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FACTORS AFFECTING EXTERNAL AUDITORS' INDEPENDENCE IN DISCHARGING THEIR RESPONSIBILITIES: A SURVEY OF MEDIUM LEVEL AUDITING FIRMS IN NAIROBI

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ABSTRACT
This study was carried to establish the factors that affect the independence of the external auditors. The research sought to analyse how provision of non-audit services, audit tenure and how large proportion of audit fees affect the auditors' independence. The target population of study was the medium level audit firms in Nairobi. The research used a descriptive design and collected data from both primary and secondary sources by use of structured questionnaires and by interviewing the respondents. The research used a sample of 20 auditing firms to carry out the research. This sample was selected using stratified sampling technique because the population is heterogeneous. Data analysis was done using descriptive statistics mean and standard deviation. The study revealed that provision of these services improved the quality of audit services to a very great extent. From the findings, relationship with clients improved over the time while to some was strong from the start. The study concludes that audit firm tenure affects audit firm independence, it was established that forcing a change of auditors lowers the quality of audits and increase their costs. The longer an auditor is with a company the more it learns about its personnel, its business and its intrinsic values. The study recommends that external auditors must maintain quality in accordance with the generally accepted auditing standard when accumulating and evaluating the auditing evidence as it is important in having better result of an audit process.
Keywords: External Auditor Independence, Non Audit, Quality of audits, Audit Performance

INTRODUCTION
External auditor independence has been a major concern to both the shareholders and the regulating bodies for a long time. In recent times, it has become more pronounced, given the collapse of Enron, which resulted in the closure of Arthur Andersen, one of the major international accounting firms (Vinten, 2003). Independence Standards Board (ISB, 2000) defined major independence as the: freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise an auditor's ability to realize unbiased audit decisions. External auditor independence will be assessed based on two standards, that is, fact and appearance. Independence in fact refers to the actual objective state of the relationship between medium auditing firms and their clients. Independence in appearance refers to the subjective state of that relationship as perceived by clients and third parties (Arens et al, 2006) and Whittington and Pany (2004). Arens *et al.* (1999) defined ''independence in auditing'' as taking an unbiased viewpoint in the performance of audit tests, the evaluations of results and the issuance of audit reports. Independence includes the qualities of integrity, objectivity and impartiality. In discussing the foundation of the concept of auditor independence, Pany and Reckers (1983) emphasize that the concept is closely originated from the reason for the existence of auditing itself. According to them, the rationale for the external auditor's work (i.e. independent audit) arises from the need for reliable financial information.

There are two types of auditor independence; actual and perceived independence. Independence in fact (or actual independence) can be defined as the auditor's state of mind, his or her ability to make objective and unbiased audit decisions (Dykxhoorn and Sinning, 1982). It basically refers to the mental attitude of the auditor in terms of professional objectivity (Gul and Tsui, 1992). On the other hand, independence in appearance (or perceived independence) refers to the publics or others' perceptions of the auditor's independence. This notion of independence (i.e. perceived audit independence - PAI) is one of the cornerstones of auditing theory and the *sine qua non* of auditing practice. Since independence in appearance relies on the perceptions of users of financial statements, thus, it is an empirical concept (Dykxhoorn and Sinning, 1981). Most of the literature on external auditor independence suggests that the credibility of financial statements depends on the *perceived* independence of the external auditor by the users of the financial statements (Dykxhoorn and Sinning, 1982). Firth (1980) argues that if the external auditor is not seen to be independent, users will have less confidence in the financial statements, and the auditor's opinion on the company's financial statements will be of no value. Thus, the credibility of auditors depends not only on facts but also, just as importantly, on the perception of independence. Both actual as well as perceived external auditor independence are critical elements in the maintenance of public confidence in the auditing profession (Pany and Reckers, 1980). However, for his study, we will only focus on 'factors affecting auditor's independence' in appearance since the actual independence of an auditor is unobservable.

The impairment or lack of external auditor independence is a main cause of many corporate collapses and corporate scandals across the world. This important issue has constantly been raised by the media. Media comments have demonstrated that external auditor independence is the main concern when talking about corporate scandals. The proposal supplies valuable input and feedback regarding external auditor independence so that these corporate scandals and collapses may be minimized or reduced (Bakar, 2005). Independence is regarded as an important attribute of external auditors. The relatively recent corporate collapses, such as the Enron, has raised important questions about the independence of the external auditor. Independence has been the focus of almost constant controversy, debate and analysis. In spite of these efforts, there are a number of crucial issues which remain unsolved in the research and literature. There is much debate whether the provision of non audit services (NASs) should be prohibited (Gendron and Suddaby, 2004; Alleyne *et al.*, 2006; Carey *et al.*, 2006, Gul *et al.*, 2007) and some researchers argue that the provision of NASs would positively enhance independence (Jenkins, 1999; Windmoller, 2000; Kinney *et al.*, 2004). Other researchers indicate NASs provisions have no influence on the perceptions of independence (DeFond *et al.*, 2002; Quick and Rasmussen, 2005). Several regulatory bodies have recently established new independence standards, since the general setting, within which external auditor independence perceptions are formed, is subject to continuous change (IFAC, 2001; ICAEW, 2001). The reform of the regulatory framework for auditing and accounting and of the ethical guidelines is an on-going process (Beattie *et al.*, 1999). The critical issue is how users perceive auditors' independence and whether it adversely affects or erodes the public's confidence in auditors. Professional accounting bodies have pointed out areas where independence might be compromised such as cases where there are unpaid fees, personal relationships, conflicts of interest and high financial involvement in clients (ICAEW, 2001). This study was aimed at identifying the factors that compromise the external auditor's independence in order to help prevent corporate collapse and restore lost confidence on the practice of external auditing.

