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AUDITORS AND INDEPENDENCE

Foreword

An old riddle loved by Abraham Lincoln asks, “How many legs does a cow have, if you call a tail a leg?” The answer: Four. Calling a tail a leg doesn’t make it one. And claiming an auditor is independent doesn’t make it so, either. In this essay, excerpted from *All You Need To Know About Ethics and Finance*, Avinash Persaud and John Plender correctly place independence as the foundation of the credibility of the capital markets.

And they are correct to say that independence is particularly important when it comes to auditors. Investors cannot be in the room when the entries are made in the company’s books. They must believe that the auditors who check and approve the figures are independent enough to represent their interests, instead of being captive to the people who select them and approve payment. But independence has been difficult to achieve and difficult to discern. Attempts, for example, to tie the independence of directors to lower risk or greater return have failed to show any special connection. The problem is not that independence is not important—the problem is that independence is difficult to determine based on the indicators required to be disclosed by the SEC and the stock exchanges.

Persaud and Plender outline the potential for conflicts of interest that can arise out of commercial relationships. They make two key points in this selection. First, a box-ticking, meet-the-standards orientation is not enough: “auditors have to ask themselves key questions that go beyond mere compliance with professional and firm codes.” Second, no matter what other relationships are foregone or prohibited, the central conflict of interest stemming from the fact that corporate managers select and pay the auditors remains: auditors must be scrupulous in examining “whether the interests of the firm are being put above the interests of the client. Yet in the case of the auditor this question is complicated by continuing confusion over the identity of the real client.” They correctly conclude that in the case of Enron, the “imbalance” created by the enormous consulting fees to the audit firm were probably less of a contributor to conflicts of interest “than the fact that its business model in both cases was fixated on keeping management happy in the interests of future fee generation for Andersen partners.” Their quotation from the audit partner who was advising the staff on the obligations to Robert Maxwell is so blatantly pandering it is almost funny, or would be if it was not tied to a massive

fraud. As Persaud and Plender note, “In this case the role of the auditor had clearly degenerated into that of a lackey/poodle.”

It is particularly enlightening to include the findings of psychologists in discussing the responses of auditors to ethical challenges. Too often, these issues and reform proposals are examined from a purely structural standpoint and it is very encouraging to see them in the larger context of an understanding of the way that we process information and respond to incentives and risks. Persaud and Plender are right to be concerned that the post-Enron reforms may not go far enough in ensuring genuine independence of mind, spirit, and conscience. Ultimately, the solution will have to rest in training, alignment of incentives, leadership from the industry itself, a commitment to the highest ideals of integrity and transparency, and oversight by the ultimate clients of corporate audits, the shareholders. To quote another US President, Ronald Reagan, their obligation must be to “trust but verify.”

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AUDITORS AND INDEPENDENCE

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This is an extract from [All You Need To Know About Ethics and Finance](#), by Avinash Persaud and John Plender (Longtail Publishing, 2006).

Independence is a concept of fundamental importance in business relations and corporate governance. It is above all crucial in auditing, which provides a guarantee of the integrity of the numbers on which an efficient allocation of capital within the capital market system depends. **The job of auditors is to express an independent opinion on whether financial statements are reliable and credible.** They report on the statements' compliance with the law and accounting standards and, depending on the jurisdiction, whether the accounts prepared by the board reveal either a fair, or a true and fair, picture of economic reality. Unlike most other advisers auditors have an overwhelming public interest obligation, which has been put with great clarity by the former US Chief Justice Warren Burger:

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.¹

Very importantly, **auditors play a central part in policing the conflict of interest implicit in the principal-agent relationship between shareholders and management.** If they allow their independence to be compromised, a decline in the quality of audits will cause the chain of accountability from management to shareholders to go slack, trust in capital markets to erode and the cost of capital to increase as a result. This is precisely what happened in the period of falling ethical standards at the turn of the millennium.

Auditors and other professionals frequently refer to independence as a habit of mind. Yet this definition is less than adequate. **Independence is better regarded as a freedom from business relationships, institutional structures and incentives that impair objectivity.** It is not enough for professionals themselves to be satisfied that they are

¹ United States v Arthur Young & Co., (1984).

independent. Those with a genuine professional and ethical commitment should aspire to a freedom from compromising business environments and relationships that would satisfy a reasonable and well informed third party that their objectivity was unimpaired.

