



Various Factor Affecting External and Internal Auditor Performance: Analytical Perspectives of Employees Working in Karachi Audit Firm and Companies

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Abstract

Giving an independent opinion on the financial statement is one the key jobs of an auditor. Issue of auditor's independence increases everywhere in the world. We have focus on the factors that compromise auditor's independence. For this purpose, we have chosen four factors to understand how it effect on auditor independence. Factors are audit fee, audit tenure, audit market competition, Non-Auditing services. We have asses' relationship between auditor independence and the four factors which can compromise auditor's independence. For this research we have developed questionnaire and distribute among internal & external auditors and also distribute among accounts and finance managers who are working in audit firms and in corporate sector of Karachi. To determine how four factors compromise auditor's independence, we use "Five Likert scale ". First we have collected the data and then analyzed by using correlation and regression analysis. Finding of our research suggest that audit tenure has significant and positive relationship with auditor independence. Other factors also influence on auditor's independence but not as audit tenure. From this study we know that audit tenure increases the level of independence. So the regulators and policy makers need to increase the year of audit rotation and reconsider their policy.

1. Introduction

1.1. How the independence of auditors has changed over time

The story of auditor independence goes back to the early days of modern accounting methods and is very complicated and always changing. Here is a quick summary:

1.2. The Early Years of Development

When accounting became an official field in the late 1800s and early 1900s, the idea of an independent auditor came about. Auditors were paid by the companies whose financial records they looked at at first, which could have caused conflicts of interest.

1.3. Response of the regulators

Because governments weren't sure how reliable financial reporting was, they started putting in place rules to protect the freedom of audits. This is how the U.S. Securities and Exchange Commission (SEC) came to be: the Securities Act of 1933 and the Securities Exchange Act of 1934. Companies that were sold on the stock market had to go through independent audits by this regulatory body.

1.4. Standards for Professionals

To help auditors be more independent, groups like the International Federation of Accountants (IFAC) and the American Institute of Certified Public Accountants (AICPA) set standards and rules. These guidelines covered issues like auditor turnover, the sharing of money between auditors and clients, and the offering of services other than audits.

1.5. Harmonization on a global scale

As businesses around the world become more linked, efforts were made to make sure that auditor independence was the same in all areas. The International Auditing and Assurance Standards Board (IAASB) and other international groups worked hard to make standards that could be used by everyone.

1.6. Problems caused by technology

As new technologies like AI and data analytics came out, they created both opportunities and problems for inspector independence. Although these technologies could make audits better, they have also raised concerns about how objective inspectors will be and how likely it is that they will have conflicts of interest.

1.7. Crimes and scandals

Accounting scams like Enron and WorldCom in the early 2000s made it clear how important it is for auditors to be free from outside influence. These scandals made people look more closely at accounting methods, and the US passed stricter laws, such as the Sarbanes-Oxley Act of 2002.

As partners and business settings change, new tools come out, and standards are updated, the area of auditor independence is always being worked on in terms of control and application. To protect the honesty of financial reporting, government bodies, organizations that set standards, and professional groups are always improving and strengthening independent standards.

Protecting the interests of investors, creditors, and other capital market stakeholders has been made easier by the idea of auditor independence. This has always been a key part of making sure that financial information is accurate and reliable.

1.8. Theories that support auditor independence

Independence of auditors is an important idea in the auditing field because it makes sure that auditors do their jobs without any bias or conflicts of interest. Many reasons and answers have been put forward for why auditor independence is important. Here are a few of the most

1.8.1. The theory of agency

The agency theory says that there are conflicts of interest when ownership and power are not linked in a company. When shareholders (principals) give managers (agents) the power to make decisions, the managers may put their own interests ahead of those of the owners. Agency theory says that owners rely on auditors to give them unbiased information about how accurate management's financial records are in showing the company's finances and success. Being independent as an auditor helps with the agency problem by making sure that auditors' goals are in line with what's best for stockholders.

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1.8.2. Communication Asymmetry

This happens when one person in a deal has better or more relevant knowledge than the other person. When it comes to audits, there is an information gap between management, who knows everything about the organization's finances, and external players, like investors and creditors, who rely on financial accounts made by management. To lessen information inequality, it is very important that auditors are independent. This is because it gives outside parties reliable and unbiased assurances about the accuracy and integrity of financial reports.

