ADVANCES IN PUBLIC INTEREST ACCOUNTING

VOLUME 12

INDEPENDENT ACCOUNTS: THE POSSIBILITIES FOR AUDITOR INDEPENDENCE IN THE AGE OF FINANCIAL SCANDAL

CHERYL R. LEHMAN
Editor

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ADVANCES IN PUBLIC INTEREST ACCOUNTING

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EDITED BY

CHERYL R. LEHMAN
Hofstra University, New York, USA

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LIST OF CONTRIBUTORS

C. Richard Baker	*School of Business, Adelphi University, Garden City, NY, USA*
David J. Cooper	*School of Business, University of Alberta, Canada*
Jeff Everett	*Haskayne School of Business, University of Calgary, Canada*
James C. Gaa	*School of Business, University of Alberta, Canada*
Yves Gendron	*École de Comptabilité, Université Laval, Canada*
Duncan Green	*Haskayne School of Business, University of Calgary, Canada*
Christopher Humphrey	*Manchester Accounting and Finance Group (MAFG), Manchester Business School, England*
Katarzyna Kosmala	*School of Management and Languages, Heriot-Watt University, UK*
Peter Moizer	*Leeds University Business School, The University of Leeds, UK*
Dean Neu	*Haskayne School of Business, University of Calgary, Canada*
Robin W. Roberts	*College of Business Administration, University of Central Florida, Orlando, FL, USA*
Pat Sucher	*Royal Holloway, University of London, UK*

John M. Thornton	*Department of Accounting, College of Business, Washington State University, Richland, WA, USA*
Stuart Turley	*Manchester Accounting and Finance Group (MAFG), Manchester Business School, UK*
Joni J. Young	*Anderson Schools of Management, University of New Mexico, Albuquerque, NM, USA*

LIST OF REVIEWERS

C. Richard Baker
Adelphi University

David J. Cooper
University of Alberta

Jeff Everett
University of Calgary

James C. Gaa
University of Alberta

Yves Gendron
University of Alberta

Duncan Green
University of Calgary

Christopher Humphrey
Manchester Business School

Katarzyna Kosmala
Heriot-Watt University

Peter Moizer
The University of Leeds

Dean Neu
University of Calgary

Robin W. Roberts
University of Central Florida

Pat Sucher
Royal Holloway – University of London

John M. Thornton
Washington State University

Stuart Turley
Manchester Business School

Joni J. Young
University of New Mexico

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EDITORIAL BOARD

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AUDITOR AND AUDIT INDEPENDENCE IN AN AGE OF FINANCIAL SCANDALS

David J. Cooper and Dean Neu

ABSTRACT

It is in the context of the huge (but largely unaccountable) impact of accounting and accountants that the demise of Arthur Andersen and the financial scandals of the past few years need to be seen. These scandals raise questions of independence and the role of the audit industry in alerting investors, employees, suppliers, customers and the general public to the realities of corporate wrongdoing and weakness. This paper introduces a Special Issue that offers a counter-hegemonic story, pointing out that things can be different and better in substantive ways, that auditor independence and integrity require more substantive thinking and analysis than simple re-arrangements of regulatory institutions or calls for super-heroes who can transcend pressures to abet crime. After reviewing the contents of the various contributions to this Special Issue, the paper makes some brief comments about possible solutions to the problem of independence of audits and suggests a focus on audit, not auditor, independence.

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THE IMPORTANCE OF AUDITOR INDEPENDENCE

The accounting industry benefits from being regarded as boring. There is little public scrutiny, and accountants are rarely held accountable for their actions. Yet, behind the gray suits and green eyeshades is an industry that has a profound impact on our way of life. Multinational accounting firms employ hundreds of thousands of people around the world, providing not simply audit opinions about their financial statements, tax (avoidance) strategies and general financial advice, but also consulting to governments, corporations, international agencies, charities, religious organizations and citizen groups about appropriate forms of governance, systems of management and assistance in processes as diverse as information management, scheduling of operations and distributional channels, human resource management practices and strategic management. These firms typically operate in the shadows, dispensing private suggestions and hidden products, not having to report on their own financial performance (Stevens, 1991). While they talk about accountability of others, they are not required to produce audited financial statements of their own. Yet the size of their economies rivals those of multinationals, such as Coca-Cola, Merrill Lynch and Merck, and countries, such as Guatemala, Sri Lanka and Belarus, and swamps the employment or money handled by almost any international aid agency or the United Nations. And while smaller (and typically less visible) accounting firms have merely local or regional reach, they dispense advice to a multitude of smaller organizations that nevertheless have a huge impact on our lives.

Accounting information is also central to the effective functioning of many economies, influencing which organizations can obtain financing, whether they are able to expand or must contract operations, and what is seen to be most profitable. Accounting measures of earnings, debt levels and assets are deemed crucial for the operation of financial markets and the efficient allocation of resources in an economy. Accounting numbers are often crucial to important contracts with suppliers and labor, and the manner of their calculation can determine whether an organization is deemed solvent or not (Briloff, 1990). Levels of employment, customer support and product safety are influenced by accounting calculations. Likewise, accounting information about the state of government finances influences debates about public expenditure, room for tax cuts and the viability of public and private pension schemes and social security funds (Cooper & Neu, 1995; Neu, Cooper, & Everett, 2001). It is often assumed that accounting is objective and neutral, like mathematics or a natural science; that there is

little dispute about how to determine the 'true' state of financial affairs. This is a gross error – what to measure and how to measure are enormously controversial. But all too often, these decisions are left to accountants themselves, as if they are neutral experts keen to do their best for society rather than make accounting choices in the best interests of their clients and themselves (Briloff, 1972).

Accounting calculations and audit procedures also have a deeper impact on society, influencing many of our attitudes and concerns. A desire to audit and inspect more and more areas of life affects our attitudes to risk and interacts with levels of trust in modern society (Power, 2004). Organizations develop more and more elaborate and all-encompassing systems to 'capture' the costs of increasing areas of life and to measure more areas of employee performance. These desires are used to expand the range of services that accountants are willing to provide. Accounting measures of the size of debt affect confidence in public institutions, such as public utilities, and measures of capital requirements affect confidence in private institutions such as banks. An audit mentality leads to an 'audit society' (Power, 1994, 1997). Yet, there is no democratic input into how accounting numbers should be determined and what elements of organizational activity are to be calculated. While firms strive to keep executive options off financial statements, government accountants increasingly push for the 'recognition' of all sorts of liabilities for future payments. In general, the accounting industry fights strenuously to not recognize in financial statements the costs of pollution, poor safety records, global warming and loss of biodiversity.

It is in the context of the huge (but largely unaccountable) impact of accounting and accountants that the demise of Arthur Andersen and the financial scandals of the past few years need to be seen. These scandals raise questions of independence and the role of the audit industry in alerting investors, employees, suppliers, customers and the general public to the realities of corporate wrongdoing and weakness. The audit industry has tried to lower societal expectations – for example, in the words of a prominent British judge of the nineteenth century – that it would be a watchdog, not a bloodhound. Yet, despite these self-serving attempts to manage an 'expectations gap' (Humphrey, Moizer, & Turley, 1992), perhaps the alleged freedom (i.e., independence) of auditing, accounting and accountants from democratic scrutiny needs to be re-assessed. From the side of audit industry apologists, perhaps the accusations of auditors' lack of freedom from pressures from corporate and other elites also need to be examined (Sikka & Willmott, 1995). Such issues form the motivation for this collection from leading experts from around the world.

These issues of public policy and the requirement of democratic accountability need to be set within the context of corporate failures and pressures on companies to restate their financial results. The images of well-dressed executives being led away in handcuffs need to be placed alongside images of pensioners, workers and small investors trying to understand what happened, especially when the 'watchdogs' of financial statements failed to give any warning. No wonder there are questions about the value of audits. Public accounting firms have been blamed for corporate failures, or charged with complicity. Inevitably, their supporters have argued that scandals are the result of a few 'rotten apples', as if we cannot remember the long list of individuals in the history of corporate scandals and failures. Hence, politicians and regulators have convened the inevitable commissions to examine what went wrong and what can be done to prevent financial scandals. Yet, these commissions rely on the evidence of those implicated in these failures and their more or less continuous attempts to restate the earnings of organizations they are associated with. What is needed is a more balanced analysis, one less tainted by sectional interests but conscious of the public outrage about white-collar crime.

The collapse of Enron sent reverberations throughout the United States and the rest of the world. Once the seventh largest corporation in the US, "Enron's collapse in late 2001 cost investors billions of dollars, put thousands of Enron employees out of work and wiped out the retirement savings of many. The company, once admired, became a symbol of corporate greed and excess, and its fall was followed by a string of scandals at other companies" (Press, 2004). The drama of seeing Lay, former Enron CEO and a close friend and financial supporter of President Bush, being led away in handcuffs served as an important sign that justice would be served. Exactly two years earlier, on July 9, 2002, George Bush went to Wall Street, and said: "The misdeeds now being uncovered in some quarters of corporate America are threatening the financial well-being of many workers and many investors. At this moment America's greatest economic need is higher ethical standards, standards enforced by strict laws and upheld by responsible business leaders"(Press, 2002). It also became apparent that Enron was just a particularly large and well-connected example of what has become a litany of corporate collapses, accounting tricks and colorful corporate rogues, including Xerox, WorldCom, Parmalat, Ahold, Global Crossing and Nortel.

The public accountants involved have not escaped the glare of publicity associated with these financial scandals. Following the spectacular failure or accounting manipulations at many large clients, Arthur Anderson, once an auditor and advisor to corporate giants and viewed as the crème de la crème

of public accountants, was charged with obstruction of justice for destroying audit documents pertaining to Enron, and was dissolved. Vice President Cheney was a big promoter of Arthur Anderson. As he stated in a 1996 promotional video for the firm, "One of the things I like that they do for us is that, in effect, I get good advice, if you will, from their people based upon how we're doing business and how we're operating, over and above, … just sort of the normal by-the-books audit arrangement"(Gutman, 2002). It is perhaps surprising that despite such ringing endorsement from the politically powerful, persuasive evidence is emerging that Arthur Andersen may have been a scapegoat, sacrificed to minimize the potential damage to other white-collar criminals in accounting, investment and corporate businesses (Morrison, 2004).

The glare associated with these financial scandals has encouraged the public accounting industry – professional associations and individual public accounting firms – to respond. These participants have sponsored commissions and think tanks, changed accounting regulations and promoted ethics as the solution to the problems associated with the financial failures. Starting in the 1980s, events such as bank and savings and loans failures, insider trading, accusations of money laundering (Sikka & Willmott, 1998) and other scandals not only resulted in scrutiny of public accountancy but also encouraged a revival of ethics, manifested in training programs, appointment of corporate ethics officers and company ethics videos as well as pronouncements by individual accounting firms and professional bodies. Some multinational accounting and audit firms promoted ethical audits. Toffler (2003) points out that Arthur Andersen actively sold 'ethical leadership' programs, ironically in ways many would consider quite unethical.

The collection of articles in this Special Issue is a different type of response. Prompted by the creation of the Association for Integrity in Accounting, a unit within Citizens Watch, it seeks to locate audit and accounting within a social context. It is not content to leave audit and accounting to so-called experts and professional groups who have much to gain by promoting 'business as usual'. Like their response to the stock market crashes of 1929 and 1987, those in positions of power and privilege have sought to respond to financial crises and scandal in terms of restoring legitimacy in market institutions and heading off questions about the instability of those markets (Merino & Neimark, 1982). This collection offers a counter-hegemonic story, pointing out that things can be different and better in substantive ways, that auditor independence and integrity requires more substantive thinking and analysis than simple re-arrangements of regulatory institutions or calls for superheroes who can transcend pressures to abet crime.

We have already outlined some of the reasons why understanding accounting and auditing is important if we are to prevent financial scandals, or at least better appreciate responses and effects of future scandals. This introduction now proceeds to examine the response of academics to these issues since the public might hope that serious analysis would have emerged from the groves of academe. Such hopes have largely remained unrealized because many accounting academics are themselves subject to the same threats to independence as are auditors. In this sense, the papers in this Special Issue are testament to the efforts of academics who have sought to be independent, and provide an analysis that offers not only a historical understanding of how and why we are in our current state, but also some comparisons and suggestions to show that the present arrangements could be different; there is nothing inevitable in our sorry state of affairs. We conclude the book with a brief review of what we know about auditor independence, and identify some of the more interesting proposals for reform.

THE IMPOVERISHED RESPONSE FROM THE 'IVORY TOWER'

Financial scandals have not gone unnoticed in the groves of academia. Yet, most academic responses indicate that the term 'ivory tower' is a misnomer since many accounting academics are seduced by the accounting industry. The appeal of industry-supported salaries and attractive research expense accounts reinforces an allegiance that is also influenced by a desire to help students get jobs in the accounting industry as well as their own experiences as former practicing accountants and auditors. Thus, one academic response (e.g., Verrecchia, 2002) has been to use stigma management strategies to deny or downplay the problem, to attribute the scandal to isolated occurrences, or to shift the blame to other actors or institutions (Neu & Wright, 1992). This is an approach favored by academics that see capitalism as a progressive economic system that learns from past mistakes and punishes and removes 'rotten apples'. It leads to a passive reaction, aimed at maintaining business as usual, typically achieved through renewed emphasis on public relations.

This has been a predominant response by North American accounting academics – it is 'business as usual' for research and teaching (Cooper,

Everett, & Neu, 2005). The scandals are presented as evidence the system works and disciplines the exceptional cases in what is presented as an otherwise well-functioning system– 'look at the majority (of organizations as well as accounting firms)' is the cry! Such analysis fails to consider the social costs of accounting failures (impacts on local communities, the environment and employment). It also ignores the possibility that heavy investment in accounting and audit is not a necessary feature of a well-functioning economic system – there are varieties of capitalist systems (Hall & Soskice, 2001), not all of which include a significant role for accounting and accounting institutions. Moreover, it ignores what precipitates social and economic change in many countries – changes typically occur as a fallout of extreme cases, such as scandals, and not owing to the performance of average or even a majority of organizations or accountants, the preoccupation of most accounting academics (Tinker, Merino, & Neimark, 1982). A second academic response has been to join forces with major accountancy firms and to jump on the ethics bandwagon (cf. Neimark, 1995). Centers for ethics and corporate governance within universities, training programs for students and practitioners and ethics textbooks are among examples of how the university has seized the opportunity and become ethics entrepreneurs. The irony seems to go unnoticed; the elite educational institutions, who are now creating compulsory ethics courses and have a new-found interest in responsible business, are the same institutions whose graduates have been pouring into consulting, accounting and major corporations for the past few decades, apparently ignorant of or uninterested in issues of responsible business or ethics. The shift to ethics receives much attention, but a recent survey by the AACSB, which accredits many business school programs, found that only a third of business school programs require an ethics course, a figure largely unchanged from 1988. Moreover, even when it is taught, the material is detached from the general curriculum. It becomes the easily marginalized course that does not praise shareholder wealth maximization or the ethic of survival of the fittest.

Further, as Macintosh (1995) points out, ethical issues, such as earnings management, are not examined in a socially or philosophically sophisticated way. Teaching of accounting ethics mirrors the relativistic, individualistic and moralistic approach of most business ethics textbooks. It is conventionally pre-occupied with individual responses to 'ethical dilemmas', with no serious recognition that dilemmas occur within structures of power and domination within organizations and society, or that different social groups may have different moralities. Attempts to locate business and accounting

ethical dilemmas in a structural context or provide a social basis for ethics (e.g., autonomy, justice, equality) are very rare (for an interesting attempt, see Lippke, 1995).

Academic research in accounting has been slow to respond to an age of financial scandal. Ongoing experimental studies of accounting ethics are conducted, but these are rooted in an individualistic, psychological framework that neglects institutional structures and pressures. It also proposes a highly contested and partial view of moral reasoning, largely sympathetic to white male sensibilities. Believers in the efficiency of current financial markets have rushed to show that investors are not fooled by accounting manipulations and the market can see through earnings restatements. They have also shown a renewed interest in accounting regulation, although the predominant orientation is to portray the virtues of market regulation and the costs of other forms of regulation (Jamal et al., 2005). Further, the preoccupation with statistical analysis, the average investor and general market responses leads to neglect of the variable ability of stock market participants to process accounting information efficiently and the intangible benefits of state and other forms of regulation. More importantly, most accounting research is wedded to a partisan view that the value of accounting and auditing should only be judged according to the interests of investors and suppliers of capital (Cooper & Sherer, 1984).

THE THEATER OF FINANCIAL SCANDAL

The theater of corporate executives being charged, accounting firms being sued, government commissions being struck, professional accounting bodies alternately denying the responsibility of its members or introducing minor reforms that they argue will protect the public interest, and the new ethical evangelists within the university suggest that something is happening, but what? How do we make sense of these events? Is this theater a spectacle to keep us entertained while nothing substantive happens outside the performance? Are these cases of corporate malfeasance and accountant complicity limited to North America, or are they worldwide phenomena? Is auditor independence achievable, or are we doomed to seeing the theater of financial scandal repeated in perpetuity? What is the role of accounting academics? And finally, how do we move forward?

In this Special Issue we have brought together academics from across the globe to consider the issue of auditor independence in different jurisdictions and provide suggestions on how to move forward. These chapters set out the

commonalities and differences on the issue of auditor independence across countries, providing the starting point for answering what is the problem of auditor independence and what can be done about it.

THE INDIVIDUAL CONTRIBUTIONS

Richard Baker examines the contested nature of auditor independence. The paper demonstrates that over time, and in a number of professional and academic debates, the concept of auditor independence has been contested; that is, several different concepts of auditor independence have existed in different periods, and even when there appears to be a consensus on the meaning of auditor independence, there are significant debates on improvements and changes to the concept. Baker advocates a complete reconsideration of the concept; one where auditors ought to be prohibited from acting as advocates in any manner on behalf of their clients, and where client management should have no ability whatsoever to determine the audit fee or the scope of the audit engagement.

Jim Gaa considers the philosophical bases of the need for auditor independence. The former member of the International Accounting Standards Committee argues that auditors are supposed to be independent of their clients and free from conflict of interest to be able to provide assurance that the financial statements published by corporate management are free of material misstatement. Gaa then considers whether acting in accordance with professional rules governing accounting and auditing is sufficient to provide such assurance. In addition to a set of rules, it is argued that investor protection requires that auditors possess, or act with, integrity. Four recent and prominent cases show that the required integrity may be lacking. Gaa's arguments can be extended to consider the rights of groups other than investors for quality information that would protect their interests in modern organizations. Employees, creditors, customers, citizens and groups who 'speak' for the environment may also have rights to credible information.

The next three contributions examine the debates in the US about auditor independence. Joni Young provides a historical perspective on the topic of auditor independence in the US. She suggests that the purpose of audit is to mitigate aggressiveness in financial reporting and that, to achieve this, we cannot ignore the structural and other obstacles that may impede the conduct of an effective audit. Independence, with its connotations of an unachievable autonomy, and its linkage of professionalism to an unobservable mind-state may hinder rather than aid this audit purpose. Independence as

autonomy is impossible within an environment in which management pays for audit, hires and fires auditors, and is their primary contact. Several decades of wrangling over whether to emphasize independence, in fact or in appearance, has not been particularly fruitful in furthering our understanding of this audit purpose. Rather than search for ways to make the auditor "more" independent, Young suggests openly examining and emphasizing the rationality of auditing practice. This change in perspective requires us to examine the various relationships in which auditors are embedded and to assess whether these impede auditor autonomy.

John Thornton examines recent attempts by the Securities and Exchange Commission (SEC) to decide whether auditors are able to maintain their independence when they provide nonaudit services. The SEC's issuance of Proposed Rule S7-13-00, *Revision of the Commission's Auditor Independence Requirements*, heard testimony from a variety of groups and individuals, focusing the public's attention on this important issue. Professor Thornton analyzes the testimonies given at the Hearings to help us understand the contentious issues. He concludes that there is considerable confusion about the meaning of independence, and that user, rather than investor or preparer primacy, should be the basis on which specific rule changes should be judged.

Any concern with independence needs to consider the social and political context in which audit firms operate. Robin Roberts examines the involvement of the US public-accounting profession in federal politics, focusing attention on the extent to which the profession engages with federal legislators and other policymakers to influence public policy. He concludes that the public accounting profession's extensive involvement in federal politics works principally to protect its own professional interests and favors conservative, pro-business agendas, most notably, donation of large sums to the Republicans and related groups. As a result, broader public interest responsibilities are often neglected. Although the profession has the right to participate in public policy debates, its parochial and patronage orientation does not resonate well with its self-proclaimed professional commitment to independence and integrity. For the profession, public interest seems to be equated with the interests of corporate America. In other jurisdictions, the political power of accountants may be based more on social networks than on the leverage produced through political donations, but the implications are similar. Professional firms and associations are committed to elites, and they cannot conceive that the public interest might be better served with less reliance on existing elites (e.g., what Stiglitz, 2002 calls the Washington

consensus about trade and development policy) and the technocratic orientation of self-professed experts.

There follows a series of contributions that provide comparative analyses of auditor independence. Collectively, they demonstrate in various ways that things can be different. Yves Gendron examines Canadian auditors' views on independence. They offer an interesting perspective: although they are near scandals geographically, they often feel that they are somehow different from their more commercial colleagues to their south. Gendron's fieldwork highlights not only the tacit understandings of auditors in Canada, which has its own history of scandals, but also how the recent spate of financial scandals has shaken these understandings. He concludes that the problems experienced by accountancy following the collapse of Enron and Andersen constitute a meaningful reminder of the negative impact that the spread of the free-market logic may have on fields of work where the independence and objectivity of workers as diverse as doctors, accountants, investment advisors, teachers and professors are deemed important. Establishing mechanisms to bring to light concerns that emerge from the daily experience of professionals could help guard against the excesses of the free-market logic. In related research, he and his colleagues (Gendron, Cooper, & Townley, 2001; forthcoming) point out that even government auditors can get overenthusiastic about promoting reforms in management, a zeal that can threaten their independence. Similar concerns relate to the independence of doctors, researchers and consumer advisors of all types.

The contribution by Jeff Everett and Duncan Green considers how the accounting profession speaks about its ethical ideals. It is worth recalling that before the creation of the SEC and the 1933 Securities Acts, the US accounting profession did not find it necessary to even mention independence in their codes of ethics. Everett and Green examine recent Canadian and US research to show how these 'ethical discourses' emerge, survive and, sometimes, decline. The analysis of these discourses helps us to better understand how the profession's conception of itself, of what constitutes the ethical accountant, has changed over time. The analysis alerts us to the various functions that ethical discourses may serve, identifies who benefits from these discourses and indicates that ethical statements may be smokescreens for corruption and collusion in financial scandals. They conclude by giving this suggestion: "The profession [should] examine the way it has spoken of and currently speaks about itself, to see that its ethical discourses are often self-referential, part of a myth of origin, and, curiously, increasingly concerned with image rather than substance".

The next two papers offer European contrasts, providing some important lessons, including the crucial role of auditor training and competence and the difficulty of forcing global prescriptions for independence on local circumstances and histories. Kosmala MacLullich and Sucher examine the issue of auditor independence in Eastern Europe. For some time they have been researching how auditor independence has been developing in three countries of the Central and Eastern European region: Czech Republic, Poland and Russia. All three countries were exposed to Communism in the second half of the twentieth century, and history and experience bring into sharp focus the differences and similarities between the North American and Eastern European contexts. Their in-depth analysis and research show that while auditors formally comply with the appropriate laws (often deriving from the International Federation of Accountants proposals for independence), the real issue of independence is in the economic context: obtaining and retaining clients, and associated pricing practices. While these concerns may seem distant for multinational accounting firms in general, in that these firms may not be financially threatened by the loss of a few clients, the economic context of independence can be critical for the partners responsible for specific audits in these firms.

Chris Humphrey, Peter Moizer and Stuart Turley provide a comparative analysis of the responses of American and UK regulators to recent financial scandals. While there is considerable variation in the context of auditing and its regulation internationally, recent developments in the US and UK illustrate some important global responses to auditor independence. They stress that the regulatory response to audit failures has been to change independence rules, yet there is important evidence that suggests the issue is also about auditor competence, including the training and ability of auditors (and the techniques they use) to identify fraud and financial wrongdoing.

AUDITOR INDEPENDENCE REVISITED

The contributions to this Special Issue demonstrate that auditor independence is a problem, that this problem is not limited to North America, and that auditors, security regulators, accounting academics and politicians are complicit. At the same time, the papers provide some basis for hope in terms of more careful analyses of the issues and potential solutions. Yes, structural problems do exist. Yes, it is difficult to set aside our individual interests. And yes, it will never be possible to eliminate all the incentives that give rise

to independence being a problem. But, perhaps, meaningful solutions are still possible and offer substantive opportunities for improvement.

Concrete recommendations as to how policymakers, security regulators, the accounting profession and academics can effectively address the issue of independence are likely to require a combination of the solutions mentioned in the papers. It is important to remember that the purpose is not independence of auditors, but more effective audit. Structural solutions, such as separating audit from other activities of accounting firms, and fixing the terms and price of audit by a body independent of corporate management, are likely to be moves in the right direction. However, there is a long and sad history in a variety of jurisdictions, and attention to structural mechanisms does not necessarily lead to better audits. Changing the education of auditors would help. Some contributors stress the need for better technical training, including an ability to generate and evaluate audit evidence, use expert systems and develop greater ability to detect white-collar crime. There seems little doubt that auditor competence is a necessary prerequisite for an independent and useful audit. Additional emphasis on community obligations, ethical sensitivity and accountability might also improve the training of auditors and suggest the need to move such training back into universities and away from internal programs run by the audit firms or professional bodies. Other contributions remind us of the need to consider the economic context of audit. This includes the economic impact of a client on the firm as a whole, and the impact of losing a specific client on the reputation and income of individual auditors. While none of these solutions on their own is likely to be sufficient, together they might help transform audit into a socially beneficial activity.

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THE CONTESTED CONCEPT OF AUDITOR INDEPENDENCE

C. Richard Baker

ABSTRACT

This paper has two purposes. The first is to demonstrate that over time, and in a number of professional and academic places, the concept of auditor independence has been contested; that is, there have been different concepts of auditor independence within different time periods, and even when there appears to have been consensus on the meaning of auditor independence, there have been significant debates about auditor independence. The second purpose of the paper is to advocate a complete reconsideration of the concept of auditor independence; one which would move us towards the idea that auditors should be prohibited from acting as advocates in any way on behalf of their clients, and that client management should have no ability whatsoever to determine the audit fee or the scope of audit engagement. These are controversial ideas. They are meant to be so.

INTRODUCTION

In a recent article, Colson (2004) observed that there have been significant changes in the concept of auditor independence over the past 150 years. The initial concept of auditor independence, which prevailed during the latter part of the 19th century, focused on the accounting profession's belief that

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one of its primary missions was the oversight of capitalist investments in various former and contemporaneously current parts of the British Empire. Colson states that:

> "whereas a firm of British accounts in 1880 might have practiced in New York and received payment from its New York clients, the firm's primary responsibilities to the owners back home would have been incontrovertible" (p. 80).

In this sort of environment, a relatively small number of accounting firms could audit a relatively large number of foreign investments. Public accountants could oversee the financial activities of competing entities and work for different investor groups. Since British investors forbade auditors from investing or working in the businesses that they audited, the prevailing concept of auditor independence in this era did not allow accountants to be advocates for their auditee "clients." Nevertheless, as long as auditors maintained their primary loyalty to investors back home, the scope of their services could be broad. For example, auditors could keep books and prepare financial statements without reproach (Colson, 2004).

After the enactment of the United States Securities Acts at the beginning of the 1930s, and the subsequent creation of the Securities and Exchange Commission (SEC), the concept of auditor independence changed significantly. The influence of the SEC on auditor independence centered on the SEC's efforts to establish generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS). As GAAP and GAAS began to be created, auditors changed their emphasis away from loyalty to a specific absentee capitalist investor towards the enforcement of accounting and auditing standards created by the accounting profession. This loyalty was transferred to the standards and not to the beneficiaries of the standards. As a result of this process, the concept of auditor independence relied on notions of objectivity and neutrality rather than loyalty to a specific party. Section 13 of the US Securities Exchange Act of 1934 specified the following requirements:

a. Every issuer of a security registered pursuant to section 12 shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate for the proper protection of investors and to insure fair dealing in the security –
    1. Such information and documents (and such copies thereof) as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with an application or registration statement filed pursuant to section 12, except that the Commission may not require the filing of any material contract wholly executed before July 1, 1962.

2. Such annual reports (and such copies thereof), certified if required by the rules and regulations of the Commission by ***independent public accountants*** (emphasis added) and such quarterly reports (and such copies thereof), as the Commission may prescribe (SEC, 2004a).

This new concept of auditor independence, based on objectivity and neutrality, continued until the 1970s, when the Financial Accounting Standards Board was formed with the mission of becoming "the" independent accounting standards setter. Dating from approximately that time, public accounting firms essentially abandoned auditor independence and assumed a role as an advocate for the accounting methods preferred by their clients (Colson, 2004). During the same period, the rapid growth of capitalist enterprises on a worldwide basis provided large public accounting firms with an opportunity to become the preferred providers of a wide spectrum of consulting services, the revenues of which quickly outpaced the fees garnered from traditional auditing and tax services. The economics of the auditing industry compelled auditors to abandon the concept of objectivity and neutrality in favor of becoming advisors and advocates for client management. This perversion of auditor independence prevailed until the scandals of 2002 and the enactment of the Sarbanes-Oxley Act, which modifies the concept of auditor independence once again towards the concept of protecting the interests of investors and creditors in capital markets.

DEBATES ABOUT AUDITOR INDEPENDENCE

During the last half of 20th century, there were numerous debates over auditor independence in both academic and professional literatures. In these debates, the concept of auditor independence was based on the US Securities Laws (i.e., "independent" means objective and neutral), combined with a more general notion of what it means to be a "professional" person, which is an idea that emerged in both British and American settings in the late 19th and early 20th centuries. For example, Lee (1986) argued:

> "An honest auditor will behave like someone who is independent, using independence to mean 'an attitude of mind which does not allow the viewpoints and conclusions of its possessor to become reliant on or subordinate to the influence and pressures of conflicting interests" (p. 89).

While this quote reflects the tenor of the debates surrounding the concept of auditor independence, Lee's rhetorical expression avoids the fact that an auditor's state of mind cannot be observed, and consequently, it is

impossible to determine whether an auditor is independent pursuant to Lee's definition.

Almost as unhelpful are the arguments of Moizier (1991) and others concerning the economic rationale for auditor independence, which can be summarized in the following quotation:

> "There is an expectation that the auditor will have performed an audit that will have reduced the chances of a successful negligence lawsuit to a level acceptable to the auditor. In the language of economics, the auditor will perform audit work until the cost of undertaking more work is equal to the benefit the auditor derives in terms of the reduction in the risk of a successful lawsuit being possible. This then represents the minimum amount of work that the reader can expect the auditor to perform. However, all auditors are individuals with different attitudes to risk and return and so one auditor's minimum standard of audit work will not necessarily be that of a colleague" (p. 37).

What Moizier is saying, in a somewhat convoluted manner, is that auditors act in an independent manner because it is in their economic interest to do so. Auditors perform an adequate amount of audit work and collect a sufficient amount of evidence to support their audit opinions in order to protect themselves against being sued. While this may be a reasonable argument from an economic equilibrium perspective, it is dysfunctional at the margin if only one auditor takes advantage of the presumption of auditor independence in order to achieve an unwarranted economic advantage.

In contrast to the professional and economic arguments for auditor independence, Bartlett (1991) has argued that auditing is actually a type of myth or ceremony involving incantations about independence. Bartlett suggested that there have been four types of incantations regarding auditor independence:

1. The "*smoking gun*" – This incantation deals with the allegation that there have been few documented instances where auditor independence was found to be implicated in audit failures, at least if we only consider the evidence provided by lawsuits and prosecutions of auditors. Most lawsuits and prosecutions of auditors are based on allegations of incompetence or lack of due diligence in the application of auditing standards rather than lack of independence. However, the inability to obtain access to records of lawsuits and other evidence about audit failures makes this incantation difficult to prove one way or the other.
2. "*We are doing pretty good*" – Based on public opinion surveys, the public accounting profession has been held in high regard. In assessing the esteem of the public accounting profession, public opinion polls often address issues such as objectivity, reliability and honesty, rather than

independence. While there may be a presumption of a relationship between objectivity, reliability, honesty and independence, it is not clear what independence means to the general public. Often, the public is misinformed or uninformed about what auditors do.

3. The "*Public good*" – This incantation suggests that if too many constraints are placed on the accounting profession's scope of services, accounting firms will not be able to serve clients properly, thereby resulting in significant costs to the public. Large public accounting firms argue that providing non-auditing services to clients allows them to perform better audits because they obtain a better understanding of client systems. While on its face this appears to be a reasonable argument, it is hard to accept that any auditor, however independent of mind, can objectively opine on the proper functioning of systems which he or she designed (Plumlee, 1985).
4. "*Trust us*" – Independence is often said to be a mental state possessed by professional accountants and therefore not subject to empirical observation or quantification. This incantation is premised on the notion of auditor economic self-interest; that is, auditors are assumed to maintain independence and objectivity in order to not protect their longer-term economic interests. This notion assumes that auditors continually evaluate the costs and benefits associated with ethical behavior and always resolve conflicts in favor of behaving ethically, because doing so produces the greatest long-term economic benefit. While the validity of these assumptions is questionable, it can be observed empirically that the individual economic calculus of a particular auditor often weighs in favor of retaining an important client rather than being objective and independent.

CHANGES IN THE MARKET FOR AUDIT SERVICES AS AN IMPEDIMENT TO INDEPENDENCE

Weil (2004) indicates that during the 1970s and 1980s there were a number of changes in the market for audit services that contributed to the general decline in auditor independence. The first of these changes was price competition in the market for audit services. Prior to the 1970s, the American Institute of Certified Public Accountants (AICPA) prohibited auditors from publicly advertising their services, from making uninvited solicitations to rival firms' clients and from participating in competitive bidding for audits. The AICPA was forced to remove these prohibitions because of threats

about anti-trust actions by the US federal government. As a result, competitive bidding for audits became commonplace during the 1970s, 1980s and 1990s. Competitive bidding produced pressures to reduce the number of hours devoted to audits. Auditing became a commodity and fixed-fee pricing became common. To maintain revenues and profitability, accounting firms began to emphasize non-audit services. Both the inability to devote an adequate amount of time to perform a quality audit, and an increased reliance on non-audit services, contributed to a decrease in auditor independence (Weil, 2004).

The second change in the market for audit services was a growing emphasis on "risk-based auditing." The theory of risk-based auditing is logical in that the greatest amount of audit effort is placed on the greatest areas of audit risk. The underlying premise of this reasonable idea is that auditors are experts in determining which areas of a company's operations are the most risky. As was demonstrated by Enron, WorldCom and other business failures, auditors are not necessarily able to determine which areas of a company's operations are subject to the greatest risk. Fraudulent activities were not detected by auditors using a risk-based auditing approach. The move to risk-based auditing is essentially a way to reduce the number of hours devoted to an audit. As an unintended result, auditors began to shift their view of auditor independence away from being an objective and neutral interpreter (which would require more audit hours) towards helping client management to achieve its goals. While the goals of management may be congruent with increasing shareholder value, all too often, management's attempts to increase shareholder value have been based on misleading accounting numbers that conceal poor economic performance. During the 1980s and 1990s, auditors often neglected their most important responsibility to act on behalf of shareholders, striving instead to maintain increased profitability for their accounting practices.

