

**INTERNAL FACTORS INFLUENCING EXTERNAL AUDITORS INDEPENDENCE
AMONG PRACTICING ACCOUNTANTS IN KENYA**

By

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MASTER OF SCIENCE IN COMMERCE (FINANCE AND ACCOUNTING)

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**A DISSERTATION SUBMITTED TO THE SCHOOL OF BUSINESS AND PUBLIC
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THE AWARD OF THE DEGREE OF MASTER OF SCIENCE IN COMMERCE
(FINANCE AND ACCOUNTING) OF KCA UNIVERSITY**

JANUARY 2017

DECLARATION

Student's Declaration

I declare that this dissertation is my original work and has not been previously published or submitted elsewhere for the award of a degree of Master of Science in Commerce (Finance and Accounting).

I also declare that this contains no material written or published by other people except where due reference is made and author duly acknowledged.

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Sign:

Date.....

I do hereby confirm that I have examined the master's dissertation of

Harrison Mbinj Omondi.

And have certified that all revisions that the dissertation panel and examiners recommended
have been adequately addressed

Sign.....

Date.....

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Supervisor

ABSTRACT

Auditor independence holds sway in ensuring that the public has confidence in financial reporting. The general setting within which audit decisions made and audit independence formed is evolving rapidly due to competitive and regulatory changes. Policy makers must work continuously to evaluate the critical threat factors and develop appropriate independence principles. This study sought to establish the determinants of auditors' independence in Kenya. Four research aims guided the study: to determine the influence of economic factors on auditors' independence in Kenya; to establish the impact of regulatory factors on auditors' independence in Kenya; to establish the effect of firm factors on auditors' independence in Kenya and to establish the challenges faced in establishing auditors' independence in Kenya. The study employed a cross-sectional descriptive study with a sample size of 214 audit firms and the target population in the study were practising accountants in Kenya. Primary data was collected using a semi-structured questionnaire and the data analysed through statistical software (SPSS) versions 22 through ordinal regression analysis to present the findings. The study established that internal factors influence auditor independence by 31.7%. From the results of the research, it also revealed that there is a significant relationship between audit tenure, audit firm size and audit independence. This was indicated with a p-value of 0.029 and 0.009. The study also established that there is no significant relationship between audit committee and audit independence with a p-value of 0.465. The study concludes that audit tenure and firm size affect audit independence and thereby the study recommends the need for ICPAK to develop a policy that will guide audit tenure and audit committee.

Keywords: Audit Committee, Auditor Independence, Auditor, Audit tenure, Audit Quality.

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DEDICATION

I dedicate this research thesis to my family who has stood by me through ought my studies.

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ABBREVIATIONS AND ACRONYMS

AC	Audit Committee
AI	Audit Independence
ANOVA	Analysis of Variance
CEO	Chief Executive Officer
CFO	Chief Finance Officer
COE	Code of Ethics for Professional Accountants
CPA	Certified Public Accountant
ICPAK	Institute of Certified Public Accounts Committee
IESBA	International Ethics Standards Board for Accountants
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standards
JDM	Judgment and Decision Making
MAS	Management Advisory Services
PAI	Perception of Auditor Independence
PCAOB	Public Company Accounting Oversight Board
PwC	PricewaterhouseCoopers
SEC	Securities Exchange Commission
SME	Small and Medium Enterprise
SOX	Sarbanes-Oxley Act
U.K.	United Kingdom
U.S.	United States

OPERATIONAL DEFINITION OF TERMS

Audit Committee: An operating committee of a company's board of directors that is in charge of overseeing financial reporting and disclosure (Akpom & Dimkpah, 2013)

Auditor Independence: is defined as “the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional scepticism (Arnold & De Lange, 2004).

Auditor: Is an approved or authorized accountant with the capacity to carry out audit, not to be declared bankrupt or subject to trading and consultancy prohibitions, have an education and experience required for the audit business, have passed the examination of professional competence as an approved or authorized accountant set by the Supervisory Board of Public Accountants or Supervisory Board of Authorized Accountants, and be fit and proper person to carry on audit process”

Auditor tenure: Audit tenure is a situation where an auditor offers audit services to the same client for consecutive number of years (Almutairi, Dunn and Skatz, 2009).

Audit Quality: A chance or probability in which an auditor can identify and report the client's material misstatement on the financial system though the period of audit work (DeAngelo, 1981).

CHAPTER ONE

INTRODUCTION

1.0 Introduction

This chapter provides the background of the study, the statement of the problem, the purpose of the study, the objectives that guided the study, the research questions, the limitations of the study and the significance of the study.

1.1 Background of the Study

Companies are perceived as the nexus of contractual relationships between different interested groups (Jensen & Meckling, 1976). The most important among these agency relationships are between managers (agents) and shareholders (principals), and creditors (principals) and shareholders (agents). In these relationships, the agents are expected to act in the best interests of the principals.

Experience shows that various mechanisms must be put in place to ensure that agents protect the interests of the other parties involved. One such mechanism is the audited financial statement (Arnold & De Lange, 2004; Chow, 1982; Jensen & Meckling, 1976; Ross, 1973; Watts & Zimmerman, 1986). According to studies conducted by [Al-Ajmi and Saudagaran \(2011\)](#), corporate failure and corporate problems with financial reporting have spawned additional reasons for the continuous debate by regulators, legislators, financial-statement users, and researchers about the importance and role of auditors in mitigating the agency problem. Performing this crucial role depends largely, among other things, on the audit quality. The model of audit quality describes audit quality as the combination of two probabilities: that of detecting a misstatement (i.e. competence) and that of reporting it, that is, independence (Al-Ajmi & Saudagaran, 2011).

The Agency Theory proposes that due to information asymmetries and self-interest, principals have no reasons to trust their agents. They will seek to resolve their concerns by putting in place mechanisms to align the interests of agents with principals to reduce the scope for information asymmetries and opportunistic behaviour (ICAEW, 2005). The Council of the Institute of Certified Public Accountants of Kenya (ICPAK) established by the Accountants Act (UNACTAD, 2006) regulates audit practice in Kenya. This Act stipulates that companies can only appoint auditors registered by the Institute. These auditors must meet the criteria for an auditor as laid out in the Act and requires that auditors' report should be annexed to the profit and loss account and balance sheet and prescribes the contents of the auditors' report (Ibid).

1.1.1 Auditor Independence

Audit independence is the ability of the external auditor to perform his/her audit duties with integrity and impartiality (Akpom & Dimkpah, 2013). They further note, "public opinions about audit independence are based more on their perception of auditor independence than on actual independence" (Ibid). Audit independence is the primary justification for the existence, and thus the hallmark of the auditing profession. Independence is recognised as the primary attribute to be maintained by auditors in all circumstances (Abu Bakar & Ahmad, 2009).

Auditor independence is a function of the existence of a dispute between the auditor and the client with regards to the treatment of audit reporting issues or issues of fraud and financial misstatements (Adelopo, 2016; Beattie, Fearnley, & Brandt, 2001). It is hard to understand and conceptualise auditor independence since there is no formal theory of auditor independence (Ibid). [Adelopo \(2016\)](#), notes that researchers and academicians are faced with ambiguity in the conceptualization and framing of ideas concerning what constitutes auditor

independence. He argues that this create room for manipulation which leads to the creation of further ambiguities.

Auditor independence according to [O'Regan \(2004\)](#) is “the absence of a relationship, obligation, or conflict of interest that could compromise an auditor’s judgment.” He notes that independence can also be conceptualised regarding a state of mind, involving personal character, ethics, and honesty”. It is the “ability to withstand pressure from management influence when conducting an audit or providing audit-related services so that the professional integrity of the auditor is not compromised” (Gay & Simnett, 2000). For an auditor to be independent, it is essential that the individual be independent in both fact and appearance.

In 2002, the failure of the public accounting firm Arthur Andersen increased scrutiny over the practices of public auditors (Eisenberg & Macey, 2004). The Andersen failure also resulted in questions about overall audits and audit quality placing stress on the audit profession (Gendron, Suddaby, & Lam, 2006). [Gendron, Suddaby, and Qu \(2009\)](#) observed that this incident, in combination with various other failures in the accounting industry, caused concern about the ethical values of professional accountants. [Fearnley, Beattie, and Brandt \(2005\)](#) further emphasised that these failures contribute to a loss of confidence in the ethical values within audit firms, which was directly linked to scepticism over the independence of audit firms and their accounting professionals. As such, among ethical values and standards in the accounting profession, one that is frequently discussed and researched is auditor independence.

The inability of auditors to maintain professional distance has led to the loss of jobs with the failure of audit firm Arthur Andersen and increased concern over the quality of auditing in the case of the failure of Chinese audit firm Zhong Tian (Du & Stevens, 2013).

Compromised auditor independence has also contributed to losses in investor confidence with audit failures and subsequent faltering of large corporations such as Enron, WorldCom, and Tyco (York-Wyatt & Leavell). Auditor independence allows an auditor to exercise due diligence without biases for or against the client. Its importance to a quality audit is paramount, and as [Fearnley et al. \(2005\)](#) explained, the independent audit of a company's financial statements is essential to the company's successful operation in capital markets.

Regulations over the accounting profession call for quality audits that are reliable and useful for the users of financial statements. As [Fearnley et al. \(2005\)](#) indicated, material changes to financial statements, along with corporate failures, further lead to doubting audit quality and doubting the ethical values of auditors. Thus, the authors suggested the need for more scepticism over the value of the opinion offered to be certain of the reliability of the audited financial statements. To improve audit quality and auditor conduct globally, the International Federation of Accountants (IFAC) promoted global harmonisation of accounting standards in the areas of practice, accounting education, professional codes of conduct, management accounting, and public sector accounting (Farrell & Cobbin, 2001). About professional ethics, over 150 national accounting organisations have adopted the Code of Ethics for Professional Accountants (COE) released by the International Ethics Standards Board for Accountants (IESBA, 2013). The IESBA is the organisational body that develops standards and pronouncements for professional accountants across the world as the professional conduct standard-setting board of the IFAC.

As [Clements, Neill, and Stovall \(2009\)](#) observed, adoption of IESBA COE varies, and some organisations have decided to retain their codes of ethics if they meet the stringency requirements of the IESBA. As (Clements et al., 2009) explained, membership in the IFAC is not contingent upon adoption of the IESBA COE. However, members and member bodies may not apply standards of conduct that are less stringent than those issued by IESBA are.

While monitoring of ethical compliance seems to be on the rise, professional accountants still have significant discretion in the interpretation of ethical codes of conduct (Flanagan & Clarke, 2007). Thus, research on the consistency of perception of, and compliance with, professional standards is increasingly more widespread as both practical and ethical standards converge at an international level. As [Fraser \(2010\)](#) posited, a global business environment has led to a complex ethical and convenient accounting environment, where it is hard for international auditing regulations to meet the needs of members of the commercial markets.

Cases of inadequate and outright auditor negligence and non-independence in Kenya have been noted by the BFID (2011) which noted for instance that in the fourth quarter of 2011, a total of Kshs 137 Million was defrauded from Kenyan banks out of which Kshs 50 Million was through insider dealings. Several studies that have been carried out in Kenya indicate that internal audit departments' effectiveness ranges from ineffective to averagely effective. These studies further highlights that auditor's independence is below average in most cases (Ongeri, Okioga, & Okwena, 2013; Rono, 2006).

1.1.2 Economic Factors

[Moore, Tetlock, Tanlu, and Bazerman \(2006\)](#) Argue that the “moral-seduction theory” predict that auditor decisions are affected by economic and social pressures in ways that affect audit quality. [Arruñada \(2013\)](#) opines that when there is a disparity between the auditor and client on the inclusion or otherwise of a particular matter in an audit report (leading either to a qualified report or the impossibility of expressing an opinion) and the client threatens to disengage the auditor, the latter may ‘accede’ to the demands of the former in order to retain the contract. He further notes that this economically motivated accession compromises the

independence of the auditor. In such a scenario auditor independence is undermined by monetary values assigned to the services offered by the auditor.

[Abu Bakar and Ahmad \(2009\)](#) posit that the Malaysian Institute of Accountants by-law (Section B-1.98 on Professional Independence) requires that “if the total fees (arising from assurance and non-assurance services) generated by one assurance client or its related entities exceed 15% of the firm’s total fees in each year over two consecutive financial periods, financial dependency shall be considered to exist, in which case, a self-interest threat to independence is created. In such event, the only course of action is to refuse to perform or withdraw from the assurance engagement”.

