The Fallacy of Auditor Independence and a Possible Solution

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Abstract

The goal of this paper is to analyze present research for the importance of independence to the auditing profession, determine the greatest threats to auditor independence today, the problems these threats have caused and to explore a possible solution to these problems. For many years, audit professionals have been considered the gatekeepers of the public market. Since the passing of the Securities Acts in the 1930's, the structure of the privatized audit industry has made it incredibly difficult for auditors to remain independent from their clients. Client fees, the rise of non-audit services and the complexity of audit-client relationships pose serious threats to auditor independence today. Without significant changes to the audit requirements imposed by the SEC, these independence threats will continue to be pervasive in the industry as made evident by audit failures by the leading firms. O'Connor, Professor of law at University of Washington, has proposed a three-part solution to place the power of audit back in the hands of shareholders and restore public trust in the auditing profession. Auditors are an essential part of a healthy market in the United States. Thus, these issues should be considered of upmost importance. Until the power of audit is placed back in the hand of the people, an auditors ability to remain independent will continue to be called into question.

Key words: *Audit, Independence, Sarbanes-Oxley, Securities, Act*

The Fallacy of Auditor Independence and a Possible Solutions

Without the public's ability to maintain faith in an auditor's independence, audit reports would be rendered useless. Auditors have long been considered the backbone of the public market as they are intended to bridge the gap between the interest of the corporation and the interest of the shareholder. This role is in danger as additional issues with auditor independence come to light in the industry. Understanding the origin of the United States accounting system will help demonstrate why it is difficult for auditors to remain independent today. Historically, the relationships between auditors and their clients have been strained as auditors strive to find a balance between their original purpose and the power imbalance created by Statutory Acts of 1933 and 1934. Although the Securities and Exchange Commission (SEC) has attempted to fix the independence issues in the accounting industry, it has done so without success. New regulations have done little to prevent some of the biggest corporate scandals in the United States. Fixing the independence issues facing auditors in America today requires a restructuring of the industry. The following will detail a brief history of the audit profession, demonstrate the problems with the current system of United States audit, and outline a solution to restore independence to the industry.

Background

The Origins of Audit

To understand the root of audit independence issues in the United States today, it is important to understand where these standards came from. The idea of having a specified individual to check financial handlings has been around for a long time. Meuwissen (2015) noted that ancient civilizations like Greece and Egypt used auditors to ensure rulers were not misappropriating funds or making mistakes in their bookkeeping. The word "audit" stems from

the Latin word ‘audire’ which simply means “to hear.” The auditors of these civilizations were tasked with “hearing” the justifications for account balances from ancient rulers to ensure everything was being recorded accurately (Hay, 2014). Evidence of this kind of checking can be found in several diverse civilizations throughout ancient history. Across the board, these audit practices were used primarily to ensure government officials were not misusing public funds. There was very little use for audit of companies until the United Kingdom industrial revolution, beginning in the 1840s (Kumar, 2015).

The Beginning of American Audit

Before the Industrial Revolution, most businesses were small and individually owned. With no external investors, there was no need to establish the credibility of the financial standing of the business. The economic boom of the Industrial Revolution brought large corporations to the forefront of the public eye. Laws were passed in England to help protect shareholders of these large corporations from being taken advantage of by corporate directors (Edwards, 2022). While companies’ financial standings were required to be audited, there was no official audit profession at the time and no established standards for those completing the audit work. (Levy, 2020). Contrary to the independence standards today, British law at the time required those who perform the audit of a company’s financial performance to have shares in the company to guarantee the auditor had a personal interest in the well-being of the company (Levy, 2020). Such legislation was aimed at ensuring that the auditor’s interest would be aligned with that of the other shareholders of the company. Until new legislation was passed in the 1930’s the scope of an audit was entirely dependent on what the auditor deemed necessary. With little legal direction from their own states, many individuals in the developing United States accounting industry looked to guidance published by other professionals in the auditing field. Robert

Montgomery was one of these professionals and arguably one of the most influential individuals in the early history of the United States accounting profession (Levy, 2020).

Montgomery published his first original work, *Auditing Theory and Practice*, in 1912 (Levy, 2020). It was here he claimed that audit should be considered the most important of the accounting professions. Before this publication, many auditors referenced the 1892 work of Lawrence R. Dicksee, a professor from England. Prior to his own work, Montgomery released an edited version of Dicksee's publication called *Auditing: A Practical Manual for Auditors*. It is in this work that Montgomery (1905) asserted that strict rules implemented by any governing authority would find resistance in the auditing profession. Instead, he argued the importance of the personal process of an auditor working for his client should come before strict rules in order to preserve the fundamentals of the occupation. Montgomery (1905) ascertained that the primary purpose of an auditor is to detect potential fraud within a company in order to protect the interest of that company's investors. Then, in 1929 came the stock market crash, marking the start of the Great Depression, an event that would change the audit profession forever.

