Auditor Independence: A Problem to the Profession and the Public

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By Charles E. Jordan and James G. Johnston

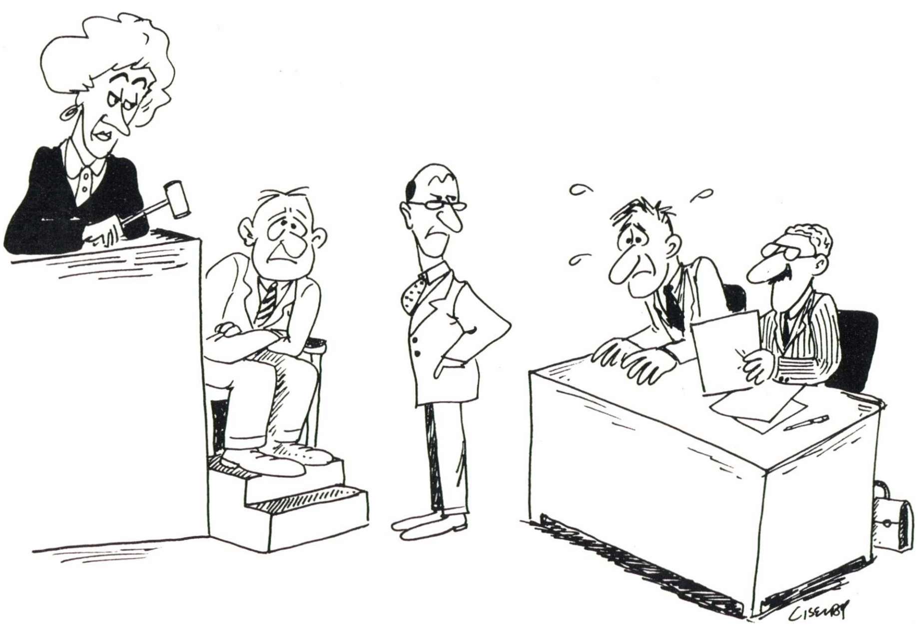
An auditor examines a set of financial statements in order to form an opinion on those financial statements and expresses this opinion in an audit report. The primary beneficiaries of an audit report are third-party financial statement users. Unless auditors are independent of their clients and their clients' financial statements, however, audit reports will be of little use. This article provides an examination of some of the problems currently facing auditors and their independence.

The auditing profession's standards recognize two types of independence that must be maintained. The first type is known as independence in fact and relates to auditors' intellectual honesty. Independence in fact means that auditors approach all matters concerning an audit examination with complete objectivity. It also means that auditors must not subordinate their judgment to others.

The second type of independence identified by professional standards is known as independence in appearance. Since auditors' opinions are relied upon by third-party financial statement users, auditors must be perceived as being independent. Auditors must avoid situations that might lead others to believe that objectivity has been impaired. But maintaining an appearance of independence is almost an impossible task.

On Trial: Independence in Appearance

Imagine that a CPA firm in on trial for losing its appearance of independence. Fortunately, CPA firms never find themselves being sued simply because they do not appear independent, but this is a good way of exemplifying the problems that plague a firm's independence in appearance. The defendant in our make-believe trial is Smith, Jones & Co. (SJ), a highly reputable CPA firm. The plaintiffs are the stockholders and creditors of Client Co., one of SJ's audit clients. The plaintiffs are suing SJ because they feel that the defendant is no longer capable of making objective decisions concerning the examination of Client Co.'s financial statements. Assume the scenario includes the characters identified in the illustration on this page.



Characters in the scenario are (from left to right): the judge (you, the reader); C. P. Akins, managing partner in the defendant CPA firm; I. M. Slick, attorney for the defense; one of the plaintiffs (an unidentified creditor of Client Co.); Fred D. Fastalk, attorney for the plaintiffs.

With an air of confidence, the defense attorney calls only one witness, C. P. Akins. The questioning of this witness proceeds as follows:

I. M. Slick: "Mr. Akins, would you please state your firm's relationship with Client Co."

C. P. Akins: "We are Client Co.'s external auditor. We examine their financial statements and provide an audit opinion concerning the fair presentation of those financial statements in conformity with generally accepted accounting principles (GAAP)."

