Auditor independence: Its Historical development and some proposals for research;

R. Glen Berryman

Follow this and additional works at: https://egrove.olemiss.edu/dl_proceedings
Part of the Accounting Commons, and the Taxation Commons

Recommended Citation
Contemporary auditing problems: Proceedings of the Touche Ross/University of Kansas Symposium on Auditing Problems, pp. 001-015;

This Article is brought to you for free and open access by the Deloitte Collection at eGrove. It has been accepted for inclusion in Proceedings of the University of Kansas Symposium on Auditing Problems by an authorized administrator of eGrove. For more information, please contact egrove@olemiss.edu.
Auditor Independence: Its Historical Development
And some Proposals for Research

R. Glen Berryman
University of Minnesota

A 1950 publication of the AICPA, written primarily for readers of audit reports, stated "Independence, both historically and philosophically, is the foundation of the public accounting profession." More recently the same idea has been restated as follows: "Independence has always been a concept fundamental to the accounting profession, the cornerstone of its philosophical structure." Auditors and the users of audit reports then and now would strongly support the above assertion. Independence has been a developing concept, as evidenced by shifts in position as to what constitutes an independent status for the auditor. For example, "strong" rules on independence have been adopted only recently.

The sections that follow review the historical development of auditor independence and note the need for the presence of its various aspects in connection with the attest function. Specific proposals for research are developed, with emphasis being placed on user perceptions of independence.

English Backgrounds

An early concern for independence is noted in the English Companies Clauses Consolidation Act of 1845, Section 102, which stated:

Where no other Qualification shall be prescribed by the special Act, every Auditor shall have at least One Share in the undertaking; and he shall not hold any Office in the Company, nor be in any other Manner interested in its Concerns, except as a Shareholder.

The requirement of shareholding, however, has not been retained in Britain as an auditor qualification as evidenced by the Companies Act of 1862, which permitted but did not require shareholding, and by subsequent Companies Acts. The provision against auditors serving as officers or employees of their auditees appears to have been maintained continually in the British system. The English Companies Act of 1948 in Section 161 provided that no person who is "... an officer or servant of the company"; or is "... a partner of or in the employment of an officer or servant of the company"; is qualified for appointment as auditor of such company.

The relationship of the auditors to the shareholders was established in the same 1845 English statute noted above. At the first meeting of a company after passage of that 1845 statute, the auditors would be elected by the shareholders.
Further, Section 118 of that Act directed that the shareholders be provided with the report of the auditors. The Companies Act of 1900, Section 21, provided that if an auditor was not appointed at the annual general meeting of the company, the Board of Trade would, on written application of any member of the company, appoint the auditor for the year and fix his remuneration. The Companies Act of 1929, Section 134, provided that the auditors were entitled to attend any general meeting of the company at which any accounts that they had examined or had reported on were to be presented and, further, that they were entitled to make any statement or explanations which they wished to make. Continued concern with auditor independence is evidenced by the Companies Act of 1948. Section 160 of that Act provided that a special annual meeting notice would be required for either the appointment of an auditor other than a retiring auditor or nonappointment of the retiring auditor.

Developments in the U.S. to 1940

In the United States, independent status for the auditor appears to have emerged slowly as a major concern. Of course, the profession itself did not grow to major size and influence until much later than in Great Britain. The American Association of Public Accountants, established in 1887, did not, in its early years, formally recognize the need for independence in its constitution or bylaws. An amendment to the bylaws adopted in 1907 did recognize the desirability of avoiding incompatible or inconsistent occupations. Recognition of the importance of independence is noted by the following comment of an early practitioner:

The position of the public accountant in respect to corporations and their management is always an independent one. Unlike the attorney, he is not expected to make out a case. The character of the service he renders is impersonal.\(^3\)