Modern Audit

Following the 1929 stock market crash, U.S. Congress passed two acts that had major impacts on the finance world – The Securities Act of 1933 and the Securities Exchange Act of 1934. For the first time in United States history, laws required that all companies register with the newly established SEC. Moreover, these companies would be required to receive a financial statement audit by a "independent public or certified accountant" (The Securities Act, 1933). This legislation publicly marked the private audit industry as a bridge between the interests of the investor and the corporation. Many of the perceptions regarding audit responsibilities found in the 1933 and 34 Securities Acts came from the history of the profession in Britain. In 1929

Britain passed the British Companies Act. This act, much like the Securities Acts, also required companies to be audited. However, unlike in the United States, "a rich and nuanced cultural practice gave weight and credibility to the company audits required under the Companies Act" (O'Connor, 2006, p. 530). At the time of Securities Acts, the accounting industry had an unsteady reputation with corporate world.

Some would argue that the Securities Acts are the cause of auditor independence issues today (O'Connor, 2006). During the market plummet of 1929, accountants argued for the audit mandate that would later come in 1933. During hearings surrounding the development of the 1933 and 1934 legislation, Colonel Carter, the president of the New York State Society of Certified Public Accountants, advocated heavily for the addition of mandatory audits. The audit of public companies was not a new idea at his point. In 1926, 82 per cent of the companies listed on the New York Stock Exchange already voluntarily participated in some kind of audit (Edwards, 2022). These reports were prepared and made available to the public even before the passing of the Securities acts. However, following the passing of the Securities Acts, the United States accounting industry came to find it may have asked for more than it was ready to handle (Levy, 2020). The flawed foundations of the audit profession in the United States gave way to the independence issues it faces today.

Defining Independence

Governing Bodies

The Public Company Accounting Oversight Board (PCAOB) defines independence in Accounting Standards update 1005 as "a judicial impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to creditors and those who may otherwise rely (in part, at least) upon the independent auditor's report" (2015, para. 2). As

noted by the Security and Exchange Commission, Office of the Chief Accountant (2023), the independence of auditors in completing their work is just as important as the actual audit work accountants perform to ensure the accuracy of revenues and expenses. While the Security and Exchange Commission, or SEC, is the only organization that has the legal authority to set accounting standards, it delegates this responsibility to multiple different organizations. One of these organizations is the Public Company Accounting Oversight Board, also known as the PCAOB. The PCAOB was created and managed by the SEC as a result of the Sarbanes-Oxley Act of 2002 (AICPA, n.d.). According to the PCAOB, one of its main responsibilities is "to oversee the audits of public companies in order to protect investors and further the public interest in the preparation of informative, accurate, and independent audit reports" (PCAOB, n.d. section 1). Another name that frequently appears in the discussion of accounting standards is the American Institute of Certified Public Accountants (AICPA). The AICPA is a privately run organization that helps set standards for accounting professionals alongside the PCAOB. However, unlike the PCAOB, the AICPA does not have the enforcement authority given by the SEC. While standards set by the AICPA are well respected by the professional community and referred to by the PCAOB, they are not law.

Established Standards

To ensure independence, standard setting bodies in the United States consider two factors: independence in fact and independence in appearance. This concept is recognized in the PCAOB Accounting Standards 1005 on independence (PCAOB, 2015). Independence means an auditor's report is not affected or influenced in any way by his or her relationship with the client. For example, if an immediate family member of the external auditor sits on the board of a company, that would not be considered an independent audit. It is highly likely that the auditor

will feel swayed to issue the client a positive opinion or overlook potential problems because of his or her relationship with the board member. The AICPA also calls this "independence of mind" (*AICPA*, 2021, p. 1). In the PCAOB AS 1005, the organization says auditors must be "intellectually honest" in order to be independent. However, even if an auditor is intellectually honest and independent of mind, the public may not perceive him or her as independent. On November 21, 2000, the SEC released a "Revision of the Commission's Auditor Independence Requirements" in which the federal agency recognized that while independence is vital and important to a reliable audit, it is not enough on its own if the auditor is not also perceived as independent. "An auditor is not independent if a reasonable investor, with knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment" (*Revision*, 2000, para. 3). The same revision references Regulation S-X Section 201.2-01(b), a regulation that came into existence with the Securities Act of 1993. Regulation S-X's primary purpose is to outline financial reporting disclosures for companies registered with the SEC (Cornell, n.d.). Section 201.2-01 of the regulation specifies relationships that automatically cause an audit team to fail an independence test. Most recently in 2020, the SEC made updates to Rule 2-01; however, since Regulation S-X was first published in 1941 the fundamental independence requirements have remained consistent. The first published version of Regulation S-X states,

> An accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is, or was during the period of report, connected as a promoter, underwriter, voting trustee, director, officer, or employee. (United States, 1941, p. 3)

For decades, governing bodies have recognized the importance of auditor Independence. Although all agree on the importance of independence, there are differing opinions concerning how it should be regulated and enforced.