Objectives of the study

The main objective of this study is to identify factors that affect the independence of the external auditor. The specific objectives are:

i. To find out how provision of non audit services by the auditor affects the auditor's independence.
ii. To determine how the tenure of an audit firm affects the independence of an auditor.
iii. To identify how the level of competition in the audit services market affects the auditor's independence.

iv. To investigate the effect of the percentage of audit fees received by audit firm, on the auditor's independence.

Research questions

i. How does provision of non-audit services by the auditor affect the auditor's independence?
ii. What is the effect of the tenure of an audit firm on the auditor's independence?
iii. How does competition in the audit services market affect the auditor's independence?
iv. What is the effect of the size of audit fees received by the auditor on the auditor's independence?

Theoretical Review

The customer switching cost theory of competition is widely accepted in the economics literature, among many others. Thus, as set out in detail below, this theory suggests three predictions with respect to audit competition. First, it predicts that audit competition is increasing in the observed proportion of clients switching audit firms. Second, it predicts that regulatory and other changes that make it easier or more valuable for audit clients to switch medium auditing firms increases audit competition. Third, it predicts that auditors will react to these competitive pressures not only by reducing audit prices, but also by becoming more amenable to clients' requests (Farrell and Klemperer, 2006).

This latter prediction follows because the customer is the person making the choice among the alternative service providers, which corresponds directly with management being the customer of audit services, as opposed to investors. Therefore, this theory of competition predicts that if management pressures auditors to accept questionable accounting treatments, even if they are to the detriment of investors, then auditors will become more compliant with such requests as audit competition increases (Zeff, 2006). Zeff (2003) documents historical, factual changes in the audit profession which he argues increased its competitiveness. He also discusses how these changes could have affected auditors' independence and the practice of auditing, and concludes that auditors in recent years seem to be more susceptible to accommodation and compromise on questionable accounting practices, when compared with their more solid posture on such matters in earlier years.

Zeff (2003) goes on to call for rigorous statistical analyses of this question, expressing concern that otherwise the numerous instances of corporate fraud, court cases, and regulatory investigations may be discounted as isolated incidences rather than as evidence of a dramatic change in the accounting profession. Competition has been identified as the most important environmental change or external factor affecting auditor independence. Firms operating in an intensely competitive environment may have difficulty remaining independent since the client can easily obtain the services of another auditor (Shockley, 1991). A number of empirical studies have proven that the high level of competition in the audit firm has resulted in less external auditor independence (Alleyne *et al.,* 2006), however, found the opposite. In explaining this, Gul 2005 argued that the existence of competition caused auditors to be more independent and create a favourable image in order to maintain their clientele.

Another stream of research investigates the economic theory of auditor independence. This theory dictates that auditors trade the expected benefits of compromising their independence against the expected losses. Thus, client importance should be negatively related to external auditor independence (Reynolds and Francis, 2001). In a private company setting, Hope and Langli (2009) use unexpected audit fees as a proxy for potential external auditor independence impairment, and test whether auditors that receive high unexpected fees are less likely to issue a going concern opinion. They argue that a private company setting provides a unique context to give independence impairment tests their best shot, due to both lower auditor reputation and litigation risk compared to a public company setting. In particular, the private client segment of the audit market is subject to fierce price competition due to lower supplier concentration and a larger number of potential suppliers. Hence auditors should not be able to charge rents to their private clients, and therefore unexpected audit fees can only reflect a client's willingness to pay for extra auditor effort or quality (Hope and Langli, 2009).

