

Kristine Hollman ©

March 5, 2002

## **AUDITOR INDEPENDENCE**

### **Abstract**

The purpose of this paper is to examine auditor independence. This paper begins with an overview of what auditor independence means as well as what can impair an auditor's independence. It also discusses the Securities and Exchange Commission's and the American Institute of Certified Public Accountant's views on independence. There is also a discussion of the new rules set forth by the SEC and what the Big 5 is doing in response to these rules. There is an overview of the Ramsay Report, a report conducted by a professor in Australia, which gives some suggestions on how to improve independence standards. There is also a discussion of Enron and the effects of its collapse on the accounting profession. The Council of the American Institute of Certified Public Accountants stated, "Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and its stature" (Leibell). Since accounting is generally considered a self-regulated profession, the idea of maintaining independence is very important. Many years ago, former SEC chairman, Harold Williams "criticized accountants not just for auditing their own work as consultants, but for lacking the appearance of independence to the public" (Berton, 2000). With many of the recent scandals being brought to light, the biggest being Enron, the idea of auditor independence has been under great debate. The main question being debated is whether a CPA firm can provide non-audit services for an audit client and still remain independent.

## **Definition of Auditor Independence**

The Independence Standards Board defines auditor independence in their exposure draft of a conceptual framework for auditor independence. This definition describes independence as "freedom from those factors that compromise, or can reasonably be expected to compromise and auditor's ability to make unbiased audit decisions." The auditor must not only comply with independence rules, but also personally assess his or her objectiveness and determine if there are other factors that may lead to the compromising of their unbiased opinions (McGrath et al, 2001). The conceptual framework also goes on to describe the goal of independence as a means to increase the ability of the user's of the financial statements to rely on the accuracy of the statements and to increase the cost-effectiveness of the capital market. Auditor independence also helps increase the credibility of the audit process and the client's financial statements, which is the ultimate goal of an auditor (McGrath et al, 2001). The rules defining and regulating auditor independence has not been clear and have been under much scrutiny. For many years, an auditor's independence has been generally directed by common sense and conservatism along with the rules already in place. These general concepts have led to the need for a more concrete definition of independence, which led to the conceptual framework (Elliott, 1998). The root of this framework is whether the auditor's interest in the client creates an undesirable risk of material bias. As well, when defining auditor independence, the topic of investors and investor confidence must be approached. One of the main factors of investor confidence is that the auditor has maintained independence (Elliott, 1998 and Rankin, 1998).

## **Threats To Independence**

The conceptual framework of the Independence Standards Board defines five types of threats that may impair an auditor's independence. One threat is self-interest. This is the

threat that occurs when the auditor acts in his or her own self-interest to satisfy personal or financial needs. Another threat is self-review which is the threat of bias when an auditor audits his or her own work or the work of a co-worker. A third threat is advocacy. This is when the auditor supports or disagrees with the client's position as opposed to providing an unbiased opinion. Another threat is familiarity which occurs when trust and a close relationship is formed with the audit client. The final threat is intimidation. This is when the auditor is either outright or secretly pressured by the client or another involved party to render a certain opinion (McGrath et al, 2001). The three "Cardinal Sins" set forth by the AICPA in regards to auditor independence and how to maintain it are as follows. One rule is that a firm should not depend financially on a client. The second rule is that the firm should not have conflicting interests, which would impair the objectivity in regards to the financial statements. The third rule is that the firms should not have relationships with clients which involve managerial decisions or that could affect the auditor's objectivity (Rankin, 1998). An additional threat to independence is the power that the company's management has over the auditors. They can hire and fire the auditors at their own will. The client's management is often seen as the client and the auditor wants to do everything they can to make them happy. The fact that the auditing company is also providing non-audit services often leads to more accommodating auditors because the auditor does not want to lose next year's audit as well as the other services being provided (Hussey and Lan, 2001).

