



IMPACT OF AUDITOR INDEPENDENCE THREATS ON AUDIT QUALITY IN TANZANIA, A CASE OF IRINGA MUNICIPALITY

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KeyWords: Client's Affiliation with CPA Firms, Audit Firm Tenure, Non-Audit Service, Audit Quality, Auditor Independence Threats.

ABSTRACT

The purpose of the study was to assess the impact of auditor's independence threats in audit quality in Tanzania, a case of Iringa municipality, the study intended to determine the effect of client's affiliation with CPA firms, audit firm tenure and non-audit service on audit quality at Iringa municipality. The study was case study design whereby the research employed quantitative research approach to gather data and answer the research problem and summarize the results. The targeted population was 38 auditors from Iringa municipality where a sample size of 35 was drawn out of it. Simple random sampling technique was used for the selection of respondents. Linear Regression using Ordinary Least Square Estimator was used for data analysis. The study revealed that when the external auditors provide non-audit service to the client, they receive more income, which may result in greater economic dependence. Auditor tenure can lead to impairment of independence. As the auditor-client relationship lengthens, the auditor may develop close relationship with the client and become more likely to act in favor of management, resulting in reduced objectivity and audit quality. Client's affiliation with CPA firms involves the situation where part of the client's personnel used to work for the current auditor. The affiliation can cause impairment of independence from personal relationship between the client's officer and the auditor or the ex-auditor's acquaintance and circumvention of the audit methodology. However, the regression result shows that client's affiliation with CPA firms, audit firm tenure and non-audit service have a significance relationship with audit quality in Iringa Municipality. The co-efficient of determination, the adjusted R^2 amounted to 0.513, which shows that the independent variables explain about 51.3% of the variation in the dependent variable. The study concludes that based on theoretical approaches, audit quality is affected by the auditor's independence, with means that the more independent an auditor the more audit quality. The researcher recommends that more investigations should be conducted most especially in Tanzania taking into consideration the four major threats revealed and extend to other sectors like manufacturing, transport, media, education etc.

INTRODUCTION

Auditor independence refers to the auditor's ability to maintain an objective and impartial mental attitude throughout the audit (Soltani, 2017). Furthermore Hayes, et.al (2014) defines the independence of the auditor is described as having a position to take an unbiased viewpoint in the performance of audit tests, analysis of results, and attestation in the audit report. Arens, et.al (2015) explains that independence requires an attitude of responsibility separate from the client's interest. The auditor must maintain an attitude of healthy professional skepticism. Based on the above understanding can be concluded that the independence of the auditor is the auditor's ability to maintain mental attitude objectively and impartially in the interests of the client in conducting the audit, analyzing the results, and attestation in the audit report.

Arens et al., (2015) explain that the independence of the auditor is divided into two parts as follows: Independence of mind reflects the auditor's state of mind that permit the audit to perform with an unbiased attitude. Independence of mind reflects a long-standing requirement that members be independent in fact. Independence in appearance is the result of others' interpretations of this independence. If auditors are independent in fact but users believe them to be advocates for client, most of the value of audit function is lost.

Audit quality means how well an audit detects and report material misstatements in financial statements, the detection aspects are a reflection of auditor competence, while reporting is a reflection of ethics or auditor integrity, particularly independence (Arens et. al., (2017). Furthermore, The US Government Accountability Office (GAO) (2015) explains the notion of quality of the audit is an

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

Various theories were put forward by the experts stated that the independence of the auditor affect the quality of the audit. Watts, et.al (2016) states that, to create a demand for audit services, auditors have to convince the market that they have some competence and they will have some independence from the client. The same thing was also confirmed by Arens, et.al (2014) that the value of auditing depends heavily on the public's perception of the independence of auditors. Similarly, Ricchiute (2016) states that, in practice, independence is powerfully important to the profession's reputation as a trusted player in the market for audit services. The financial community values the reports of certified public accountants precisely because CPAs are perceived as having no vested financial or personal interest in the outcome of the engagement.

Some recent research also said similar things about the impact of auditors' independence on audit quality, among others: Enofe, et al., (2018) states that, as auditors' independence increase, the quality of the audit also improves. The same thing was also confirmed by Suyono (2015) states that, independence of auditor and accountability affect audit quality. Similarly, Suseno (2018) asserts that, auditor independence significantly influences the audit quality.

