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Auditor's independence: An analysis of Montgomery's auditing textbooks in the 20th century

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AUDITORS’ INDEPENDENCE: AN ANALYSIS OF MONTGOMERY’S AUDITING TEXTBOOKS IN THE 20TH CENTURY

Abstract: This paper presents the progress of auditor independence from a textbook perspective during the 20th century and into the present. It analyzes the multiple editions of Auditing Theory and Practice by Robert Montgomery. The lengthy time span of these editions is divided into several shorter periods based on major changes and developments in auditor independence. Finally, the paper uses several criteria related to auditor independence to review how the Montgomery text covered these changes and developments.

INTRODUCTION

A review of the literature shows that auditor independence is considered an abstract concept and a state of mind. It is defined as an auditor’s unbiased viewpoint when preparing and issuing an audit report. It is synonymous with honesty, integrity, objectivity, courage, and character. Auditor independence is also viewed as “freedom from the control of those whose records are being reviewed” [Youkins, 1996, p. 322]. It means, in simplest terms, that auditors tell the truth as they see it and are not influenced by other factors, financial or otherwise, while rendering an unbiased opinion.

This paper focuses on the evolution of auditor independ-
ence from a textbook perspective. Auditing textbooks have been important in teaching independence, ethics, and professional values, among other topics, to accounting students before they join the workforce. The emphasis on independence in the textbook has changed over the course of the 20th century as authoritative professional pronouncements have provided new definitions and rules.

Robert Hiester Montgomery’s auditing textbook was chosen for analysis because it is the oldest auditing textbook in the U.S. Montgomery’s career in accounting began in 1889 when he worked as an office clerk for a public accounting firm where he was taught accounting and auditing. In 1898, Montgomery was a founding partner in Lybrand, Ross Bros & Montgomery (LRB&M), later Coopers & Lybrand and currently PricewaterhouseCoopers (PwC). Early in his career, he was associated with several accounting organizations – president of the New York State Society of CPAs in 1922, president of the American Association of Public Accountants (AAPA) from 1912 to 1914, and president of the American Institute of Accountants (AIA) from 1935 to 1937. Although Montgomery passed away in 1953, his textbook continued to be published throughout the remainder of the 20th century by his colleagues at LRB&M, C&L, and/or PwC. Montgomery’s auditing textbook is particularly relevant since many of its recent authors were practitioners, audit partners at Montgomery’s firm and its successors, who also served as accounting standard-setters.

The first edition of Montgomery’s Auditing Theory and Practice was published in 1912, with later editions continually updated and published throughout the 20th century. Montgomery had previously published Auditing: A Practical Manual for Auditors. Since this book was used in higher education from 1905-1912, the paper starts with this book and then continues with Auditing Theory and Practice.

L.R. Dicksee, a native of London and professor of accounting at the University of Birmingham, began his connection with accounting literature in 1891. From that time forward, he became a valued author of many accounting books and journal articles. The 1905 edition of Montgomery’s text contains an authorization from Dicksee explaining that the text encompassed his work with modifications making it applicable to American

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students and professionals. Included in the preface, Montgomery admits that most of the text is taken word for word from Dicksee’s English version, with changes made to reflect “…numerous differences existing between accountancy nomenclature, laws and customs of Great Britain and the United States” [Dicksee and Montgomery, 1905, p. 7]. Montgomery chose Dicksee’s work as his starting point because Dicksee’s British publications had been followed in both the U.S. and the U.K. as standard works on auditing. From this first version, Montgomery began publishing his own texts focusing solely on the U.S.


Criteria against which auditor independence is evaluated are given in Table 1 and are referenced by number in tracing developments in Montgomery’s textbook. These criteria can affect auditor independence, according to the Rules of Professional Conduct (RPC)3 and SEC rulings. Current rules and rulings are used in Table 1 because they are the most comprehensive developed over time. In addition, they could serve as a benchmark to date milestones in the evolution of independence.

Independence criteria are classified into seven categories in Table 1: 1) state of mind; 2) indebtedness to client; 3) ownership, employment, and other interests; 4) disputes with clients; 5) partner and staff rotation; 6) consulting and management advisory services; and 7) audit fees. The last criterion suggests that since auditors are paid by management, they may accept client positions to obtain the audit job in the future. This is a controversial issue which AICPA and SEC rules do not consider an impairment of independence. However, a 2003 ruling by the SEC requires the audit committee to set the audit fee to minimize the dependence of the auditor on the company.

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2Terms “expansion” and “controversy” periods are adopted from Previts and Merino [1998] with minor changes in the dating of periods.

3These rules were promulgated by authoritative professional bodies, the American Institute of Accountants (AIA) and the American Institute of Certified Public Accountants (AICPA).
TABLE 1
CRITERIA AFFECTING AUDITORS’ INDEPENDENCE

<table>
<thead>
<tr>
<th>1. State of Mind:</th>
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<tbody>
<tr>
<td>• Integrity</td>
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<tr>
<td>• Objectivity</td>
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<tr>
<td>• Character</td>
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<td>• Honesty</td>
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<td>• Courage</td>
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<tr>
<th>2. Indebtedness to Clients:</th>
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<tbody>
<tr>
<td>• Transaction with clients (e.g., loans received from clients by auditors)</td>
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<tr>
<td>• Gifts received from clients</td>
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<tr>
<td>• Lunch with clients</td>
</tr>
<tr>
<td>• Commission received from clients</td>
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<tr>
<th>3. Ownership, Employment, and Other Interests:</th>
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<tbody>
<tr>
<td>• Direct and indirect ownership interest in clients</td>
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<tr>
<td>• Employment relationships (both directly or indirectly through family members)</td>
</tr>
<tr>
<td>• Contingent fees</td>
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</tbody>
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<tr>
<th>4. Disputes with Clients:</th>
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</thead>
<tbody>
<tr>
<td>• Litigation between auditors and clients</td>
</tr>
<tr>
<td>• Unpaid fees</td>
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<tr>
<th>5. Partner and Staff Rotation</th>
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<table>
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<tr>
<th>6. Consulting and Management Advisory Services:</th>
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<tr>
<td>• Accounting services</td>
</tr>
<tr>
<td>• Tax services</td>
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<tr>
<td>• Management advisory services</td>
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<tr>
<td>• Other consulting services</td>
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</table>

| 7. Audit Fees                                       |

Source: The AICPA RPC and SEC Rulings

THE EARLY YEARS (PRE-1929)

During this period, Montgomery published five books: Auditing: A Practical Manual for Auditors in 1905, and the first four editions of Auditing Theory and Practice in 1912, 1915, 1921, and 1927. Each book is reviewed with regard to the seven independence criteria. The chief objectives of an audit during this period were to certify the financial condition and operations of an enterprise for its proprietors, executives, bankers, or investors, as well as detection of fraud or errors, with due consideration given [Montgomery, 1912]. These objectives remained constant throughout this period.