Srinidhi and Gul, (2009) provide evidence that the level of (unexpected) audit fees is positively related to accrual quality. The positive relationship between audit fees and audit effort can be explained by the high level of competition in the audit services market, which reduces the possibility to earn rents in audit fees. Hope and Langley (2009) indeed confirm the absence of independence impairment related to audit fees in the private firm and low litigation risks. In particular, they find no evidence of a relationship between residual audit fees and the likelihood to receive a modified audit opinion. The evidence on the effects of auditing in private firms is scanty, and mostly relates to firms as financial statement disclosure and auditing is mandatory for companies according to the companies' Act. Unlike the evidence of constraining effects of auditor differentiation on earnings management in publicly listed client segments, the evidence in private company settings is mixed (Eilifsen and Willekens, 2007). Vander and Willekens (2004) report to quality differences between big and non big auditors with respect to constraining earnings management in Belgium. They argue that this lack of differentiation might be due to the importance of non-big N players in this segment of the market. Furthermore, Meulen *et al.,* (2008) find that audit firm portfolio characteristics rather than Big 4 differentiation have a constraining impact on earnings management and disclosure quality. The effects of audit effort (instead of auditor choice) for private companies remain largely unexplored.

It has been suggested in the literature that larger audit firms (Big) are usually perceived as more capable of maintaining an adequate degree of independence than their smaller counterparts because they usually provide a range of services to a large number of clients, hence reducing their dependence on certain clients (Wilson and Grimlund, 1990). In addition, larger audit firms are generally perceived as the provider of high audit quality and enjoy a high reputation in the business environment and as such, would strive to maintain their independence to keep up their image (Wilson and Chow and Rice, 1982)High dependence on a few clients has been found to affect perception of independence (Teoh and Lim, 1996).The probability of switching big audit firms is significantly lower than the probability of switching smaller audit firms, ceteris paribus. Besides the possible effect of the type of audit firms on the length of tenure, the choice of audit firm can be related to the size of the auditee and the type of services needed. It has been argued that larger auditees, due to the complexity of their operations and the increase in the separation between management and ownership, demand highly independent audit firms to reduce agency costs and auditors' self-interest threat (Hudaib and Cooke, 2005).

Furthermore, as the size of the companies increases, it is likely that the number of agency conflicts also increases and this might increase the demand for quality-differentiated auditors (Palmrose, 1994). When businesses continue to grow, the demand for the highly independent and qualified audit firm to reduce agency costs and to provide non-audit services needed for the expansion of the firm increases. Therefore, growing businesses are expected to be more likely to retain their audit firms than their lower growth counterparts (Sinason *et al.,* 2001). DeFond *et al.,* 2000 reported evidence revealing the existence of a direct relationship between the amount of audit fees and the audit client size. The external audit firm is expected to perform more audit work as the client size increases to ensure the performance of an adequate amount of compliance and substantive testing. This increase in audit effort is natural. The relationship between audit fees and client size is unlikely to be linear nonetheless. This conjecture is based on the notion that while the amount of audit work is expected to increase as the client size increases. Very large audit clients represent an opportunity for the audit firm to benefit from certain economies of scale in reducing the amount of audit work performed, and consequently being able to charge lower audit fees. Moreover, the audit fees literature is replete with evidence suggesting that external audit fees increase at a decreasing rate with the audit client size (Gerrard *et al.,* 1994). Palmrose, (1996) research maintains that the relationship between audit fees and client size is unlikely to be linear. Thus, the natural log of the client's total assets has been typically used in most previous research as a measure of the audit client size. Prior research (Carcello *et al.,* 2002) documented empirical results indicating that audit fees are significantly influenced by the level of the audit client complexity.

Gerrard *et al., (*1994) indicated, several audit fee studies interested in examining whether audit fees paid to Big audit firms are significantly higher than fees paid to non-Big firms. There are three main grounds for such an inquiry. First, Big audit firms are said to provide a higher level of audit quality than non-Big audit firms. The second suggests that, since Big audit firms are ''wealthier'' than non-Big audit firms, in the case an audit client company went bankrupt, audit report users for example creditors and shareholders') would be more allured to file lawsuits against Big audit firms. This higher level of litigation risk exposure is expected to be associated with higher levels of external audit fees charged to compensate for such exposure risk. Third, the non-competitive pricing hypothesis suggests that, especially in the large clients segment of the audit market, big audit firms face less competition than non-Big firms and therefore are able to charge higher audit fees. Fees paid to auditors can affect audit quality in two ways large fees paid to auditors may increase the effect exerted by auditors, hence, increasing audit quality. Alternatively, large fees paid to auditors, particularly those that are related to non-audit services, make auditors more economically dependent on their clients. Such financial reliance may induce a relationship whereby the auditor becomes reluctant to make appropriate inquiries during the audit for fear of losing highly profitable fees. Conversely, the potential for audit failure imposes significant economic costs on the auditor (Rahman, 2005).

