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Introducing... The Power Quintuplets: Client Power and Auditor Independence

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The Power Quintuplets

Client Power and Auditor Independence

By William R. Pasewark and Jack E. Wilkerson, Jr.

A statement by the Commission on Auditors' Responsibilities in its *Report, Conclusions, and Recommendations* captures both the essence and the importance of the concept of independence.

> One of the main values of an audit to users of financial statements is increased confidence in those statements because management's representations as to its performance and stewardship are reviewed and reported on by someone independent of the control of management [CAR, 1978, p. 93].

Further evidence of the importance of independence is its prominent position in the authoritative literature of our profession: Independence is the topic of the first Rule of Conduct of the AICPA's *Code of Professional Conduct* [AICPA *Professional Standards*, ET Section 101.01] and the second generally accepted auditing standard in the Statement on Auditing Standards No. 1 [AICPA *Professional Standards*, AU Section 220].

The auditor's anticipation of subsequent engagements increases the power associated with threats to switch to another auditor.

Statement on Auditing Standards No. 26 states that if an auditor is not independent with respect to a client, any audit procedures performed are not in accordance with generally accepted auditing standards, and the auditor must disclaim an opinion on the client's financial statements [AICPA *Professional Standards*, AU Section 504.09]. Since a firm of independent auditors is not likely to accept an audit with the anticipation of issuing a disclaimer, a careful evaluation of the possibility of impairment of independence is always a necessary precaution.

During the client selection or continuance decision, two factors are traditionally examined when considering independence. The auditor considers: 1) whether the auditor and the client have certain financial relationships, and 2) whether the auditor could be considered part of management or an employee under management control. These two factors are given careful consideration before an engagement letter is drawn up.

Evaluation of these two factors is important, but further consideration of a third factor — client power — is also necessary. This article suggests that client power, defined as the ability or capacity to influence others [Daft, 1983, p. 382], may impair auditor independence. What follows is a description of five sources of power and recommendations for evaluating client power as it relates to the audit engagement decision.

Types of Power

The mere possession of power does not mean that power will actually be used to exert influence; it does mean that the potential to exert influence exists. The following are common sources or bases of power identified in extensive research by psychologists and organizational behavioralists [Van Fleet and Yukl, 1986].

The power of **authority** is possessed by a person who has a position or title in an organization. The superior can exercise power because the organization's hierarchical structure has given the superior a legitimate right to exercise power.

When an individual has access to information or knowledge that is not available to others, that individual possesses the power of **expertise**. This source of power gives accounting departments and systems departments influence within a company. The power of expertise is often a characteristic of an employee who has served many years with a company.

An individual has the power to influence others if he or she has **control of rewards** that are desired by others. In business, rewards are primarily salaries and promotions. Since any increase or decrease in rewards may have a major effect on the livelihood of an individual, this power has a great potential to influence.

The capability to punish others or force others to do undesirable activities is evidence of **coercive** power. Use of this power through a policy of reduced pay, fines, or dismissal may be necessary in some organizations to enforce regulations.

When a person possesses charisma or political skills that are attractive to others, that person is displaying **personal** power. Those who possess personal power display a confident image, maintain the trust of those with whom they come in contact, and express genuine concern for others. A person who possesses personal power has the ability to influence because others like and enjoy that person.

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A thorough analysis of client power before accepting an audit will give the auditor greater confidence that independence can be maintained.

Using the Concept of Power to Evaluate Independence with Respect to Prospective Clients

Each of the powers described above has the potential to influence an auditor's independence. Explanations follow that describe how each type of power can affect the auditor-client relationship.

Authority

Authoritative power in an organization is evidenced by a superior-subordinate relationship. This relationship involves the performance of several activities by the superior:

- informing the subordinate of the duties expected to be performed
- motivating the subordinate to perform duties
- evaluating the subordinate on a periodic basis
- rewarding the subordinate based on performance

Authoritative power as evidenced by the superior-subordinate relationship should not exist between client management and an auditor. The auditor should know the duties required to conduct an audit of the client or potential client. The motivation to perform these duties should come from the desire to conform with generally accepted auditing standards and the auditor's personal desire to perform a quality audit. Evaluation of the auditor's work, when necessary, is performed in accordance with established standards by organizations and/or groups such as the Securities and Exchange Commission, peer review committees, and the audit committee.