The American Institute of Accountants, formed in 1916, and its predecessor organization did not appear to have been actively concerned with independence until about 1930. A 1928 editorial in The Journal of Accountancy demonstrated interest in identifying improper relationships between auditors and their clients. The editor pointed out that an auditor should not be involved as a stockholder, bondholder, officer, or director of the organization he was serving as auditor. He did recognize one exception, namely, a company could appoint an auditor as a director when it was being reorganized. The editor stated:

The accountant should be so utterly divorced from financial or other participation in the success or failure of an undertaking under audit that no one could ever point an accusing finger, however unjustly, and allege the possibility of bias.\(^4\)

At the 1931 annual meeting of the American Institute of Certified Public Accountants, a proposal was introduced as follows:

RESOLVED, that the maintenance of a dual relationship, as director or officer of a corporation, while acting as auditor of that corporation is against the best interests of the public and the profession and tends to
destroy that independence of action considered essential in the relationship between client and auditor.\(^5\)

This resolution was referred to the Committee on Professional Ethics, but was not acted upon by the Institute that year.

The following year the Congress of the United States exhibited substantial interest in financial representations supported by an independent review. The \textit{Federal Securities Act of 1933}, Section 77aa, required that certain financial information filed with the Government be certified by an independent certified accountant or public accountant. The \textit{Securities Exchange Act of 1934}, Section 78(1), stated that balance sheets and income statements were to be certified by independent public accountants if such is required by the rules and regulations of the Securities and Exchange Commission. These are the first formal requirements mandating auditor independence.

The Securities and Exchange Commission, under authority granted it by the 1933 Act, adopted the following rule on July 6, 1933:

The Commission will not recognize any such certified accountant or public accountant as independent if such accountant is not in fact independent. Unless the Commission otherwise directs, such accountant will not be considered independent with respect to any person in whom he has any interest, directly or indirectly, or with whom he is connected as an officer, agent, employee, promoter, underwriter, trustee, partner, director, or person performing similar function.\(^6\)

In 1934, the American Institute of Accountants' Council adopted and the annual meeting approved the following resolution:

RESOLVED, that no member or associate shall certify the financial statements of any enterprise financed in whole or in part by the public distribution of securities if he is himself the actual or beneficial owner of a substantial financial interest in the enterprise or if he is committed to acquire such an interest.\(^7\)

The SEC rule prohibited any interest, direct or indirect, in any person with respect to whom the accountant is alleging independence, while the AIA position focused on "substantial financial interest," and omitted any reference to employment.

In 1936, The Securities and Exchange Commission did amend its rule with respect to independence and adopted the Institute's position prohibiting any substantial interest.\(^8\) Shortly after this, the Securities and Exchange Commission in \textit{Accounting Series Release} #2, dated May 6, 1937, discussed briefly the independence of an accountant as follows:

In response to such requests, the Commission has taken the position that an accountant cannot be deemed to be independent if he is, or has been during the period under review, an officer or director of the registrant or if he holds an interest in the registrant that is significant with respect to its total capital or his own personal fortune.

The Release continued:

In a recent case involving a firm of public accountants, one member of which owned stock in a corporation contemplating registration, the
Commission refused to hold that the firm could be considered independent for the purpose of certifying the financial statements of such corporation and based its refusal upon the fact that the value of such holdings was substantial and constituted more than 1 percent of the partner's personal fortune.

In the decade of the 1930's, both the Federal government and the public accounting profession adopted the view that auditors should be independent of their clients. The SEC exerted leadership in determining what constituted independence, as evidenced by its issuance of ASR #2. Emphasis was placed on financial interest and on employment by the client of the auditor in capacities other than that of auditor.

**Independence: 1940-1955**

In 1940, the Institute adopted the following rule on independence as part of its Code of Professional Ethics:

> A member or associate shall not express his opinion on financial statements of any enterprise financed in whole or in part by public distribution of securities, if he is himself the actual or beneficial owner of a substantial financial interest in the enterprise or if he is committed to acquire such an interest; nor shall a member or an associate express his opinion on financial statements which are used as a basis of credit, if he is himself the actual or beneficial owner of a substantial interest in the enterprise or if he is committed to acquire such interest, unless he discloses his financial interest in his report.9

This adoption is noteworthy because (1) the financial independence rule first became part of the Code of Professional Ethics and (2) when financials are used for credit purposes, approval was apparently given for an auditor's holding of a substantial financial interest if he disclosed such holding.