1905: The first auditor independence criterion, state of mind, was emphasized in this book. Montgomery noted that desir-
able qualifications of auditors included “tact, caution, firmness, fairness, good temper, courage, integrity, discretion, industry, judgment, patience, clear-headedness, and reliability” (p. 260). In explaining desirable qualifications for an “audit clerk,” Montgomery identified conscientiousness and reliability as important qualifications (p. 261). Montgomery (p. 261) further referred to the second auditor criterion when he noted: “The clerk would be wise … not to get too friendly with his client’s staff. Let him be cautious of accepting favors, and most cautious of accepting presents – which might easily drift into bribes.” To ensure that this did not occur, Montgomery suggested “occasionally changing the rounds of the audit clerks,” a suggestion related to the fifth auditor independence criterion.

Interestingly, Montgomery indirectly touched upon the last criterion of auditor independence, audit fee, in his book. He observed (p. 265):

> It is not unnatural that a president, or treasurer, who has, of his own volition, departed from the past policy of his company and called in a professional auditor, should feel some resentment if his own acts when under review do not meet with the approval of the auditor. This resentment is even more marked when the auditor has received the appointment largely as a matter of friendship (which is also of frequent occurrence).

To avoid this problem, he suggested that the stockholders should appoint auditors.

**1912, First Edition:** Montgomery (pp. 30-31) classified the first indirect showing of independence under “auditors’ qualifications” as absolute integrity, courage, and trustworthiness. More specifically, a professional auditor must have impeccable morals and a reputation for absolute integrity, along with the courage to proclaim the truth fearlessly. Montgomery contended that the auditor must be neutral about the interests of the business owners they are auditing as per criterion one. “The auditor must maintain the strictest neutrality, ... and the auditor who has shown any signs of favoritism may find himself in an unpleasant position” (p. 40).

The second criterion was implied in Montgomery’s description of an audit clerk’s attitude. He will reflect “friendly interest,”

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4The use of the term “audit clerk” by Montgomery implies professional auditors at any level working for public accounting firms.
meaning that the relations between an audit clerk and a client are close and confidential, but not “so friendly” that suspicion may arise questioning the clerk’s skill or eagerness to criticize or report on errors (p. 31).

The third criterion is touched upon when Montgomery averred: “A staff auditor cannot very well occupy two positions at the same time; he cannot originate or carry out a transaction which is administrative and later attempt independently to check the same operations” (p. 38). The above quote implies an employment relationship. Montgomery noted that having one individual to carry out administrative duties and later have the responsibility to check the same operations would be more likely to lead to fraud or go unnoticed.

As in 1905, Montgomery indirectly referred to audit fee, the last criterion. He stated (p. 48):

Auditors are sometimes placed in an embarrassing position through their appointment by the very officer whose accounts they are supposed to audit and criticize. This is peculiarly a situation which requires tact. In view, however, of the clear duty of an auditor to be helpful, it need not be assumed that the work cannot be done as well as in the case of a more independent appointment.

In this edition, Montgomery also reproduced Article VI of the by-laws of the AAPA, submitted at its September 1912 annual meeting. The second Rule of Conduct expressively relates to the second and third criteria (p. 57):

No member shall directly or indirectly allow or agree to allow a commission, brokerage, or other participation by the laity in the fees or profits of his professional work, ... nor perform accountancy work payment for which is contingent upon the result of litigated or arbitrated issues.

The third Rule of Conduct of the by-laws read, “no member shall engage in any business or occupation conjointly with that of a public accountant, which in the opinion of the Board of Trustees is incompatible or inconsistent therewith.” This also addressed the third independence criterion.

In summary, the first edition placed a significant emphasis on integrity and rules of professional conduct [Hatfield, 1913]. In addition, several pages of the book were allocated to legislation pending in Pennsylvania and New York relating to the appointment of the auditor and the auditor’s remuneration.
However, there is no direct discussion of independence and confidentiality. According to Previts and Merino [1998, p. 204]:

Many believed to do so would mean inevitable dilution of intent. Accountants sought, rather, through the national organization and within the practitioners’ offices, to internalize those values so that they were completely accepted and respected by everyone who entered the profession of public accounting. They believed that intellectual independence and confidentiality were absolutes that must apply in all circumstances.

1915, Second Edition: In contrast to the foregoing, this edition did not include most of the independence criteria. Even the first criterion was not sufficiently emphasized in this edition. The only other criterion discussed was contingent fees. Montgomery acknowledged in the preface that chapters on ethics had been deleted to allow space for new materials. Omitting the chapter on ethics in this edition was, therefore, a disservice to students and the practice of accounting. While the next two editions of the textbook started to include some rules of professional conduct, it was not until the 1934 edition that Montgomery again included more discussion of independence and ethical values.

1921, Third Edition: In the preface of the third edition, Montgomery noted that during the years since the second, he had received many criticisms and suggestions from students and other readers of the textbook. Since a new section on professional ethics was now again included, it is reasonable to assume that one criticism was the elimination of the ethics chapter. This shows that the concept of professional values, ethics, and independence was of great importance early in the 20th century and has continued to the present.

As Montgomery wrote in the preface of this edition, the book claimed to be comparable to a general audit program. Therefore, it was similar to the previous edition with regard to covering independence criteria with a slight variation. It added a section on professional ethics which included the eleven Rules of the AIA. Rule four, which related to the second criterion, proclaimed (p. 13):

No member shall directly or indirectly allow or agree to allow a commission, brokerage or other participation by the laity in the fees or profits of his professional work; nor shall he accept directly or indirectly from the laity any commission, brokerage or other participation
for professional or commercial business turned over to others as an incident of his services to clients.

The eleventh and final rule related to criterion three. This rule provided that: “No member shall render professional service, the anticipated fee for which shall be contingent upon his findings and results thereof” (p. 14). Other than this minimal change, this edition was similar to the second.

1927, Fourth Edition: Like the third edition, there was not much change in the 1927 text. The rules of the AIA on professional ethics were reproduced as in the previous edition. The only differentiation was that this edition added another section featuring a discussion of professional ethics in which Montgomery asked for “an even wider conception of moral responsibility” (p. 19) rather than mere adherence to the rules of professional ethics.

Summary: During the early years, the audit profession started to mature. This period witnessed an importance placed on integrity and objectivity with little emphasis on independence. In discussing independence and confidentiality notions, Previts and Merino [1998, p. 204] noted:

- It was assumed that any person permitted into the ranks of accountancy had been conditioned to accept both notions as fundamental norms during this period of practice experience. If that were not the case, then the practitioner-mentor had an ethical and moral responsibility to see that the person who did not measure up was barred from admission into the profession. Practitioners rejected the idea that by promulgating rules – especially rules that by their nature could have dealt only with peripheral matters – either confidentiality or appropriate independence could be assured.

While the textbooks during the first half of this period included an extensive discussion of the rules of professional conduct and seemed to emphasize the concepts of integrity and objectivity of professionals, the second-half editions either completely ignored the ethical values or minimally covered the eleven written RPC promulgated by the AIA, primarily those dealing with other responsibilities and practices of auditors.

Montgomery [1912] suggested that audit firms obtain bonds on the audit clerk to assure independence and proper audit. He stated that by requiring bonds, “the employer is assured that a
most exhaustive inquiry is made into each applicant’s character and reputation, extending back over a considerable period of years” (p. 39). This was an innovative idea, but since auditing firms did not seriously pursue it, this idea was dropped from later editions.