### **SEC's Position on Audit Independence**

The SEC began expressing some concern about the changing relationships between auditors and clients for many years. The Big 5 accounting firms, which perform 90% of the audits of publicly traded companies, no longer consider themselves to be just accounting firms. They are now "multidisciplinary professional service organizations." This has led to

questions of auditor independence not only in fact, but also in appearance. In 1999, the SEC performed a review of Pricewaterhouse Coopers LLP. In this study, the SEC discovered over 8,000 violations of independence rules regarding investments by auditors and their families and the investments offered by the audit client (Leibell). The SEC has also decided to restrict or prevent an auditor from providing an audit client with non-audit services. Isaac Hunt, the SEC commissioner, said, "I believe increased reliance on income from consulting services, as well as the growing number of business relationships between auditors and clients, calls into question the ability (of accountants) to remain independent in carrying out their statutory audit responsibilities" (Rankin, 1998). They have also decided that when providing these services, the company actually has two clients. One client is the actual firm and the other is the shareholders or other users of the financial statements. This provides evidence of an obvious conflict of interests. Therefore, the credibility of the audit report is compromised (Leibell).

### **The New Rules**

The SEC and Big 5 eventually reached a compromise on November 14, 2000. This led to the new SEC rules, which went into effect on February 5, 2001. These new rules were the first changes to audit independence rules in 18 years. These rules restrict the amount and nature of work that the auditing firms may perform. Also, audit committees of corporate boards must consider whether non-audit services maintain audit independence. Furthermore, the accounting firms are required to publicly disclose all audit, information technology, consulting and other non-audit fees paid to the firm. These disclosures are all in spite of the fact that there has never been a case where the audit's failure has occurred because of the firm's lack of independence (Leibell, Melancon, 2000 and Middlemiss, 2001). These new rules also prohibit the auditor from participating in an audit if the auditor has a

close family member working in an audit sensitive position. The new rules also name nine non-audit functions that may not be performed by the independent auditor for an audit client. Seven of these functions have already been prohibited by other existing rules and they added two new ones. These rules are mostly a codification of the current AICPA standards (Feltman and Turner). One prohibited activity is that the auditor may not keep records that are submitted to the SEC. The auditor also may not run the client's information technology systems, but they may consult with the client about their information technology systems if certain conditions are met. One condition is that the management must accept responsibility for the internal controls and must identify who will make all of the decisions for the project. Another condition is that the determination of the acceptability of the system must not be chiefly based on the auditor's work (Feltman and Turner). The auditor may also not appraise valuation services or the results will be material to the financial statements or if the auditor will be auditing their own work. Another prohibited activity is that the auditor may not perform more than 40 percent of the clients internal audit work relating to the financial statements or internal controls. The only exception to this rule is if the client's assets are less than \$200 million (Feltman and Turner). Another restriction is that the auditor cannot do any of the client's decision-making or work as an employee or manager or the client. In addition, the auditor may not recruit or recommend job applicants for the client. On the other hand, the auditor can interview applicants and assess whether the interviewee would be proficient in a financial accounting, administrative or control position (Feltman and Turner). Staying consistent with present AICPA rules, an auditor may not act as a broker-dealer, promoter or underwriter for any of the client's securities. In addition, any services that require a person to be admitted to the bar may not be performed by any auditor (Feltman and Turner).

## **AICPA's Position on Independence**

While the AICPA supports the reform of auditor independence rules, the AICPA did not agree with the SEC's opinion of auditor independence. In response, they argued to cut off funding for the Public Oversight Board and claimed that the new rules were unnecessary. The Public Oversight Board is an independent entity that was set up to consult with the SEC in order to ensure that the public interest in auditing and independence were appropriately considered. The AICPA claimed that there was no proof that the non-audit services were actually impairing the firm's independence. The AICPA also argued that cutting back on non-audit services would actually reduce the ability of the firm to provide good audits because the auditor would lose knowledge of the client. It was also argued that the most talented CPA's would no longer want to work for auditing firms and that CPA's would never risk their independence just to get the consulting fees (Leibell). There are also arguments being made that in order to be effectively involved in the current economy, one must be diverse in the services one provides. This new rule prevents the firms from gaining valuable and diverse relationships with audit clients. Another argument is that audit fees will have to go up because firms will have to reduce their size and the clients will have to bear a larger portion of the overhead. Cost will also go up for the accounting firms as they have to spend more money in order to enforce these new rules (Melancon, 2000). Lynn Odland, chairman of Deloitte Touche Tohmatsu, says, "In companies where the audit cost is shown as \$35,000 and the non-audit services as \$135,000, people reach the conclusion that the other services are more important than the audit. But doing non-audit projects probably enhances the quality of the audit and gives investors, and the audit committee and the board more assurance" (Auditors Still Feel Misunderstood).