In 1942, an amplification of the rule on financial independence was adopted—"... if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune..."10 This action brought the Institute in line with the SEC's 1937 action in ASR #2 as to investment, but not with respect to other employment arrangements.

The SEC in *Accounting Series Release #22*, of March 14, 1941, reported an opinion of its Chief Accountant, William W. Werntz, as follows:

> When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, it is my opinion that one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened. Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies.

That same release also cited, with approval, the *Cornucopia Gold Mines*, 1 SEC 364, (1936) decision which held that the certification of a balance sheet prepared by an employee of the auditor who was also serving as an unsalaried but principal
financial accounting officer of the registrant and who was also a shareholder of the registrant was not a certification by an independent accountant.

The SEC in *Accounting Series Release* #37, dated November 7, 1942, indicated that in determining independence, consideration would be given to the propriety of the relationships and practices involved in all services performed for the company by such accountant. *Accounting Series Release* #47, dated January 25, 1944, reported several situations in which non-independence was found, including the following:

1. Both an accountant and a business associate made loans to the registrant. Further, a son of the accountant was an officer of the registrant.
2. The accountant advanced funds to the registrant for financing a new department.
3. The registrant was unable to pay the accountant’s fee and the registrant pledged shares of its own stock to assure that such fee would be paid. In addition, it had given the accountant an option to purchase the pledged security at market price at the option date.
4. The accountant was the treasurer and a shareholder of a company which sold some of a registrant’s products.
5. The son of a partner was serving as assistant treasurer and chief accountant of a registrant. The son resided with his father.
6. The accountant audited cash reports prepared by the client’s staff, entered them in a summary record, posted such data to the general ledger and made adjusting journal entries each month.

The above list provides additional evidence that the SEC wanted to maximize the likelihood of an objective review by prohibiting a significant financial interest or a close personal relationship with the client.

The American Institute of Accountants through its Committee on Auditing Procedure produced a special report in 1947 entitled *Tentative Statement of Auditing Standards; Their Generally Accepted Significance and Scope*. The second general standard stated, “In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.” Independence *in fact* is emphasized in this document, as discussed on p. 17—

Independence in the last analysis bespeaks an honest disinterest on the part of the auditor in the formulation and expression of his opinion, which means unbiased judgment and objective consideration of facts as determinants of that opinion. It implies not the attitude of a prosecutor, but a judicial impartiality that recognizes an obligation on his part for a fair presentation of facts which he owes not only to the management and the owners of a business (generally, in these days, the holder of equity securities in a corporation) but also to the creditors of a business, and to those who may otherwise have a right to rely (in part, at least) upon the auditor’s report, as in the case of prospective owners or creditors.

This position was subsequently affirmed in the 1954 publication *Generally Accepted Auditing Standards*.

In 1950 the SEC revised its rule on independence by deleting the word “substantial” from the phrase “any substantial interest.” Thus, the SEC went
back to its 1933 position in which there was a prohibition against the accountant having any direct financial interest in his client. The Institute in January, 1962, some twelve years after the above stated SEC rule revision, moved to prohibit the direct financial interest or material indirect financial interest in an enterprise under audit by the member. The double standard as to investment in the client company prevailed—no direct financial interest for SEC work and no substantial direct financial interest for other engagements. The double standard also existed with respect to employment—no employment of the types listed in ASR #2 was permitted for SEC work. The Institute was silent on the matter of other employment of the auditor by the client company.

The concept of independence was being developed and articulated in the 1940-1955 period. Specific rules were adopted to require independence. Though independence in fact was emphasized, the illustrations publicized by the SEC could be interpreted to suggest that the appearance of independence was a major factor in its evaluations of the independence of accountants. Prohibition of an auditor's holding of a financial interest in a client was being established.

