Audit independence concepts

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IN BRIEF

A CONCEPTUAL FRAMEWORK FOR AUDIT INDEPENDENCE

The immediate role of audit independence is to serve the audit, and the objective of the audit is to improve the reliability of information used for investment and credit decisions. Ultimately, the purpose of audit independenc e is to improve the cost-effectiveness of the capital markets.

Materiality has to be considered within this context, and an auditor's interest should be considered material if it presents a risk of impaired objectivity with a likelihood so high and an impairment of such a dimension that the interest reasonably can be assumed to affect the outcome of the audit.

The appearance-of-independence concept should not be included in any conceptual framework unless the relationship of that concept to both the objective of independence and desirable concepts of independence is determined and spelled out.

The root question in evaluating audit independence is whether an interest creates an unacceptable risk of material bias. In answering that question, a decision will have to be made as to whether it should be based on a reasonable or prudent person concept, regulators' judgment, or investor opinion. Another question that has to be answered is whether the objective of audit independence is served by applying regulatory prohibitions to parties that cannot influence the audit.

The authors have developed a set of eight principles that should be part of the conceptual framework.

There has never been a conceptual framework for audit independence before--not even an official definition of the term. Audit independence has been guided by detailed rules, common sense, and conservatism. The public has been protected. But the rules have not had the benefit of clear concepts and consistently applied principles. It is hard to believe this of independence, because no other single idea has so much signified what the auditing profession means in the world. It is time to give it fresh thought, to rise above the clutter of detail and think through what audit independence should mean in any circumstance, what is necessary to analyze and evaluate whether the properties of independence are present, and what is the objective of the whole exercise.

There is reason for hope. The Independence Standards Board (ISB) has put the conceptual framework for audit independence in its sights. Planning decisions have been made, and a project director has been engaged. The first step will be to develop a discussion memorandum. Here are our versions of the objective, the definition, and the principles of audit independence, as well as several of the conceptual issues that will have to be resolved in order to develop the framework.

THE OBJECTIVE OF AUDIT INDEPENDENCE

The immediate role of audit independence is to serve the audit. It makes the audit more effective by providing assurance that the auditor will plan and execute the audit objectively. So the larger purpose of audit independence, its objective, must be sought in the objective of the audit.

The immediate objective of the audit is to improve the reliability of information used for investment and credit decisions. Independence is essential to that contribution. More broadly, the objective of the audit is to contribute to the effectiveness of the capital markets.

Improvements in the reliability of corporate disclosure reduce the risk that an investor or creditor will make a poor decision because the information is inaccurate or otherwise wanting in quality. This risk--information risk--is present every time an investor or creditor uses information to assess the economic risk of a potential investment. The better the quality of the information investors and creditors use for their assessments of economic risk, the better their chances of making sound decisions. In other words, their information risk is lower.

The information risk perceived by investors and creditors is reflected in the cost of capital to the corporation. Both suppliers and users of capital benefit from reliable corporate disclosure--suppliers in the form of decreased risk, users in the form of decreased capital costs. To see the social benefits of this process, it must be viewed economy-wide as a system of allocating the nation's capital.

When investors and creditors make better decisions on capital allocation for their own interests, capital flows more readily to the most productive business entities, increasing economic growth, jobs, and the standard of living. Those are social benefits from effective capital markets and, therefore, social benefits of auditing's contribution to effective capital markets.

The way in which audits improve the reliability of the information used for investment and credit decisions is well understood. Audits work by deterrence, detection, and verification. Knowing that auditors are on the way deters managements so inclined from distorting the financial results; auditors detect the vast majority of distortions that nevertheless occur; and verification of undistorted information by selective tests provides evidence of its reliability. Research shows that auditing improves the reliability of the financial information investors use for decision making.

More reliable information affects the meaning of share prices. Share prices are more likely to reflect corporate earning power if the numbers analysts use more closely reflect the substance of corporate operations. Capital is more likely to flow to the most productive enterprises if financial reports reflect corporate earning power than if they do not.

The auditor's contribution is sometimes described as adding credibility to the capital markets. Credibility is an important concomitant of auditing, but it is not the core of the auditor's contribution. The core contribution, to repeat, lies in the effects of the audit process on the reliability of the information used for decisions. Without improved reliability there would be no valid basis for investor confidence in the information, and share prices would have less of a relationship to corporate earning power. Auditors would indeed be cheerleaders for their clients if their purpose was merely or chiefly to overcome the hesitations of investors to engage in transactions because of possible management bias in the financial statements. The effect on the capital markets would be limited to improving the willingness of capital suppliers to enter transactions, with no effect on the relationship between share prices and the substance of corporate operations and no effect on the likelihood of returns from capital outlays.

