2000

Discussion memorandum: a conceptual framework for auditor independence, Feburary 2000; DM 00-1

Independence Standards Board

DM 00-1

Discussion Memorandum

A Conceptual Framework for Auditor Independence

February 2000

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Discussion Memorandum
(DM 00-1)

A Conceptual Framework for Auditor Independence

February 2000

Comments should be received by May 31, 2000 and addressed to:

Independence Standards Board, 6th Floor
1211 Avenue of the Americas, New York, New York 10036-8775
Attn: DM 00-1

Comments may also be faxed to (212) 596-6137, or sent via e-mail to isb@cpaindependence.org (the subject line should refer to DM 00-1).

ISB

Independence Standards Board

Date: February 2000

To: Interested Parties

From: William T. Allen, Chairman

One of the Board's major activities since its establishment has been developing a conceptual framework for auditor independence to help the Board issue principles-based independence standards for auditors of public companies.

As an initial step in articulating such a framework, the Board is issuing the enclosed Discussion Memorandum. The DM describes the issues the Board believes it should consider in a conceptual framework and asks respondents for their views through a series of questions in each section. A separate list of all the questions is attached for your convenience. The Board also welcomes comments and suggestions on any other matters relating to the development of the conceptual framework.

The Board recognizes that the issues discussed are complex and that the document is lengthy. We appreciate the time that respondents will spend to study the DM. It is not necessary for each respondent to reply to each question, but we are particularly interested in responses to the questions in Section I of the DM. In any event, for those questions to which you do respond, a discussion of your reasoning would be particularly helpful to the Board in its future deliberations.

The Board gratefully acknowledges the contributions made to the development, content, and writing of this Discussion Memorandum by the Director of the Conceptual Framework Project, Henry R. Jaenicke, the C. D. Clarkson Professor of Accounting at Drexel University, and by the Associate Project Director, Alan S. Glazer, Professor of Business Administration at Franklin & Marshall College.

Any individual or organization may obtain one copy of this Discussion Memorandum (DM 00-1), without charge, by

1211 Avenue of the Americas, New York, NY 10036–8775
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contacting the ISB. The DM is also available on the ISB website at www.cpaindependence.org.

Your responses, which must be received by May 31, 2000, may be sent via:

1. mail: Independence Standards Board, 6th Floor
   1211 Avenue of the Americas
   New York, NY 10036-8775
2. fax: (212) 596-6137
3. e-mail isb@cpaindependence.org

Please reference DM 00-1 in your correspondence.

All responses will be available for public inspection and copying for one year at the offices of the Independence Standards Board and also at the library of the American Institute of Certified Public Accountants (AICPA), Harborside Financial Center, 201 Plaza Three, Jersey City, NJ, telephone (201) 938-3000.

Thank you in advance for your time and effort.

A Conceptual Framework for Auditor Independence

Discussion Memorandum

Executive Summary

As part of its "Objective and Mission," the Independence Standards Board (ISB) is committed "to develop a conceptual framework for independence applicable to audits of public entities which will serve as the foundation for the development of principles-based independence standards." This Discussion Memorandum (DM) is the first step in a process that will culminate in the development of a conceptual framework for auditor independence. Readers are asked to respond to general questions as well as more specific questions about the usefulness and completeness of the various components of a conceptual framework that are discussed in the DM and about their views on alternative formulations of those components. The ISB will consider the comments received on this DM and, after deliberation, issue for public comment an Exposure Draft, which will then be followed by a final conceptual framework document or documents.

A conceptual framework for auditor independence is intended to

- help the ISB meet its responsibilities to set sound and internally consistent independence standards by providing direction and structure for resolving independence issues and questions

- help stakeholders in auditor independence understand the significance of auditor independence and the various processes that are in place to ensure it

- focus debate and serve as boundaries for discussions about auditor independence issues, thereby helping stakeholders contribute to the development of, and better understand the rationale underlying, ISB standards

The DM should stimulate discussion about alternative goals, definitions, and concepts of auditor independence, and about the role that the perceptions of various *stakeholders* play in the development of independence standards. Consistent with the objectives of the federal securities acts, however, the Board's mission is more narrowly focused on establishing independence standards applicable to audits of public companies in order to serve the public interest and to protect and promote the confidence of *investors* in the securities markets. The breadth of the issues raised in this DM is not intended to suggest that the Board's primary focus in setting independence standards will change in the future.

The DM is designed to be a neutral document. Where appropriate, it discusses issues from different points of view in order to stimulate constructive dialogue. In some instances, only single points of view are expressed because the ISB has not been able to develop operational alternatives to those views. In those cases, respondents are encouraged to describe alternative viewpoints.

The DM covers the importance of reliable financial statements to the capital markets and to various groups of stakeholders, regulation of the auditing profession in the United States, and various environmental factors that may create pressures on auditor independence, alleviate those pressures, and motivate auditors and auditing firms to maintain their independence. The DM notes that quality audits help ensure financial statement reliability. The level of audit quality is a function of many factors, including the personal attributes that individual auditors bring to an engagement. Auditor independence is only one factor and does not, by itself, produce a quality audit or guarantee that audit failures will not occur. To provide a context for understanding the audit process and how auditor independence relates to that process, the DM describes aspects of the environment in which audits take place.

The DM discusses alternative goals of auditor independence. Those goals could be expressed in terms of helping ensure that auditors are willing to exercise appropriate personal attributes—such as competence, diligence, integrity, and objectivity—for the purpose of improving the reliability of audited financial statements. Alternatively, they could be expressed in terms of helping ensure that auditors do not engage in activities or have relationships that may impair independence. The goals also could include helping ensure that users and other stakeholders perceive that those goals have been achieved, as a way to enhance the credibility of audited financial statements and improve stakeholder confidence.

The DM describes alternative sets of definitions of auditor independence based on the alternative goals. One set is based on a "personal attributes approach" and another on an "activities and relationships approach." Definitions that include explicit reference to stakeholders' perceptions also are presented.

The alternative definitions of independence are based on the assumption that certain factors—referred to as threats to auditor independence—may have a negative effect on auditor behavior. Threats arise from numerous and diverse pressures, activities, and relationships in the auditing environment. The possibility that a negative effect will result suggests the existence of risk—referred to as independence risk—that a threat may impair auditor independence. That negative effect could be avoided or mitigated, however, if one or more controls—referred to as safeguards to auditor independence—exist or are put in place. Safeguards to auditor independence exist in the environment in which audits are performed or are mandated by regulators, standard setters, or firms in response to threats to auditor independence. The DM discusses factors that may affect the significance of threats and the effectiveness of safeguards. It also considers whether stakeholder perceptions and the benefits and costs of independence should be included as concepts of auditor independence.

The DM examines basic principles of auditor independence based on the above concepts and asks for respondents' views on those principles:

Basic Principle 1: Different types of threats to auditor independence—including self-interest, self-review, advocacy, familiarity (or trust), and intimidation—arise in different circumstances.

Basic Principle 2: The significance of threats created in specific circumstances affects the level of independence risk.

Basic Principle 3: Different types of safeguards—including prohibitions, restrictions, other policies and procedures, and disclosures—can mitigate or eliminate threats to auditor independence.

Basic Principle 4: The effectiveness of the design and operation of various safeguards affects the level of independence risk.

Basic Principle 5: The ISB should assess the level of independence risk by considering the significance of the threats to auditor independence created by specific circumstances and the effectiveness of the safeguards that mitigate or eliminate those threats when it develops standards for auditor independence.

Basic Principle 6: The ISB should determine whether, in the specific circumstances under consideration, the level of independence risk is acceptably low.

Basic Principle 7: The ISB should consider which individuals in an auditing firm (as well as the firm itself) are affected by one or more threats to auditor independence in the specific circumstances under consideration and whether one or more safeguards effectively mitigate or eliminate those threats.

Basic Principle 8: The ISB should weigh the costs of alternative safeguards against the benefits of reduced independence risk resulting from those safeguards when it develops standards for auditor independence.

The DM also discusses factors that may affect perceptions of auditor independence and notes that different stakeholder groups and different individuals within a particular stakeholder group may have different perceptions about auditors and matters related to auditor independence. The DM describes several alternatives for a ninth basic principle of auditor independence to address the role of stakeholders' perceptions in the ISB's standard-setting process. Each of those alternatives could lead to a basic principle of auditor independence that addresses how the ISB should consider stakeholders' perceptions in setting independence standards. Such a principle could be expressed as one of the following:

Basic Principle 9A: The ISB should solicit the views of all stakeholders and develop independence standards that reflect stakeholders' perceptions.

Basic Principle 9B: The ISB should solicit the views of all stakeholders but develop independence standards that reflect the likely perceptions of a hypothetical group of stakeholders, namely, "reasonable, fully informed users of financial statements."

Basic Principle 9C: The ISB should solicit the views of all stakeholders and be informed by stakeholders' perceptions, but develop independence standards based on the ISB's judgment about how best to meet the goal or goals of auditor independence.

The DM concludes by noting that, regardless of the ISB's eventual conclusions about stakeholders' perceptions, effective communication between the ISB and stakeholders can help shape stakeholders' opinions about ISB standards and the process by which those standards are promulgated and, ultimately, enhance stakeholders' confidence in financial statement reliability and the independence of auditors in general.

A Conceptual Framework for Auditor Independence

Discussion Memorandum

Summary of Questions for Respondents

The DM asks for responses to the following questions:

Question I-1: Do you believe that a conceptual framework for auditor independence that contains goals, definitions, concepts, and basic principles will be useful to the ISB? Are there other components that should be included in a conceptual framework? Please explain your views.

Question I-2: Do you believe that the conceptual framework components discussed in this DM will be useful to stakeholders other than the ISB? Please explain your views.

Question I-3: Should the ISB consider the interests of all stakeholders when it sets independence standards? If stakeholders or stakeholder groups have competing interests, whose interests should prevail?

Question II-1: Are there factors related to the audit environment, other than those discussed in Section II, that are relevant to, and should be considered in, a conceptual framework for auditor independence? If so, please describe those factors and their relevance to auditor independence.

Question III-1: Which of the goals described in Section III should form the basis for the goal or goals of auditor independence to be included in a conceptual framework? Please explain your views and discuss other goals that should be considered.

Question IV-1: Which of the alternatives described in Section IV should form the basis for a definition of auditor independence to be included in a conceptual framework? Please explain your views and discuss other definitions or approaches to defining auditor independence that should be considered.

Question V-1: Do you believe that the concepts discussed in Section V—independence risk, threats to auditor independence and their significance, safeguards to auditor independence and their effectiveness, stakeholders' perceptions in independence considerations, and benefits and costs of auditor independence—are useful and should be included in a conceptual framework? What other concepts, if any, would be useful? Please explain your views.

Question VI-1: Do you believe that the principles described in Section VI will be useful to the ISB in developing future standards? Please explain your views and discuss other types of guidance that you believe would make the conceptual framework more useful to the ISB or to other stakeholders.

Question VI-2: Do you believe that it is useful to analyze threats based on their nature and significance? Please explain your views and discuss types of threats other than those identified in Section VI that should be considered in a conceptual framework for auditor independence.

Question VI-3: Do you believe that it is useful to analyze safeguards based on their type and effectiveness? Please explain your views and discuss types of safeguards other than those identified in Section that should be considered in a conceptual framework for auditor independence.

Question VI-4: Do you believe that the ISB should consider which individuals in an auditing firm (as well as the firm itself) are affected by one or more threats to auditor independence in the specific circumstances under consideration and by one or more safeguards that effectively mitigate or eliminate those threats? Please explain your views.

Question VI-5: Do you believe that the ISB should weigh the costs of alternative safeguards against the benefits of reduced independence risk resulting from those safeguards when it develops new independence standards? Why or why not? Please discuss your views about how the ISB should measure the costs and benefits of alternative safeguards.

Question VII-1: Are there aspects of stakeholders' perceptions other than those discussed in this DM that are relevant to, and should be considered in, a conceptual framework for auditor independence? If so, please describe them and their relevance to auditor independence.

Question VII-2: Which of the alternatives described in Section VII, if any, should form the basis for a basic principle related to consideration of stakeholders' perceptions to be included in a conceptual framework? Please explain your views.

Question VII-3: Are there ways other than those noted in the alternative basic principles described in Section VII by which the ISB could consider stakeholders' perceptions in its standard-setting process? If so, please describe them.

A Conceptual Framework for Auditor Independence

Discussion Memorandum

Contents

SECTION I—INTRODUCTION

1. The mission of the Independence Standards Board (ISB) is to develop, through a public process, concepts, principles, and standards of auditor independence. Compliance with those concepts, principles, and standards is expected, among other things, to offer assurance to various **stakeholders in auditor independence**[1] that auditors who attest to the financial statements of **public entities** are independent. As part of its "Objective and Mission," the ISB is committed "to develop a conceptual framework for independence applicable to audits of public entities which will serve as the foundation for the development of principles-based independence standards." The ISB is issuing this Discussion Memorandum (DM) to encourage interested groups and individuals to submit written comments on issues related to developing a conceptual framework for auditor independence.

2. The DM should stimulate discussion about alternative goals, definitions, and concepts of auditor independence, and about the role that the perceptions of various *stakeholders* play in the development of independence standards. Consistent with the objectives of the federal securities acts, however, the Board's mission is more narrowly focused on establishing independence standards applicable to audits of public companies in order to serve the public interest and to protect and promote the confidence of *investors* in the securities markets. The breadth of the issues raised in this DM is not intended to suggest that the Board's primary focus in setting independence standards will change in the future.

Purposes Served by a Conceptual Framework

3. A conceptual framework for auditor independence is expected to serve several purposes:

- help the ISB meet its responsibilities to set sound and internally consistent independence standards by providing direction and structure for resolving independence issues and questions

- help stakeholders understand the significance of auditor independence and the various processes that are in place to ensure it

- focus debate and serve as boundaries for discussions about auditor independence issues, thereby helping stakeholders contribute to the development of, and better understand the rationale underlying, ISB standards

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[1] Words and phrases that appear in the Glossary are set in **boldface type** the first time they are used in the Discussion Memorandum.

4. The conceptual framework is not intended, by itself, to resolve auditor independence issues and will not amend, modify, or interpret existing independence rules. The ISB recognizes, however, that some of those rules may be inconsistent with elements of the framework. In due course, the ISB expects to reexamine existing rules governing auditor independence to deal with any such inconsistencies.

Project Steps

5. The ISB's conceptual framework project is being developed in accordance with its established due process. This document represents the first step in that process—the issuance of a DM soliciting public comment on issues related to the framework's development. Where appropriate, issues are discussed from different points of view in order to stimulate constructive dialogue. In some parts of the DM, only a single point of view is expressed because the ISB has not been able to develop operational alternatives to those views. In those cases, respondents are encouraged to describe alternative viewpoints.

6. This DM first describes the environment in which auditors practice and the importance of auditing to the capital markets. Subsequent sections consider the goals of auditor independence and definitions of independence based on those goals. The final sections discuss auditor independence concepts and basic principles that the ISB could use in resolving specific independence issues.

7. The ISB will consider comments received on this DM and, after deliberation, issue for public comment an Exposure Draft of a proposed conceptual framework for auditor independence. After considering the comments it receives, the ISB will issue its conceptual framework document or documents.

Questions for Respondents

8. At the beginning of each subsequent section of this DM, questions are posed to encourage respondents to comment on specific issues. In addition, all respondents are asked to include their views concerning (a) the usefulness of a conceptual framework for auditor independence and (b) how the ISB should consider competing stakeholder interests. The following three questions may be helpful in structuring those responses:

> **Question I-1: Do you believe that a conceptual framework for auditor independence that contains goals, definitions, concepts, and basic principles will be useful to the ISB? Are there other components that should be included in a conceptual framework? Please explain your views.**

> **Question I-2: Do you believe that the conceptual framework components discussed in this DM will be useful to stakeholders other than the ISB? Please explain your views.**

Question I-3: Should the ISB consider the interests of all stakeholders when it sets independence standards? If stakeholders or stakeholder groups have competing interests, whose interests should prevail?

SECTION II — THE AUDIT ENVIRONMENT AND ITS IMPLICATIONS FOR AUDITOR INDEPENDENCE

9. This section describes aspects of the environment in which audits take place to help readers understand the audit process and how auditor independence relates to that process. The aspects include: the importance of auditing to the capital markets and to various groups of stakeholders, the regulation of the auditing profession in the United States, and factors affecting auditor independence.

10. The basic question raised by this section is:

Question II-1: Are there factors related to the audit environment, other than those discussed in this section, that are relevant to, and should be considered in, a conceptual framework for auditor independence? If so, please describe those factors and their relevance to auditor independence.

Importance of Auditing to the Capital Markets[2]

11. There is widespread agreement that audited financial statements are an important component of the financial information that is available to the capital markets. Audits add value to financial statements by improving their **reliability**. Audits improve financial statement reliability because management of the **auditee**[3] corrects the statements to reflect knowledge that an auditor[4] obtains during the audit and communicates to it, but that previously had not been reflected appropriately in the financial statements. Even when audits do not result in corrections to the statements, they make financial statements more reliable by motivating auditee management (a) to avoid misstatements in the first place (because it knows that the statements will be subject to correction as a result of the audit) and (b) to consult with auditors about how to account for complex transactions before those transactions are recorded.[5,6] Improved financial statement reliability reduces **information risk**. Reduced

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[2] This part of Section II focuses on the values or benefits of an audit. There are also costs associated with audits, but only the costs of *auditor independence* (discussed in Sections V and VI) are relevant for this DM.
[3] There has been considerable debate in the auditing literature on the question, "Who is the client?" For example, the report of the Public Oversight Board's Advisory Panel on Auditor Independence, *Strengthening the Professionalism of the Independent Auditor* (New York: Public Oversight Board, 1994), recommends that the auditor consider the board of directors, not management, as the client. This DM uses the term "auditee," rather than "client," to denote the entity whose financial statements are being audited.
[4] As discussed in Section VI, the composition of the class contemplated by the term "auditor" may be specified by the ISB in the context of specific independence standards.
[5] Kinney and Martin analyzed previously published studies on audit-related adjustments and concluded that "the year-end audit is seen as directly reducing positive bias in preaudit net earnings and net assets as well as improving the precision of measurement" (William D. Kinney, Jr., and Roger D. Martin, "Does Auditing Reduce Bias in Financial Reporting? A Review of Audit-Related Adjustment Studies," *Auditing: A Journal of Practice & Theory* [Spring 1994], pp. 149-56). The research summarized in this study included audits of both public and private entities and a wide range of industries, entity sizes, auditing firms, and time periods.
[6] It should be recognized that an auditor's ability to improve the reliability of financial statements is limited by the nature of the audit process. Audit evidence may be persuasive but rarely is conclusive, and even persuasive

information risk helps to lower the cost of capital to auditees; it also helps to improve the decisions of **users** of financial statements, thereby enhancing the effectiveness of the capital markets in allocating resources.

12. Financial statement reliability is likely to improve when an auditor performs a **quality audit**. The level of audit quality is a function of many factors, including the personal attributes that individual auditors bring to an engagement. Auditor independence is only one of those factors. Accordingly, independence alone does not produce a quality audit, nor does it guarantee that audit failures will not occur.

13. Controls within firms, the auditing profession, and society also affect the level of audit quality. Those controls include the entire system of public regulation and self-regulation of the profession, including an auditing firm's system of quality control. Auditor independence, and the controls that operate to ensure independence, are only one source, albeit an important source, of quality audits and improved financial statement reliability.

14. Audits also are important to the capital markets because they enhance the **credibility** of financial statements.[7] In the context of financial statements, credibility means that stakeholders in auditor independence believe that an entity's financial position, results of operations, and cash flows are presented fairly in conformity with generally accepted accounting principles (GAAP) in all material respects—that is, that stakeholders perceive the financial statements to be more reliable because they were audited.[8] Stakeholders' confidence in the reliability of the financial statements may affect their perceptions of information risk and their resource-allocation decisions.

Stakeholders in Auditor Independence

15. Many individuals and groups have an interest in, and benefit from, reliable financial statements and the quality audits that help to ensure them. External users of financial statements—including current and potential investors, creditors, and others—want reliable financial statements on which to base their resource-allocation decisions. Quality audits help

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evidence is obtainable only at a cost. Additional auditing procedures might increase the persuasiveness of the evidence obtained, but at a cost that might exceed the benefit of the additional procedures. Moreover, the characteristics of fraud—such as concealment, collusion, and falsified documents—limit an auditor's ability to improve financial statement reliability.