The mere possession of power does not mean that power will actually be used to exert influence; it does mean that the potential to exert influence exists.

It is unlikely that the auditor will ever attempt to eliminate the power of expertise that the client possesses by becoming as familiar with the accounting system and accounting records as clients.

Expertise

The client, as preparer of the financial statements, should have the most knowledge about the financial statements and should possess a reasonable amount of power in the form of expertise. In addition, the client may be in a unique industry that requires specialized accounting procedures (e.g., banking, real estate, timber, oil and gas). In such cases, the client will most likely possess an even greater amount of expertise power over the auditor.

It is unlikely that the auditor will ever attempt to eliminate the power of expertise that the client possesses by becoming as familiar with the accounting system and accounting records as the client. However, the auditor should gain sufficient knowledge about a client company and its industry to conduct a satisfactory audit. The auditor will also want to gain enough knowledge to prevent the client from being able to exercise the power of expertise in an intimidating way. In cases where the accounting is specialized to a specific industry, it may be necessary for the auditor to acquire additional training or to utilize consultants.

Control over Rewards

Rewards exist in many forms. The most common work-related rewards include salaries, benefits, promotion, and recognition. Audits are seldom performed without financial compensation from the client. Some believe that financial compensation prevents "true" independence and objectivity.

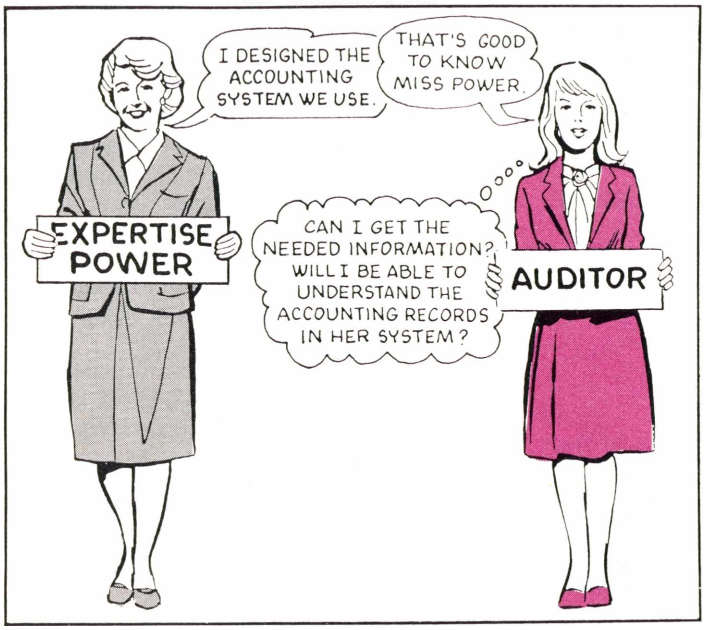
A client may use the power of control over rewards to influence the auditor by expecting the auditor to alter the audit procedures or the audit opinion in exchange for increased reward. Since audit fees are commonly stated in fixed amounts by contract, increased rewards often come in the form of extended services, consulting projects, or tax work.