PROPOSALS TO INCREASE AUDITOR INDEPENDENCE BEFORE SARBANES-OXLEY

Moizier (1991) has discussed several ways that auditor independence might be improved. These proposals include:

1. *Legal prohibition of financial interests in client companies* – A legal prohibition against an auditor possessing financial interests in a client company has been the cornerstone of auditor independence in the United

States since the 1930s. Through the 1990s, this was not true in the United Kingdom and certain other countries, even though prohibitions against holding financial interests were generally observed in practice. Currently, there is virtually a universal prohibition against auditors holding financial interests in clients. Both the SEC and the public accounting profession have focused most of their efforts surrounding auditor independence on defining and enforcing prohibitions against financial interests. Elaborate rules and reporting structures have been created for the sole purpose of revealing any type of financial interest on the part of professional employees in accounting firms, their spouses, their parents and their children. One can only speculate, to what end has all of this effort been expended? Has auditor independence been increased?

2. *Rotation of audit appointments* – In some countries (e.g., Italy) auditors are permitted to audit a client only for a specified number of years (e.g., five years). This type of regulation has never been seriously considered in the US or the UK, even though the Sarbanes-Oxley Act does require that individual auditors rotate off a client on a periodic basis. In France, the concept of auditor rotation has been reversed, because all auditors are appointed for a fixed period of time, during which time they cannot be replaced. This rule is intended to increase independence because the auditor has less fear of being fired by the client. Large public accounting firms often object to auditor rotation, arguing that there is a high cost incurred during the initial years of an audit which would be lost if there were a regular rotation of auditors. This is a specious argument because the benefits obtained from regular auditor rotation may easily outweigh the initial start-up costs of an audit.
3. *Peer review* – The idea of having another auditor review the work of a given audit firm is appealing on its face. Peer review has been a commonplace feature of the American auditing scene for many years, and it has become increasingly common in other countries. However, the challenges of peer review became increasingly evident in the US during the period when the peer review system was under the supervision of the Public Oversight Board (POB) of the American Institute of CPAs (AICPA) (until 2001). In the late 1990s, the POB became a toothless tiger, with its budgets and scope of activities constrained by both the AICPA and the large accounting firms. The Public Companies Accounting Oversight Board (PCAOB), which was created by the Sarbanes-Oxley Act, has assumed the responsibility for inspection of registered audit firms. This means that the idea of peer review has virtually disappeared from the discussion about auditor independence, at least as it relates to audits of SEC registrants and

other public companies. Peer review has been replaced by concept of "inspection" by the PCAOB. While the PCAOB inspectors are trained auditors, they are not peers of the practicing auditors.
4. *An independent auditor appointing and fee setting body* – The intent behind this proposal is to reduce the power of client management to control the appointment and remuneration of auditors, thereby increasing the auditor's ability to exert independent judgment and action. This proposal has received no support in the regulatory structures of advanced capitalist countries. The Sarbanes-Oxley Act does require that auditors be engaged by the Audit Committee of the Board of Directors of a client company. However, it is unclear whether this requirement has been observed in practice, or whether it is actually top management who continues to exert control over the amount of the audit fee and the scope of the audit.

THE CONCEPT OF AUDITOR INDEPENDENCE AFTER SARBANES-OXLEY

After the bankruptcies and revelations of fraud at Enron Corp., WorldCom and other companies during 2001 and 2002, the US Congress passed the Sarbanes-Oxley Act of 2002 (SEC, 2004b). Some have asserted that the Sarbanes-Oxley Act represents the most significant change in auditor regulation in the US since the enactment of the Securities Acts in the 1930s. Among other things, Sarbanes-Oxley created the PCAOB, which has taken over regulatory control of audits of companies with securities traded in public capital markets (i.e., SEC registrants). This includes the creation of audit, ethics and independence standards. All accounting firms that perform audits of SEC registrants, whether they are US-based or foreign, must register with the PCAOB and agree to have their audit practices inspected regularly by inspectors employed by the PCAOB. While the PCAOB is not an agency of the US government, it operates under the supervision of the SEC. The key portion of the Sarbanes-Oxley Act with regard to auditor independence is section 103, sub-part (B)(i), which states that the PCAOB *shall include, in the quality control standards that it adopts with respect to the issuance of audit reports, requirements for every registered public accounting firm relating to monitoring of professional ethics and* ***independence*** *from issuers on behalf of which the firm issues audit reports.*

In August 2004 the PCAOB issued four reports summarizing the results of limited inspections of the Big Four public accounting firms (PCAOB,

2004a, 2004b, 2004c, 2004d). These reports indicate that the PCAOB conducted certain limited procedures in connection with its inspections of the Big Four firms. The limited procedures included:

- Evaluation of the firm's "tone at the top"
- Partner evaluation, compensation, assignment of responsibilities and discipline
- Independence implications of non-audit services, business ventures, alliances and arrangements; commissions and contingent fees
- Client acceptance and retention policies
- The firm's internal inspection programs and
- Practices for the establishment and communication of audit policies, procedures and methodologies, including training

Many of the above-listed areas relate directly to auditor independence. The ability of the PCAOB to register and inspect firms and enforce audit, ethics and independence standards provides some optimism about the prospects for auditor independence. However, this still leaves open the contestable nature of the concept of auditor independence. The Chief Auditor of the PCAOB has stated in various public speeches that a professional accountant has a "special duty to society." He pointed out that, as professionals, certified public accountants (CPAs) must follow the spirit of the standards rather than try to find loopholes (Victor & Levitin, 2004). Again, this is optimistic language, but it still leaves open the question about the meaning of "special duty to society." Is it one that compels auditors to focus on the needs of investors and creditors in capital markets, or is it one where auditors are expected to be neutral and objective regarding the interpretation and enforcement of accounting and auditing standards? These may be complementary meanings, but not always. To date the PCAOB has merely adopted the rules for auditor independence created by the AICPA and the SEC during the last 50 years. These rules were established with concurrence of the large public accounting firms, thus leaving open the question whether the standards can achieve the goals that they were intended to achieve. What may be needed at this point is a complete reconsideration of the concept of auditor independence that moves toward the idea that auditors should be prohibited from acting as advocates in any manner on behalf of their clients, and that moreover, client management should have no ability to determine the audit fee or the scope of the audit engagement. Until these ideas come into effect, the concept of auditor independence will remain largely a cosmetic device to hide the general inability to determine whether an auditor is independent in fact rather merely in appearance.

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INTEGRITY, AUDITOR INDEPENDENCE, AND THE PROTECTION OF INVESTORS

James C. Gaa

ABSTRACT

A basic principle underlying the public securities markets in many countries is that the interests of investors need to be protected. Independence from their clients (i.e., client management) is supposed to make it more likely that auditors will protect investors' interests. This paper examines the question whether acting in accordance with professional rules governing accounting and auditing is sufficient to provide such assurance. In addition to a set of rules, it is argued that investor protection requires that auditors possess, or act with, integrity. An analysis of the principle of acting with integrity, as contained in the AICPA Code of Professional Conduct, shows that its formulation of the principle conflicts with the concept itself, and thus that the profession's commitment to integrity is questionable. Five recent and prominent cases are examined, which show that the required integrity may be lacking. The implications of a lack of integrity are discussed at the end.

Corporate fraud has been a major feature of the business world in the United States and, to a lesser extent, in other countries since the separation of ownership and management arose in the late seventeenth century, and has continued sporadically up to the present. Many members of society, and not

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just investors, have borne significant personal costs as a result. In addition, these frauds have a negative systemic effect on society; for example, trust in major social institutions is impaired. It seems as if the only people to benefit from these situations are the perpetrators themselves.

A central feature of modern securities markets is the separation of ownership and management of enterprises. A central feature of that separation is the process of external financial reporting, through which the management of a company informs outsiders of its financial situation. Although the official purpose of these reports is to inform outsiders, they can and (in the case of many financial scandals) have been used instead to hide management negligence and wrongdoing. Furthermore, as the cases (for example, Enron) in which "financial engineering" have resulted in enormous rewards to management reveal, financial reporting actually may be the vehicle though which wrongdoing occurs, as opposed to the cloak that hides it. In these cases, financial reporting is used to benefit management and affiliated parties (possibly including auditors) to the detriment of investors and others.[1]

The purpose of this paper is to look at what is required in order to protect the interests of investors. The next section reviews the concept of investor protection, as an important feature of securities markets. Next, auditor independence, defined by a set of rules governing situations and relationships relating to auditors and the management of the audit client, is examined as an instance of the compliance approach to ethics. This is followed by a discussion of the concept of integrity and the need for integrity in the context of investor protection. Following this is an examination of the section of the AICPA's Code of Professional Conduct about integrity. The analysis shows that the principle as stated is fundamentally flawed, and is incompatible with the concept of integrity. Then the integrity of public accounting firms is briefly considered, via an examination of several significant acts undertaken by them in the last few years. The result of this examination raises questions about their integrity, and thus their ability to protect investors. While it would be nice to think that we could rely on auditors' integrity, this does not seem to be the case. In the last section it is concluded that, for this reason, we have to fall back on the compliance approach. The compliance approach is inferior from the ethical point of view, and also has significant practical problems in implementation. However, if the integrity of accounting firms cannot be relied on, then the compliance approach may be second-best. In this case, it is necessary to be very sure that the rules provide an appropriate standard of behavior and that appropriate and effective enforcement mechanisms are in place.

This paper focuses on the primary role of external auditors, which is to provide assurance that financial statements prepared by management are free of material misstatements, and thus are sufficiently reliable for use by others. This is important since investors (including creditors) are concerned with the reliability (as well as the relevance) of the information they use to make investment decisions (FASB, 1978). It is clear that auditors have more stakeholders than members of these two groups. For example, suppliers, customers, financial analysts (who provide information and investment advice directly to individual and institutional investors, including pension funds and mutual funds), the press and government agencies all have a significant interest in the quality of information produced by corporate management. For this reason, the protection of investors' interests focuses on only one aspect of auditors' ethical responsibilities to society as a whole.[2] The degree to which auditors focus on the information needs of investors coincides or conflicts with the needs of other stakeholders is unknown. However, it is clear that the needs of investors are paramount in the context of the regulation of public securities markets. As discussed below, the numerous mentions of investor protection in the Securities Acts argue for the legitimacy and importance of a focus on auditors' responsibilities to investors.

INVESTOR PROTECTION

Although it is not discussed much outside the domain of securities market regulation, protection of the interests of non-management investors has been a fundamental issue for many years. Arthur Levitt, then-Chairman of the Securities and Exchange Commission (SEC), observed that the need to protect investors was recognized in the late 17th Century, when formal stock exchanges first appeared in England (Levitt, 1996). Only a few years later, the South Seas Bubble, which was an enormous financial fraud in the 1710s, proved the point. The scandal was so massive and traumatic that it caused the end of the joint-stock form of business organization (which was the forerunner of the modern corporation) for over a hundred years. Eventually, the need to obtain large amounts of capital for transportation companies caused the corporate form of organization to re-emerge in England, with the Companies Acts of 1844 and 1845. But these laws required audits of balance sheets, in order to limit the ability of management to commit fraud (which was regarded as inevitable otherwise) (Littleton, 1933). For more details, see Gaa (1994, Ch. 1).

Levitt also pointed out the central importance of protecting investors' interests by noting that the phrases "for the protection of investors" and "in

the public interest'' occur separately or together in the Securities Act of 1933 and the Securities Exchange Act of 1934 at least 225 times (Levitt, 1996). Similar language is found at many points in the Sarbanes-Oxley Act of 2002, the official title of which (''An Act to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the Securities Laws and for other purposes'', U.S. Congress, 2002) reinforces the point. Thus, the public interest in protecting investors' interests is clear, and has been for many years. For a theoretical analysis of the principle user primacy, which is the basis for investor protection, based on ethical theory, see Gaa (1986).

The imperative of investor protection is not only legislated. For example, the U.S. Supreme Court adopted a similar (if not stronger) position in the Arthur Young case. In rejecting the extension of work-product immunity from attorneys to the workpapers of auditors, the Court observed the following:

> The [attorney] work-product doctrine was founded upon the private attorney's role as the client's confidential adviser and advocate, a loyal representative whose duty it is to present the client's case in the most favorable possible light. An independent Certified Public Accountant performs a different role. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This public watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust. (U.S. Supreme Court, 1984, sec. IV.B)

Thus, the difference in roles imposes a fiduciary duty on auditors to act in the interest of investors, and makes it clear that they are not the agents of management.[3] This obligation to the public is also the condition in exchange for which the public accounting profession is granted the power of self-regulation (Gaa, 1990).[4]

For many years, the profession has focused on the requirement that auditors be ''independent'' (''totally independent'', in the words of the Supreme Court). The idea behind this is that if auditors are not dependent on the management of the firm being audited, it is more likely that they will act in the interest of investors, and less likely that they will act in the interest of management (in so far as their interests diverge).[5] The degree to which auditors have been independent of their clients has been controversial.[6]

THE COMPLIANCE APPROACH TO INVESTOR PROTECTION

The Code of Professional Conduct of the American Institute of Certified Public Accountants (AICPA) has two parts: a set of principles (AICPA, n.d., sec. 50) and a set of rules (the remainder of the Code). The Statement of Principles asserts service of the "the public interest" as a primary value, where "the public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others" (AICPA, n.d., Article II, sec. 53.01). Furthermore, the principles of the Code "call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage" (AICPA, n.d., Preamble, sec. 51.02). Taken together, these two statements form a general requirement that members of the AICPA give priority to the interests of others, including investors. Although this statement does not explicitly address the duty to protect investors (since it neither differentiates their interests from those of management nor gives them priority), it is in the same spirit.

According to the AICPA Code, independence is necessary in order for auditors to protect the interests of investors. Whether it is also sufficient for this purpose is the subject of the rest of this paper. Although the Code also defines "the public interest" as "the collective well-being of the community of people and institutions the profession serves" (AICPA, Article II, sec. 53.01), in the context of auditing, these statements are at least consistent with placing the interests of investors first. In short, acting in accordance with their fiduciary duty to investors requires independence from the client's management, i.e., freedom from conflict of interest. The issues are still with us today, although perhaps in an attenuated form due to the passage of the Sarbanes-Oxley Act of 2002 (discussed below).

If independence is required in order for external auditors to fulfill their fiduciary obligations, it must be asked whether anything else may be required in order to ensure that investors' interests are protected. One way of trying to ensure that auditors fulfill their fiduciary obligation to investors, and thus to protect them, is to promulgate a set of rules which either require (or forbid) specific actions or relationships on the part of auditors. Such rules may take the form of either a code of professional conduct or of public regulations.[7] In the literature of business ethics, this use of rules to enforce ethically appropriate behavior is known as the compliance approach. The hope behind this approach is that a suitable set of rules (along with an effective enforcement mechanism) will cause people to act in accordance with ethical standards. Indeed, the compliance approach assumes that people ipso facto are acting ethically if they adhere to a set of written rules. For this reason, acting in

accordance with a higher standard of behavior would not be required in order to merit calling a person's behavior ethical.

The rules in the AICPA Code of Conduct (AICPA, n.d.) are formulated in order to provide enforceable interpretations of the principles that should guide members in their work. As noted above, the Code does not define independence, even though it is a central and critical concept for accountants in public practice. Instead of providing a definition, the Code contains a principle and a rule. According to Article IV (AICPA, n.d., ET Sec. 55), "... a member who provides auditing and other attestation services should be independent in fact and appearance (Article 55.03). The rule requires independence in the provision of services, as specified by various regulatory and professional bodies (Rule 101, AICPA, n.d., ET Sec. 101.01). This is followed by a long list of detailed interpretations (AICPA, n.d., ET Sec. 101.02), describing specific conditions in which a member of the Institute is deemed to be not independent. These conditions address specific situations of the following types: (1) a direct or (certain types of) indirect financial interest in, or certain types of obligation to, the client of a member or a member of the member's family; (2) employment by or association with the client of a member or of a member's family; (3) the performance of non-attest services (in certain circumstances); (4) performance of any of a set of specific activities for the client's benefit; (5) the existence of certain legal actions; (6) joint business activity with the client; and (7) the organizational structure of firms.

Essentially, these interpretations describe a wide variety of the most important situations in which the interests of investors (to whom auditors owe a fiduciary duty, as described above) may be compromised due to a conflict of interest involving the auditor. The intent behind these rules is to prevent relationships from existing that would increase the likelihood that auditors would act in their self-interest and thus harm investors (Gaa, 1994).

As a government agency, the SEC has naturally taken a legalistic approach to auditor independence, having promulgated extensive and detailed rules regarding auditor independence for auditors of companies with listed securities.[8] More recently, the Sarbanes-Oxley Act of 2002 created the Public Companies Accounting Oversight Board, to oversee the audit function. Among its powers and duties is to promulgate ethics standards (sec. 103(a)(1)) and rules to implement auditor independence requirements (sec. 103(b)), "as may be necessary or appropriate in the public interest or for the protection of investors." In addition to PCAOB regulation, the Sarbanes-Oxley Act enshrined a number of independence-related relationships directly into the legislation. Auditors are barred from providing a range of services for their audit clients, specified in the Act;[9] and services not listed in the Act (such as

income tax services) may be performed only with the advance approval of the audit committee of the client's Board of Directors. Furthermore, the likelihood of activities that might harm investors is supposed to be reduced by requiring the rotation of the audit partner and review partner every 5 years (sec. 203). In order to increase the accountability of auditors, and to provide a means to report management misbehavior, auditors are also required to report on a number of matters directly to the Audit Committee (sec. 204). In addition, section 206 bars audits in cases where a member of the audit firm has become an executive of the client during the previous year. [10]

Because of the contentious legal setting in which the SEC and PCAOB (and the AICPA, for that matter) operate, it is understandable that independence standards precisely specify the conditions in which independence is (or is deemed to be) compromised. Referring to the growth in the provision of non-audit services to audit clients, Sutton states the issue clearly:

> This new business and professional environment raises two threshold policy issues. First, what does the declining relative economic importance of the auditing function within a public accounting firm really mean to the future of the profession? And second, what is the impact on auditor objectivity of business relationships that may create, or be perceived to create, a mutuality of interests or a conflict of interests between the auditor and the true client – the investors?
>
> ……………….
>
> The broad question raised by the first concern is whether the public accounting profession will continue to assign its highest priority to the auditing function and continue to make the necessary investments to ensure that audit quality will not be compromised and that auditor performance will meet public expectations.
>
> …………………
>
> The worrisome question raised by the second concern is how best to assure the public, Congress, regulators, the profession and corporate America that the auditor's objectivity and independence will not be compromised by auditor-client relationships, and that investors can continue to rely on the credibility and integrity of audited financial information." Sutton, 1997, p. 88

We need to consider how successful the compliance approach is in assuring that auditors fulfill their fiduciary duty to investors.

COMPLIANCE IS NOT ENOUGH

To summarize, both professional standards regulations (as well as legislation) link auditor independence to freedom from any of a long list of conflicts of interest. The problem with this view is that, taken literally and in isolation, it is supposed to impose a certain standard of behavior, such that if an auditor is independent (as defined) then he or she will act in the interest

of investors. There are several reasons why this legalistic compliance approach, even if it specifies necessary conditions, is not sufficient for guaranteeing that an auditor will protect the interests of investors. First, no set of rules is complete. This means that a given set of rules cannot be a complete list of all the factors or relationships that could cause an auditor not to act in the interest of investors. An example of this is the case of the creation of KPMG Baymark, in the mid-1990s (SEC, 2001a). KPMG decided to start an investment bank that would provide various services to its audit clients, including taking over the operation of KPMG's audit clients that were in financial difficulty. If KPMG had created Baymark legally as a subsidiary operation of KPMG, it would have clearly violated the independence standards in place at the time. So, KPMG created it instead as a legally distinct entity, with a relationship to it that it believed would not contravene SEC rules. Furthermore, KPMG attempted to hide its relationship to Baymark, so that the SEC might accept it without full knowledge of the relationship between KPMG and Baymark. In this case, the rules, as KPMG interpreted them, were not sufficient to prevent it from establishing Baymark, even though the relationship (whatever its legal structure) clearly violated the ''spirit'' of the independence rules, which is to be free of conflicts of interest, and thus increase the likelihood of acting so as to protect investors. It is clear that the current set of rules deal with only a few of the ways in which auditors could fail to protect investors.

Second, the world changes over time, and rules generally change only in response to problems. That means that they are nearly always out of date, at least to some extent. For example, the rapid expansion in the provision of non-audit services to audit clients shows that, until the Sarbanes-Oxley Act prohibited a range of consulting services, the rules were unable to cope with the entrepreneurial spirit driving these changes. The rules may not have been sufficient even at the time they were promulgated. Arthur Levitt wanted to eliminate all consulting for audit clients, but was prevented from doing so, due to tremendous political pressure exerted on him via members of the U.S. Congress. (This was an action he later regretted (Levitt and Dwyer, 2002)). In short, one can't expect the Act, or any other set of rules or standards, to be the final answer.

Third, even though the independence rules are intended to work for the benefit of investors, compliance with independence rules does not guarantee that auditors (acting in accordance with them) will in fact protect investors' interests. The reason for this is that they may act carelessly or in ignorance of other standards (such as auditing standards), and thus fall short in fulfilling their obligations.

A more fundamental problem with the compliance approach, related to the last point, is that it suggests, if not implies, that the written rules are both the minimal and (effectively) the maximal standard of behavior. As has been noted, the primary problem with the compliance approach to ethics is that it encourages, or at least condones, behavior that meets only the minimal moral standard (as defined by the independence rules in place at a given time), but does not rise above it. Thus, people are expected to act in accordance with the rules, but they are not obligated to exceed them.

ACTING WITH INTEGRITY

A higher standard than mere compliance with rules is required, in order to fulfill the fiduciary duty that investors are due from auditors. Most codes of professional conduct contain lofty statements about the character and integrity of members of the profession, and outline a number of duties that they are obligated to follow. The AICPA Code is no different; this is the Principles section of the Code mentioned above. The principles are an alternate representation of societal expectations. So, in addition to avoiding situations described in the independence rules, we expect auditors to exhibit certain character traits. It is evident that the insufficiency of the compliance approach is implicit in the structure of the Code.

The principles in the Code are stated for the most part in terms of how a member should act. But in fact, much of it is really about the personal character traits, i.e., the virtues, which accountants should possess, along with the claim that members' behavior should demonstrate those virtues. The importance of these ideas is evident in Section 50 of the Code. For example, responsibility is mentioned 23 times; objectivity 14 times, (serving) the public interest 15 times; competence 9 times; independence 7 times; diligence 4 times; honesty 3 times; honor 3 times; the sacrifice of personal gain or advantage 3 times; and excellence 2 times.

Because of its loose construction, for example, the lack of definitions of the concepts contained in the Principles section, one might conclude that it is not worth taking seriously, that it is just "cheap talk". However, if it is taken seriously, it provides the answer to the question about how auditors may fulfill their fiduciary duty. The answer is that they should act in accordance with principle; that is, they should act with integrity.

Virtue theory is concerned with the character traits that guide people in making ethical decisions and in acting ethically. Foremost among the ethical concepts mentioned in Section 50 of the AICPA Code is integrity, which is

mentioned or discussed 14 times. Although it is not defined in Section 50, the discussion of integrity in the Code is built on the foundation of other character traits, such as those mentioned in the Code.

Two prominent business ethicists, Robert Solomon (1993, 1999) and Richard DeGeorge (1993) have recently advanced the concept of virtue (including integrity) as a neglected foundation for business ethics. (See Mintz (1995) for a concise account of virtue theory and its application to accounting.) Solomon (1993, 1999) emphasizes the notion of integrity as wholeness: ''wholeness of virtue, wholeness as a person, wholeness in the sense of being an integral part of something larger than the person'' (Solomon, 1999, pg. 38). Integrity is a characteristic that people possess (i.e., people have or lack integrity), as a kind of unity or coherence of personality. As such, integrity is closely related to the virtues, but is not itself a virtue, at least not in the same sense as are honesty, trustworthiness, and other virtues (Solomon, 1999, pg. 38). DeGeorge, on the other hand, focuses on people's actions, so that the operative concept is that a person acts (or fails to act) with integrity, rather than whether a person possesses the character trait of integrity. Acting with integrity means that a person is acting in accordance with his or her ''highest self-accepted norms of behavior and imposing on oneself the norms demanded by ethics and morality'' (DeGeorge, 1993, p. 6). For both Solomon and DeGeorge, rules have a legitimate role; but they constitute at best the moral minimum discussed above. (Even this assumes that the rules themselves provide an ethically justifiable standard of behavior, so that a person with integrity may be ethically required to violate some rules (Solomon, 1993, pg. 169).) So, acting with integrity includes acting in accordance with justifiable rules, at least in the sense that rules may provide sound guidance about how to act in specific conditions. Both aspects of integrity (i.e., integrity as acting according to one's highest norms of behavior and integrity as coherence or wholeness) are important in assessing the prospects that auditors will act in the interest of investors.

Acting with integrity is a rejection of the compliance approach, because it requires behavior that is above the moral minimum. The spirit of the compliance approach is to see how close to the moral minimum (often considered to be the legal limits) one can go, while acting with integrity requires deciding how far above that minimum one should go in a given circumstance. Acting with integrity is different from the compliance approach in another way, because the norms one follows are self-imposed, rather than imposed by outside parties (such as legal authorities).

INTEGRITY AND THE AICPA CODE OF PROFESSIONAL CONDUCT

The AICPA Code of Professional Conduct (AICPA, n.d.) contains five principles governing the behavior of AICPA members. Article III states the principle: "To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity." This statement could hardly be clearer about the centrality of integrity as a professional value. However, a following comment reduces this principle to a weak and limited, and ultimately meaningless, statement. The problematic item is Section 54.03, which states the following:

> In the absence of specific rules, standards, or guidance, or in the face of conflicting opinions, a member should test decisions and deeds by asking: "Am I doing what a person of integrity would do? Have I retained my integrity?" Integrity requires a member to observe both the form and the spirit of technical and ethical standards; circumvention of those standards constitutes subordination of judgment. (AICPA, n.d., Sec 54.03)

Although this statement appears to be concerned with the notion of acting according to one's highest standards, it in fact belies it. The second sentence is in the spirit of acting with integrity, as in Article III. However, the first sentence makes it clear that members are to give priority to "specific rules, standards or guidance", and are to consider the integrity of their actions only in the absence of those specific rules. It does not recognize the possibility that existing "rules, standards, or guidance" may be insufficient as a guide to ethical behavior. Thus, it espouses the primacy of the compliance approach to ethics, to the extent that suitable rules exist. The reason for this is that, according to Sec. 54.03, a member is supposed to "consult" his or her integrity only when the rules fail to give a clear answer. Even worse from the point of view of acting with integrity, it appears to require (or at least does not forbid) following a clear rule, even when the result would constitute a violation of "the spirit of technical and ethical standards", and a violation of one's integrity.

In order to be in accordance with the principle of acting with integrity, Sec. 54.03 should say something like the following:

> Integrity requires a member to observe both the form and the spirit of technical and ethical standards; circumvention of those standards constitutes subordination of judgment. A member should test decisions and deeds by asking: "Am I doing what a person of integrity would do? Have I retained my integrity?" This test should be applied regardless of any specific rules, standards, or guidance governing the situation.

Since protecting investors' interests requires acting with integrity and the Code requires that AICPA members act with integrity, the official answer provided by the profession about protecting investors should be clear: members need to act with integrity in the performance of audits, and not merely in accordance with professional rules. Unfortunately, the section of the AICPA Code is itself is a denial of the importance of acting with integrity, whenever one's integrity conflicts with "specific rules, standards, or guidance". If, in a specific situation, following a specific rule, standard or guidance violates their integrity, they will have in fact subordinated their judgment about what they should do (i.e., do what a person of integrity would do), and will have subordinated their integrity to compliance with rules.

AUDITORS AND INTEGRITY

The compliance approach to ethics is attractive because it is predictable, in the sense that if the rules are specific and unambiguous enough, they provide a clear standard of acceptable behavior, and therefore a defensible foundation for the enforcement of such behavior. For this reason, auditors should know what behavior is expected of them, and what are the consequences to them should they fail to comply and also become the subject of an enforcement proceeding. On the other hand, acting with integrity goes beyond the rules, and requires auditors to act autonomously in making judgments about how far above the moral minimum they should act on a given occasion. So, how far above the moral minimum is appropriate is very situation- and person-specific, since acting with integrity as a standard of behavior does not have clear and precise standards of acceptable behavior.

Because autonomous choice is critical to acting with integrity, it is necessary to consider the question of the degree to which auditors are capable of acting with integrity. There are two aspects to this issue. One is what auditors are like as individuals. It will be assumed here that they are not much different, as a group, than anyone else. That is, some have high integrity, some have none, and most are in between. This means that, as a group, they are capable of acting with integrity on many occasions, but are also capable of acting in accord with the moral minimum much of the time (and less than that some of the time). Second, sometimes the result of acting with integrity will be that the agent is worse off, at least in the short run, since doing so may require acting in the interest of another person without regard to the impact on oneself. This suggests that institutional structures

may make it either more or less difficult for a person to act with integrity on a given occasion when it may be called for. In fact, this is the primary rationale for the independence rules; that is, they define an institutional structure that limits the temptations on auditors by raising the moral minimum. In the absence of such rules, or with weaker rules, situations in which investors' interests may be compromised require a measure of integrity, whereas a suitable set of rules establishes an appropriate ethical standard that does not require it.

THE INTEGRITY OF ACCOUNTING FIRMS

The foregoing observations assume that auditors are capable of acting with integrity, and wish to act in accordance with at least the moral minimum. It is important to examine this assumption, by looking at a number of important cases. While this review does not provide exhaustive evidence, it does reveal that there is a serious question about their willingness and/or ability to act with integrity.

The first case is the KPMG Baymark case discussed above. As described, KPMG attempted to structure its relationship with KPMG Baymark in such a way as to comply with the technical requirements of the independence rules (i.e., the interpretations of the rules) in effect at the time, even though (once the fact that KPMG tried to hide from the SEC came out) this was a transparent attempt to evade their spirit. Subsequently, the Commission issued a cease-and-desist order against KPMG, based on the determination that there was

> a serious risk of future violation. Peat Marwick is a Big Five accounting firm whose practice requires it to make independence determinations constantly. … When, as here, a firm enters into complex relationships with other entities that in turn have relationships with audit clients, persons in charge of making independence determinations must exercise particular vigilance. While it is of course appropriate to focus on structural concerns that could impair independence in any and all engagements, such a focus does not excuse a failure to gather, analyze, and assess sufficiently the facts peculiar to each and every engagement. … Given the lack of care, at senior levels, that attended the determinations at issue here, there is a sufficiently high level of risk of future violations to warrant a cease-and-desist order" (SEC, 2001a).

Taking the independence rules as the moral minimum, KPMG evidently did not act with integrity, since the creation of Baymark was an attempt to maximize its profits by adhering to the lowest standard of behavior. Acting with integrity would have meant that it would not have attempted to set up

an investment bank to deal with its audit clients, in the interest of maximizing its profits, and without regard for the rules. Thus, KPMG's attempted creation of Baymark disregarded its obligation to protect investors.

A second case is the now-familiar pattern of behavior that Andersen engaged in for a number of years (Toffler, 2003). A short summary of this is that Andersen engaged in practices that (in the short run) earned large profits, at the expense of investors. The list of faulty audits is long, and includes most notably Waste Management and Enron. The SEC's conclusion in the former case was the following:

> Through its partners, Andersen knew or was reckless in not knowing that the audit reports … were materially false and misleading. Andersen knew or was reckless in not knowing that (a) the Company's financial statements were not presented in conformity with GAAP and (b) the Firm's audits of those financial statements were not conducted in accordance with GAAS. Yet, in each of those years, Andersen issued audit reports falsely representing that the financial statements and audits had satisfied the requirements of GAAP and GAAS, respectively. (SEC, 2001b)

The magnitude of the problem in Andersen's behavior in the Waste Management case resulted in the issuance of an order against it by the District Court of the District of Columbia, permanently enjoining Andersen from violating Rule 10b-5 of Section 10(b) of the Securities Act of 1934. Violation of this order, to which Andersen had consented, was a primary reason for the SEC's uncompromising approach in the Enron case.

Although the concept of integrity has been defined in relation to the moral minimum, in all of these cases Andersen's behavior fell below the ethical and legal norms that it was required to follow. However, in the end, it was a lack of integrity that caused its demise (Toffler, 2003). Acting without integrity may be profitable in the short run, but often results in a larger failure as an unethical pattern of behavior becomes institutionalized, as was the case with Andersen (Toffler, 2003).

In a third case, Ernst & Young was found by the SEC (2004) to be not independent from one of its audit clients, PeopleSoft, in virtue of their ongoing business relationships (in the provision of information technology consulting). Furthermore, even though EY had sold the relevant part of its consulting practice before the SEC action, EY's attitude and pattern of past behavior caused the issuance of a cease and desist order. According to the Chief Administrative Law Judge hearing the case:

> The evidence demonstrates that it is necessary to order EY to cease and desist in order to protect public investors and the capital markets. Based on my observation of the witnesses and my review of record, I conclude that EY will likely commit future violations absent an explicit directive to cease and desist. Although EY has sold its consulting

> practice and certain partners have retired, many EY partners, who either committed the violations or knew about them and did nothing to stop them, are still at EY … [including some in the independence and legal departments]. In addition, the evidence shows that EY has an utter disdain for the Commission's rules and regulations on auditor independence. ….

A second compelling reason why a cease-and-desist order is required is that the Commission has tried and failed to bring EY into compliance through litigation. (SEC, 2004)

In addition, EY was forced to disgorge the revenues it had earned for its audits of PeopleSoft, and was required to hire an independent consultant to examine EY, and to make recommendations that will help assure future compliance with SEC independence rules. Also, EY was prohibited from engaging SEC registrants as new audit clients for a period of six months. Even if one assumes for the sake of argument that EY believed that its relationship with PeopleSoft did not violate SEC rules (the moral minimum in this case), these severe sanctions clearly demonstrate the Judge's conclusion that EY had demonstrated a lack of integrity.

A fourth example of integrity problems is the practice of Pricewaterhouse-Coopers in billing for air travel of its employees on consulting engagements (Weil, 2004). During the 1990s, PwC negotiated "back-end" rebates on tickets. These rebates were paid to PwC at the end of the year, rather than as "front-end" discounts on the ticket price itself. Rather than passing the rebate on to its clients (who had been billed for the gross travel costs of PwC consultants), PwC kept the rebate. That meant that PwC effectively charged its clients more than the actual (net) cost of travel. Furthermore, this practice was kept secret from both its clients and most of its employees. PwC justified these actions on the grounds that it had a right to the rebates because it had negotiated them separately from the price of single tickets. It was a secret because they knew it would be hard to explain to clients why PwC was not passing the rebate on to its clients (or else negotiating discounts on the tickets themselves). When some employees discovered this practice and (at some risk to themselves) objected to it on ethical grounds, they were rebuffed. Eventually, these employees succeeded in getting the practice stopped, but even then PwC did not return the rebates it had already collected.

