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Independence of Internal Auditors: Significance, Guidelines, and Influencing Factors

Manasseh Njagi
Department of Business Administration, Technical University of Mombasa.

Charles G. Kamau
Department of Accounting and Finance, Technical University of Mombasa

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Abstract:

Internal auditing plays an immensely significant role in diverse areas, encompassing the preservation of financial reporting integrity, the fortification of investor confidence, the assurance of compliance with regulations, the detection of fraudulent activities and errors, the enhancement of corporate governance, the optimization of business efficiency, the evaluation of creditworthiness, the promotion of regulatory compliance and accountability, the fostering of trust and transparency, and the safeguarding of stakeholders' interests. This article seeks to underscore the pivotal importance of auditing and the function of audit impartiality in guaranteeing the dependability and credibility of financial information utilized in credit and investment resolutions. The article accentuates the inevitability of auditor independence in preventing conflicts of interest and preserving impartiality throughout the audit process. The paper concludes that incessant endeavors to reinforce auditor independence through resilient regulatory frameworks and ethical training programs are imperative to ensuring the integrity and credibility of the audit process.

Keywords: Audit independence, Internal Audit, Audit guidelines, Audit significance

1. Introduction

Auditors, independence refers to the concept that auditors must be free from any bias, conflict of interest, or undue influence that could compromise their ability to provide objective and unbiased opinions on the financial statements of an organization. The independence of Auditors is essential to maintain the integrity and credibility of the

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auditing process and to ensure the accuracy and reliability of financial reporting (Moore et al., 2006).

Auditing can be traced back to ancient civilization, where trade and commerce activity created a need for some form of verification and assurance (Frazer, 2020). In performing an audit, an auditor has to remain impartial and objective, free from conflicts of interest and bias.

2. Importance of auditing

The fundamental and primary function of audit independence is to fulfill the purpose of conducting an audit in a manner that is beyond reproach. This is achieved by engendering an environment of utmost objectivity in the planning and execution of the audit process. The immediate goal of the audit is to enhance the dependability and trustworthiness of the information that is employed in the context of investment and credit decisions (Masyitah, 202). Auditing is an essential function in the following areas:

Financial Reporting Integrity: The process of auditing is an essential element that ensures the accuracy and reliability of financial statements and reports (Boskou et al., 2019). The significance of this process is undeniable, as investors, shareholders, creditors, and other stakeholders rely heavily on these financial statements to make informed decisions about their investments or business relationships. It is through the independent audit that assurance is provided that the financial information presented is free from any material misstatement or fraud.

Investor Confidence: The impact of audited financial statements on investor confidence in a company's financial health and performance cannot be overstated. When investors are confident in the accuracy of financial information, they are more likely to invest in the organization, thereby contributing to its growth and stability. The importance of this confidence cannot be overemphasized, and it is a critical factor that determines the success of any business.

Compliance and Regulation: The preparation of audited financial statements is mandated by various laws, regulations, and accounting standards that many businesses are subject to (Barodiya, 2019). For instance, publicly traded companies are required to have their financial statements audited by external auditors to comply with securities regulations. This compliance is essential to ensuring transparency and accountability, which are critical for organizational success.

Detection of Fraud and Errors: Auditors are trained professionals who possess the expertise required to detect fraud and errors in financial records. Through thorough examination and testing, auditors can uncover irregularities that may have gone unnoticed,

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thereby helping to prevent financial misstatements or fraudulent activities. The importance of this function cannot be overemphasized, as it contributes significantly to the integrity of financial reporting.

Enhancing Corporate Governance: Auditing contributes to good corporate governance by providing an independent evaluation of the company's internal controls, risk management practices, and overall financial health (Spira & Page, 2003). This oversight helps ensure that management acts in the best interest of shareholders and other stakeholders. The significance of this function cannot be overemphasized, as it contributes significantly to the success of the organization.

Business Efficiency and Improvement: Auditors often provide recommendations for improving internal controls and operational efficiencies, helping companies optimize their processes and reduce the risk of financial mismanagement. This function is critical for organizational success and contributes to the overall efficiency and effectiveness of the business.

