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ATTACHMENT FOR TESTIMONY OF

WALLACE E. OLSON

CONCERNING THE INDEPENDENCE

OF AUDITORS

JUNE 16, 1976

THE INDEPENDENCE OF AUDITORS

INTRODUCTION

The work of the public accounting profession in recent years has attracted a high level of attention within the business community and governmental circles. This increased interest and visibility has resulted in large part from a growing recognition of the importance of obtaining assurance regarding the reliability of financial statements.

As the nation's economy has grown in size and complexity, the Federal government has found it increasingly necessary to engage in more extensive planning and control. At the same time, our system of capital formation and the functioning of our capital markets have become more widely recognized as essential to the continuing health of the economy. The availability of reliable financial data is necessary to the establishment of sound economic policies and the maintenance of capital markets which attract a broad base of investors. The CPA's role as auditor of financial statements is indispensable to fulfilling this need. Thus it is important that CPAs perform in a manner that warrants widespread confidence in their work.

During the last decade, there have been increasing expressions of doubt about whether CPAs were, in fact, performing a satisfactory level in their capacity as auditors. Criticism of the profession has been voiced by a variety of interested

parties including financial analysts, financial reporters, academics, government officials and CPAs themselves.

The critics have not always clearly stated the basis of their concerns or expectations but their principal complaints generally fall into two broad categories:

1. Audits have not been sufficiently effective in alerting users of financial statements to material irregularities and impending financial disasters.
2. Financial statements prepared in conformity with generally accepted accounting principles have not adequately portrayed economic reality.

These criticisms stem largely from the collapse of several large companies during the late 1960s and early 1970s and hundreds of lawsuits against CPA firms in those and other cases. Some of these business failures involved management fraud which was not detected by the auditors. Some frauds involved management's distortion of the substance of complex business transactions by arranging them in a form that complied with generally accepted accounting principles but violated their intended result.

It is important to note, however, that the great majority of unanticipated business failures have come as a surprise because of honest misjudgments about future business prospects. The

miscalculations about markets for bowling alleys, franchising, commercial aircraft and real estate developments are but a few examples of one of the major causes of business failures in recent years.

More recently, the revelations about corporate bribes and illegal political contributions have raised further questions about the performance of auditors and whether they should be responsible for detecting and publicly disclosing illegal corporate acts. In addition, the energy crisis has resulted in challenges to the reliability of the financial reports of the oil and gas companies -- a development which, in turn, reflects growing skepticism about the work of their auditors.

All of these concerns appear to reflect a pervasive feeling that auditors are not sufficiently independent of their clients. Since the usefulness of the auditor's work depends on his independence -- in appearance as well as in fact -- it is imperative that the expressed doubts concerning independence be fully explored and satisfactorily resolved. The balance of this paper is devoted to that objective. No attempt is made to deal with the adequacy of existing auditing and accounting standards or the methods of their development. These are subjects which deserve extensive and separate treatment. The focus of this paper will be on the degree to which the application of auditing and accounting standards is affected by pressures

on auditors that might impair their independence.

THE CONCEPT OF AUDIT INDEPENDENCE

An understanding of the concept of audit independence requires a knowledge of the basic reasons why audits are useful. Users of financial statements who are not in a position to satisfy themselves directly as to their fairness must have some means of obtaining reasonable assurance. Because those who are responsible for the representations in financial statements are employees or principals of the issuers, they cannot be expected to be unfailingly impartial in portraying the financial condition and results of operations of their respective business enterprises. Thus the users of financial statements must look to others to gain a greater measure of confidence that statements are fairly presented. It is this need which is met by the examination conducted by an external auditor and by his professional opinion as to whether the financial statements are presented fairly in conformity with generally accepted accounting principles.

