

*Full length research paper*

# **An empirical analysis of auditor independence and audit fees on audit quality**

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Accepted 13 February, 2013

**This study aims to investigate the influence of auditor independence and audit fees towards on audit quality. This study applies explanatory research in which questionnaires and interviews serve as the primary data. The sample of this study is 73 public accountant offices which are the members of the Forum of Capital Market Accountants in Indonesia. The results of this study depicted that auditor independence significantly influences the audit quality and audit fees significantly influences the auditing quality. Such results indicate that the measures to enhance auditing quality can be taken by means of developing independent attitudes and determining sufficient audit fees. In this study, the auditing quality is further divided into seven criteria, i.e. skills, experience, ethical value, mindset, the reliability of auditing methods, the effectiveness of the utilized tools and the technical supports. In addition, independence is divided into two indicators: Integrity and Objectivity. While the audit fee is divided into three indicators: size of an auditee, complexity and risk.**

**Key words:** Auditor, independence, audit fees, audit quality, public accountant office.

## **INTRODUCTION**

Auditors constitutes a profession providing services to the people, particularly in auditing financial reports created by clients. The audit is especially intended to meet the needs of financial information users such as investors, creditors, prospective creditors and government institutions (Boyton and Kell, 2006). As a profession holding considerable responsibility in carrying the trust of the people, auditor needs to ensure the resulted audit quality (Frohnen and Clarke, 2002). In relation to the audit execution, Jun and Lin (2009) stated that recently there have been audit failures resulting from the unreported deviation in audit reports. Arens et al. (2012) stated that audit failures take place when auditors deliver inaccurate audit opinion inasmuch as not meeting the established audit standards.

In the event of audit failure cases as exemplified by the audit failure in Kanebo, Japan caused by the conspiracy of auditors in ChuAoyama public accountant office affiliated with Pricewaterhouse (PWC), one of the big four public accountant offices as well as the executive of Kanebo company (Skinner and Sriniasyan, 2011). The case in Kanebo illustrated the audit execution that does not meet auditing standards, resulting in poor audit

quality. Such case is in contrast to the standards remarked by Boyton et al. (2006) in which audit quality should refer to standards constituting the criteria and quality standards of the execution, therefore, there is gap between the actual audit execution and the appropriate audit.

Cheng et. al. (2009) remarks that audit quality is one of the most widely discussed topics in audit profession. Vanstraelen (2000) state that audit quality is the ability of auditor to detect and report material misstatement in the investigated sample during auditing process, furthermore he claims that public editor is not only demanded to detect but also to report occurring material misstatement. When such measures are taken, auditing process is considered more effective and of high quality. This is in line with Richard (2006) stating that audit quality is a balance between the auditor's competence and independence. The importance of independent attitude of the auditor is pointed out by Moore et al. (2006) by referring to a number of auditing scandals in the United States including in Enron Corp. WorldCom and several public companies in 2001 and 2002 which overlooked independence and triggered audit failure. Based on previ-

ous elaboration and exemplifications, it can be seen that the independence of auditor is one of determining factors in audit quality.

The next factor highly affecting the audit quality is audit fees (Carcello et al., 2004). According to Srinivasan et al (2002), theoretical models have explained that there is a conflict of interest between auditor and their clients in terms of audit fees and audit quality; in any case, audit fee must not diminish auditor independence, thus the offer of the amount of the fee has to be offered by clients. Audit fees are the fees provided to the auditors that reflect the cost of the effort conducted by the public editors and litigation risks (Choi, 2009). Relating to the factors influencing the decision of the amount of audit fees, Simunic (2006) claims that audit fees are determined by client size, audit risks, and audit complexity.

In accordance with the problems of audit fees in Indonesia, Suparto (2011) claims that there has been an unhealthy competition among a number of public auditor offices. Such condition is shown by a tariff war strategy implemented by several public auditor offices in order to attract the clients interest in which they provide very low fees and below minimum standards. Such strategy results in difficulties of the auditors to meet proper auditing standard procedures and it will negatively affect the quality of auditing result. In a nutshell, the researcher is interested in explaining the influence of independence of public auditor and audit fees towards audit quality.