The Importance of Audit Independence

Without auditor independence, audit reports would be worthless. As the PCAOB puts it in its AS 1005, “It is of utmost importance to the profession that the general public maintain confidence in the independence of independent auditors” (2015, para. 3). Public trust is the backbone of the public auditing industry. External auditors are responsible for ensuring a company’s management team has provided an accurate picture of the well-being and health of a publicly traded company. This information is used by investors, creditors, and other external users. As Paul Munter, the acting Chief Accountant of the SEC, has recognized, public accountants provide assurance to investors and help improve financial reporting. As such, independent accountants are a vital part of a continued healthy capital market (Munter, 2021). If an audit report is inaccurate or overlooks flaws internal to a client, investors potentially stand to lose millions of dollars. To understand the importance of the public perception of auditor independence, one needs to look no further than Arthur Anderson’s involvement in the Enron scandal of 2001.

Joseph Bernadino, CEO of Anderson at the time of the incident, admitted that the accounting firm had made mistakes in its audit of the fortune 500 company (Sridharan, 2002). Regardless of much blame should be placed on the accounting firm, the damage the event had on the company’s reputation was detrimental. Several years after its indictment, the United States Supreme Court overturned the guilty verdict pronounced upon the firm, citing poor instructions given to the jury on the case (Kelly, 2006). By doing so, the court entirely avoided commenting

on whether Arthur Andersen fell short of its responsibility as Enron's auditor. Even still, the damage had already been done to the firm. After the fall of Enron, the indictment they received from the Department of Justice caused many of the firm's largest clients to feel the need to pull away and to find a different audit firm. Shortly after, Arthur Andersen was all but out of business. One reporter described the Supreme Court's later acquittal as, "a bit like being acquitted years after the guillotine" (Kelly, 2006, p 510). Lack of public trust in the accounting firm meant any future audit work it performed would hold little significance to investors. Arthur Andersen allowed its relationship with its client, Enron, to compromise objectivity and independence, making any audit work the company may have had in the future lack credibility (Kelly, 2006).

Independence Failures

Despite the importance of auditor independence to the profession, there have been many recorded failures to meet PCAOB independence standards by major accounting firms. In 2019 the SEC noted nineteen instances in which PricewaterhouseCoopers violated independence standards by performing work and incorrectly billing it as audit related duties . In 2016 Ernst & Young (EY) was charged by the SEC with a violation of independence guidelines (SEC, 2016).

In 2010 a client of EY expressed discontentment with the audit team's performance and consequently considered switching audit firms. To retain the client, EY offered a new audit team, headed by an individual named Bednar. With the audit team change, the EY client decided to continue employing the firm. At the start of the new engagement team, Bednar understood relations with the audit client were strained and as such sought to build a better connection with the company. Internal EY policy forbids partners on audit teams from receiving or giving gifts that are out of the ordinary in order to maintain independence on the audit (Ernst & Young,

2020). In addition to these policies, firm partners are also cautioned against developing close relationships with members of the client as this could present independence risks; consequently, the amount of personal time spent with client employees should be limited. The SEC found that for the years 2012, 2013, and 2014 Bednar expressly violated these policies by taking a minimum of seven trips out of town with the client's CFO with no identified business purpose (SEC, 2016). On several other occasions, Bednar and his wife stayed at the CFO's house. There were many other violations of independence standards, including but not limited to the gifting of sports tickets, staying at vacation homes, and family trips. Despite several other EY partners and employees being made aware of Bednar's excessive spending and trips with the client's CFO, no actions were taken. By way of reprimand, EY was required to pay a total fine of $4,975,000 (SEC, 2019), and Bednar's ability to practice business as an accountant was revoked for three years.

Independence standards violations like this one are not incredibly rare occurrences. A similar situation arose in another audit conducted by EY in which the CFO of a client company was romantically involved with the partner on his company's engagement. A smaller firm was fined by the SEC for providing non-audit services to several different clients that violated independence guidelines. KPMG was fined by the PCAOB in 2019 for an inability to create and maintain proper independence policies (PCAOB, 2019). While there have been many other violations of independence regulations, these few demonstrate that despite policies in place, firms have been unable to fully self-regulate effectively.