1.1.3 Regulatory Factors

The accounting and regulatory professions are both under regulations. These regulations may affect the independence of auditors. Lack of agreement of all auditors on a particular accounting treatment due to the flexibility of accounting standards is a threat to auditor independence (Knapp, 1985; Magee & Tseng, 1990). Among the regulatory factors that influence auditor independence include: the existence of unlimited legal liability for auditors (Farmer, Rittenberg, & Trompeter, 1987); strong enforcement of standards; effective discipline of corporations and auditors; control over the appointment of auditors (ICAS 1993; APB, 1994); and the existence of an audit committee (Cadbury, 1992).

According to an Institute of Directors in Southern Africa Report (2013), “public sector entities operate within a unique regulatory framework with some pieces of legislation and regulations that need to be complied with. The terms of reference of a public sector audit committee do not always clearly define the requirements of the audit committee about the entity’s environment.”

1.1.4 Firm Characteristics

Several empirical studies have attempted to establish the relationship between audit firm size and Auditor Independence. These studies have found out that there is a positive correlation between the two (Alvin Alleyne, Devonish, & Alleyne, 2006; Bakar, Rahman, & Rashid, 2005; DeAngelo, 1981; Gul, 1989; McKinley, Pany, & Reckers, 1985; Nichols & Smith, 1983; Shockley, 1981; Shockley & Holt, 1983). To say the least, scholars and practitioners have argued that “certain characteristics inherent in small audit practices may increase the danger of impairment of independence, for example, the tendency toward a more personalised mode of service and close relationship with the client” (Shockley, 1981). According to him, large firms are likely to operate more independently as compared to small firms. The size of large firms inspires them to provide quality and independent audits to protect their reputations (Ibid).

1.1.5 Challenges Faced in Establishing Auditor Independence

In a report prepared by Ernst & Young (2013) for the Audit Committee Leadership Summit, “some of the dynamics that elevate the importance of internal audit are the same dynamics that subject auditors to significant challenges. The report indicates that at large companies, these challenges include a global operating environment coupled with an intensified focus on risk (Ibid). The global operating environment poses the challenge of resourcing and multiple regulatory regimes; while an intensified focus on risk presents information technology risks and compliance risks.

Accountability, role clarity, and reporting lines are not always clear in the public sector (concerning the shareholder, the ‘directors’ and management as applicable in the private sector). The manner in which some public sector entities are structured makes this a specific challenge (Institute of Directors in Southern Africa Report, 2013). The independence

of the audit committee may be impaired due to previous/current relationships of audit committee members or the audit committee as a whole and political standing, among other factors.

1.2 Problem Statement

Auditor's independence can be viewed through actual or perceived independence with actual independence referring to the mental attitude of the auditor regarding professional objectivity while perceived independence relates to the public's or others' perceptions of the auditor's independence (Gul & Tsui, 1992). Auditor's independence has gained prominence in the accounting profession with some corporate scandals. The recent bankruptcies of many large corporations with clean auditor's reports around the globe have called to question the validity of the financial statements prepared by those corporations. The case of Enron in the United States, Parmalat in Italy and Cadbury in Nigeria are clear examples (Oladele, 2012). In Kenya, the recent corporate accounting scandal in Mumias has also cast doubt on the quality of reported earnings and the ability of audit process to effectively constrain earnings management of companies across the world and Kenya in particular (PAC, 2015; Enofe, 2010). The aforementioned corporate financial failures have cast aspersions on the quality of audit process carried out by audit firms.

According to [Okolie \(2007\)](#), statutory auditors are expected to audit the financial statements prepared by the directors of enterprises and express an independent opinion on them. Therefore, in accounting practice of today, the independence of the auditor is one of the most important issues because it increases the effectiveness of the audit by ensuring that the auditor plans and carries out the audit objectively. 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). Also, the seventh schedule of the Company's Act (CAP 486) laws of Kenya requires

the auditor to express in their reports whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for their audit. Their regulatory frameworks have provided the basis for auditor independence, albeit at a low success level.

Prior studies have examined factors affecting auditor independence such as: external and internal factors [Rusmanto \(2001\)](#) and Oladele, 2012), Non-Audit Services as factor affecting audit independence; the size of audit firm (Bakar et al., 2005) the clients' size (Pany & Reckers, 1980) factors that influence internal audit independence in Kenya and the competition in audit services market (Gul, 1991). Though studies exists on audit independence, literature review indicates that most studies have focused on both internal and external factors with limited studies focusing solely on internal factors influencing auditor independence. Due to paucity of research, this study was conducted to establish the internal determinants of external auditor's independence in Kenya.

1.3 Objectives of the Study

1.3.1 General Objective

The general objective of the study was to establish the internal factors that determine external auditors' independence in Kenya.

1.3.2 Specific Objectives

The specific objectives of the study were as follows:

- (i) To determine the influence of firm size on external auditors' independence in Kenya.
- (ii) To determine the effect of audit committee on external auditors' independence in Kenya.

- (iii) To determine the effect of auditor's tenure on external auditors' independence in Kenya.

1.4 Hypothesis

In order to attain the objectives of this study, this research tested the following null hypotheses:

H₀₁: Firm size has no significant influence on external auditor's independence in Kenya

H₀₂: Audit committee has no significant effect on external auditor's independence in Kenya.

H₀₃: Auditor's tenure has no significant effect on external auditor's independence in Kenya.

1.5 Significance of the Study

Auditor's independence is a key requirement in ensuring that auditors give an unbiased report. However, auditor's independence varies across different regions in the world, and this begs the question what are some of the determinants that result in such differences. The study is significant due to the following contributions:

Contribution to Knowledge Base

The study contributes to the understanding of the economic and behavioural model of external auditor's independence in developing countries, particularly in Kenya. The study significantly advanced the frontier of knowledge and added to the existing academic literature on auditors' independence. Through the study findings, the current audit firms have an understanding of the determinants of auditor's independence in Kenya. Through these findings, auditors can affect internal policies that can further enhance auditor's independence.

Contribution to Book Publishing Industry Stakeholders

[Beattie, Brandt, and Fearnley \(1999\)](#) stated that reform of the regulatory framework for accounting and auditing and of the ethical guidelines is an ongoing process. The general setting within which auditor independence perceptions are formed is subject to continuous change. Consequently, there is a need for regular studies on auditor independence to enable stakeholders and policy makers such as ICPAK to develop regulations, rules, and policies to address new threats and seek new regulatory safeguards. Providing empirical evidence from local context also will assist the policy makers and other relevant international accounting agencies in their attempt towards the international harmonisation of auditing standards.

Contribution to Theory and Practice

This study sought to shed light on various factors affecting the determinants of auditor's independence. The finding of the study contributes to making the auditing process as appropriate as possible. The study also contributes to the knowledge of the economic and behavioural model of external auditor's independence in developing countries, particularly in Kenya. The study findings are also of importance to the existing audit firms who through the findings will have an understanding of the determinants affecting auditor's independence in Kenya. Through these, finding auditors can affect internal policies that can further enhance auditor's independence.

1.6 Scope of the Study

1.6.1 Geographical Scope

The geographical scope of the study was auditors based in Nairobi County that has the majority of Auditors in Kenya.

1.6.2 Content Scope

The study considered determinants to auditor's independence with a focus on the following internal factors: firm size factors, audit committee and audit tenure in Kenya.

1.6.3 Time Scope

The study was conducted for a period of six months.

1.6.4 Methodological Scope

The study was limited regarding the methodology since the study only used quantitative study and not qualitative study, which would have provided a better method to gain the views of auditors on determinants of auditor's independence in Kenya.

1.7 Assumptions of the Study

The study was conducted on the assumption that the respondents would not be biased on their opinion and perspective on auditors' independence. The study was conducted under the assumption that the audit firms would co-operate in allowing data collection from Key respondents in their audit firms.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

This chapter summarises the information from other researchers who had carried out their research in the same sphere of study. The study specifically covers the theoretical discussions, empirical discussions, conceptual framework and research gap.

2.2 Theoretical Framework

This section discusses the theoretical framework for the study. There are some theories that have been used to underscore the factors that affect audit independence. However, in this study, the theory of source credibility was utilized.

2.2.1 Auditor Independence

[DeAngelo \(1981\)](#), defines auditor independence as “the conditional probability that given a breach has been discovered, the auditor will report the breach”. This is in concert with [Schatzberg \(1994\)](#) and [Shapiro, Schatzberg, and Sevcik \(1996\)](#) who define auditor independence as “truthful reporting”. As an extension of DeAngelo; [Magee and Tseng \(1990\)](#) interpret a lack of independence to mean that “an auditor’s decisions are not consistent with his or her beliefs regarding a reporting policy”. [Magee and Tseng \(1990\)](#), elaborate that the misapplication of an accounting rule is not impaired auditor independence but impaired “auditor competence”. They propose that an auditor’s independence is impaired when the auditor allows an audit failure to occur. An audit failure happens if the auditor makes a reporting decision inconsistent with their professional judgment. In contrast with this school of thought, which fails to stipulate a requirement that the client is complicit in the failure of the auditor to report a breach, [Lee and Gu \(1998\)](#) define auditor independence as “the absence of collusion between the auditor and the manager of the client firm”.

[Gendron et al. \(2006\)](#), defined auditor independence as the ability of the auditor to examine the financial statements and circumstances of a client from an unbiased perspective. Auditor independence is an internally manifested attitude as well as a characteristic perceived by third parties (J. L. Carey & Doherty, 1966). Auditor independence is critical to the accounting profession and the ability of its members to offer investors objective opinions and reports (Anandarajan, Kleinman, & Palmon, 2008). As [Vanasco, Skousen, and Santagato \(1997\)](#) explained, the opinions issued by auditors are only useful if the auditor is independent of the client in fact and in appearance. Auditors are expected to issue opinions on the fair presentation of financial statements of their clients (Anandarajan et al., 2008). As further clarified by [Anandarajan et al. \(2008\)](#), this task is complicated by the fact that audit clients directly compensate auditors and because of this, regulators use standards of conduct to promote objective reports for the users of financial statements. However, despite its importance to the profession and the users of financial data, auditor independence can be a complex and intangible value.

As [Anandarajan et al. \(2008\)](#) explained, various situations can cause a third party to question auditor independence. It was the purpose of the Sarbanes-Oxley (SOX) (2002) legislation in the United States (US) to address non-audit services, partner rotation, audit engagement team members, inappropriate compensation from the client, and impartial audit committees as situations that can appear to influence the auditor's independence negatively. Researchers such as (Abu Bakar & Ahmad, 2009); Adeyemi and Akinniyi (2011); Alvin Alleyne et al. (2006); Beattie et al. (1999); (Faraj & Akbar, 2010; Quick & Warming-Rasmussen, 2005); Al-Ajmi and Saudagaran (2011); El-Sayed Ebaid (2011)[Al Sawalqa and Qtish \(2012\)](#) have all used factors such as those included in the SOX legislation to empirically study the perception of independence in settings across the world.

[Dopuch and King \(1996\)](#) state that auditor independence can be impaired if auditors dishonestly report their audit findings. This portion of the definition is consistent with that of [DeAngelo \(1981\)](#). The definition, however, also states that auditor independence is impaired if auditors deliberately shirk on the amount of effort expended, thereby failing to discover material errors. For the purpose of this study, the definition put forth by [Dopuch and King \(1996\)](#) is viewed as more encompassing and in line with oversight agencies.

According to [Mellon \(2010\)](#), although the prior definitions from the academic literature address both aspects of auditor independence (in mind and in appearance) forwarded by oversight agencies, the definitions are too narrow in scope. Those definitions of impaired independence require that the discovery of a breach be made before the choice is made not to report the violation. This does not allow for the possibility that auditors, whether in collusion or not, will want to report in the client's best interest and therefore decide to shirk to avoid finding a breach. [Dopuch and King \(1996\)](#), however, consider both possible situations in their definition of impaired independence.

Despite the incentives for auditors to be biased in their decision-making, there are incentives for auditors to be objective. Auditors face potential civil and criminal liabilities in the event of an audit failure. Auditors face regulatory sanctions by organisations such as the SEC, PCAOB, ICPAK and state regulators if found negligent in conducting an audit. These accountability incentives relate to reputation professional loss that could severely inhibit future revenues. Auditors also have a professional code of ethics that gives them an incentive to act in an unbiased fashion (Moore et al., 2006).