1.8.3. Stakeholder theory

which says that businesses should think about the needs of all stakeholders, like customers, workers, suppliers, and the community, as well as their own shareholders' profits. In the context of audits, stakeholders expect accountants to give them independent proof that the company is working in the best interests of all stakeholders, not just stockholders. Because accountants are not controlled by management, they can act in the best interests of all parties without any bias.

1.8.4. Institutional theory

beliefs, and institutions have an effect on how organizations act and what they do. Some societal factors that affect how accounting companies and accountants do their jobs are professional standards, government rules, and public demands. Codes of professional ethics, rules, and regulations are institutional structures that help to protect auditor independence by setting standards of behavior and giving accountants reasons to keep their independence.

1.8.5. The economists of behavior

By combining ideas from economics and psychology, behavioral economics looks at how people make choices in the real world. Behavioral economics says that auditors may fall victim to psychological and cognitive errors, such as self-interest, overconfidence, and obedience, which could make them less independent when they are auditing. The goal of methods for auditor independence, such as the turnover of audit partners and companies, is to reduce these biases and promote fairness in audit decisions. There are different ideas about how important it is for auditors to be independent. These ideas help come up with rules, guidelines, and steps that are meant to protect auditors' freedom and make financial reports more reliable.

1.8.6. Example of a neutral auditor

A recent event that shows how important it is for auditors to be independent is the bankruptcy of Wire card AG, a German financial company. Wire card was once praised for its hopeful progress in the fintech sector, but it was later accused of theft and financial irregularities, which led to the company going bankrupt and the arrest of its former leaders.

The Wire card scandal made people worry about the independence of accountants because the company had a close relationship with its accounting firm, Ernst & Young (EY). Regarding a long time, EY was Wire card's auditor, providing audit and non-audit services to the company. Critics said that EY's independence was harmed by having this dual role and that the supposed financial wrongdoing at Wire card wasn't properly identified or investigated.

Concerns were raised about the effectiveness of audit procedures, the level of governmental oversight, and the potential for conflicts of interest when auditing companies provide nonaudit services to their audit clients after the incident. It also led to calls for changes that would make audits more independent, make things more clear, and improve the way companies are run. This story about Wirecard shows how important it is for auditors to be independent in order to keep people's trust in the financial markets. This makes it very important for accountants to do their jobs without any personal or arbitrary biases or investments. They should do this with objectivity, question, and expert judgement. The Wirecard scandal's effects have led to a new look at how independent auditors really are and the start of conversations about possible changes that could be made to improve government oversight and responsibility in the auditing field.

1.8.7. Auditor independence in Pakistan

Well according to companies act 2017 each and every company must require to verify their financial statements from independent third party which is an auditor. The independence level of Pakistani auditors in Big 4 firm is quite high as compared to the rest of the audit firm, because big 4 firms are recognized internationally and their audit partner do not compromise their independence when giving their opinion.

1.8.8. Why is this important?

Auditors independence play a crucial role because they are the one that add credibility in the financial statements (Hellman, 2006). The audit quality and auditor independence have a very strong relationship because if auditor independence decline audit quality will also decline and vice versa (Lokman & Bakri, 2020). The main element for an auditor is their independence because whole building depend on it (Minh Duc et al., 2019). Independence of an auditor is the most important ingredient for the financial statement (Kinney et al., 2004).

1.9. Research problem

Auditors main role is to give their opinion on the financial statements independently, because it is crucial for shareholder decision, but auditors have been neglected their independence (Tepalagul & Lin, 2015). They compromised due to conflict of interest. Audit fee, audit tenure, Non auditing services, and audit market competition are the causes of conflict of interest (Lokman & Bakri, 2020). The corporate world and stakeholder have questioned the credibility of auditors due to controversial corporate scandals by big 5 and all happen due to auditors conflict of interest which decline their independence (Lal Bhasin, 2013).

1.10. Research Objectives

To find out the factors that affecting auditor's independency.