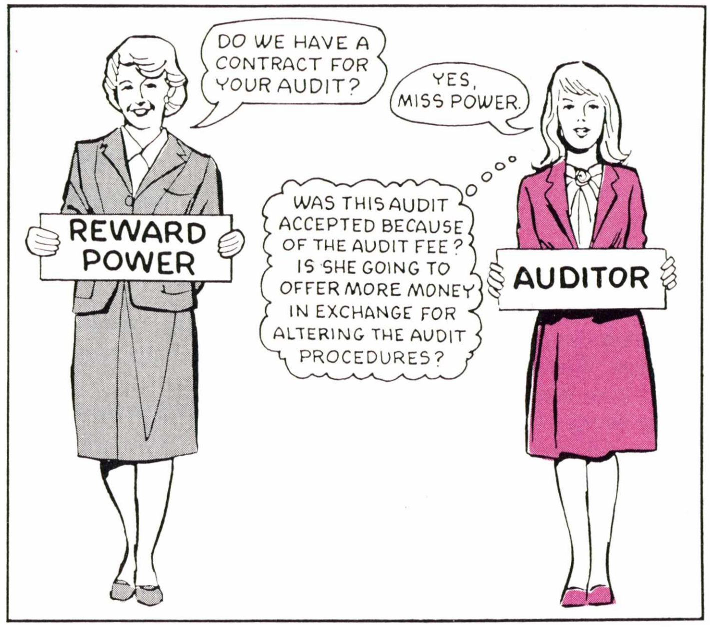
Coercive Power

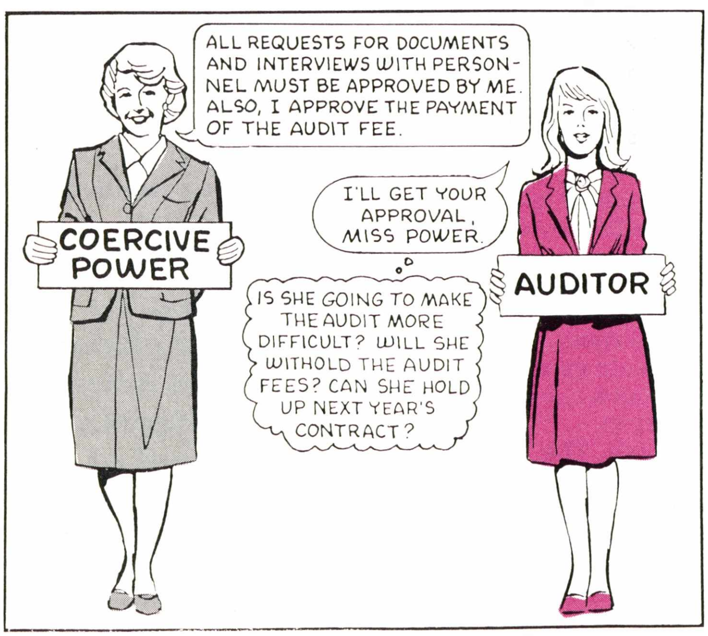
The client may use coercive power to influence the auditor by threatening to not use the auditor in subsequent audits, refusing to pay compensation that has been earned, or making it difficult for the auditor to perform required

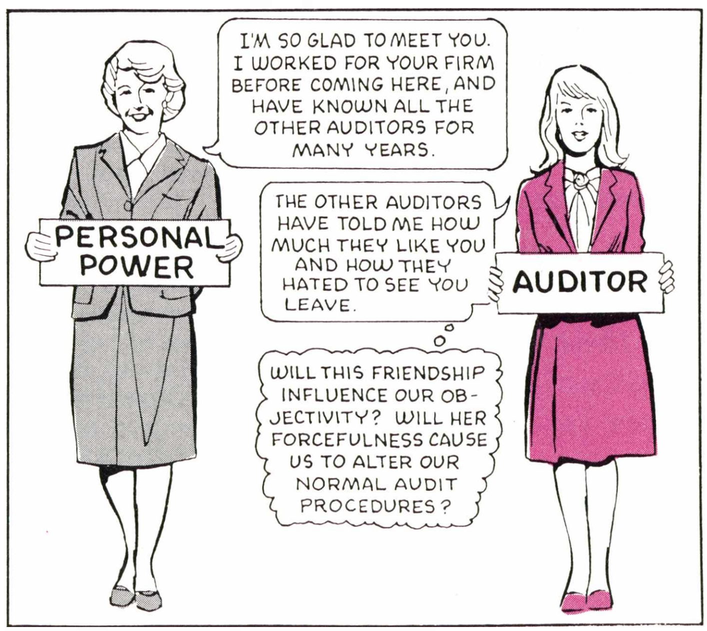
Examining the sources of the client's influence can help to identify potential impairment of independence and prevent its occurrence.

The Power Quintuplets









audit procedures.

Controversy exists over whether an audit engagement should be accepted with the assumption that the auditor will obtain subsequent audit engagements. Nevertheless, the auditor's anticipation of subsequent engagements increases the power associated with threats to switch to another auditor.