[DeAngelo \(1981\)](#) definition of an audit failure has two components: the misstatement must be in the financial statements, and the auditor must fail to require its correction (either by not detecting it or by detecting it but waiving the necessary adjustment). The case usually

made against auditor independence focuses on the auditor failing to require the correction (the second part of DeAngelo's definition) while the first part (material error must be present in the financial statements) is often ignored. Auditors cannot find an error that does not exist. Clients with incentives for accuracy develop and maintain better internal controls and pressure clients less (Moore et al., 2006). For example, the SOX requirement of CEO/CFO certification of the financial statements (under potentially criminal prosecution) provides an incentive for top management to desire accuracy, which would decrease the number of material errors entering the financial statements before the audit. Thus, an often-overlooked part of the independence argument is that incentives cannot only encourage auditor independence but can also lower the number of material errors that enter the statements initially.

2.2.2 Theory of Source Credibility

In the psychology and Judgment and Decision Making (JDM) literature, the perceived credibility of an information source can be found to be a major determinant of the effectiveness of communication (McGarry & Hendrick, 1974). Individuals use credibility as a source cue and as a cognitive heuristic to formulate judgments, determine attitudes and attitude changes and make decisions (Birnbaum & Mellers, 1983). The importance of credibility as a heuristic has been observed in psychology and in accounting on auditors, and financial analysts (Hirst, 1994; Reimers & Fennema, 1999).

In the generic JDM setting, a judge must evaluate an information source's credibility to facilitate judgment or decision formation. The judgment of a source's credibility may be broken down into three constructs: source expertise, source bias, and judge bias (Birnbaum & Stegner, 1979). To illustrate, consider the case in which an automotive mechanic has been asked by the owner of a car to provide a report on the car to a potential buyer. The source is

the car mechanic, and the judge is the potential buyer. In processing the mechanic's report, the potential buyer must assess the credibility of the source. Application of prior research in psychology and JDM would predict that the buyer's evaluation of credibility is a function of his/her perception of the mechanic's expertise, the mechanic's bias (or independence) and the buyer's bias.

A source's expertise (denoted source expertise) is determined by the extent to which his/her report correlates with outcomes that may be empirically verified. In this context, expertise may be a function of the source's competence, knowledge, experience, and ability. Source bias, the inverse of source independence, encompasses those factors that are perceived to influence the source with such that a difference between a source's report and the actual state of events may occur. Factors that have been found to affect source bias are the source's interests (Walster, Aronson, & Abrahams, 1966) and incentives (Birnbaum & Stegner, 1979). The judge is the decision maker or judge of the information, and his /her bias relates to those internal factors that may influence his/her overall credibility evaluation. Examples of such factors include his/her initial opinion about the information and point of view (Birnbaum & Stegner, 1979; Sternthal, Dholakia, & Leavitt, 1978).

Research in psychology as well as in auditing topics indicate that source expertise and bias (i.e., lack of independence) are positively related to credibility judgments in that the greater a source's know-how and bias, the greater is the perceived credibility of the source's report (Birnbaum, Wong, & Wong, 1976; Hirst, 1994). Also, source expertise is positively related to source bias in that source expertise amplifies the effect of source bias on credibility judgments (i.e., the greater the expertise, the greater the effect of independence on credibility judgments) (Birnbaum et al., 1976; Hirst, 1994). Finally, source interests and incentives are

found to be positively related to source bias (and thus negatively related to source independence (Birnbaum & Stegner, 1979; McGarry & Hendrick, 1974).

Based on the existing literature on source credibility, an investor's judgment about the credibility of audited financial statements is expected to be a function of his/her judgment about auditor expertise and auditor independence as well as other factors (e.g. investor bias, management credibility). Perceptions of auditor expertise are expected to be a function of auditor competence, which encompasses an auditor's knowledge, training, experience, and ability. Perceptions of auditor independence are expected to be a function of auditor interests and other auditor incentives (to misreport audit results or allow uncorrected material misstatements) (Duff, 2004).

These predictions are consistent with the beliefs of regulators and the concepts underlying the independence rules. However, a contribution of this study is that it, unlike the existing regulations, identifies auditor incentives, as well as auditor interests, as being critical to investor independence perceptions. The current independence rules prohibit auditor interests in the client (Direct and material indirect), but do not explicitly address auditor incentives, and thus may not be effective. In summary, no formal 'theory' of auditor independence exists and thus, to date, analytical models concerning independence are very limited. However, we will use the theory of source credibility to perceived credibility of an information source on auditor independence in this study.

2.3 Models of Auditor Independence

According to studies by [Beattie and Fearnley \(2002\)](#), there are very limited analytical models concerning auditor independence since "no formal theory of auditor independence exists". Hence, most studies attempting to design models of auditor independence "focused on identifying the factors that potentially influence independence based on rational judgment".

In the following sub-section, economic models and behaviour model of auditor independence are discussed.

2.3.1 Economic Models

[DeAngelo \(1981\)](#) provides an economic modelling approach for analysing the auditor-client relationship and is widely cited, particularly in the research field of auditor independence (Geiger & Raghunandan, 2002). DeAngelo argued that the existence of client-specific quasi-rents to incumbent auditors would lead to a practice of setting audit fees below total costs or ‘low-balling’ in the initial period of an audit engagement, thus lessening independence. The rationale for audit firms to practice ‘low-balling’ is their ability to recover the loss incurred during the initial period by manipulating the client-specific quasi-rents that would accrue to them from continually auditing the same client.

The client-specific quasi-rents arise from the existence of technological advantages on future audits of a given client and from the expensive transactions costs involved in changing auditors. Incumbent auditors can capture these rents by setting future audit fees above the total costs of producing the audits. However, if they realise that they stand to lose the quasi-rents, their independence may be compromised as they attempt to retain the quasi-rents and to avoid termination of their contract by the client. Thus, DeAngelo concluded that low balling itself is not a threat to independence since the initial fee reductions are considered as sunk costs in the future and the rules prohibiting low balling will have little effect on the protection of independence. (Antle, 1982, 1984) also characterised auditors’ independence behaviour as motivated by economic self-interest. [Antle \(1982\)](#) commented that prior theories of demand for auditing were incomplete since they ignored the problem of auditor incentives. Antle argued that modelling an auditor, as an expected utility maximiser is similar to other models such as those that seek to understand the behaviour of owners, managers, and investors. This

allows the use of agency theory tools to examine the optimal contracting arrangements with the auditor.

2.3.2 Behavioural Models

Behavioural models of auditor-client relationships take a more complex view of auditor-client interactions than do economic models. [Goldman and Barlev \(1974\)](#) argued that the threat to independence is built into the structure of the auditing profession and that this situation pressures the auditors to violate the professional standards constantly. A structure of auditing in which the auditors are being appointed and paid for services by their audit clients creates a potential conflict of interests for those auditors. This conflict may limit the auditors' ability to resist management pressures, indicating a power asymmetry in the relationship, one that results in independence problems.

The authors held in their studies that auditors gain power when they can solve non-routine problems. They viewed consulting-type services as non-routine services. Consequently, they considered providing these services will increase the power and independence of the auditors. They argued that since the non-routine services benefit the client firm directly, preventing the auditors from providing such services “may result in a loss of valuable advice to the firm” and that this “is not likely to increase independence”. In contrast, they held that the statutory audit is a routine service and exists primarily for the benefit of a third party. Given that the statutory audit involves many standardised procedures and requires minimal discretionary judgments, it is classified as a ‘low power relationship’ in the Goldman and Barlev model. This means that auditors are likely to be less independent if they only provide external audit services to audit clients.

2.4 Factors Influencing Auditors Independence

This section presents the literature on the factors that affect audit independence as researched by other researchers. Specifically, the researcher presents the literature on the study variables, which include audit tenure, audit firm size, and audit committee.

2.4.1 Audit Tenure

The prolonged association between an audit firm and company-client could lead to the closeness of the auditing firm with its company client's management that in turn makes it difficult for the auditor to express his professional opinion freely. Previous studies were done by [Bamber and Iyer \(2007\)](#); [DeFond, Raghunandan, and Subramanyam \(2002\)](#); (Carcello & Nagy, 2004); Geiger and Raghunandan (2002), have shown that lengthy audit firm tenure leads to a reduced propensity of issuing a qualified audit report. Complacency, lack of innovation, less rigorous audit procedures, and a learned confidence may arise after a long association with the company-client. Professional accounting bodies like AICPA (1978 and 1992), ICAA and CPA Australia (2001) and Coordinating Group on Audit and Accountant Issues (2003) also expressed concerns that the length of audit client relationship may impair audit quality which in turn affects the auditors' independence.

Extended audit tenures have received much criticism from regulatory bodies, congressional bodies, academics and the press (Gul, Jaggi, & Krishnan, 2007). This is because most proponents against long (extended in our case) tenure like the regulatory bodies believe that the auditor independence will be impaired and hence the audit quality. They are of the opinion that when the auditors have extended audit tenures, there is the tendency for the auditors to gradually align themselves with the wishes of the management and hence cease to be independent (Gul et al., 2007). [Geiger and Raghunandan \(2002\)](#) also acknowledge that extended associations with the same client can lead to problems with independence though such associations in themselves are not detrimental. Simply put, not all extended

associations with a client can impair independence so long as the auditor remain as an advising arm to management and not join them to perform their tasks.

Another aspect been denounced is that the work of the auditor becomes increasingly routine when they have an extended audit tenure. Extended audit tenures make the audit work to become routine which affects the competence of the auditor. This is because working with the same client for a prolonged period of time will increase the auditor reliance on previous years' work thereby resulting to a repetition of the previous years' audits without any fresh perspectives. However, in a case where the auditors are required to be rotated, implying an elimination of extended audit tenures and thus shorter tenures, the auditors bring "fresh views" requiring an in-depth review of the previous years' audit work (Knechel & Vanstraelen, 2007).

On the other hand, extended audit tenures in themselves, are not detrimental as most studies have shown (Geiger & Raghunandan, 2002; Johnson, Khurana, & Reynolds, 2002; Knechel & Vanstraelen, 2007; Myers, Myers, & Omer, 2003). Those who support long associations are of the opinion that extended audit tenures could be beneficial to the audit firms or auditors as they garner firm-specific knowledge. Though the auditor may have the auditing expertise and the industry knowledge, they may lack the adequate client/firm specific knowledge to ensure an efficient and quality audit (Geiger & Raghunandan, 2002; Myers et al., 2003).

This client knowledge comes with extended audit tenures because in the early stages of the audit, the auditor may fall short of this knowledge and the quality of the audit may suffer. As evident in [Myers et al. \(2003\)](#), another view of proponents for extended audit tenures also suggest that start-up audit costs will be higher in the initial years of the audit. They argue that short audit tenures will increase audit start-up costs and increase the risk of

audit failures as there will be increasing reliance by the auditor's tenure respectively. On the client's estimates and representation in the initial years of the audit (Myers et al., 2003). It is important that we point out some interesting literature about the economic viewpoint that is mostly referenced in articles that write on auditor independence and audit tenure respectively.

[Ouyang and Wan \(2013\)](#) in a study that was carried out in the USA to establish the effect of audit tenure on auditor independence. The empirical evidence in this study suggests that firms with lengthy audit tenure, particularly those with audit tenure longer than ten years, are more likely to backdate. However, the detrimental effect of long audit tenure on audit quality only exists in clients with small firm size. Most of the large audit firms can undertake large company audits effectively, with the aid of research facilities, superior technologies, and better-experienced employees. The study was carried out in developed nation, USA and thus necessitating need for such studies in least developing nations such as Kenya.

In a study by [Ye, Carson, and Simnett \(2006\)](#), that sought to establish the relationship between auditor independence and non-audit services, audit firm tenure, audit partner tenure and alumni affiliation. Their findings showed that the prohibition of lengthy audit firm tenure might not be necessary. However, the study was limited in terms of methodology since it used qualitative research methodology thus necessitating studies that use quantitative research methodologies.

2.4.2 Audit Firm Size

Larger audit firms are often considered less subject to a loss of independence than are smaller firms. Arguments to this effect commonly follow one of two lines. First, a large audit firm tends to be less dependent on a given client than is a smaller firm because the associated fees usually constitute a smaller proportion of the audit firm's total resources (Mautz & Sharaf, 1961). Second, certain characteristics inherent in small audit practices may increase the

danger of impairment, e.g., the nature of the typical small firm client or the tendency toward a more personal mode of service and close relationships with the client.

