

Auditor Independence? *Time to Eliminate the Question Mark*

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Financial markets need reliable, independently audited financial statements to operate effectively. Investors need information that they can trust—this requires that the information be unbiased and credible. Ronen [2010] noted that an erosion of trust in the financial statements would ultimately result in depressed stock prices and increase a firm's cost of capital. Auditor independence is essential to build this necessary trust in the financial statements. Auditing standards require a financial statement auditor (auditor) to “maintain independence in mental attitude” in all issues relating to a financial statement audit. In order to protect the public, auditors are required to be independent, both in fact and appearance, of the entity being audited. Any real or perceived lack of independence on the part of the auditor will severely impact the credibility of the audit.

How credible is an annual “independent” financial audit report when a substantial fee is involved, the auditing (i.e., accounting) firm can be fired by the organization it is auditing, and often both parties have a long-term “cozy” relationship? Auditor independence appears to be compromised under this current practice. In fact, James Doty, the chairperson of the Public Company Accounting Oversight Board (PCAOB), gave a speech June 3, 2011, on this very subject. Doty stated that “auditors face real pressure to please their clients” and he explained that the PCAOB too often discover that auditors do not exercise the appropriate level of skepticism. Auditors, Doty explained, need to change their “mindset to protecting investors.” According to Doty, “an audit has value to the public only to the extent that it

is performed by a third party who is viewed as having no financial stake in the outcome.”

Audit fees for individual clients can be substantial. For example, Enron's definitive proxy statement filed on March 27, 2001, reported that Arthur Andersen (once one of the then “Big 5” accounting firms) charged Enron \$25 million in audit fees for one year. Andersen issued Enron an unqualified audit opinion in 2000 and prior years. Enron's downfall, due to financial irregularities, also played a major role in the demise of Andersen. On March 14, 2011, *The Wall Street Journal's* Steve Eder reported the following about Lehman's auditor and the conflicts of interest that occur between the auditor and the organization being audited:

The charges come down to whether the auditing firm went easy on one of its most lucrative clients. The case strikes at one of the most deeply rooted problems in the financial system: the conflicts that can arise when watchdogs are paid by the firms they are supposed to police.

The long-term relationship between the auditor and client is also viewed as a problem because any “friendship” that develops may impair auditor independence. For example, *The Wall Street Journal* reporters Herrick and Barrionuevo [2002] stated that John Markese, president (at the time) of the American Association of Individual Investors, questioned Andersen's close connection with Enron. In the article, Herrick and Barrionuevo [2002] reported that Markese found it unusual for an auditor to have such a close association

with its client—after all, the auditor has an obligation to report on the financial records of the company. As Herrick and Barrionuevo reported, according to Markese, “All that closeness goes a long way toward breaking down barriers of independence” (p. C1).

There is obviously a conflict of interest that exists between the auditor and the organization it audits. The current process enables an auditing firm to act in its own best interest and not necessarily that of the public. It is time to revamp the current system to enhance trust in the financial reporting environment.

ATTEMPTS TO FOSTER AUDITOR INDEPENDENCE

Over the years, various ideas have been proposed to enhance auditor independence to remedy the conflict of interest that exists between the auditing firm and the organization it is auditing. For example, Healy and Palepu [2003] proposed putting the stock exchanges in charge of hiring and firing the auditors. Ronen [2010] proposed financial statement insurance as a solution to the independence issue. Under Ronen’s proposed method, the insurance companies assign and pay the auditors.

The Sarbanes–Oxley Act (SOX) (U.S. Congress [2002]) attempted to strengthen audit independence in a variety of ways. For instance, Section 203 of SOX mandates partner-in-charge rotation and Section 201 prohibits the auditor from performing many non-audit services. Section 202 of SOX requires that the client’s audit committee, not management, selects and oversees the company’s auditor and decides the auditor’s compensation rate. Section 101 of SOX establishes the PCAOB, a nonprofit organization that reports to the SEC and oversees public company audits. For the first time in U.S. history, public accounting firms that perform audits have to be reviewed by an external agency, the PCAOB. An accounting firm must register with the PCAOB if it wants to audit a public company. The PCAOB also creates audit standards, inspects registered accounting firms, and investigates and disciplines registered firms if necessary.