[7] There are other benefits that flow from audits of financial statements. For example, auditors often communicate suggestions for improving internal control to auditees' managements and audit committees. Because those benefits are not related to the mission of the ISB, they are not addressed in this DM.

[8] Researchers who use a contracting perspective to study auditor independence express this notion somewhat differently. For example, DeAngelo notes that "the ex ante value of an audit to consumers of audit services (which include current and potential owners, managers, consumers of the firm's products, etc.) depends on the auditor's perceived ability to (1) discover errors or breaches in the accounting system, and (2) withstand client pressures to disclose selectively in the event a breach is discovered" (Linda E. De Angelo, "Auditor Independence, 'Low Balling', and Disclosure Regulation," *Journal of Accounting and Economics* [Vol. 3, 1981], p. 115).

to provide that reliability, thereby reducing users' information risk. Auditors' interests are served by quality audits because they satisfy auditors' professional responsibilities under generally accepted auditing standards (GAAS) and enhance auditors' professional reputations. Auditees (including auditee management, audit committees, and boards of directors) have an interest in quality audits because, by reducing users' information risk, they help to lower auditees' cost of capital. Quality audits also help to ensure that auditee managements meet their responsibilities to prepare reliable financial statements. Regulators and standard-setters (including the U.S. Securities and Exchange Commission [SEC], state boards of accountancy, the ISB, and the American Institute of Certified Public Accountants [AICPA]) can increase the effectiveness of the capital markets by promulgating rules and regulations that help ensure that audits improve financial statement reliability. Although individuals in each of these groups—referred to in this DM as stakeholders in auditor independence—may have different knowledge and beliefs about auditors and the audit process, they share a common interest in auditor independence: namely, its importance as one component in the system that helps ensure quality audits and, ultimately, financial statement reliability.[9]

16. Auditing firms, as well as public regulatory and self-regulatory bodies, have developed rules, policies, and procedures, including many related specifically to auditor independence, that help maintain audit quality. The major components of the system that regulates the auditing profession in the United States and their relationship to auditor independence are discussed in the next subsections.

Regulation of Auditors in the United States

17. Auditors in the United States are subject to a system of controls that, taken as a whole, constitutes the oversight or regulation of the profession. Controls that seek to maintain auditor independence are only one part of the regulatory fabric that has been developed to help ensure, and to assure stakeholders about, the quality of audits. This subsection describes briefly the system of public regulation and self-regulation of auditors in the United States, including aspects of that system directed specifically at auditor independence. The principal elements of the regulation of auditor independence are state boards of accountancy, the AICPA, and, for public entities, the SEC and the ISB—a combination of public and self-regulation.

[9] "The essence of the stakeholder idea is that those who may be significantly affected by an organization's action, or who are potentially at risk as a result, have an obligation-generating 'stake' in that decision" (Thomas Donaldson and Thomas W. Dunfee, *Ties that Bind: A Social Contracts Approach to Business Ethics* [Cambridge, MA: Harvard Business School Press, 1999], p. 235). Although originally used in reference to business organizations, the term also is used in the business ethics literature to refer to those who have an interest in other types of entities or in concepts. (See, for example, Lucas D. Introna and Athanasia Pouloudi, "Privacy in the Information Age: Stakeholders, Interests and Values," *Journal of Business Ethics* [Vol. 22, 1999], pp. 27-38.)

18. Many stakeholders appear to rely, at least in part, on audited financial statements to help make decisions.[10] Their reliance suggests they believe that organizations and processes are in place to help ensure quality audits. It is difficult, however, to assess the extent to which various stakeholders are knowledgeable about specific controls and regulations that help ensure quality audits. Regulatory bodies and organizations concerned with the quality of audits take various steps to enable them to identify and respond to stakeholders' needs and expectations and thereby enhance confidence in the regulatory process.

19. Some stakeholder expectations about auditing can reasonably be fulfilled by one or more bodies or organizations involved in self-regulation. For example, the AICPA on numerous occasions has increased auditors' responsibilities in response to the perceived needs of one or more groups of stakeholders.[11] Other stakeholder expectations, however, are best satisfied through public regulation. For example, a desire for monetary compensation when there is an audit failure may need to be fulfilled through the legal system. It must be recognized, however, that some expectations, such as absolute assurance that an audit will always detect material financial statement misstatements, are simply unachievable or can be achieved only at a cost that many believe exceeds the related benefit.

Components of Public Regulation

20. The basis for public regulation of auditors is found in federal and state laws and regulations that license accountants, specify ethical and technical standards, and enforce conformity with those laws, regulations, and standards. The components of public regulation include federal and state legislatures and regulatory agencies, including the SEC and state boards of accountancy, as well as the federal and state judicial systems. Audits of public entities must be performed by accountants who are "in good standing" and either "duly registered" or "entitled to practice" in the jurisdiction in which they live or work.[12] Statutory regulation for registering and licensing accountants is vested in state boards of accountancy. That regulation serves to protect the public interest by providing:

- reasonable assurance of the competence and moral character of individuals at the time they are initially licensed to perform regulated services[13]

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[10] The results of a comprehensive survey of stockholders' use of the components of corporate annual reports, including the financial statements and related information, can be found in Marc J. Epstein and Moses L. Pava, "The Shareholders' Use of Corporate Annual Reports," Vol. 2 in M. J. Epstein (Ed.), *Studies in Managerial and Financial Accounting* (Greenwich, CT: JAI Press, 1993).

[11] In 1996, the General Accounting Office issued a report, *The Accounting Profession, Major Issues: Progress and Concerns*, that included a review of recommendations made and actions taken by various organizations and bodies between 1972 and 1995 to improve the performance of independent audits of public entities. Although that report cited ongoing concerns in several areas, including concerns about auditor independence, it acknowledged that the profession generally had been responsive to recommendations for changes.

[12] SEC Regulation S-X, Rule 2-01.

[13] Some states also register or license firms to practice within their jurisdictions.

- reasonable assurance that accountants demonstrate their continued professional qualifications to maintain or renew their licenses

- a disciplinary system that provides incentives for accountants to meet the profession's ethical and technical standards

21. Federal regulators recognize certain private-sector bodies (such as the ISB) as promulgators of ethical and technical standards, subject to continuing oversight. State regulators also recognize certain standard-setting bodies in the private sector. For example, some state regulations incorporate the code of professional ethics of the AICPA or of the state's society of CPAs.

22. The independence of auditors of public entities has long been a component of public regulation at the state and federal level. State boards of accountancy have independence requirements for auditors who are licensed or registered in their jurisdictions. Various federal legislation, beginning with the Securities Act of 1933, requires (or gives the SEC authority to require) public entities to retain auditors who are independent. Rule 2-01 of SEC Regulation S-X contains the current version of those requirements and related guidance concerning how the determination of "independence" is to be made. The SEC also has published a large number of interpretations under Rule 2-01; these were reviewed in 1982 and published as part of the SEC's "Codification of Financial Reporting Policies." In addition, interpretive letters issued by the SEC staff in response to requests from various parties are available to the public. In 1998, the SEC recognized the ISB (subject to continuing oversight) as the private-sector body with the authority to develop standards for auditor independence and to issue interpretations of existing rules.[14] The SEC intends to continue to enforce compliance with auditor independence standards, including those promulgated by the ISB.

Components of Self-Regulation

23. The system of self-regulation of auditors includes controls within the auditing profession, as well as controls designed and implemented by auditing firms themselves. It is designed to meet the goals of achieving quality audits and enhancing public perceptions, confidence, and trust in auditors and in audited financial statements. The system has the following components:

- Membership standards—requirements that individuals must meet to qualify for membership in the AICPA, such as continuing professional education requirements, and that firms must meet to maintain membership in the SEC Practice Section (SECPS) of the AICPA Division for CPA Firms,[15] such as undergoing triennial peer reviews

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[14] SEC Financial Reporting Release No. 50, *The Establishment and Improvement of Standards Related to Auditor Independence* (February 18, 1998).

[15] All U.S. firms whose **partners** are members of the AICPA and that audit SEC registrants must belong to the SECPS. Approximately 1,300 auditing firms (800 of which audit SEC registrants and 500 other firms that belong voluntarily) are members of the SECPS. Fewer than 50 U.S. firms that audit SEC registrants, auditing

- Ethical and technical standards—a code of ethical behavior for individuals; standards for determining auditor independence, both for auditors generally and specifically for auditors of financial statements issued by public entities; authoritative standards and nonauthoritative guidance for conducting audits

- Quality control standards—standards for designing and maintaining systems of quality controls over auditing services, including, for example, the systems of hiring, training, promoting, and compensating professional personnel, as well as the "tone at the top" in the firm; supplemental quality control standards applicable to members of the SECPS

- Monitoring—oversight (through peer review and other means) of individual and member firm compliance with established membership, ethical (including independence), technical, and quality control standards

- Discipline—a disciplinary system that deals with violations of the profession's membership, ethical (including independence), technical, and quality control standards

24. Various bodies and organizations are responsible for carrying out self-regulation. They include auditing firms, committees and staff of the AICPA, state societies of CPAs, and the ISB. The AICPA bodies involved in self-regulation of auditors include the Board of Directors, the Auditing Standards Board, the Board of Examiners, the Professional Ethics Executive Committee, the Joint Trial Board, the Peer Review Committee, and the SECPS. Many state societies of CPAs also participate in the self-regulation of the profession in conjunction with the AICPA, such as through the Joint Ethics Enforcement Program.

25. The Public Oversight Board (POB) provides independent oversight of the profession's self-regulatory programs for SECPS members. It monitors and evaluates the activities of the SECPS and its committees to ensure their effectiveness. It also monitors and may comment publicly on matters that relate to the overall quality of auditing and financial reporting out of a belief that "it would ill serve the public interest if the profession's quality control programs were a model of integrity and effectiveness while other forces and circumstances destroyed the public's confidence in the credibility of financial reporting in the United States."[16]

26. Various bodies and organizations within the auditing profession have issued a large number of rules and regulations dealing with auditor independence. By the early 1940s, the American Institute of Accountants (predecessor to the AICPA) had incorporated independence rules in its Code of Professional Ethics. A decade later, independence was recognized as one of the ten "generally accepted auditing standards," a designation that it has

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less than 100 registrants in total (out of more than 15,000 total SEC registrants), are not members of the SECPS (SECPS Annual Report, Year Ended June 30, 1997, and telephone conversation with SECPS staff).

[16] Public Oversight Board, *1997-98 Annual Report*, p. 2.

retained ever since.[17] The current version of the AICPA's Code of Professional Conduct includes a requirement that auditors be independent, and numerous interpretations of that requirement have been issued.

27. The AICPA's quality control standards also require each auditing firm to design and implement policies and procedures related to independence that are appropriate for the firm's practice, based on factors such as its size and the nature and complexity of the services it offers to clients. Those standards specify that "policies and procedures should be established to provide the firm with reasonable assurance that personnel maintain independence (in fact and in appearance) in all required circumstances."[18] Firms also are required to communicate their independence policies and procedures to appropriate firm personnel and to monitor compliance with them.[19] Implementation of the quality control standards, including those related to independence, is tested during the triennial peer reviews required by the SECPS membership rules.[20]

Factors Affecting Auditor Independence

28. This subsection describes various factors that may affect auditor independence, including factors that motivate auditors and auditing firms to maintain their independence.

Economic Motivations for Maintaining Auditor Independence

29. It has been argued that auditors who behave rationally will endeavor to perform quality audits because of economic incentives, namely, the firms' stake in their reputational capital and their interest in avoiding the costs of malpractice suits.[21] Auditing firms, their owners, and others who work in those firms thus share an interest in maintaining the firm's reputational capital. High-quality auditing and its effects on a firm's reputation help the firm attract and retain audit clients. Auditee managements and directors also are interested in retaining auditors with high reputational capital because doing so adds credibility to auditees' financial statements and reduces their cost of capital.

[17] Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures* (AU Section 150).
[18] Statement on Quality Control Standards No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (New York: AICPA, 1996), para. 9.
[19] Statement on Quality Control Standards No. 2, para. 23; Statement on Quality Control Standards No. 3, *Monitoring a CPA Firm's Accounting and Auditing Practice* (New York: AICPA, 1996).
[20] AICPA, SECPS, *Peer Review Program Manual*, "Quality Control Policies and Procedures and Membership Requirements Questionnaire" (New York: AICPA, 1997), section 13242.
[21] See, for example, The Law & Economics Consulting Group, Inc., "An Economic Analysis of Auditor Independence for a Multi-Client, Multi-Service Public Accounting Firm," in AICPA, *Serving the Public Interest: A New Conceptual Framework for Auditor Independence* [White Paper], (New York: AICPA, 1997), Appendix B.

30. Controls to help ensure auditor independence help protect against the rogue behavior of "free riders"—individual auditors who pursue their own short-term interests that are at odds with the interests of the auditing firm. Those controls are based, in part, on the premise that it is in each individual auditor's and each auditing firm's best interests to comply with professional standards, including those related to auditor independence, that help ensure quality audits.

Economics of Auditing Firms

31. Financial statement audits performed by auditing firms in the private sector have always had both commercial and professional aspects. Notwithstanding that, Congress mandated that audits of SEC registrants be performed by independent auditors in the private sector, rather than by government auditors. There has been no significant interest in replacing the current system by, for example, moving the auditing of registrants into the public sector.

32. Private-sector auditing comes under the aegis of the federal rules against restraint of trade. In 1989, the Federal Trade Commission and the AICPA entered into a consent decree that allowed auditing firms to advertise and to accept, from other than audit and certain other clients, commissions, contingent fees, and referral fees. All of these had been banned previously by the AICPA's ethics code. In its 1978 report, the Commission on Auditors' Responsibilities noted the "excessive competition" in the accounting profession at that time.[22] Many observers believe that the level of competition among providers of auditing services has increased substantially since then.[23]

33. Over the past several decades, the mix of services offered by many auditing firms has changed dramatically. Previously, firms provided primarily audit and tax services. Their consulting practices were relatively small, concentrating on accounting and other services that CPAs were uniquely qualified to provide. Many firms now have consulting practices that rival their audit and tax practices in revenues and profits.[24] In addition, the tax and consulting

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[22] Commission on Auditors' Responsibilities, *Report, Conclusions, and Recommendations* (New York: AICPA, 1978), p. 110.

[23] Considerable research has been conducted that examines the competitiveness of the market for audit services. Empirical work on three important elements of that market—audit fees, auditor concentration, and auditor choice—is summarized in James A. Yardley, N. Leroy Kaufman, Timothy D. Cairney, and W. David Albrecht, "Supplier Behavior in the U.S. Audit Market," *Journal of Accounting Literature* (Vol. 11, 1992), pp. 151-84.

[24] For example, *Public Accounting Report* conducts an annual survey of the largest U.S. auditing firms ("national firms"). Data from those surveys show that those firms generated, on average, 46% of their U.S. revenues in the 1998 fiscal year from "management consulting services" and 30.5% from "accounting and auditing services" (*Public Accounting Report* [Special Supplement, February 28, 1999], p. 1). Previous years' surveys showed that the percentage of total revenues derived from management consulting services has grown steadily at these firms throughout the 1990s—revenues from such activities were only 27% of those firms' total revenues in the 1992 fiscal year (*Public Accounting Report* [May 31, 1997]). A similar trend was reported for the 100 largest U.S. auditing firms, although, on average, revenues from management advisory services represent a smaller percentage of those firms' total revenues (16% in fiscal 1998) than they do for national firms (46% in the same period) (*Public Accounting Report* [August 31, 1999]). These trends, and their potential impact on auditor independence, are discussed by Ralph S. Saul, "What Ails the Accounting Profession?" *Accounting*

practices of many large firms now derive a substantial portion of their revenues from non-audit clients, which loosens the bonds that traditionally tied audit, tax, and consulting practices and personnel together.

34. Concerns about the potential pressures on auditor independence created by the rapid growth in consulting and other non-audit services have been discussed widely in the auditing literature. For example, the AICPA's Special Committee on Financial Reporting (Jenkins Committee) noted that users of financial statements "are concerned that auditors may accept audit engagements at marginal profits to obtain more profitable consulting engagements. Those arrangements could motivate auditors to reduce the amount of audit work and to be reluctant to irritate [auditee] management to protect the consulting relationship."[25]

35. The SEC has shared that concern, and in 1978 issued a rule requiring registrants to disclose in their proxy statements information about non-audit services provided by registrants' external auditors.[26] The requirement was later removed, however, because the SEC did not believe that the information was sufficiently useful to investors.[27]

36. There also have been changes in many auditing firms' infrastructures and personnel over the past few decades. Previously, firms had relatively small and decentralized infrastructures, even when the firms themselves grew quite large. Professionals began in a firm's audit practice directly from undergraduate accounting programs, rose through the audit ranks or transferred to the tax or consulting practices if their interests and abilities so indicated, and either left the firm or became partners. Today, a higher proportion of professionals entering accounting firms have work experience, bring more diverse skills and expertise, and typically are hired into the specialty area in which they intend to practice. These circumstances may make creating and maintaining a firm-wide culture more difficult.

37. Furthermore, computerized systems for processing routine transactions and calculations have reduced the frequency of random clerical errors in the records underlying most auditees' financial statements. Such systems permit auditing firms to use computer auditing techniques to perform what used to be time-consuming, labor-intensive auditing procedures. Many firms also have "reengineered" their audit processes to include more focused risk-assessment activities, better deployment of their resources toward areas of high audit risk, and increased audit efficiency. These changes have reduced the need for junior-level professional staff. Turnover among professionals is high, however, and difficulty in attracting

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Horizons (June 1996), pp. 131-37, and Michael H. Sutton, "Auditor Independence: The Challenge of Fact and Appearance," *Accounting Horizons* (March 1997), pp. 86-91.

[25] AICPA, Special Committee on Financial Reporting, *Meeting the Information Needs of Investors and Creditors* (New York: AICPA, 1994), p. 104.

[26] SEC Accounting Series Release No. 250 (June 20, 1978).

[27] SEC Accounting Series Release No. 304 (January 28, 1982). Research performed subsequent to the requirement failed to show any significant stakeholder reaction to this information or any significant change in the amount or types of non-audit services provided. See James H. Scheiner, "An Empirical Assessment of the Impact of SEC Nonaudit Service Disclosure Requirements on Independent Auditors and Their Clients," *Journal of Accounting Research* (Autumn 1984), pp. 789-97, and G. William Glezen and James A. Millar, "An Empirical Investigation of Stockholder Reaction to Disclosures Required by ASR No. 250," *Journal of Accounting Research* (Autumn 1985), pp. 859-70.

and retaining qualified personnel often is identified as a major challenge facing the auditing profession.

38. The partner and manager-level personnel assigned to an audit are typically responsible for the engagement's profitability. They usually negotiate a fee with auditee management that is subject to change only in the event of unanticipated cost overruns beyond the auditor's control. Billing for audit engagements based on actual time and expenses, once the norm, is now the exception.

39. A common measure of engagement profitability is the realization rate—the percentage of amounts charged to an engagement (based on actual hours and standard billing rates) that actually is billed to the auditee. Some firms also measure performance by using a utilization rate—the percentage of total time each professional charges to an engagement. Managers and partners sometimes are evaluated based on both their own utilization rate and the rates of the staff assigned to them.

40. Managers and partners also may be evaluated according to the number of engagement hours or total engagement fees under their management, the amount of other services they sell (or are involved in selling), the number of new audit clients they acquire, and their clients' promptness in paying fees. Firms also consider qualitative factors, such as professional competence and experience in a targeted industry, when evaluating performance. The use of a variety of factors to measure performance is intended to provide a balanced approach to meeting a firm's objectives.

Implications for Firm Cultures and Auditors' Personal Attributes

41. The question that arises in noting these changes is whether they alter the nature of the factors that affect auditor independence and the impact of those factors on audit quality.[28]

42. Auditing firms spend significant amounts on advertising and marketing, and many firms attempt to differentiate themselves by finding and marketing niches in particular lines of business or practice specialties. Others emphasize personal service, the expertise the firm can provide, the firm's ability to solve business problems, or an audit process that also measures business efficiency and benchmarks the auditee's operations to those of competitors. These "branding efforts" are directed at auditee management—the group that effectively hires auditors and consultants—but large sums also are spent on reinforcing these marketing strategies and branding slogans within the auditing firm so that firm professionals can implement the strategies and internalize a firm culture that may stress auditee satisfaction at the expense of audit quality.