In order to fulfill this role, the auditor must be someone who is not only outside the business enterprise, but is as free as possible from the influence of its management and owners and from other conflicts which might impair his objectivity. Once these conditions have been satisfactorily met, the outside auditor is uniquely qualified to make an expert investigation and add credibility to the financial statements. Under these

circumstances, the more an auditor is involved in the work which enters into the preparation of financial statements the greater will be his knowledge of their content and fairness of presentation in conformity with generally accepted accounting principles. This is an important fact to keep in mind when considering how far an auditor ought to go in providing services to an audit client. This will be examined in more detail later in this paper.

To assure that auditors maintain a satisfactory posture of impartiality, the profession has included a rule in its code of ethics which prohibits two types of relationships with audit clients:

1. Financial interests in connection with a business entity which is the subject of an audit.
2. Serving the audited entity in a capacity which would cause the auditor to be in fact or essentially equivalent to being an officer, director or employee of the entity.

These relationships are described in more detail in Rule 101 of the Institute's Rules of Conduct which is attached as Appendix A. This rule has been further elaborated on by a series of interpretations and rulings of the Ethics Committee of the AICPA, copies of which are attached as Appendix B.

The rule recognizes that it is the nature of an auditor's relationship with his client that determines whether he is satisfactorily impartial. Thus, in examining the question of auditor independence, it is necessary to analyze the various kinds of relationships which may exist and weigh their potential for impairing an auditor's independence.

The term "independence" has been traditionally used by the profession to describe the required integrity and objectivity of auditors and it is those qualities which are the essence of professionalism. Because independence is intended to describe a state of mind which is judged on the basis of existing relationships with a client, it is a complex concept that is difficult to define. For example, an unacceptable state of mind would exist for audit purposes if the auditor is so influenced by the pressures of conflicts of interest that:

1. His objectivity would be unwittingly impaired to the point that he would in good faith provide his assurance that misleading financial statements are reliable.
2. He would knowingly provide his assurance that misleading financial statements are reliable. This would be a loss of his integrity.

The state of mind implied by the term "integrity" is also an important concept in determining degrees of legal culpability. Concepts such as scienter or reckless disregard of the facts have evolved as standards of evidence that a knowing dishonest act was committed. On the other hand, the notion of simple negligence or mistakes made in good faith have generally been used as a standard of evidence that a dishonest state of mind did not exist.

When judging the integrity or objectivity of auditors it is almost always necessary to rely on circumstantial evidence as to their state of mind. This evidence consists largely of appearances in the light of relationships which exist between an auditor and his client. These relationships take a variety of forms, some of which are impossible to avoid since all audits require that there be certain basic types of contact and arrangements between auditors and their clients' personnel.

If judgments with respect to the integrity or objectivity (independence) of auditors are to be made fairly, they must include the following:

1. A knowledge of the relevant facts.
2. Application of reasonable standards as observed by society in general.
3. Recognition of pressures which would tend to impair an auditor's integrity or objectivity.

4. Recognition of countervailing pressures which tend to assure the maintenance of an auditor's integrity or objectivity.
5. Evaluation of the likely composite impact of conflicting pressures in the light of normal strength of character and human behavior under the circumstances.

In making these judgments, it should be recognized that total independence is an unattainable goal. As long as there are relationships of any kind between an auditor and his client there will be opportunity for doubt whether those relationships have resulted in unwitting or knowing bias in favor of the client.

Auditors cannot practice their calling and participate in the world's affairs without being exposed to situations that involve the possibility of pressures on their integrity and objectivity. To define and proscribe all such situations would be impracticable. To ignore the problem for that reason, however, and to set no limits at all would be irresponsible.

It follows that the concept of independence should not be interpreted so loosely as to permit relationships likely

to impair the auditor's integrity or objectivity nor so strictly as to inhibit the rendering of useful services when the likelihood of such impairment is relatively remote.

The following sections describe more specifically some of the prevalent types of relationships and pressures that have a bearing on where the line should be drawn to maintain an appropriate degree of independence on the part of auditors.