Creditworthiness and Lending Decisions: Lenders and creditors rely heavily on audited financial statements to assess a company's creditworthiness and determine the terms of loans and credit facilities (Meeks & Barr-Pulliam, 2023). Having audited financials can improve the organization's credibility and bargaining power in financial transactions. The importance of this function cannot be overemphasized, as it is a critical factor that determines the success of any business.

Regulatory Compliance and Accountability: Public entities and certain private organizations are accountable to regulatory bodies, shareholders, and the public. Audits provide an independent assessment of the organization's compliance with applicable laws, regulations, and industry standards. This compliance is essential to ensuring transparency and accountability, which are critical for organizational success.

Trust and Transparency: Auditing fosters trust and transparency between management, stakeholders, and the public. It demonstrates a commitment to accountability and ethical business practices. The significance of this function cannot be overemphasized, as it contributes significantly to the integrity of financial reporting.

Stakeholder Protection: Auditing safeguards the interests of various stakeholders, including employees, suppliers, customers, and the community at large. It helps ensure that resources are managed responsibly and that potential risks are appropriately disclosed. The importance of this function cannot be overemphasized, as it contributes significantly to the success of the organization.

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3. Rules on Auditor's Independence

The auditor's independence is emphasized primarily because it prevents conflict of interest and ensures clear judgment Decisions, by not exerting undue pressure or influence on the audit being conducted. When auditors are not independent, there is a high risk of potential errors, omissions, or even fraud in the financial statement (Taha, 2023). The paramountcy of the auditor's independence is due to its capability to prevent the emergence of conflicts of interest and ensure unbiased and transparent judgments, with no undue pressure or influence on the audit. In the absence of independence, the risk of probable errors, omissions, or fraudulent activities, which may lead to distorted financial statements, is considerably high. Therefore, the independence of auditors is a critical factor in ensuring the reliability and integrity of financial reporting. Auditor independence is a crucial factor to consider when seeking to bolster the credibility and effectiveness of auditing. As such, there exists a pressing need to enhance auditor independence through the adoption of stringent independence rules and the provision of guidance to auditors on how to maintain independence. This is in line with the recommendations made by Kamau et al. (2023), who underscore the importance of strengthening auditor independence as a means of improving the overall quality of auditing services. The auditor's independence is achieved under the following rules:

Independence in fact and appearance: The concept of independence, both in actual practice and in terms of public perception, is an essential element of auditors' work. In order to maintain impartiality, auditors must steer clear of any circumstances that might give rise to doubts about their independence, in addition to abstaining from actual conflicts of interest.

Prohibited services: To guarantee their autonomy, auditors are not allowed to provide certain non-audit services to the clients they audit. Consulting and bookkeeping services, for example, are among the prohibited services.

Rotation of Auditors: In accordance with regulations in various countries, companies are required to change their audit firms after a certain period of time. This practice serves to prevent the establishment of unduly close ties between auditors and their clients, which could compromise their ability to maintain objectivity.

Prohibition of financial interest: To avoid any conflicts of interest, auditors are advised to refrain from possessing any direct financial interests in the companies they audit, as this could lead to potential conflicts of interest, particularly with regard to their close relatives.

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Reporting to the board: Finally, auditors must report their findings to the board of directors or the audit committee of the client company, ensuring that management is unable to alter their conclusions. Such reporting is critical in upholding the integrity of the audit process. According to the findings of Kamau et al. (2014), it was observed that the degree of participation exhibited by the internal auditors in the management activities has a profound impact on their professional autonomy, and thus, their ability to perform their duties in an unbiased and objective manner. Moreover, it was also determined that the effectiveness of audit committees is a crucial factor in promoting and sustaining audit independence. Hence, it can be inferred that both internal auditors and audit committees play a pivotal role in ensuring the integrity and credibility of the audit process.

4. Factors that influence auditor's independence

Auditors have an ethical obligation to perform their work with the utmost diligence and impartiality without succumbing to any improper influence or pressure from the management or employees of the organization under scrutiny. The importance of audit independence cannot be overstated, as a lack of such independence can potentially lead to significant discrepancies between the audit work and the expectations of the users of the financial statements, thereby undermining the very essence of the auditing process (Kamau, 2022). Several factors play a role in determining the level of internal audit independence. these are:

Financial Interest and Relationships: In order to ensure the credibility and objectivity of the auditing process, it is imperative that auditors avoid any direct or indirect financial interest in the firm under investigation. This may include the possession of large shares or bonds in the company or having close family members who own stock in the organization. Failure to take appropriate measures to avoid such conflicts of interest can compromise the auditor's independence.