[28] Research has been conducted that examines the impact of various types of pressures on accountants' and auditors' attitudes and behavior. That research is summarized in F. Todd DeZoort and Alan T. Lord, "A Review and Synthesis of Pressure Effects Research in Accounting," *Journal of Accounting Literature* (Vol. 16, 1997), pp. 28-85.

43. Concerns have been expressed that, as a result of competition among firms and their marketing efforts, auditee managements may come to be viewed primarily as "customers" that need to be pleased, with auditor' responsibilities to users and other stakeholders inappropriately deemphasized. Auditee managements also may sense an auditing firm's desire to please its "customers." Some firms send periodic surveys to auditee managements asking for feedback on whether the engagement team met or exceeded auditee management's expectations and provided satisfactory service. Auditing firm management also may meet with auditee management to assess "customer" satisfaction. Negative feedback may lead to meetings among the engagement partner, the dissatisfied auditee management, and auditing firm management. In this environment, auditee management may believe that it has the upper hand, and auditors may feel undue pressure to appease auditee management when there is an accounting dispute. A requirement to report disagreements to the SEC when an auditing firm is replaced[29] can discourage changing auditing firms, but it does not eliminate the risk of intimidation or retaliation by management against an engagement partner or other professionals associated with the audit.

44. Because auditing firms and the profession have recognized the pressures that auditors in the field work under, they have established infrastructures and controls to help auditors apply the appropriate personal attributes that are necessary to help ensure quality audits. For example, a second partner must concur with important judgments and decisions made on audits of public entities, and consultation mechanisms within firms assist engagement partners in assessing complex auditing, accounting, and reporting issues. In addition, engagement personnel frequently consult informally with other firm professionals as a check on their conclusions. These informal networks of advisors and the formal firm decision-making process support engagement personnel when they are in conflict with auditee management. In some cases, auditing firm management, that is, partners who have no direct responsibility for the relationship with the auditee, may participate in determining the firm's position in such a conflict. The intent and the effect are to make the decisions *firm* matters rather than decisions of an *individual* partner, thereby relieving pressures on the engagement team.

45. Other firm policies and procedures also may serve as signals to partners and staff of the firm's commitment to quality audits. For example, many firms make significant, ongoing investments in their audit practice—updating audit methodologies and providing state-of-the-art hardware and software that enable auditors to work effectively in a computerized environment, have easy access to authoritative accounting and auditing literature and related firm publications, and share resources and knowledge. Firms also have developed or acquired expertise in specific industries and disciplines, providing engagement teams with a level of knowledge and experience appropriate for performing quality audits in a complex business environment.

46. Much of this support of audit quality represents an effort to increase auditor competence, which can help strengthen auditor independence. It also serves to balance the

[29] SEC Regulation S-K Item 304 (a) and the related instructions to Item 304 (a).

firm's emphasis on its marketing and profitability objectives. Significant investments in technology and expertise may provide compelling evidence of a firm's commitment to the audit practice. This should help foster a culture where the auditor is confident that the firm encourages individuals to maintain the profession's values—including auditor independence—as well as to achieve the firm's business objectives.

Pressures Arising from Auditors' Professional Responsibilities

47. In many professional–client relationships (for example, those that exist between physicians and their patients or between attorneys and their clients), each party is involved in decision making. Nevertheless, the two parties usually are not considered equals, in part because of the professional's specialized knowledge and experience. Clients typically must rely on the advice of professionals before a final decision is made (for example, about a specific medical treatment or line of legal defense). Because clients usually do not have the competence to evaluate the professional's work and advice, professionals have a special responsibility to their clients—often called "loyalty" —to ensure that clients' trust in the professionals and reliance on them are justified. In order for the shared decision-making process to work effectively, clients must trust professionals to act in the clients' best interests, subject to the limits placed on the professionals because of their responsibilities to other individuals and groups (for example, to other clients), to their profession (for example, as specified in the Code of Medical Ethics of the American Medical Association[30][AMA] or the Model Rules of Professional Conduct of the American Bar Association[31][ABA]), and to the public at large (for example, to comply with applicable laws and regulations).

48. An auditor's professional responsibility for loyalty is quite different from the responsibility of loyalty to a client described above because of the auditor's duty to serve the public interest. A better analogy may be to a judge's professional responsibility for ethical conduct—to serve the public interest in resolving legal disputes. To meet their professional responsibilities, judges are required to "uphold the integrity and independence of the judiciary" and to "perform the duties of judicial office impartially and diligently."[32] Judges' decisions should rest on their competence and diligence, that is, on their knowledge of applicable laws, regulations, and precedents and their ability to apply that knowledge properly in a specific case. In addition, judges are required to act without bias or prejudice toward individuals or groups. Judicial decisions should not be affected by the potential agreement or disagreement of specific individuals or groups, or by judges' personal interests in a specific outcome. As described in the ABA Code of Judicial Conduct:

> A judge shall not allow family, social, political or other relationships to influence the judge's judicial conduct or judgment. A judge shall not lend the prestige of judicial office to advance the private interests of the judge or others; nor shall a judge convey

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[30] Code of Medical Ethics (Chicago: AMA, 1996).
[31] Annotated Model Rules of Professional Conduct, 3rd ed. (Chicago: ABA, 1996).
[32] Code of Judicial Conduct (Chicago: ABA, 1990), Canons 1 and 3.

> or permit others to convey the impression that they are in a special position to influence the judge.[33]
>
> . . . .
>
> A judge shall perform judicial duties without bias or prejudice. A judge shall not, in the performance of judicial duties, by words or conduct manifest bias or prejudice, including but not limited to bias or prejudice based upon race, sex, religion, national origin, disability, age, sexual orientation or socioeconomic status, and shall not permit staff, court officials and others subject to the judge's direction and control to do so.[34]

49. Like those of judges, auditors' professional responsibilities require that they base their decisions on competent and unbiased assessments, free from pressures from individuals or groups that may have a personal interest in specific decisions and free from any emotional, financial, and other self-interests that may be served by a specific decision.[35] The AICPA Code of Professional Conduct summarizes those responsibilities as follows:

> A distinguishing mark of a profession is acceptance of its responsibilities to the public. The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on certified public accountants. The public interest is defined as the collective well-being of the community of people and institutions the profession serves.
>
> In discharging their professional responsibility, members may encounter conflicting pressures from among each of those groups. In resolving those conflicts, members should act with integrity, guided by the precept that when members fulfill their responsibility to the public, clients' and employers' interests are best served.[36]

50. Because of the environment in which they work, however, auditors are subject to some pressures that judges do not face. Judges are elected by the public or are appointed by elected representatives of the public to whom they are ultimately responsible. Although judges may stand for reelection or reappointment, those decisions are made by the public or its representatives. Judges do not have clients who pay their salaries, nor are they retained or reappointed by individual clients. Although responsible to serve the public interest, auditors may be affected by their firms' interests in serving and retaining clients. The U.S. Supreme

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[33] ABA Code of Judicial Conduct, Section 2B.

[34] ABA Code of Judicial Conduct, Section 3B(5).

[35] Other professionals have responsibilities that are similar to those of auditors and judges. For example, the International Code of Ethics and Standards of Professional Conduct of the Association for Investment Management and Research (AIMR) defines investment professionals' independence as follows: ". . . advice or investment decisions which are the product of an investment professional's own endeavors, and are not influenced by or subject to the control of an issuer of securities, the management of the investment professional's employer, or any other outside sources" (September 1998, para. 1.6). Arbitrators in commercial disputes are also expected to be independent: "An arbitrator should decide all matters justly, exercising independent judgment, and should not permit outside pressure to affect the decision" (American Arbitration Association, *Code of Ethics for Arbitrators in Commercial Disputes* [1977], Canon V-B).

[36] AICPA Code of Professional Conduct, ET Section 53.01-.02.

Court described an auditor's professional responsibility and the importance of maintaining independence in meeting that responsibility as follows:

> ... By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a *public* responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[37]

Role of Corporate Governance in Alleviating Pressures on Auditors

51. The combination of various pressures on auditors and an audit environment in which judgment is pervasive and evidence is merely persuasive can create an atmosphere in which auditee management may attempt to influence an auditor's judgments. Honest differences of opinion between auditee managements and auditors on accounting matters (as well as among auditee managements and among auditors) are to be expected, and there is nothing inherently wrong with auditee management attempting to convince its auditor that a particular accounting treatment is correct. Such attempts, however, may range from bringing relevant accounting concepts and standards to the auditor's attention to intimidating the auditor with threats of harmful economic or other consequences unless the auditor accedes to management's wishes. The former is clearly acceptable; the latter is not, because it is an improper attempt to pressure the auditor.

52. Various aspects of corporate governance can assist auditors in resisting inappropriate pressures from auditee managements, audit committees, and boards and in performing quality audits. Among these are:

- an audit committee or board of directors that plays a major role in engaging the auditing firm

- an audit committee or board of directors that accepts the responsibility to consider management's choice of accounting principles and estimates and, as part of that consideration, to obtain the auditor's views about the appropriateness of those principles and estimates

- an auditee control environment (including the "tone at the top") that emphasizes a commitment to reliable financial reporting and creates an atmosphere in which all auditee personnel understand that attempts to intimidate the auditor will not be tolerated

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[37] *U.S.* v. *Arthur Young & Co.* [465 US 805 (1983), pp. 817-18, emphasis in original].

53. An effective audit committee can moderate management attempts to pressure auditors into accepting inappropriate accounting treatments.[38] It also can be a channel of communication for the auditor to the full board, thereby helping to ensure that the auditor's positions are heard. Effective audit committees thus can serve as a **safeguard to auditor independence.**[39]

54. Auditors for some time have been required to report various sensitive accounting and auditing matters to audit committees, thereby giving committees the opportunity to be responsive to those matters.[40] In 1999 the ISB issued Standard No. 1, which requires auditors to report to and discuss with audit committees matters that may reasonably be thought to bear on independence.[41] Effective audit committees use those occasions to evaluate the auditors' independence. To the extent that audit committees take on and meet responsibilities for ensuring auditor independence through such evaluations, they also could serve as a safeguard to auditor independence. These and other aspects of corporate governance can help to discourage pressures on and intimidation of the auditor and also encourage the auditor to resist them if they do arise.

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[38] Knapp studied a variety of factors that may impact an audit committee's willingness to support the auditor when disagreements arise with auditee management. See Michael C. Knapp, "An Empirical Study of Audit Committee Support for Auditors Involved in Technical Disputes with Client Management," *Accounting Review* (July 1987), pp. 578-88.

[39] Suggestions for strengthening the relationship between external auditors and auditees' boards of directors and audit committees were contained in the following reports: Advisory Panel on Auditor Independence, *Strengthening the Professionalism of the Independent Auditor* (Stamford, CT: Public Oversight Board, 1994), pp. 12-23; U.S. General Accounting Office, *The Accounting Profession—Major Issues: Progress and Concerns* (Washington, DC: GAO, 1996); *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (New York: New York Stock Exchange and National Association of Securities Dealers, 1999).

[40] Statement on Auditing Standards (SAS) No. 61, *Communication With Audit Committees* (AU Section 380). Auditors' other reporting obligations to audit committees cover matters pertaining to internal control, illegal acts, and fraud.

[41] ISB Standard No. 1, *Independence Discussions with Audit Committees* (New York: ISB, 1999).

SECTION III — GOALS OF AUDITOR INDEPENDENCE

55. This section discusses possible goals of auditor independence. That discussion is preceded by consideration of personal attributes of individual auditors that many believe help ensure quality audits.[42] Different goals may lead to different definitions, concepts, and basic principles of auditor independence.

56. The basic question raised by this section is:

Question III-1: Which of the goals described in this section should form the basis for the goal or goals of auditor independence to be included in a conceptual framework? Please explain your views and discuss other goals that should be considered.

Personal Auditor Attributes

57. Certain personal attributes of auditors play an essential role in helping to ensure audit quality. Judgments and decisions are made by all individuals on an audit team, and audit quality can be maintained only if individual auditors at all levels within an auditing firm possess appropriate personal attributes and exercise them when performing audits. For example, the following personal attributes are discussed in the auditing literature:

- **Competence**—When applied to an auditor, competence means the ability to develop an appropriate audit plan, select suitable auditing procedures to test management's assertions, execute the procedures and evaluate evidence, draw proper conclusions regarding the conformity of the financial statements with GAAP, and render the appropriate auditor's report. To perform a quality audit, auditors need a wide variety of technical and managerial knowledge and skills. Individual members of an audit team will possess such knowledge and skills in varying degrees.

- **Diligence**—When applied to an auditor, diligence means approaching an audit with professional skepticism, efficient and careful handling of technical matters, and a willingness to devote adequate time and appropriate effort in performing an audit. Diligence sometimes is included as part of an auditor's responsibility to exercise due professional care.

- **Integrity**—When applied to an auditor, integrity means being honest, trustworthy, candid, and truthful in performing an audit and making judgments regarding the financial statements' conformity with GAAP. The AICPA Code of Professional Conduct summarizes auditor integrity as follows:

[42] Appendix B of this DM contains examples of various types of goals of auditor independence that have appeared in the auditing literature in addition to those described in this section. Although that literature often refers to the *objectives* of auditor independence, this DM uses the term *goals* in that context in order to avoid confusion with the personal attribute of objectivity discussed in this section.

Integrity is measured in terms of what is right and just. In the absence of specific rules, standards, or guidance, or in the face of conflicting opinions, a member should test decisions and deeds by asking: "Am I doing what a person of integrity would do? Have I retained my integrity?" Integrity requires a member to observe both the form and the spirit of technical and ethical standards; circumvention of those standards constitutes subordination of judgment.[43]

- **Objectivity**—When applied to an auditor, objectivity means being impartial—that is, having the ability to suppress any existing biases when obtaining and evaluating audit evidence and making audit judgments. Biases may arise from an individual's background, education, and experiences and are part of human nature; therefore, it is difficult for anyone to be completely objective. Biases can be both conscious and subconscious and also can be either in favor of or against specific things—for example, individuals, groups, organizations, ideas, or principles. Auditors must recognize that personal prejudice—for example, bias for or against specific auditees or specific accounting principles—can endanger the quality of audits by causing biased audit judgments. As a result of the potential for bias, various controls (for example, mandatory rotation of engagement partners, mandatory concurring partner reviews, and other quality control policies and procedures) have been implemented to help prevent potential biases from affecting the quality of audits.

58. The above list, while not inclusive of all of the personal attributes that auditors should have, illustrates the types of qualities that auditors need in order to perform quality audits.[44] The mere possession of these attributes, however, is not sufficient to ensure a quality audit. For example, an auditor who is competent might fail to exercise his or her competence in making audit decisions in a specific circumstance. Accordingly, to perform a quality audit, an auditor should not only *possess* appropriate personal attributes but also *exercise* them.

59. To acknowledge the role that auditors' personal attributes play in helping ensure quality audits is not to suggest that the ISB's purview includes all factors that could affect the possession and exercise of an auditor's personal attributes. The ISB's mission is to develop *independence* standards, not standards for competence, diligence, integrity, objectivity, or other personal attributes. These personal attributes are described here because they are components of some of the goals of auditor independence discussed later in this section. (A formal definition of the term "independence" is not discussed until Section IV because of the presumption that such a definition will depend on the goal or goals of independence.)

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[43] AICPA Code of Professional Conduct (as of June 1, 1998), ET Section 54.03.

[44] One model that describes relationships between auditor independence and the personal attributes of objectivity, integrity, and competence and how those attributes may affect audit quality is discussed in Robert K. Elliott and Peter D. Jacobson, "In Search of Solutions—SEC Independence Concepts," *CPA Journal* (April 1998), pp. 18-19.

Improving Financial Statement Reliability

60. To help ensure that auditors possess and exercise appropriate personal attributes, auditing firms have developed and implemented a wide variety of policies and procedures (many of which are described in Section II). Firms' hiring policies, training and continuing professional education programs, and "tone at the top" stress the meaning and importance of professionalism and the qualities that professional auditors should have. The attributes of audit team members are assessed as part of the supervision of audits by a firm's managers and partners, including the various levels of reviews of an audit team's work and periodic performance reviews of individual auditors. In addition, peer reviews of auditing firms include evaluations of the overall quality of audits performed by the firm, the work of individual auditors, and the firm's quality controls that are designed to ensure that its personnel have and exercise appropriate personal attributes.

61. Some believe that maintaining auditor independence is important because independence helps ensure that an auditor can exercise appropriate personal attributes in performing an audit. As a result, auditor independence helps ensure audit quality, thereby making it more likely that an audit will enhance financial statement reliability. Under this view, a goal of auditor independence could express the relationship among independence, an auditor's personal attributes, and improving financial statement reliability. For example:

> **Goal 1—A goal of auditor independence is to help ensure that auditors are willing to exercise appropriate personal attributes when performing audits, thereby making it more likely that audits will improve the reliability of financial statements.**

62. It can be argued that Goal 1 is too broad because it includes all of an auditor's personal attributes. Some believe that independence is related more directly to the possession or exercise of objectivity, integrity, or both than it is to other personal attributes, and a goal of independence should reflect that closer relationship. For example, the International Federation of Accountants (IFAC) recently issued a Discussion Draft containing revisions to its code of ethics that states:

> Independence requires the qualities of objectivity and integrity. Objectivity is the intellectual quality of freedom from bias; integrity is the moral quality of honesty.[45]

63. In its *Statutory Audit Independence and Objectivity* monograph, the Federation Des Experts Comptables Europeens (FEE) takes a somewhat different view:

> The expression of an objective opinion should always be the ultimate goal of the statutory audit. *Independence* is the main means by which the statutory auditor demonstrates that he can perform his task in an objective manner.[46]

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[45] *Code of Ethics for Professional Accountants* (New York: IFAC, August 1999), para. 8.2.
[46] (Brussels: FEE, July 1998), p. 8 (footnote omitted).

64. Goal 1 could be modified to emphasize the views that only objectivity, integrity, or both are relevant personal attributes. For example, the phrase "willing to exercise appropriate personal attributes" in Goal 1 could be replaced by the phrase "willing to exercise objectivity," "willing to exercise integrity," or "willing to exercise objectivity and integrity." (These modifications also could be made to Goal 3 discussed later in this section.)

65. Users of financial statements and other stakeholders outside the auditing firm cannot practicably obtain information directly about auditors' willingness to exercise appropriate personal attributes when performing specific audits. Thus, they must rely on regulators, standard setters, and auditing firms to identify activities and relationships with auditees that can impair auditor independence. Those groups have concluded that auditors who do not engage in such activities or enter into such relationships are more likely to be willing to exercise appropriate personal attributes and, as a result, are more likely to perform quality audits.

66. An example illustrates how activities or relationships can indicate that an auditor's willingness to exercise appropriate personal attributes might be threatened. Assume that an auditor is assigned to an audit team for an auditee whose chief financial officer is the auditor's spouse. In this situation, the spouse's interest in the audit's outcome and the auditor's emotional attachment to his or her spouse significantly increase the likelihood that the auditor has a personal interest in the audit's outcome, which is a **threat to auditor independence**. The absence of such a threat would improve the likelihood that the auditor will exercise the appropriate personal attributes and perform a quality audit, which would improve financial statement reliability.

67. Goal 1 makes explicit the notion that auditor independence helps ensure that auditors are willing to exercise appropriate personal attributes in performing audits. It can be argued, however, that Goal 1 is inappropriate because there is no way to determine whether it has been met. Under this view, a goal of auditor independence should be based on observable indicators of an auditor's potential unwillingness to exercise appropriate personal attributes—the existence of activities or relationships that may impair auditor independence. One example of a goal based on this view is as follows:

> **<u>Goal 2</u>—A goal of auditor independence is to help ensure that auditors do not engage in activities or have relationships that make it less likely that audits will improve the reliability of financial statements.**

Enhancing Financial Statement Credibility and Stakeholder Confidence

68. The goals of auditor independence discussed above are based on the assumption that the value provided by a quality audit is improved financial statement reliability. Quality audits also may add value by enhancing the credibility of financial statements. The Committee on Basic Auditing Concepts of the American Accounting Association described the

importance of enhanced credibility of, and users' confidence in, financial statement information as follows:

> The audit function adds to the *credibility* of information because the user can . . . be more confident in using the information for its intended purposes than he would be if the audit function had not been performed. This confidence allows the full potential value of the accounting information to be realized—for that value is realized through the *use* of the information, not its preparation and dissemination.[47]

69. It can be argued that the enhanced credibility of financial statements and users' and other stakeholders' confidence in financial statement reliability results, in part, from their perceptions of reduced information risk that results from quality audits. For example, research sponsored by the Commission on Auditors' Responsibilities noted that

> estimated risk is affected not only by actual errors but also by lack of confidence in accounting data. By increasing confidence and reducing errors, auditing reduces the associated cost of accounting information errors.[48]

70. Although stakeholders' perceptions of the reliability of financial statements may be affected by many factors, it can be argued that an audit performed by auditors whom users and other stakeholders believe are independent is an important source of enhanced financial statement credibility and stakeholder confidence. As the U.S. Supreme Court noted, "Public faith in the reliability of a corporation's [audited] financial statements depends upon the public perception of the outside auditor as an independent professional."[49]

71. Several types of goals could be developed that express the interrelationships among stakeholders' perceptions, an auditor's personal attributes, certain activities and relationships, and auditor independence. For example, one goal could concern the relationship between auditor independence and users' and other stakeholders' perceptions of an auditor's personal attributes.

