Accounting Historians Notebook

Volume 6
Number 1 *Spring 1983*

Article 1

Spring 1983

History of auditors' independence in the U.S.

Edward Wayne Younkins

The Accounting Historians
NOTEBOOK

Vol. 6, No. 1 Spring, 1983

A HISTORY OF AUDITORS' INDEPENDENCE IN THE U.S.

by
Edward W. Younkins
Wheeling College
Wheeling, West Virginia

Independence has long been a fundamental concept to the attest function of the accounting profession. Independence provides the profession with a philosophical and historical foundation. At one time independence was assumed to mean integrity, honesty, and objectivity. Another interpretation has referred to freedom from the control of those whose records are being reviewed. Independence has also been characterized as a state of mind and a matter of character.

Thus, independence is considered to be the cornerstone of the profession. The CPA must not subordinate his or her judgment to clients, bankers, governmental agencies, etc. In addition, the CPA must avoid relationships which would be likely to impair objectivity, permit personal bias, or affect professional judgment.

The ongoing debate over the independence concept with respect to certain service provided by CPAs, the strong prohibitions with respect to an auditor's relationship with clients, and the increased pressure for fuller disclosures in financial statements provide interest regarding the historical and philosophical evolution of the concept. Thus, the purpose of this article is to provide a summary of the historical development of independence in the United States as interpreted by various groups and individuals. This will be done through the discussion of the development of the independence concept throughout four separate time periods or eras.

Early Recognition of the Concept: 1900-1925

Concern in the United States regarding auditor independence grew more slowly than it did in England. The American Association of Public Accountants (AAPA) was established in 1887 and did not initially incorporate independence in its constitution or bylaws.

By 1900, evidence of the development of the concept was beginning to appear in literature as seen in the following statement:

> A public accountant acknowledges no master but the public, and thus differs from the bookkeeper, whose acts and statements are dictated by his employers. A public accountant's certificate, though addressed to president or directors, is virtually made to the public, who are actually or prospectively stockholders. He should have ability, varied experience and undoubted integrity.[1]

In 1907 the bylaws of the AAPA were amended to recognize the importance of avoiding inconsistent or incompatible occupations. The following year Elijah W. Sells made the following comment regarding independence:

> The position of the public accountant in respect to corporations and their management is always an independent

Continued on Page 22

YOUNKINS: Continued From Page 1

> one. Unlike the attorney, he is not expected to make out a case. The character of the service he renders is impersonal.[2]

During the first quarter of the twentieth century the most debated ethical issue was whether or not accountants should advertise. Subsequently, the main issue has been auditor independence.

However, an incident in 1915 is noteworthy since it anticipated the intense debates to occur years later on the subject of independence. A question arose regarding the propriety of a public accounting firm auditing statements in which a member of the firm was also the internal auditor. The early "state of mind" concept of auditor independence meant that client-accountant relations should be such that the auditor's findings would be influenced only by the facts. Later, the concept was to evolve into an "appearance to others" concept which places less emphasis on actions and more on relationships.

Development of The Concept: 1926-1939

In 1926, the report of the American Institute of Accountants' Committee on Professional Ethics posed the question of whether or not it is ethical for a CPA who is a director of a company to also certify the company's balance sheet. A 1928 editorial in the *Journal of Accountancy* answered this question as follows:

> 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 even point an accusing finger, however unjustly, and allege the possibility of bias.[3]

Another editorial in the same issue addressed the question of an auditor who was also a stockholder.[4]

Although there had been a growing number of references to the independence of auditors in the professional literature, the word "independence" was still absent from the Rules of Professional Conduct. Although several rules already adopted were designed to implicitly strengthen independence, there was an absence of explicit discussions regarding relationships with clients that might tend to impair independence or appear to do so.

At the American Institute of Accounting's 1931 annual meeting, Frederick H. Hurdman, immediate past president of the Institute, introduced the following resolution:

> Whereas the relations between a client, in the form of a corporation, and the auditor for the corporation should be one of entire independence, and
>
> Whereas, it does not appear to be practicable for the auditor consistently to hold a dual relationship, as an auditor and executive of the corporation, and
>
> Whereas, the public interest and confidence will best be preserved by a complete separation of these two functions, therefore be it
>
> 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]

After a lengthy discussion, the resolution was referred to the Committee on Professional Ethics. However, the resolution was not acted upon by the Institute in 1931 or 1932.

