXTUAL FACTORS

- ✦ Business practices and commercial law
- ✦ Laws and regulations relating to financial reporting
- ✦ The applicable financial reporting framework
- ✦ Corporate governance
- ✦ Information systems
- ✦ Financial reporting timetable
- ✦ Broader cultural factors

FINANCIAL REPORTING COUNCIL UK's independent regulator (2008: 3-7) in a statement about "a framework for audit quality" explained the dimensions and indicators to assess the quality of audit as follows:

### The culture within an audit firm;

The culture of an audit firm is likely to provide a positive contribution to audit quality where the leadership of an audit firm:

- ✦ Creates an environment where achieving high quality is valued, invested in and rewarded.
- ✦ Emphasizes the importance of 'doing the right thing' in the public interest and the effect of doing so on the reputation of both the firm and individual auditors.
- ✦ Ensures partners and staff have sufficient time and resources to deal with difficult issues as they arise.

- ✦ Ensures financial considerations do not drive actions and decisions having a negative effect on audit quality.
- ✦ Promotes the merits of consultation on difficult issues and supporting partners in the exercise of their personal judgment.
- ✦ Ensures robust systems for client acceptance and continuation.
- ✦ Fosters appraisal and reward systems for partners and staff that promote the personal characteristics essential to quality auditing.
- ✦ Ensures audit quality is monitored within firms and across international networks and appropriate consequential action is taken.

### The skills and personal qualities of audit partners and staff;

The skills and personal qualities of audit partners and staff are likely to make a positive contribution to audit quality where:

- ✦ Partners and staff understand their clients' business and adhere to the principles underlying auditing and ethical standards.
- ✦ Partners and staff exhibit professional skepticism in their work and are robust in dealing with issues identified during the audit.
- ✦ Staff performing detailed 'on-site' audit work have sufficient experience and are appropriately supervised by partners and managers.
- ✦ Partners and managers provide junior staff with appropriate 'mentoring' and 'on the job' training.
- ✦ Sufficient training is given to audit personnel in audit, accounting and industry specialist issues.

### The effectiveness of the audit process;

An audit process is likely to provide a positive contribution to audit quality where:

- ✦ The audit methodology and tools applied to the audit are well structured and:
- ✦ Encourage partners and managers to be actively involved in audit planning.
- ✦ Provide a framework and procedures to obtain sufficient appropriate audit evidence effectively and efficiently.
- ✦ Require appropriate audit documentation.
- ✦ Provide for compliance with auditing standards without inhibiting the exercise of judgments.
- ✦ Ensure there is effective review of audit work.
- ✦ Audit quality control procedures are effective, understood and applied.
- ✦ High quality technical support is available when the audit team requires it or encounters a situation it is not familiar with.
- ✦ The objectives of ethical standards are achieved, providing confidence in the integrity, objectivity and independence of the auditor.
- ✦ The collection of sufficient audit evidence is not inappropriately constrained by financial pressures.

### The reliability and usefulness of audit reporting;

Audit reporting is likely to provide a positive contribution to audit quality where:

- ✦ Audit reports are written in a manner that conveys clearly and unambiguously the auditor's opinion on the financial statements and that addresses the needs of users of

financial statements in the context of applicable law and regulations.

- ✚ Auditors properly conclude as to the truth and fairness of the financial statements.
- ✚ Communications with the audit committee include discussions about:
  - ✓ The scope of the audit.
  - ✓ The threats to auditor objectivity.
  - ✓ The key risks identified and judgments made in reaching the audit opinion.
  - ✓ The qualitative aspects of the entity's accounting and reporting and potential ways of improving financial reporting.

#### **Factors outside the control of auditors affecting audit quality.**

Factors outside the control of auditors which are likely to make a positive contribution to audit quality include:

- ✚ An approach to corporate governance within the reporting entity that attaches importance to corporate and financial reporting and to the audit process.
- ✚ Audit committees that are active, professional and robust in dealing with issues identified during the audit.
- ✚ Shareholders that support auditors, where appropriate, thereby increasing the likelihood that directors and management will comply with their obligations in relation to the preparation of reliable financial statements.
- ✚ Reporting deadlines that allow the opportunity to carry out an audit without undue reliance on work performed before the end of the reporting period.
- ✚ Appropriate agreed arrangements for any limitation of liability. An audit regulatory environment that focuses on the drivers of audit quality.

