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4-24-1972

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Address Before The Cleveland Chapter of the Society of Certified  
Public Accountants, April 24, 1972, The Theatrical Restaurant,  
Cleveland, Ohio**

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CLIENT-AUDITOR RELATIONSHIP:  
IS MORE INDEPENDENCE NEEDED?

by  
Leonard M. Savoie  
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before  
The Cleveland Chapter of the  
Ohio Society of Certified Public Accountants

April 24, 1972  
The Theatrical Restaurant  
Cleveland, Ohio

CLIENT-AUDITOR RELATIONSHIP:  
IS MORE INDEPENDENCE NEEDED?

Is More Independence Needed?

When I agreed to speak on the subject "Client-Auditor Relationship: Is More Independence Needed?" I was intrigued by the opportunity the title offers to make the shortest speech ever heard in your organization. I would simply say "yes" -- and sit down.

On reflection, however, I decided there are several things I would like to say on the subject.

Our profession's Code of Ethics notes that independence is an inward quality, an expression of the integrity of an individual. As such, it is difficult to specify precisely but is essential to the profession. The Code goes on to emphasize the importance of both the fact of independence and the appearance of independence. It proscribes particular financial relationships with a client which might cause a reasonable observer, who had knowledge of all the facts, to doubt an auditor's independence.

These proscriptions are well-founded and sensible. But I believe that most people, when they refer to the independence of an auditor, are actually thinking about a degree of that quality which goes well beyond financial relationships.

There is ample evidence to support this conclusion. Recent articles in the press reveal a more than slight opinion

that the auditor should be more independent of his client than he is now.

One of the most telling pieces of evidence of the need for more independence appeared in the March 25th issue of Business Week. In its "Washington Outlook" column there was quoted an internal staff memorandum to the Securities and Exchange Commission noting that Commissioner James Needham told an accountants committee that the SEC has found instances of problems relating to "elementary disclosure, succumbing to obvious pressure by clients, faulty judgments and decisions at the partnership level of the certifying accounting firms, and questions of independence bordering on commercial fraud." These are strong words, and they came from an official in a position to do something about the matter. A little research revealed that his comments were made in November 1970. Since then the Commission has, indeed, done a great deal about the matter, including the filing of several complaints against accounting firms seeking to enjoin them from violating the anti-fraud Rule 10b-5 under the SEC Act of 1934.

#### Litigation Revealing Attitudes

Besides press comments of this kind, a number of lawsuits, of which you are all aware, evidence the need for more integrity and objectivity on the part of independent auditors. These cases show that judges and juries expect auditors to be alert to suspicious circumstances and blow the whistle on dishonest managements.

Some lawsuits against auditors reveal an effort to express a clean opinion on a set of financial statements, even though company officers had engaged in highly unusual investments and intercompany transactions and had withheld information requested by the auditors.

A few years ago, a widely publicized lawsuit demonstrated a belief by the SEC that when an auditor knows the public is receiving misleading financial statements, the auditor should make that information public. This position, which had not before been put forward so plainly and authoritatively, obviously bore a relation to the profession's rule of ethics on client confidentiality. The profession reacted with a carefully worded Statement on Auditing Procedure, which calls for an auditor to make disclosure to a regulatory body having surveillance over the company, if management will not.

At almost the same time the Institute's SAP was issued, a merger transaction took place which, the SEC recently alleged, was based on unaudited financial statements that contained inaccurate or misleading items which the auditors called to the attention of management but not the shareholders. Once again, a defense is asserted that client confidentiality prohibited the auditors from revealing the information to anyone other than corporate officers and directors.

On the other hand, all of you can probably think of instances where it was the auditors who blew the whistle

on a company. And in some of these cases the auditors were sued nonetheless. In cases like that the auditor performing with distinction and independence still runs the risk of litigation and adverse publicity.