Montgomery [1912, p. 48] recommended that auditors must report what he called “severe criticism” and avoid reporting “unimportant matters.” He further suggested that reporting severe acts and omissions of the officers could result in “a dislike of all professional auditors and a failure to give consideration to the report.” This is because, according to Montgomery, the officer was much closer to the board of directors than the auditor. Therefore, if anything short of fraud was reported, the auditor would lose prestige and perceived value, which in the long run might also hurt the whole profession. These arguments seemed to contradict the whole idea of independence. During this period, the auditor and firm only needed to certify that the financial statements were correct. The other reason may be that a very small number of corporations were audited and there was a tendency to increase audits, even without a lack of independence. For example, Montgomery [1912, pp. 48-49] noted that: “Some slight advance has been made towards popularizing a provision in the corporation by-laws requiring the accounts to be audited by professional accountants, but such a provision has, so far, not been adopted by even one per cent of the corporations of the United States.”

In summary, there was no formal definition or rule on auditor independence during this period, just random pieces implying that independence should be used. In terms of the independence criteria, the main focus was on state of mind with some sporadic and indirect discussion of indebtedness to clients, ownership, employment and other interests, partner and staff rotation, and audit fees.

**STOCK MARKET CRASH PERIOD (1929–1945)**

Although the stock market crash occurred in 1929, ramifications from it did not appear in Montgomery’s textbooks until the 1940 edition. It can be argued that independence was not considered an issue during the decade of 1930s because auditors were never considered contributors to the 1929 crash. The main causal factors were stock speculation, margin buying, and stock manipulation. In addition, according to Seligman [1982], hearings of the Senate Banking Committee and other congressional
hearings identified a number of other causes: high salaries and interest-free loans for corporate executives, various tax-avoidance schemes, payments to publicists intended to inflate stock prices, family members of corporate insiders who profited from trading in their own company's stock, various other efforts to manipulate the market and specific stock prices, and an investment banking system that allowed politicians and corporate executives to make quick profits by buying stocks at low prices and selling them after the companies went public. Since auditors were not considered a major contributor to the 1929 crash, Montgomery may not have felt it was necessary to include the independence issue in the 1934 edition. During this period, there were only two new editions of Montgomery's text, those of 1934 and 1940.

1934, Fifth Edition: In this edition, the word “independence” first appeared in Montgomery's textbook. For example, in discussing the banks' need for auditor reports, Montgomery stated that “the auditor, by reason of his experience and independence, is able to assist the banker in forming his judgment” (p. 20). He also observed, “all partnership books should be adjusted by a professional accountant, if for no reason than that he will act impartially” (p. 21). It should be noted that the concept of independence had just begun to appear in practice. Therefore, the way it was treated (i.e., adjusting books by an independent professional accountant) could have been different from what is considered independence today.

Several passages indirectly referred to the independence criteria. Montgomery linked the audit fee to independence when he suggested that the auditor's report should be “made to the stockholders, not to the officers and directors” (p. 22). He referenced the RPC in which rules four and ten were linked to the second and third criteria respectively. In addition, rule 12, incorporated into the RPC and reflected by the third criterion, stated (p. 14):

No member or associate of the Institute shall be an officer, director, stockholder, representative, agent, teacher or lecturer, nor participate in any other way in the activities or profits of any university, college or school which conducts its operations, solicits prospective students or advertises its courses by methods which in the opinion of the committee on professional ethics are discreditable to the profession.

Similar to the fourth edition, the fifth added another section on professional ethics in which Montgomery “urges an even
wider conception of moral responsibility” (p. 14) than simple adherence to the RPC. He again emphasized “honesty” and noted, if one “is not absolutely honest, he is never free from bias and is unable to separate truth from falsity; it may even be said he cannot distinguish the essential from the nonessential” (p. 10).

1940, Sixth Edition: In this edition, there were major changes on the auditor independence issue. The 1929 crash was a major explanatory factor in the changes. The word “independence” was first used and defined here, and implementation rules on auditor independence were contained in the Securities Acts. Thus, the crash not only spawned the Great Depression but also revealed unacceptable accounting practices at public companies that had gone bankrupt.

Montgomery defined independence as follows: “Independence, in the sense used above, is the opposite of subservience; it implies an attitude of mind completely objective, without bias, and free from the influence of any affiliation which affect judgment or any matter” (p. 18). While Montgomery noted that it is difficult to determine what circumstances might affect auditor independence, he referred to direct employment, “ties of friendship or kinship between the auditor and personnel of his client” and direct ownership interest in clients as factors that reduced auditor independence (p. 18).

Montgomery noted that a demand for independent public accountants to examine published financial statements had grown quickly over the past few years. It was perceived as an advantage for stockholders when the company had an independent audit. In addition, certain rules and regulations had been implemented based upon having an independent public accountant. First, if a corporation’s securities were listed on the national securities exchanges, it should file financial statements with an accompanying report from an independent public accountant. This should be a component of the initial registration statement, as well as part of succeeding annual reports required to be filed with the SEC. Second, it was required by the New York Stock Exchange (NYSE) that for listing after July 1, 1933, except for railroads, independent public accountants must audit the annual reports of listed companies. Third, as part of the Security Act of 1933, investment bankers considered it crucial that financial statements be accompanied by independent public accountants’ reports as part of the initial public offering of securities. Fourth, there was a provision for indentures implemented with bonds that stated that trustees should be provided annually financial
statements and a report from an independent public accountant. Finally, grantors usually required reports by independent public accountants prior to extending credit.

“The independence of public accountants is crucial to the credibility of financial reporting and, in turn, the capital formation process” [Walker, 2002b, p. 11]. The new requirements for independent audits did not shift the SEC’s and the NYSE’s focus away from reliability, but rather expanded it because reports issued by an independent auditor were viewed as reliable by the public. Auditor independence is crucial because two important qualitative characteristics, relevance and reliability, are captured by the auditor’s assurance on financial statements.

On May 6, 1937, the SEC recognized the significance of a professional accountant’s total independence when reporting on financial statements. An independent audit provides the public the confidence needed in relying on financial statements, which then promotes investments in the securities of public companies. Montgomery (p. 18), in keeping with criterion three, wrote of Accounting Series Release #2:

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

Summary: During this era, there was formal mention of auditor independence. It was in the 1940 edition where Montgomery fully explained independence and its implementation. Given the 1929 crash, he realized that something had to be done. However, the actual change did not appear in his textbook until 1940 when he wrote:

The importance of independence is emphasized when there may be apparent conflict of interest between management and stockholders, or between classes of security holders; the auditor must be independent to insure his arriving at an unbiased opinion in the face of conflicting interest (p. 18).

The Securities Acts made some impact on auditor independence, but as Previts and Merino [1998, p. 273] noted, they were “designed to restore public confidence in the economic system,” and represented little more than symbolic regulation. The rules of auditor independence were considered adequate during this
period,\(^5\) as evidenced by the statement of James Landis [1936, p. 4], chairman of the SEC, that “the impact of almost daily tilts with accountants, some of them called leaders of their profession, often leaves little doubt that their loyalties to management are stronger than their sense of responsibility to the investor.” Likewise, the comment of Robert Healy [1938, p. 5], commissioner of the SEC, categorized auditors as “special pleaders for their more lucrative clients.”

