Auditors' Independence

An Honors Thesis

by

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Abstract

This thesis covers auditors' independence in three main sections. The first section is on the history of auditors' independence standards. The second section is on the current standards governing independence as set forth by the Independence Standards Board, the American Institute of Certified Public Accountants, and the Securities and Exchange Commission. The views of investors and creditors are discussed in the third section. Combined, the sections establish the importance of auditors' independence and what the current standards say.
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Introduction

The practice of auditing is not a new one. Rather, auditing has been going on in one form or another for as long as people have entrusted the control of their properties to others. Of course, audits were relatively simple in their early days. Auditing has developed from a mere practice to a profession upon which the public relies.

There are written accounting records, which offer evidence of audits, from many ancient civilizations. The audit procedures in some ancient civilizations are more complex than those in others.

It is believed that record keeping began in Babylonia around 4000 BCE. In Babylonia, records documenting such things as inventories, income, and expenses were kept. There is evidence that these records were occasionally audited (Chatfield, 5-6).

China’s accounting and auditing histories are impressive. As early as 1122-256 BCE, China developed a set of governmental funds. Reports for each of these funds were prepared every ten days, every month, and every year. Ten-day reports were audited on a random basis, while every monthly and yearly report was given an in depth audit. These audits were often used to determine the performance of government officials and had an effect on an official’s future. As the auditor could affect the future of a government official, it was recognized that the auditor needed to be free from fear of any repercussions from disagreeable findings, as well as independent. As a result, the auditor, known as the Comptroller General, was considered to be of a higher position than the Grand Treasurer. This allowed the auditor to have the independence needed (Chatfield, 8-9).
Written records were also found on the accounting and auditing practices in other ancient civilizations. Surviving accounting and auditing documents have been found in Egypt, Greece, and Rome.

More recently, there are written records of audits from the thirteenth century. Some of these early audits were performed for the noblemen to check on the honesty of their servants, while other audits were performed on public officials, such as tax collectors. Obviously, early auditors simply verified that records agreed with what was on hand. Those who performed such audits were not professional auditors, as the profession had not been established yet (Mautz, 240-242).

Eventually, audits were performed on the accounts of trustees and the bankrupt. These audits were performed with a little more skepticism than the audits of servants and tax collectors. Individuals undergoing bankruptcy were often viewed on the same level as criminals, regardless of whether the bankrupt party had actually done something wrong or not. The audits performed as a result of bankruptcy were often reviewed by courts, which, for the first time, introduced the idea of third parties reviewing the results of an audit (Mautz, 242).

More recently, audits have been performed on corporations. Corporations began to have audits performed on their financial statements for the benefit of investors and creditors. Investors and creditors were beginning to question the reliability of financial statements prepared by a corporation with no independent audit. Realizing the potential problems this could cause to the corporation itself, some corporations began to have independent audits performed.
In the United States, we can trace the concern of auditing corporations' financial statements back to 1845. In 1845, a law was in effect that stated 'every auditor must have at least one share in the undertaking, and he shall not hold any office in the company, nor be in an other manner interested in its concerns, except as a shareholder (Rise vol. 1, 17).’ While this early law does not meet current independence requirements due to the fact that the auditor was to be a shareholder, we can see that there was some concern for the auditor’s independence. While the law only allowed shareholders to be auditors, the law also allowed auditors to employ others, such as accountants, they felt were needed to make a report on the accounts (Rise vol. 1, 18).

At that time, there were no guidelines for an auditor to follow. The auditor also had no nation-wide organization in the United States available to him. However, American accountants were beginning to see a need for a nation-wide organization.

On September 20, 1887, the American Association of Public Accountants filed for a certificate of incorporation (Rise vol. 1, 27). The American Association of Public Accountants was the United State’s first national accounting body. The Association began as a small organization. The majority of what few members the Association had were from New York. Over the years their numbers grew, as did the geographical locations of members.

Early on the association focused on such matters as developing a formal education program for accountants and formalizing the profession in much the same way as their British counterparts. Formalizing the profession meant developing a way of distinguishing between the amateur accountant and one who was well-educated and experienced. The Association lobbyed for a bill proposing that qualified persons passing
an examination be issued a certificate declaring them to be a Certified Public Accountant. On April 17, 1896, this bill was passed (Rise vol. 1, 44).

The formation of the American Association of Public Accountants was a first step in the direction of forming auditing standards and guidelines. In 1906 the American Association of Public Accountants created a committee to develop ethics standards for the auditing profession (Herman, 80).

In 1916 the Institute of Accountants in the United States of America was formed from the American Association of Public Accountants (Herman, 80). The Institute of Accountants in the United States of America would later become the American Institute of Certified Public Accountants, which has been instrumental in the development of auditing standards and ethics.

Until the early 1930’s corporations issuing securities were not required to have independent audits performed. The stock market crash in 1929, which preceded the Great Depression, would change that. The crash lead to changes at the New York Stock Exchange, as well as the passage of the Securities Act of 1933 and the Securities and Exchange Act of 1934.

In 1933 the New York Stock Exchange began to require that listed companies have their financial statements audited by independent auditors. The New York Stock Exchange also required that listing companies obtain letters from the auditor’s describing the scope of the audits, the auditor’s access to information, the auditor’s opinion on the fairness of the financial statements, consistency, conformation to accepted accounting practices (Rise vol. 1, 177).
The Securities Act of 1933 and the Securities and Exchange Act of 1934 also made it necessary for corporations to have their financial statements audited by independent auditors. The Stock Exchange’s newly adopted requirements, and the newly adopted acts, placed a great demand on the auditing profession. Where once few companies were requesting auditing services, now all publicly funded companies issuing securities were requesting auditing services. Today in addition to public corporations, many businesses in the United States are audited on a yearly basis. As such the need for independent auditors is continually increasing.

Independent audits are not the only accounting service with an increasing demand. Every year tax laws are changing and increasing in number, and the business world becomes more complex. These changes increase the need for accounting services, tax services, and consulting services. As Certified Public Accountants offer more and more services to meet the increasing needs of their clients, there is a concern that the auditor’s independence will suffer.