## **The Ramsey Report and University of Technology Sydney Research**

Professor Ian Ramsay, the director of Melbourne University's center for corporate law and securities regulation, performed a study of auditor independence for the Australian government. In October 2001, he published a 237-page report making recommendations on improving auditor independence. Originally audit firms claimed that his recommendations would have little or no effect on how they currently operate. They said this because they felt that their own policies met or exceeded his recommendations. Now the large audit firms have changed their attitude toward the report. In fact, some firms are even suggesting that the rules should be even stricter than his suggestions (Walters, 2002). Some of Ramsay's suggestions include legislative changes to audit independence rules and the adoption of international professional standards by accounting bodies. He also recommended banning auditors from providing certain non-audit services, but still letting them provide some other services. By banning all non-audit services, the firms would lose millions of dollars. In allowing the firms to provide non-audit services, Ramsay suggested that there be a detailed disclosure of non-audit services and fees paid in the company's financial statements (Walters, 2002). Another recommendation in the Ramsay report is to form an Auditor Independence Supervisory Board. This board would have 12 members and would be funded by accounting organizations. However, only two representatives from the accounting profession would be allowed to be on this board. This board would be responsible for overseeing that non-audit services were properly disclosed and to review international developments regarding independence and their effects on professional practice. The board would not discipline the auditors, only monitor the existing disciplinary boards (Walters, 2002). The audit firms originally criticized this board. They claimed that 12 members were too many, the accounting profession was not represented fairly and the accounting organizations did not

want to pay for it. Nonetheless, support for this board is now growing. This board would also help the accounting profession maintain self-regulation. The chief executive of KPMG, Lindsay Maxsted, said, "Ramsay's statutory board is important for two reasons. Having people independent of the profession and statutory regulators looking at these issues will have a positive effect, reassuring shareholders and people who work for the company, everyone, that [auditors] do understand the system, and get it right 99.9 percent of the time, And to say, 'Yes, we understand why that one slipped'" (Walters, 2002). Ramsay also suggests that certain employment and financial relationships between the firm and clients be banned. He recommends that former audit-firm partners who were directly involved in a client's audit be banned from being employed in an audit sensitive position for at least two years after leaving the audit firm. This stems from the fact that some former Andersen partners were directors at Enron and HIH Insurance in Australia and both companies are now going bankrupt. In explaining the reasoning for this delay in employment, Ramsay said, "The former auditors may be so familiar with the audit approach that they know the limits of the audit. Also, if the audit partners know they are going to work for a client, potentially they may not exercise the appropriate level of care, or challenge management over a problem. Finally, the remaining members of an audit team may be reluctant to challenge a director who was their former boss or peer, limiting the healthy scepticism that is essential to independence" (Walters, 2002). Research done over six years by the University of Technology Sydney and published in January 2002 seems to contradict the belief that non-audit services lead to a conflict of interest for the auditing firm. The study was based on analysis done on the reported income of 500 companies from 1993 to 1998. The study used "earnings conservatism" as a measure of independence and found that large audit firms were able to maintain their independence even if they received fees for non-audit services. Large

firms were also found to treat the reporting of their client earnings more conservatively when they received funds from non-audit services. In addition, the higher the non-audit fees paid, the more conservative the auditors treat earnings. On the other hand, in small firms that received higher non-audit fees were linked with less conservative earnings.

