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Discussant's Response to Auditor Independence: Its Historical Development And some Proposals for Research

Le Roy E. Kist

Ernst & Ernst

Glen Berryman's paper conveys to me a very clear impression of the thoughtful sifting of voluminous source material to present a comprehensive yet concise account of the evolution of the independence concept. By contrasting the actions of the AICPA with the actions of Congress and the Securities Exchange Commission and with the English background, he has brought the reader up to date so that he can at least begin to understand and appreciate the problem of independence and to consider the possible need for further research.

In his book *The CPA Plans for the Future* John Carey stated, "From the beginning, independent auditors have recognized that they would be useless to society unless they were fair and objective in their attestations to financial data . . . The assumption that auditors must be independent was taken for granted." Independence in an abstract sense may have been taken for granted but certainly a precise definition of independence and the specifics of its implementation could not be taken for granted. Development of the independence concept obviously didn't come easy and I am inclined to believe that there was, in part, some effort by the American Institute to accommodate a dual standard that would permit the practitioner's occasional financial interest, or other close relationships, in his closely-held client. We have come a long way from the tainted independence of the twenties, and with the adoption of the revised Code of Professional Ethics as of March 1, 1973, I hope that we do not have too much further to go.

Questions for Further Research

Glen has asked five basic questions which, he proposes, should be subjected to further research. The questions relate to the following principal issues:

1. Appointment and discharge of auditors.
2. Relationships between client and auditor that are likely to impede the exercise of impartial, unbiased judgments.
3. Payment for audit services rendered.
4. Reviews of auditor work, including audit independence.
5. Measurement of independence in fact.

In addition, he has asked questions which, if answered, could help in improving the appearance of independence which, we must acknowledge, is of some con-

sequence. In my discussion, I will try to comment on these issues and hopefully to expose another viewpoint for your consideration.

In commenting upon the selection, change, and payment of auditors, the author has drawn an analogy between the work of the independent accountant and that of a judge in a judicial proceeding. Because of the similarities of the activities of the two, he has suggested the possibility of having auditors appointed by a governmental authority, paying them from public funds, and requiring their change when the regulatory agency perceives any diminution of independence.

I agree that the similarities exist; however, there are also dissimilarities and other factors to be considered. I question that a true analogy exists in that, unlike the judge, the auditor must be prepared to defend his judgments if questioned by the users of his reports and, if found to be in error, to take the consequences of his work. The role of an auditor should not be considered as one of resolving differences between antagonists (his client on one side and stockholders, creditors, etc., on the other) but one of searching for the right answers to complex business problems and then reporting them in a manner that is fair to all concerned.

Appointment and Discharge of Auditors

As noted in Glen's paper, the selection process is normally undertaken by management with the concurrence of the Board of Directors. In addition, a number of companies have adopted the practice of asking the stockholders to ratify the selection. I am not aware of any general criticism of that process; however, questions have been raised about the freedom of management to discharge its auditors, probably in some cases for being too independent. In this latter regard, the SEC has been helpful in a recent modification of Form 8-K, which requires the reporting of various current events. Item 12 of that form requests a registrant to report the engagement of a new auditor and also to furnish a separate letter stating whether in the 18 months preceding the engagement there were any disagreements with the former accountant on any matter of accounting principles or practices, financial statement disclosure, or auditing procedures, which disagreements, if not resolved to the satisfaction of the former accountant, would have caused him to make reference in connection with his opinion to the subject matter of the disagreement. The former auditor is requested to furnish a letter stating whether he agrees with the statements contained in the letter of the registrant. This requirement should have a deterring effect upon registrants who may hope to find a more compliant auditor in connection with the change. There is some problem, of course, in deciding whether a bona fide disagreement existed or whether there was merely a difference of opinion which was eventually resolved in the manner requested by the auditor. Is a table-pounding session needed before it can be said that a true disagreement existed? This is a matter requiring careful consideration by the deposed auditor and, hopefully, some concern by the newly appointed auditor.