To evaluate the most important factor that causes auditor independency compromised.

To find out how much auditors follow code of professional ethics to maintain independency

1.11. Research questions

What are the factors which affect auditor's independency?

Which is the most important factor that is the cause of auditor's independency? How code of conduct plays its role and maintain auditor's independency?

1.12. Justification

We do this research to find out how auditors independency affected by different factors. This research will be helpful for the accountancy firms to know how different factors are the cause of auditor's independency compromised. Accountancy firms will

find put through this research which factors are the most important that is the reason auditors compromised their independency. Shareholder from client perception also understand the importance of auditor's independence.

1.13. Scope

With the help of this research we will examine factors which effect auditor independency negatively. how much the auditor independency is sensitive. How these different factors impact the audit opinion. We will also see how if an auditor not remain independent due to different factors affect the corporate.

1.14. Assumptions

We have made an assumption for this research that data is not biased.

We have an assumption that data is authentic for this research and the sample we select is the representation of whole population.

We are assuming that the data we gathered from individual from Karachi is sufficient for our research.

1.15. key words definition

Professional skepticism: This means that auditor must need to have a questioning mind while doing audit and always remain alert in different situations.

1.16. Code of conduct:

This means that auditor need to follow the guide lines provided by the local institute of chartered accountant

Artificial intelligence: With the help of computer programming the machines are created which perform tasks.

2. Literature review

2.1. Regulatory Environment

Research has extensively analyzed the impact of regulatory frameworks on auditor independence. Studies examine the effectiveness of regulations such as the Sarbanes-Oxley Act, PCAOB standards, and international auditing standards in mitigating threats to independence. They also investigate regulatory changes' unintended consequences and the balance between regulatory compliance and auditor judgment.

2.2. Non-Audit Services (NAS)

A significant body of literature explores the relationship between the provision of NAS and auditor independence. Researchers investigate how offering NAS to audit clients affects independence perceptions, auditor objectivity, and audit quality. They assess whether restrictions on NAS improve independence or lead to unintended consequences.

2.3. Client Importance

The influence of client characteristics, particularly client importance to audit firms, is a focal point in the literature. Studies examine the impact of client size, revenue contribution, and relationship longevity on auditor independence. They analyze how economic incentives stemming from client importance may compromise auditor objectivity and independence.

2.4. Auditor Tenure

Auditor tenure, or the length of the auditor-client relationship, is a widely researched factor affecting independence. Scholars investigate the relationship between tenure and auditor behavior, independence perceptions, and audit quality. They explore whether longer tenure fosters auditor familiarity and complacency or enhances auditor-client understanding and audit effectiveness.

2.5. Audit Firm Characteristics

The characteristics of audit firms, such as size, industry specialization, and reputation, are examined for their influence on independence. Research explores whether larger firms face greater independence challenges due to client pressures or whether specialization enhances auditor expertise and independence.

2.6. Auditor Rotation

Mandatory auditor rotation has been proposed as a measure to enhance independence. Literature reviews assess the effectiveness of rotation policies in mitigating independence threats. Researchers analyze the impact of rotation on audit quality, auditor-client relationships, and market dynamics.

2.7. Auditor Compensation

Studies investigate the relationship between auditor compensation structures and independence. They assess whether fee structures, fee dependence on individual clients, or alternative fee arrangements affect auditor objectivity and independence perceptions.

2.8. Corporate Governance Mechanisms

The role of corporate governance mechanisms, such as independent audit committees and internal control systems, in safeguarding auditor independence is a subject of inquiry. Researchers examine the effectiveness of governance structures in mitigating independence threats and promoting audit quality.

2.9. Ethical Climate

The ethical culture within audit firms and client organizations is studied for its impact on auditor independence. Research explores the role of ethical training, codes of conduct, and organizational culture in fostering ethical behavior and independence among auditors.