RELATIONSHIPS WHICH CREATE
PRESSURES ON INDEPENDENCE

Certain relationships have long been regarded as posing such a serious threat to the independence of auditors that they have been prohibited under Rule 101 (Appendix A attached) of the profession's code of professional ethics. Under this rule auditors are prohibited from expressing opinions on the financial statements of a client if, with certain qualifications, they

1. Have any financial interest in the client.
2. Have a material joint closely-held business investment with the client.
3. Have a loan either to or from the client.

4. Are connected with the client as a promoter, underwriter or voting trustee, director, officer or in a capacity equivalent to a member of management or an employee.
5. Are trustees or executors of trusts or estates having any financial interest in the client.
6. Are trustees for any pension or profit-sharing trust of the client.

These prohibitions have received a high degree of compliance within the profession and are being rigidly enforced. Accordingly, the relationships described under the rule need not be examined further except to note that in some respects the proscriptions have been made exceptionally stringent to facilitate their enforcement. For example, it is difficult to assert that ownership of one share of stock in a multi-national client would be likely to impair an auditor's independence. This is prohibited, however, because it would be difficult to establish the precise point at which the size of an investment in a client would tip the scales. To this extent the profession has bent over backwards to maintain its appearance of independence.

Among the relationships which are not prohibited and which are perhaps most frequently cited by the profession's critics as a basis of concern are the fact that auditors:

1. Are appointed and paid by the clients which they audit.
2. Provide a variety of non-audit services that entail acting in the role of advisor or advocate for their audit clients.

Inherent in the first of these concerns is the suspicion that auditors might unduly favor a client's wishes when making difficult judgments in the course of an audit. The concern is based on the assumption that the fear of losing a client and the resulting effect on the auditor's income or prestige is sufficient to cause him to be less than objective.

The second concern arises from the belief of some that providing services in the role of advisor or advocate to an audit client will, in some instances, result in an auditor having to pass judgment on the reporting of financial data that is a result of his own advice or actions in behalf of the client. The types of service most frequently cited as causes for alarm involve acting as an advisor on matters that are furthest removed from the traditional field of accounting. On the other hand, consulting on matters that are more directly related to accounting seems to generate less concern. This ambivalent attitude toward consulting raises questions about the validity of the allegations that impairment of an auditor's objectivity is the real concern. More likely it is competence rather than independence that is being questioned.

Other types of relationships with clients which are not prohibited are those which are purely social in nature. While

it is recognized that a close personal friendship between an auditor and a principal officer of the client could pose a problem it would be difficult to know where to draw the line of impropriety.

All of the relationships with audit clients described above -- whether currently prohibited or not -- hold at least some potential for eroding the objectivity or integrity of auditors. To argue otherwise would be less than realistic. However, an appraisal of the impact of these pressures on the performance of auditors must take into account the countervailing pressures which influence auditors to maintain their independence. It should be recognized that elimination of all conflicts of interest is generally not practicable in any area of economic or social life. The objective should be to reduce the potential risks to an acceptable level. The pressures which achieve this objective with respect to auditors are explored in the following section.

COUNTERVAILING PRESSURES

There are two general factors that would normally cause auditors to resist pressures in their dealings with clients. The first of these is a strong sense of personal probity and professional pride that is inculcated in every CPA as a part of his professional training. The second is the fact that CPAs typically serve a large number of different clients and are, therefore, not beholden to any single client for their livelihood.

However, the independence of auditors does not depend solely on these traditional conditions. They are augmented by some very powerful forces. Principal among these are the threat of lawsuits and the risk of losing the right to practice.

The scores of lawsuits against auditors, spawned principally by business failures, have caused great concern among CPA firms. Confronted by the ever-present threat of litigation, auditors would have to be foolhardy in the extreme to risk their careers by being less than objective in performing their audits.

They also face the possible loss of their rights to practice by revocation of their CPA certificates by state boards of accountancy. Such action would almost certainly follow any decision in the courts that an auditor had acted dishonestly. This threat and the exposure to legal liability generate pressures of such severity that they would normally be expected to prevail over the impact of most types of relationships with audit clients.