Poor regulations for auditor independence are not new. Several previous chief accountants have taken note of the shortcomings of auditor independence regulations and have attempted to fix them; however, it would seem that no significant progress has been made. The

issue has been further complicated by other facts including the rise of non-audit services in the industry. As external parties raise concerns over audit independence, audit firms strive to defend themselves from criticism by claiming they have always followed the guidelines set by the SEC. Additionally, they argue any violations of independence guidelines that do occur are relatively infrequent and inconsequential (Ketz, 2020).

It would be a generalization to believe all auditors around the world are blatantly ignoring the rules set forth by the SEC. In fact, it would seem the majority of accountants do strive to follow existing guidelines (Bazerman et al., 2002). Some have suggested that comprehending how excellent auditors could have impaired independence without even realizing it requires an understanding of the effect of both conscious and unconscious bias (Ketz, 2020). Sometimes, auditors may not even be aware of the things that sway their opinion about an audit client.

The Basis of the Problem

Unconscious biases can be caused by the fundamental building blocks of the profession. The current layout of the accounting industry is fundamentally slated to make audit independence an uphill battle. Businesses are naturally driven to make themselves as attractive as possible to potential customers in order to increase their profits. Audit firms are no exception to this fact. This setup leads to an imbalance in power between the firm and the client (Ketz, 2020). The client has all the power to choose, and the firm that wants to stay in business must change to make itself the most attractive choice (Ketz, 2020). If audit firms orient themselves to best serve the corporations they audit, it proves very difficult to simultaneously be servants of their intended true clients: the public shareholders and other investors. O'Connor argued that the mandate of audits, as required by 1930's legislation, is the root of this problem.

> The core issue is that the statutory audit is simply a commodified cost of doing business for issuers that imposes an impossible obligation to serve an unspecified "investing public" on the auditors. Yet, this investing public neither hires, fires, nor controls the auditors. Instead, the audit relationship is managed by the board of the company being audited. (O'Connor, 2006, p. 525)

To understand the potential impact of unconscious bias in the accounting industry, consider this analogy. Ketz, a PH.D. in accounting and an associate professor at Penn State, gives the example of a difficult professor at a university. Suppose there is a professor who is known across the university for being a difficult grader. The professor agrees to tutor a student in his class for $200 an hour. Throughout the semester the professor tutors the student who ends the class with an A. When suspicion arises, the professor produces the students' exams for review; each one of which he or she received an A on. There is clearly a conflict of interest for the professor (Ketz, 2020). At best, the professor is subconsciously biased toward giving the student he tutors better grades. In the same manner, even if it is done entirely subconsciously, an audit firm is more likely to favor its clients' opinions with the prospect of continued business and improved client-firm relationships. Considering this imbalanced relationship, three different areas can be identified that currently pose a threat to independence: audit fees, non-audit services, and client-audit relationships.

Audit Fees

The SEC has left auditing to the private business sector since the start of the organization. Because an audit is a business transaction, the client must pay for the service. This means that the CPA firm, such as Deloitte, KPMG, or EY, is paid directly by the client it is auditing. This basic fact of business provides one of the most glaring independence issues throughout the history of

accounting: accounting firms rely on the audit fees from clients they audit to stay in business. In a 2011 news release, James R. Doty, the chairman of the PCAOB noted that a person cannot talk about the quality of an audit without also mentioning independence. The two are intertwined. And any serious consideration of audit independence must also consider the most basic fact - auditors are paid by their clients (PCAOB, 2011).

It has commonly been said auditors are servants of the public. Munter, currently serving as the SEC Chief Accountant, asserted that accountants have one of the most crucial roles in protecting investors and preserving the trustworthiness of public markets (Munter, 2022). However, the drive to increase profits and improve business relationships with clients may have drawn accounting firms away from this original goal. Because the audit committee boards of publicly traded companies can change audit firms, the pressure lands on the firm performing the audit to stay in the good graces of its employer. Having this kind of relationship with a highly profitable client may lead public accounting firms to overlook minor issues that are discovered during the audit. The SEC has attempted to mitigate the effect of this conflict of interest by allowing some situations if proper safeguards are put in place; however, more questions continue to arise concerning accounting firms' ability to balance their independence with client relationship incentives (Mintz, 2018).