A fifth example is the recent promotion of illegal tax shelters in the U.S. by KPMG to benefit wealthy clients.[11] 17 employees of KPMG were indicted, including a former Deputy Chairman, a former CFO, a former Associate Chief Counsel, and several former Heads of its tax practice. KPMG was charged with conspiring to defraud the Internal Revenue Service by "designing, marketing and implementing illegal tax shelters", and that conspiracy was approved and

perpetrated by its top management (U.S. Department of Justice, 2005b). In 2005, KPMG admitted its guilt and agreed to US$456 million in fines and other penalties (such as restrictions on its tax practice) (U.S. Department of Justice, 2005a). While it did not receive a cease-and-desist order, some of the requirements of the settlement point in the direction of the Government's determination that fundamental changes in KPMG's activities were required.

The last two examples are important for two reasons. First, they do not involve auditing in any special way, since one involves billings on consulting engagements and the other concerns legal violations in its tax practice. For this reason, one might regard these situations as irrelevant to the subject of this paper, i.e., the ability or willingness of accountants and accounting firms to protect investors. However, the integrity of accounting firms, and their consequent willingness to protect investors, is an issue that relates to the organization as a whole. Thus, the way in which it conducts its audit practice cannot be isolated from the ways in which it conducts other parts of its total practice. That is, acting with integrity cannot be confined to one area of an organization's activities; rather, it is a characteristic of the firm as a whole (and its employees) that carries over into all areas of its practice. So, integrity in one area is incompatible with a lack of integrity in another area of practice. This is the aspect of integrity emphasized by Solomon (1993, 1999), relating to wholeness: that is, if a firm acts without integrity in one important part of its operations (e.g., the way it bills clients for travel costs), a major question is raised about its ability to act according to the highest norms in some other part of its operation. A firm that is willing to treat its clients in this way is less likely to treat investors any better.

Second, integrity and related character traits may be ascribed to organizations as well as to individuals. A number of employees did act with integrity in challenging PwC management to stop its billing practice. This illustrates a point made earlier, that while individuals may be willing and able to act with integrity, their ability to do so is often affected (negatively in this case) by the organization's structure and values. According to Toffler (2003), this was a major problem at Andersen.

These five examples show that the willingness and ability of accounting firms to act with integrity, and to protect the interests of investors is very much in question. To the extent that these problems are systematic (and there is no reason to believe they are not), simple appeals to "character" and integrity as guides to behavior are unlikely to be very effective. It might be objected that a few examples of wrongdoing do not prove much, because they are merely anecdotes that might not demonstrate a consistent mode of behavior. In the case of Andersen, this criticism does not hold, since

systemic problems have been well documented (Toffler, 2003). Furthermore, since Andersen no longer exists, it might be claimed that it is not relevant to the post-Andersen auditing profession.

Two responses may be made to this. First, the alleged irrelevance of Andersen depends on the assumption that other accounting firms do not have the same problems Andersen had. But the examples relating to other firms indicate that any differences among them may be more of difference than of kind. Second, an important fact about judging character (including integrity) is relevant here. It is that we sometimes judge the character of a person (or organization) on the basis of a single act, because that act tells others a great deal more than a lifetime of other acts. For example, a judgment that a person is honest, based on long experience with that person, can be reversed by a single act of dishonesty.[12]

CONCLUSIONS

Public accountants are sometimes accused of dishonesty, greed, lack of integrity, the surrender of ethical principles, and similar ethical shortcomings that violate the Principles enunciated in the Principles section of the AICPA Code. Much of Abraham Briloff's criticisms (e.g., 1990) of the public accounting profession appear to be of this sort, essentially charging accountants with personal moral failings, and thereby failing to adhere to the ethical principles expressed in the Code of Professional Conduct. Whether they have such shortcomings more commonly than the rest of the population, is debatable. In any case, it is clear that the current difficulties of the profession may be caused in large part by increasing pressure on auditors to act in the commercial interest of themselves and their clients, rather than in the interest of investors. A focus on the concept of integrity, and the notion that it involves acting in ways that exceed the moral minimum, makes it apparent that many people accept the compliance approach and do not exceed the moral minimum because of internal and external pressures and incentives. The fact that these pressures may cause some people to fail to reach even that level shows the power of these forces.

This paper has emphasized the importance of acting with integrity, in terms of protecting the interests of investors. Many people believe that talk of the character of auditors and of ethical principles to guide them is just cheap rhetoric. The critical ambiguity related to the principle of acting with integrity (in Sec. 54.03 of the AICPA Code), which suggests that acting with integrity need only occur when the rules fail to give a clear answer, suggests that there is a good deal of truth to this opinion. But the core of the analysis

in this paper is that we need to recognize the real importance of acting with integrity in protecting investors. The idea of the moral minimum, as captured in professional rules and standards is valuable, for it establishes a clear threshold below which accountants' actions should not fall. Thus, if someone fails to act with integrity, a floor has been established which can be used to enforce at least the minimal standard.

Exhorting accountants to act with integrity, as Briloff has done, is laudable, since it reminds others of what they should be doing (i.e., acting in accordance with general ethical principles, rather than merely complying with specific rules). However, a focus on integrity is also of limited value to the extent that it ignores the forces that cause auditors to behave at or below the moral minimum. So, it is important to appreciate the value of rules, and more especially, the value of rules that successfully capture the standard of behavior expected of auditors. As such, the independence rules of the AICPA and of the SEC are very imperfect, since they focus on relationships rather than on the actions that might help or harm investors.

If it is important for auditors to act with integrity, then it appears that changes in the institutional structure of professional practice are necessary. Improvements in the moral standards of accountants, as advocated by Briloff (1990) might or might not be necessary. But it is clear that they would not be sufficient, since they would not address the real and powerful social and economic forces that encourage a compliance approach to auditing – if not an even lower standard of behavior. The examples of firms acting without integrity do not diminish the importance of the principles in professional codes of conduct, from the normative point of view. In the present case, they help to describe what is necessary in order for auditors to act in accordance with their fiduciary duty to investors. To the extent that they fail to act with integrity, we can also see how far from fulfilling the duty they are. Also, to the extent that they fail to act in accordance with their duty, we are left with the compliance approach. And then we need to be very careful in being sure that the rules governing auditors actually cover the range of issues (and contain the "right" answers) required in order to ensure that a minimally acceptable level of investor protection is achieved.

NOTES

1. These parties are, in the first instance, investors and creditors. But others may be harmed as well, including customers, suppliers and employees (including retirees) of companies.

2. Auditors have an obligation to society as a whole, and not just to investors. Auditing as an occupation is organized as a profession, and is thus self-regulated as part of a social contract between the profession and society, for their mutual benefit.

3. I am writing in terms of the nature of the ethical duties of auditors, and am not claiming that an auditor is a legal fiduciary according to the law of trusts, for example. According to Merriam-Webster's Dictionary of Law (1996), a fiduciary duty obligates "a fiduciary (as an agent of trustee) to act with loyalty and honesty and in a manner consistent with the best interests of the beneficiary of the fiduciary relationship (as a principal or trust beneficiary)." An agent is defined as "a person or entity (as an employee or independent contractor) authorized to act on behalf of and under the control of another in dealing with third parties" (ibid.). Since the Securities Laws require external auditors to be "independent", it is clear that they cannot be agents of management in this sense, and furthermore investors are beneficiaries rather than principals.

4. It is also the case, consistent with the analysis in this paper, that a significant feature of the creation of the Public Companies Accounting Oversight Board included a reduction in the profession's self-regulatory powers.

5. In order to serve the public interest, the Code requires members of the Institute to be objective. (AICPA, n.d., Sec. 55, Article IV) The term is not defined in the Code, but it is linked with the concepts of impartiality, intellectual honesty, and freedom from conflict of interest. The implicit reason for this requirement appears to be that objectivity is a necessary (but not sufficient) condition for acting in the interest of clients, employers, and others. The same section requires members in public practice to be independent in the delivery of audit and attest services. Although the concept of independence is also not defined, objectivity (in the provision of audit and attest services) requires the auditor to be independent.

6. A related debate has accompanied this one, the so-called expectations gap controversy. This controversy concerns what auditors should be expected to do, specifically whether they should be expected to detect, or even to look for, financial fraud. Basically, there has been a gap in expectations, with auditors taking a narrow view of their responsibilities. In relation to the topic of this paper, the expectations gap controversy is about what auditors are required to do in order to fulfill their fiduciary obligation to investors. Auditor independence relates to institutional features (i.e., rules) that limit incentives for auditors to violate that duty.

7. Other rules may be important. For example, generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) are intended in part to limit discretion in the choice of accounting policies and the ways in which audits are performed.

8. The AICPA Code, in contrast, applies to all members of the AICPA and to all audit engagements, whether or not the firm being audited has publicly listed securities.

9. The list includes the following: bookkeeping and related services; financial information systems design and implementation; appraisal, valuation services, and related services; actuarial services; internal audit services; management functions or human resources; broker or dealer, investment adviser, or investment banking services; and legal services and expert services unrelated to the audit. In addition, any other service may be barred, as decided by the PCAOB.

10. Although it has been the primary focus of the discussions relating to auditor independence recently, the Act concerns companies with publicly traded securities

only, and does not extend even as far as over-the-counter securities. Since the vast majority of businesses in the U.S. are not SEC registrants and thus not subject to the requirements of the Securities Acts or of Sarbanes-Oxley, the AICPA Code remains relevant.

11. Ernst & Young also was caught up in selling ''aggressive'' tax shelters. It was sued by both its clients and the Internal Revenue Service. It cooperated with the IRS, and settled with it (Weinberger, 2003).

12. One of the interesting things about judgments of character is that we also sometimes excuse individual transgressions of a person as ''out of character''. Depending on one's point of view, then, these examples are either telling evidence or mere anecdotes. However, the basis for the judges' injunctions was that these instances of misbehavior were not isolated, and thus illustrated the firms' true character.

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EXAMINING AUDIT RELATIONS: A RECONSIDERATION OF AUDITOR INDEPENDENCE

Joni J. Young

ABSTRACT

Auditor independence is a construct that has been, and continues to be, connected to the credibility of financial statements and the effective functioning of capital markets. Given the important role assigned to independence by various regulators including the Securities and Exchange Commission (SEC), its appearance as a recurring issue of concern and debate is unsurprising. Concerns about auditor independence in the context of various accounting scandals, such as Enron and WorldCom, contributed to the enactment of changes in the institutional arrangements for regulating auditors and renewed efforts to enhance auditor independence. Rather than continuing with perhaps futile efforts to achieve independence, I argue that we need to re-evaluate the utility of this concept as a guide to regulating audit practices. Independence, with its connotations of an unachievable autonomy and linkage of professionalism to an unobservable mind-state, may hinder, rather than aid, the audit purpose for SEC registrants – the mitigation of aggressive financial reporting. Independence as autonomy is impossible within an environment in which management pays for the audit, hires and fires the auditor, and is the primary contact for auditors. Rather than searching for ways to make the

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auditor "more" independent, I discuss changing the focus of regulatory attention to an open examination of and emphasis upon the relationality of auditing practice. This change in perspective requires us to examine the various relationships in which auditors are embedded and to assess whether these are more or less likely to encourage the auditor/audit firm to fulfill the purpose of an audit. I specifically explore three categories of relationships – relationships with the auditee, relationships with the audit committee and relationships with the audit firm. I also examine how this focus on relationships may contribute to our thinking about policy decisions relevant within the current audit environment, including assessing the likely impacts of consulting and personal relationships with auditees, ways to put a "face" on the public and assessing the compensation and marketing practices of accounting firms.

Auditor independence is a construct that has been, and continues to be, connected to the credibility of financial statements and the effective functioning of capital markets. In the United States, this connection was formalized in the aftermath of the stock market crash of 1929. Prior to 1931, no references were made to independence in the ethics code of the American Institute of Accountants (AIA).[1] However, the AIA adopted a resolution that year, stating the importance of independence:

> "…the maintenance of a dual relationship, as director or officer of a corporation, while accounting as auditor of that corporation, is against the best interests of the public … and tends to destroy that independence … considered essential in the relationship between client and auditor" (cited in Lowe, 1987, p. 81).

In 1932, the New York Stock Exchange (NYSE) began to require its listed companies to obtain independent audits. The importance of the concept of independent audits was further reinforced by the Securities Act of 1934, which required companies registered with the Securities and Exchange Commission to obtain audits conducted by *independent* public accountants. Little more than a decade later, independence was described as critical to audits, the "keystone in the structure of the accounting profession" (Carey, 1946, p. 6). In the 1952 *CPA Handbook*, E.B. Wilcox stated the significance of independence even more bluntly: "If the accountant were not independent of the management of his clients, his opinion would add nothing" (cited in Mautz & Sharaf, 1961, p. 204).

More recently, the General Accounting Office (GAO) (2002, p. 4) described the audit as "a critical element of the financial reporting structure because it subjects information in the financial statements to independent and

objective scrutiny, increasing the reliability and assurance that can be placed on those financial statements for efficient allocation of resources in a capital market where investors are dependent on timely and reliable information." The SEC (2000, p. 2) has discussed the independent audit in similar terms noting that "it furnishes investors with critical assurance that the financial statements have been subjected to a rigorous examination by an impartial and skilled professional and that investors can therefore rely on them."

This emphasis upon the audit arises from the reliance upon corporate disclosures and financial statements in securities regulation. These financial statements are management representations made to individuals and entities located outside the corporation about corporate (and management) performance and actions. By requiring an audit, the Securities Acts and NYSE attempted to provide a third-party and, hopefully, "objective" check on these representations to ensure that they were prepared in accordance with generally accepted accounting principles (GAAP). Because GAAP provides many opportunities for the exercise of judgment, this third-party check is not simply a matter of comparing financial statements to a pre-determined checklist. The financial statements presented to the public are the result of many managerial choices about estimates to be used, including the timing of revenue recognition, useful lives of depreciable assets, the expected rate of return on pension assets and many others. Managers also choose among different allowable accounting principles or methods and decide how to apply accounting principles within the context of their company. To conduct an effective audit, auditors must asses the reasonableness of management's accounting choices, and an important purpose of the audit is to mitigate the use of aggressive recognition practices, estimates and interpretations of existing GAAP. Independence requirements were designed to enhance the willingness of auditors to question management's choices as well as to convince the investing public of this willingness and thereby lend credibility to financial statements.

Given the important role that has been assigned to independence, its appearance as a recurring issue of concern and debate is unsurprising. Criticisms of auditor and audit-firm practices believed to threaten independence and recommendations to enhance it have been forwarded by many different commissions and panels in their reports including: The Accounting Establishment (U.S. Senate Staff Study, 1977), Improving the Accountability of Publicly Owned Corporations and Their Auditors (U.S. Senate, 1977), the Cohen Commission (Commission on Auditor's Responsibilities, 1978), the Public Oversight Board (1979, 1993), CPA [Certified Public Accountant] Audit Quality (GAO, 1989), and the Kirk Panel (POB Advisory Panel, 1994).[2] Perceived threats to auditor independence have also

been frequently identified and discussed in the business press and various accounting journals. Examples of issues raised in these forums include the following:

1. Types of nonaudit services that can be provided to auditees and/or the extent of such services.
2. Investments that auditors and their families may hold.
3. Affiliations that accounting firms may develop with auditees and with other firms that may sell products to their auditees.
4. Appropriate ways to compensate audit partners.
5. Concerns about the financial significance of a specific auditee, how to assess this significance and the level at which to assess it – firm, individual partner, or office.
6. Appropriate duration for the auditor/auditee relationship.
7. Impact of former auditors being employed by an auditee.
8. Investments by an auditee in its audit firm.
9. Appropriateness of advocating auditee positions during the accounting standard-setting process or in the context of tax cases.

Several different organizations have produced rules to define and maintain auditor independence in the U.S. For many years, the American Institute of Certified Public Accountants (AICPA) produced such rules in connection with the auditor code of ethics. In 1997, a separate entity, the Independence Standards Board (ISB), was formed by the SEC and the AICPA to issue standards and guidance about perceived threats to independence. The ISB chose instead to develop a conceptual framework for independence issues (ISB, 2000).[3] In 2000, the SEC acted to provide more explicit guidance and issued its own rules governing auditor independence, including a ban on the provision of certain services by auditors to their auditees.

In the aftermath of Enron and other recent economic and accounting disasters, independence re-emerged as a significant and troubling issue in the United States. Indeed, two of the 11 titles (or sections) of the recently enacted Sarbanes-Oxley legislation deal directly or indirectly with questions regarding how to strengthen auditor independence. This legislation directed the formation of a new entity, the Public Company Accounting Oversight Board (PCAOB), and granted it the authority for establishing independence standards and rules for auditors. The Act also outlines specific services that auditors are prohibited from providing to their corporate clients; details required interactions and communications between auditors and audit committees, including pre-approval of allowed non-audit services; sets out requirements for audit partner rotation; and establishes a cooling-off period

for employment of an auditor by an auditee. In January 2003, the SEC (as directed by the Sarbanes-Oxley legislation) promulgated new rules that explicitly address many issues that have arisen in connection with auditor independence. Given this recent legislative and regulatory activity, some might believe that independence issues have been adequately addressed. However, the past history of this concept coupled with the many rules already in place prior to the emergence of recent scandals suggest that it is likely to resurface as an area of concern and that issues such as those outlined above will be rehashed again.

Although independent audits have been a central concept to securities regulation, I believe we need to re-evaluate the continuing utility of the concept of independence. In the next section, I consider the impossibility of independence in practice. In its place, I propose focusing on how the various relationships of auditors and accounting firms contribute to or hinder the likelihood of mitigating aggressive financial reporting. This discussion is followed by several applications of this focus on relationships to thinking about policy decisions relevant for the current audit environment. The paper ends with a few concluding comments.

THE IMPOSSIBILITY OF INDEPENDENCE

> *Independence:* quality or state of being independent: FREEDOM
>
> *Independent:* 1. Not dependent: … as **a** (1): not subject to control by others: SELF-GOVERNING (2): not affiliated with a larger controlling unit **b** (1): not requiring or relying on something else: not contingent … (2): not looking to others for one's opinions or for guidance in conduct … **c** (1): not requiring or relying on others (as for care or livelihood) (Webster's New Collegiate Dictionary, 1976, p. 584, emphasis in original).

As evidenced by these definitions, independence is usually characterized in ways that emphasize the separation, apartness and/or autonomy of an individual or entity. It is a quality that is regarded as either present or absent. Furthermore, it is a quality whose presence or absence can be very difficult for an outsider to observe and, consequently, to assess. In the context of auditing, John Carey (1946, p. 7) expressed this difficulty well:

> Independence is an abstract concept. … Essentially it is a state of mind. … It means, in simplest terms, that the certified public accountant will tell the truth as he sees it, and will permit no influence, financial or sentimental, to turn him from that course. Everyone will applaud this idea, but a cynical world requires more than a mere declaration of intention …"

This difficulty of assessment (and worldly cynicism) has given rise to a frequently made distinction between independence in fact and independence in appearance. Independence in fact refers to the unobservable state of mind that is believed to be required in order to conduct an unbiased audit. In contrast, independence in appearance implies the impossibility of observing the "fact" of independence and gives rise to rules, activities and practices that are imposed externally upon the auditor in an effort to convince the cynical public that independence in fact is present. Although independence in fact (in Carey's sense of freedom from influence) may be present even when appearances suggest otherwise (and vice versa), its presence has little value unless nonauditors believe that auditors have subjected the financial statements to a rigorous and impartial examination. Consequently, many of the rules in the AICPA ethics code as well as those issued by the SEC have been designed to augment the appearance of independence and thereby to convince the public that the audit has enhanced the credibility of financial statements.

Despite these many rules, doubts regarding the independence of auditors are always likely to be present. No matter how many rules are issued, there can be no absolute assurance that the auditor has actively and effectively sought to assess the reasonableness of management assertions in the financial statements. Furthermore, there is a well-recognized basic contradiction between requirements for independence as expressed within the professional and regulatory literature and the dependence of the auditor upon management for payment of audit services as well as decisions about their continued employment by the auditee.[4] Under existing institutional arrangements, auditors are dependent upon management for their livelihood and, as long as this situation remains, they cannot be independent of those they audit. Those within the profession have also recognized the impossibility of achieving total independence in the context of an audit. For example, ISB (2001, para. 7) notes that an auditor need not be free from all threats to objectivity as various safeguards may lessen the severity of these threats. Bazerman, Morgan, and Loewenstein (1997, p. 91) maintain the impossibility of auditor independence as psychological research indicates that "impartial" judgments "are likely to be unconsciously and powerfully biased in a manner that is commensurate with the judge's self-interest."

Rather than continuing to search for ways to convince the public that auditors are independent, we need to re-evaluate the continuing utility of a concept that emphasizes the desirability of and need for autonomy. This emphasis on autonomy is at variance with extant work on organizations. As Wheatley (2002, p. 19) comments: "Relationships are all there is. Everything

in the universe only exists because it is in relationship to everything else. Nothing exists in isolation." Those familiar with auditing understand that it is a highly relational activity. Individual auditors are always embedded within webs of relationships – relationships with their firm, with other auditors, with the management and staff of the auditee, with the public, with friends, with family, with regulators and a host of others. Each and any of these may impact the auditor's ability to conduct an effective audit. Rather than continuing to stress the importance of independence, I follow the work of Reiter (1997) and Wallman (1996) to advocate the importance of analyzing the types of relationships in which auditors are engaged. In discussing auditors, each author also shifted the focus of analysis away from a futile search for autonomy towards a more direct examination of how different types of relationships, including various practices and activities, may impact the conduct of an audit.

This approach bears some similarities to the threats and safeguards of independence analysis advocated by the Canadian Institute of Chartered Accountants (2003) and the ISB Staff Report (2001). The relational approach employs the purpose of an audit to re-emphasize the importance of connecting the public to the audit. It also eliminates the unending debates over independence – in fact versus appearance and, thereby, shifts the burden of proof in assessing the acceptability of relationships. Each of these points is further discussed in the remaining paragraphs of this section.

Public as client. Using this alternative conceptual focus requires that we keep firmly in mind the purpose of a mandatory audit. During the 1990s, some alleged that audits were treated as a commodity and an opportunity to sell other services (see comments by Levitt in SEC, 2000b, p. 34). Levitt, former SEC chairman, maintained: "Too many auditors are being judged [by their firms] not just by how well they manage an audit, but by how well they cross-market their firm's nonaudit services" (cited in Tie, 2000, p. 16).[5] However, audits were not mandated in order to provide auditors with cross-marketing opportunities. As discussed earlier, the regulatory purpose for mandatory audits was to enhance the credibility of financial statements by examining, questioning and mitigating unreasonable and aggressive financial reporting choices of management.[6] Consequently, as policy makers, auditors, audit firms and others consider the acceptability of various relationships, this purpose of an audit must remain in the foreground of their deliberations and decisions. Unless this purpose is held paramount, there may be little or no justification for continuing to require mandatory audits, and policy makers should consider alternatives to an audit.

In accepting this purpose of an audit, we can begin our analysis by specifying an answer to the question: who is the client? Many, if not most, auditors regard management as their client. This perspective raises additional questions about auditor independence as it places a strong emphasis upon the relationship between the auditor and management.[7] However, if the purpose of an audit is to enhance the credibility of financial reports, then the public is the client rather than management. Asserting the purpose of an audit and the importance of the auditor's relationships with (or obligation to) the public does not imply that auditors will not have relationships with management and others within the auditee – that is an impossibility. Relationships with management are an inevitable element of an audit and are necessary to complete it on a timely basis. In the course of an audit, informal networks – "alliances and friendships, informal channels of communications … and other tangled webs of relationships" (Capra, 2002, p. 109) inevitably emerge from the face-to-face interactions between auditors and employees of the auditee. Rather than maintaining an insupportable illusion that auditors are separate from and unaffected by such interactions, policy makers and audit firms need to examine the content of particular relationships (either actual or proposed), and consider whether they work to strengthen the willingness of an auditor to act on behalf of his/her faceless client, the public, or whether it weakens this willingness. Those relationships, activities and practices that strengthen this willingness are to be encouraged; while those that weaken it should be discouraged and perhaps even banned.

Burden of proof. Shifting the burden of proof in deciding whether particular activities and relationships should be encouraged or discouraged represents a further benefit of this change in focus. In hearings on independence rules, prominent auditors have often argued that their professionalism requires they maintain independence in fact, and that appearances are irrelevant to their professional conduct. They have disputed the importance of independence in appearance and argued that unless "proof" could be found that activities such as consulting impair independence in fact, then these activities should be permitted. In other words, the AICPA and large accounting firms attempted to place the burden of proof upon the regulator to demonstrate that particular services reduce the effectiveness of audits.[8] In shifting the focus to relationships rather than to the presence or absence of an unobservable state of mind, those wishing to allow a particular activity or relationship could be required to demonstrate how it likely furthers (or at least does not harm) the primary relationship between the auditor and his/her client, the public.

THINKING ABOUT RELATIONSHIPS

In the following paragraphs, I consider three categories of relationships – relationships with the auditee, relationships with the audit committee and relationships with the audit firm. While no system of categories can be all-encompassing or even mutually exclusive, the categories chosen here are flexible enough to address many of the issues previously noted as of concern within the business press as well as to allow for consideration of relationships at different "levels" – between individuals, between entities, and between individuals and entities. They provide a starting point in employing an emphasis upon relationships to the ties that are to be considered acceptable or unacceptable for auditors. At times the relationship of interest occurs between two entities – e.g., an audit firm and auditee, an audit firm and an audit committee. At other times, we are concerned with the relationships between individuals working within these entities – e.g., an auditor and a manager, an auditor and an audit committee member. At still other times, the relationship of concern exists between an individual and an entity – e.g., an auditor and her audit firm, auditor and his auditee.

Relationships with the auditee. As stated earlier, if the purpose of an audit is to critically examine the financial statement assertions of management rather than to sell additional services to the auditee (or some other purpose), then the audit client is the public rather than the management of the auditee. Insufficient attention has been given to the language used to characterize the relationship between management and the auditor. While we cannot regulate the words used in accounting firm literature,[9] regulators, auditors, academics, textbook authors and others should be strongly encouraged to avoid referring to the auditee as a "client." Instead, the term auditee should be used and firms encouraged to employ it (or a similar term) in their internal discussions and memoranda as well as in their training literature. The term suggests more neutrality and less advocacy in the relationship between the auditor and auditee than does the term client.[10] "Client," as a descriptor, emphasizes a service relationship in which the auditor strives to perform well *for management*, and as Mautz and Sharaf (1961, p. 208) have noted, "the desire to be of service may get out of hand" and compromise the willingness of the auditor to mitigate aggressiveness in financial reporting. The use of this different term formalizes the shift in thinking required for auditors to place primary emphasis on checking financial statement assertions rather than selling services in their relationships with the companies whose financial statements they audit.

Many of the interactions that occur between auditor and auditee can be regarded as either financial or personal. Some financial relationships occur between the audit firm and the auditee, including the payment of audit fees, the formation of business affiliations and arrangements between the auditor and the auditee, and the provision of nonaudit services to the auditee. Others occur between the individual auditor and the auditee, such as stock ownership and loans in or from the auditee, and the provision of nonaudit services. Each relationship should be assessed in terms of whether it likely increases or decreases the willingness of the individual auditor (as well as the audit firm) to question the reasonableness of financial statement assertions made by the auditee. From this perspective, each of these examples poses difficulties. Under current institutional arrangements, management hires and fires auditors as well as negotiates audit fees. These practices strengthen the relationship between the auditee and auditor rather than that between the auditor and her client. The PCAOB might consider developing different arrangements, such as assigning auditors to a particular auditee. Given the resistance to adopting such alternatives, information regarding the significance of audit fees to a specific firm, office or individual audit partner should be provided. As the fees become more significant, it becomes more likely (not certain, just likely) that aggressive financial reporting practices may be overlooked.[11] The annual report could disclose the total fees charged by the audit firm as well as indicate whether these fees cross a specified materiality threshold for an office or firm.[12] In addition, entities such as the PCAOB might consider paying particular attention to "material" auditees when examining the audit quality provided by particular audit firms.

Fees from providing other services to auditees generate similar concerns. This highly controversial issue has received frequent attention in the business press as well as in most of the formal reports that have addressed the issue of auditor independence. These services include consulting, tax preparation and consultation, loan staff and many others – some of which have now been banned by the SEC. In the past, audit firms argued that these services enhanced their familiarity with client systems and strategies, and thereby increased audit effectiveness and efficiency. In these arguments effectiveness and efficiency appear to refer to reducing the cost of an audit. Our stated concern, however, is with audit effectiveness, defined as mitigating unreasonable managerial assertions. To the extent that provision of these services encourages an audit firm or auditor to consider an auditee as a "client" (or a partner in the instance of business affiliations), they should be discouraged. Consulting and tax services (and perhaps even other attestation services) may place the audit firm in the untenable position of acting as an advocate for the

auditee in providing these services while acting as an advocate for the public during the audit. Business alliances with auditees raise similar concerns as they alter the basic relationship from auditor/auditee to a partnership. Although the audit partner may not personally act as an advocate or view the auditee as a partner, an individual office or firm may become dependent on the fees and place subtle or not so subtle pressures on the audit partner to reassess his views on the reasonableness of the financial statements. Given the possibility of financial dependency and a subtle shift in the relationship with the auditee, a strong case can be made that these services should not be permitted, and the SEC and the PCAOB have curtailed some service offerings.[13] Furthermore, the case that these services enhance the audit may well be overstated. The SEC independence hearings in 2000 revealed that approximately only 20%of auditees purchase consulting services from their audit firms. While the firms argued that these services improved the efficiency of these audits, they were unwilling to state that the other 80% of their audits were somehow less effective in the absence of these consulting arrangements (see SEC, 2000b). To the extent audit firms are allowed to continue offering these services to auditees, the dollar amount of fees from services other than the annual audit should continue to be disclosed.[14] Similarly, if business ventures and affiliated relationships with auditees are not expressly banned, disclosures of such relationships should be required in the annual report.

Personal relationships may include auditor friendships with employees of the auditee, family members who work for the auditee and former co-workers who now work for the auditee. Many of these relationships are an inevitable and enjoyable aspect of working life. Yet, the familiarity of a long relationship may decrease the intensity of scrutiny as well as willingness to question friends or family closely, and the presence of former co-workers may have a similar effect. Again, Mautz and Sharaf (1961, p. 208) recognized the issue of familiarity and commented that "personal relationships may give rise to unrecognized prejudices; ... In a great many cases, ... the greatest threat to his independence is a slow, gradual, almost casual erosion of his 'honest disinterestedness."[15] Mandatory rotation and cooling-off periods are valuable ways to reduce the impact of familiarity as are second partner reviews. Further thought should be given to the rotation of staff (in addition to existing partner rotation requirements), including placing limits on the length of time an individual auditor may audit a specific unit within an auditee. Although auditors below the partner level are not responsible for issuing opinions, familiarity may impact the ways in which they question the auditee's assertions and claims, search for evidence, document their findings and discuss issues with partners and supervisors.

Putting a face on the public. While auditors will develop personal relationships with employees of the auditee, the client public remains a faceless, unknown entity. Simply naming this "faceless" public as the client cannot ensure that auditors will resist and mitigate aggressive accounting practices that may be undertaken by management. Consequently, it is important to consider developing and strengthening practices that create a surrogate presence for the public. In this regard, the audit committee may serve an important role. The SEC has argued that this committee can insulate auditors from various pressures that may be exerted by management. In addition, it may also act as a means by which to put a face on an otherwise "faceless" public by allowing the auditor to develop a personal relationship with this surrogate. To this end, regulations that require communications with the audit committee act to remind the auditor of her obligation to the public and responsibilities in conducting the audit. Discussion and reporting matters should include items of disagreement with management, changes in estimates and accounting principles, details about the most aggressive as well as most conservative estimates and accounting principles employed in preparing financial statements. In addition, auditors might address the audit report to the audit committee and stockholders rather than the board of directors and stockholders. If regulators continue to permit auditors to sell nonaudit services to auditees, then audit committees should be responsible for approving any proposed transactions. Currently, a pre-approval by types of services is considered acceptable.[16] However, a service-by-service approval basis would increase the level of interaction with the public's surrogate, the audit committee, and strengthen relationships with the client.

As several scandals have illustrated, audit committees vary widely in their competence; some committees are more competent than others, some more attentive than others. Some are more closely aligned with management than others. Simply requiring additional communications between auditors and the audit committee is insufficient unless attention is also given to the committee composition and other matters. Regulations may also be required to strengthen the functioning of the committee by specifying how committee members are chosen, how long they may act in this capacity, how they are compensated and many other issues.[17]

Relationships with the audit firm. Obviously, the relationship between the individual and the audit firm may also enhance or retard his willingness to question management assertions. The audit firm, through its management structure or team, decides the bases for awarding promotions, salary raises, partnership units, etc. To the extent that these elements are awarded primarily for increasing revenues or profitability or retaining existing auditees,

incentives exist for the auditor to overlook or minimize aggressive reporting practices. Not all auditors will react to these incentives in the same way. However, recent experiences with employee stock options suggest that incentive schemes may encourage abusive actions as employees manage or maximize that which is rewarded. An undue emphasis upon revenues and profitability rather than upon performing quality audit work sends a message to employees about the emphasis they should place in their own work.[18] The PCAOB should consider disclosure of the compensation practices of various firms on its web site and comment on their possible incentive effects. Such information might have the effect of altering practices that place undue emphasis on revenue generation.

Other firm policies may reinforce an undue emphasis on profitability, such as the selection of firm mission, the substance of continuing education training as well as the content of internal newsletters or memorandums. For several years, the largest accounting and auditing firms have referred to themselves as professional service firms rather than as audit firms. "Marketing materials and advertising present the firms to the world as business consulting organizations not as auditors" (Advisory Panel on Auditor Independence, 1994, cited in Zeff, 2003, p. 277). This self-description minimizes the significance of the audit to the firm. Similarly, undue emphasis in training materials and in-house communications on sales, "client" retention and other issues direct attention away from the purpose of an audit (as defined here) and place it upon "client" service. Again, the PCAOB might publicly comment on the practices of various firms and whether these are likely to have a dampening impact on the interest of the auditor in detecting aggressive reporting practices.

CONCLUDING COMMENTS

In this paper, the purpose of an audit has been defined as the mitigation of aggressiveness in financial reporting. If we desire audits to serve this purpose, then we must closely examine the contexts in which they occur. We cannot ignore the structural and other obstacles that may impede the performance of an effective audit. Independence, with its connotations of an unachievable autonomy and linkage of professionalism to an unobservable mind-state, may hinder rather than aid this audit purpose. Independence as autonomy is impossible within an environment in which management pays for the audit, hires and fires the auditor, and is the primary contact for auditors. Several decades of wrangling over whether to emphasize independence in fact or

independence in appearance, has not been particularly fruitful in furthering our achievement of this audit purpose. Rather than searching for ways to make the auditor "more" independent, I have advocated openly examining and emphasizing the relationality of auditing practice. This change in perspective requires us to examine the various relationships in which auditors are embedded and to assess whether these are more or less likely to encourage the auditor/audit firm to fulfill the purpose of an audit.