Not being a lawyer, I can give no legal opinion on the risks of making disclosure of something a client wants to conceal. But I submit for your consideration that risks of an alleged breach of confidentiality might well be preferable to the risks of an SEC injunction and a class action by stockholders claiming damages for failure to disclose. The public is likely to find it hard to understand why an auditor would feel an obligation to a management that was trying to avoid disclosure of information highly significant to investors.

The cases I have referred to are conspicuous and have caused considerable anguish to the accountants involved and, to some extent, to the entire profession. But there are, in addition, less prominent instances of accountant attitudes which are troublesome.

#### Client Management Advocacy

If, for example, a CPA attends all meetings of the directors of a client company, refers constantly to "our company" and "our plants," and gives the general impression that he is part of the management, are reasonable observers likely to believe he has the independence, objectivity and

integrity required of an auditor?

Do you not yourselves know of cases where accountants accompany clients to regulatory agencies and argue positions which favor the client company but are contrary to professional standards? What can observers think of the independence of accountants who do not defend professional standards when a client finds those standards hampering?

Occasionally, this same kind of attitude reveals itself when members of standard-setting bodies of the Institute advocate positions that are obviously favorable to, say, an oil company client, insurance company client, automobile company client, or conglomerate client.

Even more deeply rooted seems to be the idea of an identity not with a particular client but with business in general. Accountants like to say, for example, that "accounting is the language of business." And some accountants refer to their professional practice as a business. Some who specialize as consultants refer to "my end of the business." Others who specialize in a particular industry seem to be more at home in the industry and its trade associations than in professional accounting societies.

#### "Built-in" anti-independence factors

In their book "The Philosophy of Auditing," Mautz and Sharaf note that auditing does not have any "built-in"

characteristics which assure skeptics of its integrity and independence, but that it suffers instead from what they call "built-in anti-independence factors." They group these anti-independence factors as, first, those arising from the nature of the relationship between an auditor and his clients and, second, those arising from the organization of the profession.

The factors arising from the client relationship are the profession's apparent financial dependence on fees paid by companies, its rule of confidentiality, and its rendering of a variety of services in addition to auditing.

Yet, with respect to auditor's fees, it is obvious that someone must pay to have audits performed, and I have heard no feasible alternative to having the client do it.

As for confidentiality, it is an important feature of the accounting profession, just as it is of the legal or medical professions. Much of the information which an auditor receives could be detrimental to a business and its shareholders if transmitted to others. So a management that could not converse with its auditors in confidence would have strong reason to withhold information necessary for the auditors to do a proper job. Nevertheless, confidentiality should not be used as an excuse for an auditor to withhold from stockholders information they ought to have.

Counselling of clients is most conspicuous in management advisory services but is just as prevalent in tax services and is nearly always present along with auditing. Nearly all



auditors believe that it is not enough to do just an audit; that their professional competence, and indeed their professional duty, requires them to give constructive advice where opportunities arise during the course of the audit. This can be immensely helpful and need not impair audit objectivity. Yet it will always be difficult to convince the public that an advisory attitude and an independent audit attitude can coexist within the same auditor or even within the same accounting firm.

The anti-independence factors noted by Mautz and Sharaf in the organization of the profession include the emergence of a limited number of large firms, lack of professional solidarity, and a tendency toward promotional salesmanship.

Eleven years after publication of their book, competitive salesmanship seems, if anything, to have intensified. Of course, the prospect of widening opportunities is important in attracting able young people into a firm -- and new clients are needed to sustain growth. This fact may be conducive, however, to laxity in maintaining professional standards when strict observance of them seems to threaten retention of an old client or obtaining a new one.

#### Manufactured safeguards of independence

Since independence is so essential to our profession, we need to create specific safeguards to counteract the anti-independence factors cited. Some of our colleagues tend to

minimize the anti-independence factors by saying that auditors conduct themselves with independence and objectivity because, if for no other reason, the only thing they have to sell is their reputation and they cannot afford to let it be tarnished. Also, it is said, auditors are so keenly conscious of their legal liabilities that they lean over backward to avoid the risk of a lawsuit.