In summary, while “independence” started to appear during this period in the textbook, there were still few rules or directions with regard to auditor independence. From the independence criteria, the main focus was still on the state of mind criterion with some discussion of criteria two and three and indirect references to criterion seven.

**EXPANSION PERIOD (1946-1959)**

After World War II, the American economy started to grow at a rapid rate. The expansion of American businesses led to the need for new auditing standards. In October 1947, the CAP issued a statement on auditing standards. General Standard #2 prominently dealt with independence: “In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors” (p. 12). Under the section “Independence of Public Accountants,” independence was considered a “reflection of honesty and integrity” (p. 22).

**1949, Seventh Edition:** This edition of Montgomery's textbook is coauthored by Lenhart and Jennings, both CPAs and working practitioners at LRB&M. Throughout this edition, “the professional attribute of independence” was articulated with emphasis given to the Statements on Auditing Standard by the CAP and the RPC. Montgomery reprinted the Statements on Auditing Standard, which included general standards, standards of field work, and standards of reporting. Specifically, General Standard #2, “in all matters relating to the assignment an independence in mental attitude is to be maintained by the auditor or auditors” (p. 12), directly relates to the first criterion of independence.

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\(^5\) The reason that independence was not considered adequate until the 1940 edition could be due to the fact that no authority existed to establish accounting standards in the 1930s. In fact, it was not until 1938 that the SEC delegated its authority to set accounting standards to the AIA and the Committee on Accounting Procedures (CAP). In addition, Montgomery himself was not a fan of independence [Previts and Merino, 1998].
Similar to the previous edition, Montgomery discussed the value of independence for different services offered by public accountants. He contended that “even in services in which independence is not expected, the public accountant should maintain his objectivity, honesty, and integrity” (p. 8). The main focus of independence still rested on a “reflection of honesty and integrity” (p. 22). Although Montgomery referred to this as a RPC, those rules of conduct were not specifically reproduced in this edition. Instead, he referred the reader to Professional Ethics of Public Accounting, published in 1946 by John L. Carey, executive director of the AIA.

This edition, as well as the later 1957 one, presented Rule 2-01 of the SEC with regard to the “Qualification of Accountants.” Part (b) of this rule explained how the Commission would only recognize an accountant as independent if he was, in fact, independent. For example, if an accountant had any direct or indirect financial interest in a client for whom he was working, he could not be considered independent. Part (c) of the rule specified how to determine if an accountant was in fact independent. In brief, it stated, the Commission must have given proper thought to all relevant circumstances to all relationships between the accountant and the client to determine independence. In addition, the Commission had the authority to disqualify or deny an accountant the ability to appear or practice before it, if the person was found “not to possess the requisite qualification to represent others; or to be lacking in character or integrity or to have engaged in unethical or improper professional conduct” (p. 503). This was stated under Rule II (e) of the Commission’s Rules of Practice.

1957, Eighth Edition: Since Montgomery passed away in 1953, this edition of Montgomery’s book was authored by Norman Lenhart, LRB&M chairman, and Philip Defliese, a prominent LRB&M partner. In an effort to describe the independence of public accountants, the 1957 textbook discussed those accountant’s qualities related to independence. For instance, the authors opined that “independence is an inward quality, not susceptible of objective determination or definition” (p. 24). An accountant’s principal asset was his independence and integrity. The authors mention that public accountants needed independence in attitude to be truly independent.

In this edition, the RPC, as revised in December 1950, were once again published. The authors stated that “these rules are of such importance in reinforcing requirements of general
standards for adequate training and efficiency, independence, and due care that they are reproduced” (p. 21). Rules related to independence were [pp. 22-23]:

(3) Commissions, brokerage, or other participation in the fees or profits of professional work shall not be allowed directly or indirectly to the laity by a member. Commissions, brokerage, or other participation in the fees, charges, or profits of work recommended or turned over to the laity as incident to services for clients shall not be accepted directly or indirectly by a member.

(9) Professional service shall not be rendered or offered for a fee which shall be contingent upon the findings or results of such service....

(11) A member shall not be an officer, director, stockholder, representative, or agent of any corporation engaged in the practice of public accounting in any state or territory of the United States or the District of Columbia.

(13) A member shall not express his opinion on financial statements of any enterprise financed in whole or in part by public distribution of securities, if he owns or is committed to acquire a financial interest in the enterprise which is substantial either in relation to its capital or to his own personal fortune, or if a member of his immediate family owns or is committed to acquire a substantial interest in the enterprise....

While rule three reiterates the second criterion, rules nine, eleven, and thirteen relate to the third criterion.

This edition also emphasized the first criterion by stating that “independence is a reflection of honesty and integrity.” In addition, rule five of the RPC had “special importance” because it described acts that were considered “discreditable to the profession” (p. 24):

It supports the public accountant in his insistence upon an independent attitude, emphasizes the necessity for application of generally accepted accounting principles and for making his examination in accordance with generally accepted auditing procedures applicable in the circumstances, and is of great importance in determining the public accountant’s responsibilities for his opinion on financial statements.
Summary: For the first time during this period, there were official guidelines to follow that related to auditor independence. The statement on auditing standards, which discussed independence under its general standards, appeared in the 1949 edition and in all future editions. Independence was becoming an official component of generally accepted auditing standards to be followed by all public accountants. Still, independence in fact was considered important but with no attention paid to independence in appearance. In addition, “despite the rapid growth in scope of services to include tax and management services, which created serious questions about [the] independence of audit firms” [Previts and Merino, 1998, pp. 338-339], there was no discussion of the effect of consulting and management accounting services (criterion six) on auditor independence in Montgomery’s auditing books during this period.

CONTROVERSY PERIOD (1960-1975)

This period was marked by controversy over accounting methods (e.g., historical cost versus replacement cost), corporate social responsibility (e.g., social accounting and social audits), and whether “relevance” should have been the primary determinant of an asset’s existence. In addition, due to expanded services by audit firms, the AICPA adopted new rules of conduct in 1973, which required independence both “in fact” and “in appearance” for audit opinions on financial statement fairness. In 1975, the ninth edition of Montgomery’s textbook was published, 18 years after the last edition.

1975, Ninth Edition: This edition was authored by three CPA practitioners (Defliese, Johnson, and Macleod; all partners at C&L) who discussed independence in great detail as part of general auditing standards. After defining independence based on the Statement of Auditing Standards, the textbook used authoritative pronouncements to elaborate the independence issue. In particular, the Code of Professional Ethics and Regulation S-X are quoted ([pp. 18-19]).

The Code of Professional Ethics introduced Rule 101 “Independence,” providing that, “a member or a firm of which he is a partner or shareholder shall not express an opinion on financial statements of an enterprise unless he and his firm are independent with respect to such enterprise” (p. 18). The rule gave examples of when independence was impaired; however, it reminded the reader to keep in mind that the given examples were not all-inclusive. The examples can be categorized under
the first three independence criteria.

The text maintained that “auditor’s independence and objectivity must be visible and explicit rather than underlying and implicit” (p. 20). Also, Statements of Auditing Standard #1 and #4 explain how one must not only be independent in fact, but also must appear independent. The SEC provided details on relationships that may or may not lack independence. Those details parallel criterion three. Two of the examples provided were (p. 20):

No partner in an auditing firm, nor a member of his immediate family, is permitted to own even one share of stock of a client or affiliated company or even to participate in an investment club that does hold such shares, no matter what his personal fortune, the size of the company, or his distance from the actual work of the audit.