Independence: 1956-1973

The membership of the AICPA in January 1962 adopted the following rule on independence as part of its Code of Professional Ethics. ARTICLE 1: Relations with Clients and Public.

1.01 Neither a member or associate, nor a firm of which he is a partner, shall express an opinion on financial statements of any enterprise unless he and his firm are in fact independent with respect to such enterprise.

Independence is not susceptible of precise definition, but is an expression of the professional integrity of the individual. A member or associate, before expressing his opinion on financial statements, has the responsibility of assessing his relationships with an enterprise to determine whether, in the circumstances, he might expect his opinion to be considered independent, objective and unbiased by one who had knowledge of all the facts.

A member or associate will be considered not independent, for example, with respect to any enterprise if he, or one of his partners, (a) during the period of his professional engagement or at the time of expressing his opinion, had, or was committed to acquire, any direct financial interest or material indirect financial interest in the enterprise, or (b) during the period of his professional engagement, at the time of expressing his opinion or during the period covered by the financial statements, was connected with the enterprise as a promoter, underwriter, voting trustee, director, officer or key employee. In cases where a member or associate ceases to be the independent accountant for an enterprise and is subsequently called upon to re-express a previously expressed opinion on financial statements, the phrase, “at the time of expressing his opinion” refers only to the time at which the member or associate first expressed his opinion on the financial statements in question. The word “director” is not intended to apply to a connection in such a capacity with a charitable, religious, civic or other similar type of nonprofit organization when the duties performed in such a
capacity are such as to make it clear that the member or associate can express an independent opinion on the financial statements. The example cited in this paragraph, of circumstances under which a member or associate will be considered not independent, is not intended to be all inclusive.

This rule moved the AICPA closer to the SEC position in that it prohibited direct financial interest in the client and for the first time prohibited specific employment relationships, such as director or officer of a client, during the period of the professional engagement. Independence in fact was emphasized in the first paragraph of this rule, while independence in appearance was specified in the second paragraph.

Effective March 1, 1973, the membership of the AICPA adopted new rules of conduct that included the following:

RULE 101—INDEPENDENCE. A member or a firm of which he is a partner or shareholder shall not express an opinion on financial statements of an enterprise unless he and his firm are independent with respect to such enterprise. Independence will be considered to be impaired if, for example:

A. During the period of his professional engagement, or at the time of expressing his opinion, he or his firm:

1. Had or was committed to acquire any direct or material indirect financial interest in the enterprise; or
2. Had any joint closely held business investment with the enterprise or any officer, director, or principal stockholder thereof which was material in relation to his or his firm's net worth; or
3. Had any loan to or from the enterprise or any officer, director or principal stockholder thereof. This latter proscription does not apply to the following loans from a financial institution when made under normal lending procedures, terms and requirements:
   (a) Loans obtained by a member of his firm which are not material in relation to the net worth of such borrower.
   (b) Home mortgages.
   (c) Other secured loans, except loans guaranteed by a member's firm which are otherwise unsecured.

B. During the period covered by the financial statements, during the period of the professional engagement or at the time of expressing an opinion, he or his firm

1. Was connected with the enterprise as a promoter, underwriter or voting trustee, a director or officer or in any capacity equivalent to that of a member of management or of an employee; or
2. Was a trustee of any trust or executor or administrator of any estate if such trust or estate had a direct or material indirect financial interest in the enterprise; or was a trustee for any pension or profit sharing trust of the enterprise.