Questions about the willingness of auditors to mitigate aggressiveness in financial reporting will continue to emerge in the future. There can be no once-and-for-all solution to ensure that the audit purpose is met just as there can be no guarantees that the audit purpose will be met in each and every audit. Rather than claiming that I have found such a guarantee, I have tried to reinstate the central importance of the public as audit client and to examine briefly how the analytical lens provided by an emphasis upon relationality provides additional support for many of the regulations enacted in the aftermath of Enron and other corporate debacles. In contrast with its actions in opposition to the rules on independence issued by the SEC in 2000, the AICPA did not forcefully oppose new regulations in 2002. However, as memories of scandals fade and attention shifts to different matters, efforts will no doubt begin to soften the effects of these regulations. An emphasis upon relationships provides viable arguments to counter these efforts as well as to further limit the sorts of relationships that an audit firm may have with its auditees.

While I believe this lens is useful, I recognize that it does not unambiguously help us to decide which transactions, which relationships, which practices, should be encouraged, minimized or even banned. It simply shifts the focus of analysis. The shift advocated here asks us to consider the *likely* effects of specific practices or relationships. Again, we will not have absolute proof or evidence of these but will need to employ logic and our knowledge of human relationships to conduct our analysis. The starting point for my analysis was the purpose of the mandatory audit. I have little doubt that some will call this purpose naive, one that is not in keeping with the way the business world really "works." Others may argue that I am preventing the auditor/CPA from evolving into a "business consultant" with a range of expertises to provide to her/his client, an evolution that is necessary to maintain the growth of this profession. In response to such statements I would answer that unless auditors are willing to place the purpose for an audit foremost in discussions regarding whether to permit, minimize or ban other activities and relationships with auditees, there may be little reason to continue requiring audits as a means to enhance the credibility of financial reporting.

NOTES

1. The AIA is a predecessor to the American Institute of Certified Public Accountants (AICPA).

2. See GAO (1996) for summaries of these studies. Independence has also been an issue in other countries besides the United States. See, e.g., Sikka & Wilmott (1995) and Citron (2003).

3. Shortly thereafter, the ISB disbanded.

4. See, e.g., Ronen and Cherny (2003).

5. This attitude is reflected in the opening paragraph of a *Journal of Accountancy* article on the Sarbanes-Oxley Act in which Banham (2003, p. 43) states: "No longer able to use audit engagements as an opportunity to spot client needs and sell remedial consulting services such as internal control tune-ups, information technology, actuarial research ...."

6. Of course, debate exists regarding whether the Securities Acts fundamentally changed public policy with respect to securities markets or were a device to restore confidence in them while maintaining the status quo. See, e.g., Merino and Neimark (1982).

7. The GAO (2002) and the Advisory Panel to the POB (1994) each have noted the significance of this issue. The Advisory Panel recommended that the board of directors, acting as a representative of shareholders, be regarded as the client. Also see Westra (1986) for a discussion in the Canadian context.

8. See, e.g., testimony by Barry Melancon, AICPA president, in SEC (2000b) as well as (2000a, 2000b) and Palmrose and Saul (2001).

9. In the U.S., first amendment protections would likely prohibit such regulations.

10. This relationship also need not be adversarial.

11. This willingness may occur unconsciously (Bazerman et al., 1997).

12. See footnote 14 on the difficulties with such disclosures.

13. See SEC (2003), especially section II.B. Discussion of Rules: Scope of Services Provided by Auditors.

14. This requirement is also subject to manipulation as evidenced by wrangling over the definition of "audit" fee (Weil & Rapoport, 2003).

15. Also see *The Economist* (2003).

16. See SEC (2003).

17. Perhaps, consideration should be given to developing a pool of qualified individuals willing and competent to serve in this capacity.

18. See Zeff (2003) for a discussion of the impact of new policies at certain accounting firms that began to retire "underperforming" partners in their search for growth and the perverse compensation incentives offered by many firms to their partners. Also see Business Week (2001) for a discussion of similar issues.

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AUDITOR INDEPENDENCE AND NONAUDIT SERVICES: THE SEC'S INDEPENDENCE HEARINGS THROUGH A USER-PRIMACY LENS

John M. Thornton

ABSTRACT

The debate over an auditor's ability to remain independent while simultaneously providing nonaudit services to the audit client has a long history. In recent years, several factors have combined to heighten regulators' concerns about this issue. This study uses a case methodology research design to analyze the testimonies given by financial statement users at the Securities and Exchange Commission's (SEC, 2000b, 2000c, 2000d, 2000e) Independence Hearings in relation to this debate. The analysis is framed by the principle of user primacy. Findings indicate that changes from the SEC's initial proposal to final rule on independence are more closely aligned with preparers' than users' preferences, despite claims to the contrary.

INTRODUCTION

The question of whether auditors are able to maintain their independence in an audit when they provide nonaudit services to the audit client has been

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debated for at least 40 years (e.g., Schulte, 1965). The Securities and Exchange Commission's (SEC) issuance of Proposed Rule S7-13-00, *Revision of the Commission's Auditor Independence Requirements* (hereafter the Proposed Rule, SEC, 2000a, 2000b, 2000c, 2000d, 2000e), focused the public's attention on the issue and promised to make it the predominant ethical debate in accounting in the 21st century. While the Independence Standards Board (ISB) and numerous accounting researchers had addressed the auditor/nonaudit services issue, the SEC's Independence Hearings (hereafter the Hearings), held from June to September 2000, are particularly informative. Those testifying at the Hearings held strong and highly divergent views on the proposed nonaudit service proscriptions, presumably in keeping with their own self-interests. Despite the heat of the debate, six months later the issue appeared dead, put to rest with the issuance of the SEC's Final Rule S7-13-00, *Revision of the Commission's Auditor Independence Requirements* (SEC, 2000f, hereafter the Final Rule). However, the high-profile collapses of Enron and WorldCom the following year proved the debate was not extinguished, but merely smoldering, the opposing arguments awaiting a fresh wind of public concern to refuel the blaze.

The purpose of this chapter is to analyze the arguments of the testimonies given at the Hearings regarding auditor independence and the provision of nonaudit services by auditors to their audit clients, in an effort to inform standard setters of the primary issues surrounding this important topic. The analysis is based on the principle of user primacy, a normative theory espoused by the academic and professional accounting literature to guide standard-setters' assessment of the relevance of opposing arguments in public policy debates. User primacy, based on Rawls' (1971) theory of justice, holds that the interests of *users* of financial information take priority over interests of preparers of the information. As such, I focus my attention in this chapter primarily on the arguments during the Hearings made by users of financial information. This chapter relies heavily on an article published earlier on the Hearings (Thornton, 2003).

BACKGROUND

Auditor Independence and Nonaudit Services

The American Institute of Certified Public Accountants' (AICPA) *Code of Professional Conduct* (1988) states the ethical principles that are the foundation of the accounting profession in the U.S. Included in these principles

is the requirement that members of the profession be "independent in fact and appearance" when providing auditing and attestation services to their clients. Gaa (1992) argues that the principle of independence defines the role of the auditor, because it is the only norm within the Code that refers uniquely to the auditor. While there has been considerable debate over a precise definition of auditor independence (e.g., AICPA, 1997, ISB, 2000), there is a general consensus that it is necessary to ensure the quality of audited financial statements and ultimately investor confidence in the financial markets (e.g., SEC, 2000a).

In view of the importance of independent audits to the reliability of financial information, there is a long history of concern over what factors may impair auditor independence. The AICPA and the SEC have detailed rules that proscribe various financial, familial, and relational ties between auditors and their clients to ensure auditor independence, both in fact and appearance. One such relationship that has received considerable attention in recent years has been the auditors' role in providing nonaudit services to their audit clients. Antle (1984) states that the entire debate over whether audit firms should supply nonaudit services to their audit clients centers on the argument that the provision of these services impairs the auditor's independence.

Distributional Principles for Standards Setters

When policy makers attempt to resolve competing claims among differing interest groups, such as the scope of allowable nonaudit services that auditors can or should provide their clients, they generally look to a normative theory on which to weigh those claims. Gaa (1986) notes that the accounting literature has advanced two opposing general distributional principles for governing standard-setters' decisions. Either the interests of all affected parties are to be weighted equally, or one group is to be granted preferential treatment over another on some ethical or economic grounds.

The principle of user primacy is an ethics-based distributional principle that grants priority to the interests of the users of financial reports over the interests of preparers of financial reports. Positive accounting theory (Watts & Zimmerman, 1978, 1979) is another distributional principle that gives preferential treatment to one group, but on economic, rather than ethical, grounds. Gaa (1992, 1999) makes the following distinction between ethics-based and economics-based distributional theories. Ethics-based theories focus "on the problems of choice when it is explicitly recognized that one's

actions do have effects on others, and that those effects should be taken into account in deciding how to act.'' Economic theories focus ''on choice when each individual is regarded as an atomistic, self-interested, utility maximizer, who makes rational decisions without regard to the impact of her actions on the welfare of others.'' Gaa dismisses theories that place economics over ethics as inadequate as a normative guide to standard setters, because such theories are grounded in ethical egoism. As such, they provide no rationale for why one group's preferences deserve more weight than another's interests (Rachels, 1986, Gaa, 1994). User primacy, on the other hand, avoids the egoism trap, and can be justified logically using Rawls' (1971) theory of justice as a normative guide to standard setters.

Rawls (1971) posits that individuals will construct a just system when they are ignorant of any information regarding their own position in the resulting system. To assure impartiality, Rawls employs a hypothetical device called the ''veil of ignorance,'' where decision makers have no knowledge of the role they will play in the resulting system, and accordingly are prevented from making choices in their own self-interest. Gaa (1986) shows that user primacy is an extension of Rawls' theory to the financial markets, where there are two types of market agents – users and producers of financial information.[1] Users and producers have conflicting interests in the production and consumption of financial information. Producers have the incentive and the ability to deceive users by virtue of their control of the information system. Users, however, would clearly prefer not to be deceived. Behind the ''veil of ignorance,'' market agents will choose a market structure that will tend to correct the information asymmetry by constraining the feasible set of actions open to producers. In the resulting system, users' interests are given priority over producers' interests, and the principle of user primacy is born. In the applied world, since both users and producers' roles are already set, standard setters step in to play the role of disinterested financial market agents.

User primacy opposes the idea of weighting each affected party's claims equally, but rather holds that the interests of users of the financial statements should come first, on the grounds that they have restricted access to financial information that places them in a disadvantaged position.

> User primacy conflicts with the suggestions … that the task of the standard setter should be to promulgate standards that represent compromises between opposing interest groups. The notion of compromise suggests that the interests of the various groups stand on a more or less equal footing, such that the interests of one may be traded off against the interests of the other. … According to the user-primacy principle, the standard setter may act in managers' interests, but only insofar as this does not work against investors. (Gaa, 1986, p. 450)

The user-primacy principle is historically significant to the accounting profession, endorsed by the AICPA (1973, p. 17), which states that an objective of financial statements is "to serve primarily those who have limited authority, ability, or resources to obtain information, and who rely on financial statements as their principle source of information about an enterprise's economic activities." Furthermore, the principle clearly underlies the foundational professional accounting literature (e.g., the Financial Accounting Standards Board's (FASB, 1990) Statement of Financial Accounting Concepts No. 1, *Objectives of Financial Reporting by Business Enterprises*, and the AICPA's (1988) *Code of Professional Conduct*). Similarly, the user-primacy principle is fundamental to the regulatory role of the SEC, and serves as the impetus for the SEC's Proposed Rule on auditor independence (2000a).

The SEC's Proposed Rule

In June 2000, citing changes in the business and auditing world, the SEC proposed to update auditors' independence requirements by issuing the Proposed Rule. The Proposed Rule posited that an auditor may lack independence when he/she:

1) had a mutual or conflicting interest with the audit client,
2) audited the accountant's own work,
3) functioned as management or an employee of the audit client, or
4) acted as an advocate for the audit client.

The SEC, under Chairman Arthur Levitt, held four public hearings (SEC, 2000b, 2000c, 2000d, 2000e) on the Proposed Rule from July 26 to September 21, to promote "a thoughtful, fair and open dialogue among all market participants on this vitally important subject" (SEC, 2000b, 5).

The most contentious issue in the Proposed Rule related to proposed scope restrictions to nonaudit services provided by auditors to their audit clients. Ten specific services were identified in the Proposed Rule that might potentially impair auditor independence if provided by auditors to their audit clients. Most of these services were already banned or restricted by the SEC or the AICPA, but the SEC added two prominent nonaudit services to the mix (financial information systems design and implementation, and internal audit outsourcing). The impetus behind the proposed nonaudit proscriptions was the rapid growth in nonaudit fees, both in magnitude and proportion to audit fees, raising concerns that auditor independence might be impaired as auditors sought more lucrative consulting fees. In addition,

litigation reform during the 1990s potentially reduced the cost of audit failures to auditors.

The SEC's Independence Hearings on the Proposed Rule

Overall, 101 stakeholders testified at the Hearings. According to then SEC Chief Accountant Lynn Turner, every individual who requested to testify was given an opportunity to do so. To encourage feedback from stakeholders with differing viewpoints, SEC officials also invited several individuals – whom they believed opposed the proposal – to testify. Overall, Thornton (2003) found that 48 testifiers supported the Proposed Rule, 41 opposed it, and 12 were neutral.

Users' Preferences for Banning Nonaudit Services

Thornton (2003) identified 19 financial statement users among the 101 individuals who testified during the Hearings. Ten users represented investment managers, financial analysts, or investment bankers; five users represented consumer advocacy groups or public groups; and three users published investor-related publication.[2] Table 1 lists each user's name, title, affiliation, the groups they represent, and preferences regarding the Proposed Rule. In general, the users testifying represented large groups of investors and consumers of financial information (e.g., Biggs of TIAA-CREF, Gillan of California Public Employees Retirement System, Metzenbaum of Consumer Federation of America), including two testifiers who presented the results of surveys commissioned by the SEC (Neils surveyed 292 financial analysts, SEC 2000c; Kohn surveyed 3,000 investment professionals with the Association for Investment Management and Research, SEC, 2000d).

Without exception, the testifiers opposed auditors' provision of nonaudit services to their audit clients. Moreover, seven of the 18 users requested that the SEC go further than the proposed proscriptions, and draw a "bright line" banning auditors from providing any nonaudit services to their audit clients. For example, Ciesielski (SEC 2000c, pp. 79–80) stated, "I think the single best way to improve auditor independence and the appearance of auditor independence is to call for an exclusionary ban on nonaudit services to audit clients. … I support nothing less than an outright ban on nonaudit services for audit clients." Cleveland (SEC, 2000c, 43) concurred, "We regard the concurrent performance by the company's external auditor of

Table 1. Chronological Listing of Financial Information Users Testifying at the SEC's Imdependence Hearings.

Name	Title	Affiliation	Represents	NAS Pref [a]
Day 1: July 26, 2000				
John H. Biggs	Chairman/President/CEO	TIAA-CREF	Retirement asset manager	BL
Jack T. Ciesielski	R. G. Assoc., Inc. & Publisher	Analyst's Acctg. Observer	Buy/sell side analysts; observes accounting practices	BL
Day 2: September 13, 2000				
John C. Whitehead	Retired Chairman	Goldman Sachs & Co.	Investment bankers	PR
Kayla J. Gillan	General Counsel	Cal. Public Empl. Retire. Sys.	Investment managers of retirement assets	BL
Alan P. Cleveland	Special Legal Counsel	New Hampshire Retire. Sys.	Retirement asset management	BL
Ralph Whitworth	Managing Member	Relational Investors, LLC	Investment manager, also on five public company boards	BL
Tom Gardner	Co-Founder	The Motley Fool, Inc.	Advice for small investors, publication	PR [b]
Bernard Blum	Certified Financial Planner, CPA	Blum Shapiro Financial Serv.	Financial planners association, also CPA	PR
Robert Morgenthau	District Attorney	County of New York	Public defender, defrauded investors	BL
Jay Eisenhofer	Attorney for institutional invest	Grant & Eisenhofer, PA	Institutional investors, as attorney, several states' pension funds	PR
Elise Neils	Director	Brand Finance plc	Surveyed UK financial analysts, public companies	PR

Table 1. *(Continued)*

Name	Title	Affiliation	Represents	NAS Pref[a]
Day 3: September 20, 2000				
Howard Metzenbaum	Former Senator	Consumer Federation of Am.	Consumer advocate	PR
Bill Patterson	Director, Office of Investment	AFL-CIO	Consumer advocate	PR
Frank Torres	Legislative Counsel	Consumers Union	Consumer advocate	PR
Richard Blumenthal	Attorney General	Connecticut	Legal counsel for state	PR
Howard Schilit	President	Ctr. for Finance, Research & Analysis	Individual investors, publisher of research	PR
Mauricio Kohn	Principal, Kohn Fin. Consult.	Ass. for Invest. Mgt. and Res.	Investment professionals, CFA, CMA, CFM.	PR strong
Stuart Grant	Director	Grant & Eisenhofer, PA	Institutional investors, Council of Institutional Inv. members, own views	BL
Day 4: September 21, 2000		No users testified		

Note: Financial statement users are those identified by Thornton (2003), excluding Thomas Rowland (Senior VP, Fund Business Management Group), who appears to be a preparer, rather than user, of financial information, as evidenced by manager job title and 20 years' prior audit experience with a Big Five firm.

[a]Column shows each user's nonaudit service preference. BL indicates that user supported "Bright line" ban (i.e., ban all nonaudit services). PR indicates user supported the Proposed Rule proscriptions.

[b]Gardner supported the Proposed Rule, yet indicated that audit firms should be compensated for losses incurred from new proscriptions.

nonaudit services … to be inherently corrosive and fundamentally incompatible with the duty of independence and fidelity owed by the auditor to the investing public.''

CRITIQUE OF OPPONENTS' CHALLENGES TO THE PROPOSED RULE

The most consistent critics of the Proposed Rule's nonaudit service proscriptions were management of publicly traded companies (13 of 13) and the accounting profession (25 of 37) (see Thornton, 2003). Critics opposed the proposed scope restrictions on nonaudit services on the grounds that: (1) there was no evidence that nonaudit services impair auditor independence, (2) perceptions that nonaudit services impair independence were simply wrong, (3) audit quality would suffer under the proposal, and (4) numerous unintended consequences would result from implementing the proposal. I present each of these criticisms, along with users' responses to the criticisms, in the following section.

No Evidence that Nonaudit Services Impair Auditor Independence

Both the accounting profession and management argued that there was no evidence that nonaudit services impair auditor independence. For example, KPMG audit partner Guinan (SEC, 2000c, p. 103), stated, ''[T]here is no empirical evidence that the expanded scope of services has ever caused an audit failure, diminished audit effectiveness or weakened investor confidence.'' Leaders of the AICPA (Melancon, SEC, 2000c; Elliott, SEC, 2000e) and the accounting firms (e.g., Copeland SEC, 2000d) cited the Public Oversight Board's (POB) (2000) *Panel on Audit Effectiveness Report and Recommendations*, which found no evidence of independence impairment on a sample of 37 audits where the audit firms also provided nonaudit services to their audit clients.

Critics cited academic research (e.g., Kinney, 1999) that noted investors' lack of concern with auditors providing nonaudit services to their audit clients. Moreover, critics made several rhetorical arguments to support their position that there was no evidence that nonaudit services impaired independence. For example, companies purchasing nonaudit services from their auditors experienced the same cost of capital (KPMG's Butler, SEC, 2000e) and insurance rates (AICPA's Melancon, SEC, 2000e). Criticism rates of

audits (e.g., litigation rates and SEC enforcement action rates) also have remained constant since the 1930s, despite rapid growth in nonaudit services (AICPA's Elliott, SEC, 2000e). The profession (e.g., KPMG's Strange, SEC, 2000b) also argued that no research had found that independence of auditors was, in fact, impaired by nonaudit services. Livingstone (SEC, 2000d), representing the Financial Executives Institute and their 15,000 corporate financial officers, echoed this sentiment among managers, stating that their collective experience "does not support the causal link between nonaudit services and compromised audit independence."

Response

Proponents of the Proposed Rule responded to the "no evidence" argument with several arguments of their own. First, several testifiers noted that collecting evidence to verify or refute the link between nonaudit services and auditor independence was difficult, because audit firms did not disclose detailed information as to the proportion of audit and nonaudit fees from each client. Even with relative fee disclosure, Bazerman (SEC, 2000b) argued that the SEC would never find a "smoking gun," because most court cases against auditors were settled, independence was a latent variable, and suits that claimed a lack of independence were less effective than those that claimed poor audit quality. When cases are settled, it is virtually impossible to determine whether the settlement resulted from a faulty audit, or whether the audit was good, and the auditor just wanted to avoid further costs in an unmerited suit (Doogar, SEC, 2000c).

Users further argued that while markets-based research evidence linking nonaudit services to impaired auditor independence was not available, there was considerable anecdotal evidence from individual cases that such services impaired auditor independence. For example, Drott (SEC, 2000c) noted from personal experience that in 16 years of litigation involving over 50 audit failures, audit firms provided nonaudit services to their audit clients in the majority of the cases. Blumenthal (Attorney General of Connecticut, SEC, 2000d), Grant (Council of Institutional Investors, SEC, 2000d), and Bazerman (SEC, 2000b) also noted cases from their experiences that linked nonaudit services with impaired auditor independence.

Finally, three studies commissioned by the SEC provided evidence that users' perceived auditors' independence to be impaired when auditors received significant nonaudit service fees from their audit clients. Neils (SEC, 2000c), in a follow-up study to the ISB's Earnscliffe Reports (1999, 2000), found that over 90 percent of financial analysts surveyed believed significant nonaudit service fees were likely to compromise independence. Over 83

percent of analysts surveyed thought independence was threatened even if nonaudit fees were less than audit fees. Kohn's (SEC, 2000d) survey of 3,000 investment professionals found that 61–65 percent of respondents believed certain nonaudit services (appraisal and evaluation, outsourcing, and legal services) should be prohibited or severely limited in scope.

Users Perceptions are Wrong

Critics argued that financial statement users who perceived that nonaudit services impaired auditor independence had wrong perceptions. Again, citing the *Panel on Audit Effectiveness Report and Recommendations*, Deloitte & Touche's Copeland (SEC, 2000d) reemphasized that the Panel found no instances of impaired independence, while simultaneously finding audit quality was enhanced in about a quarter of the audits. Accordingly, the reality does not bear out the perception. Elliott (CEO of the AICPA, SEC, 2000c, p. 105) stated, ''[T]he proposed rule points to a problem where none exists, so it can propose a solution where none is needed.''

Response

Proponents responded that in addition to the survey evidence cited above, increasing fees from nonaudit services, along with declining costs of failed audits, posed a real threat to auditor independence. The growth in consulting services over the past two decades, which resulted in a considerable shift in proportion of nonaudit fees to audit fees, increasingly concerned users that auditor independence might be impaired (e.g., Cleveland, SEC, 2000c). Neils (SEC, 2000c) reported survey results from a study from 350 of the largest U.K. companies, indicating nonaudit fees represented 61 and 67 percent of audit firms' total fees in 1998 and 1999, respectively. Moreover, these results were generalizable to U.S. companies.

At the same time, Coffee (SEC, 2000b) argued that the cost of audit failures to audit firms had significantly declined during the late 1990s, owing to the Private Securities Litigation Reform Act of 1994 (increased pleading and *scienter* standards), the 1994 Supreme Court *Central Bank of Denver* case (eliminated aiding and abetting liability), the substitution of proportionate liability for joint and several liability, and the Uniform Standards Act of 1998 (preempted state suits). Together, these reforms greatly reduced the litigation costs to the auditor, even though suits involving accounting irregularities remained common.

Finally, proponents argued that auditors, not users, were the ones whose views of their own independence were biased. Based on psychology research,

Lowenstein and Bazerman (SEC, 2000b, Bazerman, Morgan, & Loewenstein, 1997) reasoned that an unintentional confirmation bias may exist among auditors who provided nonaudit services to their audit clients, so that their ability to make good judgments may be impaired. Moreover, the likelihood of this phenomenon increases as total audit and nonaudit fees increase.

Audit Quality would be Harmed

Critics argued that restricting the nonaudit services that auditors provide their audit clients would harm audit quality. By restricting nonaudit services, the profession would be unable to attract the best and brightest students (KPMG's Guinan, SEC, 2000c; Arthur Andersen's Berardino, SEC, 2000d), audit firms would lose valuable experience gained through providing nonaudit services, and less efficient use of resources would result in reduced auditor competence (AICPA's Elliott, SEC, 2000e). Critics also argued that nonaudit services allowed auditors to know their clients better, making it more difficult for unethical clients to deceive their auditors (AICPA's Melancon, SEC, 2000c). Internal audit and external audit functions were a continuum, and proscriptions of internal audit outsourcing would reduce overall audit quality (Controllers Barge (Time Warner) and Lockett (Johnson & Johnson), SEC, 2000d) while increasing the cost of the internal audit function, making it unaffordable to smaller clients.

Response

Users responded that they were cognizant of these concerns. For example, Biggs (SEC, 2000b, p. 49) stated, "It seems to me that a powerful argument does exist for maintaining management consulting practices within the audit firm. The extraordinary complexion of our financial information systems requires knowledgeable people to audit them." He concluded, however, that auditors should acquire these competencies through serving nonaudit clients. Users also agreed with critics that auditors gained crucial knowledge during nonaudit services, and they were able to perform better audits (e.g., Metzenbaum, SEC, 2000d, p. 6). However, the problem is that two potential outcomes follow: either the auditor ignores the conflict and performs a better audit, or the auditor succumbs to the conflict and compromises the quality of the audit. "In every instance, the reliability of the audit will be subject to question by reason of the conflict." Therefore, while auditor competence may be reduced by banning auditors from providing nonaudit services to their audit clients, users concluded that the increase in auditor

independence was worth the increased cost. Since auditors are the only source of third-party verification, their independence is an irreplaceable prerequisite for financial statement reliability. In related arguments, users believed that auditing was still an attractive, well-compensated profession that would continue to attract talented students.

Unintended Consequences

As consumers of nonaudit services, managers voiced concern about the SEC restricting their choice of service providers (e.g., FEI's Livingstone, SEC, 2000d). As providers of nonaudit services, the accounting profession expressed concern that the proposed nonaudit service proscriptions would force the disposal of their consulting practices (e.g., Deloitte & Touche's Garland, SEC, 2000b), and be very costly to them by restricting their access to the consulting market. Finally, both managers and the profession preferred self- or quasi-self regulation (e.g., audit committees, peer review, the POB, ISB) over governmental regulation.

Response

Users countered that self- and quasi-self regulation was not working, audit committees varied in quality, and there was plenty of consulting available with nonaudit clients. For example, Gillan (SEC, 2000c, p. 50) stated that she had met with over 100 audit committees, ranging from "really high caliber" to "very poor" audit committees. She recommended the SEC look to, but not be limited by, supporting players (e.g., ISB) in assuring auditor independence. Users also challenged critics' contention that auditors would be forced to sell their consulting practices. Metzenbaum (SEC, 2000d, p. 6) attacked this argument as a "false assumption" that leads to faulty conclusions (e.g., the profession argued that the audit firms would then be forced to hire back the same experts, but now as consultants, without any control over the expert's independence). "[T]here is nothing in this rule proposal that would force that outcome." Rather, critics argued that the consulting market would remain the same, with simply a shift in consulting clients between firms. Accordingly, the cost would be much less than auditors projected.

Politics and the Final Rule

Despite financial statement users' clear preference to limit the scope of nonaudit services auditors provide their audit clients, the SEC's (2000f)

Final Rule relaxed, rather than increased, the proposed proscriptions. Specifically, the newly proposed ban on financial information systems design and implementation was replaced with a requirement to disclose the fees paid to auditors for these services, and for management to provide written acknowledgement to the audit committee and audit firm accepting responsibility for their systems of internal control and management of these systems. The Final Rule also allowed the auditor to continue providing up to 40 percent of the internal audit activities for internal controls and financial reporting, with no limits to operational internal audits. The remaining proscriptions were closely aligned with the AICPA's existing standards, and did not further restrict the nonaudit services that auditors could provide their audit clients.

The Final Rule also required proxy disclosure of the aggregate audit and nonaudit fees for the most recent fiscal year, and disclosure from the audit committee that they had considered the compatibility of the nonaudit services with the auditor's independence. While increased disclosures are consistent with user preferences, disclosure alone is clearly less than users hoped for. For example, when Levitt asked if disclosure of fees would be adequate (SEC, 2000b, p. 53), Biggs responded, "I'd certainly be disappointed by that. Obviously, it helps if there is disclosure."

LESSONS FOR POLICY MAKERS

The Value of a Theory

Perhaps the clearest lesson to be learned from an analysis of the Hearings is the importance of theory in guiding policy-making decisions. In a simplistic partitioning of testimonies at the Hearings, it appears that those testifying were almost evenly split on the Proposed Rule's scope of nonaudit service proscription. A reanalysis of the data through a user-primacy lens, classifying testimonies as either *user* or *other*, reveals that financial statement users' interests were overlooked by the SEC when it issued its Final Rule on the scope of nonaudit services auditors could provide their audit clients. This analysis demonstrates that without exception, users sought increased nonaudit proscriptions, frequently calling for an outright ban on all such services. They supported their position that auditor independence was impaired by nonaudit services, both in appearance and fact, with argument, evidence, and experience.

How User Primacy Failed

Dopuch and Sunder (1980) argue that the user-primacy principle may fail to guide public policy for two reasons. First, users' preferences may lack sufficient homogeneity to guide policy-makers' decisions. That is, if users' preferences are diverse or contradictory, there may be no common ground on which policy makers can satisfy their competing claims. Second, users may lack the political or economic power necessary to impose their preferences on financial accounting.

Since users' preferences were relatively homogeneous (i.e., ban all, or at least the proposed 10, nonaudit services), it appears that they lacked the political clout to impose their preferences. In private communications with then SEC Chief Accountant Lynn Turner, he stated that the SEC was unable to proscribe the proposed list of nonaudit services owing to the political power of the Proposed Rule's critics. According to Turner, these critics threatened to revoke the rule-writing capacity of the SEC if the Commission did not back down on proscribing certain nonaudit services, and they had the political power at that time to do so.

In the wake of Enron and several other high-profile financial reporting scandals, the importance of reliable financial reporting has not been so clear since the stock market collapse in the late 1920s. Accordingly, the political climate has changed, as evidenced by the passage of the Sarbanes-Oxley Act (2002), with its proscription of the nonaudit services essentially identical to those in the Proposed Rule. Whether stronger proscriptions from the Proposed Rule would have averted the current crisis in investor confidence, one can only surmise. Clearly though, auditors' lack of independence, at least in appearance, brought on by their provision of nonaudit services to their audit clients, has proven much more costly to audit firms than they ever foresaw.

Moreover, the costs brought on by market forces lack the fairness that a regulatory solution would have imposed. For example, Arthur Andersen completely collapsed through market forces, while other firms suffered significant, but disproportionate, reputation costs. Based on an analysis of the Hearings, it appears that Andersen's position on nonaudit services was essentially identical to that of other large audit firms with consulting arms, yet they bore a disproportionately high cost from impaired independence. Policy makers who set timely standards serve to spread the agency costs more evenly across all auditors. This function is increasingly important as the number of international audit firms continues to decrease.

Defining Auditor Independence

Finally, policy makers must define auditor independence. Without a clear definition of independence, standard setters are destined to fail. Dopuch and Sunder (1980) observe that an agreed-upon definition of auditor independence is hampered by the struggle for economic advantage between the various interest groups. Competing interest groups use the term to mean to them what they want, or conversely oppose definitions that restrict their opportunities to carry out their business as they desire. Because of opposing interests, it is policy makers who must set the definition of auditor independence.

Despite the past difficulties in defining independence, we are not so far from an adequate definition as it may appear. In defining independence, policy makers must understand that it is objectivity, not independence, that the public really wants from auditors. Moreover, objectivity is already defined clearly in the Code as ‘‘freedom from bias’’ (AICPA 1988). Independence is simply the mechanism for proving objectivity. That is, since an auditor's objectivity cannot be observed, standards then require independence as an observable measure of objectivity. Despite the importance of independence, surprisingly little normative theory has been developed to guide regulators or researchers. This chapter has relied on the user-primacy principle, but encourages future work in this area.

Regulators must continue to ask the question, ‘‘Independent from what?’’ The recent focus has been on auditor independence from the company and from management. Future research should include independence from the financial information itself.

Summary

The SEC's Independence Hearings provide an unusually transparent window to the efforts of policy makers to set accounting standards when political pressures are high. The findings that changes to the Proposed Rule were more closely aligned with preparers' than users' preferences, despite claims to the contrary, serve as a clear warning to policy makers of the difficulty in achieving standards in the public's interest. Policy makers must be careful to evaluate and interpret evidence and arguments through a clear ethical framework to achieve standards that will serve the public interest in the long run.

NOTES

1. The dichotomization of all market agents into users and producers of financial information is a generalization employed to distinguish the self-interests of two prominent groups. Undoubtedly, other interest groups exist (e.g., employees, customers, the public), with their own self-interests.

2. I removed Thomas Rowland, Senior Vice President of the Fund Business Management Group, from Thornton's (2003) list of 19 users. He is more appropriately classified as a preparer than a user of financial information, based on his current position as financial accountant for the fund management group, and his 20 years' prior experience working for one of the Big 5 firms.

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POLITICS AND THE PUBLIC ACCOUNTING PROFESSION IN THE U.S.: IMPLICATIONS FOR THE FEDERAL REGULATION OF AUDITING AND FINANCIAL REPORTING

Robin W. Roberts

ABSTRACT

The purpose of this essay is to discuss the involvement of the U.S. public accounting profession in federal politics and to focus attention on the extent to which the profession engages with federal legislators and other policymakers to influence public policy. In the essay, I discuss and present evidence regarding the profession's use of political strategies such as making political campaign contributions and lobbying federal legislators and regulators. The profession's political efforts are then examined within the context of their self-proclaimed commitment to the public interest. I conclude that the public accounting profession's extensive involvement in federal politics works principally to protect its own professional interests and favors conservative, pro-business agendas. As a result, broader public interest responsibilities are often neglected. Although the profession

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deserves the right to participate in public policy debates, its parochial and patronage orientation does not resonate well with its self-proclaimed professional cornerstones of independence and integrity.

On July 30, 2002, the "Sarbanes-Oxley Act of 2002" (SOX) was signed into law by President George W. Bush. This law was created and passed by Congress principally in response to the public's uproar over a number of high-profile corporate scandals such as Enron, WorldCom, Tyco International, and Adelphi Communications. SOX is relevant to all publicly held companies that have debt or equity securities subject to the Securities Act of 1934, and it ushered in a number of substantive changes in the way these companies are governed (Lander, 2004).

The status of the public accounting profession was a major topic of debate during the development of SOX, with discussions focusing on issues of auditing standard setting, auditor independence, and the quality of corporate financial reporting. It seemed that each new revelation of corporate financial reporting impropriety whittled away the public accounting profession's reputation for successfully self-managing its regulation of accounting and auditing. And, as the public became less trusting of the accounting profession, Congressional support for "CPA (certified public accountants) friendly" reforms, such as the original bill sponsored by Representative Michael Oxley (Republican, Ohio), became less likely to pass into law. Ultimately, SOX was passed overwhelmingly by Congress and signed into law, prohibiting CPA firms from performing many traditional consulting services for their audit clients and initiating a new era of federal government involvement in the regulation of the public accounting profession.