There are, however, additional pressures reinforcing the independence of auditors. If found guilty of violating the code of professional ethics by the profession's disciplinary bodies, an auditor's reputation would be greatly impaired -- thus diminishing his ability to attract and retain clients and staff. Sanctions imposed by the profession's disciplinary bodies moreover, would

doubtless lead to similar action by state boards of accountancy.

The profession has also instigated and supported a number of important programs and procedures to enhance the ability of auditors to resist pressures on their independence.

The establishment and strengthening of corporate audit committees composed of non-management directors has long been advocated by the AICPA. This effort has now gained considerable momentum and promises to provide substantial safeguards to protect the freedom of auditors from undue management influence.

The AICPA also worked closely with the SEC in urging and assisting in the development of that agency's requirements that information on changes in auditors be included in Form 8K reports of registrants. This reporting requirement is designed to disclose those cases in which auditors were dismissed because they did not agree with management's financial statements and were unwilling to express an unqualified opinion unless the statements were changed. The position of auditors is strengthened by this procedure because management is more inclined to seek agreement than to engage new auditors and explain its action in a public report.

Another important safeguard is provided by the program of quality control review employed within CPA firms. Partners or independent reviewers who have not been directly involved in a specific audit evaluate the judgments and work

of those who have performed the audit before a report is issued. These reviews are supplemented by post-release reviews of samples of audits performed by operating offices of the firms. Such intra-firm reviews of the quality of the work of operating offices are conducted periodically by teams of qualified audit personnel, generally partners, from other operating offices of the firm.

Similar quality control reviews of firms are also carried out independently or under a program sponsored by the AICPA. Under the program, reviews are conducted either by other CPA firms as a professional engagement or by panels of auditors drawn by the AICPA from other firms. A detailed description of this program is attached as Appendix C.

The combination of the foregoing mechanisms, coupled with penalties which can be imposed for inadequate performance, provide a formidable defense against the possibility that an auditor will yield to pressures which might tend to impair his objectivity or integrity. As a result, the number of cases in which auditors have clearly succumbed to a client's demands at the expense of the public interest has been exceedingly small.

This is not to say that there have been no failures in the execution of audit procedures nor any defective judgments exercised in grey areas in which the appropriate accounting and reporting was difficult to determine because it depended on the

outcome of future events. In any profession, it would be unreasonable and prohibitively expensive to impose a standard of zero defects and this is especially so with respect to the auditing of financial statements. The existence of fallibility in execution, however, should not be misconstrued as incontestable evidence that auditors lack objectivity or integrity.

ALTERNATIVES SUGGESTED
BY CRITICS

In addition to the restraints against loss of independence imposed by exposure to legal liability, loss of rights to practice, disciplinary sanctions by the profession, the safeguards provided by corporate audit committees, SEC requirements on reporting changes of auditors and the profession's quality control review programs, a number of more radical steps have been proposed by critics.

One such proposal is that companies should be required to engage new auditors every three to five years. It is asserted that required rotation would provide auditors with greater freedom from influence by management because their limited tenure would minimize fear of losing a client.

At first blush, a rotation requirement might seem beneficial in bolstering the independence of auditors. However, a considerable price would be paid for such a requirement. The most effective audits are generally performed by auditors who have

acquired a thorough knowledge of the business entity under review. It is generally recognized that such knowledge is best gained through actual audit experience over a considerable period of years. This level of expertise would be substantially dissipated by a system of periodic rotation.

Furthermore, the costs of audits would increase because of frequent duplications of start-up learning time and development of a background data base that underlies every audit. Also, the intense competition by CPA firms to attract clients up for rotation would tend to create such severe pressures on auditor independence that the net result of rotation would be a decrease rather than an increase of independence.

CPA firms have for many years rotated their personnel on audit engagements to bring fresh viewpoints to bear on the audit process. This is accomplished on a gradual basis which permits the retention of continuity, thereby avoiding many of the disadvantages that would result from the rotation of firms. To the extent that there are advantages to be gained by rotation, they are largely achieved by these alternative procedures of systematically bringing new personnel into audit engagements.