Non-Audit Services

Consulting and other non-audit services have become some of the most profitable for accounting firms. Revenues from the Big Four accounting firms alone totaled over 200 billion dollars in 2023 (*Big*, 2023). However, these services pose a potentially serious threat to the independence of auditors engaged in an audit. This threat was first noticed by the SEC in the 1950s and by Congress in the 1970s. Despite being aware of the potential problem, neither body

took any action until the 1990s when the SEC released a standards revision (Harris, 2014). At the time of the standards update some individuals advocated for a total ban of all non-audit services being offered by an audit firm to its client. Instead of banning all non-audit services, the SEC chose to identify specific non-audit services an audit firm would not be allowed to offer its clients. In recent years, many investors have expressed concerns to the PCAOB that the continued rise of non-audit services poses an inherent threat that makes auditor objectivity impossible (Harris, 2014). In addition to the SEC's revision, the Sarbanes-Oxley Act expressly prohibited auditors from providing certain services such as bookkeeping, designing financial information systems, actuarial services, investment advising, and others (Harris, 2014). In more recent years, the SEC released an independence rules update in Release No. 33-10876 in 2020. Opposers argue that this update only relaxed independence rules in favor of the Big Four firms conducting business as they desire (Edward, 2020).

Shortly after the Enron scandal of 2001 and the subsequent passing of the Sarbanes-Oxley Act, there was a sharp decline in non-audit services offered by the larger audit firms. After the passing of the Sarbanes-Oxley Act, all but one of the largest accounting firms dismantled their non-audit practices (Harris, 2014). However, in the years since the passing of the Act, all four major accounting firms have re-established their non-audit practices. The growth of these consulting practices is rapid. Ernst & Young, currently the third largest of the big four, reported a total revenue of forty-nine billion in the year 2023. Of this forty-nine billion, fifteen billion was attributed to assurance and audit services. Another sixteen billion was from consulting services, overtaking revenue from audit fees. This represents a 16.7% increase in non-audit revenue from the previous year (Ernst & Young, 2023). At Deloitte, 60% of its global revenues for 2019 resulted from consulting and other non-audit services. That is a 13% increase over the previous

year. In the same year, only 22% of the company's revenues resulted from audit fees (Rapoport, 2020). This trend prevails across all four of the major accounting firms. In the year 2023, every big four firm reported greater revenues from advisory and consulting services as a percentage of total revenue than from audit and assurance services (Statista, 2023). Despite regulations in place, large audit firms continue to put their audit independence at risk through the offering of non-audit services.

An increase in non-audit services by audit firms jeopardizes auditor independence in two ways: self-interest and self-review (IESBA, n.d.). As formally noted, an accounting firm will organize itself to be as profitable as possible. In providing non-auditing services, as previously shown, is where firms find they have the most room for growth. It follows then that auditors would be willing to please a client by overlooking seemingly insignificant errors in the pursuit of profitable non-audit engagements. This self-interest threat is very similar to the one caused by regular audit fees received by clients. Because non-audit services provide more room for revenue growth than audit engagements and provide the largest percentage of revenue for all big four firms, the potential conflict of interest should be considered more severe (Statista, 2024).

In addition to self-interest, non-audit services pose a self-review threat. The International Ethics Standards Board for Accountants defined a self-review threat as "the threat that a firm will not appropriately evaluate the results of a previous judgment made or an activity performed by an individual within the firm" (IESBA, n.d.). In some cases, an audit firm may find itself auditing work a consulting team from the same firm previously performed. This poses a clear independence risk. Imagine a student writing a lengthy paper. When that student goes back to edit his paper, he is going to miss mistakes because it is his own work. Some would argue that self-review is different because it is not the exact same individual both writing and editing the

work. In this case, imagine an individual was writing a scholarly paper. Suppose after he has finished the paper the student asks a close friend to briefly read over the paper to make sure there are no major mistakes. In some cases, that friend may be tempted to just glance over the paper, not really paying attention to the details, because he is confident in his friend's writing abilities. While most auditors may exercise due diligence when it comes to auditing work done by their own firm, the temptation is there to assume there are no issues with the original consulting team's work.

Although other scholars have suggested that the actual correlation between non-audit services and audit independence is minimal, one must consider the requirements for an audit to be independent (Krawczyk, 2000). Not only must the auditor actually be independent, they must also appear independent (PCAOB, 2015, para. 3). As previously discussed, investors have continually raised questions as to audit firms' ability to remain independent while also providing non-audit services to clients (Harris, 2014). This would indicate a failure to comply with the independent in appearance requirement. To maintain the integrity of audit work in the eyes of an investor, audit firms must be able to provide concrete evidence that non-audit services are not impeding their ability to remain independent.