Enofe, et al., (2018) add that audit quality is not simply a linear function of auditor competence and auditor independence, but also on the market's perception about the value of the auditor's report which is the result of the perceived competence and the perceived independence of the auditor. From this perspective, audit quality in this case refers to credibility of the audit opinion which is a measurement of the degree of confidence users place upon the information provided by the auditor. Audit quality in recent times has become a source of worry locally, nationally and globally as most auditors seem not to be discharging their duties independently.

Clients appear to be deciding for the auditor the audit scope, approach and opinion. This is evident in the massive business failures. Companies like Xerox, Enron and WorldCom, amongst others, have disclosed improprieties in their financial statements amounting to billions of dollars (Cullinan, 2014).

In Tanzania, the story was not different as many companies and public organizations which were audited and certified healthy could not see the light of the day. In some of these high profile audit failures, auditor misconduct has been alleged. Since the independence of the auditor is a critical issue for the auditing profession, many studies have been performed in this area in and outside Tanzania.

Some studies in Tanzania on audit tenure find a positive association between audit tenure and audit quality measured by discretionary accruals (Bahram, 2015). Hence, the imposed mandatory partner rotation, which limits auditor partner tenure, can result in decreased audit quality. Arie (2017) showed that longer audit tenure became associated with lower audit quality for the period after mandatory auditor rotation, but conversely for the period before it became mandatory, longer audit tenure increased audit quality. They used only discretionary accruals as a proxy of audit quality which impaired generalization of the findings. While Chambers and Payne (2015) found strong evidence that the anticipated future provision of non-audit services does represent a source of impaired independence in the current year.

Empirical studies on auditor independence and audit quality were centered on one or two of the threats and more were done outside Tanzania. However, the environment differs from country to country. Moreover, there was no concrete evidence of such studies for Iringa municipality. For that matter, this compelled the researcher to assess impact of auditor's independence in audit quality in Iringa municipality. This proposed study therefore, reviewed and established the relationship evidence related to the auditor independence and audit quality. Existing literature revealed four threats to auditor independence, which are client importance, non-audit services (NAS), auditor tenure, and client's affiliation with Certified Public Accountant (CPA) firms.

LITERATURE SURVEY

The Effects of Client's Affiliation with CPA Firms on Audit Quality

Abdul, (2018) investigated the "Effect of CPA and Auditor Independence on Audit Quality in Kenya Financial Institutions". The study was a case study and 28 public auditors were involved. Regression analysis using Ordinary Least Square Estimator technique was used in data analysis. The study found that auditor's competence and auditor's independence has positive effect on audit quality. This means that the higher the auditor's competence and auditor independence, the higher the audit quality. Moreover, professional commitment strengthens effect of auditor's competence on audit quality. It means the auditors with stronger professional commitment have greater effect of auditor's competence on audit quality.

Monroe and Hossain (2018) investigated whether "Audit Partner Qualification and Audit Quality Associations Remain Significant after the Implementation of Mandatory Audit Partner Rotation in Australia". A survey study design was employed and financial statements and audit opinion for firms with a balance sheet after 1 July 2006 to 30 June 2010 were collected. A sample data of 30 public auditors were involved. Logistic regression model was used to analyze the data. Findings revealed that companies are more likely to use qualified accountants with CPA on auditing financially distressed companies on clients' incentives, benefits, and behaviors when there is mandatory audit partner rotation after a fixed period of time. Findings suggested that the implementation of mandatory audit partner with CPA rotation had improved audit quality.

Tulo, (2016) examined "The effect of Auditor Independence on Audit Quality of Selected Deposit Money Banks in Tanzania". Purposive sampling technique was used to select sample size of seven (7) listed deposit money banks from a population of twenty (20). Descriptive statistics, correlation and ordinary least square (OLS) were used to analyze the data. Findings revealed that there is a positive relationship between audit fee, clients' affiliation with CPA and audit quality. There exists negative relationship between audit firm tenure and audit quality. The model didn't conform the algebraic sign on audit firm tenure. The correlation between audit quality

ty and leverage was strong, negative and statistically significant. The correlation between audit quality and clients' affiliation with CPA was strong, positive and statistically significant.