Non-Audit Service: It is important for auditors to avoid becoming overly involved in the management decisions of the client firm, as such involvement can compromise their independence and objectivity during the auditing process (De Zwaan et al., 2011). This can have serious implications for the accuracy and reliability of the audit report and may lead to potential conflicts of interest that can undermine the integrity of the audit process.

Fee Dependence: In order to maintain their independence and objectivity, audit firms must not heavily depend on any one client or rely too heavily on revenue from a single source. This can lead to a compromise of the firm's independence and create conflicts of interest that may undermine the credibility of the audit process.

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Audit Tenure: Prolonged relationships between auditors and clients can create familiarity threats, potentially leading to the overlooking of critical issues that require attention. It is important for auditors to maintain a healthy sense of skepticism and objectivity and to continually challenge assumptions and scrutinize evidence in order to ensure that the audit process remains unbiased and objective.

Management Pressure and influences: Auditors can be subject to pressure from management that seeks to influence the outcome of the audit process in their favor. A strong and independent audit committee can help mitigate this risk by ensuring that auditors are free to make independent decisions and are not unduly influenced by external factors.

Regulatory Oversight: Regulatory bodies play a critical role in establishing and enforcing standards for auditors and audit firms, promoting ethical behavior, and ensuring independence. A robust regulatory framework is essential for maintaining the integrity of the auditing process and upholding the highest standards of professionalism and ethical conduct.

Internal quality control: Effective internal control systems can help promote independence and objectivity in the auditing process. Policies and procedures for audit planning, execution, and review can reduce the risk of undue influence and ensure that the audit process remains unbiased and objective.

Auditor's Professional Skepticism: A mindset of professional skepticism is essential for auditors, enabling them to challenge assumptions and maintain an objective viewpoint throughout the audit process. This is critical to ensuring the accuracy and reliability of audit reports and upholding the highest standards of professionalism and ethical conduct.

Education and Training: Continuous education and training programs focused on independence issues and ethical considerations are essential for reinforcing the importance of maintaining independence among auditors. Such programs can help promote a culture of ethical behavior and professionalism, ensuring that auditors remain fully committed to upholding the highest standards of independence and objectivity throughout their careers.

5. Rules on Auditor's Independence

In today's multifaceted business environment, the significance of auditing and the independence of auditors cannot be overstated. The indispensable role of auditing is to ensure the accuracy and reliability of financial information, which in turn instills trust and confidence in investors, creditors, and other stakeholders. The objectivity and impartiality of auditors are of the utmost importance to maintaining their independence. The scope of auditing extends to a wide range of spheres, including but not limited to financial reporting

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integrity, investor confidence, compliance and regulation, fraud detection, corporate governance, business efficiency and improvement, creditworthiness and lending decisions, regulatory compliance, and stakeholder protection. One of the primary goals of auditors is to promote transparency, accountability, and ethical practices within organizations through their thorough examination and testing.

To preserve their independence, auditors must follow strict guidelines and abide by specific rules. These include maintaining independence in fact and appearance, refraining from offering certain non-audit services to clients, rotating audit firms periodically, avoiding financial interests in the audited companies, and reporting their findings directly to the board or audit committee to prevent undue interference. Numerous factors influence the level of auditor independence, such as financial interests, relationships with the client firm, fee dependence, audit tenure, management pressure, regulatory oversight, internal quality control, professional skepticism, and ongoing education and training.

It is essential to recognize the significance of auditor independence and the critical role it plays in bolstering the credibility and effectiveness of auditing. Therefore, it is crucial to continue enhancing auditor independence through robust regulatory frameworks, ethical training programs, and a strong commitment to professionalism and objectivity. Ultimately, the independence of auditors is the cornerstone of ensuring the reliability and integrity of financial reporting, which is vital for fostering trust among stakeholders and contributing to the success of organizations in the global business landscape.

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