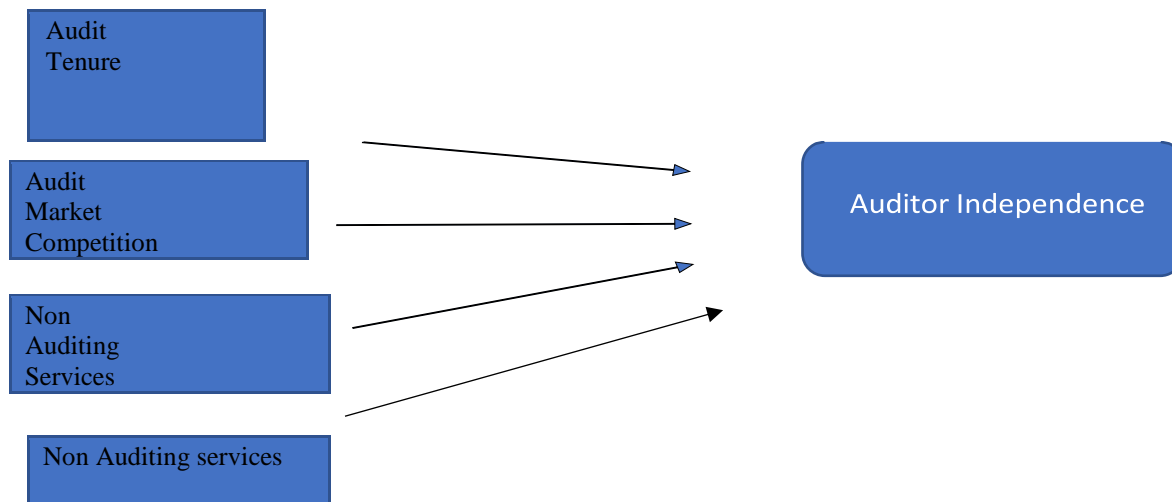
2.10. Auditor Professionalism and Judgment

Factors related to auditor professionalism, including competence, skepticism, and objectivity, are crucial for maintaining independence. Scholars investigate interventions aimed at enhancing auditor judgment and decision-making processes to mitigate independence threats.

3. Conceptual Framework

Independent Variable

Dependent Variable



4. Methodology

4.1. Research design

The quantitative facts and the nature of this paper serve as the foundation for this research study. People who are involved in auditing services, whether internal or external, as well as those who are involved in accounting and finance, were our target audience in order to complete this work. Primary data for this study was gathered through questionnaires. We selected a conceptual framework from many studies, but we also added some new constructs and modified the original framework. Next, we looked at how the alterations affected auditor independence.

4.2. Target population

Internal and external auditors, accountants, and finance managers with auditing experience were the target audience for our study.

4.2.1. Frame of reference

Because they have daily experience working with auditors and carrying out auditing tasks, we have chosen internal and external auditors as well as accounting and finance managers. They are also knowledgeable in auditing both theoretically and practically. These individuals were all chosen from Karachi alone; a small number of them work for auditing firms, and a larger number are employed by corporations. These are the persons with extensive audit expertise and knowledge who have also witnessed the many influences on auditors.

4.3. sample technique

Convenience sampling was employed in the data collection process. In addition to accountants and financial managers employed by corporations, we have also sent our questionnaires to a number of auditors employed by chartered accountancy companies. We delivered self administrative instruments to our target population to get data on the various aspects that impact auditor independence.

4.4. Sample size

Our study had a sample size of 93 out of 120, and the 93 responses were chosen by accountants, internal and external auditors, and professionals working in the finance field. These 93 answers to our questionnaire serve as the foundation for our findings.

4.5. Instrument design

We employed a questionnaire as our study tool. Five Likert scales were included in our survey to assess the degree of precision and imprecision. Strong disagreement is indicated by one point on the Likert scale. On the Likert scale, a five represents strong agreement. Cronbach's Alpha has been used to confirm reliability.

Table 1

CONSTRUCT	NO. OF ITEMS	CRONBACH'S ALPHA
Auditor independence	Statement 1,2,3,4	0.832
Audit fee	Statement 1,2,3,4	0.657
Audit tenure	Statement 1,2,3,4	0.804
Audit Market Competition	Statement 1,2,3,4	0.651
Non auditing services	Statement 1,2,4	0.825

5. Data Analysis

Table 1: Reliability

**Case Processing Summary
(Auditor Independence)**

		N	%
Cases Valid	93	100.0	Excluded 0 .0
a			
Total	93	100.0	

a. List wise deletion based on all variables in the procedure.

