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The Auditors Independence Problem

Specific Rules Are Needed Concerning Independence in Appearance

By Hans J. Dykxhoorn and Kathleen E. Sinning

In 1978 and 1979, the Securities and Exhange Commission (SEC) adopted Accounting Series Release (ASR) Nos. 250 and 264 in response to critics of the accounting profession who expressed doubt that accounting firms that provide non-audit services to their audit clients can be truly independent in their audit work. Neither release prohibited auditors from providing any type of non-audit service but did require disclosure of non-audit services in proxy statements (ASR No. 250) and presented relevant factors to be used in evaluating the scope of services to be performed by auditors (ASR No. 264).

As a result of the accounting profession's opposition to these releases, ASR Nos. 264 and 250 were rescinded in August 1981 and January 1982, respectively. The SEC stated that the self-regulatory mechanism of the accounting profession "should be able to generate sufficient information about non-audit services to enable the Commission, the accounting profession and other interested users to monitor services performed by accountants."[1] The SEC feels that its role "should remain one of oversight rather than regulation."[2] However, cognizant that the revocation of ASR Nos. 250 and 264 might be considered a signal that the SEC is less concerned with maintaining auditors' independence, SEC Commissioner Barbara Thomas remarked that the withdrawal of ASR No. 250 "requires the Commission to carefully monitor the effectiveness of the AICPA's rules in this area...we must remain prepared to revisit this area due to the critical need to maintain the independence of auditors."[3]

The SEC's renewed confidence in the accounting profession's ability to regulate itself is not unjustified. The profession, through the American Institute of Certified Public Accountants (AICPA), has had regulations, guidelines, and rulings concerning the independence status of auditors. The increased responsiblity for insuring auditors' complete independence placed on the profession by the SEC, however, is a heavier burden than it appears. It will entail developing a set of specific rules concerning independence in appearance. The balance of this paper explains why.

Background

Certified Public Accountants (CPAs) audit the financial statements of many business entities in the United States. Since the emergence of the SEC in 1934 and passage of the Securities Act of 1933 and the Securities Exchange Act of 1934, all publicly owned corporations under the jurisdiction of the SEC must undergo mandatory annual audits.

Even though the auditor is engaged by his (or her) client to express an opinion on the client's financial statements, the auditor's primary responsibility is to those who use the financial statements in making investment or lending decisions. The users rely on the auditor's opinion that the financial statements present fairly the financial position of the client, the results of its operations, and the changes in its financial position for the year ended. Thus the audit function lends credibility to financial statements. For this credibility to exist, however, the auditor must be independent from his audit clients.

The American Institute of Certified Public Accountants has established "independence in mental attitude" as one of the generally accepted auditing standards. In addition, the Ethics Committee of the AICPA has promulgated various independence requirements in the *Code of Ethics* which is adopted by all State Boards of Accountancy in the United States.

The SEC also has an independence requirement for CPAs as prescribed in *Regulation S-X* as follows: "The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent."[4] The SEC periodically issues guidelines for a number of auditor-client relationships which it believes would or would not render the auditor independent as Accounting Series Releases, such as ASRs No. 126 and 232. The AICPA does the same for its members by issuing *Ethics Rulings* that deal with auditor independence, as do its counterparts at the State level.

The Problem with Auditor Independence

Despite the rule-making efforts of the AICPA and the SEC, the auditing profession has been exposed to criticism concerning its independence. Recent Congressional investigations of the accounting profession were critical of the self-regulatory efforts of the profession and, to a lesser extent, of the role the SEC has played.[5] The Senate study on the "accounting establishment," a 1960 page analysis, was especially concerned about the lack of independence of the larger accounting firms due to factors such as the practice of providing management advisory services (MAS) to audit clients. This study pointed out that:

> *"Independent auditors must have the complete confidence of the public for whose benefit the Federal securities laws were enacted. That confidence can only be maintained by strict adherence to standards of conduct which assure the public that auditors are truly independent and competent to perform their responsibilities."*[6]

The implication of this statement is that any problem with independence is caused by a failure to adhere to standards of conduct and that auditors are unethical and are providing audit services to clients from which they are not independent. A major cause of the independence problem, however, may be the "standards of conduct" themselves. The government study alludes to this by its criticism of the self-regulatory effort of the profession which includes the formulation of independence rules. As the following section will show, the independence problem is caused not by unethical auditors violating their Code of Ethics and Generally Accepted Auditing Standards but by the independence requirements themselves.