The political clout that the "Big 5" (Now Big 4) public accounting firms and the American Institute of Certified Public Accountants (AICPA) had carefully built up over the past 15 years through political action committee (PAC) contributions, lobbying, and grassroots efforts appeared to have diminished significantly. However, as I will discuss later, SOX's regulatory demands for improvements in corporate governance generated significant new and renewed opportunities for the same U.S. public accounting profession whose lack of audit diligence initially triggered this round of public and Congressional scrutiny. The profession continues to operate effectively and intimately within the federal public policy sphere.

While the public accounting profession relishes its renewed role as a guardian of the public interest, the effectiveness of SOX and potential additional accounting and auditing reforms continue to be debated in the business, political, and public policy arenas. For example, public accounting

firms' ability to provide tax services to audit clients (Public Company Accounting Oversight Board (PCAOB), 2004; AICPA, 2005) and the financial reporting standard concerning accounting for stock options were both recently debated within Congress and regulatory arenas (Peterson, 2004). Both sides of these debates attached importance to these issues as they were viewed as economic and social issues that have significant public interest consequences.

The U.S. public accounting profession has a lot at stake in the outcome of federal policymaking, and its leadership is continually managing the public policy space that both extends and restricts its professional domain. In his October 2004 acceptance speech, Robert Bunting, the new Chairman of the AICPA board of directors, stressed the profession's need for political involvement, stating that the AICPA's "challenge is to ensure that we have a seat at every table when laws and regulations are made," and that the AICPA must "respond to legitimate public interest concerns" and preserve "the ability to vigorously oppose regulatory initiatives that do not make good sense."

The purpose of this essay is to discuss the involvement of the U.S. public accounting profession in federal politics and to focus attention on the extent to which the profession engages with federal legislators and other policymakers to influence public policy. I conclude that the public accounting profession's extensive involvement in federal politics works principally to protect its own professional interests and favors conservative, pro-business agendas. As a result, broader public interest responsibilities are often neglected. Although the profession deserves the right to participate in public policy debates, its parochial and patronage orientation does not resonate well with its self-proclaimed professional cornerstones of independence and integrity.

I have organized the remainder of the essay as follows. First, I discuss why the U.S. public accounting profession is involved in federal politics. Second, I summarize the results of prior research. Lastly, I provide a commentary on how the public accounting profession's involvement in federal politics affects the way in which notions of public accounting professional responsibilities and the public interest are constructed for use in federal policymaking.

WHY IS THE U.S. PUBLIC ACCOUNTING PROFESSION INVOLVED IN FEDERAL POLITICS?

As I began studying the public accounting profession's involvement in federal politics, I quickly learned that the words "involvement" and "politics"

mean different things to different people. In one sense, the U.S. profession has been involved in federal politics since the state licensing of certified public accountants began in the early 1900s. This type of involvement – meeting with state governments and with the Securities and Exchange Commission regarding licensing and professional jurisdiction – was the central focus of the profession's political activities for much of the twentieth century. There have been several times when the U.S. Congress turned its direct attention to the public accounting profession, most notably, the development of the Securities Acts, the Moss and Metcalf Commissions, and the investigations surrounding the U.S. savings and loan crisis. The public accounting profession responded to these inquiries by defending its public interest commitment and by pledging to improve its self-regulatory efforts. Two theories of regulation – public interest theory and economic regulation theory – compete to provide plausible explanations for why the public accounting profession is actively involved in U.S. politics.

CAN THE PUBLIC INTEREST RATIONALE FOR THE PUBLIC ACCOUNTING PROFESSION'S INVOLVEMENT IN FEDERAL POLITICS SUFFICE?

The public interest theory of regulation maintains that regulation is generated by government to protect the public from an unacceptable level of potential harm (Posner, 1974). According to this public interest perspective, the public accounting profession is regulated because accounting is a difficult, esoteric discipline that meets a critical societal need, and the public is not in a position to judge the quality of service provided by CPAs. The public accounting profession, like the medical profession, must be self-regulated as it takes an expert to judge the performance of another expert. And, as financial experts, CPAs can and should use their knowledge to help make society better. Public interest arguments are frequently used by the profession to justify its monopoly license to practice and to defend its involvement in state and federal policymaking.

Leaders of the CPA profession profess that their political activities are part of the public accounting profession's commitment to meet its public interest duty. For example, Olivia F. Kirtley, during her term as Chair of the AICPA, stated (Koreto, 1998, p. 76):

> We want to have easy access to Congress when it is debating issues important to the profession, and we also want to serve as a resource to Congress when it is addressing

> complex financial matters. Our public interest tradition requires us to speak out on public issues where our valuable and unique insight can guide the debate with unbiased facts and objective analysis.

Robert Bunting reiterated the profession's ability and willingness to contribute to public policy debates during his 2004 acceptance speech (AICPA, 2004):

> But accounting and reporting are not our only possible contribution to the financial health of our society. We can serve the public interest by offering our expertise to help frame policy, inform policy makers and educate the public on matters affecting their financial health.

Prior research (and common sense) tells us that gaining "easy access to Congress" to be able to "inform policymakers" requires a substantial financial investment in the election and re-election campaigns of legislators. The public accounting profession is only able to "guide the debate" and "help frame policy" if it has the political connections needed to gain legislators' attention (Dwyer & Roberts, 2004).

As I read the transcripts from these two distinguished CPAs, I couldn't help but wonder: "What are *unbiased* facts?" And, "how is the proper *frame* for policy determined?" Can the profession's public interest duty really explain Ernst & Young's and Price Waterhouse's place on the Republican National Committee's 1993–1996 elite "Team 100"?

The more time I spent studying the profession, the more convinced I became that the AICPA's and major international public accounting firms' political activities and their willingness to serve as *unbiased* and *objective* guides on diverse public policy issues mask an intense self-interest-motivated involvement with the functioning of government. I do not mean to imply that there is no public interest benefit to be derived from public accounting or that all members of the profession are overtly hiding a selfish motivation that drives their political actions. I do argue, however, that the leadership of the profession often strike strong advocacy positions that help the profession and their pro-business patrons, but harm the broader public interest.

ECONOMIC RATIONALES FOR POLITICAL INVOLVEMENT

In trying to think more about the profession's intense involvement in federal politics, I found help in the theoretical works of economists such as Stigler (1971), Posner (1974), and Peltzman (1984). These researchers started using

economic assumptions about people (i.e., rational, self-interest maximizers) to advance the position that, although participants in regulated industries may complain about government oversight, regulation actually exists to benefit those who are subject to the regulation. Because of professionals' monopoly of expertise and their strategic interest in the regulation of their profession, the profession is able to "capture" the regulation.

From this perspective, the public accounting profession is seen as an interest group that demands regulation as part of its strategy for promoting its own private welfare, not the public's. Favorable regulation is supplied to the profession if it provides benefits (e.g., votes, campaign contributions) to elected officials (Posner, 1974; Roberts & Kurtenbach, 1998). Using this economic framework for analysis, politics is portrayed as a market of supply and demand. Interest groups have conflicting demands for legislation (e.g., labor versus corporate managers, plaintiff attorneys versus CPAs), and legislators balance these competing constituent interests in a way that optimizes their own financial campaign-support and chances for re-election (Becker, 1986; Roberts & Kurtenbach, 1998). Legislators' ability to supply favored legislation to an interest group is constrained by factors such as their position in Congress, the ideology of their voting constituency, their need for campaign financial support, and the voting power of their political party. You don't see the public accounting profession making campaign contributions to Green Party challengers! Like any good and perfect market (theoretically speaking), interest groups seek out and support the legislators who can supply their desired legislation at the lowest cost.

Of course, real politics is a lot messier than theoretical economics. As Grenzke (1989) points out, "the currency is complex." For example, PAC contributions are limited to $5,000 per candidate per election. Can the AICPA expect to "buy" favorable legislation for a mere $5,000? The answer seems to be no. But, the donation may give AICPA lobbyists access to an influential legislator's staff, providing the profession with the opportunity to educate and persuade that legislator to support a specific bill. Also, from the interest group's perspective, to whom do they provide support? Should the public accounting profession spend resources on a legislator who is going to vote for favorable legislation all of the time anyway? Should they spend resources on a legislator who will never vote the profession's way? Couldn't the profession use campaign contributions to gain access to staunch opponents in the hope of softening their rhetoric at the next session of Congress?

As you would expect, the AICPA and the now-Big 4 public accounting firms are strategic in their allocation of PAC contributions and in their other political efforts. By "strategic," I mean that these organizations have a sense

of purpose behind their involvement, using politics as a method to help achieve their own goals. But, what are these goals? How does political involvement benefit these firms? And, can't the firms' own goals coincide with the public interest? In the next section, I will share information that helps clarify these questions and offer my own thoughts on the answers.

RESEARCH ON THE POLITICAL ACTIVITIES OF THE U.S. PUBLIC ACCOUNTING PROFESSION

Reasons for Political Involvement

It turns out that the AICPA and especially the Big 4 firms (or Big 5? 6? 8?, depending on the date) have a number of reasons for engaging in political activities. And, assuming the people running these firms are rational, there must be a lot at stake. For example, on April 18, 2004, the *New York Times* reported the top 10 campaign contributors to President George W. Bush over the course of his career. PricewaterhouseCoopers (PWC) was at the very top of the list, – outdoing Enron.

I offer four basic reasons why the leaders in the public accounting profession are involved in federal politics. First, state and federal legislation may affect professional practice directly (e.g., securities litigation reform, laws governing practice before the Internal Revenue Service, regulation concerning the scope of practice) and/or it also may affect the substantive content of the profession (e.g., changes in tax laws, changes in authority over standard setting, and changes in fraud reporting requirements). Their participation in this type of regulation is undertaken to guard and manage their monopoly over the auditing function in society – protection of professional jurisdiction. Second, the Big 4 firms compete against other professional services firms for government contracts. The firms need political capital to help gain access to government work that was being privatized. For example, the September 4, 2003 issue of the *Government Executive* reported that in 2002 the federal government awarded PWC and KPMG contracts totaling $160,625,000 and $130,838,000, respectively (this in itself is an excellent return on the federal lobbying and campaign contribution costs they incurred in the 2002 election cycle).

Third, the firms (some more than others) work as paid lobbyists on behalf of their clients. For example, a 2003 year-end lobbying report filed by PWC says that the firm received $60,000 from Noble Drilling Services, Inc. for lobbying the House of Representatives and the Senate on their behalf. PWC

represented Noble Drilling Services on H.R. 2896 and S. 1637, two bills concerned with the tax treatment of U.S.-based businesses which re-incorporate outside the U.S. One of PWC's lobbyists on this issue was the Honorable Bill Archer, a retired Republican Congressman from Texas who chaired the House Ways and Means Committee for the 104th–106th Congress. Given that tax laws are created by the House Ways and Means Committee, I tend to think that Mr. Archer was a good hire for both PWC and Noble Drilling Services.

Fourth, the public accounting profession participates in politics to promote its perspective of the role of business and government in the U.S. The profession generally follows the "What is good for GM is good for America" mentality. The profession continually uses public interest rhetoric in its political arguments. When I searched the AICPA website for the term "public interest", 5,179 hits were returned. If you look at the breakdown of campaign contributions given by the AICPA and Big 4 firms to Congressional and Presidential candidates, a pattern of preference emerges regarding the public accounting profession's political ideology. In the last complete election cycle (2004), these organizations contributed $4,735,272 to Democratic campaigns versus $8,695,977 to Republican campaigns. Thus, 65% of their donations supported Republican candidates for political office. The contribution breakdown for the AICPA and each of the Big 4 firms for the 2004 federal election cycle is shown below (data supplied by the Center for Responsive Politics):

Organization	*Contributions*	% to *Democrats*	% to *Republicans*
1 Deloitte Touche Tohmatsu	$2,164,792	28	71
2 Ernst & Young	$1,870,640	36	64
3 PricewaterhouseCoopers	$1,855,851	24	76
4 KPMG LLP	$1,393,333	29	71
5 American Institute of CPAs	$698,004	36	64

Although some of the large discrepancies in donations to the two parties can be explained by institutional artifacts, such as majority party status and committee leadership, it seems safe to assume the public accounting profession believed that the public interest is served best by the policies forwarded by the Republican Party during the 2004 elections. Once I take the profession's pattern of political campaign contributions into consideration, I think I can read between the lines when, in his acceptance speech, the 2004 AICPA Chair stated:

> We will continue our efforts to bring clarity and resolution to the tax shelter issue while preserving the taxpayers' right to minimize their taxes. And we will continue to fulfill our role in commenting on the fiscal policy of government, to ensure prudence. This includes issues of public policy prudence, including the viability of Social Security and public health insurance.

Prior Academic Research on the Public Accounting Profession's Political Involvement

Although the AICPA and Big 4 firms have public affairs offices in Washington D.C. and proactively manage a relational approach to their political strategy, there are two recent major episodes of federal political involvement by these organizations. The first episode revolved around private securities litigation reform and the second episode was the intense battle over auditor independence and the provision of consulting services to audit clients. Each of these high-profile episodes helped shape the current manner in which the public accounting profession manages its relationship with federal policymakers. Each episode is discussed below.

Private Securities Litigation Reform

Dramatic growth in the private financing of federal election campaigns happened to coincide with the public accounting profession's efforts to obtain legislative relief from legal liability exposure. The profession successfully completed a full-scale effort to directly influence Congress through the AICPA's and Big 6 firms' advocacy of securities litigation reform. The battle over securities litigation reform ran from the late 1980s through the passage of the Private Securities Litigation Reform Act of 1995 (see Avery, 1996 for a history of this Act). Table 1 shows the total campaign contributions made by the public accounting profession starting from the most important years of the liability reform debate through the 2004 election cycle.

The table shows how the level of contributions made by the AICPA and major international public accounting firms escalated during the period of time in which litigation reform was being debated. Roberts, Dwyer and Sweeney (2003) studied the profession's political involvement in the development of this legislation. We show how the AICPA and Big 6 firms used campaign contributions, Congressional testimony, and grassroots lobbying to advocate liability reform. These organizations focused their campaign contributions on members of the Senate and House committee who were responsible for developing securities litigation and reform legislation.

The profession's strategy was more sophisticated than just giving money to politicians' election campaigns. On August 6, 1992, the Big 6 firms jointly

Table 1. U.S. Public Accounting Profession Federal Political Campaign Contribution Trends.

Election Cycle	Rank[a]	Total Contributions	Contributions from Individuals	Contributions from PACs	Soft Money Contributions	Donations to Democrats	Donations to Republicans	% to Dems	% to Repubs
2004[b]	29	$13,518,979	$8,395,620	$5,123,359	N/A	$4,735,272	$8,695,977	35	64
2002	34	$11,947,809	$3,510,962	$5,595,184	$2,841,663	$3,506,918	$8,405,054	29	70
2000	28	$15,356,056	$6,904,977	$5,788,177	$2,662,902	$5,896,876	$9,362,148	38	61
1998	25	$10,245,066	$3,350,599	$5,479,080	$1,415,387	$3,996,395	$6,219,098	39	61
1996	22	$12,075,680	$4,991,094	$5,579,006	$1,505,580	$4,978,295	$7,044,027	41	58
1994	22	$7,472,464	$2,604,173	$4,169,336	$698,955	$3,833,630	$3,714,434	51	50
1992	27	$6,649,992	$3,215,782	$2,835,699	$598,511	$3,610,997	$3,088,656	54	46
1990	25	$3,350,079	$1,341,033	$2,009,046	N/A	$1,735,337	$1,622,742	52	48
Total	28	$80,616,125	$34,314,240	$36,578,887	$9,722,998	$32,293,720	$48,152,136	40	60

Note: Data supplied by the Center for Responsive Politics.
Methodology: The numbers on this page are based on contributions of $200 or more from PACs and individuals to federal candidates and from PAC, soft money and individual donors to political parties, as reported to the Federal Election Commission. While election cycles are shown in charts as 1996, 1998, 2000, etc. they actually represent two-year periods. For example, the 2002 election cycle runs from January 1, 2001 to December 31, 2002. **Data for the current election cycle were released by the Federal Election Commission on Monday, December 13, 2004.** Soft money contributions to the national parties were not publicly disclosed until the 1991-92 election cycle, and were banned by the Bipartisan Campaign Finance Reform Act following the 2002 elections.
[a]These numbers show how the industry ranks in total campaign giving as compared with more than 80 other industries. Rankings are shown only for industries (such as the automotive industry), not for widely encompassing "sectors" (such as transportation) or more detailed "categories" (such as car dealers).
[b]2004 figures do not include donations of "Levin" funds to state and local party committees. Levin funds are contributions of up to $10,000 from sources that are allowed to give to parties under the applicable state's laws, including corporations and labor organizations in some states. Levin funds may be used for certain types of voter registration, voter identification and get-out-the-vote activity.

issued a document titled ''The liability crisis in the United States: Impact on the accounting profession'' (Arthur Andersen et al., 1992). The Public Oversight Board (POB) issued a special report, ''Strengthening the professionalism of the independent auditor,'' on September 13, 1994. In it the POB strongly urged the Securities and Exchange Commission (SEC) to champion litigation reform (POB, 1994, 29). During the Congressional debate over liability reform, two representatives of the AICPA, Jake Netterville (AICPA Board Chairman) and A.A. Sommers, Jr. (POB Chairman), testified before the Senate Subcommittee on Securities on July 21, 1993 during the ''Private litigation under the federal securities laws'' hearings (Senate Hearing 103—431, 1993). On August 10, 1994, J. Michael Cook, Chairman and CEO of Deloitte Touche, testified before the House Subcommittee on Telecommunications and Finance during its ''Securities litigation reform'' hearings (House Hearing 103–156, 1994). Also, Richard Breeden, former SEC Chairman and partner with Coopers & Lybrand, spoke before both the House Subcommittee on Telecommunications and Finance (Common Sense Legal Reform Act Hearings, February 10, 1995) and the Senate Subcommittee on Securities (Securities Litigation Reform Proposal Hearings 104–157, April 6, 1995). All of these activities are designed to provide legislators with objective and expert guidance for use in policymaking. The public interest is served best if the public accounting profession receives more shelter from lawsuits. The success that the public accounting profession achieved concerning private securities litigation reform seemed to make the leaders of the profession even more determined to play a substantive role in federal politics.

Auditor Independence
As the public became more and more concerned with auditor independence issues, the public accounting profession's political activities became more intense. Arthur Levitt, the Commissioner of the SEC during this time period, chronicles the public accounting profession's efforts and influence in *Take on the street* (Levitt & Dwyer, 2002). The auditor independence issue spawned a number of formal inquiries and studies by the POB and the SEC. In Dwyer and Roberts (2004), we provide details of the financial contributions the public accounting profession made to legislators who stood by the profession's desire to maintain their ability to provide consulting services to audit clients. Table 2 lists the legislators who wrote letters to the SEC in 2000 opposing a proposal that would prohibit accounting firms from offering consulting services to clients, and includes the amounts of campaign contributions provided to them by the AICPA and Big 5 firms. Tables 3

Table 2. Big 5 Firm and AICPA Campaign Contributions to Legislators Who Wrote Letters to the SEC in 2000 Opposing a Proposal that would Prohibit Accounting Firms from Offering Consulting Services to Clients.

Senate Candidates	Grand Total[a]
Wayne Allard (R-Colo.)	$81,984
Evan Bayh (D-Ind.)	$66,324
Robert Bennett (R-Utah)	$90,453
Jim Bunning (R-Ky.)	$83,524
Mike D. Crapo (R-Idaho)	$80,225
Phil Gramm (R-Texas)	$204,185
Rod Grams[b] (R-Minn.)	$75,648
Chuck Hagel (R-Neb.)	$59,243
Rick Santorum (R-Pa.)	$146,868
Charles Schumer (D-N.Y.)	$340,006
Robert Torricelli (D-N.J.)	$47,310
House Candidates	**Grand Total[a]**
Dick Armey (R-Texas)	$99,120
Richard Baker (R-La.)	$37,042
Brian P. Bilbray[b](R-Calif.)	$91,804
Thomas J. Bliley[b](R-Va.)	$170,376
Roy Blunt (R-Mo.)	$59,888
Christopher Cox (R-Calif.)	$156,759
Barbara Cubin (R-Wyo.)	$50,004
Nathan Deal (R-Ga.)	$51,962
Peter Deutsch (D-Fla.)	$131,198
Cal Dooley (D-Calif.)	$65,000
Vito J. Fossella (R-N.Y.)	$97,440
James C. Greenwood (R-Pa.)	$2,875
Robert W. Goodlatte (R-Va.)	$41,536
Duncan Hunter (R-Calif.)	$14,000
Jim Maloney (D-Conn.)	$51,095
Jim McCrery (R-La.)	$57,286
James P. Moran (D-Va.)	$115,661
Michael G. Oxley (R-Ohio)	$121,050
Charles W. "Chip" Pickering (R-Miss.)	$68,786
John M. Shimkus (R-Ill.)	$38,500
Adam Smith (D-Wash.)	$21,500
Cliff Stearns (R-Fla.)	$75,565
Ellen O. Tauscher (D-Calif.)	$82,801
Billy Tauzin (R-La.)	$286,593
Heather A. Wilson (R-N.M.)	$85,733

[a]Data reported by the Center for Responsive Politics, based on FEC data downloaded January 1, 2002. Totals include PAC and individual contributions. Table reproduced from Dwyer and Roberts (2004).
[b]Former senator or congressman.

Table 3. AICPA and Big 5 Firm Political Contributions to Senate Conferees on U.S. Public Accounting Profession Reform.

Name	Grand Total[a]	2001–2002	1999–2000
Christopher Dodd (D-Conn.)	$68,000	$3,000	$65,000
Michael Enzi (R-Wyo.)	$60,511	$54,011	$6,500
Phil Gramm (R-Texas)	$43,500	$37,500	$6,000
Jack Reed (D-R.I.)	$29,954	$25,104	$4,850
Tim Johnson (D-S.D.)	$14,550	$5,250	$9,300
Paul Sarbanes (D-Md.)	$14,000	$0	$14,000
Robert Bennett (R-Utah)	$12,500	$0	$12,500
Richard Shelby (R-Ala.)	$4,750	$1,750	$3,000
Patrick Leahy (D-Vt.)	$0	$0	$0

[a]Data was reported by the Center for Responsive Politics, based on data downloaded from the FEC on July 8, 2002. The 2001–2002 figure represents contributions made so far in the 2002 election cycle. Table reproduced from Dwyer and Roberts (2004).

and 4 reveal the amounts of campaign contributions that the AICPA and Big 5 firms made to Senate and House conferees who participated in the Congressional discussion on U.S. public accounting profession reform.

A quick glance at the tables shows that the Republican candidates received significantly more financial support than Democratic candidates. A noticeable partisan tone is seen in the list of legislators who wrote the SEC regarding consulting services. This plea of support for the public accounting profession was signed by 27 Republicans and 9 Democrats.

In these auditor independence debates, the public interest mantra was often repeated. For example, supporters of the profession argued that the public interest would be harmed if regulations disallowed the provision of auditing and consulting services to the same client. They argued that a significant amount of the expertise gained from auditing a client would be wasted if it were not allowed to be used to better the company's performance. In essence, the economic consequences of the regulation would be more damaging than beneficial. Of course, we know now that the auditor independence debates of 2002 did not provide the leaders of the public accounting profession the same level of satisfaction as did the debates over securities litigation reform. While Representative Oxley's CPA-friendly reform bill gathered a lot of support in the early stages of debate, the public outcry over accounting and auditing problems at WorldCom and other publicly held companies pushed Congress to adopt a more radical approach to corporate governance and auditing reform. SOX included changes in

Table 4. AICPA and Big 5 Firm Political Contributions to House Conferees on U.S. Public Accounting Profession Reform.

Name	Grand Total[a]	2001–2002	1999–2000
Panel A. Primary House Members Appointed to the Conference Committee			
Michael Oxley (R-Ohio)	$73,500	$31,500	$42,000
Christopher Cox (R-Calif.)	$55,349	$17,000	$38,349
Ed Royce (R-Calif.)	$28,200	$19,400	$8,800
Bob Ney (R-Ohio)	$23,800	$9,250	$14,550
John LaFalce (D-N.Y.)	$23,561	$6,000	$17,561
Sue W. Kelly (R-N.Y.)	$21,239	$15,999	$5,240
Richard H. Baker (R-La.)	$18,292	$16,292	$2,000
Paul Kanjorski (D-Penn.)	$16,218	$12,218	$4,000
Barney Frank (D-Mass.)	$3,990	$1,000	$2,990
Maxine Waters (D-Calif.)	$0	$0	$0
Panel B. Additional House Members Asked to Discuss Only Certain Provisions of the Reform Bill			
Billy Tauzin (R-La.)	$77,293	$35,869	$41,424
Jim McCrery (R-La.)	$38,936	$26,250	$12,686
Charles Rangel (D-N.Y.)	$37,800	$10,300	$27,500
Bill Thomas (R-Calif.)	$35,375	$11,000	$24,375
John Boehner (R-Ohio)	$34,725	$16,450	$18,275
Sam Johnson (R-Texas)	$22,263	$2,000	$20,263
John Conyers Jr. (D-Mich.)	$5,250	$0	$5,250
Lamar Smith (R-Texas)	$4,500	$0	$4,500
John Dingell (D-Mich.)	$4,000	$3,000	$1,000
F. James Sensenbrenner (R-Wis.)	$3,000	$0	$3,000
James Greenwood (R-Penn.)	$2,750	$500	$2,250
George Miller (D-Calif.)	$0	$0	$0
Ronnie Shows (D-Miss.)	($3,000)	$4,000	($7,000)

[a]Data was reported by the Center for Responsive Politics, based on data downloaded from the FEC on July 8, 2002. The 2001–2002 figure represents contributions made from the 2002 election cycle. Table reproduced from Dwyer and Roberts (2004).

accounting and auditing regulations that significantly altered the way in which Big 4 firms must manage issues of auditor independence.

As evidenced by the over $13 million in federal political campaign contributions made by the public accounting profession in the 2004 election cycle, the profession continues to proactively manage its relationship with the federal government. The issue of auditor independence remains a topic of debate. The clarity and resolution that the AICPA intends to bring to the tax shelter issue most likely relates to the November 21, 2003 introduction of House bill 3599, titled the "Auditor Independence and Tax Shelter Act" and to the PCAOB's Proposed Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees. The PCAOB voted unanimously on December 14, 2004 to issue its ethics and independence proposal for public comment. For example, these rules, if adopted, will prohibit a company's audit firm from providing tax services to that audit client that is based on an aggressive interpretation of the tax law. In a February 14, 2005 letter to the PCAOB, the AICPA's Center for Public Company Audit firms asked for additional clarification of these proposed rules.

CONCLUSIONS

What can we take away from all of this discussion? I think it is important to reflect on the context in which the U.S. public accounting profession participates in federal politics. Supporters of the profession's political involvement often comment that it is reasonable and expected that the leaders of the profession will engage in politics. After all, the jurisdiction and future of the AICPA and Big 4 firms is, to a significant extent, decided by the outcome of these political processes. To them, the leaders have an obligation to the rank and file members of the profession to do everything in their power to protect and enhance the profession's chances for success. I don't automatically dismiss these arguments, but I think it is critical that the motivations, actions, and consequences of their participation be revealed and examined.

When the Big 4 firms lobby for a specific client to get a favorable change in the tax law, this change affects everyone – others not represented by the Big 4 firm will pay more taxes, or government services are reduced, or the deficit increases. It is difficult to reconcile how these firms can promote the private interests of their clients, remain independent when auditing that client's financial statements, and be the watchdog for the public interest at the same time.

Equally important, the candidates that the AICPA and Big 4 firms support are involved in the development of every federal law, not just the laws dealing with the public accounting profession. Dwyer and Roberts (2004) studied the characteristics of the federal legislators supported by the public accounting profession in the 1997–1998 election cycle. The AICPA and Big 5 firms were significantly more likely to support legislators who received poor voting record ratings from civil rights, labor, and women's rights organization. Most recently, the firms' campaign contributions appear to lean even more strongly toward conservative politicians. In the 2000 Presidential election, all of the Big 5 firms were listed in the top 20 contributors to the George W. Bush campaign during 1999–2000. And the 2004 election-cycle campaign contributions made by each of the Big 4 firms strongly favored the Republican candidates (Center for Responsive Politics, 2004).

Although economic theories of regulation can be descriptive, it is important to realize that they do not provide a complete picture of the regulatory process. The public accounting profession does not appear to have *captured* the federal regulatory process over accounting and auditing. The general nature of the economy, the staying power of institutional arrangements, shifting political winds, and competing interest groups, such as plaintiff attorneys, consumer advocates, and parochial interests, combine to form a complicated and tenuous setting in which public accounting regulation takes place. The Financial Accounting Standards Board's recent issuance of stock option expensing standards, for example, is fiercely opposed by several members of Congress who traditionally support the activities of the accounting profession. In 2003, the Financial Accounting Foundation reported lobbying activity related to two bills that were introduced before Congress: The Broad-Based Stock Option Plan Transparency Act of 2003 and The Stock Option Accounting Reform Act. And, who was one of the senators who spoke out against expensing stock options? Senator Barbara Boxer, a Democrat from California who usually sides against big business. In her testimony she stated: "We should not let unelected, unaccountable FASB officials dictate policy through a rushed accounting standard" (Congressional Record, 2003). Accounting and auditing are, indeed, involved in the larger political, economic, and social aspects of democratic governance.

In closing, I would like to say that we need to carefully examine how the AICPA's and Big 4 firms' involvement in federal politics squares with their self-proclaimed public interest responsibilities and their willingness to frame policy choices and to provide objective analyses that are used to aid in policymaking. The actions of these organizations obviously privilege some "publics" over others. As opposed to defending the public interest and

providing objective analyses, their actions often reveal partisan allegiances to themselves and to their conservative, corporate patrons. The PCAOB should be judged on its ability to hold the AICPA and the Big 4 firms truly accountable for their stated commitments to independence, objectivity, and the public interest.

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REFORMING AUDITOR INDEPENDENCE: VOICING AND ACTING UPON AUDITORS' CONCERNS AND CRITICISMS

Yves Gendron

ABSTRACT

This paper takes position against the spread of the free-market logic in the domain of accountancy, where free market is often viewed as undeniably benefiting society and users of financial statements. A key moment that paved the way for the growing influence of the free-market logic in accountancy resides in the elimination of institutional ethics rules prohibiting direct and uninvited solicitation of clients, which occurred in the 1970s. Importantly, it was (some would say quite naïvely) assumed that auditors would be able to maintain their independence from auditees in a surrounding climate emphasizing market competition and individualism. However, research indicates that before the collapse of Enron and Arthur Andersen, a number of auditors were significantly concerned about auditor independence being undermined in actual practice. Yet, their concerns were kept largely in the dark. It took the billion-equity collapse of Enron and the powerful imagery related to the shredding of documents by its external auditor Arthur Andersen, as well as the collapse of World-Com a few months afterwards, to bring to light the undermining of auditor

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independence in the public arena and to create a momentum in favour of reforming authoritative regimes of auditor independence, therefore constraining to some extent the influence of the free-market logic in accountancy. My main argument is that these collapses could perhaps have been avoided if auditors' dissenting and negative points of view on auditor independence had been voiced, heard, and appropriately taken into account by accounting organizations and regulatory bodies. Accordingly, it is recommended that channels be established for practising auditors to communicate concerns that emerge from their daily experiences and which cast doubt on the conceptual foundations of financial auditing. Establishing such mechanisms may help to guard against the excesses of the free-market logic; the latter definitely should not reign unchallenged.

> We expect judges to render impartial decisions, based on the law and the evidence. We would doubt the impartiality of a judge paid by one litigant. To preserve judges from improper influences, we guarantee judges independence, including their financial independence. Judges are paid from the public purse, with minimal governmental involvement in the setting of the compensation. Similarly, we expect academic researchers, researchers at public institutions, to render impartial, objective decisions on the evidence, according to the rules of their discipline. Academic impartiality appears threatened if research is funded by a party interested in research results. (Renke, 2000, pp. 32–33)

Independence matters to occupations (notably judges and academics as highlighted above) whose legitimacy depends on occupational members being perceived as carrying out their work in an unbiased way. Financial auditing is no exception. Independence and the related concept of objectivity indeed are generally seen as fundamental to financial auditing practice. An auditor's opinion is deemed credible as long as the auditor is viewed as unbiased toward those who are in charge of preparing corporate financial statements, that is to say top corporate managers.

For several years, though, the logic of the free market – carried out especially through the neo-liberal philosophy – has been significantly influential in North America and elsewhere (Esposito, Aronowitz, Chancer, DiFazio, & Yard, 1998; Gélinas, 2000; St-Onge, 2000), threatening occupational independence with its emphases on unconstrained competitiveness and commercialism. Accountancy has been particularly affected by the spread of the free-market logic. In the 1970s, pressures from US regulatory bodies compelled the American Institute of Certified Public Accountants (AICPA) to eliminate its rules prohibiting direct and uninvited solicitation (Zeff, 2003a). In Canada, accounting bodies swiftly followed by relaxing their advertising restrictions (Simunic & Stein, 1995). It is now generally recognized that these regulatory changes (as well as the broader

socio-political climate of the time) significantly affected practices and behaviors within accounting firms. Commercialism became a significant workplace motivator (Covaleski, Dirsmith, Heian, & Samuel, 1998; Hanlon, 1996; Wyatt, 2004), thereby placing important strains on auditor independence (Kaplan, 1987; Zeff, 2003a, 2003b).

The quote reproduced above is excerpted from a book that questions the impact of increasing commercialistic pressures in Canadian universities (Turk, 2000a). For several years the federal and provincial governments have reduced funding to Canadian universities and encouraged them to rely on private funding to ensure the viability and competitiveness of their activities. The assumption is that subjecting universities to market pressures undeniably benefits society; resources are more efficiently allocated and knowledge production is more likely to find its way to real-life application. Several academics, however, have voiced concerns over the decreasing level of public funding in universities and the ensuing commercialization of research. One of the key issues raised is that private funding threatens the independence of institutions and individual researchers. For example, a number of pharmaceutical corporations have been shown to carry out a series of practices to silence researchers whose laboratory findings threatened the market potential of some drugs. The case of Apotex, which pressured one researcher of the University of Toronto against releasing disturbing results concerning the impact on human health of a drug called ''Deferiprone,'' is well documented (e.g., Olivieri, 2000). Another key issue raised by critics is that private funding results in certain social problems being under-researched as they are of secondary concern to corporate interests, such as child poverty and the spread of infectious diseases in marginalized countries (Turk, 2000b). In short, private funding of research is seen as generating significant costs to society through the undermining of researchers' independence. However, the logic of the free market is so appealing to a significant number of research stakeholders (including politicians, university administrators and even many researchers) that its negative effects largely remain in the shadows.[1]

Similarly, the spread of the free-market logic within accountancy remained to a significant extent unchallenged until year 2002. Although large corporate failures in the past regularly generated some level of concern about auditor independence in policy-making and academic circles (Levitt, 2002; Zeff, 2003a), these concerns did not arouse significant public interest, and did not translate into major reforms at the organizational, institutional or regulatory level.[2] Moreover, concerns that auditors had about the undermining of auditor independence were largely kept in the dark. It took the

billion-equity collapse of Enron and the powerful imagery related to the shredding of documents by its external auditor Arthur Andersen, as well as the collapse of WorldCom (another client of Arthur Andersen) a few months afterwards, to bring to light the undermining of auditor independence in the public arena and to create a momentum in favor of reforming authoritative regimes of auditor independence. In this paper,[3] I argue that these collapses could perhaps have been avoided if auditors' dissenting and negative points of view on auditor independence had been voiced, heard, and appropriately taken into account by accounting organizations and regulatory bodies.[4] Auditors might then have been more inclined to react swiftly to accounting irregularities through an uncompromising attitude toward management, thereby preventing emerging problems from worsening. In short, institutional mechanisms ought to be established for individual auditors to voice their concerns regarding professional matters.