The Securities Act of 1933 required a public accountant or certified public accountant to express an opinion regarding the financial statements that accompany a registration statement. Additionally, there was concern for the independence of the auditors. A rule was adopted on July 6, 1933 which said that any CPA or public accountant will not be recognized as independent if such an 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]

Consequently, the concept of auditing independence was evolving from one of integrity and honesty with respect to fraud detection to one of fraud detection plus the objective application of accounting principles to describe the true economic and financial position and results of a firm. The emerging objectivity concept of independence can be found in the following paragraph from an editorial in a 1933 issue of the *Journal of Accountancy.*

Continued

YOUNKINS: Continued

> The public accountant has his impartial status in this great and thrilling game of business. He knows the rules. He knows the players. All the spectators up in the grandstand on the bleachers will rely on him, if he be a true umpire at heart, to see that the game is conducted fairly and that every one who paid the price of admission shall have a fair deal. The fact of an umpire does not indicate any moral obliquity in any player. An umpire is needed because he can see both sides when often the players, because of their position in the game, can see only their own.[7]

While the SEC rule prohibited any financial interest, the AIA passed a resolution in 1934 prohibiting a "substantial financial interest." Finally, in 1936 the SEC rule was amended to agree with the AIA position. Thereafter, disputes developed over the meaning of "substantial." This eventually led the SEC to delete the word in 1950.

A 1935 article by A. C. Littleton asked for more "independence in fact" from auditors.[8] Littleton called for amendment of the federal securities act and the securities exchange act to give a larger degree of real independence to public accountants. Real independence is necessary to fulfill the auditor's function as an unofficial representative of the investing public. He stated that it was the public accountant's already well-developed sense of professional independence that qualifies him for greater real independence as a "quasi-public" representative of the interests of scattered and inarticulate investors. However, more public support is needed to accomplish this task.

Evidently, it was the SEC that exerted leadership during the 1930s concerning the determination of what constituted independence. This was evidenced by its issuance of Accounting Series Release No. 2 in 1937. This was the first release to describe specific cases in which individual accountants had been found to be not, independent. The first release referred to a case in which an accountant was not independent because he owned stock in a client corporation, the value of which accounted for more than one percent of his personal fortunes.[9]

Amplification and Growth of the Concept: 1940-1959

It was not until 1940 that the AIA adopted a rule of professional conduct regarding financial independence to replace its 1934 resolution. The rule read as follows:

> A member or an 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 for credit, 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 interest, unless he discloses his financial interest in his report.[10]

In 1942, modifications of the above rule on financial independence were made. Independence was now seen to be impaired if the auditor owned or was committed to buy a financial interest in the enterprise which was substantial in relation to its capital or to his own personal fortune. In addition, the rule was expanded to incorporate financial interests of his immediate family. These changes were in accord with various earlier SEC decisions.[11]

At about this same time, the SEC was issuing Accounting Series Releases regarding auditing independence. In 1942, Accounting Series Release No. 22 quoted 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 include a departure from the standards of objectivity and impartiality which the concept of independence implies.[12]

Continued

YOUNKINS: Continued

This same release also contains an excellent summary of the SEC's attitude toward the general question of independence. It states that the main objective of total independence is to assure the impartiality and objectivity needed for fair consideration of problems arising in an audit. Any circumstances that might be likely to bias the mind of the auditor may be considered evidence of the lack of independence.[13]

Then, in 1944, Accounting Series Release No. 47 listed and summarized twenty rulings on auditors' independence in specific cases. These ranged from fairly clear-cut situations to other situations where it was not very clear that the relationships were likely to impair independence. Several situations in which independence was found to be impaired are summarized below:

1. Both an accountant and a business associate loaned money to the registrant. In addition, the accountant's son was an officer of the registrant.
2. The accountant made an advance to the registrant to finance a new department.
3. The registrant could not pay the accountant's fee and instead pledged shares of its stock to assure that the fee would be paid. Furthermore, the accountant was given an option to buy the pledged stock at market price at the option date.
4. The accountant was a shareholder and the treasurer of a company that sold a portion of the registrant's products.
5. The partner's son was the chief accountant and assistant treasurer of the registrant. In addition, the son lived with the father.[14]

It was not until 1947 that a specific definition of independence was formulated by the AIA. The AIA defined independence as a state of mind. It is an impartial attitude regarding the auditor's findings. The auditor should be able to render judgment unaffected by any self-interest which could influence his opinion. Key characteristics of the independence concept thus include honest disinterest, unbiased judgment, objective consideration of facts, and judicial impartiality. Independence "in fact" is emphasized in this document.

