Chapter 3

The meaning and importance of auditor independence
Learning objectives

• To explain importance of auditor independence and practical implications for auditor in meeting demands of audit role.
• To define auditor independence.
• To understand the difference between practitioner and profession independence.
• To explain how various kinds of conflict and risk can affect the independence of the auditor.
• To identify factors that can affect the respective power of auditor and client and perceptions of auditor independence.
• To recognize that previous academic studies have influenced profession in the preparation of ethical guidance.
• To critically evaluate Codes of Ethics issued by IFAC and APB, and suggest further ways in which auditor independence could be strengthened.
• To discuss the role of the engagement partner, the ethics partner and the engagement quality control reviewer.
• To discuss recent changes in independence rules in EU and US
• To evaluate the arguments for and against mandatory auditor rotation
Introduction

• Objectivity and independence: fundamental principle of independent auditing:
  
  Auditors are objective and provide impartial opinions unaffected by bias, prejudice, compromise and conflicts of interest. Auditors are also independent, this requires them to be free from situations and relationships which would make it probable that a reasonable and informed third party would conclude that the auditors’ objectivity either is impaired or could be impaired

• Flint (1988) defines audit in broad terms, seeing independence as an essential element:
  
  ‘The social concept of audit is a special kind of examination by a person other than the parties involved which compares performance with expectation and reports the result; it is part of the public and private control mechanism of monitoring and securing accountability.’
Monitoring and securing accountability

- Flint (1988): ‘character of accountability does not wholly lend itself to precise definition and is of an evolving nature adjusting to changes in social, political and economic thought and in the ethics and standards of society’.

- Two elements if true bond of accountability is to exist:
  - An account, e.g. published financial statements
  - A holding to account: action can be taken to make preparers of the account liable. Directors preparing financial statements can be held to account by the shareholders, who can get rid of them.

- Mackenzie (1964): ‘without audit, there can be no accountability’. Credibility can only be given by persons seen to be independent of subject of audit and of interested stakeholders.
Classifications of accountability

- **Political accountability** – often used to describe direct chain of accountability between public servant, elected representatives and electors.
- **Public accountability** – wider than political accountability – used to describe accountability of those controlling resources to public at large.
- **Managerial accountability** – arises because of position a person occupies within a hierarchy, as where subordinates are held to account by superiors.
- **Professional accountability** – exists in a professional or expert group, where members of group have a sense of duty to other members of group or profession.
- **Personnel accountability** – individual in nature and is about being accountable to yourself for maintaining your personal set of values.
Definitions of independence

• Flint (1988) uses these expressions to describe independence: ‘completely objective’, ‘unprejudiced by previous involvement in subject of audit’, uncompromised by vested interest in the outcome or its consequences’, ‘unbiased and uninfluenced by considerations extraneous to matter at issue’.

• Many of the words used are in respect of intangible qualities, not easily observable – objective, unprejudiced, uncompromised, unbiased, uninfluenced.
Practitioner independence

- **Programming independence**: auditors have freedom to develop own programme, both as steps to be included and amount of work to be performed, within overall bounds of engagement.

- **Investigative independence**: no legitimate source of information is closed to auditors, requiring that auditors have freedom to examine information that auditors themselves deem to be relevant. If auditors wish to examine budgets and forecast accounts, they should be allowed to do so.

- **Reporting independence**: the contents of report are determined by scope of examination. Mautz and Sharaf (1961) suggest that following neatly expresses this requirement:

  ‘You tell us what to do and we’ll tell you what we can write in our report; you tell us what you want us to say in our report and we’ll tell you what we have to do.’
Reasons to question profession independence

Mautz and Sharaf (1961):

A. Close relationship which the profession of public accounting has with business – apparent financial dependence – existence of a confidential relationship – strong emphasis on service to management

B. The organization of the profession – tendency towards the emergence of a limited number of firms – lack of profession solidarity – tendency to introduce ‘salesmanship’.
Conflict, power of auditor and client and effect on perceived independence (1)

• Pressures affecting independence might arise from:
  – **Conflicts** of interest between auditor and client (management and shareholders) because (truthful) audit report may not be seen as in the interests of management or shareholders or both.
  – **Conflict** between auditor’s professional duty and self-interest. Typical scenario: compliance with management view even if not professionally acceptable to retain audit.
  – **Conflict** between managers and shareholders. Managers may mislead shareholders even if only in the short-term.
  – **Conflict** between client organization and third parties. Organization may mislead providers of finance about its position – to enhance likelihood that further finance is forthcoming, even if not in best interests of the third party.