Threats to objectivity

Auditors have always faced problems with independence. If they own shares in the company they audit, for example, or if the audit client represents a disproportionately large share of the accountancy firm's fee income, objectivity is likely to be eroded. Because it is hard to do the job without establishing good working relations with the executives in the finance and accounting areas of the client company, there is inevitably a risk that the relationship will become too cosy. That risk is further heightened where the audit partner is invited to join the client company as chief financial officer or in any other role where there will be contact with the auditors.

While the accountancy profession and accountancy firms all have their own ethical rules and guidelines to deal with these potential impairments of objectivity and independence, there is always a risk that the rules may not keep pace with evolving business practice or fully cover the particular circumstances in which individual auditors find themselves. So **auditors have to ask themselves key questions that go beyond mere compliance with professional and firm codes.** The first one is whether anything in their business relationships, institutional environment or incentive arrangements puts at risk their independence, objectivity or integrity. A second, which concerns a fundamental ethical principle common to all advisory businesses, is whether the interests of the firm are being put above the interests of the client. Yet in the case of the auditor this question is complicated by continuing confusion over the identity of the real client.

In most developed countries the appointment and pay of the auditor has until recently in company law been a matter for shareholders to decide in the annual meeting. Yet **in practice the auditor's job and pay have traditionally been in the gift of management.** Managers do not have much incentive to encourage effective policing of their agency relationship with shareholders. Many feel anyway that their vision for the business is fully in alignment with the shareholders' interests. And in the 1960s and 1970s managers started to complain that the audit delivered little value to the company. Under pressure from corporate clients, who bargained fiercely to hold audit fees down when inflation was going up, the big accountancy firms thus changed their business model from one that focussed on delivering quality audits for shareholders to a more commercially driven approach. The biggest firms turned themselves into global financial advisory conglomerates, providing management consulting, actuarial, human resource, legal and other services to their audit clients. Managers, who were only too happy to be cross-sold these new services, supplanted the shareholders as the auditor's real client.

As the firms' non-audit fee income grew very rapidly, auditing came to be perceived as a low-growth, unglamorous part of the business—an orphan product in a world where most employees wanted to work in the non-audit areas of the firm. Some firms refused to take on audit work unless audit clients offered them non-audit assignments, which carried the clear and ethically dubious message that it was uneconomic for them to do audit work without a cross-subsidy from other activities. The word low-balling, the practice of loss-leading with a low audit fee to win non-audit business, came into common parlance. This had important consequences for competition. It meant that **cross-subsidised audit services were being offered below a price at which it was economic for smaller audit firms to come into the market**. So this tended to entrench the dominance of the big firms in what many perceived to be an over-concentrated audit market.

Burgeoning conflicts of interest

In this new world conflicts of interest multiplied. The problem was not limited to the audit/non-audit conflicts. The tax partners in accountancy firms, for example, became increasingly involved in mass marketing aggressive tax shelters, on which audit partners in the same firm would then have to pass an audit judgement, while profiting from the selling efforts of their fellow partners in the tax practice. Consultants installed financial information systems on which their fellow audit partners would have to reach an opinion in relation to the effectiveness of the system's internal controls which were fundamental to the integrity of the company's financial statements. And so on and so forth. Underlying it all was the basic point that the professional ethos was declining, as was the firms' ethical commitment. Rewards within partnerships, as in law firms, actuarial practices and other professional partnerships, were increasingly tailored to ensure that the biggest pay went to those who brought in most business. In the late 1990s at Ernst & Young, for example, audit partners were given targets to meet for the sale of non-audit services to corporate clients. Failure to meet the target resulted in an automatic pay reduction of 10 per cent.² This growth-hungry approach to incentives was perfectly designed to turn audit watchdogs into poodles. The independence of audit partners who presided over the low-growth part of the business was inevitably compromised.

The extent of the compromise emerged very clearly in the UK Department of Trade inspectors' report on the fraudulent business empire of Robert Maxwell, published in 2001. An internal memo sent by a senior partner in Coopers & Lybrand Deloitte (now subsumed into PricewaterhouseCoopers in the UK) outlined the firm's strategy towards the audit as follows:

² *Depreciated: Did You Hear the One About the Accountant? It's Not Very Funny*, Wall Street Journal, March 14, 2002.

The first requirement is to continue to be at the beck and call of RM [ie, Robert Maxwell], his sons and his staff, appear when wanted and provide whatever is requested.

In this case the role of the auditor had clearly degenerated into that of a lackey/poodle.