## LITERATURE REVIEW

### Independence

Auditor profession is inseparable from independent attitude in dealing with clients (Richard, 2006). In line with Arens (2012) stating that the independence of the auditor from the firm means that auditing is one of the basic requirements to keep public confidence in the reliability of the audit report. Independence adds credibility to the audit report on which investors, creditors, employees, government and other stakeholders depend to make decisions about a company. The benefits of safeguarding an auditors' independence extend so far as to the overall efficiency of the capital markets (Hayes, 2005).

Furthermore, Rittenberg et al. (2008) remarks that independence means being objective and unbiased while performing professional services. It requires being independent in fact and in appearance. In the same vein, Arens et al. (2012) puts forward that all personals in engagement should maintain independence in fact and in appearance to perform professional responsibilities with integrity and maintain objectivity in performing their professional responsibility. Integrity means that a person acts according to conscience regardless of the situation.

(Arens, 2012) and the principle of objectivity requires the

certified public accountant (CPA) to be impartial and free of conflicts of interest (Messier,2008). In the context of this study, independence is scrutinized in terms of integrity and objectivity.

### Audit Fees

Fee is any fee established for the performance of any service pursuant to an arrangement (Duska & Duska, 2003). Hoitash et al. (2005) further argues that the total of audit fees are the amount of all fees covered for auditor. The amount of the fee is normally varied, depending on client size and the complexity of the auditing process (Lyon and Maher, 2005). Choi et al. (2009) further claims that audit fees are determined, among others, by deployment risks, the complexity of the audit, client size and the complexity of the clients. Turkey et al. (2005) states that there are three factors contributing to the establishment of fees, i.e. the size of an auditee, complexity, and risk. Particularly in this study, the three factors by Turley et al. (2008) are adopted to be the indicators of audit fees.

### Audit Quality

Turley and Willekens (2008) states that audit quality is normally related to the ability of the auditor to identify material misstatement in the financial statements and their willingness to issue an appropriate and unbiased audit report based on the audit result. Furthermore, International Standard ISO 8402-1986 (1989) Titled Quality Vocabulary adapted by Mills (1993) remarks that audit quality is a systematic and independent examination to determine whether quality activities and related results company are in line with planned arrangements and whether these arrangements are implemented effectively and are suitable to achieve objectives.

In respect to services, Boynton et al. (2006) argues that every profession is consistently related to the quality of the services it provides, including auditors in which the quality of its services is of utmost importance to assure that this profession is responsible to the clients, the people, and regulations. The audit quality refers to standards concerning standards with criteria or execution quality measures and also related to the goals that it wish to accomplish by applying related procedures.

In addition, Schilder (2011) states that audit quality needs to be based on international auditing and assurance standard board (IAASB) perspective. In this study, the indicators based on IAASB are implemented. Conceptually, IAASB argues that there are three fundamental aspects in audit quality, i.e. input, processes, and context factor. The input comprises of two dimensions, namely personal attributes of auditor

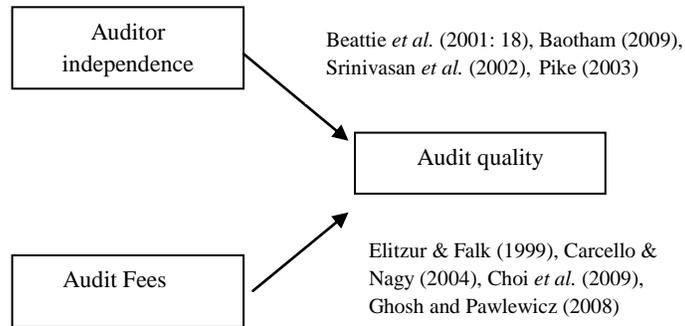


Figure 1 Audit quality causal model.

with the indicators of expertise, ethical values and mindset and auditing process with the indicators of auditing method reliability, the effectiveness of audit tools and the availability of technical support. Output in audit quality has two dimensions namely public auditor report and public auditor communication. Context factor also consists of two factors, namely governance, law and regulation.

In short, it can be concluded that audit quality constitutes the ability or expertise of auditors to identify and report significant material misstatement in the client financial report. There are seven factors determining the ability of competence. The seven factors are implemented as the indicators of auditing quality in this study.