Public Company Accounting Oversight Board (PCAOB) (2015: 13) in the statement of the "CONCEPT RELEASE ON AUDIT QUALITY Indicators" describes the dimensions and indicators to assess the quality of audit as follows: The 28 potential indicators are:

## **AUDIT PROFESSIONAL**

#### **Availability indicators are:**

- 1) Staffing Leverage
- 2) Partner Workload
- 3) Manager and Staff Workload
- 4) Technical Accounting and Auditing Resources
- 5) Persons with Specialized Skill and Knowledge

#### **Competence indicators are**

- 6) Experience of Audit Personnel
- 7) Industry Expertise of Audit Personnel
- 8) Turnover of Audit Personnel
- 9) Amount of Audit Work Centralized at Service Centers
- 10) Training Hours per Audit Professional

#### **Focus indicators are**

- 11) Audit Hours and Risk Areas
- 12) Allocation of Audit Hours to Phases of the Audit

## **AUDIT PROCESS**

#### **Tone at the Top and Leadership indicators are**

- 13) Results of Independent Survey of Firm Personnel

#### **Incentives indicators are**

- 14) Quality Ratings and Compensation
- 15) Audit Fees, Effort, and Client Risk

#### **Independence indicators are**

- 16) Compliance with Independence Requirements

#### **Infrastructures indicators are**

- 17) Investment in Infrastructure Supporting Quality Auditing

#### **Monitoring and Remediation indicators are :**

- 18) Audit Firms' Internal Quality Review Results
- 19) PCAOB Inspection Results
- 20) Technical Competency Testing

## **AUDIT RESULTS**

#### **Financial Statements indicators are**

- 21) Frequency and Impact of Financial Statement Restatements for Errors
- 22) Fraud and other Financial Reporting Misconduct
- 23) Inferring Audit Quality from Measures of Financial Reporting Quality

#### **Internal Control indicators are**

- 24) Timely Reporting of Internal Control Weaknesses

#### **Going concern indicators are**

- 25) Timely Reporting of Going Concern Issues

#### **Communications between Auditors and Audit Committee indicators are**

- 26) Results of Independent Surveys of Audit Committee Members

#### **Enforcement and Litigation indicators are**

- 27) Trends in PCAOB and SEC Enforcement Proceedings
- 28) Trends in Private Litigation

#### **The Impact of Auditor's Independence on Audit Quality**

Various theories were put forward by the experts stated that the independence of the auditor affect the quality of the audit include: Ross L. Watts, et.al (1986: 314) states that "to create a demand for audit services, auditors have to convince the market that they have some competence and they will have some independence from the client". The same thing was also confirmed by Arens, et.al (2014: 134) that "the value of auditing depends heavily on the public's perception of the independence of auditors". Similarly, David N. Ricchiute (2006: 36) states that "In practice, independence is powerfully important to the profession's reputation as a trusted player in the market for audit services. The financial community values the reports of certified public accountants precisely because CPAs are perceived as having no vested financial or personal interest in the outcome of the engagement". Some recent research also said similar things about the impact of auditor's independence on audit quality, among others: Enofe, et.al (2013: 131) states that "as auditors' independence increase,

the quality of the audit also improves". The same thing was also confirmed by Eko Suyono (2012: 42) states that "independence of auditor and accountability affect audit quality". Similarly, Novie Susanti Suseno (2013: 82) asserts that "auditor independence significantly influences the audit quality".

## Conclusion

Auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. To carry out an audit in a manner that meets the reasonable expectations of users of audited financial statements, it is essential that work is performed with due regard for audit quality. The quality of auditing is an audit conducted in accordance with auditing standards generally acceptable that can detect and report material misstatements in the financial statements include disclosure relating either caused by an error/fault or fraud, is able to provide assurance of internal controls, and capable to provide going concern warnings. It depends on auditor's independence. The independence of the auditor is the auditor's ability to maintain mental attitude objectively and impartially in the interests of the client in conducting the audit, analyzing the results, and attestation in the audit report. It is composed of three dimensions namely programming independence, investigative independence, and reporting independence. Based on theoretical approaches can be concluded that audit quality is affected by the auditor's independence. The more independent an auditor then increasing audit quality.

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