ARGUMENTS FOR MAINTAINING THE STATUS QUO

Arguments have been made against making any additional changes to the current process to enhance auditor independence. Following are some examples:

- SOX [2002] required the General Accounting Office (GAO) to assess the impact of requiring mandatory audit firm rotation as a means to strengthen audit independence. The rationale behind the concept of mandatory firm rotation is that it would eliminate the potentially adverse effects of a “firm’s long-term relationship with the client and the desire to retain the client” (GAO [2003] para.1). As part of its study, the GAO surveyed Fortune 1,000 public companies and the largest public accounting firms. Most respondents objected to mandatory audit firm rotation because they believe that the costs of such a requirement would exceed the benefits.

Exceed the benefits to whom? Are they referring to the investors in companies such as Adelphia, Enron, HealthSouth, Bernard L. Madoff Investments Securities, Tyco International, and WorldCom, who relied upon audited financial statements and in many cases lost their life savings? The results of the GAO survey do not surprise us. There is obviously a conflict of interest that exists between those institutions that were surveyed and the other stakeholders, such as investors. Fortune 1,000 firms clearly benefit from being able to select the auditor and keep the auditor for as long as they desire. Public accounting firms obviously benefit from being able to keep a client for as long as they choose.

- The GAO [2003] found that many companies believe that changing accounting firms to promote auditor independence increases the frequency of audit failures (i.e., when auditors should have, but did not, detect and/or report material financial misstatements) in the first few years of the audit because the auditor is unfamiliar with the new client.

Following that logic, an organization should use the same auditor for as long as it exists, which we believe diminishes auditor independence because it fosters a long-term comfortable relationship. Even if the close relationship does not *in fact* impair the auditor’s independence (although we believe it does), it *appears* to do so. As mentioned earlier, auditors must be independent in fact *and* appearance. Additionally, while we agree that there is a learning curve for new auditors, on the other side of the coin there are the benefits of “fresh eyes” and a heightened level of objectivity and skepticism that could result when a new accounting firm is employed.

- As explained earlier, Section 202 of SOX [2002] strengthened the audit committee by giving the committee members more power regarding the independence issue.

This is a step in the right direction, but it doesn't eliminate the independence issue. Ronen [2010] pointed out that the members of the audit committee are paid from the organization's funds. Ronen [2010] further stated that audit committee members might depend on upper-level management for various benefits such as referrals for positions at other firms.

- Section 203 of SOX [2002], discussed previously, already mandated partner-in-charge (not accounting firm) rotation to enhance auditor independence. GAO [2003] reported that many firms believe this requirement achieves the intended benefit of having "fresh eyes" on an audit.

However, the partner-in-charge is only one individual on the audit team. Why not require that the entire audit team be changed? Better yet, require accounting firm rotation.

While progress has been made, the independence problem has still to be addressed. It is time to stop looking for excuses to avoid implementing the obvious solution.

PROPOSED SOLUTION TO THE AUDITOR INDEPENDENCE PROBLEM

In summation, we believe that two main factors currently compromise an auditor's independence:

- the fact that many accounting firms have long-term friendly relationships with the organizations they audit, thereby potentially reducing the auditor's level of objectivity and skepticism, and
- that accounting firms may be pressured to side with the organizations they audit in order to remain their auditors and continue to earn substantial audit fees.

We suggest the following:

- **Mandatory Rotation of Accounting Firms**
Mandatory rotation of accounting firms would be required. An accounting firm would be permitted to audit an organization for a maximum of five consecutive years with the process being monitored by the PCAOB. The accounting firm must wait an additional

five years after its last audit of an organization before being permitted to perform any additional work for that organization. Note that the European Commission [2010] is considering mandatory firm rotation as well.

- **No Discharge of an Accounting Firm without Cause**

An organization being audited would not be permitted to fire an accounting firm without due cause, such as violation of the contract agreement, gross negligence, and so forth. An organization would be required to petition the PCAOB for dismissal proceedings; a committee of peer accounting firms and members of the PCAOB would be established to review the case.

The PCAOB has the expertise needed to undertake these added responsibilities, which would be a logical extension of their existing functions and authority. Additional costs borne by the PCAOB could be paid from a percentage levied on audit fees.

THE BOTTOM LINE

We are not claiming that auditors are corrupt or unethical; however, auditors are currently put in a position where pressure and opportunity tantalize them to either willingly or unconsciously participate in an audit failure. Under these new proposed changes, the auditor's conflict of interest that currently exists would be greatly reduced. The auditor would be independent in both appearance and form. Mandatory auditor rotation every five years should diminish the "cozy relationship" that can develop in a long-term association and should increase objectivity and skepticism on the part of the auditor. An accounting firm would also be given the opportunity to render an opinion without fear of financial retribution (i.e., being fired by the client), resulting in the watchdogs finally being able to "bite the hand that feeds them!"

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