

THE CONCEPT OF AUDITOR INDEPENDENCE REVISITED

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Abstract

The paper's objective is to offer a better picture of the complex and controversial concept of auditor independence. It explores the possibility that understanding the concept of auditor independence might be enhanced considerably by drawing out some parallels between the developments in sociological theory and those in auditing. Moreover, we argue that independence must be performed by taking into consideration the arena framework. It is neither desirable nor realistic to determine the role of auditing and to analyze financial audit by means of a single audit report from a single auditor. On the contrary, the information that flows from different engagements is important in an arena, depending on what information is made available to other parties. Lastly, there are several metaphors such as independence as separation metaphor, independence as an avoidance of dependence, or independence as an absence of interest. However, the understanding of the concept remains open and debatable.

Keywords

auditing; sociology; interdisciplinary; interactions; metaphors;

JEL Classification

M42, A14

Introduction

The financial audit activity is carried out in a strictly regulated and a highly litigious environment, where it is difficult to find any room for innovation and entrepreneurship. Financial auditors are required by rules and regulations to display professional behavior in all circumstances and to put the interest of the public above all their other potential interests. They must observe a comprehensive regulatory structure, including ethical provisions, so that their activity is rarely seen as a business open to innovation. In fact, few researchers (e.g. Țurlea and Mocanu, 2010) considered that financial audit is a business like many others. In most research papers, the status of financial audit is strictly differentiated, being considered a profession rather than a business (Cheffers and Pakaluk, 2007).

In its evolution until present days, the audit profession went through difficult times. The accounting scandals from the beginning of our century raised critique upon auditors. There is an extensive body of research that intensively debated on those events (e.g. Carnegie, Napier 2010; Cooper, Neu 2006; McMillan 2004), with significant consequences for the profession in terms of relevant regulatory framework. Moreover, because of the economic and financial “crisis” that started presumably around 2008, auditors were again heavily criticized. Headlines such as “Where were the auditors?” has been one common response of

journalists to recent financial collapses of companies, as if auditors held the responsibility for these failures. This state of facts stirred debates about current auditing practices (e.g. Sikka 2009; Humphrey et al. 2009).

The objective of the present paper is to explore the concept of independence of auditors in a broader context. The paper is structured as follows. First, the arena framework is described and applied in auditing. Second, various metaphors are explained, starting with the most common one – independence as separation. Lastly, we try to put the concept in a different light by discussing it from a sociological perspective.

Independence in an arena context

An arena describes the symbolic location of actions that influence collective decisions or policies. With the help of this metaphor, the process of policy formulation and enforcement in a specific context could be explained (Georgakopoulos and Thomson, 2008). The arena concept does not support the analysis of financial audit at individual (microlevel) or society level (macrolevel), but rather at the meso-level. Moreover, relevant in the analysis are the actions of social groups or individuals that intend to influence collective decisions or policies. An actor succeeds or fails depending on the amount of influence he has been able to exert on the resulting decision or policy (Jaeger et al., 2001). Different actors use money, power, social influence and evidence in order to attain their goals. The final objectives of an actor may be resource accumulation or even the resources themselves (Georgakopoulos and Thomson, 2008). The main elements of an arena in financial audit are described below, bearing in mind their relevance for the independence of the auditor.

(1) *Companies*. These are audit companies and audited companies. Their power in the arena depends on their size and market share. At present, the audit markets (both the international and the local markets) are dominated by the so-called “Big Four” companies.

(2) *Rule enforcers*. These are particularly important since financial audit is highly regulated. First of all, as professionals, auditors belong to a professional body, which ensures that all relevant rules and regulations are observed. The influence of rule enforcers is significant, since infringing the regulatory requirements leads to disqualification as professional.

(3) *Political institutions*. The government, the public finance ministry and other country-specific political institutions are also important actors in an arena. Their objectives may vary widely, starting with the aim for a working economy and ending with the collection of taxes from companies. Their influence is also critical within the arena.

(4) *Stakeholders*. Rubenstein (1986), cited by Porter (2009) classifies stakeholders from the perspective of the company’s managers as follows: (1) Input stakeholders – employees, owners, suppliers and creditors; (2) Output stakeholders – consumers, distributors and users of the company’s product or services; (3) Environment stakeholders – the community and local and central government.