• Important element in Goldman and Barlev’s work: emphasis on matters that increase or decrease the respective power of management and auditor.
Conflict, power of auditor and client and effect on perceived independence (2)

• Shockley’s conceptual model identified eight factors as having an impact on the auditor’s ability to withstand pressure:
  1. Provision of non-audit/non-assurance services – management advisory services (MAS).
  2. Competition in the auditing profession (competition).
  3. Period for which auditor has held the position (tenure).
  4. Size of the audit firm (size).
  6. Degree of severity of professional sanctions and their application (professional sanctions).
  7. Extent of the auditor’s legal liability to third parties (legal liability).
  8. Fear the auditor might have of losing clientele and of losing his/her reputation (fear of losing clientele, reputation).
Conflict, power of auditor and client and effect on perceived independence (3)

Figure 3.2
Published codes of ethics

- Accounting bodies in the UK and Ireland issued own codes of ethics, derived from the IFAC Code of Ethics.
- Legislation requires accounting bodies to adopt the Ethical Standards (ESs), issued by APB.
- For audits in UK and Republic of Ireland: professional accountants comply with ESs.
- For audits elsewhere: comply with Section 290 of IFAC Code dealing with Audit and Review Engagements.
- APB is not aware of any significant instances where the relevant parts of the IFAC Code of Ethics are more restrictive than the ESs.
General principles of the IFAC code

a) **Integrity** – straightforward and honest in all professional and business relationships.

b) **Objectivity** – no bias, conflict of interest or undue influence of others to override professional or business judgments.

c) **Professional competence and due care** – maintain professional knowledge and skill at level required to ensure client or employer receives competent professional services based on current developments in practice, legislation and techniques, and act diligently and in accordance with applicable technical and professional standards.

d) **Confidentiality** – respect confidentiality of information acquired as a result of professional and business relationships, and not disclose any such information to third parties without proper and specific authority, unless a legal or professional right or duty to disclose, nor use the information for personal advantage of the professional accountant or third parties.
Potential threats to objectivity
(Table 3.4)

• IFAC:
  (a) Self-interest threat
  (b) Self-review threat
  (c) Advocacy threat
  (d) Familiarity threat
  (e) Intimidation threat

• Additional threat to objectivity proposed by APB:
  (f) Management threat
Audit firm’s control environment
Figure 3.3
Safeguards to counter threats to integrity, objectivity and independence

Safeguards created by profession, legislation/regulation
• Educational, training and experience requirements for entry
• Continuing professional development requirements
• Corporate governance regulations
• Professional standards
• Professional/regulatory monitoring and disciplinary procedures
• External review by legally empowered third party of reports, returns, communications or information produced by a professional accountant

Safeguards in the work environment
• Firm-wide safeguards, such as leadership of firm establishing ‘tone at the top’ and control environment

Engagement specific safeguards, such as review by EQCR (not part of assurance team) of assurance work performed
Specific threats to integrity, objectivity and independence

• Financial, business, employment and personal relationships
• Long association with the audit engagement
• Fees, remuneration and evaluation policies, litigation, gifts and hospitality
• Non-audit (or non-assurance) services provided to audit clients
Small entities

• Can be difficult to comply with ethical standards when auditing a small entity.

• Small entities tend not to have expertise within their organization: reliant on auditor to provide a range of services that conflict with ES5 regarding advocacy and management threats.

• PASE relaxes provisions of ES1 to ES5.

• Allows audit firm to undertake part of management role, provided discusses objectivity and independence issues with TCWG, confirming management accept responsibility for decisions taken; and discloses fact in audit report.

• Despite this and similar relaxations, audit firms still required to exercise great care to ensure integrity, objectivity and independence not adversely affected.
Other pronouncements on auditor independence

• The European Commission has issued *Statutory Auditors’ Independence in the EU: A Set of Fundamental Principles*.