Though a number of recent studies have examined the relationship between audit and non-audit fees and independence, they are ambiguous as to the relationship between audit fees and auditor behaviour. They also differ on how fee composition and client importance affect external auditor independence (Larcker and Richardson, 2004). Bell *et al*., (2001) find evidence that audit fees are increasing in the engagement partners' assessments of business risk. They suggest that audit firms perceive client-level differences in auditors' business risk and obtain compensation through working additional hours. Pratt (1994) found evidence that audit fees reflect both the amount of effort and an additional premium to cover litigation risks. Houston *et al.* (1999) reports that audit fees appear to include risk premiums when the risk of irregularities is high. The risk premium may arise from potential litigation, sanctions imposed by regulatory bodies, impaired reputation capital or failure to collect fees. Brumfield *et al.* (1983) suggest that auditors could increase the audit effort above the level required by professional standards in response to high business risk of a given client. They also suggest that auditors seek insurance coverage and/or adjust their billing rates based on the perceived level of their business risk associated with clients.

Factors Affecting External Auditors' Independence

Provision of non audit services

As public concerns about the provision of non audit services impairing external auditor independence increased, recent studies have examined the association between non audit fees and auditor independence. However, no study has examined the effects of the provisions of non-audit services, on the successor auditor's perceptions of independence (Ashbaugh *et al.*, 2003). Winifred (2003), reports that auditors' incentives to compromise their independence are directly related to client importance. Client importance would be greater for those clients who pay a high proportion of non-audit fees. High proportion of non-audit fees increases economic bonding with clients, which increases the auditors' incentives to compromise their independence. On the other hand, the accounting industry has argued that the provision of non-audit services increases audit quality as auditors gain better understanding of client's characteristics and the associated audit risk. Notwithstanding the economic bonding issue, another concern about the auditor's provision of non-audit services is that when auditors provide certain non-audit services and then perform the financial statement audit they are in fact auditing their own work. Consider the case of providing FIS services. In today's audit environment, external auditors place more reliance and effort on tests of controls than substantive testing of transactions. An auditor who has performed an FIS engagement may have designed some of the internal controls that were built into the system. The audit employees may not evaluate these controls with the same critical eye and concern that they would use to evaluate the systems designed by the client or another consulting entity (Frankel *et al.* 2002).

While all fees create economic bonds between the auditor and client, debate has typically alleged that the provision of NAS gives provides incentives for audit firms to allow the clients questionable accounting choices, thus reducing external auditor independence and ultimately the quality of financial reporting. The provision of NAS has been the focus of most recent attention, presumably reflecting the widely accepted view that NAS typically is provided at a higher profit margin than audit services (Ruddock and Taylor, 2005). Overall, the survey of the related literature suggests that the provision of NAS does not impair financial reporting quality. In a litigious environment like that of the USA, auditors are expected to constrain aggressive financial reporting because of the high cost of litigation in the event of audit failure (Chung and Lallapur, 2003).

Nelson (2004) argues that the incentives to thwart aggressive reporting are provided by the threat of litigation, reputation los that reduces audit firm's ability to attract clients and maintain higher fees for audit services, professional censuring by auditing governing bodies such as ICPAK, loss of position and potential loss of partnership capital and retirement payouts. Appointing a supplier of NAS will give rise to considerable setup costs, which includes costs of searching for the supplier and familiarization with the business; and the risk of receiving low quality NAS, which comes from the lack of past interaction to demonstrate the supplier's ability. These switching costs make clients less sensitive to the fluctuations in service quality and increase their commitment to the incumbent service supplier (Patterson and Smith, 2003).

There is evidence that relationship length leads to an increase in switching costs as perceived by clients (Tellefsen and Thomas, 2005). NAS, audit firms can conduct NAS efficiently. The existence of set-up costs and knowledge spillovers provides incentives for auditors to award NAS to their current audit firms. As it takes time to pass the initial stage and build the specific assets, clients' perceptions of these costs are higher as they remain with a particular service provider for a considerable time (Jones *et al.,* 2000). A close relationship, developed over time at both the firm level and at the interpersonal level, is essential in the successful selling of NAS. However, there are regulatory concerns that such close relationships and potential economic dependence may have a detrimental effect on auditors' independence and their role as information intermediary in the agency relationship (Ashbaugh *et al.,* 2003).

Audit Firm Tenure

Flint (1988) argued that independence will be lost if the auditor is involved in a personal relationship with the client, as this may influence their mental attitude and opinion. One of such threats is lengthy tenure. He contends that lengthy tenure in office may cause the auditors to develop over-cosy relationships as well as strong loyalty or emotional relationships with their clients, which could reach a stage where external auditor independence is threatened. Lengthy tenure also results in over familiarity and consequently, the quality and competence of auditors' work may decline when they start to make unjustified assumptions instead of objective evaluation of current evidence. ICAEW (2001) recognised that this problem may be perceived as a threat to external auditor independence and recommends that auditors avoid situations that may lead them to become over-influenced or to be too trusting of the client's directors and key personnel which could consequently lead to audit staff being too sympathetic to the client interest. Since, the relationship between the auditor and his client can be close in one way or another regardless of the number of years in office, there is little the profession can do with regard to this matter.