Auditor independence is a relevant issue because investors and creditors rely heavily on the auditor’s opinion. In making sound investment decisions, an investor reviews a company’s financial statements and assumes that the auditor is giving an impartial opinion on the fairness of the statements. If the investor did not believe that the auditor was capable of giving an independent opinion on the statements, the investor’s confidence in the statements will be shaken. The same is also true for creditors. Creditors rely heavily on financial statements when determining whether or not to give credit to a company. Creditors will be less likely to trust the debtor’s financial statements if the auditors cannot provide an independent opinion of those statements.
If investors and creditors have no faith in the company’s auditors, they will have little faith in the company. This hurts a company’s ability to conduct business and is undesirable. Thus, if an auditor is unable to maintain independence, then eventually the client will, or at least certainly should, seek another auditor who can maintain independence.

It is becoming more difficult for an auditor to maintain independence and the appearance of independence. In today’s society it is increasingly difficult to do so due to the auditor’s own investment activities, family ties, consulting activities, as well as other matters. An auditor must be aware of any issue that may impair independence.

History of Auditors’ Independence Standards

In 1906 the American Association of Public Accountants, which would eventually evolve into the American Institute of Certified Public Accountants, created a committee on professional ethics with the intention of creating a code of ethics (Lowe, 80). In 1906, the American Association of Public Accountants had no code of ethics and only two provisions in the Associations bylaws related to ethics. Neither of these provisions dealt with auditor independence (Rise vol. 1, 85). The committee did not issue a code of ethics until 1917 (Lowe 80).

In 1907, the committee on professional ethics issued a report. In this report four cases were discussed, two of which dealt with auditor independence. One case discussed was about an audit firm’s relationships. The second case dealt with auditor independence as it related to client’s controlling or changing the auditor’s report. In this case, the committee on professional ethics reported that an auditor should never allow a client to control or change the auditor’s report. Also in 1907, three new bylaws were adopted
which related to professional ethics. Even with the issuance of the three new bylaws, none of the bylaws dealt with independence (Rise vol. 1, 86).

Early in the United States there was no way of addressing technical questions on a nation-wide basis. However, in 1905 The Journal of Accountancy published its first issue. Never before had there been a nation-wide publication addressing technical questions in the field of accounting. Around the same time the American Association of Public Accountants began to include the presentation of technical papers at its annual meetings. These papers were later published in The Journal of Accountancy. The issuance of a nation-wide journal that addressed technical issues lead to differences in opinion between accountants. These differences highlighted an underlying need for standards (Rise vol. 1, 74-76).

In 1912 Alexander Smith wrote a paper entitled “The Abuse of the Audit in Selling Securities.” Smith wrote in his paper of many problems related to audits. In the paper, Smith recommended that uniform accounting principles be adopted. The paper was not well received by Smith’s peers. Arthur Lowes Dickinson, a senior partner at Price Waterhouse & Co., agreed that there were many “evils” present, but that there was no “book for accountants” and that definite principles cannot be laid down. At that time more accountants agreed with Dickinson’s point of view than with Smith’s (Rise vol. 1, 78-79). While Smith and Dickinson were debating accounting principles rather than a code of ethics, the underlying problem applied to both accounting principles as well as ethical principles. At the time, there was a reluctance to adopt any set of standards. However, the common sentiment of the time would soon change (Rise vol. 1, 79).
After World War I, the accounting profession became highly visible. First, the United States became a lender after World War I. Second, more people than ever before were investing in securities. As the number of investors grew, concerns were raised about the lack of independent audits. Investors were beginning to demand more reliable financial information, which led to increased demand for independent audits and a realization that auditors needed a code of ethics (Rise vol. 1, 144).

Before any real “independence standards” existed, there was an independence doctrine. The doctrine indicated that an auditor should not have any relationship with a client that would interfere with an auditor’s findings. The existence of this “doctrine” shows that there was some concern about an auditor’s independence, but the statement was so general that one could interpret it in many different ways. The doctrine did not define what relationships would interfere with an auditor’s independence, so it was a matter of opinion as to whether, or not, a relationship interfered with the auditor’s independence.

In 1917 the AICPA issued its first code of ethics. Independence was not addressed in the initial code of ethics though. Auditor independence would not be addressed in the code of ethics until 1919 (Chatfield, 154 - 155).

In 1919 the American Institute of Certified Public Accountants began to issue rules on auditor independence. The first rule issued on auditor independence stated that an auditor should not make service fees contingent on the results obtained. This rule clearly shows a concern that an audit’s results could be affected by the amount of money the auditor might receive for services performed. A fear existed that if a client company would be willing to pay a high enough fee, an auditor would report that the audit’s
findings were favorably, regardless of the actual findings. It would be several years before another rule related to an auditor’s independence would be issued (Chatfield, 154).

In 1929 the stock market crashed. This event shook the business world, the accounting profession was no exception. After the Crash a more serious look would be taken at auditing standards in general, including auditor independence. However, it was not until 1941 that the next rule on independence would be issued.

The next rule on independence, issued in 1941, stated that the auditor should not have a substantial financial interest in companies the auditor audits. An auditor with a large financial interest in a client company might have some incentive to give a favorable opinion. This concerned the profession and financial statement users enough that the issue had to be addressed (Chatfield, 154).

Later, in 1964, a rule was issued that revised the 1941 rule. The rule stated that the auditor was to have no financial interests in the companies audited. The 1941 rule allowed an auditor to hold some financial interests, which raised the question “How much financial interest may an auditor hold in a client and still be considered acceptable?” The 1964 rule eliminated this question (Chatfield, 154).

The AICPA was not alone in issuing rules on independence. Under the Securities Act of 1933, the Federal Trade Commission had the power to enact a regulation on independent auditors. Under the new regulation an auditor would not be considered an independent auditor if “he had any interest, directly or indirectly, or with whom he was connected as an officer, agent, employee, promoter, underwriter, trustee, partner, director, or person performing similar function (Rise vol. 1, 198).” In 1934, it was noted that an auditor may own some shares of a client’s stock. In 1936, the 1933 regulation was
further revised when “any interest” was changed to substantial interest. The SEC defined substantial as auditors holding one percent or more of their wealth in the client’s stock (Rise vol. 2, 177).