> **Goal 3—A goal of auditor independence is to help ensure that users and other stakeholders perceive that auditors are willing to exercise appropriate personal attributes when performing audits, thereby making it more likely that audits will enhance the credibility of financial statements.**

72. Another goal could be based on the relationship between auditor independence and activities or relationships that may serve as observable indicators to stakeholders of an auditor's potential inability or unwillingness to exercise those attributes. For example:

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[47] American Accounting Association, Committee on Basic Auditing Concepts, *A Statement of Basic Auditing Concepts* (Sarasota, FL: American Accounting Association, 1973), p. 13.
[48] Melvin F. Shakun, *Cost–Benefit Analysis of Auditing*, Research Study No. 3 (New York: Commission on Auditors' Responsibilities, 1978), p. 1.
[49] *U.S.* v. *Arthur Young & Co.* [465 US 805 (1983), pp. 819-20, note 15].

<u>Goal 4</u>—A goal of auditor independence is to help ensure that auditors do not engage in activities or have relationships that may be perceived by users and other stakeholders as making it less likely that audits will enhance the reliability of financial statements.

73. Various individuals and organizations, including some that were cited earlier in this section, allude to increased confidence in the financial statements and their reliability as a benefit of audits and of auditor independence. It can be argued that both enhanced financial statement credibility and increased stakeholder confidence are separate benefits provided by an auditor who is perceived by stakeholders as independent and that both benefits should be included in the goals of auditor independence. For example, Goal 3 could be modified to reflect this view by adding the phrase "and will improve users' and other stakeholders' confidence in the reliability of financial statements" at the end of the goal. Goal 4 also could be modified in a similar manner.

74. As described previously, users and other stakeholders ordinarily cannot ascertain the identity of the individual members of the audit team assigned to a specific auditee, their personal attributes, or their willingness to exercise appropriate personal attributes when performing an audit. As a result, it can be argued that users' and other stakeholders' perceptions of, and their confidence in, the improved financial statement reliability added by an *independent* auditor may depend on their beliefs about the independence of auditors generally and about the effectiveness of the totality of the self-regulatory and public regulatory processes, including those concerning auditor independence, that help ensure audit quality.[50] The goals described in this subsection that explicitly mention stakeholders' perceptions could be modified to emphasize this view by replacing the phrase "stakeholders perceive that auditors are willing" with the phrase "stakeholders perceive that auditors *as a group* are willing."

Difficulties with Basing a Goal of Auditor Independence on Stakeholders' Perceptions

75. There is widespread agreement that audits performed by *independent* auditors enhance financial statement credibility and stakeholder confidence in financial statement reliability. Nevertheless, it can be argued that those benefits should not be included as separate goals of auditor independence in a conceptual framework. Under this view, while financial statement credibility and stakeholder confidence may be important to the capital markets, they are not self-contained, separately deliverable benefits of an audit apart from improved reliability. Generally accepted auditing standards do not require the auditor to undertake any auditing procedures aimed at enhancing the financial statements' credibility—a quality audit is aimed at improving financial statement reliability. Enhanced credibility and improved stakeholder confidence may be more likely to result from audits performed by *independent* auditors, but

[50] Carmichael, for example, describes the importance of maintaining the public's beliefs about the independence of auditors as a professional group. See Douglas R. Carmichael, "In Search of Concepts of Auditor Independence," *CPA Journal* (May 1999), pp. 39-43.

they are not goals that can be usefully distinguished from improved financial statement reliability. Elliott and Jacobson describe this view as follows:

> The auditor's contribution is sometimes described as adding credibility to the capital markets. Credibility is an important concomitant of auditing, but it is not the core of the auditor's contribution. The core contribution, to repeat, lies in the effects of the audit process on the reliability of the information used for decisions. Without improved reliability there would be no valid basis for investor confidence in the information, and share prices would have less of a relationship to corporate earning power. Auditors would indeed be cheerleaders for their clients if their purpose was merely or chiefly to overcome the hesitations of investors to engage in transactions because of possible management bias in the financial statements. The effect on the capital markets would be limited to improving the willingness of capital suppliers to enter transactions, with no effect on the relationship between share prices and the substance of corporate operations and no effect on the likelihood of returns from capital outlays.[51]

76. The different views about the role of enhanced credibility and stakeholder confidence typically center not on whether audits should be designed to enhance those factors but on what the relationship is among improved reliability, enhanced credibility, and stakeholder confidence in helping ensure effective resource-allocation decisions. The views of those who believe that enhanced credibility and stakeholder confidence are conceptually separate from improved reliability as goals of auditor independence were described in the preceding subsection. Others believe that enhanced credibility and stakeholder confidence are not separable from improved reliability as goals of auditor independence.

77. Many who hold the latter view believe that, in the long run, financial statement credibility and stakeholder confidence stem from the reliability of financial statements, not from stakeholders' perceptions that they are reliable. Unless financial statements are generally reliable, stakeholders eventually will find that their confidence in financial statements is misplaced. Financial statements that later are found to be unreliable, despite audits that appeared to improve their reliability but failed to do so, cannot serve as a basis for effective resource-allocation decisions. If audits do not improve the reliability of financial statements generally, those who rely on audited financial statements to help make those decisions may grow increasingly skeptical of the value of audits. Accordingly, those who hold this view believe that improved financial statement reliability is the primary value provided by an audit and that enhanced credibility is not separable from improved reliability in the long run because enhanced credibility cannot long endure if reliability is not present. Under this view, goals of auditor independence that concern financial statement credibility or stakeholder confidence are not appropriate because they suggest that enhancing financial statement credibility or improving stakeholder confidence is an important goal in its own right rather than the result of increased financial statement reliability.

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[51] Robert T. Elliott and Peter D. Jacobson, "Audit Independence Concepts," *CPA Journal* (December 1998), p. 32.

78. Another concern expressed by those who do not consider enhancing financial statement credibility or improving stakeholder confidence as a separable goal of auditor independence is the difficulty of deciding whose perceptions should be included when judging whether credibility is enhanced or confidence is improved. As discussed in Section II, there are many different groups of stakeholders in auditor independence. Different groups, and different individuals within those groups, are likely to have different perceptions because such perceptions are based on a wide variety of factors, including beliefs about the financial reporting system, about auditing firms and the auditing profession, and about the systems of public regulation and self-regulation.[52] Accordingly, those who hold this view also may believe that a goal of auditor independence based on stakeholders' perceptions is inappropriate because it is too difficult to judge when such a goal has been met.

* * * *

79. Goals 1 and 2 focus on auditor independence and its relationship to financial statement reliability *without* including the notion that auditor independence may contribute to enhancing stakeholders' perceptions of financial statement reliability. As a result, these goals lead to definitions, concepts, and basic principles of auditor independence that include the potential effects on audit quality and on financial statement reliability of threats to auditor independence but do not include stakeholders' perceptions of those factors. Goals of auditor independence that include enhanced financial statement credibility or increased stakeholder confidence, such as Goals 3 and 4 and the related modifications, lead to definitions, concepts, and basic principles of auditor independence that do include how users and other stakeholders perceive factors related to auditor independence. Examples of both types of definitions, concepts, and basic principles are discussed in Sections IV–VII.

[52] The issue of whose perceptions should be considered by the ISB in developing standards of auditor independence is discussed in Section VII.

SECTION IV—DEFINING AUDITOR INDEPENDENCE

80. A definition derived from the goals of auditor independence would serve as a fundamental building block on which other components of a conceptual framework could rest and would provide stakeholders with a common language for discussion and debate. This section discusses alternative definitions of auditor independence based on the goals described in Section III.[53]

81. The basic question raised by this section is:

> **Question IV-1: Which of the alternatives described in this section should form the basis for a definition of auditor independence to be included in a conceptual framework? Please explain your views and discuss other definitions or approaches to defining auditor independence that should be considered.**[54]

Definitions Based On Improving Financial Statement Reliability

82. A definition of auditor independence based on the goal of improving financial statement reliability could be based on various approaches, two of which are included in this DM. The first—called the "personal attributes approach"—defines independence in terms of pressures that could affect an auditor's willingness to exercise appropriate personal attributes. The second—called the "activities and relationships approach"—defines independence in terms of certain circumstances that might serve as observable external indicators of such pressure. This subsection describes examples of formal definitions of auditor independence using each approach.

Personal Attributes Approach

83. It can be argued that independence is a desirable personal attribute—similar to the attributes of competence, diligence, integrity, and objectivity discussed in Section III—that auditors should have and exercise during an audit. A definition consistent with this view could describe the personal attribute of independence and, based on Goal 1, would identify the role of independence in helping to ensure a quality audit. For example:

> **Definition 1—Independence is freedom from pressures and other factors that impair an auditor's willingness to perform a quality audit.**

[53] Appendix C of this DM contains examples of different types of definitions of auditor independence that have appeared in the auditing literature in addition to those described in this section.

[54] In answering this question, some respondents may wish to comment on several of the specific alternatives described in this section. A suggested format for structuring those comments can be found at the end of the section.

84. It can be argued that Definition 1 is inadequate or incomplete because it does not make clear that the pressures and other factors that may impair auditor independence are those that may affect the auditor's willingness to exercise appropriate personal attributes. It also can be argued that independence is not a separable personal attribute but is a state of mind that helps ensure that an auditor has the willingness to exercise appropriate personal attributes when performing an audit. A description of this view can be found in Mautz and Sharaf's *The Philosophy of Auditing.*

> [One important phase of auditor independence] is the independence of approach and attitude which any professional man should have if he is engaged in truly professional work. This is a combination of self-reliance, freedom from client control, expert skill and ability, and considered judgment based on training and experience not available to those who are not members of the profession.[55]

85. A definition of independence could describe the relationship between auditor independence and an auditor's willingness to exercise appropriate personal attributes. For example:

> **<u>Definition 2</u>—Independence is freedom from pressures and other factors that impair an auditor's willingness to exercise appropriate personal attributes when performing an audit.**

86. As discussed in Section III, it can be argued that independence is related more directly to either objectivity, integrity, or both than it is to other personal attributes and that the definition of independence should reflect that closer relationship. For example, the now-superseded AICPA Code of Professional Ethics defined independence as follows:

> Independence has traditionally been defined by the profession as the ability to act with integrity and objectivity.[56]

87. A definition of independence that describes the relationship between the personal attributes of objectivity and integrity and auditor independence could be expressed as follows:

> **<u>Definition 3</u>—Independence is freedom from pressures and other factors that impair an auditor's willingness to exercise objectivity and integrity when performing an audit.**

Similar definitions could be developed using either "objectivity" or "integrity" by itself instead of both attributes together.

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[55] Robert K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing* (American Accounting Association, 1961), pp. 230-31.
[56] *Restatement of the Code of Professional Ethics*, p. 8.

Activities and Relationships Approach

88. Section III suggests that most stakeholders have no way to determine an individual auditor's integrity, objectivity, or other personal attributes or to assess when an auditor has the willingness to exercise those attributes. Therefore, although Definitions 1, 2, and 3 may be appropriate theoretical constructs for auditor independence, they may not be suitable for a conceptual framework because they are vague about the sources of the pressures on an auditor. In other words, they may not be as operational as they could be because they do not include observable external indicators of factors that may affect an auditor's willingness to exercise appropriate personal attributes when performing an audit.

89. This view is consistent with the notion that certain activities and relationships indicate that an auditor's willingness to perform a quality audit (i.e., exercise appropriate personal attributes) may be impaired. Rule 2-01 of the SEC's Regulation S-X is consistent with that view and states, in part:

> . . .
> (b) 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 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, his firm, or a member of his firm had, or was committed to acquire, any direct financial interest or any material indirect financial interest; (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 covered by the financial statements, he, his firm, or a member of his firm was connected as a promoter, underwriter, voting trustee, director, officer, or employee. . . .
>
> (c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.[57]

90. Underlying this approach to defining auditor independence is the assumption that auditors who are free of certain activities and relationships are presumed to be more willing to exercise appropriate personal attributes and perform an audit that improves financial statement reliability. The following definitions of auditor independence are based on an activities and relationships approach. They modify Definitions 1, 2, and 3 by replacing the phrase "freedom from pressures and other factors" with the phrase "the absence of certain activities and relationships" and the addition of the word "may." These modifications reflect

[57] SEC Regulation S-X, Section 210.2-01.

this approach's focus on observable external indicators of circumstances in which auditor independence might be impaired.

> **<u>Definition 4</u>—Independence is the absence of certain activities and relationships that may impair an auditor's willingness to perform a quality audit.**

> **<u>Definition 5</u>—Independence is the absence of certain activities and relationships that may impair an auditor's willingness to exercise appropriate personal attributes when performing an audit.**

> **<u>Definition 6</u>—Independence is the absence of certain activities and relationships that may impair an auditor's willingness to exercise objectivity and integrity when performing an audit.[58]**

Definitions That Include Stakeholders' Perceptions

91. The definitions in the previous subsection do not include stakeholders' perceptions of factors related to auditor independence.[59] As discussed in Section III, however, it can be argued that the goals of auditor independence also include enhancing financial statement credibility and improving stakeholder confidence. Because these two goals are based on stakeholders' perceptions, a definition of auditor independence that is consistent with those goals could include explicitly stakeholders' perceptions of factors related to auditor independence.[60] One way to do that is to modify the wording of Definitions 1, 2, and 3. Definitions 7, 8, and 9 illustrate a "personal attributes" approach that includes stakeholders' perceptions.

> **<u>Definition 7</u>—Independence is freedom from pressures and other factors that impair, or are perceived to impair, an auditor's willingness to perform a quality audit.**

> **<u>Definition 8</u>—Independence is freedom from pressures and other factors that impair, or are perceived to impair, an auditor's willingness to exercise appropriate personal attributes when performing an audit.**

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[58] This definition could be modified in the same ways suggested previously for Definition 3.

[59] Because of the wide variety of stakeholders in auditor independence, it is likely that different perceptions of auditor independence will exist. The definitions in this section do not suggest which stakeholder groups should be considered when perceptions are being discussed. The basic principle described in Section VII deals with that question.

[60] An alternative method for including stakeholders' perceptions in a conceptual framework is to adopt a definition of auditor independence that excludes stakeholders' perceptions but to include a basic principle that describes the need for standard setters and others to consider such perceptions, as well as improved financial statement credibility and stakeholders' confidence in financial statement reliability, in the process of developing auditor independence standards. This alternative is discussed in Section V.

<u>Definition 9</u>—Independence is freedom from pressures and other factors that impair, or are perceived to impair, an auditor's willingness to exercise objectivity and integrity when performing an audit.

92. Some may believe that Definitions 7, 8, and 9 are appropriate theoretical constructs, but an operational definition for purposes of a conceptual framework should include activities and relationships that indicate an auditor's willingness to perform a quality audit. Definitions 10, 11, and 12 illustrate an "activities and relationships" approach that includes stakeholders' perceptions.

<u>Definition 10</u>—Independence is the absence of certain activities and relationships that may impair, or may be perceived to impair, an auditor's willingness to perform a quality audit.

<u>Definition 11</u>—Independence is the absence of certain activities and relationships that may impair, or may be perceived to impair, an auditor's willingness to exercise appropriate personal attributes when performing an audit.

<u>Definition 12</u>—Independence is the absence of certain activities and relationships that may impair, or may be perceived to impair, an auditor's willingness to exercise objectivity and integrity when performing an audit.[61]

93. As discussed in Section III, it can be argued that enhanced financial statement credibility and increased stakeholder confidence are based on stakeholders' perceptions of auditors *as a group*. That relationship could be included in any of the preceding definitions that include stakeholders' perceptions by changing the phrase "an auditor's willingness" to "the willingness of auditors as a group."

* * * *

94. The goals in Section III and the alternative definitions discussed in this section can be used to derive various concepts and basic principles of auditor independence. Sections V–VII discuss those elements of a conceptual framework.

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[61] As noted previously, definitions that include both "objectivity" and "integrity" could be modified to accommodate the views that (a) only "objectivity" or "integrity," by itself, is the appropriate personal attribute in this context and (b) independence relates to the possession of one or both of these attributes, rather than the willingness to exercise them.

For respondents:

95. The following definition illustrates how the alternatives described in this section could be combined.

> **Independence is freedom from pressures and other factors—indicated by certain activities or relationships—that may impair, or may be perceived to impair, the willingness of auditors, both individually and as a group, to exercise appropriate personal attributes (including objectivity and integrity) when performing an audit.**

96. The chart below lists each element of the definition in paragraph 95. Do you believe that a definition of auditor independence should include reference to those elements? Use the chart in formulating your response to Question IV-1 if you believe it would be helpful.

	Yes/No	Comments
Freedom from pressures and other factors		
Absence of certain activities or relationships		
An auditor's willingness to exercise appropriate personal attributes		
Willingness of auditors as a group to exercise appropriate personal attributes		
Perceptions of auditors' willingness to exercise appropriate personal attributes		
Auditor objectivity		
Auditor integrity		
Other elements (please describe):		

SECTION V—AUDITOR INDEPENDENCE CONCEPTS

97. The definitions of independence in Section IV assume that certain factors—referred to as threats to auditor independence—may have a negative effect on auditor behavior. The possibility that a negative effect will result suggests the existence of risk—referred to as independence risk—that a threat may impair auditor independence. One or more controls—referred to as safeguards to auditor independence—could be instituted, however, to reduce independence risk. This section discusses the concepts of independence risk, threats, safeguards, the significance of threats, and the effectiveness of safeguards. It also considers whether stakeholder perceptions and benefits and costs of auditor independence should be included as concepts of auditor independence.

98. The basic question raised by this section is:

> **Question V-1: Do you believe that the concepts discussed in this section —independence risk, threats to auditor independence and their significance, safeguards to auditor independence and their effectiveness, stakeholders' perceptions in independence considerations, and benefits and costs of auditor independence—are useful and should be included in a conceptual framework? What other concepts, if any, would be useful? Please explain your views.**

Addressing Auditor Independence Issues

99. Many factors in the audit environment help to ensure quality audits. Some apply to individual auditors (such as timely participation in continuing professional education programs), others concern auditing firms (such as implementing effective systems of quality control), and others are part of the systems of public regulation and self-regulation of the auditing profession (such as mandatory peer reviews of auditing firms).

100. Pressures on auditors and other factors can have a negative effect on audit quality. Some are common to many professions, others arise because of the unique professional environment in which auditors work, and still others may affect an individual auditor in one or more specific circumstances. Those factors, however, do not necessarily affect audit quality, in part because various controls have been developed by auditing firms and public regulatory and self-regulatory bodies.

101. Furthermore, many of the factors that negatively affect audit quality are not directly related to auditor independence. For example, some auditees are now using complex financial instruments to manage risks. Auditors unfamiliar with those instruments and the required accounting may not detect related accounting errors. Although factors such as these may have a significant impact on audit quality, they do not involve independence issues. The ISB and other stakeholders must, therefore, address two questions, either explicitly or implicitly, when they consider various factors that could affect audit quality.

- Do the issues under consideration relate to an auditor's *independence* (as opposed to other factors that could affect audit quality)?

- If so, what is the likelihood that an auditor's independence is impaired?

102. The rest of this section discusses an approach to addressing these questions using various concepts of auditor independence.