## RESEARCH FRAMEWORK

The conceptual model structure is presented in figure 1. This model is developed based on extensive literature review referring to the studies conducted in audit quality. Such model constructs are orchestrated based on literature review and relevant research results.

### The Influence of Auditor Independence towards Audit Quality

One of the pillars of audit quality is auditor independence (Beattie et al., 2001). In the same vein, Richards (2006) argues that the lower is the interdependence level, the lower the audit quality is. Baotham (2009) also supports the auditor independence significantly influences audit quality. Srinivasan et al. (2002) further tested a sample of several Andersen's clients and investigated the diminishing of public accounting office reputation after accounting scandals in 2002. The results showed that auditor independence affects the audit quality and credibility of the audited financial reports. Such results are supported by Pike (2003) claiming that when the auditor is not independent, the will to produce high quality

audit becomes low since the auditor does not make a serious attempt to identify material misstatement and when it is identified, the auditor will not necessarily report it. Based on the elaboration presented, thus, hypothesis 1 is proposed that auditor independence influences audit quality.

skills, experience, ethical values, mindset, the reliability of audit method, the effectiveness of the tools, the misstatement (Bedard, 2010; Schilder, 2011) namely availability of technical support, i.e. audit staff with up to the auditors in identifying and reporting material par

### The Influence of Auditor Independence towards Audit Quality

Several researchers have studied the relationship between audit fees and audit quality. Among others is Elitzur and Falk (1999) claiming that the higher is the audit fee, the higher quality of the auditing processes administered. Such result reflects that fees describe the effort the auditor has put in to provide the best performance. Carcello and Nagy (2004) argues that one of the factors affecting audit fees is the risks involved; when the auditor deals with a client with a high risk, the auditor will charge higher audit fees and add the auditing time to be able to magnitude the monitoring force (Walkins et al., 2004).

Choi et al. (2009) conducted a further study on audit fees in companies listed in stock market and owning a strong legal force. They concluded that stronger legal force boosts higher quality audit and the shareholders are willing to spend higher audit fees to obtain the benefit of the value of high quality audit.

The two studies support the influence of audit fees towards audit quality. Furthermore, Ghosh and Pawlewicz (2008) claim that there are several things causing positive relationship between audit fees and audit quality, i.e. the offered fees will be high if the auditing procedures require longer auditing time and involve highly skilled and experienced staff. Therefore, high quality audit involves higher audit fees. Such elaboration provides a solid ground for hypothesis 2 which is

Table 1. Research Variables.

Concepts	Indicators	Operational Definition
<b>Independence (X<sub>1</sub>)</b>	Integrity	A person's attitude acting in accordance with conscience, honesty, looking at and presenting facts as they are (Arens et al, 2012).
	Objectivity	objectivity is an attitude that does not take sides and is free of conflict of interests (Messier, 2008)
<b>Fee Audit (X<sub>2</sub>)</b>	Size of an auditee	It is by far the most important determinant of audit fees. It is the total assets and turnover the most commonly utilized measures of the size of an auditee.( Turley et al. 2005)
	Complexity	The level of business complexity of the auditee also influence audit fees. Complexity reflects the nature and diversity of the business of the auditee locations, the quality of internal control, the existence of unusual transaction. .(Turley et al. 2005)
	Risk	Auditee risk and thus the auditor might perform additional work, which means higher fees (Turley et al. 2005)
<b>Audit Quality (Y)</b>	Skill	The ability in accounting, auditing, taxation, manajement consulting and financial manajemen services that a auditor need to possess in order to perform professional services (Hayes et al., 2005).
	Pengalaman	The period of time that a auditor has served in the same KAP (Chu et al., 2011)
	Ethical value	The principles of public accountant ethics as regulated in <i>Standar Profesional Akuntan Publik</i> (public accountant professional standards).
	Mindset	The paradigm which is solidly ingrained in a community (Enrico, 2001).
	The reliability of audit methods	The reliability of audit procedures, the adherence to regulation, the ability to interpret an evidence conducted by a auditor (Kegel, 2006).
	The effectiveness of the tools utilized	Conducting information technology based auditing in which such a tool will aid auditor in performing professional services in terms of speed and accuracy (Russel, 2005).
	The availability of technical support	Auditing staff with up to par competence is readily available.