As a solution, some have suggested a total split of all audit and non-audit services within big accounting firms. The United Kingdom accounting regulators requested the Big Four firms separate out these two services by 2024. In 2022, Ernst & Young announced a plan to split the firms consulting and accounting practices entirely (Goldstein, 2022). Doing so was intended to avoid conflicts of interest and allow the consulting branch to expand without independence concerns. However, internal opposition brought the proposed split to a halt in April of 2023 (Reuters*,* 2023). None of the other Big Four firms have made any public attempts to make a split

of their own. While splitting branches may seem like an easy solution, doing so may prove more complicated than it first appears. Audit services and consulting services have become so intertwined that separating them creates complications for both the firm and the client (Sussman, 2021). Models have been made to attempt to estimate the effect a forced separation would have, but capturing the true impact on an ever-changing market proves difficult to accomplish. Thus far, these independence complications caused by non-audit services have been left unresolved by all governing bodies. Meanwhile, relationships developed during an audit introduce another reason for independence concerns.

Audit Client Relationships

Auditor and client relationships have long been under the scrutiny of the public eye. Perhaps one of the most difficult challenges an auditor has is to maintain a professional and friendly relationship with the client while ensuring personal relationships do not compromise auditor objectivity and independence. As previously discussed in the case of EY and Bednar, the better relationship the firm has with the client, the more likely it is to retain and even expand business with the client. The longer a firm is with a particular client, the harder it can become to manage limiting these relationships. Becoming too close with a client may result in a bias towards a particular client, making an auditor more likely to overlook a problem he or she may consider insignificant. Others argue longer auditor-client relationships do not impair independence but rather increase the quality of the firm's audit (Krawczyk, 2000). It takes time for an audit team to understand the operations and controls of a large corporation and onboarding a new audit team can be a costly endeavor. To address the potential independence risks associated with long tenure in audit engagements, the PCAOB made a concept release in 2011 that explored the idea of mandatory firm rotation (PCAOB, 2011).

The concept of a mandatory firm rotation originated from the idea that if firms have less time to develop close relationships with clients, the more likely their audits will remain independent in both fact and appearance. Additionally, if one firm did decide to overlook an issue in a client's financial statements, they would run the risk of the same issue being discovered by a firm following them. This debate is not unique to the United States. Several other countries have adopted the rotating firm system, including Brazil, Spain and Italy (Daniels, 2011).

The idea has received a significant amount of resistance from major companies such as Procter & Gamble who argued that the benefits of keeping and audit firm for a long period of time outweighed the potential dangers to auditor independence. Large companies like Procter & Gamble (P&G) may have the most to lose from a forced change of audit firm from the PCAOB. Deloitte has been the audit firm of the fortune 500 company P&G for nearly a century and a half (Chasan, 2012). In its concept release, the PCAOB estimated an increase of audit costs to companies of 20% should firm rotations be enforced. Valarie Sheppard, P&G's comptroller, suggested these 20% estimates were underselling the impact forced firm rotations would have on the industry (*Frequently*, 2019). For the time being, the PCAOB seems to have refrained from perusing the implementation of firm rotations. As part of the Sarbanes-Oxley Act, partners on audits are required to rotate on an engagement every five or seven years depending on their position. Large firms suggest this keeps costs low while accomplishing the same goal firm rotations aim to meet.

A Failed Fix

The SEC, in conjunction with the AICPA, attempted to address these audit independence issues in 1997 with the Independence Standards Board. The Independence Standards Board

(ISB) was created to produce solutions for concerns raised by both auditors and their clients (Goldwasser, 2001). As part of the formation of the board, four board members were chosen from the professionally audit community. Four other board members were chosen by the SEC. From the start situations were rough. The relationship between the SEC and AICPA were strained at best. and SEC board members seemed skeptical of their AICPA counter parts. The chairman of the SEC at the time refused to attend the first meeting because of what he claimed was the AICPA's attempt to take over the board (Securities, n.d.). The ISB intended to develop a useful framework to guide its future rulings in the accounting industry. This framework, however, was never established. Due to the strained relationship between the SEC and the AICPA, progress in developing standards and the organization's framework was slow. The board did manage to publish three standards as well as develop parts of a conceptual framework (Goldwasser, 2001). In the meantime, however, the SEC released its own rule on audit independence, overshadowing the work of the ISB. Much of the SEC rule did adopt guidance already published by the ISB. This rule, however, was highly contested by several of the big five accounting firms at the time which argued the SEC had not done the proper research in order to gain a thorough enough understanding to make an educated ruling on the issue. Working with the proposed arguments, the SEC published its final rule in November of 2000. By this point, the ISB published a draft of its conceptual framework. Much to the dismay of the AICPA, it was entirely dismissed by the SEC. Observing the strained relations, and anticipating very little productive collaborative work to be accomplished in the future, both the SEC and AICPA agreed to dissolve the ISB in 2001 (Goldwasser, 2001).