Audit firm size may also interact with the level of competition in the audit environment. Because of its smaller revenue base, a small firm may not be able to withstand the effects of competition as well as a larger firm. It is usually at a disadvantage because of (1) the prestige associated with larger firms, and (2) the superior financial resources available to larger firms (AICPA, Cohen Commission Report, 2008). [Habib and Islam \(2007\)](#) Performed a study in Bangladesh on factors affecting non-audit services, and their conclusion arrived at shown that larger audit firms with higher liquidity and international links purchased more non-audit services than the smaller ones. This implies that the bigger the audit firm size, the higher the provision of non-audit services. In a more litigious society, the firms are concerned with reputation costs and effect on perceived audit independence. In a study on the effect of non-recurring and recurring on audit independence, [Alexander and Hay \(2013\)](#) confirmed that companies that purchase any non-audit services from their auditors are larger than companies that purchase auditing only. These studies were limited to firm size and non-audit service while ignoring audit independence thus necessitating this study.

[Bauwhede and Willekens \(2004\)](#), carried out a study to test the effects of audit firm size on audit quality in the Belgian market for a sample size of 1302 companies. For audit size, they considered some indexed such as the auditor's market share, the number of the clients for an audit firm, the number of partners of the audit firm, the total assets and total operating profit for an audit firm. Finally, the results of their research showed that there is no significant relationship between audit quality and audit size. [Al-Thuneibat, Issa, and Baker \(2011\)](#) did a study on the effect of audit tenure and firm size on audit quality in Jordan; the findings revealed that audit tenure affects adversely audit quality while firm size had no

impact on the correlation between audit tenure and quality. These studies focused on relationship between firm size and audit quality and ignored audit independence.

In another study carried out by [Tahinakis and Nicolaou \(2004\)](#) in Greece to analyse audit independence it was established that auditors regard smaller audit firms to be more likely to lose certified auditor's independence than larger audit firms, second, this is because high levels of competition among audit firms increase the risk that certified auditor's independence might be impaired. However, the study found out that certified auditors weighted provision of management advisory services much more heavily in small audit firms than did in big ones. This difference may result because large audit firms afford special, qualified, separate staff for the management advisory services function are less likely to impair the independent certified auditor status, while in small firms such specialisation is neither possible nor feasible.

2.4.3 Audit Committee

The concept of audit committees has been in existence for decades; however, there is no ideal and/or accepted definition of it. According to [Porter, Simon, and Hatherly \(2014\)](#), most definitions include the following characteristics: (1) it is a subcommittee of the main board (2) it is comprised of a majority of non-executive directors (3) it plays a role in the review of financial reporting process, communicates with the auditors, and reviews internal controls. One major advantage of having an audit committee is that they could enhance auditor independence (Fearnley & Beattie, 2004) discovered that an audit committee is more likely to support the auditor instead of management in audit disputes and the level of assistance is consistent across members of the audit committee, regardless of whether the member is a full time or part time position, such as corporate managers, academicians and retired partners of CPA firms.

Pearson (2008) and [Dockweiler, Nikolai, and Holstein \(1986\)](#) found in a study that auditors' reliance on management is reduced due to the direct effect that independent could strongly encourage auditor independence. In addition, audit committees could play a role in selecting auditors, determining their remuneration and dismissal/retention of auditors. Beattie *et al.* (2009) reported that audit partners, finance directors, and financial journalists believed that audit committee consist of non-executive directors that also independent could strongly encourage auditor independence.

In a study by [Muhamad Sori, Mohd, and Mohamad \(2007\)](#) which attempted to establish the relationship between audit committee and auditor's independence. The study looked at five component of audit committee: active audit committee, compulsory audit committee reports, audit committee approves audit fees, audit committee reviews audit fees, audit committee comprised of a majority independent and non-executive directors, to auditor independence. The study revealed that the majority of the respondents agreed that auditor independence would be safeguarded by the presence of an active audit committee, if it was compulsory to include an audit committee report in the annual report, if the audit committee was responsible for approving and reviewing audit fees, and if the majority of audit committee members were independent and non-executive. The study solely focused on managers perception of audit committee and did not delve on auditors.

[Sharma and Iselin \(2012\)](#) did a study on the effects of independent audit committee member characteristics on auditor independence financial restatements. Specifically, this study investigates the relationship between the likelihood of financial restatements and: the expertise of the independent audit committee members, the know-how and diligence of the independent audit committee members, the reputation of the independent audit committee members, the interaction effect of specialization, diligence and reputation, the tenure of the independent audit committee members, and the cash compensation paid to independent audit

committee members. The results of the study showed that after controlling for other governance structures and firm-specific non-governance variables, the likelihood of financial restatements is related to independent audit committee member characteristics and auditor independence. The study used audit committee as a moderating variables and did not test audit committee as an independent variable.

2.5 Empirical Review

This section presents the literature on the factors that affect audit independence as researched by other researchers. Specifically, the researcher presents the literature on the study variables, which include audit tenure, audit firm size, and audit committee.

2.5.1 Audit Tenure

Okolie (2007) conducted a study to examines the relationship and effects of auditor tenure on auditor independence among public companies in Nigeria. The study relied on secondary derived from various companies' reports and financial statements. The descriptive statistics result revealed that audit tenure affects auditor independence of public companies. The study used secondary data to test the relationship between audit tenure and auditor independence thus necessitating the need for studies that use primary data.

In a study by Chia-Ah and Karlsson (2010), who purpose was to examine whether extended audit tenures can affect auditor independence. The study targeted a sample of 1,250 Swedish auditors through online questionnaire. The findings did not reveal any strong relationship between audit tenures and audit independence. Th study explored audit tenure among auditors in sweeden, a developed nation which has stronger regulations than developing countries such as Kenya.

[Tahinakis and Nicolaou \(2004\)](#), in a study carried out in Greek, sought to examine the perceived effects of audit tenure on audit independence. The study found out that increased

audit tenure is a major determinant of audit independence in Greece. The study concluded that longer audit tenure increases audit independence of small audit firms. The focus of the study was on small audit firms thus leaving medium and large audit firms. This makes it necessary to have more studies on all auditors.

According to a study by [Ouyang and Wan \(2013\)](#) that was carried out in the USA to establish the effect of audit tenure on auditor independence. The empirical evidence in this study suggests that firms with lengthy audit tenure, particularly those with audit tenure longer than ten years, are more likely to backdate. However, the detrimental effect of long audit tenure on audit quality only exists in clients with small firm size. The study also discovered that auditor's independence is positively associated with the size of the audit firm because they have difficulty in resisting client pressure. The study concludes that audit tenure has the same effect in both developed and developing countries, this necessarily is not the case.

In a study by [Ye, Carson, and Simnett \(2006\)](#), that sought to establish the relationship between auditor independence and non-audit services, audit firm tenure, audit partner tenure and alumni affiliation. Their findings showed that the prohibition of lengthy audit firm tenure might not be necessary. They disagree with recent findings of other corporate researchers that a long auditor-client relationship can have a possible adverse effect on the independence of an auditor. The study was carried out among internal auditors of companies and not audit firms as the current study.

2.5.2 Audit Firm Size

[Habib and Islam \(2007\)](#), conducted a study in Bangladesh on factors affecting non-audit services, and their conclusion arrived at shown that larger audit firms with higher liquidity and international links purchased more non-audit services than the smaller ones. This implies that the bigger the audit firm size, the higher the provision of non-audit services. In a more

litigious society, the firms are concerned with reputation costs and effect on perceived audit independence. The study delved on relationship between audit firm size and non-audit services, which is not an aspect of audit independence.

[Alexander and Hay \(2013\)](#), carried out a study to test the effects of audit firm size on audit quality in the Belgian market for a sample size of 1302 companies. For audit size, they considered some indexed such as the auditor's market share, the number of the clients for an audit firm, the number of partners of the audit firm, the total assets and total operating profit for an audit firm. Finally, the results of their research showed that there is no significant relationship between audit quality and audit size. Similarly, [Al-Thuneibat, Issa, and Baker \(2011\)](#) did a study on the effect of audit tenure and firm size on audit quality in Jordan; the findings revealed that audit tenure affects adversely audit quality while firm size had no impact on the correlation between audit tenure and quality. These studies focused on audit quality an aspect of audit independence thus excluding audit independence.

In another study carried out by [Tahinakis and Nicolaou \(2004\)](#) in Greece to analyse audit independence it was established that auditors regard smaller audit firms to be more likely to lose certified auditor's independence than larger audit firms, second, this is because high levels of competition among audit firms increase the risk that certified auditor's independence might be impaired. However, the study found out that certified auditors weighted provision of management advisory services much more heavily in small audit firms than did in big ones. This difference may result because large audit firms afford special, qualified, separate staff for the management advisory services function are less likely to impair the independent certified auditor status, while in small firms such specialisation is neither possible nor feasible.

2.5.3 Audit Committee

Pearson (2008) and [Dockweiler, Nikolai, and Holstein \(1986\)](#) found in a study that auditors' reliance on management is reduced due to the direct effect that independent could strongly encourage auditor independence. In addition, audit committees could play a role in selecting auditors, determining their remuneration and dismissal/retention of auditors. Beattie *et al.* (2009) reported that audit partners, finance directors, and financial journalists believed that audit committee consist of non-executive directors that also independent could strongly encourage auditor independence.

[Goldman and Barlev \(1974\)](#) in a study established that audit committees could monitor the financial reporting process and provide recommendations in the selection of auditors, negotiation of fees and termination of external auditors, which would ultimately diminish management's power over the auditor. Thus, the audit committee is anticipated to ensure that the firm has sufficient internal controls, proper accounting policies, and independent external auditors that will prevent the incidence of fraud and promote high quality and timely financial statements. The study focused on listed companies and left out private companies wherein audit companies fall.

In a study by [Muhamad Sori, Mohd, and Mohamad \(2007\)](#) which attempted to establish the relationship between audit committee and auditor's independence. The study looked at five component of audit committee: active audit committee, compulsory audit committee reports, audit committee approves audit fees, audit committee reviews audit fees, audit committee comprised of a majority independent and non-executive directors, to auditor independence. The study revealed that the majority of the respondents agreed that auditor independence would be safeguarded by the presence of an active audit committee, if it was compulsory to include an audit committee report in the annual report, if the audit committee was responsible for approving and reviewing audit fees, and if the majority of audit

committee members were independent and non-executive. The study also found out that the respondents have faith in the existence of audit committees in the Malaysian capital market, which would enhance communication between auditors and management. The study focus was on internal auditors in companies and did not seek to establish the perception of auditors a focus of current study.

[Sharma and Iselin \(2012\)](#) did a study on the effects of independent audit committee member characteristics on auditor independence financial restatements. Specifically, this study investigates the relationship between the likelihood of financial restatements and: the expertise of the independent audit committee members, the know-how and diligence of the independent audit committee members, the reputation of the independent audit committee members, the interaction effect of specialization, diligence and reputation, the tenure of the independent audit committee members, and the cash compensation paid to independent audit committee members. The results of the study show that after controlling for other governance structures and firm-specific non-governance variables, the likelihood of financial restatements is related to independent audit committee member characteristics and auditor independence. Specifically, the study established that the probability of financial restatements decreases when independent audit committee members are experts, specialists and diligent, reputable, experts, diligent and reputable, and appropriately compensated. The study used secondary data thus necessitating the use of primary data.

Zhang, Zhou, and Zhou (2007) In a study investigated the relation between audit committee quality, auditor independence, and the disclosure of internal control weaknesses after the enactment of the Sarbanes-Oxley Act. The study established that there is a significant relationship between audit committee quality, auditor independence, and internal control weaknesses. The study concluded that firms are more likely to identify their internal

control weakness, if their audit committees have less financial expertise or, more specifically, have less accounting financial skills and non-accounting financial expertise.

Chinwe and Okafor (2012) carried out a study to examine the relationship between auditor's tenure, audit firm size and auditor's independence in Nigeria. The study results established that audit firm has a positive correlation with audit independence with no significant relationships. This goes to show that audit firm size has no significant influence on auditors' independence in Nigeria. This could be that certain characteristics inherent in one audit firm practised in Nigeria may increase the danger of impairment of independence, with the tendency of a more personalised mode of service and close relationship with the client. The study results also confirmed that auditors' tenure has a positive correlation but no significant association with auditors' independence in Nigeria. The study used audit committee as a moderating variables findings showed that preventing a prolonged audit firm tenure may not be necessary because it may not hurt the independence of an auditor even though we know that the attachments between directors and auditors are because of a continued business relationship

Ofuan and Izien (2014) carried out a study to examine the impact of audit firms' characteristics on audit quality. The findings indicate that there is a positive relationship between firm size, board independence and audit quality whereas there is a negative relationship between auditor's independence, audit firm size, audit tenure and audit quality. The study also established that with more enforced regulation auditor's independence improve considerably in small audit firms than big firms. A key focus of the study was on audit quality and not audit independence.