The Concept of Auditor Independence

Independence consists of two components: independence in fact and independence in appearance. The auditor must be both in order to be considered independent. Whereas independence in fact deals with the auditor's state of mind or attitude toward the audit object, independence in appearance is dependent on how others interpret the auditor's independence. For an auditor to lack independence in appearance it is not necessary that he or she lack independence in fact; simply having his or her independence questioned by a legitimate third party is sufficient to render the auditor not independent. It seems that the requirement for independence in appearance may be the more stringent of the two requirements of what will be called "total independence." The effectiveness and efficiency of two types of independence rules — *general* and *specific* rules — to ensure "total independence" and how they relate to each of the two components of the independence concept are analyzed below.

Independence in Fact

Independence in fact is a concept which deals with an individual auditor's perception. It is generally agreed that there cannot be any objectively measurable specific guidelines for independence in fact that are also operational. It is this component of the "total independence" concept to which the AICPA refers in its *Statements of Auditing Standards* which state that "the possession of intrinsic independence is a matter of personal quality rather than of rules that formulate certain objective tests."[7]

To ensure independence in fact in all cases, all that is necessary is a *general* rule mandating auditors' independence in fact such as the second general auditing standard which mandates that in "all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors."[8] Of course, the implicit assumption is that all auditors are ethical, that is, no auditor will accept an audit engagement if he believes that the audit cannot be objectively and unbiasedly conducted. Whether this assumption holds is an empirical question that is beyond the scope of this paper. However, there is no reason to doubt that the U.S. accounting profession in general consists of highly ethical and professional people. Unethical conduct seems to be the rare exception that occurs in any professional group.

A rule making body could not devise a set of uniform *specific* rules to apply to all auditors to ensure independence in fact because the rules would have to be separately designed for each individual auditor. The rules would have to reflect each auditor's independent mental attitude toward each and every possible auditor-client relationship. Since no one can know an auditor's own mind as well as the auditor himself, developing such a set of comprehensive rules would be impossible. Therefore, a *general* rule would be most appropriate and is sufficient to ensure independence in fact.

A *general* rule, however, is subject to individual interpretation. Since perceptions of a *general* rule are bound to differ for some persons, different auditors will arrive at different decisions concerning acceptance or rejection of an audit engagement based on the criterion of independence in fact alone. Thus, the *general* rule will result in divergent interpretations in many cases. Nonetheless, independence in fact will have been achieved for all auditors, assuming ethical behavior.

Independence in appearance deals with the collective perceptions of users of financial statements.

Independence in Appearance

In contrast to independence in fact, independence in appearance is a concept that deals with the collective perceptions of users of financial statements. Independence in appearance requires that an auditor must *appear* to be independent to a third party. Whether or not the auditor is independent in fact is not a concern of this criterion.

In determining whether or not he is independent in appearance, an auditor could be guided by two types of rules: A *general* rule which requires the auditor to be independent in appearance, such as the Code of Ethics,[9] and *specific* rules[10] which cover every type of auditor-client relationship.

A *general* rule would require the auditor to decline any audit engagement that would impair his or her independence in appearance. The auditor would have to judge each situation when confronted with it to determine if the *general* rule indicates that he is not independent. Even if all auditors are ethical, they may eventually violate the *general* rule since they are dealing with others' perceptions of their independence. They may accept engagements that, unknown to them, impair their independence in appearance or decline engagements in which third parties would actually view them as independent.

In sum, a *general* rule will not ensure independence in appearance for all situations. It is a sufficient rule only in the extreme case where all auditor-client relationships are considered independent in appearance or if it is assumed that all auditors will interpret the general independence in appearance rule correctly. A *general* rule dealing with the independence in appearance requirement is not sufficient because it may result in auditors accepting audit engagements that should not be accepted and rejecting engagements that could have been carried out.

If an auditor's independence in appearance decision is to be guided by *specific* rules only, a complete set of *specific* rules must be developed by a rule making body and made known to all auditors. A set of specific rules alone would be sufficient to assure independence in appearance for all audit engagements because the auditor, assumed to be ethical, would need only to refer to these complete specific rules to determine whether or not a given auditor-client relationship would render him not independent in appearance and thus, whether or not to accept an engagement.