### **Enron and Its Effects**

The collapse of Enron, one of the largest energy trading firms, has brought the issue of auditor independence and questions about the entire auditing profession back into the media spotlight. In February 2002, Peter Costello, the Federal Treasurer, promised the government would make it a priority to resolve issues such as conflict of interest and legal liability for auditors. Many auditors believe that the self-regulation that they have enjoyed for so long is under threat. Public confidence in the auditor's abilities and audit independence has dropped dramatically. Rob Ward, a partner at PricewaterhouseCoopers, said, "It is not a crisis, but it is certainly bringing a whole range of rules and governance issues under scrutiny. And if it is not responded to effectively, we will wind up with a crisis" (Walters, 2002). Arthur Andersen was Enron's auditor and has had their reputation damaged in the aftermath. Part of the debate is over the fact that Andersen earned \$25 million from the audit and \$27 million from consulting. When acting as a consultant, Andersen reported directly to management (Auditor Independence). Many of Andersen's employees are resigning and looking for new work. Companies are also being forced to choose whether they want to continue to use Andersen as their auditors because of the damage done to Andersen's reputation (Aronson, 2002). Auditors also want to have a more educated public when it comes to what the audit means and what the auditor's report means. The public seems to think because the auditor signs a report that the company is doing fine. The reports may not even be qualified but the public thinks that the company will be around for a long

time. Auditors also want the public to know that they do not guarantee or comment on the company's future. They only look at the historical figures. Auditing and Consulting, Is Independence Maintained? Audit firms have realized that consulting is where they can make the most money and are now using the audit as a means to get a foot in the door. This has resulted in lower fees for the audit itself. Once the firm has secured the audit, they can use the knowledge gained from the audit to point out problems within the company. They then try to convince management that they are needed to help in fixing these problems, of course, at a much higher price. Audit firms claim that by buying audit and non-audit services from the same firm helps to cut costs and is more useful because of the knowledge gained in other areas. Other research suggests that companies that shop around and receive their services from separate firms get the better financial value (Sikka, 2002). Obviously, it would seem that an audit firm couldn't objectively report on work done by their own company. There has also never been a case where auditors have done consulting work for a company and then later reported them for having questionable practices. While there has been no evidence that providing consulting services impairs independence, it is easy to see where one could get the impression that it was indeed impaired (Sikka, 2002). One possible reason that there is no evidence of damage to independence is that auditing firms are so guarded. No information regarding the conduct of the audit is published and their working papers are not available for the public to see. The auditing industry is also protected by the Department of Trade and Industry. This department obstructs the investigation of big audit failures. There have been alleged fraud and questions of independence and standards of work in several cases, such as Levitt Group, Polly Peck and Barings and Resort Hotels. Yet each time the Department of Trade and Industry did not hold any investigations (Sikka, 2002). One questionable practice done by Andersen was the type of consulting that they did for Enron.

They helped to set up Enron's internal accounting procedures and helped train the employees. Later, when they performed the audit, they were auditing their own work and it is unlikely that they were able to be entirely objective about the procedures. In fact, when the SEC wanted to limit the consulting done by auditors, the chairman of Enron wrote a letter that commended Andersen's work in helping set up these procedures. These were also the procedures that led to the eventual downfall of the company (Aronson, 2002).

### **Suggested Solutions**

While there are no easy answers, there are some compromises and other options that may need to be considered. One option is to limit the length of time a firm may audit a company's financial statements. In some cases the same firm has been auditing a company for many years, as is the case with Ernst and Young auditing Equitable for over 100 years. This definitely raises questions of auditor independence. The auditors are unchallenged when they remain in the same place for a large period of time. One suggestion to remedy this situation is to have mandatory rotation of auditors with a maximum term of seven years. An additional suggestion was to at least have a company revalue the audit on a regular basis. This would require the existing auditor to re-bid for a new contract against other auditors. If this issue is not resolved, there may not be any other option but mandatory rotation of clients (Insight, 2002). Another suggestion is to provide more useful information in the auditor's report. The information currently provided is the bare minimum. More information could help shareholder's make decisions and still not reveal sensitive material about a company. Accounting firms should also publish their own annual reports. Shareholders and investors will gain confidence in a firm if they can see that they can manage their own financial statements correctly (Insight, 2002). A third suggestion is to ban the acceptance of audit fees. In order to do that, it would require a change in the industry. One suggestion is a

new structure that would be based on governmental auditing and audit costs that would be paid by tax revenues (Elliott, 1998). While this seems like a good idea, a tax increase would most likely be needed and the American public does not like to be subject to a tax increase.