2.6 Research Gap

Most of the studies that have been done on auditor's independence have focused on the developed nations, with most focusing on perceptions of auditors in audit firms. The literature review also revealed that few studies have been carried in Kenya on auditor's independence. Literature review showed that most studies have focused on external audit factors with few focusing on internal audit factors. This study sought to fill this research gap by looking at all the internal factors that influence auditor's independence as illustrated in the empirical review.

2.7 Conceptual Framework

The conceptual framework provides a relationship between the dependent and independent variables and is used in research to outline possible courses of action or preferred approach to the research subject (O. Mugenda & Mugenda, 2003). A critical review of the literature shows some studies that have been carried out to establish the effect of economic factors, regulatory factors, and firm size factors. [Sweeney and Roberts \(1997\)](#) in a study establish that there is an insignificant relationship between audit firm size and auditor's independence while [Caramanis and Spathis \(2006\)](#) determined that firm size has a significant association on auditor independence. This is because firm size determines education, work experience, and training within audit firms.

Flint (1998) suggested that auditor's independence is enhanced through a regulatory agency through monitoring the auditors' conduct and their professionalism with an aim to maintain public confidence. This is supported by the enforcement of audit standards, with the violators of such standards sanctioned by the professional bodies. The more rigorous the standards, the more likely an audit firm will be independent and give quality work. Previous studies on economic factors that affect auditor's independence have shown that auditor

competition has a mixed effect on auditor independence. A study by [Knapp \(1985\)](#) established that competition had no significant effect on auditor independence while a study by (Gul, 1989) found that competition has a significant effect on auditor independence. Studies on the effect of non-audit services on audit independence have shown inconsistent findings with a study by Moore (1993) show that non-audit services can affect audit independence while a study by Buchman (1996) have shown that non-audit service does not affect audit independence.

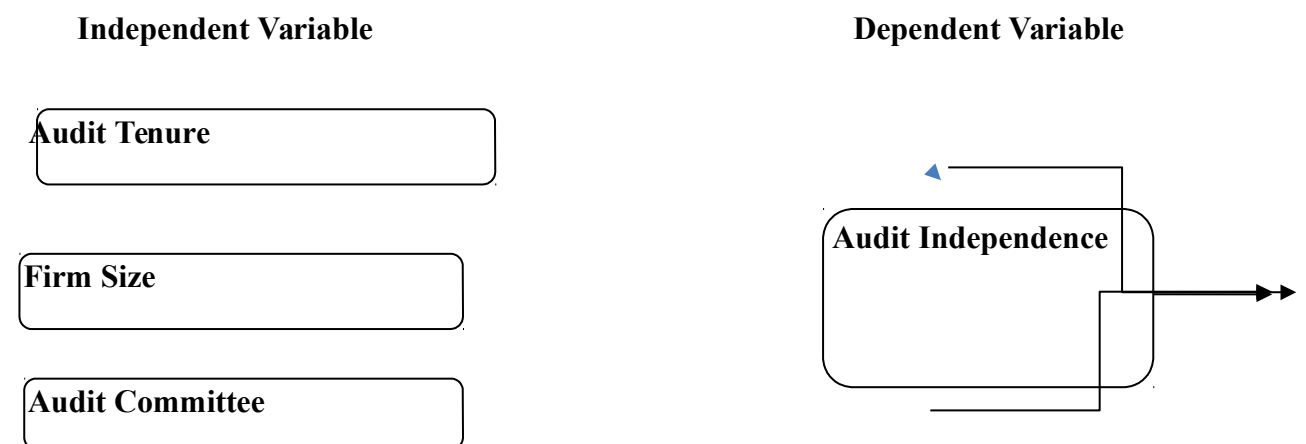


Figure 1: Conceptual Framework

Source: Author (2016)

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Introduction

This chapter describes the research methodology that was used in this study. It discusses the research design with respect to the choice of the design. It also discusses the population of study, sample and sampling techniques, data collection methods as well as data analysis and data presentation methods employed in the study.

3.2 Research Design

The study used a cross-sectional descriptive study design. Descriptive studies describe characteristics associated with the subject population. Saunders et al., (2003) assert that a descriptive research portrays an accurate profile of persons, events or situations. Kimani (2006) notes that a descriptive research collects data from members of a population and helps the researcher get the descriptive phenomena by asking individuals about their perceptions, attitudes, behaviour or values. The cross-sectional descriptive survey was also used to allow for the collection of data from many respondents over a small period thus limiting the cost.

3.3 Target Population

The population is the aggregate of all that conforms to a given specification. In other words, population refers to an entire group of individual's, events or objects having a common observable characteristic. For the purpose of this study the researcher focussed on the 666 audit firms located in Nairobi (<http://www.icpak.com/directory.php>). The unit of analysis for the study were auditors who responded.

3.4 Sample Size and Sampling Technique

Sampling is the process of selecting a sufficient number of the right elements from the population ([Groves, 2010](#)). The study used a sample size of 214 audit firms since it was large enough compared to the study population of the audit firms selected in Nairobi. This sample size was obtained using the following formula proposed by Agatha (2009):

$$P = F/N \times n. \text{ Where; } F = \text{Number of category of Audit Firms}$$

$$N = \text{Total population of Audit Firms in Nairobi.}$$

$$P = \text{Number of respondents in the category to be obtained from each audit firm}$$

$$n = \text{Total number of the respondents needed by the study.}$$

Note : $N = 666$, $F = 3$, $p = 3$ practicing staff/managers/directors per audit firm.

The study used stratified sampling to determine the number of audit firms to be selected as a sample size in the following categories of small, medium and large. This helped in categorising the audit firms according to the size of the firm. The proportion of small, medium and big audit firms was sourced from ICPAK (ICPAK, 2014). After determining the sample size for each category of the audit firms, purposive sampling was used to select Key respondents who participated in the study from different audit firms.

3.5 Data collection

Data collection is the gathering of empirical evidence to gain new insights about a situation and answer questions that prompt undertaking of the research (Flick, 2009). Primary data was collected from the key staff, managers and directors of audit firms in Nairobi using a semi-

structured questionnaire that developed by the researcher by research questions. Attached as Appendix 1.

3.5.1 Pre-testing

According to [Orodho \(2004\)](#), for a questionnaire to provide useful results, the questions must be both valid and reliable. Reliability measures the degree to which the study findings can be replicated using the same study instruments. Validity refers to the ability of the instrument to test what it is supposed to be tested. Pre-testing enables the researcher to receive valuable feedback on how questions are to be recorded or restructured. The questionnaire needs to be pre-tested under field conditions before it is ready for the field (Somekh, 2005). It is critical for the researcher to pre-test research instruments to enhance clarity of the instruments to be used. The purpose of enhancing clarity is to ensure collection of accurate information and to correct any deficiencies revealed during pre-testing exercise (O. M. Mugenda, 1999). The researcher pre-tested the questionnaire on five audit firms in Nairobi with the audit firm where the pilot study was conducted not allowed to be part of the main study. The instrument was pre-tested among ten auditors from the five audit firms, two auditors from each audit firms.

3.6 Data Reliability and Validity

3.6.1 Reliability of the Study

Reliability as the degree of consistency and precision in which the measuring of the instrument demonstrates under same circumstances, same research respondents using the same instrument should generate the same results under identical conditions (Amin, 2005). In determining the reliability of the instrument, the researcher administered ten questionnaires to auditors who were consequentially not included in the Study. To ascertain the reliability of

the study, Cronbach's Alpha coefficient was used to assess the internal consistency and a score of 0.89 were obtained which was above the cut-off point of 0.7.

3.6.2 Validity of the study

Validity measures the degree to which an instrument measure that which it is out to measure (Smith, 2003). The validity of the instrument was measured using the valid content index that is the total number of valid items/ total number of items. The questionnaire was selected and subjected to a valid content index and with a score of 0.75 established thus indicating the validity of the instrument.

3.7 Data Analysis Techniques

Data analysis usually involves reducing accumulated data to a manageable size, developing summaries, looking for patterns, and applying statistical techniques (Cooper & Schindler, 2000). The study used the quantitative method of data analysis, that is, mean and mode. To ensure easy analysis, and minimise the margin of errors, questionnaires were coded according to each variable. The raw quantitative data was entered into computers and analysed using Statistical Package for Social Sciences (SPSS) version 22. Additionally, factor analysis statistical technique was used. The use of charts presented the findings of the study, and tables to convey visual impressions of meanings or to clarify information that may be hidden within the data. Study conclusions were reached based on the summary of the data analysis. Ordinal regression technique was used to determine the significant factors to auditor independence.

3.7.1 Model Specification

The regression equation was:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$$

Where

Y is the dependent variable (auditors' independence),

β_0 is the constant of the regression model,

β_1 , β_2 , and β_3 are the coefficient of independent variables;

X_1 is the firm factor;

X_2 is audit tenure

X_3 is the audit committee

While ε is an error term normally distributed about a mean of 0 and for the purpose of computation, α is assumed to be 0. β_1 is the degree to which a change in X_1 by one unit results in a change in Y . β_2 is the degree to which a change in X_2 by one-unit results in a change in Y . β_3 is the degree to which a change in X_3 by one unit results in a change in Y . ε refers to the effect of factors that have been omitted in the regression model.

The equation was solved by the ordinal regression to test the model, with R^2 used to test the results of data; with a value of R^2 , nearing one indicating that auditor independence is caused to a significant degree by the independent variables. Pearson correlation was used to test the relationship between each predictor variable and audit independence. This was a p -value, with a p -value of less than 0.05 indicating that there is a significant relationship between the predictor factor and auditor independence.

3.7.2 Operationalization and measurement of study variables

Table 1: Operationalization of the Study Variables

Category	Variable	Indicators	Measurement	Question Number
Dependent Variable	Auditors independence	Professional objectivity	Reliability of financial statements	Question 8
Independent Variable	Firm Size	Geographical operation of audit firm, No of Partners, No of clients	No of Employees in the firm, No of Partners in the firm	Section B
Independent Variable	Audit Tenure	Duration of Audit Firm with a Client	Number of years spent as auditor with a client	Section A
Independent Variable	Audit Committee	Audit committee reports	No of committee meetings	Section C

Source: Author 2016

Table 2: Relationship between the Objectives, Hypothesis and the model used in the study

Objective	Hypothesis	Model	Interpretation
To determine the influence of firm size on auditors' independence in Kenya	H1. There is a statistically significant relationship firm size and auditor independence among auditors in Kenya.	$\beta_1 X_1$	P- Value less than 0.05 will indicate that firm size has a significant relationship on auditor's independence.
To determine the influence of audit tenure on auditors' independence in Kenya	H2. There is a statistically significant relationship between audit tenure and auditor independence among auditors in Kenya.	$\beta_2 X_2$	P- Value less than 0.05 will indicate that audit tenure has a significant relationship on auditor's independence.
To determine the influence of audit committee on auditors' independence in Kenya	H3. There is a statistically significant relationship between audit committee and auditor independence among auditors in Kenya.	$\beta_3 X_3$	P- Value less than 0.05 will indicate that audit committee has a significant relationship on auditor's independence.
To determine whether auditor independence is a perception or reality in Kenya	H4: Auditor independence in Kenya is a reality	$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \epsilon$	(R ²) will be used to test the significant relationships of all the independent variables on auditor independence with a low R ² indicating that auditor

Objective	Hypothesis	Model	Interpretation
			independences are affected by factors none other than the ones in the study

Source: Author 2016

3.8 Ethical consideration

The researcher sought for an introduction letter from the University (KCA), which was used to request permission from Institute of Certified Public Accountants of Kenya (ICPAK). The letter of permission from ICPAK was then presented to the respondents for their assent and consent to participate in the study was sought.

CHAPTER FOUR

DATA ANALYSIS, PRESENTATION, AND INTERPRETATION

4.1 Introduction

The purpose of this study was to analyse the audit firm's internal factors such as audit tenure, audit firm size and composition and diversity of audit committee influence on auditors' independence among registered and practising accountants in Kenya. It further examined the extent to which such factors affect the independence of auditors. This chapter, therefore, presents the results of the study and the inferences made from the analysis.

4.2 The Descriptive Characteristics of the Respondents

Before the results of the questionnaire survey are reported, it is important that the background information of respondents in this study be presented. The respondents were asked about their gender, age, experience and academic qualification. This information is important since it provides an overall impression of the respondents in the study and thereby allowing for investigation of the main demographic factors if possible in the study.