As the economist John Kay has argued, the auditors' position exemplifies the most famous problem in game theory, the Prisoner's Dilemma, in which rational crooks shop each other to their own ultimate disadvantage. In terms of the way the audit world works the dilemma arises because for a single firm in a respected profession, or an individual practitioner in a respected firm, the most profitable strategy is to benefit from the reputation for rigour and integrity established by others without contributing to it oneself. **Since free riding is the most profitable strategy for everyone, reputations are inevitably eroded.** Kay expands the point, saying:

The merit of competitive markets is satisfied customers and so it is with supervisory services. If property owners hire the police, policing strategies will suit property owners; if burglars hire the police, policing strategies will suit burglars. Since the audit process is one in which the property owners—the shareholders—pay for the police and the potential burglars—the corporate executives—appoint them, we should expect scrutiny to be costly but not rigorous and frequently this is what we find.³

In the litigious environment of the US where lawsuits against auditors have multiplied, an important part of the story was that accounting standards became increasingly detailed, while there was a **growing tendency to emphasise form over substance**. Auditors sought to protect themselves from professional negligence claims by adopting a rule-checking approach instead of trying to arrive at a genuinely independent professional judgement on the fairness of the financial statements. In the stock market bubble of the late 1990s independence and ethics reached their lowest ebb. At Enron and WorldCom, the two most notorious corporate collapses of the period, Andersen took more non-audit fees than audit fees from these clients. Yet this fee imbalance was probably less important, in causing trouble, than the fact that its business model in both cases was fixated on keeping management happy in the interests of future fee generation for Andersen partners. Everyone lost sight, at the time, of the vital importance of the audit function for the integrity of the capital market system. The interests of the real audit clients, the shareholders, were neglected.

A final twist to the story of declining professional standards lay in the globalisation of the Big Five accountancy firms. PricewaterhouseCoopers, KPMG, Ernst & Young,

³ *Auditors need to escape the Prisoner's Dilemma*, Financial Times, May 16, 2006.

Deloitte & Touche and Andersen used a common name across the world. The remaining four continue to do so. Yet **the right to carry out a statutory audit in most jurisdictions is usually granted only to local firms. This means that the big global firms are really no more than loose confederations. They have franchised their brand names, but do not have full ability to enforce consistent audit quality across the world.** And since they have all installed firewalls to ensure that legal liabilities for professional negligence cannot fall on partners in member firms in other countries, the chief external discipline for uniform global audit standards is weakened. The fragility of these loose confederations was exposed by the disintegration of Andersen after the Enron debacle. Each individual member of the Andersen global partnership rushed to hook up with the most attractive local partner of the Big Four in an unedifying *sauf qui peut* dash once it became clear that Andersen in the US would not survive.

In international institutions such as the World Bank which make use of the Big Four's audit services in developing countries staff are highly critical of the uneven quality of the audits delivered by the Big Four. They feel that the firms have been selling their audit services on a false prospectus and question whether this approach, brilliantly successful in purely business terms, was professional or ethical. The point was graphically borne out when the Japanese arm of PricewaterhouseCoopers, Chuo Aoyama PwC, was ordered by Japan's Financial Services agency to suspend offering audit services to its bigger corporate clients for two months in 2006 for complicity in fraudulent accounting at Kanebo, a cosmetics company. This followed the arrest of three PwC auditors for, it was alleged, wilfully certifying false accounts at Kanebo for a period of five years. What emerged clearly from the affair was that audit standards at Chuo Aoyama PwC were conspicuously lower than at the national firms of PwC in the US or parts of Europe. The global network had failed to impose common ethical or audit standards on a global basis.

Self deception and the illusion of objectivity

How is it that partners and employees in audit firms continue to regard themselves as independent and objective when their profession has turned itself into a growth hungry business where the institutional framework and incentive structures militate against objectivity? Much academic psychological research has been conducted into ethical lapses. The conclusions suggest that while most people have a realistic view of how others will behave in ethically challenging situations, everyone is wildly optimistic about their own behaviour.

There is exceptional over-optimism, it seems, in relation to the ability to remain uninfluenced by biases or conflicts of interest. Just as people tend to believe that they are better drivers than everyone else, they expect to act more ethically than everyone else. This leads to an illusion of objectivity whereby good people regularly engage in unethical behaviour without being aware of it because they over-rely on intuitive thinking or are influenced by unconscious bias.