Over the years the SEC would rule on independence in many cases. The SEC’s rulings affected the auditing profession, forcing the profession to address certain issues before the profession was ready to. Independence in appearance, not just fact, was one such forced issue. Auditors had to be concerned with independence in fact and appearance.

In 1963, the AICPA’s committee on professional ethics, which issues opinions on ethical issues, issued Opinion Number 12. This opinion stipulated that an auditor must avoid relationships that do not have the appearance of independence to the public (Rise vol. 2, 193).

Later, in 1964, Opinion Number 15 was issued. This Opinion dealt with what should be done when an auditor is found not to be independent. Opinion 15 concludes that if an auditor is found not to be independent of the client, the auditor’s report should state that the audit was not performed in accordance with generally accepted accounting principles. Previously, there had been no prescribed method on what to do with the auditor’s report when it is found that the auditor was not independent (Rise vol. 2, 458).

Later still, Opinion Number 16 was issued. Opinion 16 dealt with retired partners who held interests in client companies. This Opinion found that if the retired partner was still active in the firm and held stock, or a position on the client’s board, that the firm’s independence was impaired. This Opinion recognizes that a firm’s relationship with retired partners can have a great effect on the firm’s independence (Rise vol. 2, 459-460).
The AICPA's original Code of Professional Ethics, Opinions, government
regulations, and SEC rulings all have had an effect on the profession. These all lead to
the current AICPA's Code of Professional Ethics as it was adopted on January 12th, 1988.
The Code of Professional Ethics' current rules related to independence are Rules 101,
102, and 191.

Current Standards

Currently, there are three main independence standard setting bodies in the United
States. These are the Independence Standards Board, the American Institute of Certified
Public Accountants, and the Securities and Exchange Commission. Each body has its
own opinion on what is required for an auditor to be independent, and has issued
standards. As a result, some independence standards may conflict. In a situation where
two applicable independence standards conflict, the more restrictive standard should be
applied. Following the stricter of the conflicting standards will prevent any questions as
to whether, or not, the auditor is independent.

Independence Standards Board

The Independence Standards Board was developed in 1997. The Independence
Standards Board was developed to deal solely with the issue of auditor independence. In
the words of William T. Allen, Chairman of the Independence Standards Board, "the goal
of the Independence Standards Board is to establish independence standards applicable to
the audits of public entities in order to serve the public interest and to protect and
promote investors' confidence in the securities market." In meeting the goals of the
Independence Standards Board, the Board has developed "A Conceptual Framework for
Auditor Independence," as well as a few standards.
The Independence Standards Board's "Conceptual Framework" defines auditor independence as the "freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditor's ability to make unbiased audit decisions." However, this definition leaves much to interpretation. What pressures and other factors may compromise an auditor's ability? What would be considered reasonable or unreasonable? (Conceptual Framework, paragraph 4.)

"A Conceptual Framework" details four concepts related to auditor independence. These concepts are threats to auditor independence, safeguards to auditor independence, independence risk, and the significance of threats and the effectiveness of safeguards. The first concept, threats to auditor independence, states that a threat to auditor independence is anything that may influence the auditor. Threats include anything that can be expected to influence the auditor, regardless of whether or not the "threat" actually does influence the auditor. A safeguard to a threat, which is covered in the second concept, is anything that reduces or cancels out the threat. Independence risk, the third concept, is the risk that a threat to the auditor's independence will have some effect on the auditor's decisions. The fourth concept is related to the significance of a threat. The more a threat increases independence risk, the more significant the threat is considered.

The basic principles of auditor independence outlined in "A Conceptual Framework" are as follows: "assessing the level of independence risk; determining the acceptability of the level of independence risk; considering benefits and costs; and considering the views of investors and other interested parties when auditor independence issues are addressed." These principles are all helpful in determining whether the auditor's independence is impaired.
“A Conceptual Framework” discusses many fundamental concepts and principles related to independence. “A Conceptual Framework” provides a comprehensive understanding of independence as a concept before examining the many complex standards related to independence.

The Independence Standards Board has issued three standards in addition to the “Conceptual Framework.” Independence Standards Board Standard No. 1 deals with the discussion of independence with audit committees. Independence Standards Board Standard No. 2 is about issues that may arise during audits of mutual funds and related entities. Independence Standards Board Standard No. 3 discusses employment of former employees of the audit firm with audit clients.

Independence Standards Board Standard No. 1 mandates that each year an auditor must inform the audit committee, in writing, all relationships the auditor has with the client-company’s related parties, and the company itself, that the auditor believes might impair his or her professional judgement. The auditor must also state, in writing, that the auditor believes, using professional judgement as the basis for that belief, that he or she is independent. The auditor should then discuss the issue of independence with the client company’s audit committee, or, in the absence of an audit committee, with the company’s board of directors.

The Independence Standards Board Standard No. 2 deals with independence issues that may arise when auditing mutual funds or related entities. This standard requires that the audit firm be independent of all “sister” funds and related non-fund entities when auditing a mutual fund. Sister funds are defined in this standard as being “mutual funds in a complex with a common investment adviser.”
The Independence Standards Board Standard No. 3 deals with employment with clients. This standard states that a firm’s independence may be impaired when a client employs an individual who was employed by the audit firm at one time. If the individual was an auditor, or if the individual has maintained relationships with the firm, auditor independence will be considered to be adversely affected.

American Institute of Certified Public Accountants

The American Institute of Certified Public Accountants developed the “Code of Professional Conduct.” The “Code” was developed for members and member firms of the American Institute of Certified Public Accountants. Hereafter, the word member will refer to the members of the AICPA. In the “Code” there are two rules related to independence, Rules 101 and 102. In addition to the actual rules, the “Code” also includes interpretations with each rule.

Rule 101 deals solely with independence. Rule 101 states that “a member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.”