(5) *Issue amplifiers*. As in other areas of activity, the issue amplifiers are the media. Media is the one that sheds light upon accounting scandals. Its influence is greater than initially thought, since as consequence of the immoral acts of professional accountants (auditors), the perception of the public and other stakeholders on the professionalism of auditors in general and in particular may change and may even lead to a change in rules.

(6) *General public*. The general public is the audience of the issue amplifiers. The public comprises simple citizens, in their position as consumers or employees. They cannot be directly influenced by auditors. However, these could be the “anonymous” voice that highlights issues and drives changes in the arena.

Main metaphors of auditor independence

Independence as separation. The most frequently used metaphor that structures the language about independence of the financial auditor can be formulated, according to Reiter (2004), as follows: “Independence is separation”. This metaphor originates in the separative model or ethics of rights perspective and forms the basis for the discussions on auditor independence. The separation metaphor is strongly related to the morality of rights or justice, which is formal, abstract, and emphasizes universal abstract principles (Reiter, 2004). Cole and Coultrap-McQuin, cited by Reiter, state that “the ethics of rights emphasizes detachment, impersonality, objectivity, and individual autonomy at the expense of attachment, particularity, emotion, and intersubjectivity” (Reiter, 2004). Within this ethical framework, human beings are considered autonomous and immune to social influences.

Independence as an avoidance of dependence. The main flaw of this “independence is separation” metaphor is that it does not take into consideration an essential fact: financial auditors do work within relationships (relationships to the client’s management, its accounting department, other experts, former auditors, regulators, other competing professionals, as well as within a social and cultural environment). According to Wallmann, cited by Reiter (Reiter, 2004), it is very difficult for the financial auditor to conceiving of how to have independence (i.e., no relationship) within a relationship. In his opinion, it would be much easier to imagine the characteristics of an inappropriately dependent relationship. In fact, there is obviously some degree of dependency in all relationships of the auditor. Mautz and Sharaf, cited by Gray and Manson (2005), stated that “auditing, unfortunately, does not have any ‘built-in’ characteristics that assure the skeptic of its integrity and independence”. On the contrary, “auditing suffers from what may be described as ‘built-in anti-independence factors’”, since the auditor’s fees are paid by the client’s management. Therefore, Wallmann proposes a focus on “avoiding dependence”.

Independence as an absence of interests. Another perspective on auditor independence is offered by Elliott and Jacobson (1992), who define independence as a matter of interests. They state that “the auditor should have no interest in the financial statements except their reliability” (Elliott and Jacobson, 1992). The definition offered by Elliott and Jacobson is, according to Reiter (2004): “audit independence is an absence of interests that create an unacceptable risk of material bias with respect to the reliability of financial statements”. Moreover, in defining independence, Elliott and Jacobson radically separate this concept from those of integrity and objectivity, which they consider to be personal qualities of the financial auditor.

Independence as an ideal. Auditor independence may be considered up to a certain point idealized. This utopist perspective on independence originates in its role in legitimating the profession. The social contract, namely the contract of the auditor with the society in general implies certain requirement. The professional group of financial auditors must continuously legitimate their status and justify public trust in them, whereas independence is a key in fulfilling this aim. R.W. Bartlett (1991) suggested that every time the independence concept is put into question, a series of semi-spiritual incantations are recited with fervor. According to Bartlett (1991) and Baker (2005), the “ceremony” of auditing consists of four kinds of “incantations” regarding auditor independence used as counter-arguments when the logic of independence is doubted:

- *The “smoking gun”.* Due to the difficulties in assessing an intangible quality of the auditor such as independence, most lawsuits and prosecutions have been based on assertions of incompetence or lack of due diligence in the application of auditing standards, rather than lack of independence.

- *“We are doing pretty good.”* This incantation is based on public opinion surveys, which show that certified public accountants are highly respected and are perceived to be ethical. However, the public may not be well informed about what auditors do and the meaning of “independence” may be unclear to the general public.
- *The “public good.”* This incantation suggests that the existence of too many constraints on the public accounting profession’s scope of services leads to inability to serve clients properly, thereby incurring costs to the public. On one hand, some considered that management advisory services have a positive impact on auditing, because they offer a better understanding of the client’s systems. However, many think that independence in appearance is difficult to attain in this circumstance, since it is difficult for the public to believe in the objectivity of the auditor’s opinion on a system designed by the auditor him or herself.
- *“Trust us.”* The main assumption is that auditors constantly have in view the costs and benefits associated with ethical behavior and chose to behave ethically since this decision leads to the greatest long-term economic benefit. The “trust us” argument might be undermined by the fact that sometimes, individual economic calculus of a particular auditor may actually encourage the auditor to retain an important client, rather than maintain objectivity and independence.