Of course, proponents of the free market will argue that the collapse of Arthur Andersen demonstrates that the market worked efficiently and that there is no need to establish further regulatory mechanisms. That is, market reactions to Arthur Andersen's close involvement with Enron caused the accounting firm's collapse and sent a strong signal to the surviving accounting firms of the significance of maintaining auditor independence. Auditors' claims about independence met the test of reality through market mechanisms. This argument, however, can be criticized on several grounds. First, market players do not have homogeneous capacities. In comparison to institutional investors, who possess extensive resources to assess financial data and keep pace with business literature, individual investors have much more limited capabilities. In this context, regulation is seen as necessary to ensure some level of protection to individual investors. Second, the argument that accounting firms and corporations would have had to incur a huge expenditure if more stringent standards of independence had been enforced appears quite nebulous and abstract in comparison to the billions of dollars that individuals, pension funds and other parties have lost through their investments in corporations such as Enron and WorldCom. Third, a reduction in market regulation translates into higher transaction costs to investors, who have to devote more time and efforts to make decisions in markets characterized by a higher level of distrust among parties (Freidson, 2001). Finally, on a more fundamental basis, commercialism and the aggressive pursuit of profit conflict with professionalism (especially with one's commitment not to subordinate their judgment to that of others) and may undermine it (Freidson, 2001); regulatory action is therefore needed to protect professionalism as long as society sees value in professions.[5]

DOWNPLAYING CONCERNS ABOUT INDEPENDENCE

In the pre-Enron era a number of academics, regulators and policy-makers expressed concerns about auditor independence being threatened by non-audit services provided by accounting firms to auditees. These concerns were fuelled by the collapse of large public corporations and the questioning that they often raised about the quality of the work performed by external auditors. For example, one of the conclusions issued in 1976 by the Metcalf subcommittee was that the Big Eight firms lacked independence from their clients (Zeff, 2003a). In 1978, the Securities and Exchange Commission (SEC) highlighted to the US Congress several issues ensuing from non-audit services provided to auditees (Zeff, 2003a). One may wonder why such concerns did not translate into a substantial reform of auditing independence standards. Literature indicates that several factors played a role in hindering translation.

Accounting organizations were then quite active in ''managing'' allegations of audit failures. For example, the AICPA usually responded to allegations by forming a committee and/or issuing a special report, thereby signaling that it cares about criticisms. However, once a report was issued the AICPA typically ''relaxed'' and refrained from adopting significant reforms until the next crisis emerged (Hendrickson, 1998). Accounting institutes also established mechanisms such as peer review to signal to outsiders that audit quality and auditor independence are monitored in accordance with society's expectations. However, in actual practice it seems that the peer review process was quite lenient among accounting firms (Fogarty, 1996). Accounting firms also sought to reassure stakeholders by stressing that little was wrong within the profession, and that auditing failures constituted atypical cases (Humphrey, Moizer, & Turley, 1992). Further, accountancy's proponents commonly maintained that many of the people taking legal action against audit firms were opportunists trying to recover losses by suing solvent parties, regardless of who was really at fault (e.g., Arthur Andersen & Co. et al., 1992; Estey, 1996). These so-called ''deep-pocket'' and frivolous lawsuits were even discussed in auditing textbooks (e.g., Arens & Loebbecke, 1999), thereby socializing would-be auditors about the appropriateness of extant institutional arrangements concerning auditor independence. Accounting firms also relied on political influence to stifle or mitigate the impact of proposed regulatory changes (Levitt, 2002). Moreover, it is important to note that allegations of audit failure, pre-Enron, did not

arouse much significant interest in the public arena, in contrast to the media attention generated by Arthur Andersen's shredding of documents in the Enron saga.

It was also quite difficult for academics during the pre-Enron period to produce highly convincing evidence about auditors' lack of independence. Statistical evidence on the matter was scarce owing to the lack of publicly available data and difficulties inherent in the operationalization of independence, which is often viewed as an attitude of mind (Humphrey et al., 1992). Field research evidence was also limited, notably because of the difficulties of getting access to firm data (Gendron, 2000). Furthermore, in some cases, pressures were made on academics to prevent them from diffusing disturbing findings about auditor independence (Sikka, Willmott, & Puxty, 1995).

In this regard, the following anecdote provides insights about the way in which accounting organizations formally reacted, around the end of the 1990s, to academic papers that questioned auditor independence. I was then involved with David Cooper and Barbara Townley in a research project where document analysis led us to raise doubts about the independence of the Office of the Auditor General of Alberta, the Province's government auditor (Gendron, Cooper, & Townley, 2001).[6] We found that in the 1990s the Office of the Auditor General of Alberta became a strong advocate of a particular way of managing government (i.e., new public management), which led us to express concerns regarding the threat of self-review. In a meeting that we had with staff of the Office of the Auditor General to discuss a preliminary version of the paper, Office members reacted quite negatively to our conclusions and mentioned being unconvinced by our argument, although one senior Office auditor later highlighted privately that we had "a few good points." It therefore seems that there was some ground for a substantive discussion of the paper. However, rather than using our paper as a way to initiate reflective thinking about the nature of auditor independence, the Office adopted a highly defensive stance.

In short, accounting organizations in the pre-Enron period did not really engage in a reflective examination of the notion of auditor independence. Criticisms addressed by policy makers and academics were typically downplayed in order to protect accountancy's legitimacy. However, as described below, criticisms toward auditor independence developed in the auditor community as well, although individual auditors tended not to voice their concerns.

AUDITORS' CONCERNS ABOUT INDEPENDENCE

In interviews that Roy Suddaby and I carried out in 2000 and 2001 with 15 experienced Canadian Chartered Accountants, we were quite surprised by the extent to which interviewees were doubtful about the notion of auditor independence (Gendron & Suddaby, 2004). The objective of the research project consisted of examining attitudes of Chartered Accountants (CAs) about professionalism and the extent to which they are committed to the profession. Our interviews were with the following CAs: three audit partners from Big Five firms, four partners from non-Big Five firms, three top managers working in the industry, one director of the Canadian Institute of Chartered Accountants and four directors of provincial institutes. More information about the interviews is provided in Table 1. We interviewed a relatively large number of directors of professional institutes given the practical knowledge that they have about issues of professional commitment and changing professionalism. We limited our interviews to CAs occupying high hierarchical functions as these individuals went through and were able to observe significant changes in the accounting profession, such as the emergence of multidisciplinary firms and the commodification of financial auditing. Several steps were taken to increase the reliability of the interviews. In particular, we emphasized at the beginning of the interview that complete anonymity would be provided to interviewees and their respective organizations. We also told participants that they would have the opportunity to subsequently verify the accuracy of their interview transcript and make necessary changes.[7]

Most interviewees discussed at length the notion of independence after having been broadly asked about their point of view about the initiative of the SEC, issued in June 2000, to adopt more rigorous independence standards.[8] For example, one-third of the interviewees mentioned, without being directly prompted, that auditor independence is fundamentally compromised – even when the firm does not earn any non-audit fee from the auditee – as the compensation and status of the partner in charge of the audit engagement are affected when s/he loses an audit engagement and the corresponding audit fee. Interestingly enough, this concern casts doubt on the dilution thesis maintained by large audit firms when emphasizing that they are better able than smaller accounting firms to deal with pressures from large clients (e.g., Ernst & Young, 2002), as the fees generated by any of the firm's largest clients only account for a small proportion of the firm's total revenue. One interviewee (an audit partner from a Big Five firm) elaborated that the source of the problem lies in the way auditors are nominated and

Table 1. Interview Details.

Date of Interview	Interviewee	Occupation
Big Five partners		
November 23, 2000	A	Audit partner of Big Five firm A. Works in the Toronto area. Is in charge of overseeing the firm's professional support process in Canada
November 23, 2000	B	Audit partner of Big Five firm B. Works in the Toronto area. Is on the firm's executive policy committee
November 24, 2000	C	Audit partner of Big Five firm C. Works in the Toronto area. Is in charge of the firm's professional standards in Canada
Non-Big Five partners		
November 3, 2000	D	Audit partner of smaller accounting firm D. Works in the Edmonton area
November 23, 2000	E	Audit partner of smaller accounting firm E. Works in the Toronto area. Is specialized in information systems
November 24, 2000	F	Tax partner of larger accounting firm F. Works in the Toronto area
February 28, 2001	G	Audit partner of smaller accounting firm G. Works in the Edmonton area
Practitioners in industry		
February 12, 2001	H	Had been a smaller firm audit partner, and a larger firm audit manager. Is now top manager of a not-for-profit organization. Works in the Edmonton area
February 19, 2001	I	CEO of a large private corporation. Works in the Edmonton area
February 21, 2001	J	CEO of a medium-size private corporation involved in the information technology industry. Works in the Edmonton area
Directors of professional institutes		
November 24, 2000	K	Senior director of the Canadian Institute of Chartered Accountants
November 24, 2000	L	Director of standards enforcement at provincial institute I
February 5, 2001	M	Executive director of provincial institute II
February 21, 2001	N	Director, professional standards, at provincial institute II
December 17, 2001	O	Senior director of provincial institute III

compensated – although s/he mentioned having little hope in a radical overhaul of the nominating process by government authorities, given the predominance of the free-market logic in North America.

Also, six interviewees mentioned being doubtful of auditors' ability to remain unbiased when they audit processes that their firm previously supported and advocated. For example, one non-Big Five partner, in a provocative way, qualified as "bullshit" the Chinese wall structures adopted by the Big Five to isolate the audit function from the personnel providing non-audit services.[9]

In brief, the interviews indicate that shortly before the collapse of Arthur Andersen, experienced auditors were to a significant extent uncomfortable with the concept of auditor independence.[10] It appears that the social fabric underlying the concept of auditor independence was then significantly weakened and undermined in the professional accounting community. A few consequences of this undermining were found in the interviews, such as the loss of confidence in peers' professionalism and a sense of dissatisfaction with one's professional life. Would it have been relevant for regulators to be aware of auditors' concerns about independence before the collapse of Enron et al.? Would today's confidence in financial auditing be higher if accounting organizations had been more proactive in probing their members and reacting upon their concerns? The fact is, however, that most auditors did not voice their concerns, nor were they actively encouraged to do so by accounting institutes and accounting firms.

For example, the vast majority of individual accountants in public practice did not bring up concerns about auditor independence during public hearings held in September 2000 by the SEC on a regulatory proposal that would have made it more difficult for large accounting firms to provide several types of non-audit services to auditees (Suddaby & Greenwood, 2005). We now know that Arthur Andersen's audit managers were virtually petrified at the idea of expressing a point of view that could upset audit partners in the firm (Toffler & Reingold, 2003). Even in the post-Enron period, auditors do not tend to voice substantive concerns about independence, as suggested by my preliminary reading of several of the comment letters sent in 2002 to the Canadian Institute of Chartered Accountants on a proposal to modify the profession's independence standards. The following paragraph, which is excerpted from one of these letters, illustrates this point:

> We at Grant Thornton value our integrity and are committed to high ethical standards, including robust independence standards. We have adopted the International Federation of Accountants' (IFAC's) Code of Ethics, are committed to early adoption of the new Canadian independence standards, and support the Canadian Public Accountability

> Board. In our opinion, the proposed new independence standards will strengthen the independence of auditors and others providing assurance services, and will more clearly distinguish areas of management responsibility, while enabling us to continue adding value to our clients and contributing to high quality financial reporting. (Grant Thornton, 2002)

Specific concerns about the process by which auditors are nominated or about self-review threats are conspicuously absent from this paragraph (as well as from the remaining part of Grant Thornton's letter). Moreover, as Grant Thornton emphasizes in its comments, the significance of "adding value" to their "clients" takes on particular importance, post-Enron, given the nature of the criticisms in the public domain concerning the close links that developed between Arthur Andersen and several of its audit clients.[11]

REFORMING INSTITUTIONAL MECHANISMS?

Large accounting firms have been shown to be quite effective at socializing their members, that is to say at instilling ways of reasoning in auditors' frames of reference and at shaping their identity (Anderson-Gough, Grey, & Robson, 1998; Gendron, 2002). To my knowledge, research did not find significant evidence that socialization processes within audit firms encourage auditors to voice concerns with regard to the way in which independence is dealt with in actual practice. On the contrary, in the 1990s accounting firms promoted mental models that were focused on the provision of a wide range of services to audit clients; professionalism was not a key concern in these models (Bailey, 1995). Further, information published subsequently to the collapse of Arthur Andersen indicates that the firm expected employees to strictly follow its leaders; deviation from the norm and the voicing of dissent were not encouraged (Toffler & Reingold, 2003).

Similarly, would-be auditors, during their university education, are commonly not encouraged to criticize institutional mechanisms and to voice concerns.[12] Accounting education typically provides students with a superficial, uncritical attitude toward accountancy and the functions it performs in society (McPhail, 2001). Further, undergraduate business programs (in North America) attribute only a very minor importance to courses in liberal arts (Neimark, 1996). As a result of all this, most professional accountants are not prepared to deal with situations in which they are uncomfortable about auditor independence. Moreover, individual auditors to a large extent cannot currently rely on facilitating mechanisms at the professional institute level to voice their concerns.[13]

In summary, although a number of experienced auditors were quite doubtful and insecure about the notion of auditor independence in the years that preceded the collapse of Enron and Arthur Andersen, they did not voice their concerns, nor did they seek to sustain institutional change. This is not specific to accountancy, though. Like most modern institutions, professions in general basically seek to exclude from their members' lives fundamental issues that cast doubt on the legitimacy of their system of expertise (Giddens, 1991). In retrospect, however, it can be argued that the collapses of Enron and Arthur Andersen might have been prevented if auditors' concerns had been voiced and taken appropriately into account by accounting firms, professional institutes and/or regulators. It is therefore reasonable to suggest that channels ought to be established for practicing auditors to communicate concerns that emerge from their daily experiences and which cast doubt on the conceptual foundations of financial auditing, and adopt mechanisms to examine these concerns and formulate, if need be, proposals for institutional change (Gendron & Suddaby, 2004). Although suspicious and dissenting voices may be costly to deal with in the short term, the provision of conduits for members' concerns and the adoption of a process to examine them might translate into professions having standards that fit society's expectations. Sensitive issues that have been either downplayed or stifled in the past will hopefully come to light and be carefully considered, such as a direct involvement of government or securities commissions in nominating and remunerating audit firms. Whether channels should be developed within the umbrella of accounting firms, professional institutes, regulatory bodies, or some combination of these organizations is an open question, though. Given the significant degree of influence that accounting firms have on individual auditors, it seems reasonable to suggest that, to some extent, accounting firms need to be involved in the process. However, depending on the level to which firms are deemed trustworthy, their involvement should be more or less closely monitored by institutional or regulatory authorities.

Academics may have a significant role to play in making accounting organizations and/or regulatory authorities aware of individual auditors' concerns. In spite of never-ending reproaches regarding the applicability of research findings and the degree of sophistication that is needed to read research papers (Bell & Wright, 1995), academic research is generally well regarded in North America and significantly involved in the production of legitimate evidence (Preston, Cooper, Scarbrough, & Chilton, 1995). Therefore, it might be easier for individual auditors to verbalize concerns regarding professional matters in front of an academic researcher (especially when

explicit guarantees concerning anonymity are provided) than when they face a representative from a formal authority. Accounting organizations and/or regulators should, therefore, give some thought to the use of academic research as a way of channeling concerns of individual auditors.[14]

Accounting academics (especially in North American settings) should also modify the teaching of accounting as a way of developing would-be auditors' abilities to reflect on the appropriateness of the conceptual foundations of financial auditing, and as a way of making them comfortable at voicing the outcome of their reflections. In a report issued by the American Accounting Association, Albrecht and Sack (2000) maintain that the teaching of accounting and auditing at the undergraduate level is often reliant on technical textbooks and lectures. Would accounting students benefit in the long run from being required to read and write an essay based on Toffler and Reingold's (2003) book, which describes the cultural shift that took place at Arthur Andersen in the 1990s? Should business students in general be required to follow undergraduate courses in critical theory, which aims to make visible covert and questionable assumptions that characterize current institutional arrangements?

In conclusion, the problems experienced by accountancy following the collapse of Enron and Arthur Andersen constitute a meaningful reminder about the negative impact that the spread of the free-market logic may generate in fields of work where workers' independence and objectivity are deemed important. Establishing mechanisms to bring to light concerns that emerge from the daily experience of members of a given profession may help guard against the excesses of the free-market logic. The latter should not reign unchallenged.

NOTES

1. It is worth noting that economics academics are, generally, key allies of the free-market logic (Gélinas, 2000). For example, Milton Freidman of the University of Chicago has been particularly influential in participating in the construction of the neo-liberal ideology. The influence of neo-liberal economics extends to other academic disciplines. For example, a large number of North American doctoral students of accounting are exposed thoroughly to "Chicago economics" during their graduate studies, and are socialized not to question its underlying assumptions (Panozzo, 1997).

2. Of course, over the years, institutes and regulators tinkered with regulation and policies – but largely refrained from engaging in substantive reforms of the authoritative regime of auditor independence.

3. As should already be obvious to the reader, this essay is predicated on a North American perspective. Events, experiences and interpretations that are taken into

account in constructing the argument are therefore not necessarily representative of events, experiences and interpretations pertaining to other geographical areas.

4. In this essay, independence (and the related concept of objectivity) is conceived of as an ideal type – specifically as an ideal state of mind that can never be fully reached in actual practice, but which nonetheless can be influenced to some extent through regulation, firm policies and education. My conception of auditor independence significantly differs from that developed by Bazerman, Morgan, and Loewenstein (1997), who maintain that individual auditors are unconsciously and psychologically biased in favor of corporate management – hence their thesis regarding the "impossibility of auditor independence". Their thesis, however, can be debated on the ground that although it may be difficult for an auditor to be aware of her/his own biases, s/he is able through reflective acts to assess the behavior of peers and colleagues within the firm (Schutz, 1967). Indeed in Gendron and Suddaby's (2004) study, interviewees often referred to the behavior of peers when discussing concerns about auditor independence. Bazerman et al.'s (1997) focus on the individual auditor should be re-considered, especially since the multi-person character of the audit environment is well established in auditing literature (e.g., Solomon, 1987).

5. To make it clearer, my plea for strengthening the regulation of independence applies to fields of work other than financial auditing, such as financial analysis, university teaching and research, and medicine.

6. Although some might consider this anecdote inappropriate given that it relates to government auditing, there are more and more indications in literature that boundaries between the public and private sectors are becoming blurred in a number of jurisdictions across the world (e.g., Hood, 1995). Boundaries between government auditing and private sector auditing are no exception, which is precisely one of the points argued in Gendron et al. (2001).

7. Only minor modifications resulted from interviewees' revision of their transcript.

8. In this respect, our findings differ from those of Humphrey and Moizer (1990), whose interviews indicated that auditors were generally adamant that they could unproblematically maintain their independence from audit "clients" in spite of their increasing provision of non-audit services.

9. For more detail about interviewees' concerns regarding auditor independence, see Gendron and Suddaby (2004).

10. Although the interviews were carried out with Chartered Accountants in Canada, they are likely to be significantly reflective of auditors' mindset in other countries, given the type of concerns sometimes expressed, for example, by US and UK accounting practitioners (e.g., towards the commercialization of accountancy) in auditing literature (e.g., Covaleski et al., 1998; Grey, 1998; Zeff, 2003b).

11. At the time of writing, two partners of Grant Thornton in Italy are suspected of having collaborated with other parties in falsifying the accounts of a subsidiary of Parmalat (Le Devoir, 2003).

12. Again, recall that this essay is predicated on a North American perspective. As pointed out by one of the reviewers, the teaching of accounting at the undergraduate level in a number of institutions in Europe aims "to challenge students and to break down stereotypical views of accounting".

13. It needs to be recognized, though, that auditors' codes of ethics commonly specify that an auditor should promptly report to her/his institute any information

concerning a breach of professional conduct by another member (e.g., ICAA, 2003). However, this requirement is not emphasized in codes of ethics, nor do professional institutes stress it when communicating with members. Information obtained from the disciplinary area of the Institute of Chartered Accountants of Alberta indicates that up to now there have been "few complaints from CAs" against other CAs.

14. Given the relatively low number of accounting academics in North America accustomed to field research and interview techniques (Gendron & Bédard, 2001), academics involved in a variety of disciplines, such as sociology and organizational analysis, should be involved. As a result, a broader range of viewpoints and perspectives would be brought to bear on the notion of auditor independence, thereby possibly translating into a better understanding of individuals' experiences and of the way in which their sense of independence is influenced by organizational, institutional and regulatory mechanisms.

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THE CHANGING NATURE OF ACCOUNTING VIRTUES

Jeff Everett and Duncan Green

ABSTRACT

This paper looks at changes in the manner in which the accounting profession speaks about itself. Specifically, it considers Canadian and American research that has examined how the profession's internal and external ethical discourses have emerged, survived, and declined over time. The functions that ethical discourses serve are briefly reviewed, and the changes observed in these discourses are contextualized in light of a number of social, cultural, political, and economic factors.

Good accounting practice demands integrity, independence, skill, and character. These are desirable qualities, part of the foundation that underpins truly professional behavior. But what exactly are these things? And to what extent are the meanings of these terms the same to different accountants, across different periods of time or in different places? It is just these questions that have motivated researchers to reflect upon accounting's ethical ideals – its 'virtues' – and how these have changed over time. What this research finds is rather surprising: some of the ethical ideals that are important to today's accountants appear not to have been so important to earlier accountants, most notably the notion of independence (see also

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Young, this issue). In fact, this often-mentioned notion seems to have barely existed on the moral compass of early accountants. Other ethical notions, meanwhile, were on that compass, yet many of these are hardly mentioned today. Such notions as duty, service, and calling, for example, figure much less prominently in the moral lexicon of today's accounting practitioner.

In this paper, we consider how the accounting profession speaks about its ethical ideals. We examine recent Canadian (Everett, Green, & Neu, 2005; Neu, Friesen, & Everett, 2003) and American (Preston, Cooper, Scarbrough, & Chilton, 1995, also Baker, this issue) research to show how these 'ethical discourses' emerge, survive, and sometimes decline. We consider two types of discourses, those intended primarily for accountants, namely, editorials in the profession's magazines, and those intended for a somewhat wider audience, namely, the codes of conduct promulgated by the profession. We look at these discourses in order to better understand how the profession's conception of itself, of what constitutes the ethical accountant, has changed over time. We further attempt to contextualize these changes in light of a number of social, cultural, economic, and political factors. Finally, we consider some implications for accounting practice that arise out of these "how" and "why" questions. One of these concerns the way practitioners so often refer to the term independence as if the term were clearly and universally understood. But before moving on to our analyses and these suggestions, it is worth first considering the various functions that ethical discourses serve.

THE FUNCTIONS OF ETHICAL DISCOURSES

Ethical discourses are thought to fulfill control, legitimation, and cohesive functions. On the one hand, ethical discourses help professional associations exert influence over the behaviors of their members (Larson, 1977). Through the enforcement of codes of practice, ethical discourses help the profession control the activities of its members. But control also occurs simply through moral exhortations to be, for example, 'independent in both appearance and fact', or through appeals to 'act with integrity'. Indeed, this is the function most people would associate with such discourses. However, the control function does have its limits, especially if behaviors are deeply ingrained or induced by the very system within which they occur.

Nonetheless, when undesirable behaviors are structurally embedded, and ethical discourses are not working to control dysfunctional or undesirable behaviors, ethical discourses may still be serving another important

function. Whether in the form of association-sanctioned ethical codes or casual pronouncements on the behavior of the profession's members, ethical discourses also serve to demonstrate to the non-accountant that accountants are morally responsible, even morally superior, social actors (Kieser, 1989; Klegon, 1978). A sense of moral competence and moral conduct (Gaa, 1994, p. 13) allows outside parties to believe that any monopoly privileges granted to the profession are indeed justified (Abbott, 1988, p. 20). In short, discussions that invoke the issue of morality make the profession look good in the eyes of the public.

Yet, ethical discourses serve at least one more function, and this is to provide a rationale to group members that there is a benefit to be derived from belonging to that particular group (Abbott, 1983, p. 862). In the case of the accounting profession, ethical discourses provide a cohesive function; they let association members know that the association can differentiate between right and wrong, and this helps establish common ground for the association's individual members. This cohesive function is increasingly important as accounting associations grow in size and diversity, which is the case today, or where tensions might be pulling an association's membership in different directions, which certainly occurs from time to time.

However, whether they are used to serve control, legitimation, or cohesive purposes, none of this is to say that ethical discourses are necessarily deployed in a calculative or rational manner. In fact, given the often self-referential and vague manner in which such ethical notions as character, integrity, or independence are used, it seems that they are needed as much "to give order to a chaotic array of actions arising out of the pragmatic problems facing society" (Richardson, 1987, p. 347) as they are to achieve some carefully considered and thought-out end. This loose and almost unconscious 'giving of order' suggests that moral pronouncements, ethical debates, and even professional codes of conduct all have broader, social, cultural, economic, and political dimensions, and it is in considering these dimensions that one begins to better understand why ethical discourses have changed over time. We turn now to examine these changes.

OF IMAGES AND APPEARANCES: A SOCIAL DIMENSION

In examining both the internal and external ethical discourses of the Canadian Chartered Accounting (CA) profession over the last century (Everett et al., 2005; Neu et al., 2003; Neu & Wright, 1992), it becomes apparent that the

concern, even obsession, over the ethical stature of the accounting profession vis à vis other professions is a relatively recent one. Yet, so too is the recognition that it may be impossible for an accountant to *appear* to be independent. This emerging preoccupation with image is evident in a number of editorials found in Canada's main professional periodical, *CA Magazine*.[1,2] For example, we hear in this editorial from 1962:

> It is important to strive to create, not merely the appearance of independence, but the idea that true independence is a personal matter which can be upheld wholly by the attitude of the individual member.

And we hear in this one from 1968:

> The essence of the problem of independence and conflict of interest is that independence cannot be defined. It is a state of mind and a matter of the professional integrity of the auditor. The problem is further complicated by the accepted standard that the auditor must not only be independent but appear to be independent. Without appearing independent the auditor cannot expect the full confidence of the investing public and the financial community.

In the earlier part of the century, the notion of independence existed exclusive of any concern over the difference between appearance and fact, or form and substance. It was sufficient for an accountant simply to be moral in character, not to have to appear to be so. Thus we hear, in the very first mention of independence in these editorials in 1923, "Of course provisions of this sort do not encourage the hope that the auditor will be independent." Again, it was the being rather than the appearing that was most important in the early part of the century.

To understand why this change occurred, it is necessary to consider how the social context itself changed over the period. In doing so, it is possible to see the growing concern with the appearance, representation, and image of the professional accountant as a response to society's growing awareness of the centrality of accounting in the affairs of commerce, particularly in the affairs of commercial ventures that failed. This awareness could have been borne alone of the exposure that failing firms increasingly receive, Enron and the attention it has garnered being a particularly apt case. But it probably has as much to do with the increasing financial interests that members of the public began to have on account of their investments in pension funds and, to a lesser extent, employee stock options and stock participation schemes. This is to say that sometime in the middle of the last century, society-at-large began to actually notice accountants and the important role they played in corporate activities– and corporate failures (Abbott, 1988, p. 325, see also Roberts, this issue). The profession responded to this growing awareness of

the role of accounting by concerning itself with the public's perception of accounting, the profession's appearance and image, and the possibility that what the public expected of accounting was not what accountants themselves expected – a purported digression which came to be known as the 'expectations gap'.

THE SECULARIZATION OF ETHICAL DISCOURSES: A CULTURAL DIMENSION

Ethical discourses in the beginning of the last century, at least those found in the profession's magazines, were unapologetically religious, and particularly Judeo-Christian, in nature. On the one hand, accountants were clearly of the mind that one practices accounting not as a 'career', as one might see it today, but rather in response to a 'calling', a divine appointment by none other than God himself. This reliance on the idea of one's calling is evident in, for example, this 1922 editorial:

> There is no more important work I know of than that entrusted to the men of your calling, demanding as it does not only the highest integrity and ability of no mean order, but an honest conception of the responsibilities which it entails.

The purpose of one's calling was to serve the public, and one was expected to subordinate one's own interests in the act of service, as this 1919 editorial suggests:

> As we grow older, the truth that there is nothing worth living for except service and the conscious rectitude that a life of service gives forces itself upon us. Personal successes, unless they bring good to others, lose their interest and cease to gratify.

Moreover, and particularly characteristic of the 'Protestant work ethic', such service demanded discipline and a moral commitment to hard work. Hard work relieved the anxiety of not knowing if one was one of God's 'elect', one of the few pre-destined and pre-selected for heaven. The profession's ethical discourses resonated with this religious zeitgeist, as evident in this comment from 1915:

> Suppose we were to consider each of the 300 working days yet before us as a page in a book, and suppose we made it a point each morning to resolve that the page represented by that day should contain at least one entry to which we could turn back mentally with the feeling that it represented something worthwhile accomplished…

The accountant "qua Christian" truly had a cultural concern with striving, as an end in and of itself. Whether there was great economic success

attendant with this striving was beside the point, or, perhaps more accurately, was conveniently ignored, as success was seen as:

> … unhealthy and unwholesome. Man was not created to be prosperous in the permanent and established sense of the word. He was created to strive toward prosperity. Striving and fitness are synonymous terms. (1925)

While the idea of hard-work-as-virtue seems to have survived and followed the profession into the current century, the religious connotations inherent in the ethical discourses of service and calling diminished noticeably, at least in the main arenas of professional communication. This may have to do again with changes in the greater social context, one of which concerned the increasing size and diversity of the Canadian population. In keeping with the increasing number of Canadians, the profession grew at a rate that was nothing less than explosive: there were 255 CAs in 1910, 2,728 in 1945, 13,555 in 1965, and then 58,544 in 1995 (*DACA/CICA Yearbooks*). In keeping with both the widening geographic distribution and increasing diversity of its people, the profession's geographic and ascriptive character also changed; no longer were members of the profession being drawn as previously from an homogenous, male, Caucasian, and Judeo-Christian population (Creighton, 1984).

It was to this larger, less centralized and more mosaic profession that ethical discourses were being issued, and the Judeo-Christian-based ethical notions that were once so important no longer resonated with the profession's membership to the extent they once did. This is not to say that Judeo-Christian sentiments have entirely disappeared, however, or that the profession is now highly diverse. Indeed, religious undertones still permeate the profession's activities –one can point to the prayer session that began a recent Chartered Accountants of Alberta luncheon for evidence of this, and women, moreover, still represent only 13 percent of partners in practice (Flynn, Leeth, & Levy, 1997).

THE CODIFICATION OF ETHICS AND THE ACCOUNTANT'S DUAL IDENTITY: AN ECONOMIC DIMENSION

That the profession was becoming larger, more widespread, and more diverse also helps explain another change in the ethical discourses of accountants over time: the increasing codification of these discourses, their transmutation into an almost scientific set of rules or prescriptions that could be transported across borders and that would appear to work for all,

regardless of race, creed, or color. This change has been well-documented by Preston et al. (1995). They showed how ethical discourses in the United States, at least those not intended strictly for internal consumption, have became more programmatic over the last century. Generalizable language, rules, and law-like ethical concepts have come to take precedence over appeals to specificities or more contextually based ideas. Such ideas, inherent in all religious discourses, including that of Judeo-Christians, may resonate well with the group's members, but they may not necessarily travel well.

The globalization of accounting motivates this move towards ethical 'laws' (Francis, 1990, p. 13), for globalization is not simply about the harmonization of accounting and auditing standards, but also the harmonization of ethical standards. (The same could be said, incidentally, in respect of principles, both accounting and moral. These rules or laws at one remove are also being exported globally: accounting principles (such as 'conservatism', 'lower of cost and market', etc.) are being pushed – by politicians, business leaders, and academics alike – as forcefully around the world as are a number of moral principles (such as 'utility maximization', the 'right' to own property, and so on.) Moreover, efforts are well under way to establish a global foundation for both accounting standards and moral standards, these efforts having produced both global accounting bodies (e.g., The International Accounting Standards Board) and global morality frameworks (cf., Kipnis & Meyers, 1987; Maxwell, 1998).

Yet, the universalization or 'disembodiment' of ethical discourses, the divorcing of prescriptions from the people and contexts in which they were to be applied, is not complete: while ethical discourses intended for the non-accounting public have become more rule-based and law-like, those intended for consumption within the profession still rely on notions of attitude, character, and other more 'personal' or embodied ideals. Consider this fairly recent editorial from 1985, wherein we can see the tension between the external and the internal, the rule-based and the character-based:

> As the Adams Report…pointed out so well, there are two aspects to independence – substance and appearance – and only the latter can be susceptible to rule-making. "The substance of independence," said the report, "is the attitude of mind termed objectivity. [This attitude] is developed and preserved by personal qualities such as professionalism, integrity and strength of character and cannot be achieved by rules or legislation."

More typically, one sees ethical discourses alternating between a reliance on character-based and rule-based notions in separate editorials, such as we see here:

> … it is far more important for us to realize that professional conduct rules can't make us independent any more than they can make us professionals. That's something that can truly exist only in our own mind. (1985)

> While every professional's code is designed to achieve orderly conduct among its members, its paramount purpose – without exception – is to protect the public. It does so by stipulating rules to ensure those who practice are competent, objective people of integrity... (1986)

This tension between virtues and laws, between the embodied-local and the decontextualized-global, is similar to another tension found in the profession's internal discourses. That concerns the accountant's 'two masters', the public and the self. This need to serve both is evident in these quotes from 1987 and then 1991:

> ... others, critical of our stature, have suggested that our profession is more concerned with self-service than public service – that we're in this profession for the money we can make advising affluent clients how to make more of their own, and keep more of it from the tax department. Those critics need reminding that much of our service carries no price tag.

> There can be no doubt that CA firms today require solid and sound business practices. But those qualities must support our professional activities – not be an end in themselves. We have won the recognition we enjoy today by putting professional activities first, and receiving any rewards as a consequence of quality and service.

That this tension between the public interest and the self interest has intensified should come as no surprise, as the commercialization of accounting, especially in respect of the industry's economic globalization, has become particularly acute in the last few decades (Hanlon, 1994). As has been noted, accounting is now a major, global industry (Preston et al., 1995, p. 522), one in which the combined income of the top firms rose from £347 million in 1982 to around £2,800 million in 1995 (Willmott & Sikka, 1997, p. 831). In such an industry, competition is of paramount importance, and concerns for some vague notion of the public interest come second, the assumption being perhaps that the public interest is automatically served by the beneficent but invisible hand of that other vague notion, the market. One wonders if it is even accurate to describe the public-interest/self-interest debate as a tension, or perhaps a reversal (Gendron & Suddaby, 2004), one that is leading accountants toward a new commercial identity focused on the 'maximization of utility' and 'minimization of risk'.