Independence Risk

103. Independence risk can be thought of as the risk that, in a particular circumstance, an auditor's independence may be impaired. A more precise definition of independence risk depends on the definition of independence adopted in the conceptual framework. Each of the definitions discussed in Section IV could serve as the basis for a more precise definition of independence risk. For example:

- Independence risk is the risk that pressures and other factors impair an auditor's willingness to perform a quality audit. (consistent with Definition 1 of auditor independence in Section IV—personal attributes approach)

- Independence risk is the risk that an activity or relationship may impair an auditor's willingness to exercise appropriate personal attributes when performing an audit. (consistent with Definition 5—activities and relationships approach)

104. Independence risk is increased when new factors are introduced that could impair auditor independence. Those factors are defined in this DM as threats to auditor independence. Independence risk is reduced when controls—including prohibitions, restrictions, disclosures, and other policies and procedures, working singly or in combination—mitigate or eliminate threats to auditor independence. Those controls—defined in this DM as safeguards to auditor independence—exist in the environment in which audits are performed or are put in place by regulators, standard setters, or firms in response to threats to auditor independence.

105. Threats to auditor independence arise from numerous and diverse pressures, activities, and relationships, and they may emerge in a wide variety of circumstances. Because they may increase independence risk and lower the quality of audits, threats need to be analyzed carefully.

106. Identifying and classifying the types of threats posed in specific circumstances and the types of safeguards in place may help the ISB and other stakeholders better understand the independence risk that those circumstances may pose. Classifying threats and safeguards also may provide a common language for the ISB and other stakeholders to use in discussing specific independence issues. It also may assist the ISB in developing a general approach to analyzing independence risk that could help ensure an internally consistent set of independence standards.

Significance of Threats and Effectiveness of Safeguards

107. Assessing independence risk requires analyzing the significance (or strength) of threats to auditor independence posed by a given set of circumstances and the effectiveness of the safeguards that are, or could be put, in place to mitigate or eliminate a particular threat. Because of the large number of potential threats and safeguards that are not susceptible to quantification, this DM employs the general terms "significance of threats" and "effectiveness of safeguards," rather than "materiality," which is more frequently associated with quantitative measures or guidelines. Some threats and safeguards are susceptible to quantification, however, and the ISB may determine that their significance and effectiveness can be evaluated, in whole or in part, by reference to numeric benchmarks.

108. The significance of a threat in a particular set of circumstances is a function of many factors. A particular threat could have vastly different effects on independence risk depending on such factors as the force with which pressure is exerted, the stature of the person exerting the pressure, the stature of the auditor who is being pressured, the strength of the auditor's integrity, and the importance of the matter that is the subject of the pressure. The effectiveness of a safeguard depends on whether it is suitably designed to meet its objective, how it is applied, the consistency with which it is applied, by whom it is applied, and to whom it is applied.[62]

109. Independence may be viewed as a quality or a condition that an auditor has in varying degrees ranging from being "clearly independent" to being "clearly not independent." Under that view, the level of independence risk can be thought of as a position on a continuum that ranges from "no risk of impaired independence" to "certainty of impaired independence."[63] The following definitions of significance and effectiveness in an independence context are consistent with this view:

> A threat to independence is significant if the threat increases independence risk to an unacceptably high level (i.e., the likelihood of impaired independence is too high).

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[62] These are the same factors that are described in AU Section 319, *Consideration of Internal Control in a Financial Statement Audit*, as determinants of the effectiveness of the design and operation of internal control generally; safeguards are one type of control.

[63] It also can be argued that independence is not a quality or a condition that an auditor has in varying degrees but, instead, is something that an auditor either has or does not have. Under that view, only two levels of independence risk exist—it is either acceptable (i.e., the auditor is independent) or unacceptable (i.e., the auditor is not independent). Unlike an observable condition, however, an auditor's independence cannot be directly observed by others. As a result, judgment must be relied on to assess whether an auditor is, or is likely to be, independent in a specific situation. The judgments of different individuals are likely to result in varying levels of beliefs about auditor independence, the level of independence risk created in various circumstances, and the acceptability of that level of independence risk. These two views on the nature of independence, therefore, may be functionally equivalent—in both cases, independence risk can best be thought of as positions on a continuum. This DM avoids the terms "unacceptable" or "acceptable" when referring to levels of independence risk because those terms imply that independence risk can be described only as one of two alternative levels rather than as consisting of points along a continuum. Respondents to the DM are encouraged to comment on whether they agree with the appropriateness of this decision.

A safeguard to independence is effective if the safeguard reduces independence risk to an acceptably low level (i.e., the likelihood of impaired independence is sufficiently low).

110. These definitions of significance and effectiveness imply the need to judge, for a given set of circumstances, where along the independence risk continuum the level of independence risk becomes unacceptably high. That point will be a matter of judgment for the individual or group that is assessing independence risk in a specific situation.

Stakeholders' Perceptions in Independence Considerations

111. Different views concerning the desirability of including stakeholders' perceptions in the goals and definition of auditor independence are discussed in Sections III and IV. If stakeholders' perceptions are included in those goals or definition, the ISB will need to consider a third question, in addition to the two discussed previously in this section, when it addresses auditor independence issues:

- What is the likelihood that stakeholders would perceive that an auditor's independence is impaired?

112. Two approaches can be used to address this question. The first would be to include stakeholders' perceptions in the definition of the term "auditor independence." Because the definition of independence risk is based on the definition of independence, this approach also would result in including stakeholders' perceptions in assessments of independence risk. Those assessments would, as a result, be based on both the likelihood that an auditor's independence may be impaired *and* the likelihood that stakeholders would perceive that independence may be impaired. The following examples illustrate how some of the definitions of auditor independence in Section IV (i.e., those that include stakeholders' perceptions—Definitions 7–12) could serve as the basis for a definition of independence risk that included stakeholders' perceptions (the *italicized* words are additions to the definitions of independence risk discussed previously). If the ISB were to assess independence risk using one of these definitions, it would need to consider stakeholders' perceptions of auditor independence in the specific circumstances under consideration in addition to (a) the existence and significance of the threats posed in specific circumstances and (b) the existence and effectiveness of safeguards that eliminate or mitigate those threats.

- Independence risk is the risk that pressures and other factors impair, *or are perceived to impair*, an auditor's willingness to perform a quality audit. (consistent with Definition 7 of auditor independence in Section IV—personal attributes approach)

- Independence risk is the risk that an activity or relationship may impair, *or may be perceived to impair*, an auditor's willingness to exercise appropriate personal attributes when performing an audit. (consistent with Definition 11—activities and relationships approach)

113. A second way for the ISB to consider stakeholders' perceptions when examining auditor independence issues is to adopt a definition of independence (and therefore a definition of independence risk) in the conceptual framework that does *not* include stakeholders' perceptions but to include those perceptions when the acceptability of the level of independence risk is assessed. Section VII discusses such an approach.

Benefits and Costs of Auditor Independence

114. There are benefits and costs of auditor independence to many of the various stakeholders in auditor independence.[64] Consideration of those benefits and costs may be relevant when the ISB and others evaluate the level of independence risk.

Benefits of Auditor Independence

115. The benefits of auditor independence can be expressed in terms of helping to ensure quality audits and financial statement reliability, lowering the cost of capital to auditees by reducing the premium that investors and creditors demand as compensation for assuming information risk, and increasing the effectiveness of the capital markets in allocating resources. Maintaining auditor independence also may help reduce litigation and related costs to auditees and auditors resulting from alleged and actual situations involving unreliable financial statements. Independence also may enhance the reputational capital of individual auditors, auditing firms, and the auditing profession as a whole—an important factor in maintaining the confidence of stakeholders in auditor independence. Individuals and auditing firms with reputations for high-quality audits may be able to "leverage" those reputations and help the firms retain existing clients, attract new clients, and charge higher fees.

Costs of Auditor Independence

116. Costs of auditor independence include costs of developing, applying, maintaining, monitoring, and enforcing safeguards. Those costs include the costs to auditees and other stakeholders associated with various safeguards—for example, the cost of foregone economies of scope when firms are proscribed from providing certain types of services to auditees and the potential reduction in audit efficiency resulting from the rotation of audit partners. There

[64] Benefits and costs to society generally are sometimes referred to as social benefits and costs; benefits and costs to specific individuals, groups, or organizations—such as auditors, auditing firms, and the auditing profession—are referred to as private benefits and costs. This distinction, however, is difficult to draw in the case of auditor independence because some private benefits and costs may be diffused throughout society, thereby becoming social costs and benefits. This DM, therefore, does not attempt to categorize benefits and costs of auditor independence as social or private.

are also costs associated with the system of public regulation and self-regulation of auditor independence—for example, the expenses incurred by state and federal regulators and standard-setting bodies, much of which is underwritten, directly or indirectly, by auditing firms. Other costs of auditor independence relate to the costs incurred by individual auditors and auditing firms associated with administering and complying with independence rules and regulations. In addition, income may be lost by individual auditors (and their families) and by auditing firms as a result of prohibitions against or restrictions on various activities and relationships imposed by standard setters, regulators, or auditing firms. There also may be costs related to reductions in audit quality that may result if less competent individuals are attracted to the profession because of independence rules—for example, if restrictions against auditors' investments in auditees reduce the pool of high quality entry-level individuals.

Measuring Benefits and Costs

117. The benefits of auditor independence in the form of more effective resource-allocation decisions and auditees' reduced cost of capital are not easily measured. Benefits that may be reaped by auditors in the form of reduced litigation and enhanced reputational capital are also difficult to quantify.

118. Some of the costs of auditor independence may be measurable—for example, the costs of maintaining and monitoring independence rules and policies and costs related to the operations of professional associations, standard setters, and oversight bodies. These costs may be measured by the amounts expended by auditing firms and by bodies responsible for regulating auditors, but allocating those amounts to issues involving independence or to specific safeguards to auditor independence is a difficult, if not impossible, task. The costs related to foregone economies of scope and reduced audit quality also are extremely difficult to measure.

119. Clearly, judgment, rather than precise measurement, will need to be used if the ISB and others include costs and benefits when they consider issues of auditor independence. In fact, the difficulties of identifying and measuring the relevant benefits and costs may suggest to some that the ISB should not attempt to do so. Section VI discusses a basic principle concerning the role that benefits and costs could play when the ISB develops independence standards.

SECTION VI — BASIC PRINCIPLES OF AUDITOR INDEPENDENCE: ANALYZING THREATS AND SAFEGUARDS

120. This section examines basic principles related to threats and safeguards that can be used to analyze the independence of auditors in a wide variety of circumstances and can serve as guidelines for the ISB when it develops standards for auditor independence. Section VII discusses an additional basic principle dealing with how the ISB could include stakeholders' perceptions in its standard-setting process.

121. The basic questions raised by this section are:

> **Question VI-1: Do you believe that the principles described in this section will be useful to the ISB in developing future standards? Please explain your views and discuss other types of guidance that you believe would make the conceptual framework more useful to the ISB or to other stakeholders.**
>
> **Question VI-2: Do you believe that it is useful to analyze threats based on their nature and significance? Please explain your views and discuss types of threats other than those identified in this section that should be considered in a conceptual framework for auditor independence.**
>
> **Question VI-3: Do you believe that it is useful to analyze safeguards based on their type and effectiveness? Please explain your views and discuss types of safeguards other than those identified in this section that should be considered in a conceptual framework for auditor independence.**
>
> **Question VI-4: Do you believe that the ISB should consider which individuals in an auditing firm (as well as the firm itself) are affected by one or more threats to auditor independence in the specific circumstances under consideration and by one or more safeguards that effectively mitigate or eliminate those threats? Please explain your views.**
>
> **Question VI-5: Do you believe that the ISB should weigh the costs of alternative safeguards against the benefits of reduced independence risk resulting from those safeguards when it develops new independence standards? Why or why not? Please discuss your views about how the ISB should measure the costs and benefits of alternative safeguards.**

Threats to Auditor Independence

122. The first step in analyzing the independence of auditors, based on the concepts described in Section V, involves identifying potential threats to auditor independence that arise in specific circumstances. Identifying potential threats is important because threats represent sources of independence risk—that is, they increase the likelihood that an auditor's

independence may be impaired. Two basic principles of auditor independence related to the identification and analysis of threats are described below.

Threat Identification

123. Considerable research has addressed the circumstances that represent potential sources of threats to auditor independence. Researchers have considered many environmental and situational variables—such as the nature of the relationship between auditors and auditees, the types and extent of non-audit services provided to auditees, the size of fees for both audit and non-audit services, the existence and nature of available authoritative guidance pertaining to accounting issues, and the systems by which auditing firms compensate and promote their employees.[65]

124. Researchers also have studied the effects on auditor independence of various pressures and other factors. This research considers the processes by which auditors' judgments are formed and decisions are made and the variables related to auditor independence that may influence those judgments and decisions. These studies have found that an auditor's ability to maintain his or her independence in specific circumstances is based on the interactions among different types of variables, including:

- auditors' personal attributes and beliefs, such as their integrity and their level of ethical development

- cultural characteristics of the auditing firm in which auditors work, which stem, in part, from firm leadership

- contextual variables that depend on the specific circumstances faced by an auditor that may affect the relative "bargaining power" of an auditor and an auditee—for example, economic factors such as the financial health of the auditee, the size of the audit fee, and the existence and size of fees for non-audit services

125. The results of this research suggest that the judgments and decisions of auditors, when faced with potential threats to their independence, are likely to be affected by a wide variety

[65] Some of the research on auditor independence has involved developing analytical models that examine theoretical relationships between auditor independence and various factors, such as audit pricing and non-audit services. The predictions of some of these models have been examined in subsequent studies to test whether the hypothesized relationships affect auditors' judgments and decisions. A summary of those models and related empirical research can be found in Gary Kleinman, Dan Palmon, and Asokan Anandarajan, "Auditor Independence: A Synthesis of Theory and Empirical Research," in Gary J. Previts, Thomas R. Robinson, and Nandani Chandar (Eds.), *Research in Accounting Regulation*, Vol. 12 (Stamford, CT: JAI Press, 1998), pp. 3-42.

of pressures and other factors, and different auditors are likely to react to a specific set of circumstances in different ways.[66]

126. Regulatory bodies in the United States, including the SEC and the AICPA, as well as organizations outside the United States, have developed independence rules and interpretations concerning specific circumstances that they believe may create threats to auditor independence—for example:

- financial interests between an auditor and an auditee—such as financial investments, loans, joint ventures, and unpaid fees
- services provided to an auditee deemed incompatible with an auditor's role—such as bookkeeping and related professional services
- business relationships with an auditee—such as acting as an officer, director, underwriter, broker/dealer, or trustee
- personal or family relationships with an auditee
- actual or threatened litigation between an auditor and an auditee

127. Threats to auditor independence created in the kinds of circumstances described above can be classified based on the general nature of the threats—for example:

- Self-interest threat—a threat that arises from an auditor acting in his or her own interest.[67] Self-interests include an auditor's emotional, financial, or other personal interests. An auditor may favor, consciously or subconsciously, those self-interests over his or her interest in performing a quality audit. For example, auditors'

[66] Carolyn A. Windsor and Neal M. Ashkanasy, "The Effect of Client Management Bargaining Power, Moral Reasoning Development, and Belief in a Just World on Auditor Independence," *Accounting, Organizations and Society* (Vol. 21, 1995), pp. 701-20.
[67] This type of threat is similar to an information processing bias identified in the behavioral science literature as the "self-serving bias." People do not process information perfectly, and one common imperfection is the tendency to prefer outcomes that serve an individual's own self-interests. Bazerman, Morgan, and Lowenstein summarize research in this area and suggest that the bias is a result of people's tendency to view information and arguments that support their own self-interests as being more persuasive than those supporting other positions. This bias in interpreting evidence in favor of a position that supports an individual's self-interests may limit an auditor's ability to gather and interpret audit evidence objectively. The authors suggest that even for an auditor with a high degree of integrity, this inherent self-serving bias, and thus self-interest threat, is likely to remain an issue in connection with auditor independence (Max H. Bazerman, Kimberly P. Morgan, and George F. Lowenstein, "The Impossibility of Auditor Independence," *Sloan Management Review* [Summer 1997], pp. 89-94). Burke, however, argues that auditors' self-serving bias actually helps support auditor independence. He suggests that this occurs because of the "positive consequences" if auditors maintain their independence (such as performing quality audits, which result in their receiving rewards from their firms) and the "negative consequences" of their not doing so (such as losing their jobs or harming their firms) (W. Warner Burke, "Auditor Independence: An Organizational Psychology Perspective," in AICPA, *Serving the Public Interest: A New Conceptual Framework for Auditor Independence* [White Paper] (New York: AICPA, 1997), Appendix C, p. 9).

relationships with auditees create a financial self-interest because auditees pay the fees, both for audit and for any non-audit services performed for them. An auditor also would have a financial self-interest if he or she owned stock in an auditee or an emotional self-interest if an employment relationship existed between the auditor's spouse and an auditee. Various types of safeguards may mitigate or eliminate self-interest threats, such as prohibitions against certain financial interests and family relationships between auditors and auditees, restrictions on the percentage of total firm fees earned from one auditee, and auditing firm disclosures to audit committees of fees for audit and non-audit services.

- Self-review threat—a threat that arises from an auditor reviewing his or her own work or the work done by others in the auditor's firm. It is more difficult to evaluate without bias one's own work, or that of one's firm, than the work of someone else or of some other firm. Therefore, a self-review threat exists when an auditor reviews judgments and decisions made by the auditor or by the auditor's firm. Safeguards that may mitigate or eliminate self-review threats include concurring partner and peer reviews, firewalls, and prohibitions against auditors acting in the capacity of auditee management.

- Advocacy threat—a threat that arises from an auditor acting as an advocate for or against an auditee's position or opinion rather than as an unbiased attestor. An advocacy threat is present, for example, if an auditor acts as an underwriter or broker/dealer for an auditee's securities. An advocacy threat also may be present if an auditor takes a position against an auditee, such as in litigation between an auditee and an auditing firm. Safeguards that may mitigate or eliminate advocacy threats include prohibitions against and limitations on auditors providing certain non-audit services for auditees that involve advocacy roles.

- Familiarity (or trust) threat—a threat that arises from an auditor being influenced by a close relationship with an auditee. A familiarity threat is present if an auditor is not sufficiently skeptical of an auditee's assertions and, as a result, too readily adopts an auditee's viewpoint because of his or her familiarity with or trust in the auditee. For example, a familiarity threat may exist when an auditor has a particularly close or long-standing personal or professional relationship with an auditee. Safeguards that may mitigate or eliminate familiarity threats include mandatory rotation of engagement partners and restrictions on certain employment relationships between auditors' family members and auditees.

- Intimidation threat—a threat that arises from an auditor being inappropriately pressured by an auditee or by another interested party. Various pressures faced by auditors are described in Section II; many of those pressures are present in all audits and do not represent intimidation unless the pressures become too severe. Nevertheless, intimidation threats may arise, overtly or covertly, in a variety of situations where disagreements occur between an auditor and a member of an auditee's management—for example, disagreements over the auditee's application of an accounting principle. This threat also may arise if individuals higher up in an auditor's firm pressure the auditor to accede to the position of an auditee's management in that or in similar situations. Safeguards that may mitigate or eliminate intimidation threats include concurring partner reviews, internal consultation requirements, and an appropriate "tone at the top" in both auditing firms and auditees.

128. Different types of threats may arise in one set of circumstances. For example, if an auditor's relative is a member of auditee management and the auditor works on that auditee's engagement, three types of threats may be present:

- Self-interest—the auditor's personal relationship with his or her family member may create an emotional or financial self-interest in the outcome of the audit.

- Advocacy—the auditor may show partiality toward the work of the family member, which may impair the auditor's ability to serve as an unbiased attestor of the auditee's financial statements.

- Familiarity (or trust)—the auditor's personal relationship with the family member may make it difficult for the auditor to maintain professional skepticism.

129. Although different methods of classifying threats could be developed, the classifications used above are based on the systems in use and under development by standard setters in various places outside the United States, including the United Kingdom (the Institute of Chartered Accountants in England and Wales [ICAEW]), in Europe (the Federation des Experts Comptables Europeens [FEE]), and internationally (the International Federation of Accountants [IFAC]).[68] Some respondents to this DM may believe that modifications to these classifications are desirable or that a different system should be considered by the ISB in developing its conceptual framework. When commenting on this DM, those respondents are encouraged to describe those modifications or an alternative classification system and the advantages the modifications or alternative system provides.