Slick: "Does your CPA firm set forth this GAAP?"

Akins: "No, GAAP is promulgated by the Financial Accounting Standards Board (FASB). As an auditing firm, we simply provide reasonable assurance that Client Co. has not materially deviated from GAAP."

Slick: "Have you ever had any disagreements with the management of Client Co. concerning the proper application of GAAP?"

Akins: "Oh, yes. Disagreements are not uncommon, but we (SJ) never subordinate our judgment to that of the client. We have our professional reputation and integrity to think of, you know."

Slick: "As far as your audit of Client Co. is concerned, to whom is your ultimate responsibility owed?"

Akins: "As with any audit engagement, our ultimate responsibility is owed to the financial statement users, Client Co.'s investors and creditors. Without these third-party users, there would be no need for an audit engagement."

Slick: "Do you or any of the other partners and employees of your firm own stock or other types of financial investments in Client Co.?"

Akins: "No. The auditing profession's code of ethics does not allow us to own financial interests in the firms we audit. Furthermore, none of our employees who work on the Client Co. engagement have close relatives holding influential positions within Client Co."

Slick: "Do any of your employees or fellow partners of SJ make managerial-type decisions for Client Co.?"

Akins: "No, we do not engage in the management activities of Client Co. If we notice inefficiencies in Client Co.'s accounting system, we do provide recommendations and advice for improvement, but the decision to implement the improvements rests with Client Co.'s own management."

Slick: "I have only one more question for you, Mr. Akins. Before now, has your firm ever been sued for lack of independence?"

Akins: "No. As a matter of fact, we have never been sued for anything, until now. As with most CPA firms, our most prized possession is our integrity. This integrity keeps us honest and independent in all our dealings with Client Co."

Slick: "Before turning Mr. Akins over to Mr. Fastalk for cross-examination, I would like to make a few summary remarks to the jury. Mr. Akins contends that his firm does not owe its ultimate responsibility to Client Co. Furthermore, no one associated with SJ owns a financial interest in or makes managerial decisions for Client Co. All employees and partners associated with SJ are professionals and are above reproach. There is no reason to doubt SJ's independence with respect to its examination of Client Co.'s financial statements."

With C. P. Akins still under oath, it is time for the prosecuting attorney, Fred D. Fastalk, to cross-examine the witness.

Fastalk: "Before questioning the witness, I would like to remind the jury that SJ's independence, in fact, is not on trial here. We are concerned only with its appearance of independence. The issues I raise will be directed toward proving that SJ does not appear independent to an investor or creditor."

Fastalk: [Addressing C. P. Akins] "You stated earlier that your firm's ultimate responsibility is to third-party financial statement users. Did these third-party users hire you to perform the audit of Client Co.?"

Akins: "No, we were hired by Client Co."

Fastalk: "I see, and who pays your fees when you examine Client Co.'s financial statements?"

Akins: "Client Co. pays our fees."

Fastalk: "In terms of total fees generated, is Client Co. an important client of SJ?"

Akins: "Well, yes. Client Co. is our firm's second largest audit client."

Fastalk: "Approximately what percentage of your firm's total fees earned each year are attributable to the services performed for Client Co.?"

Akins: "That is difficult to say for sure, but the revenue generated by the Client Co. engagement is probably around 5 percent of our total revenue."

Fastalk: "Can Client Co. terminate the engagement and seek the services of another CPA firm if it so desires?"

Akins: "Yes, of course it can."

Fastalk: "Mr. Akins, your firm's relationship with Client Co. seems to create an ironic situation. How can you expect an investor or creditor to believe that you are independent and objective with respect to Client Co. when your firm's very livelihood depends upon the fees paid by Client Co. and others like it?"

Akins: "Well, as I stated earlier, we are professionals. Our integrity keeps us independent. Outsiders must have faith in our integrity."