The above examples are not intended to be all-inclusive.\textsuperscript{12}

RULE 102—INTEGRITY AND OBJECTIVITY. A member shall not knowingly misrepresent facts, and when engaged in the practice of
public accounting, including the rendering of tax and management advisory services, shall not subordinate his judgment to others. In tax practice, a member may resolve doubt in favor of his client as long as there is reasonable support for his position.\textsuperscript{19}

The need for the appearance of independence is not stated as it was in the previous Rule 1.01 (\ldots he might expect his opinion to be considered independent, objective and unbiased by one who had knowledge of all the facts,) but the listing of the prohibitions and the indication of specific situations which are acceptable strongly urges continued interest in the appearance of independence. It is also interesting to note that some of the previous “Interpretations of Rules of Conduct of the AICPA Division of Professional Ethics” were incorporated in the new \textit{Restatement} publication. Interpretation “101-3—Accounting Services” emphasizes independence in appearance by suggesting that the auditor consider whether he is “\ldots lacking in independence in the eyes of a reasonable observer.”\textsuperscript{14} It is also noteworthy that the 1973 Restatement includes Rule 202 which incorporates expressly generally accepted auditing standards. Those standards include the general standard requiring an “independence in mental attitude,” which is independence in fact.

\textit{Statement on Auditing Standards} \#1, dated November, 1972, issued by the Committee on Auditing Procedure of the AICPA, included in paragraph 220.03 the following statement. “To \textit{be} independent the auditor must be intellectually honest; to be \textit{recognised} as independent, he must be free from any obligation to or interest in the client, its management, or its owners.” Thus, continued emphasis on independence in fact as well as the appearance of independence is maintained in this document.

The SEC continued to push the development of rules related to independence, as evidenced by its issuing of \textit{Accounting Series Release} \#81, December 11, 1958, and \textit{Accounting Series Release} \#97, May 21, 1963. In ASR \#81, 54 situations were reviewed, 34 of which noted the accountants as “not independent,” 19 of which noted the accountants “have not been held to be not independent” and one in which accountants would be independent as to one entity and not independent as to another entity. The SEC in ASR \#97 found that a CPA in practice was not independent where he was one of three stockholders and an officer and co-manager of a finance company which made loans to customers and employees of a client who was a registered broker-dealer.

The SEC’s primary pronouncement on independence is Rule 2-01(b) of Regulation S-X. That rule, enforced today, states:

The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents, its subsidiaries, or any other affiliates, (1) in which, during the period of his professional engagement to examine the financial statements being reported on or at the date of his report, he or his firm or a member thereof had, or is committed to acquire, any direct financial interest or any material indirect financial interest; or (2) with which, during the period of his professional engagement to examine the financial statements being reported on, at the date of his report or during the period being covered by the financial
statements, he or his firm or a member thereof was connected as a promoter, underwriter, voting trustee, director, officer, or employee, except that a firm will not be deemed not independent in regard to a particular person if a former officer or employee of such person is employed by the firm and such individual has completely disassociated himself from the person and its affiliates and does not participate in auditing financial statements of the person or its affiliates covering any period of his employment by the person. For the purposes of Rule 2-01, the term "member" means all partners in the firm and all professional employees participating in the audit or located in an office of the firm participating in a significant portion of the audit.\textsuperscript{15}

It is interesting to note that the SEC rule does not include a distinction between independence in fact and the appearance of independence.

\textit{Accounting Series Release \#123}, March 23, 1972, endorsed the establishment of standing audit committees composed of outside directors as a means of providing "protection to investors who rely upon such financial statements." \textit{Accounting Series Release \#126}, July 5, 1972, provided some guidelines for accountants for determining existence or lack thereof of independence. It stated, "The concept of independence, as it relates to the accountant, is fundamental to this purpose because it implies an objective analysis of the situation by a disinterested third party." Examples were provided of situations in which the independence of accountants could be challenged. With respect to management service activities, the Release states . . .

The basic consideration is whether, to a third party, the client appears to be totally dependent upon the accountant's skill and judgment in its financial operations or to be reliant only to the extent of the customary type of consultation of advice.

As to EDP and bookkeeping services, the Release states . . .