Reliability Statistics

Cronbach's

Alpha	N of Items
.657	4

Case Processing Summary

(Audit Fee)

		N	%
Cases Valid	93	100.0	
Exclude	0	.0	
d ^a			
Total	93	100.0	

a. Listwise deletion based on all variables in the procedure.

Reliability Statistics

Cronbach's

Alpha	N of Items
.832	4

Case Processing Summary (Audit Tenure)

		N	%
Cases Valid	93	100.0	
Excluded ^a	0	.0	
Total	93	100.0	

Reliability Statistics

Cronbach's

Alpha	N of Items
.804	4

**Case Processing Summary
(Audit Market Competition)**

		N	%
Cases Valid	93	100.0	Excluded ^a 0 .0
Total	93	100.0	

a. Listwise deletion based on all variables in the procedure.

Reliability Statistics

Cronbach's

Alpha	N of Items
.651	4

**Case Processing Summary
(Non-Auditing Service)**

		N	%
Cases Valid	93	100.0	0 .0
Excluded			
Total	93	100.0	

a. Listwise deletion based on all variables in the procedure.

Reliability Statistics

Cronbach's

Alpha	N of Items
.825	3

The data is reliable as we can see from the Cronbach's alpha. It shows that it is higher than .7 and also tell us that the response of the respondents is accurate. Cronbach's alpha value is .832 which is reliable to accept the data. continue

Table 2: Correlations

		AF_1	AT_1	AMC_1	NAS_1	AI_1
AF_1	Pearson Correlation	1	.727**	.493**	.583**	.624**
	Sig. (2-tailed)			.000	.000	.000
AT_1	Pearson Correlation	.727**	1	.512**	.571**	.589**
	Sig. (2-tailed)	.000		.000	.000	.000
AMC_1	Pearson Correlation	.493**	.512**	1	.516**	.240*
	Sig. (2-tailed)	.000	.000		.000	.021
NAS_1	Pearson Correlation	.583**	.571**	.516**	1	.534**
	Sig. (2-tailed)	.000	.000	.000		.000
AI_1	Pearson Correlation	.624**	.589**	.240*	.534**	1
	Sig. (2-tailed)	.000	.000	.021	.000	

** . Correlation is significant at the 0.01 level (2-tailed).

We've conducted a thorough analysis using SPSS software, encompassing both correlation and regression. The table displays correlations between variables, revealing relationships, whether positive or negative, between them. Notably, there's a positive correlation between the dependent variable, Auditor independence, and the independent variables: Audit fee, Audit tenure, Audit market competition, and Non-Auditing services.

Among these, Audit tenure shows the strongest relationship with Auditor independence (**0.727**), followed by Audit fee (**0.624**), Non-Auditing services (**0.583**), and Audit market competition (**0.493**).

5.1. Regression

By using regression analysis, we can understand how independent variable impact on the dependent variable. All variable impact is checked by using linear regression method.

Table 3

Model Summary				
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.699 ^a	.489	.466	.48384

a. Predictors: (Constant), NAS_1, AMC_1, AT_1, AF_1

ANOVA ^a						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	19.723	4	4.931	21.062	.000 ^b
	Residual	20.601	88	.234		
	Total	40.324	92			

a. Dependent Variable: AI_1

The model's R coefficient indicates a correlation between the two variables. With an R value of (.699), it demonstrates a positive relationship between the independent variables (audit fee, audit tenure, audit market competition, non-auditing services) and the dependent variable (Auditor independence).

The R square value in the table elucidates the coefficient of determination, explaining the square of the coefficient of correlation. With an R square value of .489, it suggests that 48.9% of the variation is reliable for population estimation. The standard error, crucial for analysis, denotes the extent to which collected data may fluctuate within the sample. With a standard error of the estimate of .48384, it implies that 48% of the collected data fluctuates around the mean.

The R Square, representing the coefficient of determination, defines the square of the coefficient of correlation. In this context, the analysis yields an R square of .070, indicating 7% reliability for population estimation.