The study collected data from 97 auditors. Among them, 71% were male and 29% female (*Figure 2*). These findings show that the field of auditing is still dominated by the males as also reported by [Wekesa \(2014\)](#).

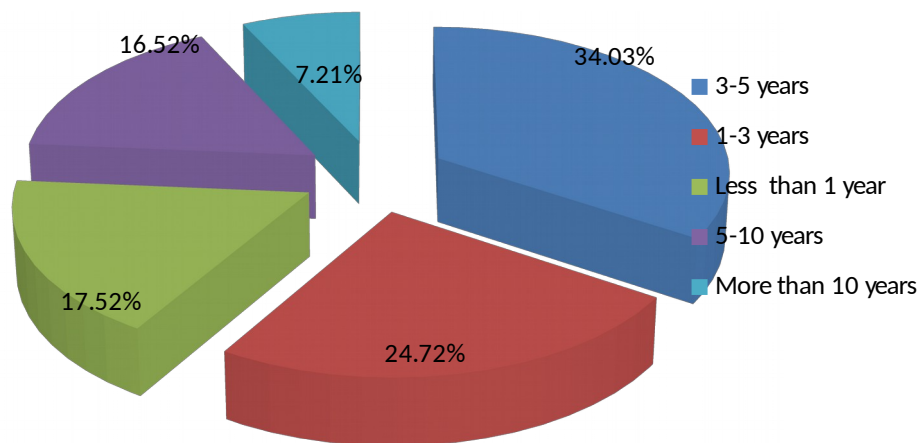


Figure 2: Distribution of Respondents by Gender

Source: Author 2016

The majority of the respondents (85%) were aged between 18 and 33 years, which comprised of the youth. Forty-five per cent were aged between 18 and 27 years, while 39% were aged between 28 and 33 years, 9% between 34 and 39 years, 4% and 2% between 40-49 years and more than 50 years respectively (*Table 4*). This indicated that respondents in the study were heterogeneous.

Table 3: Distribution of Respondents by Age

Age	Frequency	Percentage
18-27 years	44	45.4
28-33 years	38	39.2
34-39 years	9	9.3
40-49 years	4	4.1
50 and above	2	2.1
Total	97	100

Source: Author 2016

Concerning the level of education of the respondents, most of them had first degree and above with 80% possessing a Bachelors' degree, and 19% of them had a Master's degree. Only 1% of the respondents had diploma level of education (*Figure 3*). These Findings indicate that the respondents esteem the importance of higher education in the career as such

majority had at least degree level of education. These results are similar to the results of [Wekesa \(2014\)](#).

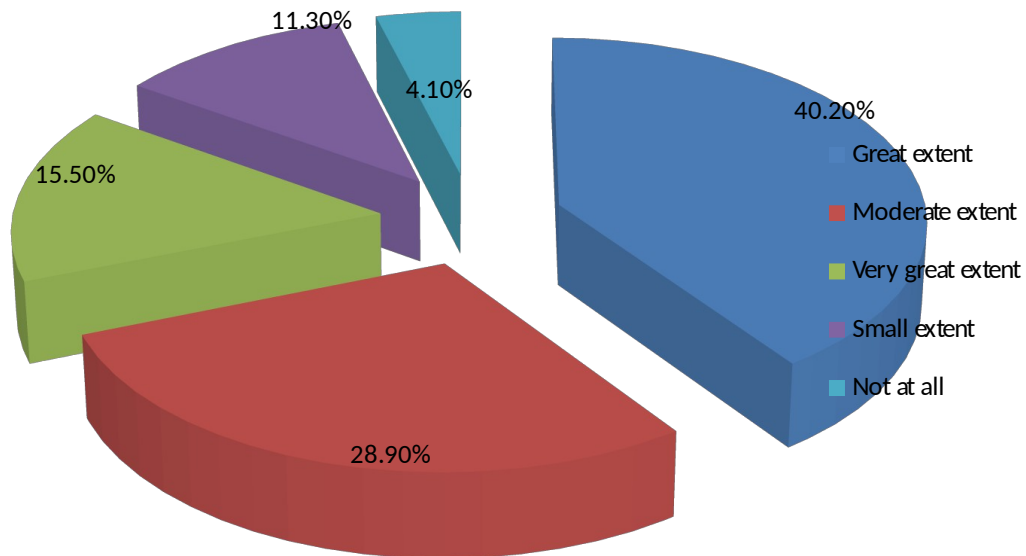


Table 4: Level of Education of Respondents

Source: Author 2016

Most of the respondents (82%) had a working experience of at least one year in the audit firm they worked in, whereby 34% had been working for between 3-5 years in the audit company and another 25% between 1 and 3 years, 17% had been working for between 5 and 10 years and 7% for more than 10 years. Only 18% had been working in their respective audit firms for less than one year (*Figure 4*). The study indicates that majority of the respondents had considerable experience in the audit industry as such could be acquainted with some of the challenges facing auditor independence. These findings are contrary to the study by [Ahmad \(2012\)](#) who had the majority of the respondents with work experience of above five years. This was attributed to the reason that the study targeted managers as the main respondents.

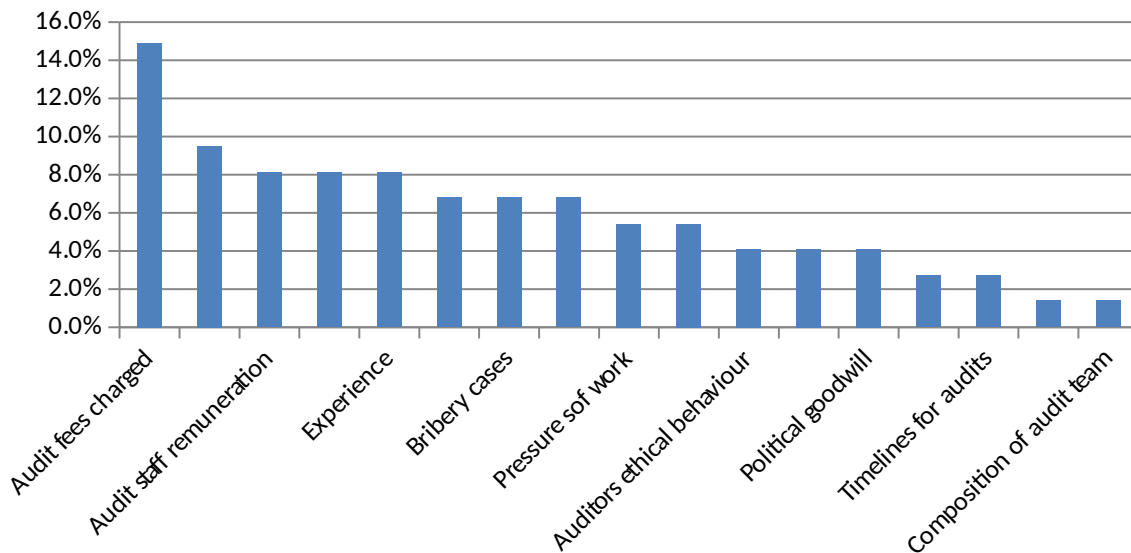


Figure 3: Distribution of respondents based on the years of experience

Source: Author 2016

The study also sought to understand the sizes of firms depending on the number of their employees. The majority of the firms (62.5%) had more than 100 employees while 27% had less than 50 employees and 10% had between 50 and 100 employees (*Table 5*). From the findings, it can be deduced that majority of auditors work in big firms, and this may be attributed to the dominance of big firms in the audit industry.

Table 5: Size of the Firm

Number of employees	Frequency	Percentage
More than 100 employees	60	62.5
Less than 50 employees	26	27.1
50-100 employees	10	10.4
Total	96	100

Source: Author 2016

The researcher sought to establish whether the respondents possessed professional certificates such as ACCA and CPA. Most of the respondents (81%) were in possession while 19% did not possess. Among those who possessed the professional certificates, 51% had fully registered as members of professional bodies such as ICPAK while 49% were associates or had partially registered as members. Very few of the respondents indicated that they had no

professional certificates on accounting qualification such as the ACCA or CPA. This is not surprising given that accounting qualification is a requirement for one to work as an auditor. From the findings of the study, it was established that majority of the respondents perceive that being a member of ICPAK is beneficial to them. Hence the results indicate that majority of the respondents were full members of ICPAK, an institute for certified public accountants in Kenya.

Table 6: Membership to Professional bodies

Variable		Frequency	Percentage
ACCA or CPA certificate	Yes	79	81.4
	No	18	18.6
	Total	97	100
Membership	Full Membership	41	51.3
	Associate	39	48.8
	Total	80	100

Source: Author 2016

The study further sought to establish the auditor's level of independence through a five-point Likert scale (where 1 is very high and 5 very low). The respondents felt that the auditors held a high degree of independence (mean=2.61). Half of the respondents (50%) cited that the level of independence was average, while 28% believed it was high and 11% each believed it was very high and low respectively. The perception of the respondents towards auditor independence was that AI level is moderate. This finding only confirms that there are possible factors that affect AI in Kenya. These results are supported by the results of [Bichanga and Kamau \(2012\)](#) who established that most auditors are members of professional bodies.

Table 7: Auditors’ level of independence

Auditors level of independence	Frequency	Percentage	Mean
Average	48	49.5	2.61
High	27	27.8	
Very high	11	11.3	
Low	11	11.3	
Total	97	100	

Source: Author 2016

4.3 Factors that Influence Auditors’ Independence

The aim of this study was to analyse the factors that affect auditors’ independence among registered and practising accountants in Kenya. This section, therefore, presents the detailed findings of the study. The findings are based on respondents’ perceptions and regression analysis.

4.3.1 Audit Tenure and Auditors Independence

The study sought to establish the various factors that contribute to the independence of the auditors.

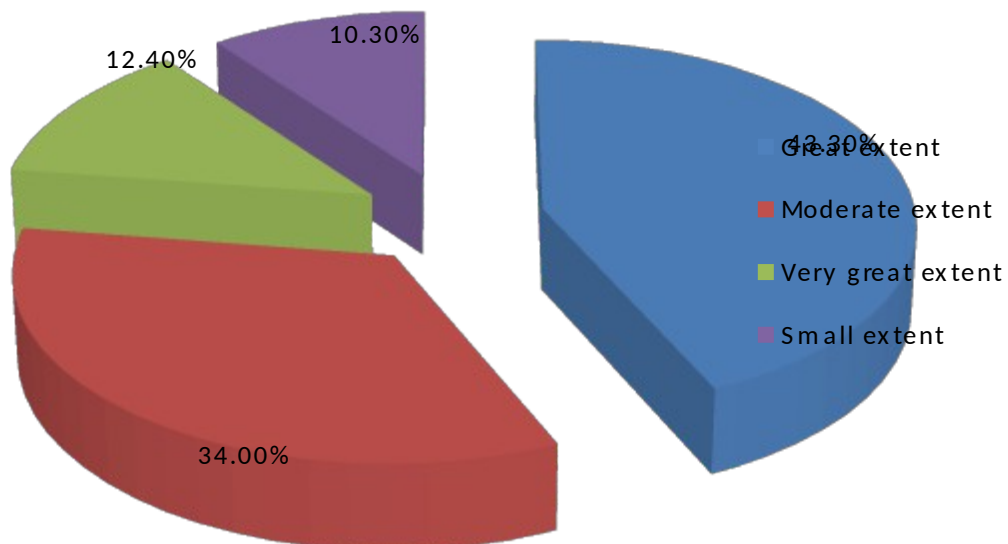


Figure 4: Audit firm size and auditors’ independence

Source: Author 2016

To understand the relationship between audit tenure and audit independence, various Likert questions were asked. From the responses, it emerged that 43% of the respondents believed that audit tenure affects audit independence to a great extent, 34% of the respondents believed to a moderate extent, 13% believed to a very great extent and 10% to a small extent. It can thus be established that there is a perception that audit tenure as a factor determines auditor independence. This according to [Alvin Alleyne et al. \(2006\)](#) is because tenure impacts on the relationship between clients and auditors with the resulting impact being on the quality of information shared.

An in-depth look at the extent of the influence of audit tenure to the auditors' independence revealed that audit tenure influenced the auditors' independence to a great extent as shown in Table 8 below (mean=2). The respondents perceived that large audit firms were able to resist pressures from clients to a very great extent (mean=1.71). Again they perceived that prolonged auditors' tenure was bound to impair the independence of the auditors to a great extent (mean=2.26) and an audit tenure of more than 10 years could cause the auditors to lose their scepticisms to a great extent (mean=2.36). Further small tenure was also believed to cause some audit independence problems to a great extent (mean=2.44). From the Likert responses, it can be deduced that the respondents believed that both short-term tenure and long-term tenure could affect the independence of auditors. This could be attributed to the reason that complacency in audit or conformity to audit procedures can be carried out by audit firms with both short and long-term tenure. A possible explanation to this is audit fees that act as moderating factor to both long term and short-term tenure thus affecting audit independence of firms. These findings are supported by the results of Oladele (2012) in a study carried out in Nigeria.