The AIA also noted that rules of conduct only dealt with objective standards and accordingly could not assure independence. Since independence is a state of mind, its existence is at a much deeper level than the visible display of standards.[15]

A rather philosophical description of the independence concept was offered in 1950 by Edward B. Wilcox, a past president of the AIA. As seen in the following quotation, Wilcox implied that there are segments of public accounting that do not require independence on the part of the CPA:

> That part of public accounting which does clearly require independence relates to the expression of an expert opinion on representations in financial statements. The purpose of the expert opinion is to add to the credibility of the statements. Those who rely on this credibility are apt to be creditors or investors, or sometimes employees, customers or governmental agencies. As in other areas of public accounting, the expert incurs professional obligations of an ethical nature to do a sound, competent job. But he also incurs more than that. He incurs an obligation to his unknown audience for integrity. He must protect them even though he does not know who they are, and he must do so even when it means opposing and denying the wishes of those who have employed him, and who he knows may cease to do so. This is independence.[16]

As noted earlier, in 1950 the SEC amended its rule on independence by omitting the word "substantial" from the phrase "any substantial interest." This change was prompted because the SEC was tired of debates regarding the essence of a "substantial" financial interest. Interestingly, it was not until 1962 that the AICPA moved to disallow the direct financial interest or material indirect financial interest in a firm being audited by a member. Thus, during a twelve year period, a double standard existed. No direct financial interest was allowed for SEC engagements and no substantial direct financial interest was permitted for non-SEC engagements.

Shortly after the SEC introduced its restriction, efforts were made by some members of the Illinois Society of CPAs to broaden the scope of their rules of ethics. In 1954 a new rule was adopted in that state to prohibit a member, or a firm of which a member was a partner, from expressing an opinion on the financial statements of any organization if the member, his partners, or their immediate families living in the same household, had a direct

Continued

or indirect financial interest in the organization in question. It was the most rigorous rule on financial interests, to that date, to have been adopted by any professional society of accountants. The purpose of the Illinois Society was clearly to raise standards of professional conduct.[17] The adoption of the rule was apparently in recognition of the need to preserve the "appearance of independence" as well as independence in fact.

Refinement and Maturation of the Concept: 1960-Present

A 1960 article by Sharaf and Mautz suggested that independence is a three-dimensional concept with each dimension being affected by the complex of a social, economic, and personal relationship encountered by the auditor in his professional work. An auditor must be free from restriction or bias in all three dimensions concurrently if he is to be totally independent. These three dimensions of independence are:

1. Programming independence: This is freedom from undue influence in the choice of audit procedures and techniques and in the extent to which they are applied. The auditor must have freedom to develop his own program with respect to the steps included and the amount of work to be undertaken.
2. Investigative independence: This is freedom from influence in the choice of activities, areas, managerial policies, etc. to be examined. No legitimate information source should be unavailable to the auditor.
3. Reporting independence: This is freedom from undue influence in the statement of facts revealed during the examination of, in the expression of opinions, or recommendations resulting from the examination.

Sharaf and Mautz go on to note that influence and control can exist even without apparent outside pressure. An accountant's prejudice or personal bias, his desire for social or economic success, etc., may in effect impair his independence. Thus, the detection of impaired independence is difficult in many cases. It is therefore important to have guides that can help the accountant evaluate his own situation.[18]

Also, in 1960, the American Institute's committee on professional ethics proposed an amendment of the rules of conduct to prohibit any member from serving as an employee or director of a firm for which he was the auditor or from having any financial interest in such a firm. After a long and vigorous debate, the proposal was voted on and passed at the Institute's 1961 annual meeting. In effect, the rule moved the AICPA closer to the SEC position.[19]

In 1961, Mautz and Sharaf published a monograph called *The Philosophy of Auditing* which included a critical examination of the concept of independence. One important aspect of independence addressed was whether the rendering of management services to a client is likely to impair a CPA's independence in expressing an opinion on the financial statements.