IFAC (2005) recognises that familiarity is one of the significant threats to auditor independence. The main concern of IFAC is that excessive familiarity may result in auditors' complacency or hesitancy to challenge appropriately and thereby reduces the level of scepticism necessary for an effective audit. Louwers (1998) also finds that the length of auditor-client relationship affects auditors' propensity to issue a going concern disclosure to a distressed client. Hence, the proponents suggest that rotation could significantly improve the overall quality of an audit and enhance the quality of the financial reporting process. The view of auditor expertise suggests that auditors gain more experience and build client-specific assets from the ongoing relationship and in turn have a greater ability to detect accounting irregularities (Geiger and Raghunanda, 2002). Some recent studies regard the association between audit firm-client relationship and the quality of earnings to assess the potential effectiveness of auditor rotation (Ghosh and Moon, 2003).

High dependence on a few clients has been found to affect perception of independence. The probability of switching big audit is significantly lower than the probability of switching smaller audit firms, ceteris paribus. Besides the possible effect of the type of audit firms on the length of tenure, the choice of audit firm can be related to the size of the auditee and the type of services needed. It has been argued that larger auditees, due to the complexity of their operations and the increase in the separation between management and ownership, demand highly independent audit firms to reduce agency costs and auditors' self-interest threat (Hudaib and Cooke, 2005). Furthermore, as the size of the companies increases, it is likely that the number of agency conflicts also increases and this might increase the demand for quality-differentiated auditors (Palmrose, 1994).When business continues to grow, the demand for highly independent and qualified audit firm to reduce agency costs and to provide non-audit services needed for the expansion of the firm increases. Therefore, growing businesses are expected to be more likely to retain their audit firms than their lower growth counterparts.

Sinason *et al* (2001) found that the probability of distressed clients switching audit firms is significantly higher than the probability of healthier clients switching audit firms, ceteris paribus and the length of audit tenure to be positively affected by the type of audit firm. In other words, smaller audit firms experience shorter tenure compared to their larger counterparts who often enjoy lengthy tenure. Differences in the length of tenure between the two types of audit firms could impair independence because in the long run, small audit firms will find it difficult to keep their existing clients and at the same time maintain a high degree of independence and objectivity due to increased competition and size mismatch. Ideally, the size of audit firm should match the size of auditee. A size mismatch between large auditees audited by small audit firms could cause termination of the audit engagement (Hudaib and Cooke, 2005).

These views expressed above are not universally accepted. Opposed to auditor rotation is the auditing profession which has argued that as auditor tenure increases, so does an auditor understands of the client's business, control risks and other factors that contribute to audit failures (Pricewaterhouse Coopers, 2002). Geiger and Raghunandan (2002), find that auditors are more likely to issue a clean audit report to a bankruptcy filing in the early years of the auditor-client relationship. Johnson *et al.* (2002) find that the absolute value of unexpected accruals is higher in the early years of the audit-client relationship as compared to ''medium'' auditor tenure, whereas they find no relation between the absolute value of unexpected accruals and auditor tenure when medium tenure is compared with long tenure (nine years or longer). More recently, Geiger and Raghunandan (2002) find that long-tenured auditors are more efficient in the collection and evaluation of evidence than short-tenured auditors. Their results are consistent with long-tenured auditors having a more in-depth knowledge of their clients' financial status and operating systems than short-tenured auditors.

Carcello and Nagy (2004) find that fraudulent financial reporting is more likely to occur in the first years of an audit. In addition, they find no evidence of greater fraudulent financial reporting by clients of long-tenured auditors. Myers *et al.* (2003), test for the association between auditor tenure and earnings quality where the auditor-client relationship lasted for at least five years. In addition, the incentives facing an audit partner are likely to be different from those facing an audit firm which can also lead to a different relationship of tenure with audit quality. As the length of time on an engagement increases the economic incentives to bond with the client may be more strongly present at the partner level than at the audit firm level. Audit partners have compensation incentives that are related to the fees received from client-firms (Trompeter, 1994). Failure to keep a client satisfied can lead to a client's dismissal of the audit firm. Loss of a client affects an audit partner more directly than the audit firm because the latter is able to diversify its revenues over its existing and future client base. Loss of a valued client can lead to an audit partner's dismissal or limit future opportunities offered to that partner by the audit firm. As an audit partner's tenure on an engagement increases, the economic incentives to bond with the client may become stronger. For these reasons, it is possible that the quality of an audit suffers as the tenure of the audit partner on an engagement increases (Arrunada, 1999).

Level of Competition in the Audit Service Market

The audit market has generally been viewed as monopolistic competition. Suppliers could differentiate their services by providing higher quality services. The big auditors' services, for example, are generally perceived as higher quality than others. Within each quality segment, however, the market is considered as generally competitive (Gul, 1999). In a competitive equilibrium, audit fees should reflect audit effort and the expected costs of auditor business risk (Bell *et al.*, 2001).The costs of business risk and the cost of audit failure arise from different reasons although they may correlate. The auditors are paid audit fees for their audit services and the fees reflect the work the auditor must perform to reduce audit risk to an acceptable level. In contrast, business risk is, by definition, a residual risk that cannot be eliminated or reduced below a certain level (Bell *et al.*, 2001).

