Compromised Work in the Public Accounting Profession: The Issue of Independence

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The pursuit of good work is challenging, especially against the backdrop of a society shaped by the broad forces of globalization, information technology, and the forces of our market economy. By studying those individuals and institutions who have been able to achieve good work, the Good Work project has found the source of good work to be the positive reinforcement (or an “alignment”) of the following: the values of individuals, the values and behavior of those in a profession (the “field”), the professional knowledge and ethical standards that professionals must abide by (the “domain”), and the values and behavior of stakeholders outside of a profession (such as the government and the public).

Recently, the project’s team of investigators has turned its attention to “compromised work,” work that falls within the confines of the law, but nonetheless compromises the ethical core of a profession. Examples of such work include the journalist who makes up stories or the physician who provides substandard treatment because he has failed to inform himself of the latest medical innovations. Compromised work can occur at the level of the individual, the institution, and the profession. For the purposes of this paper, I will focus on compromised work at the level of a profession. I have chosen a profession that many have characterized as being in a state of crisis—the public accounting or auditing profession.

The public accounting profession in the United States was established with the passage of the Certified Public Accountant (CPA) laws: in 1896 New York passed the first law recognizing the qualification known as Certified Public Accountant, and by 1921, all of the then-forty eight states had passed such legislation (Boynton, Johnson, & Kell, 2001).
During the turn of the century, the markets expanded as more companies sold shares of ownership to several investors, who relied on managers to oversee the day-to-day operations and to provide periodic reports on these activities. Recognizing that the managers of a company had an incentive to present the economic activities of the firm in a favorable light, owners wanted an audit performed on the information they were provided. The profession rose to ascendancy when the securities acts of the 1930s required all publicly traded companies to submit statements of their financial activities (e.g., sales and expenses) and balances (e.g., debt and equity) that had been audited and certified by a public accountant.

The public accountant is charged with the responsibility of making sure that a company’s financials do not contain any “material” violations of the body of accounting standards used to measure and report financial activities (referred to as Generally Accepted Accounting Principles or GAAP). The accountant performs an audit according to a body of standards known as Generally Accepted Auditing Standards or GAAS. An integral part of the ethical component of the accountant’s domain is the requirement to maintain “independence” from the managers of the company being audited so as to ensure that the accountant provides the public with an objective, unbiased assessment of the financial statements.\(^2\)

In this paper, I trace the development of the notion of independence, from its origins in the late nineteenth century to the late twentieth century. In particular, I focus on the issue of non-audit services performed for an audit client, an issue that has dominated discussions of auditor independence since the 1950s. One hypothesis for the crisis in the profession has been that the accountants were trying to wear two hats: the hat of an accountant and the hat of a consultant. Did the consultant’s hat interfere with
the accountant’s responsibilities to maintain independence from his client, and thus, compromise the profession?

The Origins of Auditor Independence: Independence in Fact vs. Independence in Appearance

As late as the 1870s many owners of companies were able to perform their own audits. As this practice became increasingly more difficult, however, due to the expansion in size and scope of corporations, owners hired accountants to perform audits. Because the owners were their clients, it was easier for auditors to remain independent from the management of the company they were auditing. As the markets in the United States expanded to include larger numbers of smaller investors in the twentieth century, the management of a company took over the responsibility of hiring and remunerating the auditor. As a result, the auditor effectively had two clients: the public who relied on the accuracy of the financial statements in order to make investment and other decisions; and the management of the company being audited.

From the earliest days of the profession, many public accounting firms also offered some form of consulting services, which included the installation of factory cost systems, organizational efficiency studies, and investigations of possible investments. These services were often provided in conjunction with audits. An announcement dated December 1, 1913 noted that Andersen, Delaney & Co. would provide, in addition to financial statement audits, “investigations for special purposes, such as to determine the advisability of investment in a new enterprise…the designing and installing of new systems of financial and cost accounting and organization” and other non-audit services (Mednick, 1990).
Many members of the profession at that time were reluctant to formalize the concept of independence into specific rules or guidelines:

Fundamental and pervasive concepts, such as confidentiality and independence, were not codified. Many believed to do so would mean inevitable dilution of intent. Accountants sought, rather, through the national organization and within the practitioners’ offices, to internalize those values so that they were completely accepted and respected by everyone who entered the profession of public accountancy….To imply that accountants were independent because they observed certain minor prohibitions was considered dangerous. The public might be misled by assuming that this guaranteed independence, which was not true. (Previts and Merino, 1998, pp. 203-5)

The first formal requirements mandating auditor independence from their clients were the federal securities acts in the 1930s. These (Securities Act of 1933 and the Securities Exchange Act of 1934) mandated that all publicly traded companies file financial statements that were certified (audited) by “independent” public accountants, in their first public stock offering and on an annual basis thereafter. The 1934 Act established the Securities and Exchange Commission (SEC), which was given the authority to promulgate standards for financial accounting and auditing.