As a result of the above analyses, it becomes apparent that the following conditions would be sufficient to ensure an auditor's "total independence:"

> 1. A general *rule mandating independence in fact.*
> 2. Specific *rules concerning independence in appearance for all auditor-client relationships.*
> 3. *Ethical auditor behavior, that is, an auditor will decline any audit engagement which impairs his or her independence in fact and/or independence in appearance.*

Auditor-Client Relationships

Recent empirical research indicates that there may be differences in the perceptions of auditors' independence between auditors and certain groups of financial statement users. Lavin[11] investigated the perceptions of auditors' independence for a sample of CPAs, bank loan officers, and financial analysts of brokerage houses. In a mail questionnaire, the sample subjects were asked to indicate for each of twelve different auditor-client relationships take from ASR No. 126 whether they considered the auditors involved to be independent or not independent. Lavin found that there were statistically significant differences in the responses of the three sample groups for six of the twelve situations. In five of the six situations significance was not caused by one group considering the auditors to be independent and the other groups not but rather by the degree of consensus between the three groups. However, in the auditor client relationship in which an accounting firm provided bookkeeping services for its audit client, a majority of the CPAs questioned considered the auditors to lack independence while the two financial statement user groups perceived the auditors to be independent.

Imhoff[12] conducted a survey which included a similar sample group of CPAs and financial statement users. He investigated the perceived effect on an accounting firm's independence if employees of their audit staff accepted employment at companies that they had previously audited. The results of this study indicate that users are somewhat more critical of CPAs accepting positions with client firms than are practicing CPAs.[13]

A study by Pearson and Ryans[14] which investigated how practicing CPAs, Chartered Financial Analysts, and corporate accountants perceived potential auditor-management conflicts also found differences in perceptions of auditor independence between CPAs and non-CPAs for some situations. Empirical research conducted in Germany[15] and the United Kingdom[16] also indicate that differences between auditors and financial statement users may exist.

Although the conclusions of these studies are limited to the auditor-client relationships investigated, they indicate that problems may arise for the auditing profession if no specific rules are devised concerning independence in appearance for those auditor-client relationships in which differences exist between the perceptions of auditors and users of financial statements.

Admittedly, the problem exists only if the users of financial statements take a stricter view of the auditors' independence than the auditors. This was not conclusively shown in the Lavin study. The results obtained by Imhoff and Pearson and Ryans seem to indicate that users of financial statements are more inclined to consider auditors' independence to be impaired than the auditors themselves. These findings take on more significance since the studies included some auditor-client relationships that have not been properly addressed by the SEC or AICPA such as auditors accepting employment at companies they are currently auditing or have previously audited or the situation in which an accounting firm received a significant portion of its total revenue from one audit client. Since these auditor-client relationships have not been addressed, there is very little guidance available to the auditor and, as a result, a risk that independence in appearance may be violated.

The above analysis indicates that the controversy surrounding auditors' independence arises from having a *general* requirement that auditors must be independent in *appearance* and a lack of *specific* rules. The solution, thus, is to identify and prohibit all auditor-client relationships for which the consensus perceptions of users of financial statements are that the auditors lack independence. The definition of what represents consensus and who represents users of financial statement must be left to an appropriate rule making body.

It seems unlikely, however, that the rule making body will be able to devise complete *specific* rules concerning independence in appearance. To overcome the practical limitation of devising complete *specific* independence in appearance rules, even though an effort should be made toward comprehensive coverage, the current *general* requirement of independence in appearance must be changed so that it applies only to those auditor-client relationships prohibited by the *specific* rules. In other words, an auditor's independence in appearance would only be impaired if he violates any of the *specific* rules. This will eliminate the auditor's present uncertainty in deciding whether he is independent in appearance or not.

Thus, the task of ensuring independence in appearance rests with the efforts of the rule making body. Any independence in appearance problems that arise after the rule making body has devised and published its *specific* rules will be the result of the unresponsiveness of the body in reflecting the perceptions of financial statement users. (Unethical auditors can also create independence problems. However, as mentioned earlier, this is not a serious consideration.) The rule making body should base its decisions on empirical research of the perceptions of users.

Conclusions

Auditors must be independent in fact *and* in appearance. A *general* rule requiring auditors to be independent in fact is the only way to deal with this component of the independence concept. However, a *general* rule requiring auditors to be independent in appearance is not appropriate if perceptions of auditor independence differ between auditors and users of financial statements. Some research indicates that there are differences of perceptions between these two groups. Consequently, the possibility exists that auditors may accept engagements which may render them not independent in appearance unless there are *specific* rules prohibiting such engagements. Thus the controversy surrounding auditor independence stems from the *general* requirement that auditors must be independent in appearance and the lack of complete *specific* rules indicating which relationships will impair their appearance of independence. To solve the independence problem the following changes should be implemented:

1. *A rule making body should devise comprehensive* specific *rules prohibiting any auditor-client relationships which are considered by users of financial statements to impair independence in appearance, and*
2. *the requirement for independence in appearance should be redefined so that auditors could only be accused of not being independent in appearance if they violated any of the* specific *independence in appearance rules.*

Even with the best effort it is unlikely that the proposed comprehensive rules will be complete, that is, that they will cover every possible auditor-client relationship. Thus requirement (2) is needed to eliminate the auditors' uncertainty for situations where specific rules are lacking concerning independence in appearance. This, however, shifts the burden of ensuring independence in appearance to the rule making body. As noted above, the SEC is currently relying more on the accounting profession's self-regulating effort. The profession could continue to promulgate the more comprehensive *specific* rules through the Ethics Committee of the AICPA. However, it seems advisable to appoint a rule making body which will be independent of the AICPA to gain the credibility of the financial statement users. By limiting the independence in appearance requirement to *specific* rules only, most criticism of the lack of auditors' independence in appearance is likely to arise from a perceived inadequacy of specific rules, or standards of conduct, which is the responsibility of the rule making body. Since actual lack of independence in appearance will be limited to violations of any *specific* rules such misconduct could be dealt with through disciplinary action. Ω

NOTES

[1]*The Week in Review*, Deloitte, Haskins & Sells, January 29, 1982, p. 1.

[2]*The CPA Letter*, AICPA, September 14, 1981, p. 3.

[3]*The Week in Review*, op.cit., p. 2.

[4]Securities and Exchange Commission, *Accounting Series Releases* (Commerce Clearing House, Inc., 1980), para. 3003.

[5]For example, U.S. Securities and Exchange Commission (1979), *Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role* (U.S. Government Printing Office, July 1979).

U.S. Senate, Subcommittee on Reports, Accounting, and Management of the Committee on Government Operations, *The Accounting Establishment: A Staff Study* (U.S. Government Printing Office, 1976).

U.S. Senate, Subcommittee on Reports, Accounting and Management of the Committee on Government Affairs, *Improving the Accountability of Publicly Owned Corporations and Their Auditors* (U.S. Government Printing Office, 1977).

[6]U.S. Senate, *A Staff Study,* op. cit., p. 1.

[7]American Institute of Certified Public Accountants (AICPA), *Codification of Statements on Auditing Standards, Numbers 1 to 26* (Commerce Clearing House, Inc., 1980), AU Section 220.04.

[8]Ibid., AU Section 150.01.

[9]AICPA, *Code of Professional Ethics, "Concepts of Professional Ethics, Rules of Conduct,* Interpretations of Rules of Conduct," (AICPA, 1975), p.7.

[10]Some examples of *specific* rules are contained in Rule 101 (AICPA, 1975 pp. 17-18) and in ASR Nos. 126 and 232.

[11]Lavin, D., "Financial Statement Users' and Accountants' Perceptions of the Independence of the Auditor in Selected Client-Auditor Relationships" (unpublished Ph.D. dissertation, University of Illinois, 1974).

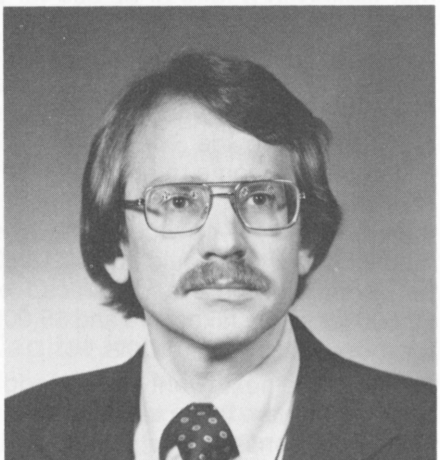
[12]Imhoff, E.A., "Employment Effects on Auditor Independence," *The Accounting Review* (October 1978), pp. 869-881.

[13]Ibid., p. 878.

[14]Pearson, M.A. and J.K. Ryans, Jr., "Perceptions of an Auditor-Management Conflict," *Review of Business and Economic Research* (Winter 1981-82), pp. 110.

[15]Dykxhoorn, H.J., and K.E. Sinning, "Changes in the *Wirtschaftsprüferkammer's* Directives Concerning *Wirtschaftsprüfer* Independence: An Empirical Investigation," *Journal UEC* (Fall 1980), pp. 161-167.

[16]Firth, M., "Perceptions of Auditor Independence and Official Ethical Guidelines," *The Accounting Review* (July 1980), pp. 451-466.



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