Fastalk: "Does your firm perform services for Client Co. other than your annual examination of their financial statements?"

Akins: "Yes, we also provide tax services and management consulting services for Client Co."

Fastalk: "In providing tax services, just exactly what does your firm do for Client Co.?"

Akins: "We do, of course, prepare Client Co.'s tax return. In so doing, our primary responsibility is the legal minimization of Client Co.'s income taxes. We also represent Client Co. in tax audits and other proceedings conducted by the IRS."

Fastalk: "This is quite interesting. Your firm is a strict advocate of Client Co. when providing tax services, but when you audit Client Co.'s financial statements, you are completely independent and objective. Is this a correct statement?"

Akins: "Yes, that is correct."

Fastalk: "Mr. Akins, could you give us an example of the type of management consulting services your firm provides for Client Co.?"

Akins: "Yes, that will be easy. We at SJ pride ourselves on being a multi-talented CPA firm. We have provided consulting services to Client Co. on numerous occasions. For example, three years ago Client Co. decided to switch from a manual periodic inventory system to a computerized perpetual inventory system. SJ was engaged as a consultant for this transition. We studied the situation and recommended the computer hardware and software and accounting controls we felt would be best for Client Co."

Fastalk: "Mr. Akins, I am confused again. When you audit Client Co.'s financial statements, does this include an examination of Client Co.'s inventory system?"

Akins: "Yes, we do examine their inventory system. Inventory makes up a major portion of Client Co.'s total assets."

Fastalk: "How is it that your firm can be independent and objective when you are evaluating a system that was implemented based upon your firm's recommendation? This seems like a direct conflict of interest. It appears as though you are auditing your own firm's work."

Akins: "No, we are not auditing our own work. When we recommended the inventory system, we were working strictly in an advisory capacity. It was Client Co.'s management who actually decided to implement the inventory system. When auditing the inventory system, we are trying to determine if Client Co. is using the system properly. Thus, we are performing two completely different roles for Client Co."

Fastalk: "Thank you, Mr. Akins. I have no further questions. I would now like to make my closing remarks to the jury. Ladies and gentlemen of the jury, the task before you is to decide if sufficient evidence has been presented to indicate that Mr. Akins' CPA firm's independence in appearance has been impaired.

"The fee relationship that exists between Client Co. and its CPA firm seems to negate the latter's appearance of independence. The non audit services provided by the CPA firm also tend to impair the firm's independence. Any prudent investor or creditor must question a CPA firm's ability to be independent in one instance and a strict advocate in another.

"Mr. Akins' firm may be independent in fact, but this is not the issue here. The issue before us is whether his firm appears independent. I believe the evidence shown here today proves that this CPA firm's appearance of independence has indeed been impaired.

A jury of reasonable investors and creditors could, very easily, find that Smith, Jones & Co. is not independent in appearance. Even though the participants in this make-believe trial do not exist, the issues are real. Because of the nature of the CPA/client relationships, CPA firms simply do not always appear independent. Note, however, that these independence-damaging relationships are not new. On the one hand, society has tolerated these relationships over the years because the ensuing benefits are considered "necessary evils." On the other hand, society frowns upon the auditing profession's apparent inability to maintain its independence in fact.

Independence in Fact

Independence in fact means that an auditor's decisions should be made objectively, free and clear of any influence that other parties or factors might bring to bear. Since independence in fact deals with intellectual honesty, its existence is difficult to prove or disprove. Yet, currently there are certain conditions that would seem to create a gray area where independence in fact is involved.

The auditing profession's standards recognize two types of independence that must be maintained.

For example, competition among CPA firms has increased dramatically in the last few years. Increased competition is the result of, primarily, the sanctioning of competitive bidding by the AICPA, a decrease in profits due to skyrocketing malpractice insurance rates, and a shrinking pool of clients due to numerous corporate mergers. The current competitive environment is exemplified in a statement made by J. Michael Cook, chairman of Deloitte, Haskins, & Sells, the nation's seventh largest accounting firm. Cook states: "Five years ago, if a client of another firm came to me and complained about the service, I'd immediately warn the other firm's chief executive. Today, I try to take away his client" [Berton, 1985a].