An auditing firm may not have its employees/pension fund managed by an investment counselor that also manages a mutual fund client; there is no actual financial relationship, but there might be an appearance of lack of independence.

The textbook also covered audit fee, observing that “the greatest practical threat to an auditor’s professional, independent mental attitudes is that he is often selected, retained, or replaced at the sole discretion of the management on whose representations he is expected to report” (p. 20). The authors suggested that the selection and retention of auditors by the stockholders should have remedied this independence problem. Another way to reduce this type of independence problem was to report to a committee of “outside directors” of a client company.

**Summary**: The major change that took place during this period was the emergence in authoritative pronouncements of the independence issue as a concept of both “independence in fact” and “independence in appearance.” According to Previts and Merino [1998, p. 339], “accountants had long recognized the importance of maintaining independence in appearance as well as in fact.” They contended that the 1962 Code of Professional Conduct included a rule to that effect. However, it was not until 1975 that independence in appearance was introduced in the textbook.

**IDENTITY CHANGE PERIOD (1976-1990)**

This period was characterized by a rapidly expanding practice base and changes in the range and scope of services [Previts
and Merino, 1998]. During this period, the tenth and eleventh editions were published.

1987, Tenth Edition: This edition was authored by Defliese (retired chairman of C&L and professor at Columbia University), Jaenicke (professor at Drexel University), Sullivan (C&L director of audit policy), and Gnospelius (C&L managing partner). In this edition, the authors dropped the discussion of SEC Independence Rule 2-01 of Regulation S-X, but added many new elements to the textbook.

First, the role of independent audits as described by the Financial Accounting Standards Board in Statement of Financial Accounting Concepts No. 1 was quoted:

...Independent auditors commonly examine or review financial statements and perhaps other information, and both those who provide and those who use that information often view an independent auditor's opinion as enhancing the reliability or credibility of the information (p. 10).

Second, there was a discussion of control, which was considered an audit function by the American Accounting Association Committee on Basic Auditing Concepts. It was seen as an audit function to maintain control over the quality of information because it acted as an independent check on information. Moreover, if the preparer knew that an independent auditor would be checking his work, he would take greater pains to guarantee its accuracy.

The AICPA Code of Ethics and its four categories – Concepts of Professional Ethics, Rules of Conduct, Interpretations of Rules of Conduct, and Ethics Rulings – were discussed in detail. Also, five ethical principles were included in the Code ET Section 51.07, and independence, integrity, and objectivity were embodied in the Code ET Section 52.01. ET Section 52.02 defined independence as “the ability to act with integrity and objectivity.”

The Statements on Auditing Standard and the Code of Professional Ethics both explained the importance of appearing to be independent, when such was not the case. Subsequently, there was a discussion of Interpretation 101-3 (ET Section 101.04) relating to accounting services (criterion 6), Interpretation 101-4 (ET Section 101.05) relating to family relationships (criterion 3), and Ethics Ruling 52 (ET Sections 191.103-104) relating to past-due fees (criterion 4). For accounting services,
Interpretation 101-3 permitted (pp. 64-65):

Members to provide bookkeeping or data processing services to nonpublic audit clients only if the following requirements are met: ... no relationship or conflict of interests between the CPA and client ..., CPA must not assume the role of an employee or management of the client, ... the CPA must comply with generally accepted auditing standards.

Interpretation 101-4 addressed three categories of family relationships. The first category enjoined a member’s spouse, dependent child, or relative living in his household from having financial interests or business relationships with the particular client(s). Next, close kin, siblings, parents, etc., were not allowed to have “significant financial interest” in the client. Finally, remote kin, uncles, aunts, cousins, etc., were not “ascribed” to the client unless there was “closeness” with the client.

Ethics Ruling 52, concerning the impact on independence of past-due fees, was reviewed. It stated, “Independence may be impaired if more than one year's fees are unpaid when the member issues a report on the client's financial statements for the current year (p. 65).”

The text also mentioned Rule 302 (ET Section 302.01) related to contingent fees (criterion 3) and Rule (503) ET Section 503-01) related to commissions received from clients (criterion 2). Rule 302 provided (p. 70):

Professional services shall not be offered or rendered under an arrangement whereby no fee will be charged unless a specified finding or result is attained, or where the fee is otherwise contingent upon the findings or results of such services. However, a member's fees may vary depending, for example, on the complexity of the service rendered.

Rule 503 read, “A member shall not pay a commission to obtain a client, nor shall he accept commission for a referral to a client for products or services of others” (p. 73).

Statement on Quality Control Standard #1 described nine elements relating to a firm’s quality control and mandated firms to consider them all. Element eight, independence, urged that “policies and procedures should be established to provide the firm with reasonable assurance that persons at all organizational levels maintain independence to the extent required by the rules of conduct of the AICPA” (p. 76).
Finally, there were three other relevant discussions relating to independence. One was concerning disciplinary actions against individuals for violating the Code of Professional Conduct. Another dealt with proposals to enhance the independence of audits, including “protecting the auditor from management influence” through the audit committee and transfer to the public sector (criterion 7), “rotation of auditors” (criterion 5), and “prohibition of non-audit service” (criterion 6). In summary, this edition provided a comprehensive discussion of independence issues but for some minor items.

1990, Eleventh Edition: The eleventh edition was authored by Defliese, Jaenicke, O’Reilly (C&L deputy chairman of accounting and auditing), and Hirsch (C&L vice-chairman of auditing). This edition included only minor changes from the tenth. It added the six principles of the Code of Professional Conduct: responsibilities, the public interest, integrity, objectivity and independence, due care, and scope and nature of services. This edition dropped the discussion of ET Section 52.01 with regard to independence, integrity, and objectivity, but added definitions for integrity and objectivity (p. 61). Finally, this edition included Rule 102, which stated:

In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others (p. 64).

In addition, this edition noted that the SEC had certain requirements including the periodic rotation of partners, review of audit reports by another partner, and annual communication by the audit committee. A discussion of audit personnel rotation was also included in this edition, but it was noted that the Cohen Commission had not made it a requirement.

Summary: Independence was becoming imperative and was described in much more detail than prior editions. Public accountants who violated the Code of Professional Conduct could have had disciplinary actions taken against them, including “letter of minor violation,” “administrative reprimand,” or “presentation of a prima facie case to a joint trial board” (p. 80). However, as Previts and Merino [1998, p. 339] noted, “the Code was not as forceful as it could have been” in disciplinary actions against public accountants.
Although the SEC, the AICPA Code of Professional Conduct, generally accepted auditing standards, and individual firms required independence, total independence may have been impossible to attain. There were always potential threats since the client selected and paid the auditor. Auditors themselves were aware of how vital independence was to their reputations, but there was no guarantee that independence would be maintained. Other non-audit services, such as tax and management services, were also threats to auditor independence because neither the SEC nor the AICPA prohibited these services from attest engagements.