Systems design is a proper function of the qualified public accountant. Computer programming is an aspect of systems design and does not constitute a bookkeeping service . . . where source data is provided by the client and the accountant's work is limited to processing and production of listings and reports, independence will be adversely affected if the listings and reports become part of the basic accounting records on which, at least in part, the accountant would base his opinion.

As to unpaid fees the Release indicated,

When the fees for an audit or other professional service remain unpaid over an extended period of time and become material in relation to the current audit fee, it may raise questions concerning the accountant's independence because he appears to have a financial interest in the client . . . normally the fees for the prior year's audit should be paid prior to the commencement of the current engagement.

As to business relationships with clients, the Release suggested that joint business ventures with clients, limited partnership agreements, investments in supplier or customer companies, rental of blocks of computer time to a client (except in emergency or temporary situations) would adversely affect independence.
Accounting Series Release #144, of May 23, 1973, considered the independence of a large firm of public accountants and alleged that they were not independent because partners or employees of accountants’ branch office during the time when they were working on the audit of a client, received payments from the general partners of the client company totaling about $17,000, “in the guise of profits from participation in the purchase and sale of ‘hot issues’.”

During the 1956-1973 period, emphasis centered on refining the rules for determination of the existence of independence. The SEC tended to lead the way in establishing guidelines, though substantial efforts were made by the AICPA to clarify the meaning of its ethics and its concept of independence. The appearance of independence was considered critical, though the profession and the SEC remained as “judges” of independence. The AICPA adopted the SEC position on avoidance of any direct financial interest in a client.

Aspects of Independence

The purpose of the auditor’s representation as to his independence is to develop in users’ minds a high level of confidence in his reports. If that confidence with respect to his technical skills and his independence is not present, then the value of the audit report is diminished greatly.

The concept of independence implies freedom from control and domination by another party. It implies impartiality and the absence of bias in the gathering of evidence, interpretation of evidence and opinion formulation. The auditor as an independent party must be willing and be in a strong position to insist on that course of action which his professional judgment urges is the appropriate one in the circumstances.

Independence has a “time” component—it must exist for some minimum period of time for each audit situation. An independent state of mind must exist from the time an audit contract comes into existence until the report is rendered and subsequent responses interpreting such report have been given. It seems to be generally agreed that an independent attitude must be maintained from the time that an engagement is undertaken until all audit work, including reporting, is completed.

Independence has a “party” component—the auditor must not be under the influence of the client or other party at interest. Aspects of this are reflected by the question raised by a CPA, quoted in a Forbes article, “Since auditors are selected and paid by management, are they truly independent?” This raises a series of issues, including: (1) Who should select the auditor? (2) Who should make the decision to change auditors? (3) Who should pay the audit fee? and (4) With respect to what parties should the auditor be independent?

Independence has a “what” component. Carey has stated:

Independence has three meanings to the certified public accountant. First, in the sense of not being subordinate, it means honesty, integrity, objectivity and responsibility. Second, in the narrower sense in which it is used in connection with auditing and expression of opinions on financial statements, independence means avoidance of any relationship which would be likely, even subconsciously, to impair the CPA’s objectivity as auditor. Third, it means avoidance of relationships which to a reasonable observer would suggest a conflict of interest.
Mautz and Sharaf suggest, “Three phases of independence are important to independent auditing. First is the independence of approach and attitude . . . The second phase . . . freedom from bias and prejudice, . . . The third phase . . . to separate the two divisions (auditing and other services) of public accounting . . .”

Questions could be asked such as (1) How important is the appearance of independence? (2) Can independence in fact be measured? and (3) What relationships should be avoided?

Independence has a “How shall it be maintained?” component. This raises questions such as (1) Who shall judge whether it has or has not been maintained? (2) What procedures should be adopted to provide assurance to users that independence has been maintained? and (3) What operational tests shall be applied by reviewers to detect a lack of independence?

Selection, Payment and Change of Auditors

The user group for audit service now includes at least management, creditors, the current shareholders, prospective shareholders, employees, and governmental units. External users in general have a strong desire for the auditor to take an impartial and unbiased approach to his work.