In 1933, the Federal Trade Commission, under authority granted to it by the 1933 Act (before the SEC was given rulemaking authoring in 1934), adopted the following rule to provide guidance on what it meant for an auditor to be independent:

The Commission will not recognize any such certified accountant or public accountant as independent if such accountant is not in fact independent. Unless the Commission otherwise directs, such accountant will not be considered independent with respect to any person in whom he has any interest, directly or indirectly, or to whom he is connected as an officer, agent, employee, promoter, underwriter, trustee, partner, director, or person performing similar function. (Berryman, 1974, 3)

This definition showed two dual conceptions of independence: independence in fact and independence in appearance. The appearance of independence was necessary because it was difficult to ascertain one’s independence “in fact” given that objectivity
was a state of mind. Thus, the SEC had prohibited financial interests in audit clients and certain employment relationships with audit clients to preserve the appearance of independence.

The SEC amended its rule in 1936 to prohibit any “substantial” financial interest. (In 1950 the SEC went back to the 1933 prohibition on any financial interest rather than a “substantial” financial interest.) In 1937 the SEC’s Accounting Series Release No. 2 specified that “substantial” interest referred to its significance with respect to the total capital of the corporation and the personal fortune of the accountant. It described an accountant that owned stock in a client corporation—the value of which constituted more than one percent of his personal income—as being deemed not independent (Carey, 1970). In 1940 the profession’s trade group (the Institute of American Accountants, at that time) adopted their Code of Professional Ethics. A rule within prohibited accountants from having financial interests—which represented their first admission that the “appearance” of independence was important—in audit clients.

A member or associate shall not express his opinion on financial statements of any enterprise financial in whole or in part by public distribution of securities, if he is himself the actual or beneficial owner of a substantial financial interest in the enterprise or if he is committed to acquire such an interest; nor shall a member or an associate express his opinion on financial statements which are used as a basis of credit, if he is himself the actual or beneficial owner of a substantial interest in the enterprise or if he is committed to acquire such interest, unless he discloses his financial interest in his report (Berryman, 1974, 4).

The Institute did not adopt the SEC’s prohibitions against certain employment relationships into their code at that time. Therefore, there were two standards for independence: 1) the standards set by the SEC, those which auditors had to comply with for audits of publicly traded companies, and 2) the standards set for audits of private
clients. This dichotomy underscores the profession’s reluctance to place restrictions on the profession, even for the sake of the preservation of the appearance of independence.

At the same time, the importance of independence was never questioned. In 1947 the Council of the Institute adopted a statement on independence that underscored its importance to the profession: “Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession’s strength and its stature” (Carey, 1970, 182). That same year, the Institute’s Committee on Auditing Procedure produced “Tentative Statement of Auditing Standards; Their Generally Accepted Significance and Scope,” in which the second general standard stated, “In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors” (Berryman, 1974, 5). The importance of maintaining the appearance of independence, however, was not as highly valued by members of the profession, as evidenced by this section of the committee’s report:

In the profession’s early days, “hanging out his own shingle” sufficed for an outward mark of independence, while the literature of his profession taught the simple virtue of complete intellectual honesty as its essence. But progress brought problems, and one of them in the auditor’s realm was how the attribute of complete intellectual honesty might be recognized as something additional to the fact of his being engaged in professional public practice. So there arose a quest for signs—signs by which any lack of independence might be recognized...The profession has gradually compiled...precepts and conditions to guard against the presumption of loss of independence. “Presumption” is stressed because insofar as intrinsic independence is synonymous with mental integrity, its position is a matter of personal quality rather than of rules that formulate certain objective tests. (Carey, 1970, 179)

It is worthwhile to note that during this time period an auditor could not be found liable to third parties who did not enter into a contract directly with the auditor (i.e., investors, lenders, other third parties who may use the client’s financial statements).
The landmark decision in this area, *Ultrameres v. Touche* (1931), which was virtually unchallenged for 37 years, held that an auditor was not liable to third parties who relied on a negligently prepared audit report. Judge Cardozo ruled,

> If liability for negligence exists, a thoughtless slip or blunder, the failure to detect a theft or forgery beneath the cover of deceptive entries, may expose accountants to a liability in an indeterminate amount for an indeterminate time to an indeterminate class. The hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences. (Amhowitz, 1987, 179)

Therefore, unless an auditor actively committed fraud (he or she was liable to third parties for fraud under the securities acts), he or she would not be found liable. As a result, an unintentional compromise in an auditor’s independence and its effect on the quality of an audit was not as major a concern during this time period.

1950s and 1960s: The Effect of Non-Audit Services on the Appearance of Independence

During the 1950s and the 1960s, most auditors who reached the level of partner were assured of tenure until they retired. If they stood up to clients regarding questionable accounting practices, they expected their firms to support them. The leading partners of the eight largest public accounting firms in the industry (referred to as the “Big Eight”) were not afraid to speak and write about major accounting principles. The idea of “marketing” to new clients did not exist because the profession (through its professional trade group) had frowned upon advertising and other forms of self-promotion. Partners were rewarded on the basis of the quality of the audit services they provided (Zeff, 2003, September 1). These conditions fostered an ability for auditors to preserve their independence in judgment.
It was also at mid-century that several major accounting firms, such as Arthur Andersen & Co., Peat, Marwick, Mitchell & Co, and Touche, Niven, Bailey & Smart, expanded their service lines to offer new “management advisory services” or “administrative services,” which included computer systems design and installation, electronic data processing, and operations research. As of 1957 the profession’s trade group (which was renamed the American Institute of CPA’s, AICPA, in 1957) had prepared and distributed a pamphlet describing the management services offered by CPAs.