In this period, a significant portion of public accounting firms’ revenue was derived from tax and management consulting services, which overshadowed auditing fees. During this period Montgomery's twelfth edition was published. The biggest change that post-dated the 1998 textbook was the creation of a new regulatory structure in the aftermath of the Enron/Arthur Andersen scandal.

**1998, Twelfth Edition:** The authorship team for this edition were O'Reilly (a retired C&L vice-chairman), three PwC assurance partners (McDonnell, Winograd, and Gerson), and Professor Jaenicke once again. This edition was mostly consistent with the previous one regarding auditor independence. Major changes on the topic included the Independence Standards Board (pp. 3-12); SEC Independence Rule 2-01 of Regulation S-X, included in the ninth edition but subsequently dropped (pp. 3-13); an expanded discussion of loans received from clients (pp. 3-14); independence and agreed-upon procedure engagements and interpretation 101-11 (pp. 3-15); and auguring the future, a discussion of the prohibition of management advisory services, focusing on the SEC’s Staff Report on Auditor Independence, which concluded that no changes in SEC rules and regulations were needed.

The edition also touched upon extended audit services and interpretation 101-13, stating that: “Extended audit services, such as assisting in the client’s internal audit activities and performing audit services that go beyond the requirement of GAAS, does not impair independence, provided the CPA does not act or appear to act in the capacity of the client’s management or employees” (pp. 3-15).
Finally, the text discussed “Strengthening the Professionalism of the Independent Audit,” a report published by the Advisory Panel on Auditor Independence, which was appointed by the Public Oversight Board (POB).

**Summary:** Only one edition of Montgomery’s auditing textbook appeared during this period. A detailed discussion of independence criteria was presented in this edition, highlighting significant changes that had taken place up to the date of publication.

**LEGALIZATION PERIOD (2001-PRESENT)**

The Enron/Arthur Andersen scandal, as well as other accounting irregularities, spurred Congress to institute the Sarbanes-Oxley Act (SOX) in 2002. The Enron debacle caused a shift of focus as investors, creditors, and other users of financial statements began to lose trust that audit committees and boards of directors were effectively executing their assigned responsibilities. The following sections discuss developments in independence since the last publication of the Montgomery textbook in 1998.

2001 **POB – Final Annual Report:** In 1999, the Independence Standards Board adopted Independence Standard #1 which encouraged discussions with audit committees. However, in July 2001, the Board was terminated because the AICPA and the SEC did not agree with its actions. The POB felt that it was time for Congress to enact reform that would make a difference.

In January 2002, the Commission’s chairman, Harvey Pitt, issued a proposal to institute a new private-sector regulatory structure. However, the POB was excluded from the discussions, leading to its dissolution. The POB felt that a new regulatory structure would be both feasible and essential, and it recommended that Congress create the Independence Institute of Accountancy (IIA) to be the center of all regulations.

The POB suggested the IIA be comprised of a seven-member board to run the Institute independent of the AICPA and all accounting firms. The members should be appointed by a panel composed of the SEC chair, the Federal Reserve Board, and the secretary of the treasury. The funding should also be independent from firms. The important functions of the IIA would include “oversight of all standard setting bodies; yearly and special reviews; investor powers; international liaison; and profes-
sional education and training” [POB, 2001, p. 53].

**Present:** SOX set forth new auditor independence restrictions, and Congress required the SEC to adopt new implementing rules by January 26, 2003, to be placed into operation on May 6, 2003.

“For over 70 years, the public accounting profession, through its independent audit function, has played a critical role in enhancing a financial reporting process that has supported the effective functioning of our domestic capital markets, which are widely viewed as the best in the world” [Walker, 2002b, p. 8]. The demise of Enron led to the public questioning “the effectiveness of our systems of corporate governance, independent audits, regulatory oversight, and accounting and financial reporting, which are the underpinnings of our capital markets...” [Walker, 2002a, p. 29]. The public’s loss of confidence in independent auditors and the reliability of financial information made change imperative.

SOX attempted to balance auditor independence with audit quality. Two safeguards taken were “pre-approval by the audit committee of audit and non-audit services; and disclosure to investors of the company’s pre-approval policies and its audit and non-audit service fees” [Ernst & Young, 2003, p. 1]. These two safeguards relate to criteria six and seven.

As for non-audit services, three new restrictions were developed, “a prohibition on financial information systems design and implementation services; a prohibition on internal audit outsourcing services; and a restriction on certain types of ‘expert’ services” [Ernst & Young, 2003, p. 2]. The rules specified a rash of expert services that could no longer be provided “unless it is reasonable to conclude that the results of the service will not be subject to audit procedures during an audit of the client’s financial statements.... Tax services are the only permitted non-audit service that Congress specifically names, in passing the Act, as being subject to the audit committee pre-approval requirements and not included in the prohibited service restrictions” [Ernst & Young, 2003, p. 5]. However, recent rules of the Public Company Accounting Oversight Board (PCAOB) restrict the tax services that independent auditors can provide. According to the PCAOB new rules, independence is violated if an audit firm provides any non-audit service to a client relating to advertising, developing, or opinion rendering in favor of tax transactions that are performed under a confidentiality condition or are belligerent. Tax transactions are aggressive if
they meet at least one of these three criteria: (1) they are initially recommended by the audit firm, either directly or indirectly; (2) a significant purpose to the transaction is tax avoidance; or (3) the tax treatment is more likely to be disallowable under applicable federal, state, local, or foreign tax laws.

SOX provided that all non-audit and audit services should be pre-approved by the audit committee if performed by an independent auditor. Issuers are required to disclose the aggregate fees that are billed in the latest two fiscal years. Another requirement is a one-year cooling-off period for audit engagement team members to accept employment at a client in a “financial reporting oversight role” [Ernst & Young, 2003, p. 10]. SOX also imposes a maximum of five consecutive years of service for lead and concurring partners and seven years for other engagement team partners.

Another new rule from the SEC is mandatory communication from the auditor to the audit committee prior to filing an audit report disclosing [Ernst & Young, 2003, p. 13]:

- All critical accounting policies and practices to be used;
- All alternative treatments within generally accepted accounting principles for policies and practices related to material items that have been discussed with management of the issuer; and other written communications between the independent auditor and the management of the issuer.

In late 2004, effective in 2005, the AICPA updated the Code of Professional Conduct’s Independence Interpretation 101-3 and Outsourcing Professional Services. Independence Interpretation 101-3 was updated in the following three areas: client agreement of its responsibilities, documentation requirements, and applicability of the client agreement and documentation requirements. Outsourcing professional services added three new ethics rulings to the AICPA Code of Conduct. All these updates relate to the sixth criterion, consulting and management advisory services.

**Summary:** Despite major changes in independence rules during this period, no new edition of the Montgomery textbook has been published. These major changes are related to partner and staff rotation, which is becoming mandatory, and prohibition of performing most management advisory services on the part of external auditors.
CONCLUSION

Table 2 presents a summary of how the independence criteria, as identified in Table 1, are covered in different editions of the Montgomery textbooks discussed in this paper.

Prior to 1915, Montgomery textbooks emphasized state of mind, in addition to some discussion of other independence criteria. Rules of the AIA on professional ethics, eight of which appeared in 1917, are first recounted in the 1921 textbook. The word, “independence,” first appeared in the 1934 edition of the text. Although the Federal Trade Commission discussed “independence in fact” in 1933, that term did not appear in Montgomery until 1957.