• Adopts principles-based approach to its recommendations on independence – such as IFAC Code and APB ESs – because it created a ‘robust structure within which statutory auditors have to justify their actions’.

• SEC rules in the US under Sarbanes–Oxley Act tend to be more detailed and prescriptive.
Sarbanes–Oxley Act – main provisions

1. Audit firm not to audit bookkeeping/accounting services provided.
2. Prohibit work on client’s information system if subject to audit.
3. Prohibit appraisal/valuation services by audit firm if subject to audit.
4. Audit firm not to provide actuarial service, relevant to determining amounts in financial statements, if amounts subject to audit.
5. Ban internal audit services relating to internal accounting controls, financial controls or financial statements if subject to audit.
6. Members of audit firm should not be director/employee of audit client, nor perform decision-making/supervisory function. Firm not to provide recruitment services for client senior personnel.
7. Audit firm should not act as a broker, dealer, investment adviser or investment banker for client as it might be seen as advocacy.
8. Audit firm should not provide legal service to audit client where service can only be given by someone qualified to practise law.
9. Audit firm should not provide expert opinion on litigation or regulatory proceedings or investigation for audit client because it might be perceived as acting as an advocate.
Sarbanes–Oxley Act – other provisions

• Audit committee pre-approve non-audit services by the auditor.
• Disclosure of non-audit services approved by audit committee including details of fees paid for certain non-audit services.
• Lead and concurring partner to rotate every 5 years and not to be involved in audit of same client for another 5 years. Other significant audit partners should rotate every 7 years with a 2-year time-out period.
• If audit partner receives compensation based on procuring non-audit services, partner will be considered not independent.
• Members of audit engagement team may not accept certain positions with an audit client until at least one year after they have left the employment of the audit firm.
• Where former lead or concurring partner or certain other defined members of the engagement team is involved in financial reporting matters of a client within one year of leaving the audit firm, the
Figure 3.1 The role of audit
Figure 3.2 Shockley’s (1982) conceptual model of perceived independence
Figure 3.3 Audit firm’s control environment and elements to enhance ethical behaviour in a firm providing audit and other services

* The asterisk indicates all those persons who are in a position to influence the conduct and outcome of the audit. This includes some or all of the leaders of the audit firm including ‘key audit partners’ and all those within a network firm who can directly influence the outcome of the audit engagement. These are the people known collectively as the ‘audit team’ by the IFAC Code.
Notes to figure 3.3

1. Leadership of the Audit Firm creates the Firm's Control Environment.
2. Similarly, the Audited Entity creates the Entity's Control Environment.
3. The Ethics Partner helps to create and maintain the Firm's Control Environment.
4. An important element of the Entity’s Control Environment comprises the role of Those Charged With Governance.
5. The Technical Advisory function gives advice on audit procedures and reporting to the Engagement team via the Engagement Partner.
6. The Engagement team comprises the Engagement Partner, Manager(s), Other Audit Staff, and Other Professional Staff (tax, IT, etc.) providing services to the team, and those who provide quality control or direct oversight of the audit, such as ethics partner and engagement quality control reviewer.
7. The Ethics Partner communicates possible breaches of the firm’s policies and procedures to the Engagement Partner.
8. The Engagement Partner evaluates and reports back to the Ethics Partner and course of action is decided.
9. In the event of disagreement between the Engagement Partner and the Ethics Partner, the matter may be discussed with the Engagement Quality Control Reviewer and resolved.
10. The existence of potential threats to objectivity and independence, and safeguards communicated to Those Charged With Governance at the Audited Entity.
11. The Engagement Partner and the Engagement Quality Control Reviewer discuss significant matters arising from the audit.
12. These matters also communicated to Those Charged With Governance at the Audited Entity.
13. Any member of the Engagement team are empowered to communicate with the Ethics Partner.
14. The Engagement Partner prepares the draft Audit Report on the basis of conclusions of the Engagement team.
15. The Engagement Quality Control Reviewer reviews individual procedures and conclusions of the Engagement team.
16. The Engagement Quality Control Reviewer reviews the draft Audit Report before it is finalized.