In an article in the *Journal of Accountancy* in 1957 entitled “Ethical Considerations in Rending Management Services,” one CPA predicted that consulting might raise doubts related to an auditor’s independence from its audit client: “On the question of maintaining independence and auditing work for a client who regularly seeks the accountant’s advice upon management problems or for whom various other management services are rendered, it is probable that all doubts as to complete independence cannot be avoided” (Mednick & Previts, 1987, 6).

In its 1957 annual report the SEC voiced concern about the breadth of services that auditors were providing. Two years later, the SEC’s Chief Accountant, Andrew Barr, commented that an auditor’s performing managerial services for a client risked the possibility of losing his objectivity.

The academic community was also concerned. In 1961 R.K. Mautz and Hussein A. Sharaf, educators at the University of Illinois, published *The Philosophy of Auditing*, in which they concluded that non-audit services (which included tax services and what they referred to as “management services”) tended to cloud the auditor’s appearance of independence. The authors also recommended that an accounting firm separate its audit
services from its non-audit services (and the respective staffs of those departments). They allowed for smaller firms to continue as “general practitioners,” however, since very few of them “make what may be called a public audit” (Carey, 1970, 192).

In 1963 the AICPA’s committee on professional ethics responded by publishing its Opinion No. 12 on independence. This statement stipulated that normal professional or social relationships would not suggest a conflict of interest in the mind of a reasonable observer. Specifically, it read,

…in the areas of management advisory services and tax practice, so long as the CPA’s services consist of advice and technical assistance, the committee can discern no likelihood of a conflict of interest arising from such services. It is a rare instance for management to surrender its responsibility to make management decisions. However, should a member make such decisions on matters affecting the company’s financial position or results of operations, it would appear that his objectivity as independent auditor of the company’s financial statements might well be impaired. Consequently, such situations should be avoided.

In summary, it is the opinion of the committee that there is no ethical reason why a member or associate may not properly perform professional services for clients in the areas of tax practice or management advisory services, and at the same time serve the same client as independent auditor, so long as he does not make management decisions or take positions which might impair that objectivity. (Carey, 1970, 193-194)

In the July 1965 volume of the Accounting Review, Arthur A. Schulte, Jr., then an accounting professor at the University of Portland, Oregon, presented his findings from a survey of financial executives on the issue of auditor independence: thirty-three percent of the respondents believed that management consulting seriously endangered the CPA’s audit independence, while 24 percent were undecided. Schulte concluded that these results should be a cause for concern for the profession (Carey, 1970, 194-195).

The AICPA rejected Schulte’s advice:

It is difficult to believe that reasonable observers—stockholders, creditors or other users of financial statements, or the business public generally—would see any conflict of interest in the fact that the auditor, in addition to giving an opinion
on the financial statements, also applied his technical knowledge and skill to the improvement of management’s planning, control and decision-making processes.

As a matter of fact, advice and assistance in improving clients’ accounting systems and internal controls have been normal functions of auditors from time immemorial—functions which have never raised any questions about independence. (Carey, 1970, 195)

The AICPA also wrote that the fees from the management services would not impact the audit because most management services were non-recurring. Then it spoke about the difference between the conditions of independence in fact and independence in appearance, and the tension between the two.

It is clear that a measure of confusion has been engendered within the profession on this important matter. It has arisen partly because of a tendency to extend to the ultimate theoretical limits the concept that the auditor must not only be but also seem independent….But concern with appearances should not confuse appearance with reality. Too much emphasis on relationships which might conceivably suggest a conflict of interest to the most suspicious observer may be a disservice both to the profession and the public.

The result might be to deprive clients of valuable creative contributions to improved management which their auditors, through their very familiarity with the clients’ business, acquired in the course of the audit, are in a better position than anyone else to make. To split the accounting profession into two segments—one a group of ivory-tower auditors who did nothing but attest to the fairness of financial statements, and the other a group of experts in management and tax problems—would not only reverse the natural trend of accounting practice which has evolved over a century of experience; it would also add substantially to the cost of providing business with all the professional accounting service it needs.