Official guidelines with regard to independence appeared in 1947 in the Statements of Auditing Standard and were discussed in the 1949 edition. While greater emphasis was given to ownership, employment, and other interests in the 1957 edition, no attention was given to others, especially management advisory services despite its increase during this period. Independence in appearance was not mentioned in Montgomery's textbook until 1975, despite the fact that the 1962 Code of Professional Conduct included a rule to that effect. It should be noted that “independence in appearance” was officially included in the 1973 AICPA's RPC.

Independence was discussed in more detail in the 1987, 1990, and 1998 editions of Montgomery's textbooks covering most of the criteria that would impair independence. Still, the status of management advisory services (MAS) remained unchanged despite increases in these types of services by public accounting firms. Through the 1990s, MAS became the services provided by public accounting firms that produced the most debate over auditor independence. The failing of several companies in the early 21st century caused Congress to institute SOX, which drastically changed independence rules with respect to MAS and auditor rotation.

Generally, new developments in the area of independence took several years to be included in the textbook. There was typically a lag in publishing the Montgomery textbooks, and many of these textbooks were well out-of-date before the new editions were published. In addition, no new edition of the textbook has been published since 1998 despite monumental changes taking place post-2000.

The untimely inclusion of independence changes suggests that accounting students may not have received up-to-date
### TABLE 2
Summary of Independence Coverage in the Montgomery Textbooks

<table>
<thead>
<tr>
<th>Textbook edition</th>
<th>Independence Criterion</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1</td>
</tr>
<tr>
<td></td>
<td>state of mind</td>
</tr>
<tr>
<td>Pre-1915</td>
<td>tact, caution, firmness, fairness, courage, integrity, discretion, industry, judgment, patience, clear-headedness, and reliability</td>
</tr>
<tr>
<td>1915</td>
<td>no contingent fees</td>
</tr>
<tr>
<td>1921</td>
<td>be cautious of accepting favors and presents</td>
</tr>
<tr>
<td>1927</td>
<td>moral responsibility in relation with the clients, investors, lenders, business community, fellow members, and employees</td>
</tr>
</tbody>
</table>
### TABLE 2 (continued)

**Summary of Independence Coverage in the Montgomery Textbooks**

<table>
<thead>
<tr>
<th>Textbook Edition</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>State of Mind</strong></td>
<td>(\text{Same as 1927; absolute honesty})</td>
<td>(\text{Same as 1921})</td>
<td>(\text{Same as 1921; no auditor can be an officer; director; or stockholder nor participate in activities or profits of the business})</td>
<td>(\text{Same as 1921})</td>
<td>(\text{No direct or indirect financial interest in the client})</td>
<td>(\text{No commissions, brokerage, or other fees shall be accepted directly or indirectly})</td>
<td>(\text{Same as 1921; same as 1927; absolute honesty same as 1921; no auditor can be an officer, director, or stockholder nor participate in activities or profits of the business})</td>
</tr>
<tr>
<td><strong>1934</strong></td>
<td>(\text{Same as 1934})</td>
<td>(\text{Same as 1934})</td>
<td>(\text{Same as 1921})</td>
<td>(\text{Same as 1921})</td>
<td>(\text{Same as 1921})</td>
<td>(\text{Same as 1934; no transactions with clients such as loans})</td>
<td>(\text{Same as 1934; no commissions, brokerage, or other fees shall be accepted directly or indirectly})</td>
</tr>
<tr>
<td><strong>1940</strong></td>
<td>(\text{Same as 1934})</td>
<td>(\text{Same as 1934})</td>
<td>(\text{Same as 1934})</td>
<td>(\text{Same as 1934})</td>
<td>(\text{Same as 1934})</td>
<td>(\text{Same as 1934; no transactions with clients such as loans})</td>
<td>(\text{Same as 1934; no direct employment relationship})</td>
</tr>
<tr>
<td><strong>1949</strong></td>
<td>(\text{Same as pre-1915; absolute honesty; objectivity; independence in mental attitude})</td>
<td>(\text{Same as pre-1915})</td>
<td>(\text{Same as pre-1915; same as 1934 same as pre-1915; same as 1934})</td>
<td>(\text{No direct or indirect financial interest in the client})</td>
<td>(\text{No direct employment relationship})</td>
<td>(\text{Same as 1934; no direct employment relationship})</td>
<td>(\text{Same as 1934; no transactions with clients such as loans})</td>
</tr>
<tr>
<td><strong>1957</strong></td>
<td>(\text{Same as 1949})</td>
<td>(\text{Same as 1949})</td>
<td>(\text{Same as 1934; No direct or indirect financial interest in the client})</td>
<td>(\text{Same as 1921; absolute honesty same as 1921; no auditor can be an officer, director, or stockholder nor participate in activities or profits of the business})</td>
<td>(\text{Same as 1949; no direct or indirect financial interest in the client})</td>
<td>(\text{Same as 1934; no transactions with clients such as loans})</td>
<td>(\text{Same as 1934; no commissions, brokerage, or other fees shall be accepted directly or indirectly})</td>
</tr>
<tr>
<td><strong>1975</strong></td>
<td>(\text{Same as 1949})</td>
<td>(\text{Same as 1949})</td>
<td>(\text{Same as 1949; no transactions with clients such as loans})</td>
<td>(\text{Same as 1949; no direct employment relationship})</td>
<td>(\text{Same as 1949; no direct employment relationship})</td>
<td>(\text{Same as 1949; no direct employment relationship})</td>
<td>(\text{Same as 1949; no direct employment relationship})</td>
</tr>
</tbody>
</table>

1. Independence Criterion: ownership, employment, and other interest
2. Disputes with clients
3. Partner and staff rotation
4. Consulting and management advisory services
5. Auditor's report should be made to the stockholders, not to the officers and directors
## TABLE 2 (continued)

### Summary of Independence Coverage in the Montgomery Textbooks

<table>
<thead>
<tr>
<th>Textbook Edition</th>
<th>Independence Criterion</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>State of Mind</td>
</tr>
<tr>
<td>1987</td>
<td>same as 1949</td>
</tr>
<tr>
<td>1990</td>
<td>same as 1949</td>
</tr>
<tr>
<td>1998</td>
<td>same as 1949</td>
</tr>
</tbody>
</table>

Source: Montgomery textbooks (1st through 12th editions)
information with regard to independence issues. Of course, supplemental materials could fill the gaps depending upon the instructor’s willingness to incorporate such materials. However, the availability of additional teaching materials may have been a significant problem in the 20th century, at least before the introduction of computers and the Internet.