The auditor’s role can be likened to that of a judge, who listens to the charges or petitions, hears the arguments, evaluates the evidence presented and its bearing on the issues, considers the legal rules that are applicable, reasons to a conclusion and renders an opinion indicating his findings and their underlying rationale. But audit practice differs somewhat. The auditor collects his own evidence rather than rely on the two or more parties in the case to each collect evidence and present it in an adversary proceeding. Also, no cross examination is provided for in auditing. On the other hand, the public accountant must be aware of the underlying rules, must reason to a conclusion and must render an opinion as does the judge.

Who should select the auditor? The parties in a legal action do not make the final determination as to what judge will hear the case nor what jurors will be called. Would the user’s view of auditor independence be strengthened by having auditors appointed by a governmental authority (e.g., an equivalent to the English Board of Trade)? Some companies have audit committees composed of outside directors. Does this arrangement, as far as it is related to selection of auditors and communications with the auditors, increase perceived independence?

Who should pay the auditor? A judge receives his “fee” in the form of salary from the state, whereas the auditor receives his fee from his client and the auditor has some control over the size of the fee. Is this arrangement on audit fees one that should be continued or do the users perceive this arrangement as one which impairs the auditor’s independence?

On what basis should public accounting firms accept new clients? At the present time, each firm adopts its own criteria for acceptance of new engagements. Consideration could be given to the question of whether independence with respect to any existing client would be affected adversely by the acceptance of a new client.

When should auditors be changed? What internal or external changes in relationships might have an effect on independence? What relationships between
auditor and client could impact independence? For example, would the hiring by the client of several audit staff members have a negative impact? Who should be responsible for detecting such changes and then urging and or making a change in auditor?

A number of questions have been asked above, and no answers appear to be readily available. Research could well be undertaken to ascertain user and auditor views on each of the above, including their implications for the behavior of the auditor under varying sets of circumstances.

What Constitutes Independence?

Independence in appearance has received attention in the literature. It involves the perception of the auditor's independence by parties interested in audit reports. From the standpoint of the external user, every judgment made by the auditor has an independence aspect. Such judgments include but are not limited to his search for clientele, staff hiring, assignment of staff to the engagement, approach to his audit investigation, evaluation of evidence, and development of his opinions. If any judgment appears to involve compromise, even though of apparent minor import, subordination may be alleged and perceived independence may be questioned. For example, the decision to omit a confirmation of a specified receivable or auditor acquiescence to the change in the wording of a footnote could give rise to a feeling by a user that the auditor's judgment was subordinated.

How can auditors be assured that users have a high level of confidence in their independence? The perception of the user must certainly be taken into account. How do we measure the reader's perception of independence? Perhaps some measuring instrument could be developed such that the profession as a whole could monitor user pulse. Deterioration of the level of perceived independence could then be attacked by the profession in a variety of ways, such as proscriptions as to activities felt by the user to be impinging on independence and education of the users as to the "real" state of auditor independence. Different users and different groups of users may have different concepts of what constitute independence and "how much" independence is essential. The differences or even conflicts in viewpoints could present difficulties as well as could attempts to develop recommendations for actions to raise the level of perceived independence.

There has been little emphasis placed on the determination of what attributes create independence in fact. Independence in fact seems to require absolute intellectual honesty and the absence of obligation to any potential user.

Professor Barrett has indicated that "... the audit profession's ethical notion of apparent independence can be operationally defined as a sociological role construct, and ... its conception of real independence can be operationally defined as a personality construct." He suggests that:

*Professional Audit Independence* contains two constructs. *Interpersonal Independence* describes functional situations which promote or dysfunctional situations which impair the profession's auditor image as perceived by reasonable observers ... *Intrapersonal Independence* is the second order factor containing three operational content variables. It is assumed that male individuals—who are field analytical rather than
global field types, who evidence a low social approval need rather than being approval motivated and who prefer to describe themselves in terms of independent rather than intermediate or dependent personality typologies—tend to possess a high degree of intrapersonal independence as characterized by their behavior in test and non-test situations.21

Professor Barrett goes on to indicate that, in his opinion, on the basis of exploratory studies, interpersonal and intrapersonal independence can both be determined by means of empirical testing. Additional research in this area, largely untapped to date, seems warranted.