Competition increases the likelihood that an auditor will be replaced by one who is more likely to comply with the client's wishes. Knowing that they can be replaced with relative ease, auditors may approach controversial issues with impaired objectivity. Because of this increased competition, clients now have more power over their auditors.

This increased competition is forcing auditors to hold down their audit fees. To hold down audit fees, audit engagements are being completed more quickly, and substandard audit work may be occurring. As a result of the need to complete audits more quickly, auditors currently face intense time-budget pressures. To meet the stringent time budgets, auditors resort to various practices. Ibrahim [1986] notes that one such practice involves signing off on audit program steps without ever completing the steps. Obviously, such a procedure results in the reduction of audit quality. The frequency of such behavior is impossible to determine, but a study by Kelly and Seiler [1982] showed that over 30 percent of the staff auditors responding to their survey had performed in such a manner.

Another problem plaguing auditor independence results from auditors performing successive audits. There are benefits derived from long auditor/client relationships; for one, auditors do not have to relearn the client's accounting system each year. Thus, audits can be performed more efficiently, benefiting both the auditors and their clients. However, long auditor/client relationships may result in auditor complacency. This problem was summed up in a 1979 Senate Subcommittee report on the accounting establishment. The report stated:

> Long association between a corporation and an accounting firm may lead to such a close identification of the accounting firm with the interests of its client's management that truly independent action by the accounting firm becomes difficult [Metcalf Report, 1979].

The Subcommittee recommended mandatory rotation of auditors at periodic intervals. Their suggestion fell on deaf ears, and the problem still exists today.

Now, several years later, another Congressional Subcommittee is examining the accounting profession. Chaired by Representative John Dingell, a Democrat from Michigan, the Subcommittee's primary concern is the independence of accountants. The Subcommittee's investigative hearings began in early 1985 and will not be completed until late 1987 or perhaps 1988. In his opening remarks, Dingell raised an important question about auditor independence. He stated: "When an independent CPA helps set up a company, offers it financial and management advice, then performs an audit of its books, questions are raised about the ability of that accountant to remain objective in his dealings" [Williams, 1985].

This same issue of performing nonaudit services was discussed in an earlier section of this article dealing with independence in appearance. Dingell's concern, however, runs deeper than an accountant's appearance of independence. Dingell and the other members of his Subcommittee feel that the accounting profession's ability to remain independent in fact may be impaired. As Michael Barrett, the Subcommittee's chief counsel, stated: "We're very concerned that the more hats an accounting firm wears for its clients, the more the firm is in the client's pocket" [Berton, 1985a].

As mentioned earlier, proving or disproving an accountant's independence in fact is almost impossible because independence in fact deals with an accountant's mind-set. Since mind-reading is out of the question, the best way to evaluate the accounting profession's ability to maintain independence in fact is to examine its recent track record. Table 1 contains a partial listing of questionable audits brought to the public's attention in the 1980's.

The listing of questionable audits in Table 1 is not all-inclusive, but it is sufficient to show that the accounting profession is experiencing problems. Note that the circumstances surrounding the questionable audits are varied. Some involved personal greed; others involved a disregard of professional standards. But no matter what the reason for the problem audit — increased competition, auditor complacency or some other reason — the end result was a definite lack of independence. The auditors failed to make the kind of objective, rational decisions that are expected of prudent auditors.