Independence from a sociological perspective

Financial auditing and the functionalist perspective. Researchers, as well as practitioners in the field of financial auditing, frequently state that the ultimate goal of financial auditing is trust at the market place (e.g. Cheffers, Pakaluk 2007, 39). The basic underlying assumption in this analysis is that the society is a set of interdependent parts, a system that strives for stability. The social situation is financial auditing, to be analyzed within a wider social institution called "market economy". The main function of financial audit is to offer credibility to the financial statements of the audited companies by issuing an opinion on whether they present fairly, in all material respects, the financial position and performance of that company, in accordance with a certain financial reporting framework. The sole fact that an auditor examines financial statements of a company makes them credible to lenders, investors and other stakeholders. Therefore, the main function of financial audit is to meet the need for trust in the market economy.

Financial auditing and the conflict perspective. Researchers, as well as practitioners in the field of financial auditing repeatedly stated, explicitly or implicitly, that the auditor's decision-making process takes place in a conflict-driven environment (e.g. Arnold, Collier, Leech, and Sutton, 2001). First of all, as Goldman and Barlev claim, the client organization (management and shareholders) may strive for power and control over the outcome of the financial auditing process. It is said that the cause of this conflict between a financial auditor and a client organization resides in fact that the truthful audit report collides with the interests of management or shareholders or both groups. The main source of power for management and/or shareholders resides in the fact that a client organization is the one that mandates and remunerates the financial auditor. Another possible conflict that is frequently cited in the literature is the conflict between managers and shareholders (Gray and Manson, 2005). Managers may wish to mislead shareholders, even if only in a short term. Last but not least, a client organization may wish to deceive outside providers of finance (such as lenders) regarding its position, in order to increase the probability to receive further financing, although this may not be in the best interest of a third party.

Financial auditing and the interactionist perspective. Researchers, as well as practitioners, claim that a financial auditor does not exert his/her profession in a social vacuum. The debates on this issue are mainly related to the ethical requirement of auditor independence. The basic underlying assumption in this analysis is that societies and persons in them are guided by the way they define and interpret events, behaviors etc. The social situation to be analyzed from this perspective is financial auditing, defined by the Oxford Dictionary of Business and Management as "an independent examination of, and the subsequent expression of opinion on the financial statements of an organization. This involves the auditors in collecting evidence by means of compliance tests (tests of control) and substantive tests (tests of detail)". Consequently, the idea of independence is inherently related to the very definition of financial auditor.

Conclusions

The present paper discussed the concept of independence, which still remains controversial. The main metaphor related to independence, namely "independence is separation" does not satisfy the need of the professionals to understand how to speak, think, and act in relation to independence. Alternative metaphors such as "independence as lack of dependence", "independence as matter of interests" and "independence for legitimating the profession" could be possible solutions to the problem of independence.

Additionally, we explored three sociological perspectives on financial audit, which offer a better understanding of the auditing profession. From the functionalist perspective, financial audit represents a functional part of the system called "market economy" and meets a vital need – the need for trust at the market place. From the conflict perspective, the financial audit process takes place in a conflict-driven environment, with the following potential areas of conflict: between an auditor and a client organization (management and shareholders), between management and shareholders, and between an audited company and its lenders. From the interactionist perspective, a financial auditor does not live in a social vacuum, thus the metaphor "independence is separation" is apparently inappropriate.

This is the reason why the analysis of independence needs to be made taking into consideration the arena framework, which facilitates the understanding of financial audit. The role of auditing cannot possibly be determined by analyzing a single audit report from a single auditor. The information that flows from and within various audit engagements is essential in an arena, where it may be that each party receives different pieces of information regarding the financial audit activity. This conclusion conforms to reality, since multiple parties of the audit environment may usually influence decisions, even slightly. In conclusion, the debates on auditor independence remain open.

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