After the Rule several interpretations of Rule 101 are discussed. These interpretations provide answers to a multitude of questions raised by the seemingly simple rule. Some of the issues addressed include the effect that investments, family ties, and other services provided by the auditor have on independence.

Many interpretations of Rule 101 deal with an auditor’s investments, or financial interests, in client-companies. An auditor’s financial interests can have significant effects on independence. As such, the “Code” goes into great depth on this subject.
The “Code” divides financial interests into direct and indirect financial interests. Direct financial interests are considered to be equity holdings the auditor has in a client. These include holdings generated from retirement plans, investment clubs, and blind trusts. Also, an auditor who is involved in a partnership, acts as an executor of an estate, or acts as a trustee for a trust with financial interests in clients has direct financial interests in clients, which result in impaired independence.

Indirect financial interests are characterized by equity holdings in a company that is not a client but has ownership interests in a client. Members who are involved in mutual funds, or partnerships where the auditor is a limited partner, have indirect financial interests in the client.

In general, any time a member has direct financial interests in a client, the member’s independence is impaired. A member who holds investments with the client’s officers, directors, or principle stockholders will also be lacking independence. Material indirect financial interests in a client will also impair independence.

Related to financial interests are loans to and from clients, client-company’s officers, directors, and principle stockholders. These loans will, in general, impair an auditor’s independence. Exceptions do exist though. Grandfathered loans and some other types of loans do not have any effect on a member’s independence. Grandfathered loans are loans that existed on, or before, January 1, 1992. This interpretation was issued in 1991, which is why the Code states that loans on, or before, January 1, 1992 will not impair an auditor’s independence. Grandfathered loans must have been made as a normal loan, using the lenders normal lending procedures, terms, and requirements.
Other loans that do not affect auditor independence must also be made using the lenders normal procedures, terms, and requirements. Automobile loans will not impair independence, nor will loans collateralized by cars. Independence is not impaired by loans that are fully collateralized by cash surrender value of an insurance policy. Also, loans that are fully collateralized by cash deposits at the same financial institution making the loan do not impair independence. Credit cards and cash advances for $5,000 or less will not impair independence either.

The interpretations of Rule 101 also address family ties. The interpretation dealing with family ties states that the term member in Rule 101 also includes spouses and dependents.

There are circumstances in which a spouse, or dependent, maybe employed by a client will not impair the auditor's independence. However, the interpretation does not directly address these situations. Instead, the interpretation states what employment situations for spouses and dependents will impair the auditor’s independence. If a spouse or dependent has significant influence over the client’s policies, such as operating, financial, or accounting policies, the auditor’s independence will be impaired. Independence will be impaired if auditors have spouses or dependents are proprietors, partners, or shareholders who are located in an office participating in a substantial portion of the audit. Auditors who have spouses or dependents in a position to exercise influence over the audit, or who have any involvement with the audit will impair independence. Also, independence will be impaired if a spouse or dependent of a person in the audit engagement has a position with the client involving audit-sensitive activities. Audit
sensitive-activities include those activities that have an element of, or are subject to, significant internal accounting controls.

Nondependent close relatives may also impair a member’s independence. Nondependent close relatives may include children, grandchildren, step children, brothers, sisters, grandparents, parents, and parents-in-law. Brothers-in-law and sisters-in-law are not considered close relatives for the purposes of Rule 101.

If a nondependent close relative holds financial interests, which the member is aware of, in a client the auditor’s independence will be impaired. As with dependents, in situations where the auditor’s nondependent close relative can exercise significant influence over the operating, financial, or accounting policies of the enterprise, the auditor’s independence is impaired. Independence is also impaired if a close relative is employed in a position in which the close relative’s activities are audit sensitive.

It should be noted that an individual living with a member, though not a spouse, may be considered the equivalent of a spouse. The reason for this is that the appearance of independence is just as important as the fact of independence.

Interpretations are also given with regards to a member who performs other services, in addition to auditing, to a client. In general, members may perform other services, which do not require independence, without impairing their independence as an auditor. Other services an auditor might be asked to perform include extended auditing services and consulting services.

Before performing other services the member should review the effect those other services might have on independence. Members should also document, in an engagement
letter, their responsibilities in the engagement and client’s responsibilities so there are no misunderstandings.

The interpretations clearly state what the client’s responsibilities are. The client is responsible for designating a management-level individual or individuals to be responsible for overseeing the services being provided. The client is also responsible for evaluating the adequacy of the services performed and any findings and results, making management decisions, including accepting responsibility for the results of the other services, and establishing and maintaining internal controls.

There are several activities that a member should not participate in, as the activities will impair independence. These include authorizing, executing, or consummating a transaction, or otherwise exercising authority on behalf of a client or having the authority to do so, preparing source documents or originating data, having custody of a client’s assets. Also, a member who supervises a client’s employees while those employees are performing normal, recurring activities will not be considered independent. If a member makes recommendations to a client, the member determining which recommendations to implement will impair independence. The member reporting to the board of director on behalf of management and serving as a client’s stock transfer or escrow agent, registrar, general counsel or its equivalent also impairs independence.

Independence may also be impaired as a result of litigation. Litigation is relevant to independence because a member’s objectivity may be affected. A member must be able to render a fair and impartial opinion. Litigation may prevent a member from doing so as members may be concerned with their own interests.
Litigation between clients and members may be brought about by either party in various circumstances. The "Code" identifies litigation, or threatened litigation, by a client against a member for reasons of deficient audit work, as an impairment of independence. Litigation brought about by a member, against a client, for reasons of management fraud or deceit will also impair a member's independence. However, the interpretations do state that if a client litigates a member for an engagement that does not require independence and the amount in question is not material to either the client or the member, independence will not be impaired.

Security holders may also decide to litigate. The litigation may be against clients or members. In such situations, independence will generally not be impaired. However, when litigation is raised against a client, and the client wishes to file a cross-claim against the member to protect a right to legal redress, independence may be impaired. Independence will be impaired in this situation if the amount of the claim is material to the member's firm. Cross-claims against members by underwriters will not impair the members' independence so long as no claims are raised by the client or its management. Also, if officers or directors of other clients' raise litigation against a member the member's independence, with respect to those other clients, will not be impaired.