The Effects of Audit Firm Tenure on Audit Quality

Randal, (2017) examined the "Effect of Auditor Rotation and Audit Tenure of the Public Accountant and the Public Accounting Firm on Audit Quality (before and after the implementation of the mandatory auditor rotation regulation) in Indonesia". The study used two observation periods in the study: year 1999-2001 to represent years before mandatory auditor rotation regulation and year 2014-2018 for years after the mandatory auditor rotation regulation. Descriptive statistics and linear regression model using Ordinary Least Square Estimator technique were used to analyses the data for both periods. Results showed that longer audit tenure became positive associated with lower audit quality for the period after mandatory auditor rotation on auditors' incentives, benefits, and behaviors, but conversely for the period before it became mandatory, longer audit tenure increased audit quality. The study only used discretionary accruals as a proxy of audit quality which impaired generalization of the findings.

Mark, (2014) examined "The Influence of Auditor Independence, Audit Tenure and Audit Fee Both Partially and Simultaneously on the Audit Quality of Members of Capital Market Accountant Forum in Indonesia". The study used primary data that was collected via the distribution of questionnaires. The population where a sample size of 45 was taken comprised senior auditors, supervisors and managers. Linear regression analysis using Ordinary Least Square Estimator technique was used for data analysis Findings showed generally that auditor independence, audit tenure and audit fee have a positive influence on audit quality. The use of questionnaire as data collection instrument if not handled professionally can impair generalization of findings.

Enofe, et al., (2018) examined "The relationship between audit quality and auditors independence in Nigeria". A cross sectional study analysis of companies listed on the Nigerian Stock Exchange was carried out. A sample of twenty (20) audited financial reports of these companies for the period ending 2017 was selected using the simple random sampling technique. The data collected for the variables were subjected to descriptive statistics analysis. Findings indicated that as auditors' independence increases, the quality of audit also improves and as the independence of the board and audit tenure as ownership structure increases, the quality of audit reduces. It was therefore recommended that auditors should strive for independence in order to ensure quality audits.

The Effects of Non-Audit Service on Audit Quality

Mahmoud (2015) examined "The Effect of Joint Audit on Audit Quality: Empirical Evidence from Companies Listed on the Egyptian Stock Exchange". A sample of 32 companies listed on the Egyptian stock exchange in the period 2009 through 2018 representing 160 firm- year observations was determined. Correlation analysis was used in data analysis. Findings showed that companies audited by joint auditors are more associated with audit quality than companies audited by single auditors. The study design did not disclose the entire population where a sample of thirty two was taken.

Causholli, (2015) investigated the "Effect of Selling Non-Audit Services on Auditor Independence in America". The study was a case study research design and correlation analysis was employed. 50 public auditors were sampled. The study found strong evidence that the anticipated future provision of non-audit services is insignificant and it does associated with auditor independence.

Kabiru and Abdullahi (2015) carried out "An empirical Investigation into the Quality of Audited Financial Statements of Deposit Money Banks in Tanzania". Cross-sectional design was employed using a population of 12 banks. Linear regression analysis using Ordinary Least Square Estimator technique was done in data analysis. The study found that a non-audit service does not significantly improve the quality of audited financial statements of money deposit banks in Tanzania, and it does not conform the algebraic sign. Compliance to auditing guidelines has positive and significant effect on the quality of audited financial statement of money deposit banks. Material misstatement does significantly affect the quality of audited financial statements of money deposit banks in Tanzania.

METHODOLOGY

The study was case study design whereby the research employed quantitative research approach to gather data and answer the research problem and summarize the results. The targeted population was 38 auditors from Iringa municipality where a sample size of 35 was drawn out of it. Simple random sampling technique was used for the selection of respondents. Linear Regression using Ordinary Least Square Estimator was used for data analysis.

RESULTS & DISCUSSION

Multiple Regression Analysis

Multiple linear regression analysis was also conducted to examine how multiple independent variables (client's affiliation with CPA firms, audit firm tenure and non-audit services) are related to the dependent variable (audit quality) whereby 35 observations were used. According to Weiers (2015), a multiple regression analysis is an analysis that involves one dependent variable and two or more independent variables. In other words, it is an analysis of association in which the effects of two or more independent variables on a single, interval-scaled dependent variable are investigated simultaneously.