TABLE 1
A Partial Listing of Problem Audits

CPA Firm Involved (Year of Audit)	**Client Co.**	**Audit Problems**
Arthur Young & Co. (Early 1960's-1976) Frederick McGraw & Co. (1977-1983)	Bell & Beckwith	Both CPA firms were sued because neither followed generally accepted auditing standards which should have revealed the misdeeds of the client's managing partner over the years [Ingersoll and Berton, 1985].
Arthur Andersen (1968-1970)	Fund of Funds	The CPA firm was sued for fraud because it failed to warn its client, Fund of Funds (FF), that it was purchasing highly overvalued investments. FF purchased the assets from another of AA's clients. AA was sued because they had "knowledge of or recklessly disregarded" the fraudulent prices [WSJ Staff, 1981a].
Arthur Andersen (1969)	Viatron Computer Systems	The CPA firm failed to qualify its opinion even though it was evident that the client could not raise enough capital to survive [WSJ Staff, 1981b].
Ernst & Whinney (1974)	Franklin National Bank	The CPA firm was sued by the FDIC for providing the bank with a clean opinion only a short period of time before the bank failed. The CPA firm failed to recognize that the bank's reserves were inadequate to cover bad loans [Stricharchuk and Darlin, 1982].

(continued)

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Of course, the important concern is the pervasiveness of this problem within the accounting profession. The AICPA feels that cases like those shown in Table 1 are only isolated occurrences; thus, there is little cause for alarm. In regard to the number of problem audits that are occurring, John W. Zick, chairman of the AICPA's SEC practice section, states: "We are aiming for zero defects, but we believe the profession's record is a good one" [News Report, 1985]. Representative Dingell, however, takes quite a different stand. He states:

> The accounting profession tells us with considerable enthusiasm that these [problem audits] are only a microscopic percentage of the total number of audits, and yet one of them [ESM Government Securities] was sufficient to bring about

TABLE 1
A Partial Listing of Problem Audits
(continued)

Kenneth Leventhal & Co. (1974-1975)	Emerson's Ltd.	The CPA firm was censured by the SEC for conducting an audit that was not in conformity with generally accepted auditing standards. The auditors did not keep detailed working papers, and they "ignored warning signals suggesting a need to probe further into Emerson's questionable accounting practices" [WSJ Staff, 1981c].
John P. Butler Accountancy Corp. (1978)	West Side Mortgage Co.	The CPA firm was sued for negligence. Among other things, the firm failed to discover that a $100,000 note receivable was worthless [Berton, 1986b].
Lester Witte & Co. (1978)	J. B. Lippincott Co.	The SEC censured the CPA firm because it did not conduct its examination in accordance with generally accepted auditing standards. The CPA firm overlooked significant factors that would have indicated Lippincott's materially misstated financial statements [Warner, 1981].
Touche Ross & Co. (1978-1981)	Data Access Systems	The client's assets and profits were materially overstated due to improper accounting methods. The auditors allegedly knew of these inaccuracies and were therefore grossly negligent and reckless in performing their duties [WSJ Staff, 1985a].
Peat, Marwick, Mitchell & Co. (1979)	Itel Corp.	The CPA firm gave a clean opinion even though the client's income was overstated due to improperly handled defaulted leases [Drinkhall, 1982].
Amundsen & Co. (1979)	Olympic Oil & Gas Co.	The CPA firm was sued by the SEC. Among other things, the CPA firm gave Olympic a clean audit opinion without even conducting an examination [WSJ Staff, 1983a].

(continued)

the collapse of the entire state-regulated savings and loan industry in the State of Ohio and was attended by a significant drop in the value of the dollar [Williams, 1985].

Based on the number of lawsuits filed against accountants, the public also believes the problem to be serious. Most of the lawsuits are settled out of court, with the accounting firms paying large settlements. For example, Arthur Andersen & Co., the nation's largest CPA firm, has had settlements of almost $140 million since 1980 [Berton, 1985b].

One final point should be made regarding the extent of the independence problem. A problem audit is usually detected only after the audit client files for bankruptcy. As long as the client company remains solvent, the accountant's work is rarely scrutinized by persons outside the profession. This raises a big question. If this many problem audits have been detected, how many more have gone undetected? Is it possible that only the tip of the iceberg has been exposed?