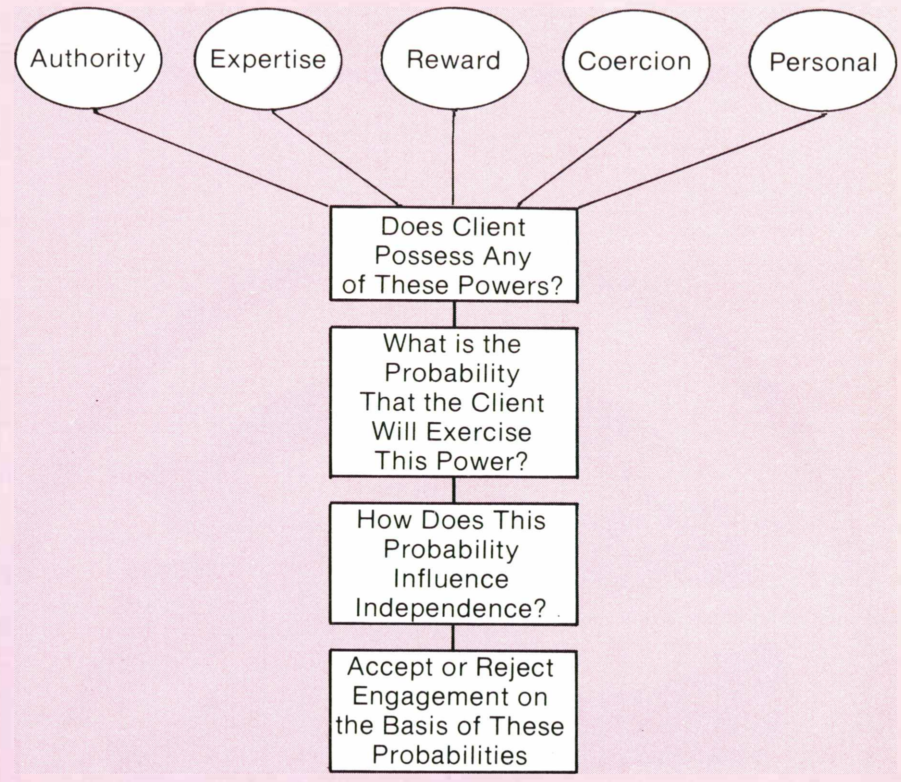
Before an audit is accepted, the auditor makes decisions concerning the profitability of an audit. Acceptance of an audit usually entails the acceptance of certain assumptions concerning payment from the client and expenses incurred during the audit. The auditor should be sure that these assumptions can be reasonably relied upon, usually by inclusion in the engagement letter, before accepting an audit.

The client may also exercise coercive power by withholding information that keeps the auditor from performing the audit work efficiently or that prevents the auditor from performing tests of accounting records. An auditor should have free access to both documents and personnel that provide the knowledge needed to conduct an audit.

Personal Power

Some people, by nature of their personalities, may possess the ability to influence an auditor to deviate from independent audit procedures. While it may be difficult to anticipate whether this power will be exercised during an audit, personal power of client representatives should be considered. The auditor must ask questions such as, "Will our friendship with this person influence our independence?" or "Will the forcefulness of the client representative cause us to alter our normal audit procedure?"

Power Profile of the Audit Client



Developing the Power Profile of the Client

When evaluating a specific client or potential client, it is helpful to examine the client's potential to influence auditor independence. A client may affect independence only if the client possesses the power to do so. A thorough analysis of client power before accepting an audit will give the auditor greater confidence that independence can be maintained.

The following procedure might be helpful in determining if the client can influence independence:

1) **Consider the client in terms of each of the five sources of power.** Review each power source and ask yourself, "Does the client possess any of these powers over our firm?"
2) **Assess the probability that the client might exercise the power possessed.** Again, the fact that power exists does not mandate its use.
3) **Consider how the probability of the use of power might influence your independence.** Higher probability of the use of power increases the probability that independence will be impaired.
4) **Accept or reject the engagement on the basis of the evaluation of power and other considerations.**

Impairment of independence should not be considered the fault of the client. Independence may be impaired due to actions by either the auditor or client, but it is the duty of the auditor to recognize that independence has been impaired. Examining the sources of the client's influence can help to identify potential impairment of independence and prevent its occurrence.

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