Finally, there is the possibility that litigation will be raised by third-parties. Third parties who may litigate include creditors, insurance companies, and others. When third-parties file to litigate against a member, the relationship between the actual client and member is not affected, and thus, independence is not impaired. In some situations third-parties litigating may also be a client. Another client may be considered a third-party in a litigation when that client is raising litigation against the auditor due to the audit of
another client. This may happen in situations where the third-party corporation has ownership interests in the client whose audit is in question. Independence, with respect to the client litigating, will be impaired if the amount involved is material to the firm or the third-party client.

When a member believes that the circumstances involved in litigation would lead a reasonable person to believe that the member's independence is, or has a real threat of being impaired, the member should act as though independence is impaired. The member should disengage or disclaim the opinion due to a lack of independence.

One interpretation of Rule 101 deals with "former practitioners." In this interpretation, the term former practitioner refers to anyone who was a proprieter, partner, shareholder, or equivalent at the firm and who leaves by resignation, termination, retirement, or sale of all or part of the practice. Generally, a former practitioner is not considered a member when determining a firm's compliance with Rule 101. However, there are some requirements that must be met for this to be true. One requirement is that any amount due to the former practitioner from the firm, must not be material to the firm. The former practitioner must not be involved in, or appear to be involved in, the firm's business activities. The former practitioner must not have significant influence with clients and must not be provided with office space by the firm. The failure to meet all of these requirements may result in the former practitioner still being considered a member of the firm, which, needless to say, can have significant implications on the firm's independence.

Another situation that may impair independence is a cooperative arrangement with the client. A cooperative arrangement is when a firm and a client participate,
together, in a business activity. Examples of cooperative arrangements are joint ventures to develop or market products and arrangements to combine services or products of the firm and the client and market the combined services or products. When the amount of money involved in cooperative arrangements is material to the client or the firm, independence will be impaired.

The interpretations also address situations in which a member allows a not-for-profit organization to use his or her name. A member may be named as an honorary director or trustee of a not-for-profit organization and still maintain independence with respect to the not-for-profit organization as a client, provided that the member does not have the right to vote or participate in board or management activities.

Rule 102 states that “in the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.” Unlike Rule 101, the word independence is not specifically mentioned. While independence is clearly implied, this rule has less to do with the subject of independence. The implication of independence lies in the fact that an auditor must be independent to remain objective during an audit.

An interpretation of Rule 102 related to independence discusses conflicts of interest. This interpretation states that if a member believes that a conflict of interest exists, the member must notify the client, and any other relevant parties, and obtain permission from the client to provide the services in light of the conflict. However, in services requiring independence, such as audits, disclosing the conflict of interest and
obtaining permission to provide the services will not change the impairment of independence.

The rules set forth by the American Institute of Certified Public Accountants cover such issues as financial interests, family ties, providing other services, and litigation, to name a few. These rules and standards give auditors the basic requirements to what must be done in order to maintain independence from the viewpoint of the profession.

Securities and Exchange Committee

In the year 2000, the Securities and Exchange Commission reviewed, and revised, its auditor independence standards. Prior to the year 2000, the SEC’s independence regulations had not been updated since 1984. Needless to say, the business environment has changed significantly since then, causing a need for the reevaluation by the SEC of independence.

Early in 2000, the SEC developed its proposed rule on independence. Many practitioners and other interested parties viewed this “proposed rule” as being extremely restrictive. The proposed rule contained several restrictions that would have weighed heavily on auditors and firms. The proposed restrictions would have prevented auditors from performing information technology consulting services, internal auditing services, and expert services such as tax services. Also, an auditor or the auditor’s firm could not hold an investment in an entity that held more than a 5 percent investment in a client without it being considered a “material indirect investment.”

Many objections were raised to the proposed rule through some 3,000 letters on the matter, as well as testimonies given during three hearings held on the issue. The
proposed rule, if adopted as the final rule, would have had significant effects on many accounting firms and practitioners.

After the SEC’s proposed rule was issued, the SEC held three hearings on auditor independence. The purpose of these hearings was for interested parties to come together and discuss the rule. Some of the parties participating in these hearings include professionals from accounting firms, CEOs, professors, investors, and public officials, to name a few.

Through all the testimonies, there tends to be a common theme. Most individuals spoke on the effects of consulting, and other non-audit, services have on independence. Other issues were discussed as well, such as investments.

Those present at the hearings tended to believe that independence was not affected by non-audit services, or independence was adversely affected by non-audit services. There were a surprisingly large number of individuals present at the hearing to represent both sides of the issue. However, the majority of people tended to believe that independence is not impaired by non-audit services.

Each individual who testified generally gave well-prepared comments. While there are basically two sides to this issue, many different reasons for arriving at these conclusions were raised. Some reasons are more thought provoking than others.

J. Michael Cook, the former Chairman of the Board and Chief Executive Officer of Deloitte & Touche, was only the second individual to give testimony at these hearings. Cook disagreed with the belief that non-audit services have no effect on independence for one very simple reason, the appearance of independence. The standards establish the
appearance of independence to be just as important as the fact of independence. Thus, if independence appears to be impaired there is a serious problem.

Robert Elliott, the Chairman of the American Institute for Certified Public Accountants, also gave testimony. Elliott, representing the AICPA, showed concern and disappointment in the SEC’s proposed rule. Elliot stated that “There is no evidence that lack of auditor independence is even an infrequent problem, let alone a current crisis. Yet the proposed rule points to a problem where none exists, so it can propose a solution where none is needed.” Elliot pointed to the study conducted by Earnscliffe, which found that most investors were confident in auditors and the financial statements and did not believe a real problem existed.

Also representing the AICPA was Barry Melancon, the President and Chief Executive Officer. Basically, Melancon agreed with all of Elliot’s points. Melancon did add that he felt the proposed rule was too broad and many of the terms used in the rule were not clearly defined. Melancon stated that this would lead to an auditor believing they are independent, while the SEC might not consider the auditor independent.