It should also be recognized that rotation of firms could have an adverse effect on the ability of auditors to obtain information from their clients. The effectiveness of audits depends to a substantial degree on the maintenance of an

attitude of candor and goodwill by a client toward his auditor. This attitude would not be as readily developed if there were frequent changes in auditors and clients would tend to be less open in discussing their affairs.

When all of these factors are considered it seems likely that on balance a requirement to rotate audit firms would weaken rather than strengthen the independence and effectiveness of auditors and the costs of audits would be increased. Accordingly the proposal should not be adopted because it would be counter-productive.

A second proposal that is often advanced by the profession's critics is that the scope of services of auditors be restricted to preclude those services which are perceived to create adverse pressures on the objectivity and integrity of auditors. There are varying opinions among the critics as to what specific services should be prohibited and whether the restriction should extend only to audit clients or to all clients regardless of whether audits are performed for such clients.

Among the services which have been cited as posing a threat to auditor independence are the following broad categories:

1. Advice leading to management decisions and assistance with systems and their implementation.

2. Preparation of accounting records or financial statements which are subsequently audited by the preparing firm.

The concern underlying both of these categories is that an auditor may be biased in reporting on the reliability of financial statements based upon the results of decisions or systems in which he played an advisory role or assisted in their implementation. It is alleged that under such circumstances an auditor would be reluctant to concede that his advice or assistance to the client has been faulty. This reluctance would be evidenced by expressing a favorable opinion on financial statements that failed to reflect any adverse results of the auditor's services to the client.

No doubt the providing of non-audit services to audit clients could create some potential for conflicts that might affect the objectivity or integrity of auditors. Indeed, even judgments made as a part of conducting an audit could cause an auditor to be defensive about such judgments in a succeeding audit when events may have proved him wrong. But the risks of impairment of objectivity or integrity are so minimal in relation to the benefits that accrue from providing non-audit services that prohibition of such services would be unwarranted and undesirable. Consulting services help management to achieve efficient business operations and auditors are uniquely qualified to provide them because of their knowledge gained through observation and analysis of the activities of a wide range of clients. In addition,

the insights gained by auditors in providing consulting services are highly beneficial to the effectiveness of their audits. The quality of audit judgments frequently depends on the application of expert knowledge about business operations and practices.

There are many reasons to conclude that the risks of providing consulting services to audit clients are not significant. The most important of these are:

1. No evidence has been produced that providing services involving an advisory role or assistance with implementation has in fact impaired the objectivity or integrity of auditors.
2. Auditors providing such services are likely to be constrained by the strong countervailing pressures of threat of lawsuits, loss of reputation and disciplinary action leading to loss of rights to practice.
3. Auditors are by training, background and experience inclined to resist the various pressures on their independence.
4. Management is not likely to conspire with auditors to issue financial statements that hide the results of poor advice or assistance by the auditors.

5. Auditors do not express opinions on the quality of management or management decisions. Their opinions relate only to financial statements. Thus auditors do not express direct opinions about their own advice or assistance and are not under strong pressure to agree to the issuance of financial statements that distort operating results.

6. Providing non-audit services provides an auditor with a more intimate knowledge of a client's affairs and enhances his ability to perform an effective audit because of his understanding of the business. Thus the more an auditor is professionally involved in the preparation of financial statements and the underlying accounting records the greater will be his knowledge of them and his ability to form an opinion about the fairness of the statements.

The argument by critics that auditors cannot audit their own work, consisting of non-audit services, misses the main purpose of an audit which is to obtain a degree of confidence from someone outside the control of management. An auditor

does not fall under the control of management simply by rendering non-audit services. Thus his ability to lend credibility to financial statements should not be diminished. To the contrary, he will know more about the client and its affairs and is likely to be a more effective auditor. The main objective of an audit is achieved because an outside party, the auditor, is passing judgment on the fairness of management's representations in the financial statements.