Utilizing the well-established economic theory of customer switching cost competition, we examine the relation between audit competition and external auditor independence as reflected in the quality of publicly-traded firms' financial statements. Customer switching cost competition theory fits the audit market well because switching cost models of competition best describe service industries characterized by repeated purchases and transactions which require building a relationship; in these industries a firm switching service providers must recreate anew its valuable relationship-specific investments (Farrell and Klemperer, 2006). Sharpe (1997) notes that such relationships-implicit or explicit-clearly abound, particularly among service industries such as medical care, auto repair, life insurance and banking services. These descriptions fit exactly the auditing market where relationships are generally long-term, considerable transactions costs are incurred on switching, and costly-to-duplicate, client specific knowledge is crucial.

CONCEPTUAL FRAMEWORK

In the absence of independence, the value of audit services will be greatly impaired (Sweeney, 1992) and in turn, if an auditor lacks independence, this increases the likelihood that they would be perceived as fewer objectives and therefore less likely to report a discovered breach. Compromised independence results in a lower level of audit quality being provided on financial statements (Baber *et al.*, 1995). In other words, if the auditor is not independent, the incentive to do a high quality audit is weakened, as misstatements will not be reported even if found (pike, 2003). The conceptual framework link the independents variables which as factors affecting independents of auditors to dependent variables (independents of auditors in the firms)

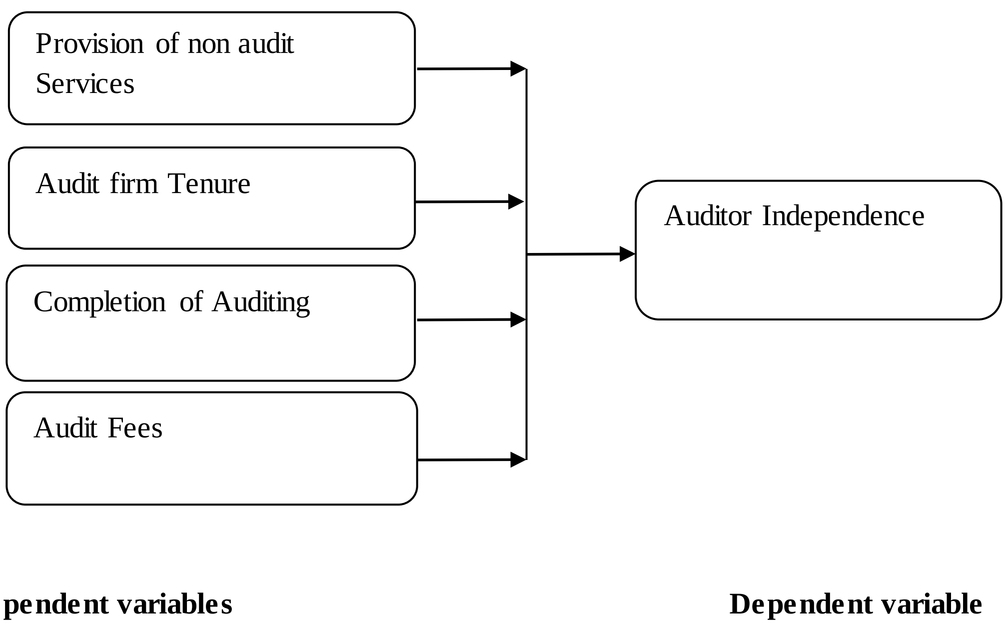

Figure 1 Conceptual Framework

RESEARCH METHODOLOGY

This study used a descriptive survey design approach whereby, the characteristics of the target population are described. This design is appropriate because some information exists about the phenomenon under study. The target population of this study was medium auditing firms operating in Nairobi. According to ICPAK, there are 718 approved auditing firms as at 31st July 2009. 509 of these firms are located in Nairobi, while the remaining 29% are located in other towns countrywide. The audit firms located in

Nairobi can be classified according to size as 5 large, 125 medium and 380 small audit firms. The target population comprises of 83 large and medium auditing firms in Nairobi. The study population comprised 217 staff who are audit managers, audit supervisors, chief auditors and assistant audit officers in the selected audit firms in Nairobi.

Stratified sampling approach was used to select the sample size whereby, the level of auditors in the auditing firms forms the bases for the strata (stratum). The researcher then used simple random sampling technique to select the sample from each stratum. This gave all the elements of the target population an equal chance of being selected. To select the respondents from the, the study adopted Mugenda and Mugenda (2003) who indicated a sample of 10% and 20% will be sufficient for a study. For the purpose of this study, 30% was taken as a sample proportion to sample 64 respondents.