I understand that consideration currently is being given to requiring the report to be filed at the time of the discharge of the former auditor, rather than upon the engagement of the new auditor. This change should improve the value of the report, but I believe that other changes could be made to improve

it even more. For example, consideration might be given to requiring the registrant to report any intention to discharge its present auditor several months before doing so. A panel including representatives of the accounting profession, as well as the SEC, could review the facts and circumstances and decide whether the divorce should be granted. As it now stands, the discharged auditor may get some satisfaction from knowing that his former client and the successor auditor will be watched carefully, but that knowledge would do little to strengthen his independent attitude in the first place. Research in this direction should be productive.

Relationships between Client and Auditor that Are Likely to Impede the Exercise of Impartial, Unbiased Judgments

In this matter, the pronouncements of the SEC and the interpretations of the AICPA have been very useful and do much to clarify specific situations encountered in practice. Interpretations for the most part have been understandable and progressive. I will not attempt to comment upon any particular interpretation included in the numerous Accounting Series Releases issued by the SEC, other than to note that when the SEC took a dim view of unpaid fees in ASR #126, many accountants must have been made much happier. What is probably needed in this area is to classify and analyze the various interpretations of the SEC and of the AICPA in an attempt to derive from them the fundamental features in a more abstract form.

Payment for Audit Services

As mentioned previously, Glen has suggested the possibility of paying the auditor from public funds. Because of the wide disparity in the extent of services required and the absence of a universal need, this does not seem to be a practical solution. Fees conceivably can affect the independence of the auditor as much or more than if he were to have a direct financial interest in his client. Nevertheless, this aspect appears to be more detrimental to perceived independence than to independence in fact, provided, of course, that other controls and conditions are effective.

Reviews of Auditor Work including Audit Independence

Recently the AICPA, in part upon the urging of the Securities Exchange Commission, undertook to develop a program of quality control. The program, which has been accepted by the Board of Directors of the Institute, calls for the independent review of an accounting firm's performance, looking at the adequacy of the procedures being followed, and later assessing the degree of compliance of the firm with its own procedures. This is something like the review, evaluation, and test of compliance of a system of internal control. In addition to its other features, the review would be concerned with client selection and retention, and independence. When this program is operative, the accounting profession should have another strong and worthwhile tool to police its membership and to maintain a satisfactory level of independence.

Measurement of Independence in Fact

Independence is a very complex issue. For those who have not been involved in an audit, it might seem quite easy to hold a client at arm's length and subject its financial statements to a dispassionate, microscopic review. In actual practice, however, we realize that an auditor must maintain a close relationship with his client in order to understand its operations and to obtain appropriate information essential to the formation of his opinion. Possibly for this reason I would not be very receptive to a suggestion that persons outside the profession should evaluate our performance and independence. In this respect, I strongly believe that the profession should be self-policing.

In the discussion of what constitutes independence, the author appears to be concerned about the appearance of independence. It seems to me that if we are concerned primarily with independence in fact, the appearance of independence will largely take care of itself. Is an active PR program necessary for the accounting profession, or will doing a good job observing all of the present rules of conduct be sufficient? It may be useful to obtain the views of users, but the ultimate conclusion as to what does and what does not constitute independence should be generated from within the profession itself.

Additional Suggestions

Many here may have heard of the so-called "auditor of record" concept, which is receiving active consideration by the SEC. This concept would require the auditor to become more closely associated with his client throughout the year and would require him to assume some, as yet unspecified, degree of responsibility for the adequacy of interim financial reporting. The auditor will become more deeply involved in the day-to-day decisions regarding accounting matters, which he will then be expected to audit and report on at a later date. This association raises a question as to whether the auditor's independence will be adversely affected. It seems to me that research should be undertaken in this matter.

The personal characteristics or traits of honesty and integrity are critical to independence, and men and women entering the accounting profession should possess, and be well aware of the need for, those characteristics in abundance. It has been said that everyone's character is almost completely established during his childhood; however, an awareness of the demands of the public accounting profession in this regard becomes implanted at a much later date. It seems to me that educators could provide a real service to the public if they were to discuss and ponder over these considerations with their accounting students as an integral part of the academic program.

When I was a young man I clerked in a drugstore for several years. At that time I noticed a motto appearing on the label of a large pharmaceutical company that impressed me a great deal, and I have never forgotten it. It said, "The priceless ingredient of every product is the honor and integrity of its maker." This also should be true for every audit engagement. If we were assured of the quality of these ingredients, there would be no need to be concerned over independence.