Solutions

An AICPA Alternative Framework

During the troubled operation of the ISB, the AICPA proposed its own solution to the independence issues found in the audit profession. This solution proposed that independence issues could be solved by adopting a "flexible conceptual framework" (Goldwasser, 2001. p. 1). This framework left room for each accounting firm to decide for itself what independence regulations were necessary to maintain an independent audit. In a more recent publishment, the AICPA released the updated 2022 *Conceptual Framework Toolkit for Independence*. In this framework, the AICPA includes its suggested "threats and safeguards" approach for auditors when it encounters situations not expressly prohibited by the SEC's more ridged rule-based approach. This threats and safeguards approach carries five steps to help auditors make decisions when faced with a situation that may impair independence. Using these five steps the AICPA suggests that auditors know what is best for independence in their own situation. It would be far too great a task to devise individualized rules for every situation an auditor could ever encounter. The AICPA instead leans heavily on a more principals based approached commonly found in IFRS regulations. (AICPA, 2022)

Step one of the AICPA conceptual framework is to identify the threats. The AICPA defines threats as "relationships or circumstances that could impair your independence" (AICPA, 2022, p. 1). Due to the complicated nature of independence the audit profession, there will not always be a law by the PCAOB or SEC that directly addresses every situation. Considering this, the AICPA's framework asserts that the first step an auditor must always take is to use professional judgment to determine if a relationship presents a threat to his or her independence. Even if there is a threat, it does not mean that independence has been violated.

In step two of the conceptual framework, if a threat has been identified, the auditor must then determine how significant the threat is. Not all identified threats require action. In order to determine if a threat does carry a high level of significance, the AICPA suggests asking "would a reasonable and informed third party who is aware of the relationship or circumstance conclude that the threat identified would not impair your independence?"(AICPA, 2022, p. 3). This question is very similar to the independence in appearance test set forth by the PCAOB. In addition to considering the significance of any threat identified, the auditor should also take into consideration any safeguards already in place that may reduce a highly significant threat to an acceptable range. If the auditor finds the identified threat to be at acceptable range, the AICPA suggests he or she continues with the audit. If the threat is significant, the auditor should then move on to step three.

Step three is to "identify and apply safeguard." Before accepting an engagement, all threats identified must be at an acceptable level. This can be done by implementing new safeguards or adjusting already existing ones. These safeguards can be created by the audit team, legislative bodies, or the client. The AIPCA provides some examples of safeguard in its framework published on its site. After the proper safeguards have been implemented, the auditor should then proceed to step four.

Step four of the conceptual framework is to evaluate the effectiveness of the safeguards. Just because a safeguard has been developed does not mean it operates as intended. As the auditor cautiously proceeds with the audit engagement, he or she should observe the effectiveness of the established safeguards. There will be times at which the safeguards implemented are either ineffective or no safeguard can be developed to bring a threat to an acceptable level. In this instance AICPA guidance suggests the auditor either change the

conditions of the audit or remove him or herself from the audit all together to avoid violating independence standards (AICPA, 2022). If throughout the engagement relationships change or new situations arise, the auditor should take the time to re-evaluate the situation instead of assuming the current safeguards are adequate. After all these actions have been considered, it is time to move to step five.

Each step of the process must be documented. When threats are identified and safeguards implemented, each one must be documented by the auditor. An individual may do all the work to help prepare safeguards to mitigate independence threats, but if there is no documentation it will be as if no steps were taken. Documentation helps protect both the auditor and the client by guaranteeing proper steps have been taken in every situation to ensure independence. Without documentation there would be no evidence that safeguards were implemented, and the auditor would be in violation of the "Compliance with Standards Rule" (AICPA, 2022).

The AICPA's Conceptual Framework is not without critics. As already demonstrated by the SEC's less-than-perfect relationship with the organization through the course of the ISB, not every professional agrees with this more flexible approach. Historically, the SEC, along with its Generally Accepted Accounting Principles prefer a much more rule-based system. This system is stricter and lays out more specific requirements for specific situations. Rule based laws are only applicable to one scenario and not intended to be guidance for multiple different kinds of situations. Perhaps the biggest concern with a principals-based system is the amount of freedom that is given to individual audit firms. While it is true that it takes much time and effort for an organization like the SEC to develop a tailored solution to a single problem, doing so ensures consistent standards across the board. Otherwise, one auditor may determine a situation or relationship does not pose a significant threat to the independence of an audit while a different

auditor decides the same situation does pose a significant threat. Leaving the decision to the auditor also positions that individual to potentially experience pressure from the client to overlook some relationships that negatively impact the independence of the audit. This is a natural consequence of the responsibility of the auditing process being given to the private industry.