Convincing evidence of this emerges in an experiment conducted by academic psychologists on 139 professional auditors.⁴ Participants were given different auditing cases to examine, involving controversial areas of accounting such as revenue recognition or capitalisation versus expensing of expenditures (which was, incidentally, the issue on which the accountancy scandal at WorldCom turned). The auditors were told that the cases were independent of each other and were randomly assigned either to work for the company or to work for an outside investor considering investing in the company in question.

The psychologists found that the auditors who were told they were working directly for the company were 31 per cent more likely to accept the various dubious accounting treatments than those who were told they were working for outside investors. Other work by the same academics has demonstrated that while auditors were aware of the biasing influence of the particular role they fulfilled, they failed to grasp how powerful the bias was and were unable to correct for it. When these professional people were accountable to a partisan audience with clear preferences, they were found to be more willing to engage in actions consistent with the interests of their audience that they would otherwise find ethically problematic.⁵

Some remedies, but an unchanged business model

The Sarbanes-Oxley Act in the US and corporate governance codes in Europe have now tried to address the confusion over the identity of the audit client and the auditors' flawed business model by shifting responsibility for the appointment and pay of the auditor to audit committees peopled by independent non-executive directors. In many countries oversight has been strengthened and restrictions have been introduced in the provision of non-audit services to audit clients. It is becoming common for audit partners to be rotated at regular intervals, while in countries such as Italy the audit firm itself is rotated. Regulatory authorities such as the US Public Company Accounting Oversight Board are taking a close and healthy interest in the way audit partners are incentivised.

For their part the big accountancy firms are on their mettle since the raft of corporate collapses in the first half of the decade, the demise of Andersen and the US Department of Justice's investigation into the sale of aggressive tax shelters by KPMG. Audit has become less of an orphan business because it has been generating more money as a result of the Sarbanes-Oxley Act's demanding requirements, especially in relation to internal controls. Since the act has extra-territorial reach, covering foreign companies listed in the US, **the non-US members of the global accountancy**

⁴ *Auditor independence, conflict of interest and unconscious intrusion of bias*, Moore, Loewenstein, Tanlu and Bazerman, 2004.

⁵ We are indebted to James Montier of Dresdner Kleinwort Wasserstein for much of the discussion of auditors' psychology. See *Doing the right thing or the psychology of ethics*, DrKW Global Equity Strategy note, July 8, 2005.

partnerships are feeling additional benefit over and above increases in fees on the back of their own regulators' responses to domestic corporate scandals. Ethics partners are now normal in big accountancy firms, with a remit to ensure high standards are observed. The big firms have also produced statements of values to be applied globally, while **efforts have been stepped up to achieve more consistent auditing standards worldwide. The professional bodies of the accountancy world likewise prescribe unvarying ethical standards globally.**

Yet it remains to be seen whether the firms really can enforce global auditing standards and whether a common set of values can be embedded in the hugely different ethical and religious cultures that prevail in the countries where the firms operate. Arguing that a client should be turned away by the global partnership on ethical grounds entails big conflicts of interest when member firms stand to lose very different amounts of fee income that the client delivers to different firms in the global partnership. The conflict is then compounded because whatever the global values code may say, we all know that attitudes to ethics are highly variable from country to country.

The fact remains that the Big Four still aspire, outside the US at least, to be multi-service advisory conglomerates. Many of the leaders of the business whom we encounter tend to talk as though they do not see auditing as the key to future growth, which implies that there is a continuing question over the compatibility of the goals and incentive structures in the Big Four with genuine auditor independence. Nor is it our impression that they uniformly talk as though the business model has really changed. So for all the well-intentioned efforts of lawmakers, regulators and auditors to clean up the business since 2000, the Big Four and the wider accountancy profession have arguably yet to meet the test on the independence of the auditor of satisfying a reasonable and well informed third party that objectivity is unimpaired.

About the Author

After taking his degree at Oxford University, John Plender joined Deloitte, Plender, Griffiths & Co in the City of London in 1967, qualifying as a chartered accountant in 1970. He then moved into journalism and became financial editor of *The Economist* in 1974, where he remained until joining the UK Foreign Office policy planning staff in 1980.

On leaving the Foreign Office, he became a senior editorial writer and columnist at the *Financial Times*, an assignment he combined until recently with current affairs broadcasting for the BBC and Channel 4.

A past chairman of Pensions and Investment Research Consultants (PIRC), John Plender has served on the London Stock Exchange's quality of markets advisory committee and the UK government's Company Law Review steering group. He is a non-executive director of Quintain PLC, a FTSE 250 company.

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