All of the foregoing factors, coupled with the fact that auditors serve many clients and provide all their services from the posture of an outside contractor, tend to keep pressures on their objectivity and integrity within acceptable limits. On balance, then, the disadvantages would far outweigh the benefits if auditors were precluded from providing non-audit services to their audit clients.

Most of the other suggestions of critics are directed at changing the fact that auditors are appointed and paid for their services by their audit clients. Some have proposed that auditors be paid out of a pool of funds created by assessments against companies subject to audit. This misses the principal issue since it is the appointment of the auditor which counts rather than how he is paid.

Others have suggested that a government agency have the power to appoint and dismiss auditors or that all audits be con-

ducted by government employees rather than by members of a private profession.

These proposals are so drastic that if they were adopted they would virtually destroy any vestiges of a private profession. Such an invasion of the private sector by government would not seem warranted in the light of the many achievements of the public accounting profession and the advantages of its retention. Indeed, there is no assurance that a government bureaucracy would perform the audit function nearly as well as the private profession. It has been alleged, for example, that government regulatory agencies tend to become protective of the industries they regulate and are less independent in their relationships than are private auditors. Furthermore, transfer of the audit function to a government agency runs the risk that it may be used for partisan political purposes.

Short of converting the private profession to a government function there would seem to be no practical alternative to the present system under which auditors are appointed and paid by their clients. In any event, the pressures that stem from a fear of dismissal and loss of fees are probably not nearly as great as might be contended by critics of the profession. Also, the countervailing pressures which have been previously cited are of such magnitude that any drastic changes in the present system would seem to be unwarranted.

CONCLUSIONS

To sum up, auditors cannot practice their calling without

being exposed to pressures on their integrity and objectivity. To define and proscribe all such situations would be impracticable.

The pressures that accompany normal relationships with clients are offset by powerful countervailing restraints. These include the possibility of legal liability, professional discipline involving revocation of the right to practice, loss of reputation and the inculcated resistance of a professional to any infringement upon his basic objectivity and integrity.

In deciding which types of relationships should be prohibited, both the magnitude of the threat posed by a relationship and the force of countervailing pressures have to be weighed. Such judgments should be based on whether reasonable men, having knowledge of all the facts and taking into consideration normal strength of character and normal behavior under the circumstances, would conclude that a particular relationship would pose an unacceptable threat to an auditor's objectivity or integrity.

The profession has applied these criteria in establishing its prohibitions of relationships between auditors and their clients. It believes that those prohibitions are being scrupulously observed and are adequate to assure the independence of auditors.

The profession has also taken steps to minimize the pressures on auditors by urging the establishment of corporate audit committees and assisting in the development of reporting

requirements on changes in auditors. Safeguards to assure a high level of performance have also been imposed by adopting and carrying on extensive quality control review programs and requiring continuing professional education by practitioners.

In short, the profession is doing all that can reasonably be expected to assure that a high level of independence is maintained by auditors. However, no procedures or system of constraints, whether self-imposed or invoked by government, can provide a guarantee of zero defects.

Even though there have been failures in the performance of auditors they have been minuscule in number in relation to the overall volume of audits performed. When failures have occurred they have rarely involved impairment of objectivity or integrity. In almost all instances, audit judgments were found to be faulty in the light of hindsight, audit procedures were not effectively applied or generally accepted accounting principles had not been sufficiently narrowed to deal appropriately with new forms of business transactions. None of these shortcomings would have been cured by the rotation of auditors, restrictions on the scope of services of auditors, different methods of appointment or remuneration of auditors or transfer of the audit function to a governmental body.

The problems that have been encountered are to a large extent inherent in the difficulties in accounting for and reporting

in a highly condensed format on the operations of large complex corporate structures. Impairment of the independence of auditors is not a principal or fundamental cause of the few shortcomings that have been encountered in audited financial statements. Auditors have, overall, displayed a remarkable degree of objectivity and integrity in fulfilling their role and are likely to do so in the future without changes in the present system of constraints.