130. A basic principle of auditor independence concerns the need to classify threats that may arise in various circumstances. Such a principle could be expressed as follows:

> **<u>Basic Principle 1</u>—Different types of threats to auditor independence —including self-interest, self-review, advocacy, familiarity (or trust), and intimidation—arise in different circumstances.**

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[68] These are called "threats to objectivity" by ICAEW and FEE. See ICAEW, *Guidance for Members in Practice* (London: ICAEW, 1996), Section 1.201, and FEE, *Statutory Audit Independence and Objectivity* (Brussels: FEE, July 1998), p. 9. IFAC describes four classifications of "risks" or threats to independence; it combines the familiarity and intimidation classifications into one category, labeled "client influence." (See IFAC, Discussion Draft, "Independence," proposed revision to *Code of Ethics of Professional Accountants* [New York: IFAC, August 1999], Part B, paras. 8.6-8.22.) Threats to auditor independence and objectivity also are discussed in the guidelines for social and ethical audits developed by the Institute of Social and Ethical AccountAbility (ISEA) (Exposure Draft, *AccountAbility 1000 Framework* [London: ISEA, November 1999], p. 38).

Significance of Threats

131. The significance of a threat depends on factors such as its force, the stature of the persons involved, the nature of the matter causing the threat, and the strength of the auditor's integrity. All of those factors need to be evaluated in the context of the specific circumstances in which the threat arises. Some of the factors may be quantifiable; others may not be. For example, the extent to which an auditor's financial interest in an auditee creates a threat to the auditor's independence may depend, in part, on the value of the interest relative to the auditor's net worth (which is quantifiable) and on the degree of "directness" of the interest (e.g., a direct investment in an auditee's equity securities contrasted with an indirect investment through a mutual fund that invests in the equity securities of many entities), which is not quantifiable. A threat can be considered significant if, considering all of its quantitative and qualitative aspects, it increases the level of independence risk to an unacceptably high level.

132. A basic principle of auditor independence concerns the relative significance of threats to auditor independence. Such a principle could be expressed as follows:

> **Basic Principle 2—The significance of threats created in specific circumstances affects the level of independence risk.**

Safeguards to Auditor Independence

133. The process of analyzing the independence of auditors includes identifying and assessing the effectiveness of safeguards that are in place that may mitigate or eliminate the threat or threats posed in specific circumstances. Two basic principles related to safeguard identification and analysis are discussed below.

Safeguard Identification

134. As described in Section V, safeguards work either singly or in combination to mitigate or eliminate one or more threats to auditor independence, thereby reducing the level of independence risk. Different safeguards may mitigate or eliminate different types and levels of significance of threats,[69] and one safeguard may mitigate or eliminate several threats. Some safeguards are quantifiable (e.g., a policy regarding the maximum percentage of total fees that an auditing firm can derive from one auditee); others are not (e.g., a prohibition against an auditor undertaking a specific activity or having a family member with a specific employment

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[69] Burke discusses various types of safeguards to auditor independence from an organizational psychology perspective. He considers factors that motivate auditors to maintain their independence, including specific safeguards that are internal to an individual auditor and those that are external. See W. Warner Burke, "Auditor Independence: An Organizational Psychology Perspective," in AICPA, *Serving the Public Interest: A New Conceptual Framework for Auditor Independence* [White Paper] (New York: AICPA, 1997), Appendix C.

relationship with an auditee). Some safeguards are preventive in nature (e.g., an orientation program for newly hired auditors that emphasizes the importance of independence); others are related to threats arising in specific circumstances (e.g., prohibitions against certain employment relationships between auditors' family members and auditees); still others are designed to deter violations of other safeguards by increasing the likelihood that they will be discovered (e.g., reviews of auditors' securities portfolios to detect prohibited investments).

135. Some safeguards reside in the environment in which audits are performed as part of the systems that help ensure overall audit quality—for example, the activities and requirements of the various bodies involved in public regulation and self-regulation of the auditing profession. Those safeguards include regulatory actions by state boards of accountancy, the SEC and other regulatory bodies, and the legal liability faced by auditors and other participants in the capital markets. Other elements in the present environment related to safeguarding auditor independence include the following:

- the importance of the reputations of auditing firms and individual auditors and the importance of independence in maintaining those reputations

- peer review programs that assess firm-wide compliance with professional standards and regulatory requirements regarding independence

- general oversight by auditees' audit committees and boards of directors concerning compliance with the regulatory requirement that an auditee's financial statements be audited by auditors who are independent

- other aspects of corporate governance, including an auditee's "tone at the top," that support auditor independence

136. This group of safeguards also includes the wide variety of rules that are designed specifically to help maintain auditor independence. For example, public regulatory bodies, such as the SEC and state boards of accountancy, and self-regulatory bodies, such as the ISB and AICPA, recognize that auditors face potential threats to their independence. In response, those bodies have developed rules, standards, and codes of professional conduct that contain various types of safeguards to auditor independence.

137. A second group of safeguards exists within auditing firms. Some are mandated by regulators, and others are adopted voluntarily by the firms. These safeguards are part of an auditing firm's quality control policies and procedures[70] and include policies and procedures related to auditee acceptance and retention, the rotation of engagement management, concurring partner reviews, requirements for internal consultation on technical issues, and maintaining a

[70] Auditing firms are required by AICPA quality control standards to develop and implement effective internal policies and procedures that provide "reasonable assurance" that firm personnel are independent. Those responsibilities are described in AICPA Statement on Quality Control Standards No. 2 (QC Section 20.09).

"tone at the top" in the auditing firm that stresses the importance of auditor independence.[71] Other safeguards in auditing firms include policies and procedures related specifically to independence, such as a policy prohibiting investments in any auditee by any auditor or other professional employee of the auditing firm, and personnel hiring, training, promotion, and retention policies that emphasize the importance of auditor independence, the potential threats raised in various circumstances that auditors in the firm may face, and specific safeguards in place to mitigate or eliminate those threats.

138. Some have suggested that additional safeguards entailing structural changes in the environment should be developed. Those suggestions include having auditors employed by a governmental agency rather than by auditing firms; requiring government appointment of auditors; requiring mandatory rotation of auditing firms; having auditors retained for multi-year, instead of annual, periods; permitting auditees to change auditing firms only for cause; and prohibiting auditing firms from performing all management advisory services for auditees.

139. One way to classify safeguards related specifically to auditor independence is based on the extent to which activities and relationships are restricted. Under this method, one type of safeguard provides for absolute prohibition of an activity or relationship—for example, prohibiting auditors from having any direct financial investment in any auditees. Another type of safeguard permits the activity or relationship, but restricts its extent or form—for example, a restriction that auditors cannot have material indirect financial interests in auditees. A third type of safeguard permits the activity or relationship, but requires other policies and procedures to address the threat—for example, the mandatory rotation of an engagement partner after he or she has spent a certain period of time on a specific audit engagement. A fourth type of safeguard permits an activity or relationship but requires the auditor to disclose information about it to the auditee's management, audit committee, board, or others—for example, disclosure to an auditee's audit committee of non-audit services provided by the auditor to the auditee.

140. A basic principle of auditor independence concerns the need to identify different types of safeguards. Such a principle could be expressed as follows:

> **<u>Basic Principle 3</u>—Different types of safeguards—including prohibitions, restrictions, other policies and procedures, and disclosures—can mitigate or eliminate threats to auditor independence.**

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[71] Researchers have suggested that an ethical "tone at the top" can be established in various ways. For example, when members of senior management in an auditing firm serve as role models by behaving ethically, they send clearer signals to subordinates that the firm expects that kind of behavior from all who work in the firm. Another method that helps establish an ethical "tone at the top" is for the auditing firm to adopt a code of ethics and related policies and procedures that help ensure that the code is communicated and enforced. See Don W. Finn, Lawrence B. Chonko, and Shelby D. Hunt, "Ethical Problems in Public Accounting: The View from the Top," *Journal of Business Ethics* (Vol. 7, 1988), pp. 605-15.

Effectiveness of Safeguards

141. When analyzing safeguards, it is not sufficient to consider the types of safeguards that are, or could be put, in place. Independence risk will not be reduced unless safeguards operate effectively to mitigate or eliminate threats created in specific circumstances. The extent to which they do so depends on their design, how they are applied, the consistency with which they are applied, by whom they are applied, and to whom they are applied. A safeguard is considered effective by itself or in combination with other safeguards if it reduces the level of independence risk to an acceptably low level.

142. A basic principle of auditor independence concerns the relative effectiveness of alternative safeguards. Such a principle could be expressed as follows:

> **Basic Principle 4—The effectiveness of the design and operation of various safeguards affects the level of independence risk.**

Independence Risk and Auditor Independence

143. As discussed in Section V, the level of independence risk can be thought of as a continuum. At one end of that continuum, there is "no risk of impaired independence." At the other end, there is "certainty of impaired independence." Because they increase the level of independence risk, threats to auditor independence move an auditor toward the "certainty of impaired independence" end of the continuum. Safeguards to auditor independence may mitigate or eliminate threats, thereby reducing the level of independence risk—that is, they may move an auditor toward the "no risk of impaired independence" end of the continuum. Identifying and analyzing the types and significance of threats and the types and effectiveness of safeguards, as described in Basic Principles 1–4, allow standard setters to assess the level of independence risk in specific circumstances.

144. A basic principle of auditor independence concerns the process of assessing independence risk. Such a principle could be expressed as follows:

> **Basic Principle 5—The ISB should assess the level of independence risk by considering the significance of the threats to auditor independence created by specific circumstances and the effectiveness of the safeguards that mitigate or eliminate those threats when it develops standards for auditor independence.**

145. Section V notes that the level of independence risk—that is, its position on the independence risk continuum—is not easily quantifiable (although respondents who believe that quantification is desirable are encouraged to include in their comments a description of a quantitative approach to independence risk assessments). Nevertheless, it can be argued that segments of the independence risk continuum can be described in terms of the likelihood that

independence is impaired. For example, three segments and two endpoints of the continuum could be described as follows[72]:

- No risk of impaired independence—auditor is clearly independent
- Remote risk of impaired independence—impaired independence is very unlikely
- Some risk of impaired independence—independence might be impaired
- Probable risk of impaired independence—impaired independence is very likely
- Certainty of impaired independence—auditor is clearly not independent

146. After analyzing both the threats to auditor independence created in specific circumstances and the safeguards that mitigate or eliminate those threats, the level of independence risk can be described as being in one of the segments, or at one of the endpoints, on the independence risk continuum. The ISB then can determine whether that level is in a segment or at the endpoint on the independence risk continuum that it considers to be "acceptably low." If it is not, the ISB can decide which additional safeguard, or combination of safeguards, will reduce independence risk to an acceptably low level.

147. A basic principle of auditor independence that addresses the need to ensure that independence risk is "acceptably low" could be expressed as follows:

> **Basic Principle 6—The ISB should determine whether, in the specific circumstances under consideration, the level of independence risk is acceptably low.**

148. It can be argued that the only acceptably low level is at the "no risk of impaired independence" endpoint of the independence risk continuum. Under this view, the goal of ensuring financial statement reliability is too important for the ISB to allow any independence risk—that is, any threats to auditor independence that are not fully eliminated by safeguards. Some may believe that such a goal is appropriate in the face of the difficulties described above in assessing both the level of independence risk and the effectiveness of various safeguards in dealing with potential threats to auditor independence. Under this view, this is the only way that the ISB can define an objective, ascertainable "bright line" for establishing an acceptably low level of independence risk.

149. In order for independence risk to be at the "no risk of impaired independence" endpoint of the continuum, effective safeguards would need to be in place to ensure that independence risk resulting from any threats to auditor independence that arise in specific circumstances is completely eliminated. It can be argued that a position at the "no risk of

[72] This description of the segments on the independence risk continuum is adapted from the classifications used in FASB Statement No. 5, *Accounting for Contingencies* (Stamford, CT: FASB, 1975), para. 3.

impaired independence" endpoint of the independence risk continuum is unrealistic, unattainable, or too costly to achieve. Establishing that endpoint as a goal would, in effect, mandate that the ISB prescribe safeguards that could provide "absolute assurance" of auditor independence, a level of assurance that audits themselves are not designed to provide. It also can be argued that safeguards rarely can be completely effective in eliminating all threats, or that such a level of effectiveness can be achieved only at an excessive cost. Those who hold this view may believe that individual auditors have different personal attributes and different degrees of those attributes.[73] Those who hold this view also may believe that the "no risk of impaired independence" end of the independence risk continuum is best considered an aspirational ideal, rather than something that can be achieved.

150. Those who hold this view also believe that the ISB will need to judge when the threats to auditor independence that arise in specific circumstances are sufficiently mitigated by existing or new safeguards so that independence risk is acceptably low—that is, in an area of the continuum that is sufficiently close to the "no risk of impaired independence" endpoint.[74] Under this view, accepting some level of independence risk is a practical necessity, but that level should be sufficiently low to ensure that there is only a very small risk of impaired independence.

151. Given the extent of judgment involved in determining independence risk in specific circumstances and the importance of independence in ensuring audit quality and reliable financial statements, the ISB could use as a guideline that only a very low level of independence risk is acceptable—for example, one that falls in the "remote risk of impaired independence" segment of the continuum. Under this view, such a low level might balance the practical difficulties of eliminating all independence risk against the need to ensure that audits provide increased financial statement reliability and that stakeholders have confidence in the independence of auditors and in the reliability of audited financial statements.

Which Individuals Are Affected by Threats and Safeguards?

152. It can be argued that the ISB's assessments of independence risk should include consideration of which individuals in an auditing firm are subject to threats created in specific circumstances and what safeguards concerning those individuals are, or could be put, in place. Under this view, some threats concern only specific individuals within an auditing firm—for

[73] Research has been conducted that considers what factors may influence individual auditors' judgments regarding their independence. For example, Sweeney and Roberts found that auditors at lower levels of moral development were also more likely to rely solely on independence rules, rather than their own ethical beliefs, when making judgments about independence. They also suggested that the "tone at the top" in an auditing firm works together with an individual auditor's level of moral development in determining an auditor's reaction to independence issues (John T. Sweeney and Robin W. Roberts, "Cognitive Moral Development and Auditor Independence," *Accounting, Organizations, and Society* [Vol. 22, 1997], pp. 337-52).

[74] Such judgments also would need to be made by other individuals or organizations when they assess independence risk—for example, auditing firms adopting independence policies, individual auditors making decisions when faced with situations for which there is neither authoritative guidance nor firm policy, auditees and audit committees meeting their responsibilities to retain auditors who are independent, and regulators meeting their statutory responsibilities.

example, an employment relationship between a family member of a junior staff member on an engagement team and an auditee may create a threat only for the junior staff member. Under this view, safeguards that mitigate or eliminate a threat concern only those specific individuals directly involved—in this case, only the junior staff member.

153. It can be argued, however, that a sense of collegiality often develops among individuals in auditing firms, whether or not they work together on an audit engagement, and therefore that a person's judgment also might be influenced by relationships involving colleagues' families. Consequently, those relationships also may pose a threat to auditor independence. To mitigate or eliminate such threats, safeguards could apply to others in addition to the specific individual or individuals directly involved in the audit. In the previous example, instead of prohibiting only family relationships between the engagement team and the auditee, the prohibition could be extended to include all individuals in an auditing firm who supervise or otherwise are in a position to influence the design, performance, or outcome of the audit; to all individuals in the firm who provide any type of service to the auditee; to all individuals with a certain level of responsibility in the firm (e.g., partners); or to all individuals in the firm without exception.

154. It also can be argued that different safeguards should be applied to different groups of individuals within an auditing firm, depending on the significance of the threats posed. For example, the most stringent safeguards (such as prohibitions) could be applied to those most closely involved with the engagement, such as the members of the engagement team (and perhaps including those in the auditing firm in a position to influence the audit). Less stringent safeguards (such as required disclosure to the auditee's audit committee) might be adequate for others within the auditing firm for whom the threat is less significant because they are less likely to be able to influence the audit. Those who hold this view also may believe that some threats to auditor independence relate to the independence of the auditing firm as a whole—for example, loans by an auditee to an auditing firm or financial investments in an auditee by an auditing firm's defined benefit pension plan. For these threats, it can be argued that safeguards should apply to all professionals (or to some subset, such as all partners) in an auditing firm and to the firm itself.

155. The need to consider the individuals affected by threats and safeguards could be expressed in a basic principle as follows:

> **<u>Basic Principle 7</u>—The ISB should consider which individuals in an auditing firm (as well as the firm itself) are affected by one or more threats to auditor independence in the specific circumstances under consideration and whether one or more safeguards effectively mitigate or eliminate those threats.**

156. It can be argued, however, that the ISB should not be concerned with which individuals in an auditing firm are affected by threats to auditor independence. Under this view, it is difficult, if not impossible, to identify which specific individuals or groups of individuals in an auditing firm face threats to auditor independence in specific circumstances. For example, in circumstances in which an auditor's relative is a member of auditee management, the ISB may be unable to determine whether the threat posed by the employment relationship is limited to

the individual engagement team member whose relative is employed by the auditee; the threat to auditor independence may extend to all auditors located in any of the auditing firm's offices where firm personnel work on the engagement, or possibly to all auditors in the entire firm. Under this view, it is difficult to design effective safeguards that apply to specific individuals or groups within a firm that mitigate or eliminate threats to auditor independence because of the difficulty in identifying which individuals in a firm face threats in specific circumstances and the relative significance of the threats faced by those individuals. Those who hold this view may believe that Basic Principle 7 offers no substantive guidance to the ISB. Instead, the ISB should develop broadly applicable safeguards, including prohibitions, when it identifies threats to auditor independence.

Benefit and Cost Considerations in Independence Standard Setting

157. As described in Section V, safeguards to auditor independence may have many types of benefits and costs. It can be argued that the ISB should consider the costs of existing and proposed safeguards and the benefits resulting from reduced independence risk. That would require the ISB to assess not only the level of independence risk when it considers threats posed in specific circumstances but also the costs of possible safeguards.

158. A basic principle concerning the need to consider costs and benefits could be expressed as follows:

> **<u>Basic Principle 8</u>—The ISB should weigh the costs of alternative safeguards against the benefits of reduced independence risk resulting from those safeguards when it develops standards for auditor independence.**

159. Section V describes some of the difficulties in identifying and measuring the benefits and costs of safeguards. For this and other reasons, it can be argued that the ISB should ignore costs and benefits in setting independence standards. Faced with a similar choice, the FASB chose to do otherwise.

> Despite the difficulties, the Board does not conclude that it should turn its back on the matter, for there are some things it can do to safeguard the cost-effectiveness of its standards. Before a decision is made to develop a standard, the Board needs to satisfy itself that the matter to be ruled on represents a significant problem and that a standard that is promulgated will not impose costs on the many for the benefit of a few. If the proposal passes that first test, a second test may subsequently be useful. There are usually alternative ways of handling an issue. Is one of them less costly and only slightly less effective? Even if absolute magnitudes cannot be attached to costs and benefits, a comparison between alternatives may yet be possible and useful.[75]

[75] Financial Accounting Standards Board, Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* (Stamford, CT: FASB, 1980), para. 143.

160. The ISB often will be faced not only with a choice among different safeguards that vary in terms of their cost and effectiveness but also with alternative ways of applying a particular safeguard. In weighing the costs and benefits of alternative safeguards, the ISB need not consider the dollar amount of costs and benefits of a particular safeguard, but rather only the differential costs and benefits of that safeguard as compared with others. The latter may be more susceptible to measurement than the former.

SECTION VII — BASIC PRINCIPLES OF AUDITOR INDEPENDENCE: CONSIDERING STAKEHOLDERS' PERCEPTIONS

161. As part of its process of establishing independence standards, the ISB is committed to seeking the views of the various stakeholders in auditor independence.[76] Different stakeholder groups and different individuals within a particular stakeholder group may have different perceptions about auditors and about matters related to auditor independence. In addition, there are different ways in which the ISB could include those perceptions in its standard-setting process. This section discusses factors that may affect perceptions of auditor independence and describes how a basic principle of auditor independence might address the role of perceptions in the ISB's standard-setting process.