To contend that a CPA acting as auditor should have no relations with his client except those involved in his work as auditor, for fear that the public might suspect a conflict of interest, would lead to an absurd situation. (Carey, 1970, 195-196)

In 1966, as criticism from the academic community continued, a committee within the AICPA began a study of the scope of auditors’ services. The committee found no evidence that non-audit services impaired independence “in fact.” However, it found that some financial statement users did believe that non-audit services impaired the appearance of independence (Carey, 1970, 201).
1970s and 1980s: Prohibition of Non-Accounting-Related Services, Disclosure Requirements for Amount and Nature of Non-Audit Services, and the Toll of Increased Industry Competition and Litigation

Since 1968 several court decisions served to extend the auditor’s liability to third parties for negligence. The ruling in the Rusch Factors v. Levin (1968) extended the liability to a “foreseen class:” “The accountant should be liable in negligence for careless financial misrepresentation relied upon by actually foreseen and limited classes of persons. In this case, the defendant knew that his certification was to be used for potential financiers of the...corporation (emphasis added)” (Boynton et al., 2001, 127).

Other court decisions at the end of 1960s served to increase the auditor’s liability. For example, in the Continental Vending Case (1969), which was tried in the U.S. District Court in New York City, the judge ruled that adherence to GAAP (Generally Accepted Accounting Standards, the body of accounting standards that financial statements needed to conform to) did not exempt auditors from liability if it were proven that there was a need for further disclosures (Zeff, 2003, September 1).

Litigation against auditors exploded in the 1970s. There were 71 cases in 1970, 140 in 1971, and 200 in 1972 (Squires et al., 2003, 68). A number of highly visible financial reporting failures also haunted the profession at the beginning of the 1970s. Therefore, the AICPA set up a committee in 1974 led by former SEC’s chairman Manuel Cohen (often called the Cohen Commission), to investigate whether “a gap may exist between what the public expects and needs and what auditors can and should reasonably expect to accomplish. If such a gap does exist, it needs to be explored to determine how the disparity can be resolved.”
In its report issued in 1978, the Cohen commission criticized the profession for having “failed to react and evolve rapidly enough to keep pace with the speed of change in the American business environment.” It further criticized members of the profession for not dedicating enough resources, in terms of time or money, to its audits. It recommended that auditing standards be more stringent (Berenson, 2003). Related to management consulting services, however, the Cohen Commission concluded that management consulting did not compromise an auditor’s ability to remain independent. It did recommend that the auditor fully inform the board of directors (or its audit committee) of all such services and their relationship to the audit services provided, and that the board of directors (or its audit committee) duly consider all services provided by the auditor.

Shortly after the Cohen Commission was formed, the U.S. Senate’s Subcommittee on Reports, Accounting and Management (often referred to as the Metcalf Committee) launched an investigation of the accounting profession. Although non-audit services—even including tax services—represented only about 30 percent of audit firms’ revenue at the time, Congress considered limiting the services that independent public accountants could provide to those that were directly related to accounting. In 1977 the Metcalf Committee issued its report, “The Accounting Establishment.” The committee found that, “The accounting profession must improve its procedures for assuring independence in view of the public’s needs and expectations….The best policy…is to require that independent auditors of public owned corporations perform only services directly related to accounting.” It believed that only certain management advisory services were appropriate to provide to public audit clients; these included “certain computer and systems analyses…necessary for improving internal control procedures of
corporations.” It concluded that other types of management advisory services should not be provided to audit clients. These services included executive recruitment, marketing analysis, plant layout, product analysis, and actuarial services.

The profession responded to the reports issued by the Cohen Commission and the Metcalf Committee by undertaking a new program of self-regulation. In 1977 the Institute created a Division for CPA firms, composed of an SEC Practice Section (SECPS) and a Private Companies Practice Section. The SECPS adopted criteria for scope of services and prohibited an auditor from providing the following services to a public audit client: psychological testing, public opinion polls, merger and acquisition assistance for a finder’s fee, executive recruitment, and actuarial services to insurance companies. Members were also required to report to the audit committee of each SEC client the amounts and nature of management advisory services performed, on an annual basis. Finally, to oversee the activities of the SECPS, the AICPA established the Public Oversight Board (POB). The POB was charged with the tasks of establishing and enforcing quality control standards for public accounting firms and establishing a peer review process.4 The POB immediately began a study on the scope of services by accounting firms.

In 1978 the SEC required that public companies disclose certain information related to non-audit services (e.g., the percentage of non-audit service fees to audit service fees, whether the audit committee or board had approved the services) in their annual proxy statements. At the same time, it also announced that it was awaiting the results of the POB’s study before it would propose any rules limiting the scope of services.
In its study released in 1979, the POB wrote about the concerns related to non-audit services:

There is enough concern about the scope of services in responsible quarters so that the question cannot be dismissed as a ‘nonproblem. The Board believes that there is potential danger to the public interest and to the profession in the unlimited expansion of MAS (management advisory services) to audit clients, and some moderating principles and procedures are need. (Zeff, 2003, September 1, 13)

Yet it concluded that no rules should be imposed to prohibit certain services. Rather, it would be better to rely on the public disclosures of non-audit services required by the SEC and the AICPA’s SECPS, along with an admonition to auditors to exercise restraint and judgment. The POB’s conclusion on this matter was based on the “many potential benefits to be realized by permitting auditors to perform [management advisory services] for audit clients that should not be denied to such clients without a strong showing of actual or potential detriment.”