The data was collected on selective basis by use of interviews and questionnaires administered to auditors who are practitioners in the target population. The questionnaire was pre-tested and where appropriate adjusted before the study to establish the effectiveness of the instrument. The opinion of the experts, supervisor was sought in development of the questionnaire to ensure it collects the relevant data to answer the research questions. Cronbach's alpha formula was used in calculating the reliability of data coefficient where reliability value closer to 1 was accepted (Mugenda, 2008).

After fieldwork, the questionnaires were coded for purposes of transcribing the findings into the computer. The coded data was then processed using the Statistical Package for Social Sciences (SPSS version 17.0). The data was presented using tables, charts and cross tabulations facilitate comparison and enhance understanding. Data analysis was done using descriptive statistics mean and standard deviation. Quantitative data analysis involves generation of descriptive statistics namely frequencies and percentages. Qualitative data was done using content analysis technique and presented in prose form.

RESULTS AND DISCUSSIONS

Factors that affects the independence of the external auditor

Figure 2 below shows the average number of audit clients the firm have.

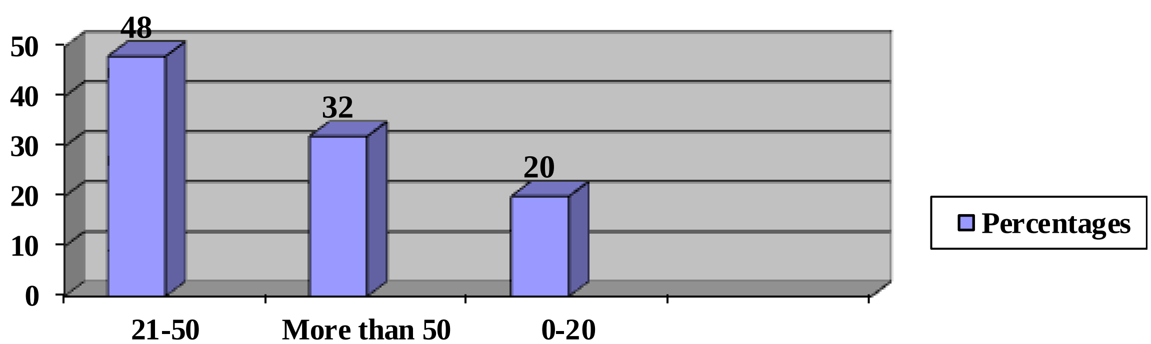

Figure 2 Average number of audit clients

On the average on how many audit clients the firm have, the findings show that 48% of the respondents indicated that the firm had 21-50 audit clients, 32% had 0-20 while 20% of the respondents indicated that the firm had more than 50 audit clients.

Extent to which firm provide other services to clients

Table 1. Extent to which firm provides other services to clients

	Frequency	Percentage
Very great extent	38	65
Great extent	20	35
Total	58	100

The study sought to investigate the extent to which the firm provides other services to the clients. From the findings, 65% of the respondents indicated that the firm provides other services to the clients to a very great extent while 35% of the respondents indicated that firm provides other services to the clients to a great extent. The study found that the firm provided non-audit services to the clients for the expansion of the firm, thus reducing external auditor independence and ultimately the quality of financial reporting. This was in line with Ruddock and Taylor, (2005) who stated that the provision of non auditing services has been the focus of most recent attention, presumably reflecting the widely accepted view that non auditing service typically is provided at a higher profit margin than audit services

Table 2 Other services provided to clients

	Frequency	Percentages
Management services	25	44
Secretarial services	17	29
Tax consulting services	16	27
Total	58	100

The study sought to know the services firm provide to the clients. Most 44% of the respondents indicated that the firm provided the management services, 29% said Secretarial services while 27% of the respondents indicated that the firm provided the tax consulting services. The study further found that other services such as assurances services, including traditional audit, information systems security, internal audit outsourcing and risk assurance were provided. The tax services included corporate and individual planning and compliance and global strategic tax planning while consulting services, included strategic change management, process improvement, systems design and implementation

Table 3 The proportion of total revenue obtained from the services

	Frequency	Percentages
26-50%	28	59
51-75%	17	39
76-100%	8	23
0-25%	5	19
Total	58	100

The study sought to find out the proportion of the total revenue the firm obtained from the services. From the findings, majority 59% and 39% of the respondents indicated that proportion of the total revenue the firm obtained from the services was 26-50% and 51-75% while 23% and 19% indicated that proportion of the total revenue the firm obtained from the services was 76-100% and 0-25%.