Table 8: Extent of the influence of audit tenure on the auditors' independence

Descriptive Statistics	N	Mean	Variance
Large audit firms are often considered to be more able to resist pressures from client's management.	97	1.71	0.721
Prolonged auditors tenure impair the independence of the auditors.	97	2.26	1.083
Auditors tend to lose their professional scepticism if the audit tenure is more than 10 years.	97	2.36	1.165
Audit firms with small tenure are also likely to face audit independence problems.	97	2.44	1.145

Source: Author 2016

4.3.2 Audit firm size

Audit firm size was also seen to influence the independence of the auditors in that 40% of the respondents believed it influenced to a great extent, 29% to a moderate extent, 16% to a very great extent and 11% to a small extent. However, 4% felt that audit firm size had no influence on the auditors' independence. From the results of the study, it is worth noting that there was no clear majority as to whether the size of the audit firm impacts audit independence. This could be attributed to respondents coming from both small and big audit firms, with the respondents believing that both faces the challenge of audit independence. This is supported by the findings of [Naslmosavi, Sofian, and Saat \(2013\)](#) who asserted that audit firm size might not affect audit independence for audit firm faces same challenges, big or small.

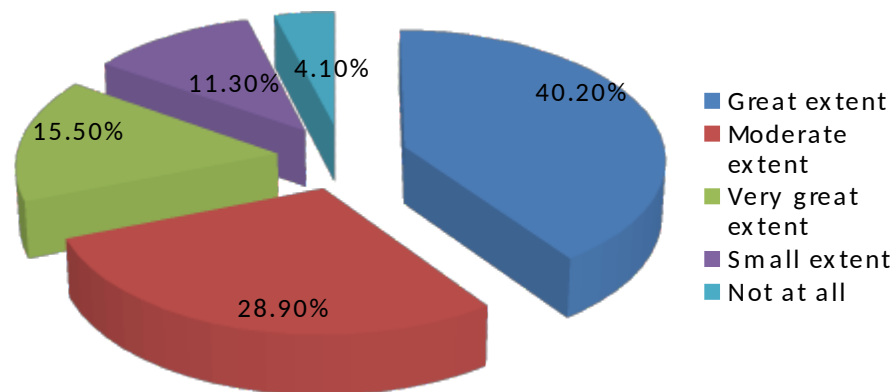


Figure 5: Audit firm size and auditors' independence

Source: Author 2016

The audit firm size was found to be another factor influencing the auditors' independence. According to the results of Table 6, the respondents perceived that most of the audit firm size factors exerted a significant impact on the independence of the auditors (mean =2, great extent).

Table 9: Audit firm size and auditors' independence

Descriptive Statistics	N	Mean	Std. Deviation
Large firms can have higher professional ethics hence better audit independence	97	1.7	0.974
Large firm, with more trained personnel, has a higher audit independence	97	1.7	0.856
The larger the audit firm, the higher the audit independence	97	2.2	1.152
Audit firm size is not a major factor influencing audit independence	97	2.9	1.31
Small accounting practitioners also issue independent audit reports	97	2.2	1.01

Source: Author 2016

Large firms were perceived to have higher professional ethics hence not interfere with the independence of the auditors (mean=1.7). The reason that could explain this is that large audit firms may have more resources at their disposal to train their employees on professional ethics. It was also presumed that large firms have more trained personnel translating to higher audit independence (mean=1.7). The respondents also agreed to a great extent that the larger the audit firm higher the audit independence. This could be attributed to the reason that it is believed that big audit firms tend to have depersonalised services that may allow more independence than small audit firms that have personalised services with their clients. A question was also posed to respondents whether the firm size mattered with regards to auditors' independence. It was established that audit firm size was a factor to a moderate extent (mean=3).

4.3.3 Audit Committee and Auditor's Independence

The study sought to find out the perceived effect of audit committee on auditor independence. The study established that majority of the respondents 45% of the respondents agreed to a greater extent that audit committee affect audit independence. [Muhamad Sori and Mohamad \(2009\)](#), argues, is linked to the perception that audit committee composition is linked to supporting the management or the shareholders, and this may affect the auditors while carrying out their day-to-day audit work.

Further, the study sought to establish the auditors' perception on the effects of audit committee on the independence of the auditors. The results revealed that auditors perceived that audit committees wielded a significant influence on the independence of the auditors (mean=2). The most significant factors (lowest mean) were the expertise of the audit committee enhance auditor independence; audit committee meetings lead to independence and reporting of the committee improve auditors' independence. The responses shown by the majority of the respondents might be a sign of agreement with the general perceptions that composition of audit committee and active audit committee that spend more time through having frequent meetings to discuss issues of internal control, risk, corporate reporting and any matters arising from business operations would enhance auditor independence.

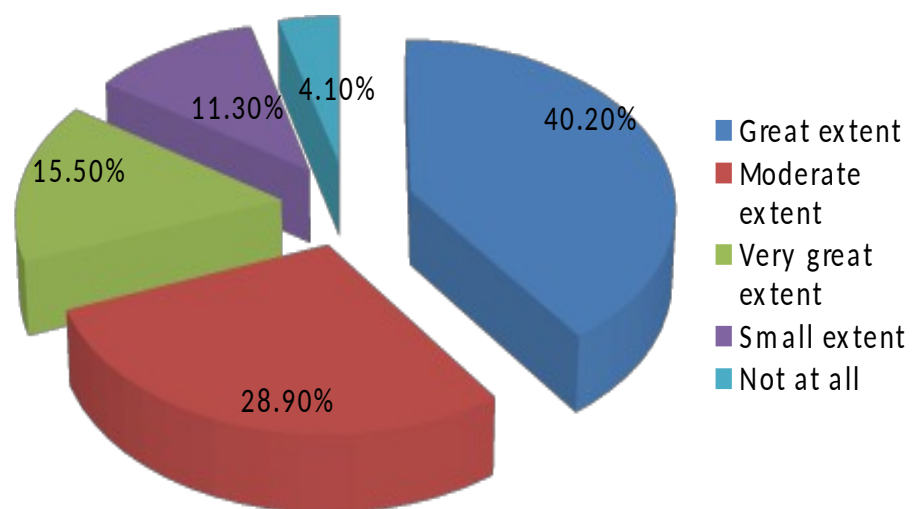


Figure 6: Audit Committee and auditors' independence

Source: Author 2016

Table 10: Extent of audit committee influence on the auditors' independence

Descriptive Statistics	N	Mean	Variance
Audit Committee Meetings leads to auditor independence	97	2.09	1.137
The expertise of audit committee members enhances auditor independence	97	1.84	0.954
The size of the audit committee plays a role in improving auditor independence	97	2.37	1.158
Audit committee reports improves auditor's independence	97	2.12	1.043

Source: Author 2016

4.4 Other factors

Apart from the above factors, auditors identified other factors that could be affecting their independence while performing their daily duties. The factors ranged from the audit fees charged as cited by 15% of the respondents, other non-audit services the auditors are required to perform aside from auditing (10%), audit staff remuneration (8%), inappropriate client relationships (8%), the experience of auditors in terms of length of service (8%), unhealthy competition in the auditing industry (7%) and bribery cases where auditors receive gifts and bribes from clients in order to give a report that favours the clients (Figure 3). Other factors mentioned were management's influence, inadequate training of auditors, fear of peer reviews procedures and political influence among others.

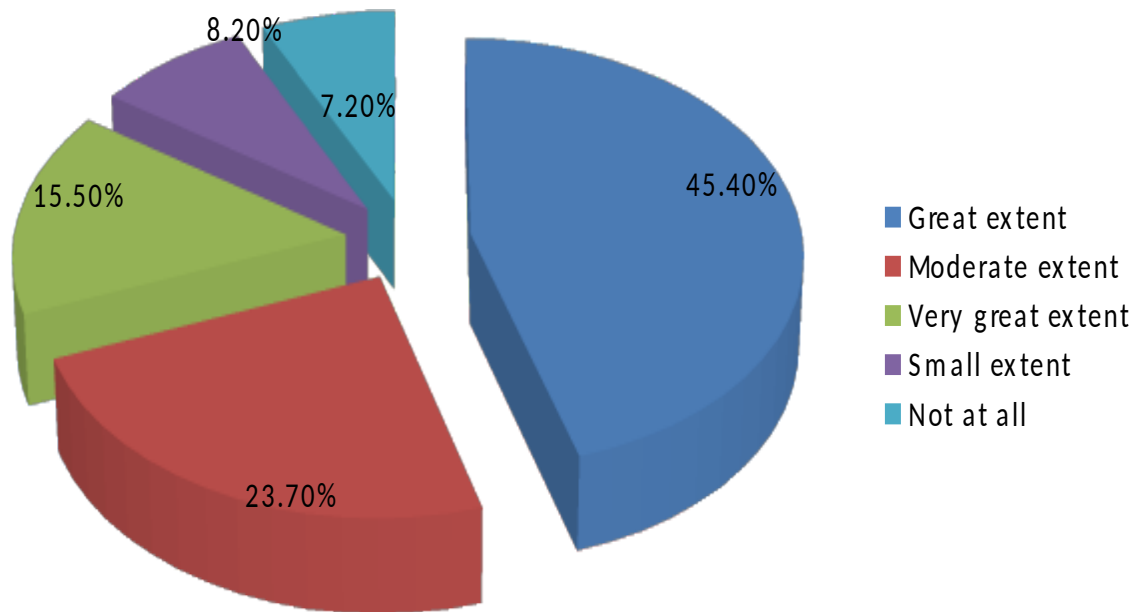


Figure 7: Other factors that influence auditors' independence

Source: Author 2016

4.5 Ways to eliminate the threats to auditor independence

The research sought to establish the ways that can be used to overcome the threats that impair auditors' independence. 36% agreed that relying on self-regulation and self-independence, while 45% of all the respondents believed strengthening supervision and management would overcome the threats. Also, regulating competition was seen as a solution by 39% of the respondents, while 53% believed increasing penalties for violations would improve auditors' independence. Further, 51% believed that more training of auditors would help overcome the vices in the industry while 61% believed that regulations should be formulated to impose a rotation system among the auditors.

Table 11: Ways to eliminate threats that impair auditors' independence

Variable		Frequency	Percentage
Relying on self-regulation and self-independence	Yes	35	36.1
Strengthening supervision and management	Yes	44	45.4
Regulating competition within the industry	Yes	38	39.2
Increasing penalties for violations	Yes	51	52.6
Emphasising on the training of auditors	Yes	49	50.5
Formulating regulations to impose an auditor rotation system	Yes	59	60.8

Source: Author 2016

Regression Model

Regression analysis was performed to determine the relationship between audit independence and audit tenure, audit committee and audit firm size. The results of a linear regression are presented below.

Table 4.16 shows the model summary with $R^2=0.108$ showing that the independent variables predicted 11% of the outcome; audit tenure, audit committee, and audit firm size. The remaining 89% can be explained by other variables not included in the model. This means that 11% of the change in audit independence can be occasioned by the internal factors in the study.

Table 12: Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.329a	0.108	0.079	0.802

a Predictors: (Constant), Audit_comm, Audit_Firm_size, Audit_tenure

Source: Author 2016

Table 13 further presents the results of ANOVA that explains how well the regression equation fits the data. The results show that the regression model predicts the change in audit independence significantly well as demonstrated by the significance value of 0.013. This is

further supported by the model F- statistic that is greater than 1(3.757). This indicates that the effects were statistically significant, and therefore the growth is not by chance.

Table 13: ANOVA Table

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	7.254	3	2.418	3.757	.013b
	Residual	59.859	93	0.644		
	Total	67.113	96			

a Dependent Variable: Auditors level of independence

b Predictors: (Constant), Audit_comm, Audit_Firm_size, Audit_tenure

Source: Author 2016

Table 14: Regression Coefficients

Model		Unstandardized Coefficients	Std. Error	Standardized Coefficients	t	Sig.
		B		Beta		
1	(Constant)	3.241	0.374		8.677	0.000
	Audit_tenure	-0.279	0.101	-0.28	-2.747	.007
	Audit_Firm_size	0.162	0.082	0.198	1.985	.050
	Audit_comm	-0.146	0.078	-0.189	-1.88	.063

a Dependent Variable: Auditors level of independence

Source: Author 2016

The coefficients analysis gives β_0 (Beta) at 3.241, β_1 at -0.279, β_2 at 0.162 and β_3 at -0.146.