The model used, as shown from the conceptual model, was linear regression;

That is $AQ = \alpha_0 + \beta_1 CAF + \beta_2 AFT + \beta_3 NAS + U$

Where; AQ = Audit quality; CAF= Client's affiliation with CPA firms; AFT= Audit firm tenure; NAS= Non-audit service; U= Disturbance term

And $\beta_1 > 0$, $\beta_2 > 0$ and $\beta_3 < 0$

The estimated linear model was $AQ = -0.504 + 0.549CAF + 0.429AFT - 0.481NAS$
(-0.401) (2.166) (2.441) (-2.631)

$R^2 = 0.513$, $F = 8.977$, and t values are in parentheses

All algebraic signs of the parameter estimate for client's affiliation with CPA firms, audit firm tenure and non-audit service conform to the hypothesized signs of the economic theory

Table 1: Coefficients

| Model | | Unstandardized Coefficients | | Standardized Coefficients | | Sig. |
|-------|-------------------------------------|-----------------------------|------------|---------------------------|--------|------|
| | | B | Std. Error | Beta | T | |
| 1 | (Constant) | -.504 | 5.030 | | -.401 | .020 |
| | Client's affiliation with CPA firms | .549 | .415 | .714 | 2.166 | .018 |
| | Audit firm tenure | .429 | .390 | .494 | 2.441 | .036 |
| | Non-audit service | -.481 | .411 | -.717 | -2.631 | .013 |

a. Dependent Variable: Audit quality

The estimated regression model indicates that a one unit change in client's affiliation with CPA firms leads to a positive change of 0.549 in audit quality. A unit change in audit firm tenure imposed leads to a positive change of 0.429 in audit quality. A unit change in non-audit service leads to a negative change of -0.481 in audit quality. All three parameter estimates are statistically significant at 5% level. Moreover, all algebraic signs of the parameter estimate for client's affiliation with CPA firms, audit firm tenure and non-audit service conform to the hypothesized signs of the economic theory.

The t -values are all greater than 2.0. Therefore, according to the rule of thumb, the parameter estimates are statistically significant. That is they affect audit quality in Iringa Municipality.

F- Test

Table 2: Analysis of Variance – ANOVA

| Model | | Sum of Squares | Df | Mean Square | F | Sig. |
|-------|------------|----------------|----|-------------|-------|-------------------|
| 1 | Regression | 23.643 | 3 | 6.747 | 8.977 | .000 ^b |
| | Residual | 19.900 | 31 | .752 | | |
| | Total | 43.543 | 34 | | | |

a. Dependent Variable: Audit quality

b. Predictors: (Constant), Client's affiliation with CPA firms, Audit firm tenure, Non-audit service

Interpretation

This was used to test the overall significance of the regression results.

The hypothesis test

$H_0: \beta_1 = \beta_2 = \beta_3 = 0$ (model insignificant)

$H_A: \beta_1 \neq \beta_2 \neq \beta_3 \neq 0$ (model is significant)

The level of significance is 5% = 0.05 with 95% confidence interval.

The calculated 'F' as shown in table 4.4 is 8.977 and the critical 'F' is 3.15

Since the calculated 'F' is greater than critical 'F', the researcher rejects null hypothesis in favor of the alternative hypothesis; that is β_1 , β_2 and β_3 are statistically different from zero implying that client's affiliation with CPA firms, audit firm tenure and non-audit service affects audit quality in Iringa municipality.

Adjusted R2 test

Table 3: Model Summary

| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate | Change Statistics | | | | | Durbin-Watson |
|-------|-------------------|----------|-------------------|----------------------------|-------------------|----------|-----|-----|-------------|---------------|
| | | | | | R Square Change | F Change | df1 | df2 | Sig. Change | |
| 1 | .682 ^a | .543 | .513 | .86697 | .543 | 8.977 | 3 | 31 | .000 | 2.581 |

a. Predictors: (Constant), Client's affiliation with CPA firms, Audit firm tenure, Non-audit service

b. Dependent Variable: Audit quality

Interpretation

This test was used to explain the total variations in the dependent variable i.e. audit quality caused by variations in the independent variables i.e. client's affiliation with CPA firms, audit firm tenure and non-audit service. In the case of the regression output the adjusted $R^2 = 0.513$ implying that the model explains about 51.3% variations in the audit quality hence the model does more than half in explaining variations in audit quality.