Table 3: Tenure with the client affects independence of auditing firm

Factors	Disagree	Neutral	Agree	Strongly agree	Mean	Std deviation
The proportion of non-audit fees paid to you has increased economic bonding with your clients	0	15	29	14	4.87	0.86
Provision of these services has improved on your relationship with your client	6	8	26	18	4.48	0.58
The client's business operations and reporting issues influence audit independence	0	12	22	24	4.44	0.43

The study sought the extent to which respondents agreed with the given statement concerning tenure with the client effects on independence of auditing firm. From the findings, most of the respondent strongly agreed that the proportion of non-audit fees paid to the firm has increased economic bonding with clients as indicated by a mean of 4.87 supported by standard deviation of 0.86. The study further found that most of the respondent agreed that the provision of these services has improved on the relationship with clients and that the client's business operations and reporting issues influence audit independence as indicated by a mean of 4.48 and 4.44 supported by standard deviation of 0.58 and 0.43. On the other ways through which audit firm tenure affects audit firm independence, respondents stated that forcing a change of auditors lowers the quality of audits and increase their costs. The longer an auditor is with a company the more it learns about its personnel, its business and its intrinsic values. To change every several years will simply create a merry-go-round of mediocrity. this was in line with Flint (1988) who argued that independence will be lost if the auditor is involved in a personal relationship with the client, as this may influence their mental attitude and opinion, one of such threats is lengthy tenure. This implies that audit quality is lower given longer auditor tenure.

Relationship with the client effects on audit firm independent

Table 4 : Relationship with the client effects on audit firm independent

	Disagree	Neutral	Agree	Strongly agree	Mean	Std deviation
Auditors should be rotated over time	8	17	24	9	4.29	0.46
Over the years relationship in serving your clients has expected knowledge of the business increased	8	14	19	17	4.48	0.78
Losing a client by being dismissed affects relationship with the client and independence of the auditing firm	0	12	24	22	4.67	0.65
Audit reporting effectively qualified your report to any of your clients	0	9	9	40	4.57	0.73

The Table 4 shows the responses of the extent to which the respondents agreed on the given statement concerning the relationship with the client effects on audit firm independent. From the findings, majority of the respondents strongly agreed losing a client by being dismissed affects relationship with the client and independence of the auditing firm and that audit reporting effectively qualified your report to any of your clients as indicated by a mean of 4.67 and 4.57 supported by standard deviation of 0.65 and 0.73. The study further found that most of the respondents agreed that over the years, relationship in serving clients has expected knowledge of the business increased and that auditors should be rotated over time as indicated by a mean of 4.48 and 4.29 supported by standard deviation of 0.78 and 0.46.

Extent to which competition affects independence of auditing firm

Table 5. Extent to which competition affects independence of auditing firm

	Frequency	Percentages
Very great Extent	37	64
Great Extent	12	21
Moderately Extent	9	15
Total	58	100

The study sought to find out the extent to which competition that exists in the audit service market affects independence of auditing in firm. From the findings, majority (64%) of the respondents indicated that competition that exists in the audit service market affects independence of auditing in firm to a very great extent. 21% of the respondents indicated that the competition that exists in the audit service market affects independence of auditing in firm to a great extent while 15% of the respondents indicated that competition that exists in the audit service market affects independence of auditing firm to a moderate extent.

Large proportions of audit fees lead the auditor to compromise independence

The respondents were requested to indicate how large proportion of audit fees received by an auditor from one client can in some cases lead the auditor to compromise the independence of auditing. From the findings, respondents indicated that unexpected audit fees as a proxy for potential external auditor courses independence impairment, and test whether auditors that receive high unexpected fees are less likely to issue a going concern opinion.

CONCLUSION

The independence of the auditor is a vital aspect for any entity. From the findings, this study concludes that audit firms have a large number of clients that hold exotic financial derivatives. Audit firms provide non-audit services to the clients, the management services, secretarial services, tax consulting services.

The proportion of non-audit fees paid to the firm affects the independence of the external auditor. The effects of providing non-audit services to audit clients on the perception of auditor independence and audit quality have been widely debated. The increased economic bonding with clients, the provision of services improves the relationship with clients and the client's business operations and reporting issues influence audit independence. The study concludes that audit firm tenure affects audit firm independence, it was established that forcing a change of auditors lowers the quality of audits and increase their costs. The longer an auditor is with a company the more it learns about its personnel, its business and its intrinsic values. However the proponents suggest that rotation could significantly improve the overall quality of an audit and enhance the quality of the financial reporting process

RECOMMENDATION

The independence of external auditors is essential to the provision of an objective opinion on the truth and fairness of the financial statements. As such, the audit committee is mandated to ensure continuing objectivity and independence of the external auditors.

The study recommends that external auditors must maintain quality in accordance with the generally accepted auditing standard when accumulating and evaluating the auditing evidence as it is important in having better result of an audit process.

The external auditor's service is a very important aspect to increase financial statement users' trust in the financial report; it gives added value to the financial statement in which users apply this information for decision making. However, some corporate scandals have decreased users' trust in the external auditors. The study recommends that independence of the external auditors must be perceived in order to gather confidence in the financial statements of the clients and to value the auditor's opinion on the company's financial statements. Auditor independence, both in fact and appearance, has long been recognized as an important aspect of audit quality, the study recommends that factors affecting independence of external auditors must be avoided

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