THE DEMONSTRATION OF INDEPENDENCE: A POLITICAL DIMENSION

As we pointed out at the beginning of the paper, the idea that accountants somehow need to be independent never figured regularly on the moral compass of early accountants. The notion did receive mention – in 1886, for

instance, Ernest Cooper spoke of independence as an 'essential qualification of an auditor' –but it did not seem to be one of accounting's key virtues. This is similarly the case with the notion of objectivity; it too has only recently become a part of the main suite of ethical ideals.

What is interesting besides the emergence of the notion of independence is that independence tended to be mentioned as much in the context of professional independence (the independence of the *profession*) as individual independence (the independence of the individual *accountant*). This is to say that it was seen to be just as important for the professional body to maintain its independence as it was for any given individual to maintain her or his independence, as this editorial demonstrates:

> Great stress is laid by the profession on the independence of its members. Our codes of ethics are the evolution of many particular incidents which have resulted in the drafting of rules ... which will impress on all those with whom they come into contact the accountant's independence, integrity and sincerity. (1947)

The idea of professional independence was to receive very little attention later. Indeed, in the wake of the failure of the Canadian Commercial Bank in 1985 the auditors involved claimed they were not culpable on account of the lack of sufficient bank reporting standards available for guidance – the profession was now comfortable saying it was dependent on another party. At least for these auditors, this was a complete turnaround from the profession's position in 1923 after the collapse of another major financial institution, the Home Bank of Montreal.

We have already pointed out that following the emergence of the notion of independence there emerged the idea that independence could come in both forms: independence in appearance and independence in fact. What was also occurring was the slow naturalization or sedimentation of the idea of independence, the belief that independence had somehow always been integral to the profession. These quotes illustrate the myth-making in respect of independence that occurred over the last century:

> ... independence is the indispensable attribute of the public accountant and the foundation of professional accounting practice. (1941)

> ... independence is the all-important criterion of the trusted public accountant. (1951)

> One basic ethical principle which is peculiar to the public accounting profession is the concept of independence. This concept was one of the most important factors in the development of our profession, and nothing would be more damaging to the status of the profession than a deterioration in the practical application of this concept. (1962)

> The magic solutions to our current challenges are simply the characteristics and attributes that have already made us an effective, powerful, well-respected profession.

> There are four of them and they're familiar to all of us: integrity, objectivity, independence and cooperation. Our reputation and effectiveness have been built on all four; if we lose any of them, we lose all. (1987)

To suggest that members of the accounting profession engage in myth-making activities is neither to imply that myth-making is a bad thing, nor that the profession's spokespersons conspire to obfuscate its true origins. Myth-making is a necessary means of identity formation for all groups, and it tends to be conducted in an uncalculating, even unconscious, manner. Indeed, examples of the taken-for-granted reproduction of the 'myths of origin' of accounting's ethical discourses are easy to find, and the manner in which they tend to be used in an uncalculating, even logically inconsistent, manner is similarly evident. Consider the taken-for-granted and self-referential way that independence and objectivity are used in this editorial:

> … there are two aspects to independence, substance and appearance, and only the latter can be susceptible to rule making. "The substance of independence," said the [Adams] report, "is the attitude of mind termed 'objectivity'." That attitude is developed and preserved by personal qualities such as professionalism, integrity and strength of character … (1985)

In this passage, objectivity is used to define independence, while integrity, a no less vague term, is used to define objectivity. All of these discourses come to be defined by their linkages, which results in the creation of an ethical mélange. To be sure, it would be hard to argue, given this 'definition-by-linkages', that ethical discourses are clearly understood, well thought-out, or carefully rationalized.

It would be possible to attribute the emergence and gaining importance of the notion of independence to some real and pragmatic need, the idea that independence is *the* virtue among all accounting virtues needed at this period of time to right many of the ills facing the profession. However, the changing manner in which this term is used, its lack of real meaning or 'hardness', tends to belie such an explanation. Our own thinking is that independence is simply another distillation of some character-based, and implied, moral standard, one that seems to endure through time. It is used, like the terms integrity, duty, and so on, not because it so perfectly describes some real moral referent, but because it is yet another means of signaling to the public that accountants indeed have a genuine, even noble, commitment to the profession's ethics (Abbott, 1983, p. 185). But why, though, has the particular term independence gained so much favor?

Again, one needs to contextualize the change, and we think that in the case of the growing popularity of the idea of independence that contextualization concerns a number of societal-level transformations that are currently under way. One of these pertains to the globalization and increasing

commercialization of the accounting industry, a phenomenon that breeds both conformity through a slavish devotion to cost minimization, profit maximization, and growth, and a need to buffer oneself ethically, as it is the credo that 'business should only be in the business of business'. The notion of independence then is increasingly important owing to the manner in which discourses of autonomy (i.e., independence) help fuel resistance toward conformity, a phenomenon that Covaleski, Dirsmith, Heian, and Samuel (1998) have observed in the context of the major accounting firms. Once one feels insurmountable pressures being placed upon oneself, the natural tendency is to want to be free, to be independent. Yet, independence is also increasingly important because it implies a degree of security against scrutiny; its use may reflect a tacit attempt to create a barrier between the two fields in which accountants increasingly find themselves: the cultural field, wherein the accountant produces with an eye to the public good, and the economic field, wherein the accountant produces with an eye to that necessary yet dirty object of naked possession, money.

Yet, there is another reason we think, and this reflects the political zeitgeist of the day, the increasing predominance of what is sometimes referred to as neoliberalism. Contemporary liberal democracies can no longer be characterized by welfarism, the idea that government is to enframe society within mechanisms of security, whether these mechanisms be conceived as economic or social (Dean, 1999, p. 150). Rather, the purposes of government are increasingly being seen in terms of the promotion of freedom and the free conduct of individuals. As a consequence, the emphasis has been placed on the rights and liberties of individuals, and ensuring that government does not govern 'too much' (*ibid.*, p. 164). In so doing, a world of autonomous individuals and free subjects is created. In this neoliberal political climate (Gendron, this issue) the self-actualized, self-determining, and self-managing individual is valorized, and the dependent subject, whether viewed in an economic, socio-legal, political, or moral-psychological register, is stigmatized. Aid to the homeless person, the drug addict, or the single mother, for this reason, is aimed at helping these people 'help themselves', at breaking these people's 'dependencies', rather than at providing them with 'hand-outs'. The goal is to see not just these individuals, but all individuals, become truly self-managing, that is, independent.

While there are numerous factors behind the emergence and growing popularity of the ethical notion of independence, we are suggesting that it has become popular in part simply because it resonates with this idea (or ideal) of the free and autonomous individual. Just as the 'calling' resonated so well with the Judeo-Christian professional in the early part of the last century, so 'independence' resonates now with today's professional. And whether that

independence is couched in terms of the profession, the individual, fact, or appearance, the term garners a certain amount of symbolic capital; it is a means of establishing in the eyes of others that, again, accountants have a genuine, even noble, commitment to the profession's ethics (Abbott, 1983, p. 185).

SUMMARY

In this paper, we considered the manner in which the ethical discourses of the accounting profession – its moral virtues – have changed over time. Relying on research in the Canadian and American contexts, we discussed how some notions, such as independence and objectivity, emerged, while others, such as duty, service, and calling, declined. We also suggested that while the discourse of the profession has become increasingly codified and 'scientized' in its external communications – i.e., there has been a move toward a more rules-based or law-like ethical discourse – the discourse has remained more or less character-based, personal, and 'embodied' in its internal communications.

Having reviewed these changes, we also speculated as to why they have occurred. Culturally, there was an increasing secularization of the profession, and this forced the profession to decrease its reliance on more religious, Judeo-Christian notions. Socially, the general public became increasingly aware of the importance of accounting, and this forced the profession to grapple with the idea of the profession's image, and how this may or may not conform to any underlying reality. Economically, accounting followed the trend toward 'globalization', with the result that it became more commercialized, and subsequently more concerned with the self-interest. It concerned itself less with its antinomy, the public interest, with the result that the profession began to speak of, and rationalize, its dual identity. Finally, along with the shift that is occurring in advanced liberal democracies toward freedom and away from security, the accounting profession has had to demonstrate that its members are self-managing, that is, independent individuals, agents capable of breaking any chains of dependence, whenever and wherever these might be formed.

What then are the implications for practice of our analyses? An examination of the changing nature of accounting virtues throws into question the use and meaning of such terms as independence, integrity, character, and so on. It compels us to wonder which, if any, purposes are being served when references are made to these notions. As we said, there are different purposes of ethical discourses, such as to control members of the profession, legitimate the profession in the eyes of the public, and help provide common ground for members of the profession. Further, because moral suasion only works if behaviors are

not deeply ingrained or structurally conditioned, the profession needs to recognize the limitations of trying to control its membership by imploring members to 'act with integrity' or 'independence'. More troubling, such a consideration asks us to reflect on whether these notions are being used consciously and strategically, or if they are being relied upon only because they help "give order to a chaotic array of actions" (Richardson, 1987, p. 347).

In considering the changing nature of accounting virtues, we are also forced to wonder whether accountants are speaking of the same thing when they use these terms. Are the profession's spokespersons invoking some timeless moral referent when they refer to something such as 'character', or do they really have something more specific in mind? That is, are they speaking about some abstract universal ideal, or are they speaking about something that is more time- and place-specific? As Kosmala-MacLullich (this issue) shows in the case of independence, just because a term is popular does not mean that it has a universally agreed-upon definition. It is a consequence of the great amount of ambiguity surrounding the term that the profession needs to be explicit about what it means by such notions as 'independence', 'integrity', or even 'competence' (see Gaa, this issue). It further needs to be explicit about whether it thinks these terms can even mean one particular thing to such a geographically and ascriptively diverse membership.

These are the sorts of questions and issues that members of the profession need to confront and discuss among themselves. We think that, by and large, members of the profession do care about ethics, that they see 'good practice' as conforming to moral principles, and that they believe, if only implicitly, in the idea of virtues. But with the trend toward increasing commercialization and the need for individuals to become more 'entrepreneurial', and with a more vigilant and skeptical public watching over it, the profession needs to better understand its ethics. A first step would be for the profession to examine the way it has spoken of and currently speaks about itself, to see that its ethical discourses are often self-referential, part of a myth of origin, and, curiously, increasingly concerned with image rather than substance. It is only through such self-knowledge that the profession's members can maintain a genuine, even noble, commitment to what is called 'the profession's ethics'.

NOTES

1. This was *Canadian Chartered Accountant* prior to 1973.
2. We made the assumption in reviewing this periodical that the views of editors and editorialists were largely representative of the views of the profession's members.

Our logic was that had these individuals not acted as spokespersons for the profession, they would not have been given the opportunity to speak in the first place.

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ON THE (IM)POSSIBILITY OF AUDITOR INDEPENDENCE: INSIGHTS FROM CENTRAL AND EASTERN EUROPE

Katarzyna Kosmala and Pat Sucher

ABSTRACT

We suggest that a notion of auditor independence, constructed in Anglo-American epistemology and practice, is a social construct that has different meanings in different historical, socio-cultural and economic milieus. We have researched how this idea of auditor independence, incorporated locally from the International Federation of Accountants (IFAC) Code, is perceived and has been implemented in three countries of the Central and Eastern European (CEE) region: Poland, the Czech Republic and Russia. With a view to seeking a comprehensive understanding of what is happening in transition economies, all aspects of auditor independence – from basic educational provision for an auditor, to complex aspects such as the provision of non-audit services – were considered. From all these aspects of independence, a framework of the requirements for independence was developed. As a result of this research, we question whether the usual international definitions of auditor independence, as laid out in the IFAC Code, with their separation into mind and appearance, are at all realisable.

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INTRODUCTION

In the last four years we have been researching how auditor independence has been developing in three countries of the CEC region: Czech Republic, Poland and Russia. Though only the Czech Republic and Poland are now part of the European Union (EU), all three countries were exposed to Communism for over 40 years in the second half of the 20th century.[1]

Much research on auditor independence has been conducted in an Anglo-American context (e.g. Kleinman, Palmon, & Anandarajan, 1998; Windsor & Ashkanasy, 1995). We argue that researching auditor independence in a different socio-cultural context enables us to question the construct of auditor independence and what it really means. The IFAC statement on auditor independence states that independence requires:

(a) Independence of mind:

> The state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity and exercise objectivity and professional scepticism.

(b) Independence in appearance:

> The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude that a firm's, or a member of the assurance team's, integrity, objectivity or professional scepticism had been compromised.' (IFAC, 2003, p. 32)

We suggest that a notion of auditor independence defined above, as constructed in Anglo-American epistemology and practice, is a social construct that has different meanings in different historical, socio-cultural and economic milieus. We are looking at auditor independence as an idea that encompasses 'the individuals falling under the idea, the interaction between the idea and the people, and the manifold of social practices and institutions that these interactions involve' (Hacking, 1999, p. 34). This is no mere academic debate but has practical implications for those involved in consultancy and in drafting 'real' legislation and regulations concerning the operation of auditor independence. And, as more and more countries adopt the international terminology of auditor independence, auditors practise in local contexts, working with ideas developed in other contexts. Auditor independence is seen as crucial in the audit of financial statements for external reporting. The audit, by providing an independent audit opinion on

the statements, adds credibility tothem; users can rely on the information presented, and the system of financial reporting is enhanced. For CEE countries, auditor independence is a novel concept imported into legislation and Codes of Practice as part of the their preparation to join the EU. We argue that in a transitional economy, where much of the language of external audit may seem alien to the particular culture and society, some consideration should be given to the cultural context as it may drive the operationalisation of the meaning of auditor independence.

A basic premise of our research approach is that auditor independence is not a single-faceted concept but a multi-layered construct that should be analysed holistically. For a comprehensive understanding of what was happening in thesetransitional economies, all aspects of auditor independence – from basic educational qualifications for an auditor to complex aspects such as the provision of non-audit services – were considered. From all these aspects, a framework of the requirements for independence was developed.

We have researched how the idea of auditor independence, incorporated locally from the IFAC Code, is perceived and has been implemented in these three countries of the CEE region. We have focused on:

(1) the legislation, national auditing standards and institutional requirements in place to ensure auditor independence in the Czech Republic, Poland and Russia (an analysis of the de jure situation);
(2) the general issues that have arisen in practice with the implementation of legal and professional requirements to ensure auditor independence (an analysis of the de facto situation); and
(3) the cultural, social and historical context as it shapes how the construct of auditor independence is practised.

We argue that auditor independence cannot be understood outside its cultural context as, for example, notions of what is considered professional may differ between cultural traditions. We also highlight the contextual constraints on the Anglo-American interpretation of auditor independence.

The de facto situation was studied through interviews with local auditors, regulators, academics and users of financial statements. In the Czech Republic and Poland, we gained insight into the situation through a review of the local professional press, business journals and media coverage. A narrative analysis of the interviews helped identify what was perceived as auditor independence by reference to what can be established as the local culture and tradition. We asked the auditor interviewees in the countries studied to provide a background to auditor independence and define it. At the same time, we were attentive to how they made sense of this construct,

how they rationalised it and what examples they gave to illustrate auditor independence. As a result of this research, we question whether the usual international definitions of auditor independence, as laid out in the IFAC Code, with their separation into mind and appearance, are at all realisable.

In the remainder of this chapter, we will first provide a brief background to the CEE region followed by an account of the development of the audit profession in the Czech Republic, Poland and Russia. In the second section, we will provide illustrative situations which exemplify how the local Codes of Ethics concerning auditor independence are de jure similar to the relevant sections of the IFAC Code. In the third section, we will consider the economic issues that arise locally with respect to auditor independence. We then discuss the cultural themes that form part of the social construction of the idea of auditor independence in the local context. That section focuses on our research in Poland and the Czech Republic, as less work has been undertaken on culture and auditor independence in Russia. In the subsequent section, we locate some practical issues relevant to the CEE region, such as the development of robust legal frameworks. In the final section, we suggest the implications for the (im)possibility of the operation of auditor independence on 'dominant' terms; that is, without acknowledgement of the local context.

RECENT PROFESSIONAL DEVELOPMENTS IN THE CZECH REPUBLIC, POLAND AND RUSSIA

With the changes in political systems since 1989, and the focus on joining the EU in two of the countries, the requirement for an audit has been enacted through regulations concerning many joint stock companies and large private companies in all three countries (in the Czech Republic, Act on Accounting (1991), s.20; in Poland Audit Act (1991), s.3; in Russia, Federal Law on Accounting (1996), art.13(d) and Order 1355, (1994)). Subsequently, local legislation has been drafted, local Chambers of Auditors have been formed or re-formed (in Poland) and regulations put in place to deal with the education and examining of auditors, the setting of audit standards and the regulation of audit practice. All registered auditors in the Czech Republic and Poland, though not in Russia, have to be members of the national Chamber of Auditors. In Russia, a new law on audit was implemented in 2001. It provided for the establishment of 'accredited professional auditing associations' and stated that any auditing organisation or

individual could be a member of at least one such association (art.20.3, Federal Law on Audit, 2001). As on 16 July, 2002, there were six such associations in Russia.[2]

In the three countries concerned, there are de jure requirements for registered auditors regarding their education, training and licensing. A significant number of professionals who have become registered auditors were active as enterprise accountants or controllers under the Communist regime. Except in Poland, there was no tradition of external audit under Communism. In each country, national Codes of Ethics for auditors and national auditing standards have been drafted, which, to an extent, are based on international auditing standards (see, e.g., in the Czech Republic, Sucher & Kosmala, 2004; in Russia, Sucher & Bychkova, 2001; in Poland, Kosmala & Sucher, 2003).

In the three countries, the law on audit specifies that auditors be independent when providing audit services, and outlines certain situations in which they and/or the audit firms cannot carry out an audit (in Czech Republic, Audit Act (2000) s.2.5; in Poland, Accounting Act (2000) art. 66; in Russia, Federal Law on Audit (2001) art.l2).

AUDITOR INDEPENDENCE REGULATIONS IN LOCAL LEGISLATION AND CODES OF ETHICS

The similarities and differences between the IFAC Code, 1999, section 8, and the relevant sections of local legislation and Codes of Ethics with regard to auditor independence in the three countries concerned are discussed in detail elsewhere (Sucher & Kosmala, 2004; Kosmala & Sucher, 2003; Sucher & Bychkova, 2001). Each country under consideration has implemented regulations in such areas as financial involvement with clients, appointments in companies, and personal and family relationships. These regulations, whether included in legislation (in Russia, in the Federal Law concerning auditing activities, 2001, s.12) or in the local Codes of Ethics (in the Czech Republic and Poland), seem similar to anyone with knowledge of the equivalent regulations in the UK. However, not all the countries concerned have implemented the IFAC Code requirements regarding dependence on a large percentage of 'receipt of recurring fees' from a client. In Russia, there is no such requirement. In Poland and the Czech Republic, requirements limiting the amount of fees from one client are included in the Codes of Ethics, though the percentages given vary (20 for Poland and 25 for the

Czech Republic). Both Poland and the Czech Republic have regulations in their Code of Ethics concerning the provision of non-audit services (NAS), which are quite general. The Czech Code specifies that the provision of NAS 'is acceptable as long as the auditors do not assume responsibility for the client's decision' (Czech Code, 2000, art.6c). The Polish Code requirement specifies that 'auditors should not get involved in any activities impairing their independence' (Polish Code, 1999, s.3.2). The Russian Code specifies that 'when an auditor provides consulting services, it is important not to impair auditor independence' (Russian Code 2001, art.5.5). In both Poland and Czech Republic, in 2002, the provisions in the Codes of Ethics were revised to bring them in line with the new independence provisions in the IFAC Code of Ethics 2001.[3] However, the interviewees in Poland and Czech Republic expressed concerns whether the more conceptual approach enshrined in the IFAC Code 2001 can be effective locally. Yet, as these codes and laws have been implemented, our research indicated that there are much larger contextual factors that impact on the perception of auditor independence (Sucher & Kosmala, 2004; Kosmala, 2003; Kosmala & Sucher, 2003). In this chapter we focus on the economic and cultural issues that, we argue, shape auditor independence.

LOCAL SOCIO-ECONOMIC ISSUES AND AUDITOR INDEPENDENCE

It appears that a substantial issue in all the transitional economies is that of economic competition amongst smaller audit firms and auditors. This was reflected in interviews with auditors. In particular, there are issues of price, with some evidence of low-balling and auditor switching; issues of how new audits are taken on (where the requirements to contact previous auditors are either ignored or have been relaxed); issues regarding the provision of other services and issues regarding going concern qualifications. For instance, one of the interviewed audit partners from a midsize Polish firm stated:

> The prices for audit services are dictated by the clients in the ratio 1:5 in comparison with the Big Four [firms]. Also, the practice of switching is more common with Polish auditors who do not have enough established bargaining power.

There are indications that the local Code of Ethics requirements, for example in the Czech Republic, regarding the provision of other services, are ignored owing to the pressure to retain clients. The same applies to small practices in Poland. In interviews, many auditors said they did not wish to

qualify their audit report, even though it might be warranted, as they were more interested in whether their clients had complied with tax regulations. Often, auditors, particularly in Poland, were concerned about retaining their clients. With accounting and tax legislation changing continuously, clients required, and expected, a full range of accounting and taxation services from their auditors, and this was considered more important than the audit. With the competition for clients, particularly amongst smaller audit firms, auditors emphasised the problems of retaining their clients. As noted by a local Czech auditor:

> [There is] one great problem with auditor independence. In the general model exist shareholder, management and auditor. Shareholders vote and the audit report is to shareholders. In very much smaller companies, the shareholder and the management are the same person. […] If the auditor makes a report to management and gives a qualified opinion, there is a problem of who pays.

This was seen by interviewees as related to economic reality and issues of transition from the previous system. The exclusion of many smaller companies from the obligation to have an audit, in Poland and Czech Republic (since 2001), may remove the most problematic of these clients and those with the lowest public interest, whilst on the other hand it is likely to increase competition for clients amongst the smaller auditors (Sucher & Kosmala, 2004; Kosmala & Sucher, 2003).

The efficacy of subjecting a large number of enterprises to the requirement of an independent external audit must be questioned. In the past, the main users of most enterprise financial statements were state bodies such as the tax authorities. Now, the tax authorities are often the only organisations with the powers to levy substantial fines on enterprises for non-observance of local accounting regulations (e.g., in Russia and the Czech Republic). Amongst the smaller auditors, there was therefore an emphasis on providing valued-added services to clients, especially with regard to taxation and accounting advice. The provision of value-added services was also a common practice among smaller auditors in Poland, in the context of what was regarded as 'transition reality', where evolving laws and conflicting interpretations of tax and accounting laws regarding possible accounting treatments made reporting particularly difficult. In each of the countries, it is not clear whether there is a large group of investors requiring annual, independently audited, financial statements. Though much legislation on accounting and audit in the three countries has been based on the model of enterprises preparing financial statements for local investors, it is not clear whether there has been a large pool of local investors who have demanded

audited financial statements (Sucher & Bychkova, 2001; Sucher & Zelenka, 1998). Much investment has been direct foreign investment in large local enterprises where due diligence is likely to be observed by an international audit firm. In the Czech Republic, many of the state enterprises were privatised in the early 1990s.[4] However, during the mid-1990s, many of them had problems with their corporate governance. There was a combination of widely dispersed shareholdings – large investment funds owned the majority of shares in many enterprises – and loosely framed corporate governance regulations, and this paved the way for several instances of corruption and mismanagement of corporate funds (EBRD, 2000; Sucher & Alexander, 2002). There are few indications that there is a large pool of local investors willing to provide equity for local enterprises. Since its inception in 1992, the Prague Stock Exchange has witnessed no initial public offerings by companies to raise equity finance. Indeed, there have been substantial issues of enterprise liquidity in many transitional economies (EBRD, 2000; ROSC, 2003). Referring to the local situation, one local Czech auditor interviewee commented:

> The problems are also because exact translations [...] like translation from international codes into Czech – [are difficult]. So, in some cases, it does not match our background. [For example] If we follow the principles of a going concern, [then] in 1990, only 10% [of companies] would have been able to move ahead (quoted in Sucher & Kosmala, 2004).

Rather than to provide going concern qualifications, most auditors provided what can be regarded as 'clean' audit reports.

IMPACT OF CULTURE ON THE CONSTRUCTION OF AUDITOR INDEPENDENCE

Key elements of Anglo-American culture, as identified in prior cultural research, have focused on what is rational and effective in auditor independence, e.g., ideas of professional integrity and objectivity. Through implementation of local Codes of Ethics, which mimic international codes, these definitions have been exported to the CEE. A discourse on auditor independence has been constructed in this way, privileging a particular epistemological stance, i.e., an emphasis on objectivity, integrity and professional competence in forming a sense of being professional (Kosmala, Sikorska, & Gierusz, 2003). If there is no discussion on relative and absolute values, the idea of auditor independence is likely to be constructed differently, and its appropriateness in different situations debated. However, it is

necessary to understand *how* it is constructed before there can be a debate on appropriateness. In our research we have sought to identify how local auditors construct auditor independence.

In all the three countries, as auditors defined auditor independence, there were strong similarities with regard to three particular themes.

First, auditor independence was seen as related to economics – the economics of the market and individual. Many interviewees in each country referred to the competitive audit market, the percentage of fees derived from each client and the difficult living conditions. One interviewee in the Czech Republic commented on the living conditions as follows:

> 'I think that it's fine if the independent auditor has lots of money or has some possibilities to make money as an accountant. If I have some financial reserves, I can be independent. It is not possible now, of course, because auditors [...] depend on their clients' (Sucher & Kosmala, 2004).

In previously published research on auditor independence in Russia, one of the authors raised the question whether auditor independence, as defined in the IFAC Code, was feasible in local (Russian) economic conditions. The question related to particular economic circumstances where many individuals were concerned about the precarious nature of local earnings. Some Russian interviewees implied that auditor independence was a luxury only a prosperous society could afford (Sucher & Bychkova, 2001, p. 836). Though this discussion drew upon the 'classic' idea of auditor independence, it does raise wider issues about the possible wastefulness of compulsory external independent audit for many enterprises in some economies in the CEE. These issues of the appropriateness of 'Anglo-American' accounting and audit have been raised in other research on developing economies (Bailey, 1995; Briston, 1978).

Second, there was much reference to what we have termed the rules basis for auditor independence. In the Czech Republic and Poland, reference was made to the local Codes of Ethics in defining auditor independence. A professional auditor, one who was independent and competent, knew the rules for auditor independence as set out in the local Codes of Ethics, as suggested by local practitioners (Kosmala & Sucher, 2003; Sucher & Kosmala, 2004):

> I understand auditor independence in the same way as I learned it from the Code of Ethics (Polish auditor).

> I am quite independent. It means I must obey all conditions of the law. I can't take part in some companies where a member of the Board is my husband, and so on and so on.

> This is [a] basic list for my business: section 6, Code of Ethics (representative of a small Czech audit firm).

In recent interviews in Russia (October 2003), though there was reference to local rules on auditor independence in the Code of Ethics, the discussion focused on the ability to manipulate local rules on auditor independence.

In all three countries, there was also a discussion on the theme of 'our (transition) reality'. In Poland and the Czech Republic, this seemed to point to issues arising from the transition from a Communist economy to a market economy that shaped the construction of auditor independence. Discourse on 'our reality' reflected issues that were seen as a temporary necessity, such as 'unethical' audit firms, enterprises, and instances of an 'economy of favours' (Ledeneva, 1998) or local corruption. It was sometimes perceived as a consequence of the Communist period. As noted at the Polish Chamber of Auditors:

> During and after the war, society was fighting an enemy, the government was an enemy in the communist times, therefore everything including nonethical behaviour was then accepted (Kosmala & Sucher, 2003).

The theme of 'our reality' seemed to be also used as a rhetorical device, as a defence against external criticisms of the current state of affairs with regard to auditing in the CEE countries.

There were also differences between the discourses on auditor independence in the Czech Republic and Poland in three areas – freedom, egalitarianism and adaptability.

In interviews in Poland, there was much emphasis on individual freedom. Freedom here meant freedom from interference, as one Polish auditor defined, 'a sense of freedom from any external influences that affect quality and objectivity'. Bartminski (1993) argued that perhaps what distinguishes the Polish attitude is that which accepts as the most basic value – national freedom (wolność) and independence (niezależność) – and deduces a set of obligations of the individual towards society. This may also be seen as a reaction to the Communist regime pre-1989. During interviews, frequent references were made to auditor independence as having its grounding in the notion of freedom; what we call the freedom-based approach. Here is what the Polish auditor said:

> Auditor independence is I think *to be free from limitations*; professionalism in other words' (…) *Also freedom from politics*; left wing, right wing, changes of Boards of Directors in public companies. Auditor must not be political at all (President, Chamber of Auditors).

There seems to be an intermingling of constructs of independence (as linked to individual freedom) and auditor independence. However, it may cause problems when it comes to regulation of auditors.

In the Czech Republic, in discussions on local culture, there was a focus on envy (zavist). Here, the word seemed to refer to envy of the economic status of fellow Czechs. There was a perception that fellow Czechs should not have any more consumer goods than oneself and that one should not display one's full wealth as others would become envious. Therefore, it seemed likely that Czechs would not like to provide information about themselves. It was also suggested in the interviews that this could cause a problem for auditors seeking to ascertain all details about an enterprise, especially small and medium-scale units (Sucher & Kosmala, 2004).

Many interviewees in the Czech Republic also discussed the local creative approach to new ideas. It was perceived that there was a 'Czech way of doing things', and interviewees took pride in the way Czechs had always been adaptable to new ideas (or rules) (Sucher & Kosmala, 2004; Clark & Soulsby, 1999). This emphasis on creativity might lead to very local interpretations of rules on auditor independence. Though the concept of 'creativity' may have certain negative connotations (Smith, 1992) when applied to financial reporting in the UK or the USA, this might not be seen to be the case in the Czech Republic, where a competent professional may not only know all the rules but also be capable of creatively interpreting them in the local context.

However, across the three countries, there were differences between how younger and older auditors perceived professional independence. Though the great majority of our interviewees were local auditors who had worked for many years under the Communist regime, some of our interviewees were younger auditors who had not had great exposure to Communism. Their views of auditor independence, and those of expatriates who had Anglo-American accountancy qualifications, were often quite different from the views of older local auditors:

> The auditor cannot provide audit services for companies where he is involved in any way. [The] problem [is the] same as in other countries. [The] auditor is paid by the company. This is the corridor of auditor independence. The auditor […] would like to keep his client, but he has to issue an opinion which is independent of the management of the company and gives a true view of the financial statements (expatriate audit manager of a large international audit firm in the Czech Republic).

> It is really a frame of mind. There are obvious factual considerations that are easy to define, such as restrictions on ordinary shares in client firms or not having a direct [member of] family in a chief executive position, but the other aspect is the frame of

> mind…trying to remain objective, unbiased and reasonably sceptical but not ridiculously so in doing the work (expatriate audit manager, international audit firm in Poland).

Having discussed some of the issues arising from the impact of culture on auditor independence, we discuss in the next section some particular local practical issues concerning auditor independence in the CEE region. We focus on the issues of legal framework and regulation of audit firms.

LEGAL FRAMEWORK

There was an issue of law enforcement in all three countries. As has been noted in earlier reports from the European Bank for Reconstruction and Development, there have been problems with legal enforcement and the time it takes for cases to be heard (EBRD, 2000). The problems with legal enforcement can be seen in the Czech Republic where cases such as the non-payment of audit fees can take years to be heard in court. Then the President of the Czech Chamber of Auditors commented on this situation in a discussion on the reasons why it is difficult to sue audit firms:

> There are results (from court cases) that are unpredictable in many cases. And the judges have very little experience because they haven't dealt with this in the past. And this is basically a full circle. There are not enough cases, so we will not sue; we don't know how this happens, so we have no cases.

Therefore, auditors may not see this threat of legal action as serious; the threat of litigation is not a significant safeguard to support auditor independence. There has been particular concern about this issue in the Czech Republic, where several large banks have gone into liquidation despite having 'clean' audit reports. However, recent reports from the EBRD suggest that the situation may be improving (EBRD, 2003).

DISCIPLINARY ENFORCEMENT

Concerns were expressed by users of financial statements, particularly in the Czech Republic and Russia, about the enforcement of local Chamber regulations amongst auditors. Though in Poland and the Czech Republic each Chamber had fined some auditors for infringements of particular regulations (e.g., in the Czech Republic in 2000, two individuals were fined for infringement of auditor independence regulations; in Poland there were 234

disciplinary investigations between 1991 and 2001; the break-up was not available as investigations were going on), these were a very small percentage.[5] In the Czech Republic, no audit firm has been removed from the Chamber's list of auditors for failure to perform standard audit work.

The institutional users of financial statements interviewed had a negative perception of auditor's work. Here is an example for the Czech Bank:

> In reality, if [we] see some serious problems with auditors, [there is] no impact on them from the Chamber. Then [there is] limited confidence in the application of such rules.

Some cases regarding infringement of regulations had involved large international audit firms. In one case it had taken the Czech Chamber of Auditors three years to conclude a disciplinary investigation against an international firm of auditors who audited a major Czech bank that had failed (Sucher & Kosmala, 2004). There was concern (shared by some in the Chambers) that local Chambers of Auditors, who were charged with quality control and disciplining of their member auditors, lacked the resources to undertake substantial disciplinary investigations. Some consideration must be given to putting in place a network of support for local Chambers of Auditors to undertake investigation (Sucher & Kosmala, 2004) as an adequate number of suitably trained auditors (ROSC, 2003) are not available.

CONCLUSIONS AND POLICY IMPLICATIONS

The notions of external audit and auditor independence are new in Russia, Poland and the Czech Republic. Discussions with external users of financial statements suggested that there was no perception amongst them that local auditors were independent of their clients. Large international audit firms were generally seen as more independent than local audit firms, though there were some exceptions in Russia and in the Czech Republic. It could be argued that the international audit firms have managed to associate only themselves with the idea of auditor independence as constructed in the Anglo-American context, with its connotations of individual independence, integrity and objectivity (Sikka & Willmott, 1995). This may cause problems for local audit professionals trying to establish credibility with external users.

Though a body of regulations and laws on auditor independence has been enacted in each country based on international Codes of Ethics, there are deeper, richer contextual issues that shape how auditor independence is constructed and understood locally. The issues of market competition for

audits among the smaller firms must be emphasised as it constrains the operation of an effective audit, no matter how auditor independence is constructed. These are not issues unique to the countries of the CEE, and have been raised in research in the UK and USA. The nature of the cultural construction of auditor independence must be understood. The idea of auditor independence shaped by rules within the constraints of the economic context was very much a reality to many auditor interviewees in the Czech Republic and Poland, whilst in Russia the economic context seemed to be a more vibrant reality.

The transfer of the idea of auditor independence to the CEE may be seen as part of globalisation. Though there are debates about definitions and timings concerning globalisation (well aired in Guillen, 2001), one comment is that globalisation is a "fragmented, incomplete, discontinuous, contingent…process" (Guillen, 2001, p. 238). Then there has been a debate concerning the substance of the convergence towards uniformity of patterns of behaviour. Some have claimed that there are similarities in form between structures in different countries though not in substance (Meyer & Hannan, 1979). On the other hand, some have argued that globalisation brings more variety to economy and society, whether dialectically (Giddens, 2000) or through cultural fragmentation (Friedman, 1994). Much of this debate is conducted at a macro-economic level concerning tendencies to follow particular economic frameworks (e.g., neo-classical or social democratic corporatist), and whether one believes there is convergence or not depends on the unit of analysis used.