ANOVA model confirms the model's fitness, showcasing the complete variability around the mean. The sum of squared regression values demonstrates improvement in predicting the value of Y by utilizing the mean of Y. Degree of freedom, associated with variance, is obtained by subtracting the total number of respondents from 1.

The F value in the model indicates its fitness, assessing whether the independent variables correctly predict the dependent variable. Any value above 7 suggests a good fit, signifying accurate prediction. In this model, with an F value of 21.062, it is deemed acceptable and not rejected.

6. Conclusion and Discussion

Our research paper contributes to the literature on auditors' independence by examining this topic within Karachi-based audit firms and corporate sectors. We have assessed the level of auditors' independence from the perspective of both internal and external auditors, as well as accounting and finance managers. According to our respondents, the level of independence is high. A high level of independence indicates that auditors are delivering objective and unbiased services to their clients, which is crucial for boosting the confidence of owners and creditors. It is mandated by the Companies Act 2017 that only qualified

chartered accountants can provide services to limited companies. Auditors are obligated to provide an impartial view to accurately depict the condition of companies. The Institute of Chartered Accountants of Pakistan has implemented stringent policies to enhance auditors' independence, thereby increasing the trust of financial users. Owners, creditors, and banks heavily rely on audit reports when making investment decisions, underscoring the importance of maintaining a high level of independence. Our research suggests that longer audit tenure is associated with an increased likelihood of auditors maintaining independence, as it allows auditors more time to understand client needs and assist in improving their businesses. Contrary to the findings of Abu Bakr & Ahmad (2009), our study did not find evidence that longer audit tenure poses a risk to auditor independence. However, our study has limitations as we only surveyed respondents from Karachi and utilized web-forms, which may introduce bias. Future research should consider these limitations and incorporate additional factors not covered in this study.

6.1. Limitation

- Due to time constant we have only selected few factors that affecting auditor's independency.
- Data sample may be small and it might not be the representative of whole population.
- The research data that we have selected is secondary and the data may have some bias opinion.
- Due to time constraint we have only selected firm's individual from Karachi.

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Appendix

Name: _____

Gender:

- Male Female Age:
 24-30 31-40 Above 40

Level of education Diploma in accounting and finance

- Bachelors in accounting and finance
 MBA Finance
 Professional accountancy qualification

Length of services

- 2-3 year 3-6 year Above 6 year

Designation:

- Accountant Internal Auditor Junior Auditor External auditor
 Trainee Auditor **Dependent Variable:**

1. Auditors have questioning mind
2. Auditors remain objective during audit of a company
3. Auditors pass their judgment based on facts
4. Auditors always follow code of professional conduct during audit.

Options: Strongly disagree Disagree Neutral Agree Strongly agree

First Independent variable:

1. Amount of Audit fee influence on the auditor independence
2. Clients influence on the auditor decision with the amount of audit fee

3. Auditors provide judgment based on facts and his/her and not on the basis of remuneration
4. Auditors satisfied with fees they get from clients **Options:** Strongly disagree Disagree Neutral Agree Strongly agree

Second Independent variable:

1. Long audit tenure impact on an auditor independence
2. Due to long audit tenure an auditor get gift from client that impair its independence
3. Due to long audit tenure an auditor acting as an advocate for client in legal dispute which impact on its independence
4. An auditor leak confidential information to his/her friend due to long audit tenure which impact on its independence
Options: Strongly disagree Disagree Neutral Agree Strongly agree

Third independent variable:

1. Audit market competition enhances auditors independence
2. Audit firm put pressure on staff to accept client proposals.
3. For the sake of auditors status auditors do not want to lose key client which decline auditors independence
4. Due to high competition there is an impact on independence of an auditor **Options:** Strongly disagree Disagree Neutral Agree Strongly agree

Fourth independent variable:

1. Audit firm should not provide Non-Auditing services and only provide auditing services to retain independence
2. If audit firm provides non auditing services to client, it does not impair auditors independence
3. If audit firm restrict their auditors to not provide Non-Auditing services to client it enhance their independence
4. When auditors provide Non-Auditing services it decrease economic dependency on client and create threat to independence
Options: Strongly disagree Disagree Neutral Agree Strongly agree