Graham Ward, the President of the Institute of Chartered Accountants in England and Wales, also gave testimony at the hearings. As a representative of a professional body in another country Ward offered an interesting perspective. Ward stated that the “rule” approach to trying to insure independence is unlikely to work well. Instead, Ward suggested an approach based on “threats and safeguards” should be used. Ward, as well as many other professionals, expressed that no evidence existed to suggest that providing other services to a client has any effect on independence at all.
Another individual who gave a thought provoking testimony was Paul B.W. Miller. Miller is a professor of Accounting at the University of Colorado at Colorado Springs. In his testimony Miller stated, "I’m not convinced that the financial statements do contain useful information. If they do not, then it doesn’t matter whether they’re audited, and then it doesn’t matter whether the auditor is indeed independent.” Miller did not go on to discuss this statement any further. Miller also brought up another interesting point. When accountants want to make rules on accounting, or auditing, they consult with other accountants. Miller then went on to encourage that investors be consulted before making a final ruling.

The SEC also allowed those needing auditing services to give testimony on the issue. Many of the individuals chosen by their respective companies to be representatives believed that some services, such as internal auditing, would not have any effect on independence if structured properly. Robert Ryan, the Chief Financial Officer of Medtronic, James W. Barge, the Controller of Time Warner, and Clarence E. Lockett, the controller for Johnson & Johnson, were among a few of the individuals to express such beliefs. Lockett also went on to say that he believed that the profession should be developing the rules themselves. Lockett mentioned that the SEC had stated that they would look to the ISB to lead the way in independence and that he agreed that the ISB should be doing so.

One individual from the investing community who presented was John H. Biggs, who is the Chairman of the Board, President, and Chief Executive Officer of TIAA-CREF. Biggs disagreed with Miller in that financial statements are “essential.” Biggs states that it is assumed that these statements have undergone an independent audit and
that any serious problems would have been found during the audit. Biggs also goes on to
describe a situation in which his company made an investment based on independently
audited statements, which were later to be found incorrect, after the company went
bankrupt. Biggs believes that the company did not find the misrepresentation present on
the financial statements during the audit because the auditor did not do a complete audit
due to pressures on the auditor. Biggs implied that the pressures on the auditor impaired
independence, and had the auditor been truly independent, this incident would not have occurred.

The testimonies discussed here are only a small proportion of the testimonies
given. The testimonies discussed here, as well as others, had a serious impact on the
SEC’s rule. After the hearings the SEC made several changes to the proposed rule. The
final rule was much less restrictive than the proposed rule, and was developed to more
closely coincide with professional standards. The SEC’s final rule was issued on

The SEC states that an auditor’s independence will be impaired if “the accountant
is not, or a reasonable investor with knowledge of all relevant fact and circumstances
would conclude that the accountant is not, capable of exercising objective and impartial
judgement on all issues encompassed within the accountant’s engagement.” In addition
to this statement, the SEC recognizes that such factors as investments, family ties, and
other services might impair an auditor’s independence.

The SEC recognized that special attention needed to be given to investments as
they relate to independence. The SEC needed to determine whose investments would
affect independence. In doing so the SEC defined the terms covered persons, immediate
family members, and close family members. Covered persons are defined as those persons who are members of the audit team, the superiors of the audit team, managers and partners who spend at least 10 hours providing the client with non-audit services, and other partners in the office of the lead auditor. Immediate family members are spouses, or the equivalent of a spouse, and dependents. Close family members include immediate family members, parents, siblings, and non-dependent children.

The SEC will consider independence to be impaired if a covered person or immediate family member holds a direct investment, or an indirect material investment, in a business that is invested in the client and has significant influence over the client. Independence will also be impaired when a covered person or immediate family member holds a direct investment or an indirect material investment in a business that has a material investment in a business that has significant influence with the client. If a material investment is held in an entity in which the client has significant influence, independence will be considered impaired. Independence is also impaired if a covered person, immediate family member of a firm professional, or any close family members has an investment in the client allowing that individual to control the client, or if the individual files a Schedule 13D or 13G. If a client, its officers, or its board members, invests in the auditing firm, independence will also be considered impaired.

Independence will not be impaired if a covered person or their immediate family holds an investment in an investment company with investments in a client. This is true so long as the covered person or immediate family member holds less than five percent of the outstanding shares of stock of the investment company.
Not only can family members’ investments affect independence, but their job can too. A family member who is employed by a client will adversely affect independence only if the position involves accounting or financial oversight. An oversight position is one where the employee has influence over the accounting records that influence the financial statements. Examples of this type of position would include a board member, Chief Executive Officer, Chief Financial Officer, president, controller, director of financial reporting, and other similar positions.

The SEC also addressed the effect of an auditor performing other services, such as consulting, has on independence. The SEC’s rules on performing other services discuss nine services that may impair independence. These services are bookkeeping and other services related to the company’s accounting records, financial information systems design and implementation, appraisal or valuation services and fairness opinions, actuarial services, internal audit services, management functions, human resources, broker-dealer services, and legal services.

Under Rule 2-01(c)(4)(i) independence is considered impaired if an auditor “maintains or prepares the audit client’s accounting records, prepares the clients financial statements that are filed with the SEC, and prepare the originating source data.” It would be difficult for the auditor to render a fair and impartial opinion on documents the auditor helped to prepare.

Rule 2-01(c)(4)(ii) governs financial information systems design and implementation, these services are referred to as information technology services. An auditor’s independence is impaired if the auditor operates or supervises a client’s information system. Independence is also impaired if the auditor designs or implements a
system that handles source data that is used to generate the information used in financial statements. Unlike the SEC's original proposal, which never allowed for these services to be offered, the final rule has a few exceptions that will allow for the performance of such services.

One exception is when a client's management details, in writing, that they are responsible for establishing and maintaining internal controls. Another exception is if the management has an employee make all the management decisions on the design and implementation, or if management makes all those decisions themselves. If management evaluates the design and implementation's effectiveness and results that would qualify as another exception. A final exception is that management must not rely on the work of the auditor in determining whether or not procedures for internal control and financial reporting are adequate. The purpose of this is to reiterate the fact that management is ultimately responsible for internal controls and financial reporting.