The SEC responded to the POB’s report in Accounting Series Release (ASR) No. 264, also issued in 1979. The SEC stated that the report “did not adequately sensitize the profession and its clients to the potential effects on the independence of accountants of performance of non-audit services for audit clients” and invited comments so that it could further evaluate the issue. ASR No. 264 was rescinded in 1981, almost immediately following a requirement by the SECPS that member firms disclose the extent of non-audit services in annual reports to the SECPS. In 1982 the SEC repealed Accounting Series Release No. 250 (issued in 1978), which had required public companies to make certain disclosures in proxy materials about fees for nonaudit services. The SEC withdrew this requirement due to “the absence of evidence that investors want or use the
disclosure or that performance of nonaudit services impairs accountants’ independence” (Mednick & Previts, 1987, 7)

In 1983 the auditor’s liability to third parties was extended to “foreseeable parties” in *Rosenbloom v. Adler*. This ruling made the auditor liable to all those whom he could reasonably foresee as users of the client’s financial statements (Boynton et al., 2001). As a result, a compromise in the independence (whether in fact or in appearance) could be used to help build a case for auditor negligence. Between 1973 and 1987, more lawsuits were filed against accountants than in the entire previous history of the profession. Although the number of claims per year stabilized at around 850 in 1987, the amount awarded in claims continued to increase. Accounting firms faced escalating insurance premiums and decreased coverage. In fact, many carriers ceased to offer liability insurance (Miller 1988).

The eighties was also a time of intense competition among the accounting firms in the industry, a major change from previous decades. Facing pressure from the Federal Trade Commission due to anticompetitive concerns, the AICPA rescinded its ban on advertising and other forms of client solicitation in 1978. Consequently, competition became fierce. This situation was exacerbated by the trend of mergers and acquisitions during the eighties, which led to fewer and fewer clients being available (a merged company only needed one auditor). Some audit clients threatened they might go “shopping” for lower priced audits, while others actually required auditors to bid competitively. In 1982 Max Block, the former editor of *The New York Certified Public Accountant*, said that the “accounting profession” was “a term that has lost some of its relevance…some of the major firms do not refer to themselves as Certified Public Accountants or Accountants and Auditors” (Zeff, 2003, December 1, 1).
The accounting firms responded to the new economic pressures that accompanied the intensely competitive environment by merging with each other and expanding into highly lucrative non-audit services. From 1983 to 1985 revenues from audits at the Big Eight firms grew by only 14 percent, while those for management consulting were up by 33 percent and for tax practice, 28 percent (O’Glove, 1987, 17-18). In 1984 the Supreme Court emphasized the auditor’s responsibility to the public and then re-emphasized the importance of the appearance of independence (in addition to independence in fact):

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. (quoted in Bartlett, 1991, 15-16)

In 1986 the POB conducted a study to assess the attitudes of various groups towards the impact of non-audit services on auditor independence. The results indicated concerns that non-audit services could impair independence.

In 1986, the AICPA’s Special Committee on Standards of Professional Conduct for Certified Public Accountants found “The competitive environment has placed pressure on the traditional commitment to professionalism in the practice of public accounting” (Zeff, 2003, December 1, 1). The increasingly competitive environment had changed the job security of partners. In the past, job security depended on adherence to professional and technical standards. In the mid-1980s partners were pressured to bring in sufficient business, including non-audit service fees. In addition, the compensation of
new entrants into the profession was lowered, which, in turn, led to a drop in the number of college students choosing to major in accounting (Sunder, 2003).

In 1988 three major accounting firms petitioned the SEC to modify certain independence rules to allow expanded business relationships with their audit clients. In mid-1989 all of the Big Eight accounting firms approached the SEC for a modification in the independence rules.

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During the seventies and eighties, the industry experienced two major trends: increased litigation and more aggressive moves into consulting services. It is unclear whether these trends were independent or whether one caused the other. The increase in litigation was caused by several court decisions that served to extend the auditor’s liability to third parties for negligence; the aggressive move into consulting was caused by increased competition resulting from the AICPA’s rescinding of industry advertising and client solicitation (after facing pressure from the Federal Trade Commission due to anticompetitive concerns).

1990s: The Rise of Non-Audit Services and Other Threats to Independence

In the nineties, accounting firms continued to expand their offerings of consulting services, despite concerns from the SEC, Congress, and other interested parties that these services jeopardized the auditor’s ability to maintain its independence from its clients. Other trends in the nineties also put auditor independence in jeopardy: low auditor rotation from clients, audit client’s hiring former auditors, and a diminished legal threat.

In 1994 an SEC Staff report on auditor independence found that much of the growth in non-audit services up until that point could be attributed to services provided to
parties that were not audit clients. Thus, it decided not to make any changes to Commission rules or federal securities laws. Nevertheless, it would “continue to be alert to the development of problems of independence that may be caused by [non-audit services].” Yet, the Office of the Chief Accountant said, “the staff is mindful of the potential impact of MAS on auditors’ independence, in the light of the increasing role of non-audit personnel who are not bound by the accounting profession’s Code of Ethics at the top management levels of the firms…” (Zeff, 2003, December 1, 7).