What relationships should be avoided? At a recent bank’s annual meeting, a minority shareholder sharply criticized a $1,600,000 loan by the bank to the company’s auditors on the ground that such was a “conflict of interest and jeopardized the independent status of the auditor.”22 Many public accounting firms are strongly interested in “selling” management services. Might not the user of an audit report suspect a tradeoff between the accounting firm and its client on the basis that the audit might be reduced in scope or a disclosure requirement changed if the particular management service was “purchased”? As related earlier, the SEC has indicated in various releases situations where independence is questioned. No comprehensive research appears to have been undertaken on this question. A substantial pay-off should be obtainable from a comprehensive research project covering satisfactory and unsatisfactory relationships, particularly if user views are taken into account in the project.

Maintenance of Independence

What party or parties should assess the presence or absence of independence? To date, the public accounting profession and the Securities and Exchange Commission have been the formulators of the rules regarding independence and also the enforcers of such rules. The view of the SEC can be presumed to reflect their perception of the needs of the security investors for auditor independence. However, it appears that a major thrust of the SEC work and of the AICPA documents is providing for the appearance of independence. If such appearance of independence is the prime focus, why should not all external parties or their representatives have a voice in formation and enforcement of the rules on independence? Would not such position provide a “watch-dog” and aid greatly in maintenance of confidence by users in auditors’ reports?

In developing confidence in the minds of the users of financials, should we institute a review of the audit report and its underlying documentation? In the judicial system a judge’s opinion is appealable to successively higher levels, up to the Supreme Court of the U.S. We do not have an equivalent procedure for appeal of an auditor opinion, nor for a subsequent investigation of it by another professional. Might not the adoption of a procedure for auditing the auditor enhance user confidence levels in the effective independence of the auditor? Research into the opinion of users and auditor reactions to such a required review would be helpful in anticipating the effect of such a requirement.

Operational tests of independence must await a determination of those attributes which contribute to independence and those that detract from it. If those attributes can be determined, the profession and the users of its services,
or the parties designated to assess the existence of independence, can proceed to formulate operational tests or guides to ascertain the existence of a satisfactory state of independence.

Summary

Independence has, in varying degrees, been a concern of auditors and the users of audit reports since the early days of the profession in England and the United States. In the U.S., development of the concept of independence has been pushed by the Securities and Exchange Commission as a representative of one set of users. The American Institute of Certified Public Accountants has, through various publications, articulated concepts of independence and has adopted independence as a mandatory qualification for the auditor. It is suggested that the need for independence is related exclusively to the attest function and that unless the user perceives independence to exist, the attest function has extremely limited value. Various relationships between (1) auditor and client and (2) auditor and external parties can have impacts on perceived independence and independence in fact.

Research needs to be undertaken with respect to user perceptions of independence; the relationships which they feel impair independence as well as those which promote independence. Research could be undertaken on a joint basis by representatives of the profession and representatives of various user groups. This arrangement should promote soundness of research design, impartiality in evidence gathering, summarization and interpretation, and acceptability of the research reports. The research projects could focus on many questions, such as (1) Who should appoint and remove the auditors? (2) What relationships between client and auditor are likely to impede the exercise of impartial, unbiased judgments? (3) Who should pay for audit services rendered? (4) Should reviews of auditor work, including audit independence, be undertaken? and (5) What instruments best measure independence?

Footnotes

9. 1940 Yearbook of the American Institute of Accountants, p. 50.
10. 1942-1943 Reports of Officers, Council, and Committees, American Institute of Accountants, p. 36.
13. Ibid., p. 21.
21. Ibid.