The SEC addressed valuation services and fairness opinions in its final rule as well. The SEC believes that valuation services and fairness opinions will impair independence when it is probable that the results will be material to the financial statements and where the auditor will have to audit the results. However, when the results are expected to be immaterial, the auditor may perform valuation services without impairing independence. Valuation services may also be provided when the services are being provided as a review of the client's work, or the work of an outside specialist. When the valuation services are provided for pensions, other benefits, similar liabilities, so long as the client takes full responsibility, the auditor may provide valuation services. An auditor may also provide valuation services when the valuation services are provided
Actuarial services may also impair independence. The SEC will consider independence to be impaired anytime an auditor performs services to determine insurance company policy reserves and related accounts. Again, there are exceptions. If the client has its own actuaries to provide the client with major actuarial services, if management accepts responsibility for any methods and assumptions, and if the auditor’s services are not continuously provided, then independence will not be impaired.

The SEC in its final rule also addresses internal audit services. Originally, the SEC sought to make the performance of internal audit services by independent auditors an impairment of independence under all circumstances. This was revised for the final rule.

Rule2-01 (c)(4)(v) states that auditor provided internal audit services should not exceed 40 percent of the total amount of hours the client spends on internal auditing activities for clients with total assets of $200 million or more, otherwise independence will be impaired. However, clients with total assets of less than $200 million have no such restriction.

Regardless of the amount of total assets held by the client, some requirements must be met in order for internal auditing services to be performed. First, the management must acknowledge, in writing, the audit committee recognition of their responsibility to establish and maintain a system of internal controls. Also, management must not use the work of the auditor in determining that the internal controls are
adequate. Finally, the client must maintain management’s responsibility for such services.

Management functions are also identified as a threat to auditor independence. As discussed in virtually every other section of the SEC’s rule, auditors who perform management activities for the client are not considered independent.

In Rule 2-01(c)(4)(viii) the SEC discusses broker-dealer services. This rule states that an auditor will not maintain independence if the auditor acts as a broker-dealer, promoter, or underwriter for the client. The auditor cannot remain independent while making investment decisions, or having custody of assets, for the client.

The SEC discusses legal services in Rule 2-01(c)(4)(ix). An auditor will not be independent if the auditor begins to perform other services to a client that require some form of licensing from courts in the US jurisdiction. Primarily, this refers to legal services. The SEC points out that lawyers are primarily interested with promoting their clients interests, which does not coincide with the concept of auditor’s independence.

Occasionally, former firm employees go to work for audit clients. When this happens there may be serious implications on the independence of the auditors and the auditing firm. Rule 2-01(c)(2)(iii) states that if a former partner, principal shareholder, or professional works for a client in an accounting of financial oversight position, independence will be impaired. If the former employee in question does not have any influence over the accounting firm, does not have any capital balances with the firm, and has no financial arrangement with the firm, independence will not be impaired.

Also related to this matter, if a former officer, director or key employee of a client becomes employed with the auditing firm as a partner, professional, or principal
shareholder, independence will be impaired. However, if the former client’s employee is not engaged in any activities related to the client’s audit and has no way of influencing the audit, independence will not be considered to be impaired.

The SEC’s final rule also finds contingent fees to impair independence. A contingent fee is a fee that is determined by the results of the work done. A contingent fee on an audit would mean that the client would be paying the auditor based on the outcome of the audit. Needless to say, a favorable opinion from the auditor would be rewarded with a higher fee and an unfavorable opinion resulting in a lower fee. This results in the auditor having some interest in the outcome of the audit and no longer being independent.

The SEC’s newly issued revised independence rules are much less restrictive than the originally proposed rule. The SEC revised several of the restrictions found within the proposal. The revisions that make the SEC’s rules similar to those issued by the professional standard setting bodies.

**Investors and Creditors View on Independence**

The SEC requires public companies to have their financial statements audited by independent auditors. The purpose of this is to protect the financial statement users, such as investors and creditors, from fraud and misrepresentation by companies. The audited financial statements are intended to allow its users to make sound financial decisions with regards to the company.

Creditors often use the financial statements in determining the financial soundness of a company. Before lending a company any funds, creditors review the statements to ensure that the debt can be repaid. Creditors must be able to trust that the financial statements used for this purpose are fairly presented and have undergone an adequate
independent audit. Creditors who do not trust the independence of the auditor cannot trust that the financial statements have been fairly presented.

This is also true for investors. The audited financial statements are intended to be used by reasonable investors wishing to make sound investment decisions. As such, the investors’ views on auditors and independence is an important issue. Just as creditors, investors rely on the fair presentation of financial statements and that the statements were audited by an independent party.

Realizing the importance of independent audits, the Independence Standards Board commissioned Earnscliffe Research and Communications to conduct a study on auditor independence and objectivity. The study, entitled “Report to the United States Independence Standards Board: Research into Perceptions of Auditor Independence and Objectivity,” was issued in two phases, the final phase being issued in July 2000. This study dealt with many issues related to independence, but the perceptions of investors and analysts are of particular importance.

Earnscliffe reported that analysts on the selling side of the market tended to accept things as they are. These analysts did recognize auditors’ independence is under strain from such issues as their firm’s earnings from other services. Earnscliffe also found that the sell side analysts do not have an in depth understanding of the independence issue and the related safeguards and standards. The sell side analysts also tend to feel that most major companies and accounting firms do a good job.

The analysts on the buy side hold slightly different views than their sell-side counterparts. The buy side analysts tended to generally trust the audited financial statements, but are more skeptical of the auditors’ independence. One reason buy side
analysts are becoming more skeptical of auditors' independence is that the vast majority of firms are currently using audits as a stepping stone to sell other services, such as consulting.

Earnscliffe also spoke with many investors, and focused much of the report on investors. The investors Earnscliffe spoke with for this study are considered to be reasonable investors because they bought stock within the last year, reported to have researched the companies they purchased stock in themselves, and typically held stock longer than one year. In the course of speaking with these investors, Earnscliffe studied the investors' research habits, confidence in the financial information, perceptions of audits and auditors, risks and safeguards.