These points are certainly valid. Yet the fact remains that the credibility of the profession has eroded. Therefore, in my judgment, new, positive actions are needed.

#### Proposed Restatement of the Code of Professional Ethics

One such action would be to adopt the proposed restatement of the Code of Professional Ethics. The importance of protecting and strengthening independence has been recognized by the restatement committee. Its proposal goes beyond the present rule by adding a new one on integrity and objectivity which reads: "A member shall not knowingly misrepresent facts, and when engaged in the practice of public accounting, including the rendering of tax and management advisory services, shall not subordinate his judgment to others."

In addition to this enforceable rule of conduct, the restated Code contains an essay elaborating on the proposition that (and I quote) "a certified public accountant should maintain his integrity and objectivity and, when engaged in the

practice of public accounting, be independent of those he serves."

These additions to the Code significantly advance the profession's recognition of the basic attitude which runs to the heart of the attest function. It officially and explicitly underscores that without the fact and the appearance of independence, an auditor cannot perform adequately his function of adding credibility to financial statements.

Who is the client?

In my opinion, a further major strengthening of auditor independence could be made by re-defining the word client. Too often auditors act as if the client were a company's management rather than its owners.

To the credit of our committee on Code restatement, the proposed rules of conduct do include a definition of "client" which reads: "The person or entity which retains a member or his firm, engaged in the practice of public accounting, for the performance of professional services." I applaud the committee for its attempt -- yet I believe that the definition is not free of ambiguity. For example, under this definition the client could be the corporation as a whole or the person within management who retained the public accounting firm.

Use of the word "client" throughout the restated Code, it seems to me, shows vestiges of the use commonly pre-

vailing today -- namely, that the client is the president or financial vice president or other corporate officer who has negotiated the engagement.

A definition of client geared to 1972 might say that a client is a person or entity which engages a public accountant or accounting firm to perform services -- and then go on to state that, in the case of a corporation, the investors constitute the entity. Under this kind of definition an auditor could not cite the client confidentiality rule as justification for reporting to the officers and board of directors but not the stockholders -- for it would be the latter who really constituted the client. As already provided in SAP 41, where it was impractical for an auditor to give notification to the stockholders at large, notification to a regulatory agency such as the SEC could be stipulated as sufficient disclosure.

#### Change in auditor

An encouraging recent development affecting independence is the new SEC requirement for reporting a change in auditor. The Institute worked closely with the SEC in developing this requirement in the Commission's Form 8-K.

In a dialog continuing over several months, the SEC and the Institute became increasingly concerned about "shopping for accounting principles." This concern stemmed not only from the relatively few instances where a change in

auditor appeared to involve a dispute with a client over accounting principles but from the pressure that might be exerted on an auditor through the mere threat of change.

The amendment to Form 8-K on this matter, among others, was adopted in September of last year. Now, if a new auditor has been engaged, the 8-K Form filed with the Commission must report the date of engagement, and the registrant must furnish the Commission a separate letter stating whether in the preceding 18 months there were any disagreements with the former auditor about accounting principles which, if not resolved to the satisfaction of the former auditor, would have caused him to refer in his opinion to the subject matter of the disagreement. Furthermore, the registrant has to furnish the Commission a letter from the former auditor stating whether he agrees with the statements in the registrant's letter.

When the proposed new rule was circulated for comment, the Institute suggested that the letters concerning the reasons for the change of auditor be non-public, but in the final release the SEC wisely decided against this restriction. Already the Wall Street Journal has published a revealing article based on an 8-K report, and I hope there will be more. The bright light of publicity should go far in strengthening the hand of an auditor in dealing with a client who wants to cut corners, and also in deterring a firm from lowering standards to obtain a client.

Standing audit committees of outside directors

Another way of buttressing auditor independence is for corporations to create audit committees composed of outside directors. Such committees nominate the independent auditors of their companies' financial statements and keep in contact with the auditors concerning their work.