162. The basic questions raised by this section are:

> **Question VII-1: Are there aspects of stakeholders' perceptions other than those discussed in this DM that are relevant to, and should be considered in, a conceptual framework for auditor independence? If so, please describe them and their relevance to auditor independence.**
>
> **Question VII-2: Which of the alternatives described in this section, if any, should form the basis for a basic principle related to consideration of stakeholders' perceptions to be included in a conceptual framework? Please explain your views.**
>
> **Question VII-3: Are there ways other than those noted in the alternative basic principles described in this section by which the ISB could consider stakeholders' perceptions in its standard-setting process? If so, please describe them.**

Bases of Stakeholders' Perceptions

163. The professional auditing literature has long recognized the importance of the public's views concerning the independence of auditors. For example, Statement on Auditing Standards No. 1 notes:

> It is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors. Public confidence would be impaired by

[76] "The operating policies of the ISB . . . are designed to permit timely, thorough, and open study of issues involving auditor independence and to encourage broad public participation in the process of establishing and improving independence standards. The objective of the ISB's policy of openness and public participation is to stimulate public consideration and debate on matters relating to its objective and mission. All of the ISB's constituencies, including members of the public, are encouraged to express their views on matters under consideration in order to stimulate constructive public dialogue" (ISB, "Independence Standards Board Operating Policies," <www.cpaindependence.org>, Preamble).

> evidence that independence was actually lacking, and it might also be impaired by the existence of circumstances which reasonable people might believe likely to influence independence. To *be* independent, the auditor must be intellectually honest; to be *recognized* as independent, he must be free from any obligation to or interest in the client, its management, or its owners. ... Independent auditors should not only be independent in fact; they should avoid situations that may lead outsiders to doubt their independence.[77]

164. The AICPA Code of Professional Conduct's discussion about an auditor's professional responsibilities for maintaining independence includes a similar notion concerning the "appearance" of independence:

> For a member in public practice, the maintenance of objectivity and independence requires a continuing assessment of client relationships and public responsibility. Such a member who provides auditing and other attestation services should be independent in fact and appearance.[78]

165. Many academic research studies have examined the perceptions of different groups of stakeholders about matters related to auditor independence. Among the groups studied are stockholders, creditors, financial analysts, auditors, auditee managements and board members, and regulators. Those studies have looked at a wide variety of interests and relationships between auditors and auditees that researchers felt might create the perception of a threat to auditor independence. Researchers also have examined those groups' beliefs about aspects of the environment in which audits take place, including various characteristics of auditing firms and auditees. The following are examples of the types of factors that have been studied:

- the characteristics of auditing firms—such as their size and reputation
- the characteristics of auditees—such as their financial condition and industry
- the characteristics of the relationship between auditing firms and auditees—such as the number of years the auditor works on a specific audit engagement and the types and extent of various auditor–auditee relationships
- environmental factors—such as the risk of legal liability and the level of competition in the audit market
- the types and extent of non-audit services provided to auditees
- the effectiveness of various safeguards to auditor independence—such as concurring partner reviews

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[77] Statement on Auditing Standards No. 1, *Codification of Auditing Standards and Procedures* (AU Section 220.03, emphasis in original).
[78] AICPA Code of Professional Conduct, ET Section 55.03.

166. The results of this research suggest that stakeholders' knowledge about the organizations, processes, and rules related to auditor independence is very limited.[79] It also suggests that, because of differences within and between stakeholder groups, the ISB may have to decide whose perceptions should be considered and the weight those perceptions should be given in the standard-setting process.

167. Stakeholders' perceptions of auditor independence may be similar to perceptions in other situations in which public opinion is based on beliefs about the effectiveness of regulatory systems that help ensure the quality of goods and services, rather than on detailed knowledge about the quality of the goods or services themselves. For example, airline passengers do not ordinarily know, or have access to, the maintenance and inspection records of an airplane before they board it. Instead, they may believe that relatively few safety incidents occur and that it is safe to fly. This may reinforce passengers' beliefs that the Federal Aviation Administration (FAA), the regulatory agency that has responsibility for ensuring airplane safety in the United States, has appropriately discharged its responsibility by ensuring that regulations for airplane safety have been properly designed and are operating effectively. Passengers also may believe that airplane manufacturers and airline companies have satisfied their responsibilities for meeting safety regulations as well as their own manufacturing and operating standards for the airplanes that they build and operate. When safety problems with planes occur, public confidence in the industry and in the regulatory system overseeing it is enhanced if people believe that follow-up investigations are handled appropriately and that any changes in the regulations or processes necessary to ensure passenger safety are successfully implemented. Members of the public also may believe that, when necessary, recourse to the legal system is available to ensure that consumers will be compensated for losses caused by responsible parties and that, when appropriate, criminal sanctions will be imposed. This also may be thought to have a deterrent effect.

168. In a similar manner, it can be argued that most stakeholders in auditor independence cannot identify the individual auditors assigned to a particular engagement or the attributes

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[79] In November 1999, the ISB published the results of a comprehensive series of interviews with various stakeholders concerning their perceptions of issues related to auditor independence. The study indicated that there were differences between and within various stakeholder groups (Earnscliffe Research & Communications, "Report to the United States Independence Standards Board: Research into Perceptions of Auditor Independence and Objectivity," <www.cpaindependence.org>. Engle and Sincich studied the perceptions of a random sample of auditors concerning a wide range of independence issues and also found differences in their beliefs (Terry J. Engle and Terry L. Sincich, "The Loss of Auditor Independence: Perceptions of Staff Auditors, Audit Seniors, and Audit Managers," *Research on Accounting Ethics* [Vol. 4, 1998], pp. 167-84).

For a summary of many of the research findings on stakeholders' perceptions, see Gary Kleinman, Dan Palmon, and Asokan Anandarajan, "Auditor Independence: A Synthesis of Theory and Empirical Research," *Research in Accounting Regulation* (Vol. 12, 1998), pp. 3-42, and F.Todd DeZoort and Alan T. Lord, "A Review and Synthesis of Pressure Effects Research in Accounting," *Journal of Accounting Literature* (Vol. 16, 1997), pp. 28-85. The authors note that the findings tend to be inconclusive or contradictory, in part because different types of stakeholders and different individuals perceive the factors that create threats to auditor independence quite differently. The authors also suggest that a variety of methodological problems, such as modeling pressures on auditors in experimental research environments and biases that may exist in survey research, make it difficult to interpret the findings.

that those auditors may have and exercise during an audit. Nor are they aware of threats to auditor independence that may increase independence risk on a specific audit engagement, the safeguards that may mitigate or eliminate the threats on that engagement, or details of the rules that help ensure auditor independence on all audit engagements. As a result, stakeholders' perceptions about auditor independence may be based on their beliefs that the organizations, processes, and rules that help ensure auditor independence generally are functioning effectively.[80] Those beliefs, in turn, may be influenced by the relatively few instances of independence problems that are reported in the financial press or otherwise brought to the public's attention. When an independence problem does surface, stakeholders may believe that the problem was caused by the actions of an individual, a firm, or an auditee and generally can be resolved satisfactorily through the regulatory or legal system. If systemic problems are found with the organizations, processes, or rules that help ensure auditor independence, stakeholders also may believe that they will be addressed appropriately by standard setters or regulators.

Incorporating Stakeholders' Perceptions

169. Section III of this DM suggests that the goals of auditor independence could include improving financial statement reliability and enhancing financial statement credibility and stakeholder confidence in financial statement reliability. The ISB's views about those goals may affect how and to what extent stakeholders' perceptions are incorporated in the independence standard-setting process. The remainder of this section describes three views of the role that stakeholders' perceptions could play in the ISB's standard-setting process. Each of those views could lead to a basic principle of auditor independence that addresses how the ISB should consider stakeholders' perceptions in setting independence standards. Such a principle could be expressed as one of the following:

> **<u>Basic Principle 9A</u>—The ISB should solicit the views of all stakeholders and develop independence standards that reflect stakeholders' perceptions.**
>
> **<u>Basic Principle 9B</u>—The ISB should solicit the views of all stakeholders but develop independence standards that reflect the likely perceptions of a hypothetical group of stakeholders, namely, "reasonable, fully informed users of financial statements."**

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[80] Mautz and Sharaf used the term "profession-independence" to describe

> the image of auditors as a group brought to mind when the term "auditor" or CPA is used.... To many people who have never had direct acquaintance with independent auditors, the term still has meaning, a meaning which they have gained from what they have read, from the impression various forms of mass communication media have made upon them, and from the ideas passed on to them by various opinion leaders. There are many people who, although they know an individual auditor and think highly of him, may well have quite another impression of the profession. When the time comes for them to rely on the work of unknown auditors, it is their general impression that will govern (*The Philosophy of Auditing,* p. 205).

<u>Basic Principle 9C</u>—The ISB should solicit the views of all stakeholders and be informed by stakeholders' perceptions, but develop independence standards based on the ISB's judgment about how best to meet the goal or goals of auditor independence.

<u>Reflecting the Perceptions of Stakeholders</u>

170. Reflecting the perceptions of stakeholders in auditor independence—the approach described in Basic Principle 9A—is compatible with the belief that both improved financial statement reliability and enhanced financial statement credibility and stakeholder confidence in that reliability are appropriate goals of auditor independence. It is incompatible with the belief that the only appropriate goal of auditor independence is improved financial statement reliability. This alternative reflects the belief that a standard-setting process based on the views of all, or at least a broad cross-section of, stakeholders is more likely to ensure stakeholder confidence in the ISB, in its standard-setting process, and in the independence of auditors.

171. To promulgate standards that reflect the perceptions of all, or at least a broad cross-section of, stakeholders, the ISB first would have to identify those perceptions. Information about stakeholders' perceptions could be gathered from many sources—including surveys, focus groups, and other types of research; input from stakeholders who serve on ISB task forces and other working groups; stakeholders' responses to issues raised in ISB discussion memoranda and exposure drafts; and stakeholders' testimony at public hearings.

172. Because of the complexity of the issues and differences in knowledge and beliefs about auditors and their independence, however, there are likely to be significant differences in perceptions between and within stakeholder groups. The ISB would need to decide how to incorporate those differing perceptions into its standard-setting process, in effect deciding whether the perceptions of some stakeholders or stakeholder groups should be weighed more heavily than the perceptions of other individuals or groups.

<u>Reflecting the Perceptions of Reasonable, Fully Informed Users</u>

173. An alternative view—expressed in Basic Principle 9B—is that the ISB should develop independence standards that reflect the perceptions that a hypothetical group of stakeholders, namely, "reasonable, fully informed users of financial statements," would be likely to have. Like the previous alternative, this view is compatible with the belief that both improved financial statement reliability and enhanced financial statement credibility and stakeholder confidence in that reliability are appropriate goals of auditor independence, and incompatible with the belief that the only appropriate goal of auditor independence is improved financial statement reliability.

174. The "reasonable, fully informed user" concept has its roots in the "reasonable person" and "reasonable investor" concepts that are currently in the auditor independence literature. For example, the AICPA Code of Professional Conduct notes:

> Members must be aware that it is impossible to enumerate all circumstances wherein the appearance of a member's independence might be questioned by third parties.... [M]embers must consider whether [a relationship or interest] ... would lead a reasonable person aware of all the facts, who took into consideration normal strength of character and normal behavior under such circumstances, to conclude that the situation poses an unacceptable threat to the member's objectivity and appearance of independence.[81]

175. The SEC describes that group of stakeholders in a similar way:

> Pursuant to the Commission's regulations, the basic test for auditor independence is whether a reasonable investor, knowing all relevant facts and circumstances, would perceive an auditor as having neither mutual nor conflicting interests with its audit client and as exercising objective and impartial judgment on all issues brought to the auditor's attention.[82]

176. The ISB can gain insights into what the perceptions of "reasonable, fully informed users" would likely be from the various sources of stakeholders' perceptions discussed previously. If it uses this approach, the ISB will have to infer, from the input it receives, the relevant views of a hypothetical group of reasonable, fully informed stakeholders concerning the effectiveness of alternative safeguards in mitigating or eliminating threats to auditor independence. Because it may be difficult to draw such inferences, however, some believe that the ISB should not adopt an approach to standard setting requiring that its decisions reflect the perceptions of even a limited class of stakeholders. Rather, the ISB should use its own judgment to evaluate what new standards, if any, best meet the goal or goals of auditor independence. That alternative view is described below.

Using Judgment Informed by Stakeholders' Perceptions

177. As expressed in Basic Principle 9C, an alternative to the two views described previously is that the ISB should be informed by stakeholders' perceptions, but should not base its decisions on those perceptions. Under this view, the ISB, rather than a group or groups of stakeholders, is in the best position to judge the long-term impact of proposed standards on the goal or goals of auditor independence, and its standard-setting process should not prevent it from making those judgments, even if those judgments differ from those of

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[81] AICPA Code of Professional Conduct, Interpretation 101-9 (ET Section 101.11).

[82] SEC Financial Reporting Release No. 50, *The Establishment and Improvement of Standards Related to Auditor Independence* (February 18, 1998), Section I (footnote omitted).

stakeholders. Like the alternatives discussed in the previous two subsections, this alternative is compatible with the belief that both improved financial statement reliability and enhanced financial statement credibility and stakeholder confidence in that reliability are appropriate goals of auditor independence.

178. The difference between this alternative and those discussed previously can be illustrated by considering how the ISB might choose among alternative courses of action when dealing with a specific issue. Using either of the two previous alternative approaches, the ISB would necessarily reflect in its standards the perceptions of one or more stakeholder groups, regardless of the views of the ISB members themselves. Under this alternative, the ISB would not be bound by the views of any stakeholder group or groups—for example, the ISB might issue a standard that mandates safeguards the ISB believes are necessary to help ensure financial statement reliability, even if one or more stakeholder groups believe otherwise. The ISB might believe, in this situation, that the benefits of the additional safeguards—expressed as improved financial statement reliability or decreased independence risk—exceed their costs. The ISB might conclude, in another situation, that additional safeguards are unnecessary because it believes independence risk is sufficiently low without them, even if one or more groups of stakeholders—for example, reasonable, fully informed users—believe that a significant threat to auditor independence exists in those circumstances. In this situation, the ISB might take the position that the costs of additional safeguards exceed the limited benefits of enhanced financial statement credibility or stakeholder confidence that might result from those additional safeguards. Although stakeholders' perceptions would not serve as the basis for the ISB's conclusions, insights into those perceptions not only would inform its consideration of the issues, but also might affect the way that it communicates its conclusions and their rationale to stakeholders and, as a result, serve to improve stakeholders' understanding of independence risk.

179. Some who believe that the alternative discussed in this subsection, or a variation thereof, is the appropriate alternative for the ISB to embrace, point to the processes used to establish rules by other bodies of experts, such as the Food and Drug Administration (FDA) and the FAA. Those bodies base their judgments about the need for new rules on all available information—including the results of actual and simulated testing of safety and efficacy as well as the public's views about proposed rules—not simply on whether the public believes that the new rules are needed. Members of the general public, in turn, rely on the system (which includes the regulatory bodies responsible for setting and monitoring compliance with those rules) when they buy food and medicine or board an airplane. The public relies on the system because it believes that others with more expertise are in the best position to judge what rules are necessary and to enforce those rules. The regulatory bodies have open lines of communication with the public and typically receive extensive media coverage, thus affording them opportunities to explain their proposed policies and the underlying rationale.

180. Those who hold this view may believe that the ISB's standard-setting process should work in the same way. That is, the ISB is in the best position to establish appropriate standards, based on a thorough evaluation of all available information, including input from stakeholders. Under this view, the ISB would neither ignore stakeholders' perceptions nor base its decisions only on those perceptions. Instead, the ISB would solicit the views of

stakeholders and be informed by their perceptions by, for example, considering the potential impact of its conclusions on financial statement credibility and stakeholders' confidence, as well as the potential impact on the reliability of financial statements.

181. This alternative is permissive with respect to the extent to which the ISB might incorporate stakeholders' perceptions in its standard-setting process. Under a variation of this alternative, the ISB would adopt an independence standard *only if* it believed that the standard would improve financial statement reliability (subject to possible cost/benefit considerations). Under this view, the ISB would solicit the views of stakeholders and be informed by their perceptions, but it would not base its decisions on the potential impact of the standard on financial statement credibility or stakeholder confidence in financial statement reliability. This variation reflects the view that enhancing credibility and stakeholder confidence should not be part of the goals of auditor independence—improving financial statement reliability is the only appropriate goal of auditor independence. Basic Principle 9C would still apply, but the ISB's focus would be on the goal of improved financial statement reliability. Under this view, if ISB standards improve financial statement reliability (and an effective system exists that ensures compliance with those standards), audit failures related to impaired independence should be rare, and stakeholders' long-term views about the independence of auditors should reflect that reality. Effective communication and reliable financial statements would be the means by which independence standards would enhance financial statement credibility and stakeholder confidence in financial statement reliability. Independence standards themselves would not be based on whether they enhanced financial statement credibility or stakeholder confidence.

* * * *

182. Regardless of the ISB's views about stakeholders' perceptions, effective two-way communication between the ISB and stakeholders can help shape their opinions about the ISB, the process by which independence standards are promulgated, and the standards themselves, and ultimately enhance stakeholders' confidence in the independence of auditors generally. The ISB can provide a variety of opportunities for stakeholders to furnish timely input—for example, stakeholder representation on task forces and working groups, presentations and panel discussions with stakeholder groups on issues of mutual concern, and broad distribution of discussion memoranda and exposure drafts to encourage stakeholders to share their views with the ISB. At various stages in the standard-setting process, the ISB can communicate its views on the nature of the threats that it believes are posed in the circumstances under consideration and the reasons why the ISB believes that additional safeguards are or are not the best solution in those circumstances. The Board also can explain the bases for its conclusions, both in the ISB standards and through other media. Efforts by the ISB to ensure effective communications with stakeholders may serve to increase stakeholders' confidence in the organizations and processes involved in maintaining auditor independence as well as in financial statement reliability and the independence of auditors generally.

APPENDIX A

Glossary

This appendix contains definitions of certain terms or phrases used in this Discussion Memorandum.

Auditee

The entity whose financial statements are being audited.

Competence

When applied to an auditor, the ability to develop an appropriate audit plan, to select suitable auditing procedures to test management's assertions, to draw proper conclusions regarding the conformity of the financial statements with GAAP, and to render the appropriate auditor's report.

Credibility

The quality of information that makes it believable.

Diligence

When applied to an auditor, approaching an audit with professional skepticism, efficient and careful handling of technical matters, and a willingness to devote adequate time and appropriate effort in performing an audit.

Information risk

The risk that users will make incorrect investment and credit decisions because the financial statements used in making those decisions contain material misstatements.

Integrity

When applied to an auditor, honesty, trustworthiness, candor, and truthfulness in performing an audit and making judgments regarding the financial statements' conformity with GAAP.

Objectivity

When applied to an auditor, impartiality—the ability to suppress any existing biases when obtaining and evaluating audit evidence and making audit judgments.

Partner

A person in an auditing firm (regardless of the legal form of organization) who is ultimately responsible for ensuring that the audit is planned, conducted, and reported on in accordance with the firm's policies and generally accepted auditing standards, as well as those in the firm's chain of command to whom that person reports.

Public entity

An entity that is required to file financial statements with the Securities and Exchange Commission.

Quality audit

An audit performed in accordance with generally accepted auditing standards.

Reliability

"The quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent."[83] (Financial statements typically purport to represent that an entity's financial position, results of operations, and cash flows are presented fairly, in all material respects, in conformity with generally accepted accounting principles.)

Safeguards to auditor independence

Controls—including prohibitions, restrictions, other policies and procedures, and disclosures—that exist or could be put in place by standard setters, regulators, or auditing firms that mitigate or eliminate threats to auditor independence.

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[83] FASB, Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information* (Stamford, CT: FASB, 1980), "Glossary of Terms."

Stakeholders in auditor independence

Auditees, auditors and auditing firms, regulators, users of audited financial statements, and others who may be affected by or who have an interest in the independence of auditors.

Threats to auditor independence

Factors—including pressures, activities, and relationships—that could impair auditor independence.

Users

Investors, creditors, and others who use audited financial statements in making investment and credit decisions.

APPENDIX B

Examples of Goals of Auditor Independence

This appendix contains examples of goals of auditor independence found in a variety of authoritative and nonauthoritative sources in addition to those discussed in Section III. The examples are divided into two groups that roughly parallel the goals discussed in that section. Within each group, the examples are in chronological order. In some cases, however, precise chronological order was difficult to determine because it is unclear when some examples first appeared in the literature.

Goals Related to Financial Statement Reliability

Examples in the first group, like Goals 1 and 2 (and related modifications) in Section III, focus on the relationships among auditor independence, auditors' personal attributes, and financial statement reliability.

1 **AICPA, *Code of Professional Conduct* (New York: AICPA, 1998 edition), ET Section 55.01.**

Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member's objectivity in rendering attestation services.