This study found that investors use a wide variety of sources for information when deciding on what companies to invest in. The audited financial statements were not commonly used in the investing decisions. Instead, investors used the stocks' past performance, analysts' recommendations, the company's image, and several other factors. While the majority of investors interviewed in this study did not often use the audited financial statements to make investment decisions, most of the information the investors did use was derived in some form from the financial statements. This being the case, the importance of the financial statements is not in the least diminished.

This study also found that most investors trust the financial information made available to them by public companies. While investors trust the financial information, most investors are largely unaware of the safeguards and standards that are in place to ensure the accuracy of the information. However, investors are certain that safeguards and standards do exist. This is a factor in why investors trust the financial information.
Most investors were also found to hold positive views of auditors and audits. The investors interviewed tended to believe that auditors are well-trained individuals, no more or less honest than anyone else, who do a good job. The majority of investors also tended to believe that auditors and audit firms make an effort to maintain ethical standards, including independence, for reasons such as reputation, laws and regulations, and litigation.

When the investors were asked about independence, the investors were largely unaware of the specific facts of auditor independence issues. However, many of the investors stated independence issues as being problems at the accounting firm’s level, rather than problems at the individual auditor’s level. The investors tended to believe that the firms had some level of control over employees, which help prevent activities that would impair independence.

When investors were asked about factors that might compromise an auditor’s independence, the investors recognized several possible risks. One risk many investors recognized was that of auditors holding financial interests in the company being audited. Investors recognized that if the auditor held interests in the company they were auditing, the opinion issued by the auditor was likely to be swayed. Investors also recognized that if an auditor held a close personal relationship with the company being audited, presumably through family, independence could reasonably be expected to be impaired. Investors also mentioned pressure placed on the auditors by the client might impair an auditor’s independence. However, investors also recognize that some amount of pressure from the client can be expected.
When Earnscliffe discussed the issue of audit firms’ increased consulting activities, the investors tended to feel that this was not a threat to independence. However, when the subject of offering non-audit services, to audit clients was mentioned, there was a large proportion of interviewees who felt that there was some risk to independence. Many investors felt that separating the auditing and consulting divisions, as well as incorporating other safeguards, would reduce any independence risks to an acceptable level.

This study revealed the fact that many investors who are considered “reasonable” do not often refer to the audited financial statements and are only vaguely aware of independence issues facing auditors. While these investors do not directly refer to the audited financial statements, much of the information these investors refer to are derived in some form from financial statement. Also, many other investors do use the financial statements. As such, it is still extremely important for the financial statements to undergo independent audits.

Conclusion

At first glance the issue of auditor independence seems a simple one. As has been shown, it does not remain a seemingly simple issue for long.

Before delving into those things that have an effect on auditor independence, why independence is important must be learned. As has been stated earlier, auditor independence is an important issue because investors and creditors rely on audited financial statements when making decisions.

Some individuals, such as Paul Miller, may argue that financial statements do not contain useful information, so the issue is irrelevant. Here I must disagree with Miller.
Regardless of whether Miller feels financial statements are useless or not, many investors and creditors base their decisions on financial statements. These investors and creditors assume that the financial statements are basically accurate, and that the statements have undergone an independent audit. As such, auditor independence is a relevant issue.

As investors and creditors are the individuals who need the financial statements independently audited, it is important they believe the auditors to be independent. I agree completely with the idea that the appearance of independence is as important as independence in fact.

After examining why independence is a relevant issue, one may then begin to look at those things that may have some effect on auditor independence. Financial interests, family ties, and other services are a few things that must be considered.

When I first began researching independence, the only type of financial interest that really occurred to me was direct ownership in a client. Of course, this does adversely effect independence. However, I did not consider such things as loans to or from the client, including credit cards. I agree, loans of substantial amounts to the auditor, or client, may effect independence. I also agree with the AICPA in that an auditor who holds a credit card, issued by the client, with a balance of $5,000, or less, will not effect independence. However, I am sure that there are situations in which higher balances that are immaterial to both the client and the auditor would not effect the auditor’s independence in fact.

With regards to a close relative, who works for the client of the auditor effecting independence, I agree. If a close family member works for the auditor’s client and has some control over financial information, independence can be impaired.
An auditing firm that provides an audit client with other services, such as consulting, is a less clear-cut situation. Some believe that providing other services, such as consulting, can enhance the independent audit, while others believe that it can only hurt the auditor's independence. I believe that if the auditor follows the procedures discussed earlier to ensure management understands their responsibilities, as well as keeping the audit function and the other services clearly and distinctly separate, independence may be maintained.

Another issue that never occurred to me before I began researching this issue is litigation. I believe that anytime litigation is raised between the client and the auditor's firm, independence is impaired. It would be difficult, if not impossible, for an auditor to issue an impartial and objective opinion. I do not believe that litigation that is not directly between the auditor and client effects independence.

As far as the effect former partners, or other employees, it is entirely possible for these individuals to have no significant effect on independence. As long as the former partner or employee, who is now either an employee or owner in a client, is disassociated from the firm and has no control over the financial records of the client, independence is not impaired.

I could discuss several other issues that may effect independence, but I will contain my comments to the most relevant ones, already discussed. Basically, the AICPA and SEC have addressed every issue that may have some effect on independence through their rules.

The SEC's rule, as it was originally revised, was extremely restrictive. I agree with many individuals in the accounting profession who said the SEC had made the
proposed rule much too restrictive. However, after the SEC listened to professionals at the hearings and reconsidered, the SEC's final rule was much more reasonable. It is important for the SEC and the auditing profession to agree what it takes for an auditor to be independent. This will avoid the confusion of all interested parties.

After finishing the research for this paper I have concluded that auditor independence must be maintained in order to ensure the integrity of financial statements. Occasionally this may cause the auditor, and the client, some inconvenience. However, any inconvenience that may result is well worth the confidence of investors and creditors. Also, the issue of auditor independence will be a relevant one so long as independent audits are needed. As the business world changes, the rules of independence must change to accommodate those changes.
Works Cited