Where β_0 is the constant, β_0 , β_1 , β_2 and β_3 are parameters for estimation of the independent variables; audit tenure, audit firm size and audit committee respectively. From our regression equation;

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \varepsilon$$

Where audit tenure, is denoted by X_1 , audit firm size by X_2 and audit committee as X_3 while audit independence is Y , the regression equation of the model becomes;

$$Y = 3.241 - 0.279X_1 + 0.162X_2 - 0.146X_3 + \varepsilon$$

It is evident from the above regression model that if all independent factors were to be held constant, then the change in audit independence would increase by 3.241.

The regression coefficient of audit tenure was negative and significant in predicting the auditor's independence. This implies that an increase in audit tenure results in decrease in auditor's independence by 0.279. The findings of the study are consistent with the results of Chia-Ah and Karlsson (2010).

The regression coefficient of firm size was positive and significant in predicting the auditor's independence. This result could be attributed to what Hislop (2005) argues that increase in audit firm size reduces dependency on clients for other non-audit service and this has the potential to increase auditor's independence. This implies that an increase in firm size results in increase in auditor's independence by 0.162. These results are similar to the findings Alexander and Hay (2013) who established that networks improve the performance of firms.

The regression coefficient of audit committee and auditor's independence was found to be non-significant in the study as indicated by p-value of 0.063. This could be attributed to what Sharma and Iselin (2012) labels as different components of audit committee have varied effects on audit independence.

CHAPTER FIVE

SUMMARY, DISCUSSIONS, CONCLUSIONS, AND RECOMMENDATIONS

5.0 Introduction

This chapter gives a brief overview of the findings of the study, discussions, conclusion and recommendation of the research. Additionally, it also provides limitation of the study and suggestion for further studies.

5.1 Summary of the findings

The research was carried out on the effect of internal factors on Audit independence of Audit firms in Nairobi County. The research instrument was mainly through questionnaires for primary data. Multiple regression and correlation analyzed the data. The target population was auditors in Nairobi County of which responses came from auditors in big and small firms. The regression model in the study and previous research findings illustrates this. Auditors from small firms represented a bigger portion of the responses at 59% with the remaining 41% being auditors from big firms. A detailed analysis of the findings is provided in the continuing sections.

The study sought to find out the relationship between audit tenure and audit independence. The study tested the hypothesis that there is no statistically significant relationship between audit tenure and audit independence among auditors in Kenya. This was tested by correlation analysis tests, with the results of the study indicating that there is a significant relationship between audit tenure and audit independence. This was indicated with a p-value of 0.007. The results also showed that the relationship between audit tenure and audit independence is a weak positive relationship as indicated with a beta value of -0.279. Thus, the null hypothesis is rejected in the study.

On the second objective that was to establish the relationship between audit committee and audit independence, the study tested the hypothesis that there is no significant relationship between audit committee and audit independence. The findings of the study indicated that there is no significant relationship between audit committee and audit independence as shown by a p-value of 0.063. Thus, the null hypothesis that audit committee is not significantly related to audit independence is accepted.

On the third objective of the study which was to establish the influence of audit firm size on audit independence in Kenya. To test this objective, the hypothesis that there is no statistically significant relationship between audit firm size and audit independence. From the study results, it was established that there is a statistical relationship between audit firm size and audit independence. A p-value of 0.05 indicated this. Additionally, the results indicated that the relationship between audit firm size and audit independence is a weak positive relationship of 0.162.

Respondents from the summary data indicated that predictor variables cause changes in dependent variable by 10%. 90% of the variation in the dependent variable is due to error term of the model and other factors not in the model. The model is statistically significant as indicated by the F-statistics 3.757 with a significant value of 0.013.

5.2 Discussion of Findings

According to the study, the length of time that an audit firm is associated with the same client significantly affected the perceptions of auditor independence held by respondents in this study. The results showed that the longer an audit firm acted for the same client, the more independent the auditors would be perceived to be. These results align themselves with the findings of other studies that investigated the effects of audit tenure on perceptions of auditor independence, though the results are not directly comparable because they focused on

different target respondents. These findings are similar to the results of [Yuniarti \(2012\)](#) where the study concluded that the longer the tenure, the more audit independence and this corresponds to the findings of [P. Carey and Simnett \(2006\)](#) which concluded that as tenure increases, the audit independence increases.

Also, the results indicated that auditors' tenure has a significant positive relationship with auditors' independence in Kenya. This agrees with the findings of [Ye et al. \(2006\)](#) which showed that a prolonged audit firm tenure might result in increased audit independence that can be occasioned by increased attachments between directors and auditors is as a consequence of a continued business relationship. They found that trust and pleasant business partnerships increase the commitment of clients to the relationship and their intention to continue it. These results have the potential to increase auditor independence.

From the study results, it was established that firm size was negatively correlated with audit independence. This can be attributed to the reason that big audit firms offer other non-audit services. This may expose the audit firm to the risk of compromising their audit independence at the expense of other services that can be provided to the clients. These findings contradict the popular results that have indicated that larger audit firms are often considered abler to resist pressures from management (i.e. higher auditor's independence). This is proven by almost all of the empirical studies that attempted to find the relationship between audit firm size and auditor's independence, whereby they found that there is a positive relationship between them ([Alvin Alleyne et al., 2006](#); [Bakar et al., 2005](#)). On the contrary, it has been argued that small audit firms be more likely to face audit independence challenges, with these occasioned by the characteristics that are inherent like the relationship between audit firm and the clients. However, the study findings conclude that larger firms are more likely to face audit independence challenges.

It was expected, based on other findings, that the study results would indicate a significant relationship between audit committee and audit independence. However, the auditors perceived audit committee as being inconsequential in audit independence. This is indicative of what [Muhamad Sori and Karbhari \(2006\)](#) and [Muhamad Sori, Mohamad, Saad, and Shaharatulfazzah \(2007\)](#) cites as the main determinant of audit committee in audit independence is audit committee characteristics interviewees would support the introduction of audit committees in companies and that they view the establishment of an audit committee as a means of enhancing the independence of auditors by firstly, reducing the power of management and secondly, as a means of encouraging auditors to see the shareholders, and not management, as their clients and in that way strengthen their independence of management.

The lack of significance of audit committees on audit independence can also be attributed to the reason that audit committees are increasingly beginning to take root in Kenya as such it was not surprising that their role and significance has not been fully appreciated among the auditors in the audit process. The study also showed that the more experienced the respondents, the more concerned they were that the lack of an audit committee would result in the auditor succumbing to management pressures. Also, the results from the mail questionnaire indicated a significant difference in the perceived reliability of financial statements when an audit committee existed than when it did not, with financial statements being perceived as more reliable in the former, than in the latter, case. These results are consistent with those obtained in the study undertaken by [Lam and Lee \(2012\)](#).

5.3 Conclusions

Factors including; the size of an audit firm and the audit tenure are perceived by auditors in Kenya to be having negative and a positive relationship respectively with auditor

independence. In particular, auditors perceived that the larger the size of an audit firm, the more likely the firm would face challenges of audit independence.

On the contrary, the study established that the longer the tenure, the more independence the auditor would have while carrying out their work. This could be attributed to the reason that long tenure enables the establishment of structure and relationship that big audit firms can rely on to ensure increased audit independence. However, these findings must be interpreted with caution for the reason that a majority of the respondents were from large audit firms and thus the possible bias in the study results.

The research findings also conclude that audit committee does not influence audit independence in Kenya. However, these findings must be interpreted within the context of the experience of the auditors in the study, where a majority of them had less than five years' experience and thus may not be well versed with audit among the small firms. The results of this study indicate that the respondents seemed not aware of the importance of the audit committee to be able to read, analyse and interpret the financial statements so that they would be able to perform their function effectively. As argued by [Carcello and Neal \(2003\)](#), an audit committee will be more likely to understand and support auditors' decisions (i.e. to issue a GC report) and will be more effective in preventing management from dismissing its auditors subsequent to the issuance of the report. Thus, the understanding of the role of audit committee on audit independence is crucial in shaping the perception of auditors on audit independence.

5.4 Recommendations

Given the rapid changes in the economy that increase business risk, there is need to establish more and strong audit committees with “much more time” to effectively perform their duties.

It has been determined that majority of respondents were not acquainted with the role of audit committee, and thus audit committee need to be entrenched in firms.

There is a need for ICPAK to develop rules that will guide audit rotation among auditors working for any given client. This will help restore professionalism, accountability, and integrity in the work of auditors.

Given the recent cases where large audit firms have been involved in falsification of accounts, there is a need for ICPAK to develop policies and rules that will enhance the independence of both big and small firms.

5.5 Limitations of the study

The study encountered a number of obstacles that affected the research findings. Non-response rate from audit firms was very appalling, this affected the results. This particularly made a comparison between small firms and large firms to be difficult since we had a few responses from this group. The reason given for non-response was that some information in the questionnaire was confidential.

Most of the questionnaire questions were based on self-evaluation since the users of financial reports were not included. The study was based on audit firms only. This has the effect of increasing the error in the data.

5.6 Suggestion for Further Research

The study only examined the perceptions of the auditors. The findings from the study can be generalised only to the auditors. Future studies could investigate the perceptions of other users such as institutional and private investors, audit committees and members of regulatory bodies. Their views are also important as they have very different motivations for using financial statements. Their expectations of auditor independence should be recognised so that

comprehensive rules on auditor independence could be developed that take into considerations the views of all affected parties.

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APPENDIX

Dear Participant,

My name is **Harrison Mbinj**, a student of MSc. Commerce from KCA University. I am conducting research that investigates the determinants of auditor's independence in Kenya for registered and practising accountants. This research is purely for academics purposes. I am assuring you that all the information provided in this survey will be kept confidential and anonymous. Your cooperation in this regard is highly appreciated.

Thank you.

Questionnaire

1. What is your gender? Female Male

2. What is your age?

18 to 27 28 to 33 34 to 39 40 to 49 50 and above

3. What is the highest level of education you have completed?

Diploma Bachelor Masters Doctorate/PhD

4. Total years of experience in auditing

Less than 1 year 1-3 years 3-5 years 5-10 years More than 10 years

5. How many employees currently work at the location where you work?

Less than 50 people 50-100 people More than 100 people

6. Whether you have/hold an ACCA or CPA certificate or not?

Yes No

If yes above, are you (a) A full member or partial (associate)

7. What is your evaluation of the level of Kenyan auditor independence?

Very high High Average Low Very low

Section A: Audit Tenure and Auditors Independence

8. To what extent do you agree with the following statement on the influence of audit tenure on auditor's independence? Very great extent =1 Great extent =2 Moderate extent =3 Small extent =4 Not at all=5

Statement	1	2	3	4	5
Large audit firms are often considered to be more able to resist pressures from client's management					
Prolonged Auditors' Tenure could impair the independence of Auditors					
Auditors tend to lose their professional scepticism if the audit tenure is more than 10 years					

Audit firms with small tenure are also likely to face audit independence problems.					
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Section B: Audit Firm Size and Auditor’s Independence

9. To what extent do you agree with the following statement on the influence of audit tenure on auditor’s independence? Very great extent =1, Great extent =2, Moderate extent =3, Small extent =4 Not at all=5

Statement	1	2	3	4	5
Large firms can have higher professional ethics hence better audit independence					
Large firm, with more trained personnel, has a higher audit independence					
The larger the audit firm, the higher the audit independence					
Audit firm size is not a major factor influencing audit independence					
Small accounting practitioners also issue independent audit reports					

Section C: Audit Committee and Auditor’s Independence

10. To what extent do you agree with the following statement on the influence of audit committee on auditor’s independence? Very great extent =1, Great extent =2, Moderate extent =3, Small extent =4 Not at all=5

Statement	1	2	3	4	5
Audit Committee Meetings leads to auditor independence					
The expertise of audit committee members enhances auditor independence					
The size of the audit committee plays a role in improving auditor independence					
Audit committee reports improves auditor’s independence					

11. Please list at least 3 other factors (in addition to the above) that may influence auditor independence

12. What should be done in order to eliminate the threats of impairing auditor independence? (Select one from the list below)

- Relying on self-regulation and self-independence
- Strengthening supervision and management
- Regulating competition within the industry
- Increasing penalties for violations
- Emphasizing on the training of auditors

[] Formulating regulations to impose an auditor rotation system