It should be noted that this paper considers only the Montgomery textbooks. Other auditing texts, which may have covered the concepts of independence and ethical values in greater detail, were not generally published until later in the 20th century. It is the longer series that makes the use of Montgomery’s textbooks more relevant to an analysis of auditor independence. In addition, a study could be conducted to see if the lengthy Dicksee series of audit texts reflects the same patterns as Montgomery’s. Such a comparative project could judge the attitudes of U.K. and U.S. accounting professionals towards the importance of ethics education.6

REFERENCES

Primary Sources:


6 We would like to thank an anonymous reviewer for pointing out this possibility.

Secondary Sources:


APPENDIX A

HISTORY OF INDEPENDENCE 1887-2005

<table>
<thead>
<tr>
<th>Year</th>
<th>Description of Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>1887</td>
<td>American Association of Public Accountants was established, but did not originally include independence in its constitution or by-laws.</td>
</tr>
<tr>
<td>1900</td>
<td>The concept of independence began to appear in accounting literature.</td>
</tr>
<tr>
<td>1915</td>
<td>An issue developed from a situation where a public accounting firm was auditing statements of a company in which a member of the firm was also the internal auditor.</td>
</tr>
<tr>
<td>1926</td>
<td>The report of the American Institute of Accountants’ (AIA) Committee on Professional Ethics posed the question of whether it is ethical for a CPA who is a director of a company to also certify the company's balance sheet.</td>
</tr>
<tr>
<td>1928</td>
<td>The question of an auditor who was also a stockholder surfaced; the word independence was still not included in the Rules of Professional Conduct.</td>
</tr>
<tr>
<td>Year</td>
<td>Event</td>
</tr>
<tr>
<td>------</td>
<td>-------</td>
</tr>
<tr>
<td>1933</td>
<td>The Federal Trade Commission adopted a rule that any CPA or public accountant would not be recognized as independent unless he/she was, in fact, independent.</td>
</tr>
<tr>
<td>1934</td>
<td>The Security and Exchange Commission (SEC) was formed and prohibited any financial interest in the company being audited; the AIA passed a resolution prohibiting a “substantial financial interest.”</td>
</tr>
<tr>
<td>1936</td>
<td>The SEC rule was amended to agree with the position of “substantial financial interest.”</td>
</tr>
<tr>
<td>1937</td>
<td>The SEC issued Accounting Series Release (ASR) No. 2, “Independence of Accountants: Relationship to Registrant,” which described specific cases in which accountants were not considered independent.</td>
</tr>
<tr>
<td>1940</td>
<td>The AIA adopted a rule of professional conduct regarding financial independence to replace its 1934 resolution.</td>
</tr>
<tr>
<td>1941</td>
<td>The SEC issued ASR No. 22, “Independence of Accountants: Indemnification by Registrant,” which states that the main objective of total independence is to assure the impartiality and objectivity needed in an audit and that any circumstances which might bias the mind of the auditor may be considered evidence of the lack of independence.</td>
</tr>
<tr>
<td>1942</td>
<td>The AIA rule adopted in 1940 was modified; independence was considered impaired if the auditor or his immediate family had financial interest in an enterprise that was substantial to his capital or his own personal fortune.</td>
</tr>
<tr>
<td>1947</td>
<td>The AIA specifically defined independence, in its “Tentative Statement of Auditing Standards,” as a state of mind; an impartial attitude regarding the auditor’s findings and noted key characteristics of the independence concept as honest disinterest, unbiased judgment, objective consideration of facts, and judicial impartiality; thus, Rules of Conduct only dealt with objective standards and, accordingly, independence could not be assured; basically, independence “in fact” is emphasized.</td>
</tr>
<tr>
<td>1950</td>
<td>The SEC amended its rule on independence by omitting the word “substantial” from the phrase “any substantial interest” due to debates over the essence of “substantial” financial interest.</td>
</tr>
<tr>
<td>1960</td>
<td>The American Institute of Certified Public Accountants (AICPA) Committee on Professional Ethics proposed to amend the Rules of Conduct to prohibit any member from serving as an employee or director of a firm for which he was the auditor or from having any financial interest in such a firm.</td>
</tr>
<tr>
<td>1961</td>
<td>The 1960 proposal was voted on and passed at the AICPA’s annual meeting.</td>
</tr>
<tr>
<td>1963</td>
<td>The AICPA Committee on Professional Ethics issued Opinion no. 12, “Independence,” which stated that it was ethical to offer management advisory and tax services.</td>
</tr>
<tr>
<td>1966</td>
<td>The AICPA appointed a special ad-hoc committee on independence to study whether the provision of management services tended to impair audit independence.</td>
</tr>
<tr>
<td>Year</td>
<td>Event</td>
</tr>
<tr>
<td>------</td>
<td>-------</td>
</tr>
<tr>
<td>1969</td>
<td>The AICPA ad-hoc committee reported that it had not found any substantive evidence that the provisions of management services had, in fact, impaired independence; the committee, however, suggested the use of the audit committee of the board of directors to deal with questions relating to appearance of independence and management services.</td>
</tr>
<tr>
<td>1972</td>
<td>The SEC issued ASR No. 126, “Independence of Accountants: Guidelines and Examples of Situations Involving the Independence of Accountants,” which covered guidelines for determining the existence of independence; situations in which independence could be challenged, as well as several statements concerning specific circumstances which would or would not impair independence.</td>
</tr>
<tr>
<td>1973</td>
<td>The AICPA adopted new rules of conduct (Rule 101), which required accountants to issue opinions about fairness of presentation of financial statements only if they are independent both “in fact” and “in appearance.”</td>
</tr>
<tr>
<td>1978</td>
<td>Rule 101 was modified slightly; the status management accounting services remained unchanged through the 1990s.</td>
</tr>
<tr>
<td>1997</td>
<td>The Independence Standards Board (ISB), a private sector body, was formed to provide a conceptual framework for independence issues related to audits of public companies.</td>
</tr>
<tr>
<td>1999</td>
<td>The ISB issued Standard No. 1, “Independence Discussion with Audit Committees,” which requires the auditor to provide the audit committee a written description of all relationships between the auditor and the company that, in the auditor’s professional judgment, may reasonably be thought to bear on independence. It also issued Standard No. 2, “Certain Independence Implications of Audits of Mutual Funds and Related Entities,” which was amended in July 2000.</td>
</tr>
<tr>
<td>2000</td>
<td>The ISB issued Standard No. 3, “Employment with Audit Clients,” which describes safeguards that firms should implement when their professionals accept employment with clients.</td>
</tr>
<tr>
<td>2001</td>
<td>The ISB was dissolved; the SEC issued “Revision of the Commission’s Auditor Independence Requirements,” which, for the first time, explicitly considers independence “in appearance,” and places limits on management accounting services including internal audit and appraisal/valuation services, but permits tax services subject to pre-approval by the audit committee.</td>
</tr>
<tr>
<td>2002</td>
<td>The Sarbanes-Oxley Act was signed into legislation, which established the Public Company Accounting Oversight Board (PCAOB) appointed and overseen by the SEC.</td>
</tr>
<tr>
<td>2003</td>
<td>The SEC adopted rules “Strengthening the Commission’s Requirements Regarding Auditor Independence” consistent with the requirements of the Sarbanes-Oxley Act, which further restrict the provision of consulting services to audit clients, include restriction on employment of former audit firm employees by the client, and require audit partner rotation to enhance auditor independence.</td>
</tr>
<tr>
<td>2005</td>
<td>The AICPA made changes to the Code of Professional Conduct regarding Independence Interpretation 101-3 and outsourcing professional services.</td>
</tr>
</tbody>
</table>

Source: Younkins (1996) and Loscalzo et al. (2005)