That same year, the Public Oversight Board’s Advisory Panel on Auditor Independence (Kirk Panel) issued a report that stated “growing reliance on non-audit services has the potential to compromise the objectivity or independence of the auditor by diverting firm leadership away from the public responsibility associated with the independent audit function.”

Also in 1994, the AICPA Special Committee on Financial Reporting (Jenkins Committee) found that financial statement users were concerned that “auditors may accept audit engagements at marginal profits to obtain more profitable consulting engagements. Those arrangements could motivate auditors to reduce the amount of audit work and to be reluctant to irritate management to protect the consulting relationship.”

Between 1993 and 1999, the average annual growth rate for revenues from non-audit services and similar services was 26 percent, while growth rates for audit and tax services had been nine percent and thirteen percent respectively. In 1999, U.S. revenues for management advisory services and similar services for the five largest public accounting firms (“Big Five”) amounted to over $15 billion. These revenues now accounted for approximately half of the total revenues of these firms (Securities and Exchange Commission Proposed Rule S7-13-00).
For the largest firms, the growth in these services involved audit clients as well as non-audit clients. The percentage of audit clients who paid management advisory services fees in excess of their audit fees to Big Five firms did not exceed 1.5 percent until 1997. By 1999, this figure grew to 4.6 percent, an increase of over 200 percent in just two years. For the Big Five firms, non-audit services from audit clients amounted to ten percent of all of their revenues in 1999. Only one-fourth of their audit clients purchased non-audit services, and thus, ten percent of their revenues came from non-audit services from just one-fourth of their audit clients (Securities and Exchange Commission Proposed Rule S7-13-00). There were also allegations that accounting firms were “lowballing” audit fees (even offering to perform them at losses) in order to gain opportunities for non-audit service fees (Coffee, 2001, May 21).

In 1998 the AICPA’s president Barry Melancon wrote, “The marketplace says the worst thing we have going for us is the ‘A’ in CPA,” referring to the word “accountant” (Hilzenrath, 2001, 3). In its 1999 publication titled “Make Audits Pay: Leveraging the Audit Into Consulting Services,” the AICPA wrote “Intense competition has reduced the audit to a mere commodity that is distinguishable to the consumer only according to price” (Hilzenrath, 2001, 3). The book advised the auditor to think of himself as a “business advisor.” It did note that conflicts could arise from performing the role of business advisor (which was a client advocate) and the auditor (which had to be independent). It advised erring on the side of looking out for the public interest (Hilzenrath, 2001).

Other Threats to Auditor Independence in the Nineties

*Low Auditor Rotation and Audit Client’s Hiring of Former Auditors*
During the nineties, auditors were effectively appointed and reappointed by managers (who also had a significant say in the audit fees) in most companies. The board’s audit committee was primarily involved in an auditor’s appointment, and his or her reappointment was approved in the annual shareholders’ meeting. In addition, the rotation of auditors from a particular audit client was very low. Auditors frequently served the same company ten to twenty years or more (Lev, 2002). Therefore, public accounting firms tried to match their auditors with clients that had similar interests and personalities and encouraged them to fraternize. Another threat to independence stemmed from that fact that auditing personnel were often later employed by clients they had helped to audit. Thus, several accountants had an incentive to please the audit client in the hope that they would have a future job opportunity.

**Diminished Legal Threat**

During the nineties, a diminished legal threat to auditors lowered the costs of compromised independence. Several court decisions aimed at reducing auditor liability. The *Billy v. Arthur Young* case (1992) ended the foreseeability standard in the State of California, for example. Perhaps even more significant were the decisions related to the securities laws: the Supreme Court’s *Lampf v. Gilbertson* decision in 1991 significantly shortened the statute of limitations applicable to securities fraud; the Supreme Court’s *Central Bank Central Bank of Denver* decision in 1994 eliminated private “aiding and abetting” liability in securities fraud cases (Coffee, 2002, August 1).

The largest public accounting firms and the AICPA united to lobby Congress for legislation to reduce their liability. Between 1989 and 2001, accounting firms spent nearly thirty-nine million dollars on political contributions (Mayer, 2002). The Private Securities Litigation Reform Act of 1995 (PSLRA) limited the financial liability of
accountants for lawsuits under the federal securities acts. The Securities Litigation Uniform Standards Act of 1998 (SLUSA) prohibited securities fraud class actions based on state law. It did allow securities fraud class actions filed in state courts to be removed to federal courts.