Management services tended to cloud the CPA's appearance of independence in his capacity as auditor. They recommended that the audit function by strongly separated from the other services offered by an accounting firm.[20]

Practitioners were disturbed to learn that the propriety of offering management services was being challenged. The Institute's committee on professional ethics believed that an authoritative opinion on this question was needed to guide the membership. Therefore, in 1963 the committee issued its Opinion No. 12 on independence. The opinion stated that there was no likelihood of a conflict of interest arising from the offering of management advisory services and tax services. It was, therefore, ethical to offer such services.[21]

This statement did not satisfy the academic accountants. One, Arthur A. Schulte, Jr., was concerned that the opinion offered no empirical evidence to support its contentions. Schulte thus conducted a survey and reported his results in the July, 1965 issue of *The Accounting Review,* He mailed questionnaires to four selected groups: (1) research and financial analysts of brokerage firms; (2) commercial loan and trust officers of banks; (3) investment officers of insurance companies; and (4) investment officers of domestic mutual funds. Schulte found that ninety-seven percent of the responding third parties attached a special importance to the CPA's audit independence. In addition, forty-five percent believed that management consulting did tend to impair audit independence and fifty-five percent believed that it did not.[22]

These findings were sharply criticized by Carey and Doherty. They state that:

> Nowhere in the questionnaire or the article interpreting it is there a definition of the term 'management consulting.' This term may well evoke a reaction different from that evoked by 'management services,' which is commonly used by the profession itself.

Continued

YOUNKINS: Continued

> In any event, it cannot be assumed that all the respondents to the questionnaire were familiar with the specific services offered by CPA firms as aids to management. The respondents may have read into the question types of 'consulting' which in fact are not commonly engaged in by CPAs.
>
> It is difficult to believe that reasonable observers—stockholders, creditors or other users of financial statements, or the business public generally—would see any conflict of interest in the fact that the auditor, in addition to giving an opinion on the financial statements, also applied his technical knowledge and skill to the improvement of management's planning, control and decision-making processes.[23]

On the other hand, it is sometimes suggested that in providing management services the CPA effectively becomes an employee of the client and loses hs independence as an auditor. One response to this charge runs as follows. The essence of an employee is his dependence on management. If fired, he has no job. However, neither the consultant, nor the auditor is out of a job if he loses a client. Both the auditor and the consultant have economic independence with respect to their client.[24]

In 1966, Abraham J. Briloff conducted a survey which supported the results of the Schulte study previously mentioned. Briloff's questionnaire was sent to financial personnel, practicing accountants, and academic accountants. Fifty-three percent of the responding financial personnel believed that the provision of management services by CPAs detracted from the significance of their audit opinions.[25]

In response to such confusion, the Institute appointed a special ad hoc committee to study the problem. The committee was chaired by Malcolm M. Devore. The committee stated that it had found no substantive evidence to indicate that the provision of management services has, in fact, impaired independence. However, it also found no empirical evidence to dispute Schulte's findings linking management services with an "apparent" lack of independence. The committee made several noteworthy recommendations. One involved the issuance of two statements or position papers regarding (1) the nature of management services offered by a CPA and (2) the role of CPAs in rendering those services. A second noteworthy suggestion was the use of audit committees, consisting of outside directors, to choose the company's auditors and to determine questions relating to the appearance of independence. In addition, the CPAs should report periodically to the audit committee regarding all services rendered. This reporting would be done prior to the committee's selection of the firm's auditors.[26]

A 1968 article by Walter Kell classified management services into "accounting" and "administrative" services. According to Kell, accounting-based services, such as budgeting and inventory control, evolve naturally from the audit engagement and the CPA's familiarity with the client's information system. Kell believed that the public accepts these services as legitimate concerns of the independent auditor. Administrative-based services such as market surveys and plant layout are outside the scope of the audit and extend far beyond the client's information system. Kell contends that there is no conflict between the performance of accounting services and audit independence but that the rendering of administrative services could possibly affect such independence. He suggests the establishment of an ethics rule identifying the provision of administrative services to an audit client as incompatible with independence.[27]

Accounting Series Release No. 126 was issued in 1972. This release covered several areas including:

1. The provision of guidelines for determining the existence of independence;
2. A listing of example situations in which independence could be challenged;
3. A statement that the basic consideration in management service activities was whether the client appears to be completely dependent upon the CPA's judgment and skill or is reliant only to the extent that is customary with respect to consultation advice;
4. A statement that systems design is a proper function of a public accountant and that computer programming is an aspect of systems design and does not constitute a bookkeeping service;
5. A statement that when unpaid fees to the accountant become material relative to the current audit fee, a question may arise regarding the accountant's independence; and
6. A statement that joint business ventures with clients, limited partnership agreements, investments in supplies or

Continued

YOUNKINS: Continued

> customer companies, and rental of blocks of computer time to a client would adversely affect independence.[28]

In 1973, the AICPA adopted new rules of conduct (Rule 101). This was modified slightly in 1978 and has remained unchanged since.