### **Bibliography**

Aronson, Barton. "The Enron Collapse and Auditor Independence: Why the SEC Should Go Further In Regulating Accounting Firms." FindLaw's Legal Commentary, 24 January 2002, <http://writ.findlaw.com/aronson/20020124.html> (1 March 2002).

"Auditing the Auditors" January 2, 2002. Shares Magazine (Australia). Available: Lexis-Nexis (February 25, 2002).

"Auditor Independence Falls Under the Spotlight." February 18, 2002. The Straits Times (Singapore). Available: Lexis-Nexis (February 25, 2002).

,

"Auditors Still Feel Misunderstood." November 1, 2001. Business Review Weekly (Australia). Available: Lexis-Nexis (February 25, 2002).

Basar, Shanny. February 6, 2002. "Deloitte Succumbs to Pressure and Separates Consultancy Arm." eFinancial News. Available: Lexis-Nexis (February 25, 2002).

Berton, Lee. January 3-23, 2000. "Ernst, Cap Gemini Raise the Stakes." Accounting Today. Available: Lexis-Nexis (February 25, 2002).

Editorial Staff. July 23, 2001. "Audit Conflicts Are Worse Than Originally Thought, Unger Says" Investor Relations Business. Available: Lexis-Nexis (February 25, 2002).

Elliott, Robert K., and Jacobson, Peter D. December 1998. "Audit Independence Concepts." CPA Journal 68:12. Available: Business Source Premier (March 1, 2002).

Feltman, Peter F., and Turner, Andrew. "SEC Adopts Auditor Independence Rules" <http://business.cch.com/banking/news/independence.htm> (March 1, 2002).

"GAO Press Statement" January 25, 2002.

<http://www.agacgfm.org/news/press%20rel/gao012502.pdf>. (March 1, 2002).

Henriques, Diana B. February 5, 2002. "Enron's Many Strands: A Big Investor; Even a Watchdog is Not Always Fully Awake." *The New York Times*. Available: Lexis-Nexis (February 25, 2002).

Hussey, Roger, and Lan, George. July 2001. "An Examination of Auditor Independence Issues From the Perspective of U.K. Finance Directors." *Journal of Business Ethics* 32:2. Available: Lexis-Nexis (February 25, 2002).

"Insight: A Financial Manifesto; Restore the Faith." January 31, 2002. *Accountancy Age*. Available Lexis-Nexis (February 25, 2002).

Leibell, Jeffrey N. "Auditor Independence: Fact or Fiction?" <http://www.blbglaw.com/pubworks/jlauditind.pdf>. (March 1, 2002).

McGrath, Susan, Sieger, Arthur, Dunfree, Thomas W., Glazer, Alan S., and Jaenicke, Henry R. January 2001. "A Framework for Auditor Independence" *Journal of Accountancy* 191:1. Available: Lexis-Nexis (February 25, 2002).

Melancon, Barry. October 2000. "The Proposed SEC Rule on Auditor Independence and Its Consequences." *Journal of Accountancy* 190:4. Available: Lexis-Nexis (February 25, 2002).

Middlemiss, Jim. April 2001. "New Auditor Independence Rule in Place." *CA Magazine* 134:3. Available: Lexis-Nexis (February 25, 2002).

"A Perspective on the Costs of Audit Independence." December 1998. *CPA Journal* 68:12. Available: Lexis-Nexis (February 25, 2002).

Rankin, Ken. January 19, 1998. "Auditor Independence Paper Sparks AICPA, SEC Clash." *Accounting Today*. Available: Lexis-Nexis (February 25, 2002).

Rittenberg, Larry E. 1999. "Discussion of: The Effects of Internal Audit Outsourcing on Perceived External Audit Independence." *Auditing* 18. Available: Business Source Premier (March 1, 2002).

Sikka, Prem. February 14, 2002. "Independence a Myth When Auditor Plays the Game Too." *The Times* (London). Available: Lexis-Nexis (February 25, 2002).

Walters, Kath. February 14, 2002. "Audit Reform Begins to Look Good." *Business Review Weekly* (Australia). Available: Lexis-Nexis (February 25, 2002).