audit fees influence audit quality.

adapted from Duska and Duska (2003). Furthermore, referring to Turley (2005), audit fees is divided into three indicators, i.e. size of an auditee, complexity, and risks. The concept of audit quality is adapted from Turley and

## RESEARCH METHODOLOGY

### Variabel Operationalizations

Operationalizing research variables is a process of translating or defining a concept to make them measurable. The concept of auditor independence used in this study adopts the concept developed by Rittenberg et al. (2008) in which auditor independence consists of integrity and objectivity. The definition of audit fees is

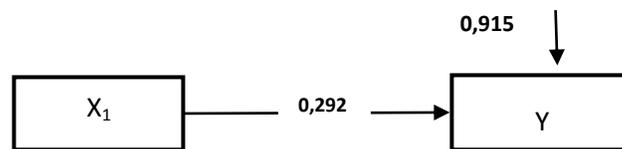
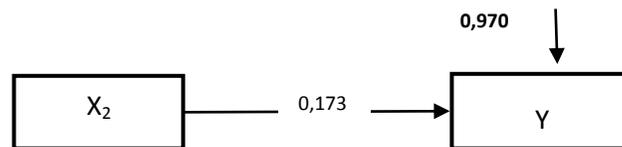
Willekens (2008). In addition, the operationalization of audit quality adopts the seven indicators proposed by Schilder (2011), i.e. skill, experience, ethical value, mindset, the reliability audit methods, the effectiveness of the tools used, and the availability of technical support. The operationalization of the variables is presented in table 1.

**Table 2.** The guidelines to interpret correlation coefficient.

Coefficient Intervals	The relationship level
0,000 – 0,199	Very low
0,200 – 0,399	Low
0,400 – 0,599	Medium
0,600 – 0,799	Strong
0,800 - 1,000	Very strong

Source: Sugiyono (2008)

Based on path analysis calculation, the coefficient of the path of the independence variable ( $X_1$ ) towards audit quality (Y) is 0.292. It is further described in a path diagram in the following figure.

**Figure 2.** Path diagram of the influence of auditor independence ( $X_1$ ) towards audit quality (Y).**Figure 3.** Path diagram of the influence of audit fees ( $X_2$ ) towards audit quality (Y).

## Measurement

The measurement scale implemented is five scales ranging from 1 constituting never to 5 constituting always. The data is processed by using Lisrel 8.70. The data collecting method is by means of surveys.

## The Sample of the Study

The unit of analysis of this study is public accountants offices in which the population is the members of Indonesia capital market accountant forum (FAPM). The sampling technique applied is probability sampling, specifically random sampling technique. The size of the sample is 73 public accountants' offices, the members of FAPM. In this study, the research participants responding to the questionnaires are the auditor partners and managers. The reason behind the choices of auditor partners and managers of the offices of FAPM members is that they have practicing experiences of more than five years. Such experience is deemed appropriate since they have vast insights of the condition of their offices.

## Validity and Reliability

Based on the data processing results, the coefficient value of all of the items is higher than 1.994. It means that the items are considered valid. Furthermore, based on reliability testing, the research variables have reliability coefficient values higher than 0.60. When the value is  $\alpha > 0.6$ , then the concept is considered reliable and when  $\alpha \leq 0.6$ , then the concept is not reliable (Simamora, 2004). Thus, all of the research variables are considered to have a high consistency level.

## DATA ANALYSIS AND HYPOTHESES TESTING

### The first hypothesis: The influence of auditor independence towards audit quality

The analysis of the data is conducted by using path analysis. The model interpretation or the testing result is interpreted in accordance with the theories of the data and logical reasoning. In order to interpret the relationsh-

ip between the variables, the following guidelines are used.

The amount of the influence of  $X_1$  variable towards  $Y$  variable is shown by  $R^2$  value of 0.085 or 8.533% with the correlation level of 0.292 or 29.2%. Referring to table 2, such value is considered low. Furthermore,  $t$  test is conducted to measure the significance of the influence of public auditor independence ( $X_1$ ) towards audit quality ( $Y$ ). The following hypotheses are proposed:

$H_0 : \rho_{yx1} \leq 0$  Auditor independence has no influence over audit quality.