Five years ago the American Institute of CPAs urged appointment of audit committees, and last month the Securities and Exchange Commission endorsed establishment of such committees in all publicly-held companies. In doing so, the SEC noted that it had recommended such committees in 1940 following the McKesson & Robbins investigation. The movement for audit committees also received strong support in a 1970 research study by Robert K. Mautz and Fred L. Neumann.

With this kind of backing, audit committees should soon become standard features of corporate organization. They provide opportunity for auditors to discuss problems where there is a disagreement between the auditors and company management, and they can contribute significantly toward easing management pressures against auditors.

Public sector or private sector

The primary role of the independent auditor is to add credibility to financial representations made by others. The audit function is thus essential to the public interest. In the performance of this function it is imperative that the

public have confidence in the independence and objectivity of those doing the work. If the public loses faith in those now performing it, there will be a drastic change in the way the audit function is carried out.

I have cited four specific steps which should help strengthen auditor independence --

- The restated Code of Professional Ethics
- A redefinition of client to mean the owners and investors in a business
- Standing audit committees of outside directors
- Reporting reasons for a change in auditor.

This last step is already an SEC rule. If improvements in auditor independence are not soon perceptible to concerned regulatory agencies, sophisticated segments of the public, and legislators, more rules and regulations are inevitable. And if more regulation fails, the entire concept of an independent audit function in the private sector will be brought into question. If auditors are not regarded as independent, what use is their function? If in this circumstance the function is considered essential, what alternative is there to having it carried out by a government agency or by the profession under strict government regulation?

Forty years ago when Congress was considering securities legislation, some Congressmen suggested that the auditing function belonged in a Federal agency. Leading accountants persuaded the Congress that the function could be

best carried out in the private sector by the public accounting profession.

I believe that the record proves this to be so -- that the performance of the auditing function by the profession has been outstanding. But in these past forty years not only has the level of audit performance risen, so have public expectations, and even faster. If the profession cannot remain at least one step ahead of these expectations, government auditing of private business looms as a possibility.

Some CPAs shrug off this possibility, citing a presumed inability of the government to create a staff large enough to handle the job.

It would obviously take some time for a Federal agency to be created which could audit all publicly-held corporations. But consider that probably fewer than 50,000 accountants in the private sector are now engaged in auditing these corporations -- while probably a number nearly that large are already engaged in auditing for the Federal government in capacities ranging from internal revenue agent to defense contract auditor to General Accounting Office auditor. In light of this I think that a large enough staff could be established within government.

On the other hand, if a Federal auditing agency is not considered feasible, there is the danger that the accounting profession could be brought under government control through legislation providing for a Federal CPA certificate and Federally



determined standards.

To some, Federal regulation may appear to be a golden opportunity to bring uniformity to the diverse state requirements. But it is inevitable that making the accounting profession subject to Federal regulation would result in loss of professional autonomy.

Instead of CPAs determining their professional requirements and standards, a Federal agency would do so. It is easy to see this Federal agency setting education and experience requirements, determining the content of the CPA examination, laying down rules of professional conduct, and imposing accounting and auditing standards.

In order to obviate developments of this sort (which I'm certain would be unwanted by most businessmen and government officials alike) the public accounting profession must re-dedicate itself to independence and objectivity.

An editorial on client-auditor relationship in the April 22, 1972 issue of Business Week concludes, "But the final decision about the future of accounting must be made by the accountants themselves. To preserve their credibility, they must first of all preserve their independence."

Basically, it comes down to a matter of attitude. Accountants must decide whether they are engaged in a commercial activity with a few professional overtones, or in a profession which, like all professions, inevitably entails

some elements of business but without allowing these elements to become dominant.

As for myself, I see but one rational and good decision: accountancy is clearly a profession. Independent and objective conduct by the overwhelming preponderance of practitioners is required to demonstrate that this decision has been taken.

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