Also, it indicates, R coefficient is 0.682 meaning that there is a correlation of 68.2% between the independent variables (client's affiliation with CPA firms, audit firm tenure and non-audit service) and dependent variable (audit quality). This shows that the independent variables (client's affiliation with CPA firms, audit firm tenure and non-audit service) are significant predictors of the dependent variable (Audit quality) at Iringa municipality.

FINDINGS BASED ON THE SPECIFIC OBJECTIVES

The Effects of Client's Affiliation with CPA Firms on Audit Quality

Three potential problems that may lead to impairment of auditor independence with regard to client employment issue are auditor may view client as the potential employer, the closeness with management may create a distance between the auditor and shareholders, who are in fact the real employer of the auditor and the audit team may have difficulty in maintaining independence while dealing with their former colleagues. These problems lead to reduced objectivity and audit quality.

Regarding to the first research hypothesis on what are the significant relationship between client affiliation with CPA firms and audit quality?, one of the respondent reported that, auditor has stronger intention to report the audit manager's potential affiliation with the client when perceived personal costs of reporting are lower or when perceived personal responsibility for reporting is higher.

Another respondent commented that, apart from the common relationship that the client hires the auditor (referred to as 'employment affiliation'); he also said that auditors are more likely to issue clean audit opinions to companies with either employment or alma mater affiliated executives than to unaffiliated client firms.

Expected future quasi-rents decrease the optimal level of auditor independence and leads auditors to low-ball in the initial period to gain incumbency. The fee reductions are sunk costs and, hence, do not impair auditor independence.

These findings are related with Tulo, (2016) who found that there is a positive relationship between audit fee, clients' affiliation with CPA and audit quality. There exists negative relationship between audit firm tenure and audit quality. The model didn't conform the algebraic sign on audit firm tenure. The correlation between audit quality and leverage was strong, negative and statistically significant. The correlation between audit quality and clients' affiliation with CPA was strong, positive and statistically significant.

These findings show that there is a positive relationship between client's affiliation with CPA firms and audit quality and the p-value is less than 0.05, therefore the null hypothesis (H_0) which states that client's affiliation with CPA firms has no effect on audit quality at Iringa municipality, is rejected and hence, H_A was fully supported.

The Effects of Audit Firm Tenure on Audit Quality

From the second research hypothesis, are there any relationship between audit firm tenure and audit quality? One of the respondent claim that, long audit partner tenure with the client increased auditor's identification with the client, which in turns, increased the likelihood of auditor acquiescing to client's preference. This suggests that the audit partner who usually deal with the client may become attached to the client and provide substandard audit. However, commented that unlike audit partner tenure, audit firm tenure is found to be marginally associated with decreased acquiescence to the client's preference. The contrary association implies that, unlike the audit partner, audit firm have incentive to remain independent to secure their reputation.

Granting the evidence concerning the financial statement users mostly covers the audit firm tenure, other respondent claim that, there is no significant difference in independence perceived by non-professional investors between audit firm and audit partner rotations. More importantly, the non-professional investors perceived that strong audit committee can help strengthen auditor's independence.

From this study, auditor's tenure exceeding five years is not significantly perceived as reducing auditor independence. Audit committee perceived that auditor tenure affected the likelihood of auditors discovering material errors. Auditors, with tenure of between five and twenty years are perceived as being more likely to discover material errors than those with zero to five-year experience with the client. Audit quality decreased as the auditor-client relationship lengthened.

Failure to issue going concern audit opinion immediately before bankruptcy is more likely in the first few years of auditor-client relationship. The quality of financial reports is lower for companies with short-tenure audit firms as compared to those with medium tenure audit firms. There is no evidence of lower quality of financial reports for firms with long-tenure audit firms. As auditor tenure lengthens, the discretionary accruals and current accruals are less dispersed, suggesting higher earnings quality.