*The “Culture of Gamesmanship”*

Arthur Levitt, Chairman of the SEC from 1993 to 2000, believed that a “culture of gamesmanship” pervaded American business and its gatekeepers during the nineties:

…a gamesmanship that says it’s okay to bend the rules, tweak the numbers, and let obvious and important discrepancies slide…a gamesmanship where companies bend to the desires and pressures of Wall Street analysts rather than to the reality of numbers…where analysts more often overlook dubious accounting practices and too often are selling potential investment banking deals…where auditors are more occupied with selling other services and making clients happy than detecting potential problems…and where directors are more concerned about not offending management than with protecting shareholders. (Levitt, Jr., 2002, February 12,1)

In 2000, Levitt was trying to reform the industry practice of an audit firm’s also offering consulting services to its audit clients. In the four weeks after Levitt’s announcement of new rules that would restrict accountants’ ability to consult for the same companies they audited, Levitt received letters from over forty Congressmen. The accounting industry contributed more than ten million dollars to political campaigns and spent $12.6 million on federal lobbying in 2000 alone. Levitt has said that lobbyists told him that the SEC’s funding would be cut if he tried to implement his rules. He decided to compromise with the industry: accounting firms could continue to consult for the companies they audited as long as the details were disclosed to investors (Mayer, 2002).

In addition to receiving letters from Congressmen, Levitt also was lobbied by
businessmen, including none other than Enron’s Chairman and Chief Executive Officer Ken Lay.

Conclusion: The Enron-Andersen Debacle

Good work in the public accounting profession requires an accountant to maintain independence from his audit client so as to provide to the public an objective assessment of the financial statements. The notion of auditor independence has evolved over the course of the history of the profession. Independence has been defined by members of the profession and interested stakeholders (the SEC, Congressional committees, academics) in terms of various threats that could serve to compromise independence on two levels: independence in fact and independence in appearance. Among the possible threats, the issue of the scope of services an auditor could provide to an audit client had attracted a significant amount of attention since the late 1950s and continued to dominate most discussions of auditor independence. Interested stakeholders outside the profession continued to urge the profession to restrict the amount of non-audit services it offered to audit clients, while members of the profession resisted. The toll of litigation and an increased competitive environment led the profession to expand aggressively into non-audit services during the nineties. As a result, non-audit services threatened auditor independence in appearance (if not in fact) in two ways: first, by making the auditor vulnerable to economic pressures from audit clients and secondly, by creating a stake (or interest) in a certain result for the audit work.

Compromises in this independence can lead to an auditor certifying financial statements that contain managers’ omissions or miscalculations, intentional or unintentional. Once these errors are eventually uncovered, the public suffers as the price of the stock--in which it has invested on the basis of inaccurate financial statements—
falls on account of the new information. According to one estimate, companies that restated earnings suffered market losses of $17.7 billion in 1998, $24.2 billion in 1999, and $31.2 billion in 2000. Yet, financial restatements were on the rise during the late nineties. Between 1990 and 1997, the number of financial restatements by publicly held companies only averaged 49 per year, increased to 91 in 1998, and then soared to 150 and 156 in 1999 and 2000, respectively (Coffee, 2002, March 5). Some 270 companies restated their financials in 2001, double the number in 1997 (Turner, 2002). There were only three restatements in 1981 (Mayer, 2002).

Members of the public accounting profession have defended the number of restatements as being a tiny percentage of the total number of audits—fewer than one percent, according to Barry Melancon, of the American Institute of Certified Public Accountants (Squires, Smith, McDougal, & Yeack, 2003) and with the argument that some business and audit failures are inevitable due to human error (Hilzenrath, 2001).

Not only have the number of restatements been on the rise, but so have the amounts involved. According to an estimate by former SEC Chief Accountant Lynn E. Turner, earnings restatements and lost market capitalization following auditor failures between 1995 and 2001 cost investors close to $200 billion (Byrnes, 2002). One of the major contributors to these losses was the fall of global energy powerhouse Enron, the seventh-largest company on the Fortune 500 in 2000 before it filed for bankruptcy in 2001. Although Enron’s executives were deemed the most responsible for the debacle, Enron’s auditor Arthur Andersen also came under fire for having certified the fraudulent financial statements.5

Andersen’s credibility was already eroded in recent years by its having certified the fraudulent financial statements of the Baptist Foundation of Arizona, the Sunbeam
Corporation, and Waste Management. All hopes of restoring credibility were lost when Andersen’s team of Enron auditors admitted to charges of obstruction of justice in connection with shredding documents related to Enron. Their decision to destroy evidence made the public particularly suspicious about what Andersen was trying to hide, and investigations by the SEC, Congress, and the media were launched. These investigations brought to the fore certain issues regarding the appropriate scope and nature of non-audit services that an auditor should be able to provide to audit client, in addition to other factors that might lead to compromises in independence (e.g., the length of the relationship between the auditor and the audit client).