Conclusion

Independence is the sine qua non of professional auditors. It has been a major concern of auditors and users of audit reports since the early days of the profession. The SEC has had an important influence on the accounting professions' emerging standards of independence. Specifically, the responsibility of the SEC was to determine independence in specific cases. It therefore gravitated toward a practical definition of the concept which stressed the importance of observed behavior and relationships.

For the most part, the accounting profession has relied upon a theoretical definition of independence and has used phrases such as "a state of mind," an "attitude of impartiality," etc. The profession in the United States is now dealing in a more realistic manner with the practical aspects of the concept. As shown in this article, independence has been and still is the historical and philosophical foundation of the accounting profession.

FOOTNOTES

[1]Norman E. Webster, "What is a Public Accountant?" *The New York Certified Public Accountant* (November, 1944), p. 707.

[2]Elijah W. Sells, "Corporate Management Compared with Government Control," *The Journal of Accountancy* (April, 1908), p. 236.

[3]Editorial, "Should an Auditor Act as Director?" *The Journal of Accountancy* (March, 1928), p. 205.

[4]Ibid., p. 207.

[5]John L. Carey, *The Rise of the Accounting Profession* (American Institute of Certified Public Accountants, 1970), pp. 240-241.

[6]Federal Trade Commission, *Rules and Regulations Under the Securities Act of 1933* (1933).

[7]Editorial, "Why Engage Public Accountants?—Independence is Essential—There Must Be Umpires," *The Journal of Accountancy* (September, 1933), p. 196.

[8]A. C. Littleton, "Auditor Independence," *The Journal of Accountancy* (April, 1935), pp. 286-291.

[9]American Institute of Accountants, *1940 Yearbook of the American Institute of Accountants* (American Institute of Accountants, 1941), p. 154.

[10]Ibid., p. 50.

[11]American Institute of Accountants, "Reports of the Executive Committee," *1942-1943 Reports: Officers, Council, and Committees* (American Institute of Accountants, 1943), p. 36.

[12]Securities and Exchange Commission, "Accounting Series Release No. 22" (1941).

[13]Frederick H. Hurdman, "Independence of Auditors," *The Journal of Accountancy* (January, 1942), pp. 57-58.

[14]Securities and Exchange Commission, "Accounting Series Release No. 47" (1944).

[15]American Institute of Accountants, "Tentative Statement of Auditing Standards," (American Institute of Accountants, 1947).

[16]E. B. Wilcox, "Independence from the Viewpoint of the Certified Public Accountant,"- *How to Improve Accounting and Tax Service to American Business* (American Institute of Accountants, 1950), p. 73.

[17]Editorial, "Another Rule on Independence,' *The Journal of Accountancy* (June, 1954), pp. 673-674.

[18]Hussein A. Sharaf and R. K. Mautz, "An Operational Concept of Independence," *The Journal of Accountancy* (April, 1960), pp. 52-53.

[19]Carey, pp. 186-190.

[20]R. K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing* (American Accounting Association, 1961), pp. 218-224.

[21]Carey, pp. 193-194.

[22]Arthur A. Schulte, Jr., "Compatibility of Management Consulting and Auditing," *The Accounting Review* (October, 1968), pp. 587-593.

[23]John L. Carey and William O. Doherty, "The Concept of Independence—Review and Restatement," *The Journal of Accountancy* (January, 1966), p. 41.

[24]Kenneth S. Axelson, "Are Consulting and Auditing Compatible?" *The Journal of Accountancy* (April, 1963), p. 54.

[25]Abraham J. Briloff, "Old Myths and New Realities in Accounting," *The Accounting Review* (July, 1966).

[26]Malcolm M. Devore, "Compatibility of Auditing and Management Services: A Viewpoint from Within the Profession," *The Journal of Accountancy* (December, 1967), pp. 36-39.

[27]Walter G. Kell, "Public Accounting's Irresistible Force and Immovable Object," *The Accounting Review* (April, 1968), pp. 266-269.

[28]Securities and Exchange Commission, "SEC Adoption of Amendments to Regulations S-X,"- *SEC Accounting Rules* (Commerce Clearing House, 1972).