As a result of globalisation and European harmonisation, patterns of conduct, based on Western ideas in terms of best practice, travelled to the CEE region without the recognition that there were 'differences' in local culture and accounting traditions, and that professional ethics were historically constructed by other sets of concerns. New levels of perceived normality have been established for professionalism without reference to local cultural constructions within the CEE region. The framework for audit independence may be developed as a template to facilitate a dialogue between Europe and the accession countries, to establish what constitutes perceived normality in professional conduct and to define an appropriate time span to bring such conduct into line (where possible) with the globalisation trends.

Our research indicates that, at the level of the individual and the organisation, an idea can simultaneously have universal and local meanings. Individuals and groups will seek to annex the global meaning into their own local practices.

NOTES

1. Constituents of the former Soviet Union – Ukraine, Belarus and Moldova –are not classified under the CEE as it is believed they have a separate political economical and cultural identity, and are identified more with Eastern values in the socio-political context. However, in this chapter, for convenience, we will refer to Poland, Czech Republic and Russia as the representatives of the CEE region.
2. Ministry of Finance of the Russian Federation, 16th July, 2002, notification No. 145.
3. See www.kacr.cz and www.kibr.pl
4. One high-profile method of privatisation was the issue to every Czech citizen, for a small fee, of vouchers that could be used to obtain shares in Czech enterprises. This privatisation took place in 1993 and 1994. Subsequently, the shares of these Czech enterprises were traded on the Prague Stock Exchange. This made the Exchange one of the largest in Central Europe in the mid-1990s.
5. The information was not available for Russia.

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INDEPENDENCE AND COMPETENCE? A CRITICAL QUESTIONING OF AUDITING

Christopher Humphrey, Peter Moizer and Stuart Turley

ABSTRACT

This paper reviews key aspects of the regulatory response in the UK and the USA to the apparent crisis of confidence in auditing stimulated by Enron and other recent corporate scandals. Drawing on a consideration of the nature of the market for auditing services and the regulatory and corporate governance structures in which auditing is embedded, the paper argues that the bulk of recent regulatory attention appears to have been on matters of auditor independence rather than auditor competence. Such a focus is seen to have parallels with former 'crisis' eras in the auditing arena, while the analysis presented also raises questions about the status of the auditing function within accounting firms and the capacity of regulatory reform to deliver a fundamentally enhanced auditing function. The paper concludes by stressing the importance of making more transparent what is being done in the name of auditing and audit regulation.

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EXPECTATIONS

> I've been tracking this matter for a lifetime, and my greatest surprise was the sheer scale of the inadequacy of the accounting profession and some of its most prominent members. I've been looking at auditors' signatures all my life, but I will never again do so without some doubts as to their validity. (J. K. Galbraith, aged 93, interviewed in Cornwell, 2002)

The post-Enron demise of Arthur Andersen and the loss of confidence in the operation of capital markets and regulatory bodies illustrate the extent to which corporate scandals and collapses can raise serious questions of the accounting and related professions. How could reported company results change so significantly from one year to the next? How could financial analysts have misread the various financial and economic signals? Where were the auditors? What were regulators doing? How could management be so incompetent or crooked?

It is important, though, to recognise that corporate scandals and auditing failures are nothing new. The auditing function and its practitioners generally survive and move on post-scandal, pursuing a pattern of reform and change driven by the need to respond to scandals and to attempt to close any apparent 'audit expectations gap'. Some in the accountancy profession have argued that any such gaps reflect timing differences – with social demands of auditors regularly changing, and the profession having to adjust to catch up with and respond to such demands. However, it is evident (see Humphrey, 1997) that the underlying issues to have featured in audit expectations-gap debates have been relatively static and (for more than 100 years) have persistently revolved around notions of auditor independence, responsibility, reporting, the extent of regulation and processes of evidence collection. It is not a question of auditors failing to meet new expectations but appearing to fail to deliver, as the quote at the start of this article indicates, on a number of persistently relevant matters and concepts.

Nonetheless, Enron and the series of cases of alleged inadequate auditing which followed represent a major shock to the auditing system, particularly in Anglo-Saxon countries. The reported acts of financial engineering and document shredding in the Enron case, together with its political intrigue and evident excesses of corporate power, have served to give this case a special and distinctive status. Notably, in comparison with previous cases, Arthur Andersen did not survive post-Enron because it lost credibility rather than because of the impact of a successful claim for damages. The legislative response in the US via Sarbanes-Oxley and the range of reviews

around the world with respect to national and international standards of accounting, auditing and corporate governance have created a sense of breaking new ground, of doing things with auditing that have not been done before. In this paper, we will use examples from the US and the UK to illustrate how regulators in these two countries have responded. This is not to privilege these two countries, simply to give the chapter some manageable focus. While accepting that there is considerable variation in the context of auditing and its regulation internationally, the recent developments in the US and UK do illustrate some important general themes.

The main response of regulators to the crisis of confidence in auditing has been to argue that the problem is one of independence and therefore that what is needed are measures to ensure that auditors act more independently in the future. This may represent a genuine belief or it may be a pragmatic response. Politicians need to be seen to be responding to crises, and attributing the Enron audit failure to a lack of independence allows them to introduce measures that will give the impression that they are tackling the causes of audit failure. In contrast, little has been said about the competence of auditors (i.e., their ability to detect material misstatements and omissions in financial statements and fulfil other assigned responsibilities). One explanation could be that it is very difficult for regulators to address the issue of auditor competence because it is a rather nebulous concept and less amenable to headline measures. One of the purposes of this paper is to redress the balance by discussing auditor competence as well as independence.

The paper offers a contextual review of the way in which the auditing function and the profession, more generally, has developed and responded in the face of corporate scandals and accusations of audit failure since the early 1990s – which in the UK was the last time when the auditing profession was wrestling with the aftermath of some major audit failures. A number of different elements in the auditing arena are discussed to illustrate aspects of the changes and developments that have occurred both before and after Enron, with particular reference to the issue of auditor independence and auditor competence. These elements relate to the context within which audit services are delivered (competition in the audit market and developments in corporate governance), regulatory response (regulatory structures and ethical requirements) and the actions of auditors regarding what is done on an audit (the content and competence of audit practice and audit reporting). The subsequent analysis then identifies and reflects on some common themes and policy issues to emerge from the review of these illustrative contextual factors and the processes of regulatory response.

COMPETITION IN THE MARKET FOR AUDIT SERVICES

One of the characteristics of the audit services market since the mid-1980s has been its increasingly competitive nature. The first big change was probably the two mergers in the Big Eight in 1989 to produce the Big Six. There then followed a period of intense price competition as audit firms tried to increase market share by offering audits at a lower price than their competitors. Studies of audit fees in the late 1980s and early 1990s found lowballing to be prevalent. As finance directors became aware of the trend, it became something of a badge of honour to be a finance director who had reduced his or her company's audit fee. The reduction of audit fees then proceeded at a pace, with the firms eager to promote other services in an effort to extract the money perceived to be lost by the audit engagement. In the UK, we have as yet unpublished evidence that this trend continued until the merger of PricewaterhouseCoopers (Wan Mohamed, 2005). After this time, there is no obvious evidence of any lower audit fee for new engagements. The effect of the Andersen demise is likely to have increased audit fees without any regulatory intervention. The effect of the extra work required of auditors as a result of Sarbanes-Oxley can only increase audit fees. We may now be moving to that part of the cycle when audit fees increase at a greater rate than inflation as audit firms adjust their pricing policies to reflect the new commercial realities.

The position of the regulatory authorities is interesting in regard to the increasing concentration of audit firms. From a competition perspective, reducing the number of large international accounting firms is to be deplored. One of the reasons advanced by the managements of Ernst & Young and KPMG to account for their failed merger in 1998 was that both the European Union's Merger Task Force and the US Department of Justice had extended their investigations and requested further audit pricing information. At that time, it was possible that the competition authorities would not have countenanced a Big Four. However, the collapse of Andersen brought this about in quite dramatic fashion. The traditional instinct of competition authorities is to believe that the more competition the better and therefore any reduction in competition is to be resisted, particularly if it produces an oligopoly. In contrast, that part of the regulatory regime interested in promoting auditor independence should favour less competition as that will help ensure that auditors are better able to stand up to clients, safe in the knowledge that another firm will not subsequently undercut their

position. From this perspective, increasing the power of auditors relative to client management is likely to lead to an improvement in independence.

CORPORATE GOVERNANCE

One of the fundamental issues at the heart of the debate on the independence of auditors is the fact that they are effectively appointed by the directors of a company, who also effectively determine the size of the audit fee. The word 'effectively' is used because in some environments, such as the UK, it is strictly a company's shareholders who appoint the auditors and approve their remuneration, but in practice the shareholders merely rubber-stamp the recommendations of the directors. Hence, if the auditors conclude that the financial statements do not show a true and fair view and qualify their audit opinion, they know that there is a possibility either of losing the audit or of having their fee reduced. There is also a sense of loyalty that is built up between an auditor and the managers being audited, largely because, as far as auditors are concerned, the managers of the company, particularly the finance director, are their client (for more discussion on this, see Humphrey & Moizer, 1990). One result of this is that auditors tend to view matters from the viewpoint of the management, probably without even realising it. For their part, finance directors tend to view the audit service as the one expense code over which they have some control. This situation therefore becomes an obvious area to be targeted whenever the issue of auditor independence is discussed.

The traditional response of the audit profession is that there is no independence problem and that the ethical codes of conduct and the more general requirements of being a professional protect the public from conflicts of interest that might impair auditor independence. However, regulators have historically been very concerned about this issue and the related issue of corporate governance, which is the perceived need to make corporate directors, particularly chief executive officers, more accountable to shareholders. This move towards improving corporate governance has taken a number of forms in different countries, but in essence all such approaches try to introduce checks on the powers of the executive directors by appointing non-executive directors. These non-executive directors are supposed to represent the interests of shareholders and be able to take an independent view of the actions of the executive board. From the perspective of auditor independence, the main effect of such moves towards

corporate governance has been the creation of 'audit committees' comprising a majority of non-executive directors.

The establishment of audit committees in the US was recommended by the Securities and Exchange Commission (SEC) as early as 1940, but it is only within the last 30 years that the place of audit committees in the corporate governance process has increased dramatically. At first, the formation of audit committees was voluntary, but in such a voluntary environment either very few companies formed audit committees (Bradbury, 1990) or the audit committees that did exist either never met or were staffed by insiders (Menon & Williams, 1994). It thus became apparent that economic incentives alone would be insufficient to bring about the creation of effective audit committees (Kalbers & Fogarty, 1998) and therefore regulators saw compulsory audit committees for listed public companies as one way of being seen to do something about improving auditor independence. The view of regulators was that if the decision to appoint and determine the remuneration of auditors was placed in the hands of non-executive directors on the audit committee, then the direct link between auditors and company executive management would be broken.

However, introduction of an additional structure such as the audit committee does not guarantee a solution to independence concerns, and the evidence available on the effectiveness of audit committees is mixed (Turley & Zaman, 2004). Audit committees are not likely to be equally effective as the protection of auditors depends on the degree of technical competence and independence of the non-executive directors themselves. For example, one key role of the audit committee is to defend external auditors from pressure from management to modify their opinion using the threat of dismissal if the auditors do not accede to management's wishes. Recent research (see Carcello & Neal, 2003) suggests that an audit committee that is more independent (i.e., has a lower than average percentage of affiliated directors on the audit committee), with members who sit on more boards (governance expertise) and who own less company stock, is more effective in protecting the auditor from dismissal following the issuance of a going-concern report.

REGULATORY STRUCTURES

The relative role of the state and the auditing profession in regulating practice has been an issue of debate for many years. While the balance of responsibilities has shifted over time, the framework of regulatory authority

in auditing has changed in two significant ways in recent years. First, there has been a move to conduct standard setting through bodies that are separate to a significant degree from the accountancy profession, mirroring similar earlier changes in the field of accounting regulation. Second, the scope of authority of these standard-setting agencies has been extended to incorporate ethical matters and thus auditor independence.

In the UK, the Auditing Practices Board (APB) has been the primary standard-setting body for audit practice for some 30 years. During that period its constitution and composition have changed. Originally, a committee of the professional accountancy bodies, the APB was reconstituted in 2001 to give independent regulation of auditing standards under an Accountancy Foundation, and its membership was changed to ensure a minimum of 60% non-auditor members. Following the case of Enron, the UK government established further reviews of the regulation of accounting and auditing (see Co-ordinating Group on Audit and Accounting Issues (CGAA), 2003), resulting in two further major changes. First, from 2003, the APB has been given the responsibility for developing and issuing ethical standards for auditors. Other areas of ethics affecting professional accountants remain under the influence of the professional institutes, but standards relevant to auditing are now part of the APB's remit. Secondly, from 2004, the activities of standard setting for auditing have been brought within a unified structure with those for accounting standards. Both the Accounting Standards Board (ASB) and the APB, together with other oversight and discipline functions, are boards of the Financial Reporting Council, an 'independent regulator'.

Following the Sarbanes-Oxley Act, the creation of the Public Companies Accounting Oversight Board (PCAOB) has made major changes to the structure of standard setting in the US. It is beyond the scope of this discussion to consider all the details of this development, but a number of illustrative points can be noted. The legislative backing introduced for a body to establish "auditing, quality control, ethics independence and other standards relating to the preparation of audit reports" (Sarbanes Oxley, 2002, Section 103(2)) is a radical change from the position under the previous standard-setter, the Auditing Standards Board of the AICPA. The role and authority of the latter, which continues to exist as the profession's own standard setter, have changed significantly following the creation of the PCAOB. The inclusion in the statute of prohibitions on certain activities and "services outside the scope of practice of auditors" (Section 201) is also a major change in the environment for audit practitioners. In addition, the requirement for public accounting firms outside the US who audit a US

company or any of its subsidiaries to register with the PCAOB and be subject to its rules has been a contentious provision internationally.

The current formal position for auditing standard setting in both the UK and US is thus markedly different from the position at the beginning of the 1990s, regarding both the independence of standard setting from the profession and the scope of independent regulation extending to ethical matters. Different structural solutions have been applied in the two countries (and other variations would be evident in other environments), with differing degrees of legislative involvement but with the common themes of taking regulation away from auditing professionals and broadening the scope of regulation. It is worth noting that much, although not all, of this change has been initiated as a result of the scandals that have hit major corporations. Thus, recent history has repeated the pattern of earlier years where change follows various corporate crises and alleged failures.

THE CONTENT OF ETHICAL GUIDES

If guidance or regulation is to be applied to influence auditors' behaviour, then the fundamental question of what regulatory standard is to be applied must be addressed. A significant aspect of the debate on appropriate standards in recent years has been the choice between 'principles-based' and 'rules-based' standards (see Nelson (2003) and Schipper (2003) for a discussion with reference to accounting standards). This issue is characterised by, on the one hand, the need for more defined and clear rules which set unambiguous standards and allow certainty in judging the adequacy of behaviour and, on the other hand, the claim that principles in fact set higher standards by placing obligations on auditors to consider more than mere compliance with a checklist. To an extent this is a semantic debate depending on views regarding what exactly constitutes a principle or a rule, and can distract from basic questions regarding the content of standards, what auditors should be expected to do and how they should be expected to behave.

One factor which is different in the current environment from the early 1990s is that there is much less acceptance of the claim that "independence is a state of mind" as a reason for not regulating against situations which threaten independence. For example, as noted earlier, Sarbanes-Oxley has established prohibitions on the delivery of certain non-audit services to audit clients. There are stricter rules on the rotation of audit partners to guard against familiarity and measures linked to ideas of fee-dependence have tightened – although whether or not such regulations have a direct impact

on the conduct of audits is something that will require evidence from their operation over a number of years.

The specification of standards is in itself a difficult matter and this can be illustrated by reference to the following statement from the APB's draft Ethical Standards regarding the criterion that auditors should apply in considering whether any circumstances, relationships or services give rise to potential problems that would undermine the delivery of an independent audit:

> Accordingly, in evaluating the likely consequences of such situations and relationships, the test to be applied is not whether the auditors consider that their objectivity is impaired but whether *a reasonable and informed third party* would conclude that the auditor's objectivity either *is impaired or is likely to be impaired.* (APB, 2004, paragraph 14 ES1) (emphasis added).

Within this statement there are choices regarding both the relevant party against whose judgement independence should be considered and the threshold for determining that there is an independence problem. For example, a typical approach of traditional professional guidelines on independence would be to ask auditors themselves to use their own expert opinion to determine if there is a problem. In contrast, a very widely drawn threshold might refer to whether any third party might consider that there could be a possible problem. The statement above lies somewhere between these two extremes, by referring to a reasonable and informed third party concluding that, at the least, it is likely there is a problem. The adequacy or operationalisability of this approach is not what is at issue here, but rather the fact that it illustrates some movement towards the need to be able to demonstrate the acceptability of the firm-auditee relationship to outside parties. Similarly, moves to establish greater disclosure regarding the nature and volume of non-audit services and to have such engagements approved by audit committees also illustrate this approach of introducing greater transparency about the relationship between the audit firm and the client company.

THE CONTENT AND COMPETENCE OF AUDIT PRACTICE

So far we have considered the big picture within which auditing is conducted, the competitive nature of the market for audit services, the system of corporate governance in which auditing is embedded and the role of the state and the auditing profession in regulating conduct, including ethical guides to improve the objectivity of auditors. However, a consideration of the nature and context of ethical behaviour by auditors, possible erosion of

independence and the regulatory framework within which these issues have been addressed would be incomplete without some comment on the subject of the technical activity undertaken by auditors and the competence of auditing to generate the necessary evidence to support proper reporting. While the visible reaction to high-profile cases of alleged ineffective auditing has focused on factors affecting auditor behaviour, such as economic dependence and proximity to management, it is important not to lose sight of the need also to ask questions about the effectiveness or power of the audit activity itself. For example, if auditors have missed relevant factors is this because their activity has become distracted by a concern for selling additional services (an independence issue) or because their audit procedures are insufficient for the complexities of the modern business environment (a competence issue)? To answer such questions, we now turn to the topic raised at the beginning of the chapter, namely the competence of auditors.

Competence relates to the ability to execute the basic audit task of discovering errors and omissions. The difficulty for auditors is that there is no guaranteed process that will allow them to find all material errors and omissions, and so there will always be a residual risk that they have failed to find something. The penalties for failure in Anglo-Saxon countries can be significant and the response of audit professionals during the last 10–15 years has been the introduction of methodologies which have adopted a greater and more explicit orientation to an evaluation of the business risks of the enterprise being audited (the business risk audit – see Lemon, Tatum, & Turley, 2000). Much of the original motivation behind the business risk audit was to have a more powerful audit approach. Sooner or later problems in business will impact on financial statements, so if auditors improve their analysis and understanding of the business they should be in a stronger position to diagnose issues that are significant for the quality of the financial statements. Also, in the modern environment, the speed at which business problems translate into financial statement impacts has increased, and therefore the risk of ineffectiveness in the periodic audit is greater if auditors fail to look beyond the historic financial statements to the business itself.

However, while the rationale offered above for the development of the business risk audit for 'better' auditing can be persuasive, it must be recognised that a focus on business risk was also attractive to audit firms because it appeared to offer a better basis for generating information which might be considered valuable by management of the audited organisation and which, in turn, might provide a platform for selling additional non-audit services. It is debatable whether this has been the experience in practice. Further, concepts and practices around understanding business entities and assessing their risks

have considerable potential to influence the way in which auditors conceive the purpose of their activity. Rather than strengthen the auditor's diagnostic power, a 'consultancy' model of audit could undermine the focus on the financial statement opinion (Jeppessen, 1998). Indeed, there is evidence to suggest that the business risk approach proved problematic to roll out on a global scale in the large firms, perceived as an unduly North American inspired initiative and not respectful of different national audit traditions (see Toffler & Reingold, 2003). It could also be argued that the new approach had less to do with responding to client demands for a new audit product and more to do with supply-side factors–repackaging audit as a broader-based business service so as to bolster the fee earning capacities of audit partners within the larger firms and thereby reassert their power and significance (see Humphrey, Jones, Khalifa, & Robson, 2004). Significant questions also remain as to the ease of the linkage between overall business risk assessments and the audit testing needed to assess the manageability of such risks and their potential impact on a company's financial statements (see Lemon et al., 2000).

AUDIT REPORTS

One of the traditional responses of the audit profession to the view that they were not delivering the service that was expected of them by the general public has been to claim that the nature of the service is misunderstood. The public was characterised as investing auditors with superhuman powers. Given that the problem was deemed to lie with educating the perceptions of the general public rather than with the conduct of auditors, the technical competence of auditors was not challenged. To this end, both in the US and the UK, changes were made to the recommended wording of the auditors' report, essentially designed to lower the performance benchmark against which to judge both the competence and independence of auditors.

For example, in the US in 1988, SAS 58 Reports on Audited Financial Statements (AICPA, 1988) set out a standard audit report, including an explicit statement that an audit provides reasonable assurance of reliance on the fairness of the financial statements. Five years later, a similar standard was issued in the UK, SAS 600 Auditors' Reports on Financial Statements (APB, 1993). In both cases the wording of the standards included descriptions of the work of auditors and the respective responsibilities of the auditors and the directors. The trend has been continued with ISA 700 issued by the International Auditing and Assurance Standards Board (IFAC, 2004), which includes the recommendation that the auditor's report should

have a title that clearly indicates that it is a report of an independent auditor (para. 18). The standard takes the view that using the expression "Independent Auditor's Report" affirms that the auditor has met all of the ethical requirements, including that of independence, and that this therefore distinguishes the auditor's report from the reports issued by others.

The audit report can be taken as a very evident signal of auditor competence and independence if it says more than the minimum laid down by the standards discussed above – the presumption being that a competent and independent auditor will discover unpalatable facts and not be afraid to speak his or her mind. Unfortunately, the effect of the so-called 'expectations gap' standards relating to audit reporting has been to reduce the number of occasions when the auditor has used a form of wording other than that recommended for an unqualified report. The result has been that in most Anglo-Saxon countries, over 90% of all audit reports are unqualified and therefore indistinguishable from each other. The reader has little if any idea as to what has created this state of affairs. Audit professionals would argue that an unqualified audit report demonstrates that the external audit process is working, and that all material errors or omissions have been detected and corrected, so that there is no need to issue anything other than a general statement that the financial statements are fairly presented.

Another, more cynical, view would be that most reports have no real information content as they all tend to look the same (possibly even when the audit process is not working). It could, therefore, be argued that removing the ability of auditors to say something specific about a company actually contributes to the belief that auditors are neither competent nor independent. Post-Enron, there have been moves to ask auditors to make statements about matters relating to the company, such as the effectiveness of internal controls. For example, in the UK, in May 2004, the Financial Services Authority (the UK equivalent of the SEC) released proposals for consultation that would see the auditors of listed companies required to review the provisions relating to audit and accountability in the Combined Code (the UK's guide to corporate governance for companies listed on the London Stock Exchange). These include the board's review of the company's internal control systems and the role and responsibilities of the audit committee. In addition, it will also require auditors to consider whether the 'comply or explain' statement required by the Code has been made after 'due and careful enquiry'. These proposals are a watered down version of those in section 404 of the Sarbanes-Oxley Act, which force auditors to make a judgement on the effectiveness of a company's internal controls. How effective such requirements will be in making auditors say something different to the norm is hard to predict. The most likely outcome may be that

some form of words is produced which is then incorporated into all audit reports, and the reader is still faced with the issue of deciding upon an auditor's competence and independence given no evidence of apparent action.

THE SUBSTANCE OF REFORM: NEW OPPORTUNITIES BUT OLD PROBLEMS FOR AUDITING?

The above discussion has presented a series of brief snapshots of factors that have been significant in the development of the system of auditing during the last 15 years or so. Much has changed since the early 1990s in the context of auditing. There have been significant market pressures of audit engagements, additional structures have been relied on to reinforce the position of auditors, developments have been pursued in the technical methodology of auditing and audit reporting and there has been significant change in the structure of regulation and content of related standards. In the remainder of this chapter we offer some comments arising from the fact of recent alleged audit failures occurring against this context. Specifically, our comments focus on what these events suggest regarding the potential for regulation, the need to consider both competence and independence, and possible implications for policy and research.

THE POTENTIAL OF REGULATION

The general impression is that regulatory reforms, such as those instituted by Sarbanes-Oxley, will prove to be substantive. However, reviews of scandals and eras of corporate crisis in the past have often concluded that very little changes in the longer-term. Despite attempted reforms to strengthen the system of auditing, we still have audit failures, audit-expectations gaps, 'uneducated' users and uninformative audit reports. In the early 1990s, we wrote about the expectations gap under the theme of 'plus ça change, plus c'est la même chose' (Humphrey, Moizer, & Turley, 1992). We highlighted the static nature of debate in this arena, the need for more detailed analyses and understanding of the audit function and the dangers of not taking action in this regard, particularly with respect to issues such as the detection of fraud:

> "Whether changing audit responsibilities concerning the detection of fraud come about voluntarily or statutorily, we believe that any such changes need to be based on a greater awareness, and continuing public investigation, of the operation and capabilities of the

> audit function in this regard. Otherwise, we would anticipate that the position in 10 years' time will, unfortunately, be little different from that outlined in the January 1991 editorial of Accountancy when predicting the changes to be experienced within the accountancy profession over the next 10 years:
>
> There will be a gigantic fraud. The auditors will fail to detect it, and will be surprised when they read about it, at the same time as everybody else, in the pages of the Sunday Times. The auditing guideline on fraud will be reviewed…There will be nothing new under the sun." (Humphrey, Moizer, & Turley, 1993, p. 57)

It is true that for a time in the 1990s, audit expectations debates did seem to become less significant and prominent than they had been in preceding decades (such as the 1970s and the 1980s). The profession appeared to have become more comfortable with the whole notion of an expectations gap. Expectations gaps were common in other professions so auditors should not be too worried about that in auditing. They were also a way of enabling the profession to promise to improve its performance. A profession capable of living with and embracing its radical critics was a mature profession, not a profession under undue threat. The mid-1990s became a period of visioning (see Fogarty, Radcliffe, & Campbell, 2006) – of new opportunities, new products and markets, new concepts, methods and methodologies. Auditors were set to move into a redesignated world of assurance services, becoming added-value business advisers, not just plain auditors. Notions of independence needed re-writing to reflect more the substance rather than the appearance or image associated with the work of auditors. Business risk-based methodologies sought to bring auditing technologies up-to-date, accessing capabilities made possible by advances in information technology, and to focus on business understanding, enabling auditors to provide a more value-added service to their 'clients'.

The scale of intended change and the scope of new thinking were evidenced most notably by the way in which the word auditing became de-emphasised from the public documentation and web-sites of many of the larger accounting firms. There was also a very evident embracing of the arguments put forward many years ago by Goldman and Barlev (1974) that auditors providing a range of services to audit clients were likely to be more effective than those solely providing a statutory financial audit.

Then, like a big bang, came Enron and a number of other scandals, including WorldCom, Xerox, Ahold and Parmalat. The collapse of Arthur Andersen and its role in the Enron scandal challenged the credibility of the larger firms to act as global regulators through vehicles such as the Forum of Firms of the International Federation of Accountants (IFAC). National and cross-national governmental regulators have responded with a host of

reforms – in some cases put together very quickly in the aftermath of the Enron scandal. For some, it can feel like we are operating in a very different world, with more stringent provisions governing the delivery of audit services, a more active role on the part of regulators, more detailed standards and a clear commitment and desire to establish global auditing standards and practices. However, from another perspective, it can be argued that there are still great commonalities with the past in that we have moved beyond the critical, reflective phase in the immediate aftermath of Enron to a more attractive, forward-looking scenario where we are again being promised a better auditing world – wherein auditing and associated services function as they are supposed to do, working consistently and effectively in the public interest. It is important to recognise that the precedents of past eras of corporate crisis and reform suggest that regulation will not remove the inherent uncertainties around financial reporting and auditing that, in particular circumstances, will serve to trigger new corporate scandals and audit failures.

Perhaps, things will be different this time round in a more globally regulated world of international accounting and auditing standards, oversight bodies and more explicit rules and bans on the provision of non-audit services. However, even now one can find questions and concerns that the new regulatory forms may place undue faith in certain regulatory and governance provisions or too easily accept that new oversight structures will serve the public interest. There also remain questions as to the extent to which the business model of audit firms is compatible with the provision of a public-oriented and accountable auditing service.

AUDITOR INDEPENDENCE OR COMPETENCE?

Historically, debates on auditor independence have tended to take auditor competence as a given – the problem to be addressed was not so much one of auditors failing to find errors but one of not reporting (or not reporting clearly or timely enough) errors found. Some of the recent scandals suggest that despite the developments in auditing methodologies, auditors have failed to cope with some fairly basic frauds as well as more complex cases of financial engineering. There is, therefore, a question concerning how the auditing methodologies, the approaches to evidence collection and the abilities of auditing staff have managed to keep pace with changes in client companies' accounting systems and the attitudes and outlook of company accounting personnel, who have favoured cutting audit fees. The attempts of

accounting firms to make auditing more interesting and to give it a more substantial and respected internal profile have contrasted with the need to guarantee a level and consistency of audit-testing adequate for the verification of the financial statements of companies doing business on a world stage.

Recent legislative and regulatory reforms may well serve to establish the right 'tone at the top' that was evidently missing even before Enron came about. It may be that the extra disciplines and penalties invoked by Sarbanes-Oxley will increase audit practitioner diligence and cut down on the desire of corporate management to deceive their auditors. Formal regulatory inspections of the Big Four Accounting firms in the US (see PCAOB, 2004), while detecting significant accounting and auditing issues missed by the firms and identifying concerns with their quality control systems, have not shaken the regulator's belief that such firms are "capable of the highest quality auditing". However, past experience tends to suggest that it is, at least, an open question as to how far regulatory reforms are able to infiltrate and influence the ruling cultures in accounting firms. The client-auditor relationship is often one governed by notions of inter- or mutual-dependence rather than one disciplined by notions of independence. The regulatory reform movement is based on a view of the audit process driven by regulators whose existence depends on having an audit function to regulate. Expectations that reforms will get to the heart of the dilemmas facing auditors in their day-to-day working environment may be unduly optimistic.

The need for continued questioning seems to be supported from a number of different angles. In response to crisis and concerns over the capabilities of auditors, auditing firms often highlight other factors – a problem of governance, managerial integrity or unfair auditor liability laws rather than a question of auditor competence. Well-publicised cases of apparent audit failure followed by further calls for reductions or limits in auditor liability do not sit together positively. There are also questions over the kind of skills and competencies needed for individual auditors to be effective. Is the public interest really being served by external auditors offering 'added value', business risk advice to senior management? This may make sense in the smaller company sector (and owner-managed businesses), but a more visible public-spirited commitment may be appropriate for auditors of companies with clear public interest responsibilities. Auditing standards require auditors to be 'neutral' and not to assume that client management is neither fundamentally honest nor completely dishonest. However, this may leave auditors with a dangerous handicap – especially when client management is not neutral and capable of significantly influencing the auditor's appointment. Fundamentally, do the

people who train, qualify and stay as auditors generally have the right set of abilities to be good at detecting senior-management-led fraud or at giving business advice?

QUESTIONS OF POLICY AND RESEARCH

A key point to emphasise with respect to post-scandal reform processes is that they have rarely proved capable of challenging the belief that there will always be some new rules, codes, principles, regulations, restrictions, methodologies and practices available that will improve auditing, corporate transparency and accountability. Further, while we might have seen clear cases of accounting, audit or regulatory failure, the proposed solutions invariably seek to produce more accounting, more auditing, more regulation, more formally stated principles and codes. Where there was once external audit, we now need internal audit, audit committees, corporate governance and public oversight boards. Where we once trusted ethical principles, we now need more detailed codes (although these may still be drafted with reference to principles). Even the strongest critiques of the accounting profession appear to hold a firm belief in existing systems and structures to work better. Thus, contemporary radical solutions to audit failure invariably include calls for better auditing, for more auditing. Cases of auditors failing to detect significant fraud are met with calls for auditors to detect such fraud. Questions about auditor independence lead to requirements to be more independent. Situations of regulatory failure are followed by demands for new regulations. Ironically, despite all the various regulatory developments (whether pre- or post-Enron), attempts over the years to advance and broaden audit methodologies and the apparent growing social and global significance of auditing and governance initiatives (e.g., see Power, 1997), we still know only a limited amount about auditing practice, the effectiveness and degree of application of new audit methodologies and the extent to which the audit culture within the large accounting firms is conducive to the development and establishment of a public spirited external audit function (also see Kosmala MacLullich, 2003). It is possible to argue that too much attention is being devoted currently to matters of auditor independence and not enough focus placed on to more basic issues of auditor competence.

The above analysis highlights some difficult questions concerning the potential and adequacy of regulation to avoid future failures, the necessary and actual status of auditing within accounting firms, the ability of audit

approaches to respond to the complexities of modern business developments and the role of research in policy debates. Above all, what this review tells us is the need for auditors (and, indeed, audit regulators) to open up their world as much as possible and enable more insight to be provided of auditors' day-to-day working environments and the capacities of auditors and the audit process. There can be risks to any such policy of openness. However, given the scale of the questions capable of being directed at today's audit function, the way in which auditing is spreading globally via governance and financial transparency initiatives and the public interest responsibilities of auditors, auditing is a process too important to be allowed to remain as a relatively private function. The main chance for closing the audit expectations gap is to ensure more transparency in the audit process and what it can realistically achieve rather than placing faith in (yet more) regulatory reforms alone.

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Accounting History

Editor
Garry D. Carnegie
School of Enterprise
The University of Melbourne
442 Auburn Road
Hawthorn Victoria
Australia 3122
Telephone: +61 3 9810 3369
Fax: +61 3 9810 3149
g.carnegie@soe.unimelb.edu.au

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Thursday 9 August

Accounting History Doctoral Colloquium
Conference registration
Panel Session – *What does it mean to be a co-author?*
Chair: Alan Richardson, York University, Canada
Opening reception

Friday 10 August

Opening Plenary – *Accounting's Latent Scientism: Revisiting Scientific Management Roots* by Lee Parker and Philip Ritson
Presenter: Lee Parker, The University of Adelaide, Australia
Paper presentations held in parallel sessions
Mid-point Plenary – *Executing Chaebols: Democracy, Globalization and Accounting*
Presenter: Soon Nam Kim, University of Saskatchewan, Canada
Conference dinner

Saturday 11 August

Paper presentations in parallel sessions
Closing Plenary – *Race and Memory: Pioneering Black Accountants in South Africa and the United States*
Presenter: Theresa Hammond, Boston College, USA
Closing conference dinner

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The *Accounting History* Doctoral Colloquium (*AH*DC) will be held on the first day of the *AH*IC conference, prior to the panel session and the opening reception. The Colloquium provides an opportunity for up to ten doctoral students in accounting history to make presentations on issues in their research area. A panel of academic faculty will comment on the formal student presentations and offer encouragement and advice to all participants. Doctoral students and aspiring doctoral students who are interested in attending the Doctoral Colloquium are requested to contact Garry Carnegie, Colloquium Panel Chair at: 5AHIC@soe.unimelb.edu.au.

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