Proponents of a more principals-based rules system argue it would allow auditors the freedom to consider more in their audits (Ng, 2004). By being restricted to the narrower requirements of a rules-based system, auditors would be susceptible to a “check the box” kind of mindset (Ng, 2004). Such a mindset may lead auditors to ensure the technical side of a company’s financial reporting to be correct without considering the bigger picture. Additionally, rule-based legislation could take a long time to develop and tend to be very complex. Different solutions must be created for each individual problem. Under a principle-based system, guidelines are significantly faster to develop and contain fewer complex rules for users to implement.

Re-building Audit

If the foundation of the audit profession in the United States remains the same, audit independence issues will continue to arise. The public expectation is that auditors serve the interest of the shareholders. Pressure from business relationships encourage allegiance to the client an audit firm is working for. As the Bible notes in Matthew 6:24-26, “No one can serve to masters, for either he will hate the one and love the other, or he will be devoted to one and despise the other” (ESV, 2016). The weight of regulation has been placed on the shoulders of auditors by the SEC, and the industry is not built to handle the pressure. While the audit industry gained responsibility, the passing of the Securities Acts brought a boom of business to the

profession and the industry was not prepared the handle the requirements thrust upon it. O'Connor (2006) suggests a three-part solution to the issue of auditor independence: Removing the mandatory audit requirement, moving audit control directly to the shareholders, and finally combining regulations across the board for Certified Public Accountants.

Since their inception in in the early 1930's, mandatory audits have not prevented significant scandals in the business world. These scandals, which have continued to occur despite current regulations, serve as evidence that auditors cannot be trusted, or expected, to simultaneously work for the best interest of both the corporation and the public (O'Connor, 2006). Additionally, this problem is amplified when the public and the corporate interests are opposed to one another. The investor wants to know possible risks and worst-case scenario before investing in a company. At the same time, the corporation wants to present the best possible outlook to the investor to increase their likelihood of investing. An auditor cannot serve both purposes at once. If an auditor must take the preferences of two parties into consideration, the independence of an audit will be called into question. To avoid this problem, the "statutory audit" as enforced by the Securities Acts should be replaced with what O'Connor calls a "audit right" (O'Connor, 2006). This right allows an investor to enlist an auditor to conduct an audit on their behalf. Having such an audit would allow the auditor himself to determine the size and scope of the audit instead of being restricted to what would normally be expected of today's general audits. The broad nature of today's required audits does not allow auditors to ask more specific question that shareholders may want to know.

Removing mandated audits also helps remove the incorrect assumption by some investors that any company that is being audited has received a guarantee from the government. The reality is that general audits are primarily focused on ensuring that items are portrayed accurately

on a company's financial statements. This does not guarantee that all other records are correct within the company. All things considered, removing statutory audits from the picture leaves room for audit procedures to be taken over once again by the party it was intended to benefit. Instead of companies being required to use an audit firm, audit firms will have the opportunity to demonstrate their value to the shareholder in the marketplace.

While, under this plan, the federal government would no longer require an audit by law, the intention is that states and other local governments would grant investors the ability to conduct an audit (O'Connor, 2006). To prevent the financial burden from falling upon shareholders, a public company would remain obligated to pay for such and audit. While audit fees would still be paid by the company, placing the burden of audit firm choice solely on the shareholder would remove the potential feeling of indebtedness auditors may be inclined to feel today. This plan would allow shareholders the opportunity to select which auditors they want to perform the audit. This takes a power currently held by the audit board of a company and places it in the hands of the shareholders. This would allow shareholders the power they were always intended to have, instead of auditors being torn between the interest of management and the public.

Conclusion

The history of the audit profession in the United States has landed today's professionals in a difficult position. While standard setting bodies have attempted to fix the industry's independence issues, the problem continues. With the rise of non-audit services the depth of these issue has increased. O'Connor's suggested the plan is not the first of its kind. Many have acknowledged that the foundations of the audit industry established after the Securities Acts of 1933 and 1934 have made it difficult for a standard of true and complete independence to be held

as realistic (Sussman, 2021). It has been proven by audit failures in all of the big four firms that updates of standards by governing bodies have not done enough to protect the public investor. Significant changes must be made regarding who holds the power of audit in the United States in order for progress to be made. Auditors are a vital part of keeping the public market healthy (Munter, 2022). Therefore, such changes as previously mentioned should be a priority so that auditors may continue to serve their real clients: the public. If auditors are to serve as a public watchdog, it is time for governing bodies to hand the leash back to its original owner and place the power of audit back in the hands of the people.

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