These findings are related with Mark, (2014) who found that auditor independence, audit tenure and audit fee have a positive influence on audit quality. The use of questionnaire as data collection instrument if not handled professionally can impair generalization of findings.

These findings show that there is a positive relationship between audit firm tenure and audit quality and the p-value is less than 0.05, therefore the null hypothesis (H_0) which states that audit firm tenure has no effect on audit quality at Iringa municipality, is rejected and hence, H_A was fully supported.

The Effects of Non-Audit Service on Audit Quality

The last research hypothesis on what are the relationships between non audit service and audit quality? from the findings of this study, Non-audit services can also adversely affect auditor independence. When the external auditors provide non-audit service to

the client, they receive more income, which may result in greater economic dependence, as discussed earlier. Furthermore, the joint provision of audit and non-audit service by the same auditor may cause conflict of interest since he may become less skeptical in reviewing his own work.

One of the respondent reported that, non-audit services are usually viewed as more profitable. Further the respondent indicate that restricting an auditor from providing both audit and non-audit services does not lead to improved efficiencies but may result in auditors choosing non-audit over audit service. The other respondent reported that the potential to obtain non-audit service engagements did not affect client acceptance or staffing decisions by the auditor. Apart from the economic incentives for non-audit services, there has also been a support for knowledge spillover argument. Also they contend that the joint provision of audit and non-audit service may result in spillover of knowledge between both services.

From this study, it founds that, there is significant evidence of knowledge transfer when the same auditor performed both audit and non-audit service but not when the auditor had access to non-audit service working papers. They also state that the joint provision of audit and non-audit services by the same firm resulted in fewer frauds identified by the auditor. Therefore, whether auditors actually receive benefits from knowledge transfer between both services is still questionable.

Auditors agree with the client more often when threat of losing client is high and litigation risk is low. Audit partners and managers favor the client less often than the senior and staff. Decreasing marginal cost of auditing causes auditing firms to low-ball their audit fee but the lowballing did not result in reduced audit quality, relative to no-lowball settings. In non-competitive market settings, high degree of lowballing did result in lower audit quality.

These findings are consistence with Kabiru and Abdullahi (2015) who found that non-audit service does not significantly improve the quality of audited financial statements of money deposit banks in Tanzania, and it does not conform the algebraic sign. Compliance to auditing guidelines has positive and significant effect on the quality of audited financial statement of money deposit banks. Material misstatement does significantly affect the quality of audited financial statements of money deposit banks in Tanzania.

These findings show that there is a negative relationship between non audit service and audit quality and the p-value is less than 0.05, therefore the null hypothesis (H₀) which states that non audit service has no effect on audit quality at Iringa municipality, is rejected and hence, H_A was fully supported.

Conclusion

Client's affiliation with CPA firms, audit firm tenure and non-audit service have a significant relationship with audit quality in Iringa Municipality as indicated from the regression results. In such sense, audit quality depends on client's affiliation with CPA firms, audit firm tenure and quality audit services. There will be a need for auditors to ensure quality audit services to their clients as to increase the quality of auditor independence. Therefore, client's affiliation with CPA firms, audit firm tenure and non-audit service are the threats to the audit quality in Iringa Municipality.

RECOMMENDATIONS

Recommendations for Action

Findings revealed that non-audit service negatively and statistically significant affect audit quality. This is line with the expectation of the study. On this basis of these findings, the researcher makes the following recommendations; auditors should make sure they perform auditor services to their clients so as to ensue audit quality.

The findings of this study have revealed that client's affiliations with CPA firms and audit firm tenure have positive impact on audit quality. This is similar to the hypothesized outcome. It is therefore recommended that, more emphasis on client's affiliations with CPA firms and audit firm tenure should be done to ensure audit quality to clients.

Recommendations for Further Studies

It is crystal clear from the review that some studies indicated a significance relationship between auditor independence and audit quality while others showed contrary due to the type of study design employed, sample size, data collection instruments and analysis techniques used. Most of the studies on auditor independence and audit quality were centered on one or two of the threats to auditor independence and more were done outside Tanzania. Even the ones done in Tanzania were focused more on the banking sector.

This review therefore, recommends that more investigations should be conducted most especially in Tanzania taking into consideration the four major threats revealed and extend to other sectors like manufacturing, transport, media, education etc.

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