One of Andersen’s largest clients, Enron paid Arthur Andersen $46.8 million in fees for auditing, business consulting, and tax work for the fiscal year ended August 31, 1999; $58 million in 2000; and more than $50 million in 2001. More than half of the fees were charged for non-audit services. An individual auditor’s compensation and prestige within the firm at Andersen depended on his or her ability to sell other services in addition to auditing to clients. In addition, one of the non-audit services provided by Andersen, that of performing Enron’s internal audit function, was particularly controversial. By doing so, Andersen was essentially auditing its own work. Details surrounding the nature of the relationships between the auditors at Andersen and Enron’s managers also surfaced questions over Andersen’s ability to maintain professionally unbiased towards Enron.6

As we can see from the Enron scandal, providing non-audit services to audit clients could potentially compromise an auditor’s independence in performing an audit in two ways: first, by making the auditor vulnerable to economic pressures from audit clients and secondly, by creating a stake (or interest) in a certain result for the audit work.
The former referred to the hardship of losing lucrative non-audit fees if the audit client is not pleased with the result of the audit. The latter referred to the auditor being in a position of auditing his (or his accounting firm’s) own non-audit work, functioning as an employee or management of the client, advocating a position for the client, or a mutual or conflicting interest with the client.

To address investors’ concerns and protect investors against future Enrons, Congress passed a sweeping legislation in 2002, the Sarbanes-Oxley Act. The Act created a regulatory board, the Public Company Accounting Oversight Board, to regulate and oversee accounting firms. In addition, the Act includes new requirements aimed at preventing compromises in auditor independence, among them a restriction of the scope of non-audit services an auditor can provide to an audit client, the mandatory rotation of audit partners, and a one-year cooling off period between serving as an auditor and being hired in a “financial reporting oversight role” at an audit client. Whether this effort to wear two separate hats—auditor-consultant—will succeed remains to be seen.
References


Securities and Exchange Commission, Proposed Rule S7-13-00.


Accounting is the practice and the system of recording economic and financial information such as sales and costs. Auditing refers to the process of verifying that a company’s accounts are reasonably accurate. Rudimentary forms of accounting and auditing can be traced back to antiquity. The modern accounting system is often attributed to Luca Pacioli, who was the first to formalize double-entry bookkeeping in 1494.

The certified public accountant checks for “material” violations of GAAP, using a set of auditing standards known as Generally Accepted Auditing Standards (GAAS), and issues four types of professional opinions: 1) unqualified, which means that management’s assertions conform to GAAP; 2) qualified, which means that the overall financial statements are a fair representation “except for” a material departure from GAAP or a lack of evidence; 3) disclaimer, which means that the auditor cannot give an opinion because of a lack of sufficient evidence to form an opinion on overall financial statements or a lack of independence due to material financial interest in or performed managerial functions for the entity; and 4) adverse, which means that the assertions do not present fairly in conformity with GAAP because departure(s) affect(s) overall financial statements.

Two actions in the 1940s by the SEC foreshadowed the attention that might be attracted to auditor’s providing non-audit services. In 1942 the SEC issued Accounting Series Release #37, which indicated that consideration needed to be given to the relationships and practices involved in all services performed for the company, in order to determine independence. In 1944 the SEC issued Accounting Series Release #47, which reported 20 rulings in which the SEC had deemed an accountant to be not independent. The Institute’s committees on ethics and on auditing procedure disagreed with one of the SEC’s rulings. The ruling involved an auditor performing bookkeeping services for the company being audited. This represented their first clash over the provision of non-audit services.

The peer review process that was established required that major accounting firms have their audits (3 to 6 percent of a Big Five firm’s total audit hours over the previous years) scrutinized by another major firm once every three years. The two prior years were not allowed to be investigated. The categories of audits that had to be included were: an audit involving several offices of a firm; an audit of a public entity; and an audit of a company’s employee-benefits plan. The peer review process did not involve doing a “re-audit,” but rather was aimed at assessing whether the figures documented by the original auditor appear plausible. The original auditor could also plead guilty to “failing to document,” a relatively minor offense.

Several other “gatekeepers,” or professionals charged with the responsibility to protect the public from such financial disasters had also failed: Enron’s Board of Directors authorized various transactions that facilitated many of Enron’s fraudulent practices; securities analysts continued to rate Enron’s security as a “buy;” credit rating agencies rated Enron’s debt as “investment grade,” up until four days before Enron’s bankruptcy; and the Securities and Exchange Commission did not investigate Enron’s practices until it proved to be too late.

More than eighty former Arthur Andersen accountants were working at Enron. Several were in senior executive positions, including Jeffrey McMahon, who served in the positions of treasurer and president; and vice president Sherron Watkins; and chief accounting officer Richard Causey. Causey made a point of recruiting many Andersen alumni to work at Enron. Thus, several accountants had an incentive to please the client in the hopes that they would have a future position at Enron. The closeness of the relationship in general also raised questions about the ability of the auditor to remain professionally independent. Andersen was actually located in Enron’s headquarters in Houston. Andersen employees attended Enron-sponsored events and office parties. Andersen’s auditors boasted about the closeness of their relationship in a promotional video. “We basically do the same types of things…We’re trying to kinda cross lines and trying to, you know, become more of just a business person here at Enron,” said one accountant.

Andersen’s lead auditor, David Duncan, and Enron’s Chief Accounting Officer, Richard Causey, who had previously worked as an auditor at Arthur Andersen were close friends. They often had lunch together. In fact, their families had even gone on vacations together.