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Summary and Conclusion

An auditor's opinion has meaning because the public places confidence in the auditor's ability to make decisions objectively. There is no doubt that the accounting profession, as a whole, is comprised of men and women of high integrity. At the same time, however, accountants are human. Because they are human, their audit decisions cannot be made in a vacuum. Their decisions always have and always will be affected by a certain amount of pressure (e.g., time-budget pressure and client pressure). When this pressure becomes too great, however, the accountant's independence can become impaired. The number of questionable audits that have been disclosed in recent years indicates that perhaps this pressure point has been reached quite often. Ω

TABLE 1
A Partial Listing of Problem Audits
(continued)

Ernst & Whinney (1979-1982)	United American Bank	The bank collapsed just three weeks after receiving a clean opinion from the CPA firm. Even though FDIC examiners were at the bank the same time as E & W, the accountants did not talk to the examiners to find out the status of the FDIC investigation [Stricharchuk and Darlin, 1982].
Coopers & Lybrand (1980)	Security America Corp.	The CPA firm did not qualify its opinion even though the client's income was inflated due to inadequate reserves for losses on workers' compensation cases [WSJ Staff, 1983b].
Ernst & Whinney (1980)	Dayco Corp.	The CPA firm failed to detect $120 million in phony orders for rubber hoses and belts and $14 million in advance commissions paid a sales agent who allegedly placed the orders [Stricharchuk and Darlin, 1982].
Price Waterhouse (1980)	AM International	The SEC sued the CPA firm because the auditors knew of, or "but for a conscious or reckless disregard for the facts" would have known of, many instances where the financial statements were not in accordance with GAAP [WSJ Staff, 1985b].
Alexander Grant & Co. (1980-1983)	ESM Government Securities	A CPA firm partner accepted personal payments totaling $125,000 from officers of the client company. In return, even though the client was insolvent, clean audit opinions were given on the client's financial statements from 1980-1983 [Brannigan, 1985].
Peat, Marwick, Mitchell & Co. (1981)	Penn Square Bank	Along with officers of the bank, the CPA firm was sued for fraud for concealing the nonperformance of certain delinquent loans [Pasztor, 1985].

(continued)

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TABLE 1
A Partial Listing of Problem Audits
(continued)

Fox & Co. (1981)	Alpex Computer Corp.	The CPA firm was censured by the SEC for performing a reckless audit. The firm did not adhere to professional standards. This resulted in its failure to discover material fraudulent transactions, including worthless notes and overvalued real estate property [Wendell, 1985].
Coopers & Lybrand (1981-1982)	Digilog Inc.	The SEC charged that the CPA firm had engaged in "improper professional conduct" when it issued a clean opinion on the client's financial statements. Digilog failed to consolidate its financial statements with that of DBS International, a company controlled by Digilog. This resulted in a $1.2 million overstatement of Digilog's 1982 pre-tax earnings [Ingersoll, 1984].
Seidman & Seidman (1983)	Chronar Corp.	The CPA firm was censured by the SEC for failing to gather sufficient evidence to warrant the clean opinion given. The CPA firm did not challenge two questionable transactions that overstated revenue by $2.7 million [Ingersoll, 1985].
Numerous CPA firms (1984)	Government grants	A GAO study asserted that 1/3 of the audits performed on government grants by accounting firms in 1984 were sloppy and may warrant discipline by the state regulators. Furthermore, many accountants conceded that their audits of U.S. grants were inadequate [Berton, 1986a].
Touche Ross & Co. (1984)	Beverly Hills Savings & Loan	The CPA firm helped its failing client restructure some of its ailing investment projects into equity-participation loans. This allowed the client to accrue interest on these loans and was a highly questionable accounting practice [Pound, 1985].

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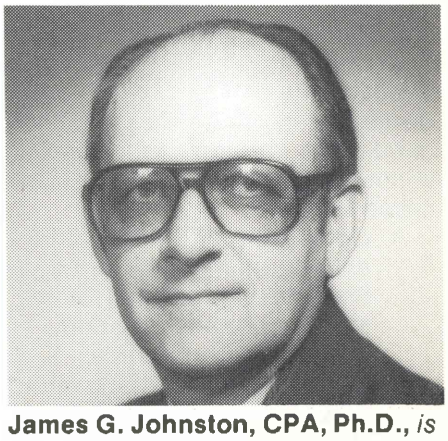

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