2 **Robert K. Elliott and Peter D. Jacobson, "Audit Independence: Concept and Application," *CPA Journal* (March 1992), p. 35.**

What does it mean to say that the auditor is independent of the assertion [e.g., the financial statements] or without bias with respect to the assertion? It means that there is no bias of any kind with respect to the assertion, and it also means, by inference, that there are no interests causing bias. However, it makes no sense to ban the auditor's interest in the reliability (or truth) of the assertion. Therefore, the auditor should have no interest in the financial statements except their reliability.

3 **Steven M. H. Wallman, "The Future of Accounting, Part III: Reliability and Auditor Independence," *Accounting Horizons* (December 1996), p. 79.**

After all, the ultimate goal of auditor independence is *not* independence for its own sake—although that is a goal that some seem to seek. Rather, it is to ensure the ongoing reliability of accounting and financial reporting and the effectiveness of our system of capital formation.

4 **AICPA, *Serving the Public Interest: A New Conceptual Framework for Auditor Independence* (White Paper) (New York: AICPA, 1997), pp. 14-15.**

In operational terms, independence ensures that those who perform an audit or other assurance engagement will be mentally objective when obtaining, examining, and reporting on information. Independence, therefore, constitutes one of the cornerstones of the accounting profession.

5 **Robert K. Elliott and Peter D. Jacobson, "Audit Independence Concepts," *CPA Journal* (December 1998), p. 32.**

A usefully stated objective of audit independence would capture both the cost and the benefit side of the contribution to the capital markets. Here is the way such an objective might be formulated:

> ***The purpose of audit independence is to improve the cost effectiveness of the capital markets.***

This objective follows from the idea that the purpose of auditing is to improve the cost-effectiveness of the capital markets (independence improves auditing, which should improve the cost-effectiveness of the capital markets).

Goals Related to Perceptions, Credibility, and Confidence

A second group of examples of goals of auditor independence, like Goals 3 and 4 (and related modifications), focuses on the relationship among independence, perceptions of various groups of stakeholders, financial statement credibility, and stakeholders' confidence.

6 **SEC Codification of Financial Reporting Policies, *Role of Independence in the Auditing Process,* Section 601.01 (originally issued as part of Accounting Series Release No. 247, May 26, 1978).**

The role of the independent accountant as an outside expert has expanded. Auditors now perform limited reviews of interim financial information and, on occasion, report the results of such reviews in Commission filings. In addition, generally accepted auditing standards require auditors to report to their clients material weaknesses in internal accounting controls that come to their attention during an examination of financial statements in accordance with such standards.

The increased participation by the independent accountant in the financial reporting process makes it even more important that this relationship be fully understood and appreciated by investors and other users of financial information. To sustain confidence in financial statements by their users, the Commission and the accounting profession require that auditors remain independent, both in fact and appearance, of the companies they audit.

7 **SEC Codification of Financial Reporting Policies, *Role of Independence in the Auditing Process,* Section 601.01 (originally issued as part of Accounting Series Release No. 296, August 20, 1981).**

The Commission continues to endorse and require scrupulous adherence to these principles [of independence as defined by generally accepted auditing standards]. The Commission views both the fact and appearance of independence as essential in order that the public may justifiably view the audit process as a wholly unbiased review of management's presentation of the corporate financial picture. Through his audit and certification, the auditor provides the means for independently checking and confirming the information reported by corporations. Independence is thus of vital importance to investors, creditors, agencies of government and others who rely on the public accountant's opinion that financial statements fairly reflect the financial position and results of operations of the enterprise which he has audited. Absent independence, in fact and appearance, investors will have little confidence in public companies as investment vehicles.

8 **Auditing Standards Board, Australian Accounting Research Foundation, *Auditor Independence*, Statement of Auditing Practice AUP 32, 1992, para. 6.**

The concept of independence is fundamental to auditing, since the auditor's objective is to enhance, through the expression of an independent opinion, the credibility of the reported financial information of an entity. The value of the independent audit lies both in the fact that the auditor is, and is seen to be, independent of the audited entity, and hence is able to carry out the audit free of any externally imposed constraints.

9 **Office of the Chief Accountant, Securities and Exchange Commission, *Staff Report on Auditor Independence* (March 1994), p. 2.**

The independence of accountants who audit the financial statements included in filings with the Commission is crucial to the credibility of financial reporting and, in turn, the capital formation process. The public confidence in the reliability of issuers' financial statements that is provided by the performance of independent audits encourages investment in securities issued by public companies. This sense of confidence depends on reasonable investors perceiving auditors as independent professionals who have neither mutual nor conflicting interests with their audit clients and who exercise objective and impartial judgment on all issues brought to their attention.

10 **Steven M. H. Wallman, "The Future of Accounting, Part III: Reliability and Auditor Independence," *Accounting Horizons* (December 1996), p. 79.**

Finally, an examination of auditor independence also involves consideration of not only the realities, but also the public's perception, of independence. Some argue, credibly, that this *should not* be the case. However, these two factors do interact, and although public perception may not always be based on fact, it is important to the public's confidence in accounting information.

APPENDIX C

Examples of Definitions of Auditor Independence

This appendix contains examples of both definitions and descriptions of auditor independence found in a variety of authoritative and nonauthoritative sources in addition to those discussed in Section IV. The examples are divided into five groups; the first three groups roughly parallel the sequence of the definitions discussed in that section. Within each group, the examples are presented in chronological order. In some cases, however, precise chronological order was difficult to determine because it is unclear when some examples first appeared in the literature.

Personal Attributes Approach

Examples in the first group, like Definitions 1, 2, and 3 in Section IV, are based on a personal attributes approach, focusing on the qualities that individual auditors should possess.

1 **John L. Carey, *Professional Ethics of Public Accounting* (New York: American Institute of Accountants, 1946), p. 7.**

> Independence is an abstract concept, and it is difficult to define either generally or in its peculiar application to the certified public accountant. Essentially it is a state of mind. It is partly synonymous with honesty, integrity, courage, character. It *means*, in simplest terms, that the certified public accountant will tell the truth as he sees it, and will permit no influence, financial or sentimental, to turn him from that course.

2 **Carey, *Professional Ethics of Public Accounting*, pp. 20-21.**

> But independence has come to have a special meaning to certified public accountants in conjunction with auditing and expressing opinions on financial statements. Here independence has come to be almost a "term of art." The reason is that investors, credit grantors, prospective purchasers of businesses, regulatory agencies of government, and others may rely on a certified public accountant's opinion that financial statements fairly reflect the financial position and results of operations of the enterprise which he has audited. It is most important that the CPA not only shall refuse to subordinate his judgment to that of others but that he *be independent of any self-interest which might warp his judgment* even subconsciously in reporting whether or not the financial position and net income are fairly presented. Independence in this context means objectivity or lack of bias in forming delicate judgments.

3 **American Institute of Certified Public Accountants,** ***Code of Professional Ethics*** **(AICPA: New York, 1977 edition), ET Section 52.02.** [84]

> Independence has traditionally been defined by the profession as the ability to act with integrity and objectivity.

<u>**Activities and Relationships Approach**</u>

Examples in the second group, like Definitions 4, 5, and 6 in Section IV, are based on an activities and relationships approach that emphasizes external indicators of auditor independence.

4 **Australian Accounting Research Foundation (AARF), "Auditor Independence," Statement of Auditing Practice (AUP) 32 (Melbourne: AARF, 1992), para. 7.**

> The professional ethical pronouncements . . . define independence as a freedom from any interest incompatible with integrity and objectivity..

5 **AICPA,** ***Serving the Public Interest: A New Conceptual Framework for Auditor Independence*** **(White Paper) (New York: AICPA, 1997), p. 7.**

> For purposes of the new framework, independence would be defined as an absence of interests that create an unacceptable risk of bias with respect to the quality or context of information that is the subject of an audit engagement.

6 **New Zealand Society of Accountants (NZSA), "Guideline on Integrity, Objectivity and Independence," Ethical Guideline No. 1 (Wellington: NZSA, 1982 [revised 1991]), para. 9.**

> Independence has come to have a special meaning to members [of the New Zealand Society of Accountants] in conjunction with professional engagements resulting in opinions on financial information. In this sense, independence means avoidance of situations which would tend to impair objectivity or create personal bias which would influence judgments.

7 **Robert K. Elliott and Peter D. Jacobson, "Audit Independence Concepts,"** ***CPA Journal*** **(December 1998), p. 34.**

> Audit independence is an absence of interests that create an unacceptable risk of material bias with respect to the reliability of financial statements.

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[84] This language was included by the SEC in Accounting Series Release No. 296 (August 20, 1981). See *SEC Codification of Financial Reporting Policies*, Section 601.01.

Focus on Perceptions, Credibility, and Confidence

The third group of examples, like the definitions and additions in Section IV beginning with Definition 7, focuses on the perceptions of users of financial statements and other stakeholders as well as on the goals of auditor independence that deal with enhancing financial statement credibility and stakeholder confidence.

8 AICPA, *Code of Professional Conduct* (New York: AICPA, 1998 edition), ET Section 55.01.

> Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member's objectivity in rendering attestation services.

9 Independence Issues Committee, Materiality Task Force, "Preliminary Analysis of the Use of the Materiality Concept for Independence Purposes" (unpublished, 1998), p. 1 (footnote omitted).

> An auditor is independent when informed investors, knowing all the facts and circumstances surrounding relevant relationships, matters and situations, would conclude that there is no more than an insignificant risk that auditor objectivity would be impaired.

10 SEC, Financial Reporting Release No. 50: *The Establishment and Improvement of Standards Related to Auditor Independence* (Washington, DC: SEC, February 18, 1998), Section I.

> Pursuant to the Commission's regulations, the basic test for auditor independence is whether a reasonable investor, knowing all relevant facts and circumstances, would perceive an auditor as having neither mutual nor conflicting interests with its audit client and as exercising objective and impartial judgment on all issues brought to the auditor's attention. In determining whether an auditor is independent, the Commission considers all relevant facts and circumstances, and its consideration is not confined to the relationships existing in connection with the filing of reports with the Commission.

Multidimensional Approach

A fourth approach to describing independence found in the literature views the concept of independence as having several dimensions, each of which requires a separate description or definition.

11 **John L. Carey, *Professional Ethics of Public Accounting* (New York: American Institute of Accountants, 1946), pp. 21-22.**

> To sum up, independence has two meanings to the certified public accountant. First, in the sense of not being subordinate, it means an aspect of integrity, which is expected of all professional men, and enables them to accept responsibility. Second, in the narrower sense in which it is used in conjunction with auditing and expressing opinions on financial statements, independence means avoidance of any relationships which might, even subconsciously, impair the CPA's objectivity as auditor.

12 **Carman G. Blough, "Responsibility to Third Parties," *Journal of Accountancy* (May 1960), p. 60.**

> When considering independence, one must not only look at his own mind to see whether the relationship is such that he feels there might be danger of his being biased, he must also examine the situation and try to see how it would look through the eyes of those who will be called upon to rely upon his representation. One had better sacrifice the business that such a relationship would bring than run the risk of letting his judgment be distorted to the point where he might not be completely objective, or of destroying his usefulness by appearing to others to be lacking in independence.

13 **Robert K. Mautz and Hussein A. Sharaf, *The Philosophy of Auditing* (American Accounting Association, 1961), pp. 204-05.**

> This is to say that real independence is of little value if those who read an auditor's report refuse to acknowledge that independence does exist. Thus there are two aspects of independence requiring attention if a useful concept is to be developed; these are, first, the real independence of the individual practitioner in the performance of his work and, second, the apparent independence of auditors as a professional group. For the purposes of this chapter, we will refer to these as "practitioner-independence" and "profession-independence" respectively.
>
> The meaning of practitioner-independence seems clear. It has to do with the ability of the individual practitioner to maintain the proper attitude in the planning of his audit program, the performance of his verification work, and the preparation of his report. Profession-independence has to do with the image of auditors as a group brought to mind when the term "auditor" or CPA is used.

14 D. R. Carmichael and R. J. Swieringa, "The Compatibility of Auditing Independence and Management Services—An Identification of Issues," *Accounting Review* (October 1968), pp. 698-99.

Professional independence—This phase of independence is essential to the practice of *any* profession. To attain professional independence, the auditor must possess an approach and attitude which make him self-reliant and not subordinate to his client. Additionally, the auditor must be free from control or influence of management in making decisions based upon universal standards, specificity of professional expertise, and authority based on his expertise. Professional independence is based on control by self-imposed standards and peer-group surveillance and, therefore, requires freedom from control by superiors.

Audit independence—This phase of independence is peculiar to the CPA's function of examining and expressing opinions on financial statements. To attain audit independence, the auditor must "*be independent of any self-interest which might warp his judgment* even subconsciously in reporting whether or not the financial position and net income are fairly presented. Independence in this context means objectivity or lack of bias in forming delicate judgments" [Carey, *Professional Ethics*, pp. 20-21].

The freedom from bias and prejudice required to attain audit independence carries an implication of duality. Not only must the auditor refrain from intentionally favoring the client's interests in planning his examination, gathering evidence, and preparing his report, he must also avoid any *unintentional* feelings which might cause him to take such actions. The basic nature of these two situations is so divergent that they deserve separate recognition. The question of avoidance of intentionally biased and prejudicial action is referred to as "objective audit independence," while the subconsciously motivated facet is referred to as "subjective audit independence."

Perceived independence—[One aspect of this phase is that it] involves a reasonable and knowledgeable individual's perception of an individual practitioner's independence. . . . The other phase of perceived independence, then, is the general public's perception of the profession as a whole. The perceived independence of auditors as a professional group is something quite different from the perceived independence of an individual practitioner; the former is a matter of professional image, while the latter is an evaluation of singular circumstances. Accordingly, the appearance of independence should be recognized as a dichotomy, composed of "individual perceived independence" and "group perceived independence."

Another important facet of this two-fold phase of independence is the fact that it is solely a matter of perception. . . . This means that an observer's opinion will be based, not on the objective features of a situation, but on the meaning that situation has for him. This facet of perceived independence should not be ignored.

15 **Federation Des Experts Comptables Europeens (FEE), *Statutory Audit Independence and Objectivity* (Brussels: FEE, 1998), p. 8 and note 1.**

Independence[1] is the main means by which the statutory auditor demonstrates that he can perform his task in an objective manner. In dealing with independence, one must address both:

- **Independence of mind**, i.e., the state of mind which has regard to all considerations relevant to the task in hand but no other; and
- **Independence in appearance**, i.e., the avoidance of facts and circumstances which are so significant that an informed third party would question the statutory auditor's objectivity.

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[1]Use of the word 'independence' on its own has often created misunderstandings in discussing this topic because standing alone the word appears to denote an absolute standard which professionals must attain. It leads observers to suppose that a person exercising professional judgement ought to be free from all economic, financial, and other relationships which appear to entail dependence of any kind. This is manifestly impossible, as every member of society has some dependency and relationship with every other.

16 **International Federation of Accountants (IFAC), "Independence—Proposed Changes to the Code of Ethics for Professional Accountants" (New York: IFAC, August, 1999), paras. 8.1-8.4 (footnotes omitted).**

It is in the public interest, and therefore required by IFAC's Code of Ethics, that professional accountants in public practice who undertake reporting assignments be independent of the entities on which they are reporting and the subject matter of their reports.

Independence requires the qualities of objectivity and integrity. Objectivity is the intellectual quality of freedom from bias; integrity is the moral quality of honesty. Both qualities relate to independence of mind.

In addition to independence of mind, the public interest requires that reporting accountants be concerned about the appearance of independence. Relationships with clients that may appear to affect judgments by the reporting accountant present threats or risks to independence. Reporting accountants have an obligation to evaluate those relationships and to take appropriate action to eliminate the threats and risks, or to reduce them to acceptable levels. Such evaluation and action should be supported by evidence prepared before accepting the reporting assignment and during the course of the assignment.

The reporting accountant must be both (a) independent of mind, and (b) independent in appearance.

17 American Institute of Certified Public Accountants/National Association of State Boards of Accountancy, Exposure Draft, "Proposed Model Code of Conduct" (August 18, 1999 revised), Principle VII.

A licensee should be independent in fact and appearance. Independence in fact is the absence of a licensee's interest in, relationship with, or services provided to, a person or entity, that results in the licensee's loss of objectivity. Independence in appearance is the absence of such interests, relationships, or services which may, to a reasonable person having knowledge of all the facts, appear to result in an unacceptable threat to the licensee's objectivity.

When considering independence issues, it is presumed that the reasonable person would consider, among other factors:

- A licensee's normal strength of character under the circumstances;
- Pressures that may be exerted on the licensee by clients and others;
- The countervailing pressures of legal liability and professional discipline, including loss of reputation and license; and
- The safeguards established by the profession for the licensee's practice entity, such as peer review and quality control standards.

Academic Approaches

A fifth group of definitions and descriptions of auditor independence includes those developed by academic researchers writing about positive accounting theory, developing theoretical models, and describing empirical research. Although these examples are not intended to be operational definitions, they do provide another view of auditor independence.

Positive theory views auditing as one of the methods by which contracts among owners, managers, and stockholders can be monitored. Audits provide value only if the parties to the contract believe that the probability that the auditor will report a breach of the provisions of the contract is greater than zero.

18 Ross L. Watts and Jerold L. Zimmerman, *Positive Accounting Theory* (Englewood Cliffs, NJ: Prentice-Hall, 1986), pp. 314-15 and note 3.

The probability an auditor reports a breach, conditional on a breach occurring, depends on

1. The probability that the auditor *discovers* a given breach
2. The probability that the auditor *reports* the discovered breach

> The first probability (discovery) depends on the auditor's **competence** and the quantity of inputs devoted to the audit. The second probability (reporting) refers to the auditor's **independence** from the client. If the client pressures the auditor to *not* disclose a discovered breach, will the auditor withstand the client's pressure?
>
> To create a demand for audit services, auditors have to convince the market that they have some competence (i.e., there is a nonzero probability the auditor will discover a breach) and that they will have some independence from the client (i.e., there is a nonzero probability that the auditor will report a discovered breach). The market will only be convinced of the latter if auditors stand to lose something by never reporting breaches. If auditors have nothing to lose by succumbing to managerial pressures not to report a breach and if managers can impose costs on them, auditors will succumb.
>
> . . . .
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> Since voluntary corporate auditing has survived for over 600 years . . . institutions and contractual arrangements must exist that provide the auditor with incentives to be independent, to resist the manager's pressures.[3] Those institutions and arrangements include the auditor's reputation, professional societies, the audit firm's organizational form, and large-scale audit firms. Further, the institutions and contractual arrangements have evolved over time as the capital market's structure has changed.
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> [3] Note that we do not expect auditors to be totally independent (i.e., report discovered breaches with probability 1). The auditor trades off the cost of reporting and not reporting a discovered breach, and there is no reason to believe that an extreme policy is adopted.

Researchers also have spent considerable effort developing models of the market for audits that have included definitions of auditor independence.

19 Linda E. DeAngelo, "Auditor Independence, 'Low Balling,' and Disclosure Regulation," ***Journal of Accounting and Economics*** **(August 1981), p. 116 (footnote omitted).**

> The level of auditor independence is defined as the conditional probability that, given a breach has been discovered, the auditor will report the breach.

20 Robert P. Magee and Mei-Chiun Tseng, "Audit Pricing and Independence," ***Accounting Review*** **(April 1990), p. 317.**

> [We] define independence as an auditor's making reporting decisions consistent with his or her beliefs as to whether the reporting decision may be regarded as an audit failure. That is, an auditor compromises his or her independence when

> he or she allows the client to use a reporting policy that he or she believes would be viewed as an audit failure.

Other researchers have developed formal theoretical models of the manager–auditor–stockholder relationship based on the principles of game theory. In the context of auditors and managers cooperating in pursuing their own self-interests, some of these models include analytical definitions of alternative expressions of auditor independence.[85]

21 Mark Penno and John S. Watts, "An Independent Auditor's Ex Post Criteria for the Disclosure of Information," ***Journal of Accounting Research*** **(Supplement 1991), p. 195.**

> If the auditor's preferences over disclosures depend neither directly on management's wishes nor indirectly on management's preferences (for example, through future audit fees), one could say that the auditor is "independent."

[85] See, for example, Rick Antle, "The Auditor as an Economic Agent," *Journal of Accounting Research* (Autumn 1982), pp. 503-27, and "Auditor Independence," *Journal of Accounting Research* (Spring 1984), pp. 1-20.

Independence
Standards
Board