$H_1 : \rho_{yx1} > 0$  Auditor independence influences audit quality.

Based on the structural equation resulting from LISREL, the  $t$  count of auditor independence ( $X_1$ ) is 4.591, meanwhile the  $t$  table of  $\alpha = 0.05$  for the sample ( $n$ ) of 73 is 1.994. It means that  $t_{count} > t_{table}$  which is  $4,591 > 1,994$ , thus  $H_0$  is rejected. It means that there is a significant influence of auditor independence over audit quality.

Based on such results, it can be interpreted that auditor has an awareness to consistently maintain independence in any situation to keep the people's trust. Independence in this respect is maintaining integrity which is being honest in accordance with conscience, looking at and presenting facts the way they are and maintaining objectivity by not taking sides and free of conflict of interests.

Such results are in line with the applied theory in auditing as remarked by Rittenberg et al. (2008) state that independence is being objective and unbiased while performing professional services. It requires being independent in fact and in appearance. Arens et al., (2012) further support that auditing should be done by a competent and independent person.

The results inform that auditors consistently maintain independence by providing statements or opinions that are not affected by the things that would compromise their independence for example gifts, the kindness of the clients, acting as they are, and presenting opinions in accordance to the actual facts. Such results are supported by Arens et al. (2012) claiming that despite being paid by the company, auditors are expected to be continuously capable of acting independent to provide reliable audit reports. Such results also support the studies conducted by Beattie et al. (2001), Baotham (2009), Srinivasan et al. (2002) and Pike (2003).

### **The second hypothesis: The influence of audit fees towards audit quality**

Based on the path analysis results, the coefficient of audit fees ( $X_2$ ) variable path towards audit quality ( $Y$ ) is 0.173. The following path diagram shows the result.

The amount of the influence of  $X_2$  variable towards  $Y$  variable is shown by  $R^2$  value of 0.030 or 3% with the correlation level ( $R$ ) of 0.173 or 17.3%. Referring to table 5.1, the value is considered very low.

Furthermore,  $t$  test is conducted to measure the significance of the influence of fee audit ( $X_2$ ) variable towards audit quality ( $Y$ ) variable. In doing so, the following hypotheses are proposed:

$H_0 : \rho_{yx1} \leq 0$  audit fees have no influence over audit quality.

$H_1 : \rho_{yx1} > 0$  audit fees influence audit quality.

Based on the structural equation resulting from LISREL, the  $t$  count for audit fees ( $X_2$ ) is 2.757. Meanwhile, the  $t$  table of  $\alpha = 0.05$  for the sample ( $n$ ) of 73 is 1.994. Therefore,  $t_{count} > t_{table}$  which is  $2,757 > 1,994$ , then  $H_0$  is rejected. It means that there is a significant influence of audit fees over audit quality.

Based on such results, it can be interpreted that the offered fees by public auditor are considered optimum. Such is resulting from the fact that the offered fees consider the size of an auditee, the complexity of the audit and the risks encountered as put forwarded by Turley et al. (2005) and Simunis (2006). However, for several offices, especially lower middle offices, the offered fees are occasionally decided by not considering the three factors but considering the economy factor; the survival of their practices. The accountants in such offices offer the fees in accordance with the market price or based on the information from other offices on the fees that they previously offer to the company. This condition will influence the audit quality since fees describe the effort the auditor puts in to accomplish their task. By offering fees which are not optimum amount, the auditor may abandon necessary procedures. This results support the studies conducted by Elitzur & Falk (1999), Carcello & Nagy (2004), Choi et al. (2009) and Ghosh and Pawlewicz (2008).

## **CONCLUSION**

The significant influence of auditor independence towards audit quality reflects that the auditor has an absolute attitude that needs to be maintained, which is independence. Such attitude keeps the auditor in the right track in performing their practices and maintaining an image as a group that carries the people's trust to enhance the credibility of financial reports produced by companies. In terms of audit fees, optimal audit fees provide audit quality reassurance since the auditing procedures require a long period of time and highly experienced and skilled staff. Thus, in order to produce high quality audit requires efforts both from the public auditor and optimal audit fees.

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