There are costs to effective capital markets. The costs of preparing, auditing, and distributing

corporate disclosure are among those costs, and the cost of audit independence is one of the costs of auditing. The lower the costs of effective auditing, the higher its net contribution to the capital markets. The costs of audit independence include compliance, quality controls and safeguards, compensation for opportunities lost by obedience to prohibitions, and incremental service costs borne by clients deprived of service providers' economies of scale and scope.

A usefully stated objective of audit independence would capture both the cost and the benefit side of the contribution to the capital markets. Here is the way such an objective might be formulated:

The purpose of audit independence is to improve the cost effectiveness of the capital markets.

This objective follows from the idea that the purpose of auditing is to improve the cost-effectiveness of the capital markets (independence improves auditing, which should improve the cost-effectiveness of the capital markets).

RELATED CONCEPTS

Embedding cost-effectiveness in the objective of audit independence provides a useful context for discussing the concept of materiality. As applied to audit independence, materiality means that some auditor interests present so low a risk of impaired objectivity or present a risk of such slight impairment in objectivity that they cannot reasonably be assumed to affect the outcome of the audit. A risk of bias can be so small as to be reasonably disregarded. It would not be cost-effective to prohibit the interest that causes so small a risk--say, a free cup of coffee from the auditee. Materiality concepts have been applied in the past, but not always by name.

No one can know whether an interest will affect an auditor's objectivity, certainly not in advance of the judgments that could provide evidence of objective behavior. This makes it difficult to identify what should be proscribed and when. Moreover, it is harder to win support for rules if they appear arbitrary than if they do not, and apparent inconsistency suggests arbitrariness. If rules are to be consistently derived, they must be based on a set of assumptions or principles.

For example, if some interests are banned wholesale, and others only when they are material, there is an apparent inconsistency. Direct financial interests are now banned wholesale. But a tiny direct financial interest, say, owning a single share of stock in an auditee with a market value of $1, is not sufficient to create an unacceptable risk of material bias. There is no concept or principle that lends consistency to this practice.

One might argue that the prohibition is justified because it is so difficult to assess degree of potential bias for every financial interest no matter what its size for each auditor on each engagement. A principle that reflected this rationale--call it administrative convenience--would avoid the appearance of inconsistency, provided the principle were properly applied. In the chosen case, it is arguable that with modern information technology, it is feasible and practicable to monitor every auditor's stock holdings every day. The point, however, is not to make the judgment, but to describe the issue. Administrative convenience is a candidate for treatment in the conceptual framework and in a principle for regulating independence.

The degree of bias that an interest can generate cannot be assumed to be strong even though its likelihood is high. This differentiation is embedded in regulatory decisions, but has not been officially conceptualized. The audit fee, for example, is a direct financial interest that is omitted from the prohibition against such interests. It is considered the type of interest--direct and financial--that can cause bias; it is present in all audits of SEC registrants; but it is not considered

to create a bias strong enough to be prohibited. This can be viewed as another application of a materiality concept, but it also has a wider context with conceptual implications.

Banning the acceptance of audit fees from audit clients would necessitate a transformation of the industry. A new structure based on governmental auditing, with audit costs paid through tax revenues, is a possible replacement. Thus rules on independence can have ramifications beyond the issue of potential bias. This notion is another candidate for treatment in the conceptual framework and in a principle for regulating independence.

Although some interests that might cause bias, such as the audit fee, are always present, a highly significant interest is always present that weighs in favor of objective auditing. This is the auditor's interest in his or her firm's reputation. The better the reputation, the greater the cost-of-capital savings to the auditee, and therefore the greater the fee the auditor can command. Auditors thus have strong incentives to protect and enhance their reputations, and these incentives favor objective auditing. No set of independence concepts can be considered complete if it ignores the interests that are incentives to objective auditing.

DEFINITIONS

The definition of audit independence will be central to any conceptual framework. The independence definition used in this article, which is modeled on the definition of assurance independence developed by the AICPA Special Committee on Assurance Services, is as follows:

Audit independence is an absence of interests that create an unacceptable risk of material bias with respect to the reliability of financial statements.

The definition bears the marks of statistical concepts. In statistical sampling, one wants to know the confidence level and the precision interval. These correspond here to the risk of bias and the materiality of that bias, respectively. One needs to know both the likelihood of an event's occurrence and the magnitude of the event's effect that might occur in order to appreciate the risk it represents.

Materiality for purposes of independence regulation should encompass both of these qualities. Thus, for purposes of independence regulation:

An auditor's interest is material if it presents a risk of impaired objectivity with a likelihood so high and an impairment of such a dimension that the interest can reasonably be assumed to affect the outcome of the audit.

A large, but highly unlikely impairment would be immaterial, as would a small, and highly probable one.

The definition of independence sets no limit on the types of interest that can create bias. The interest could be financial or nonfinancial, as in the case of a close relative in top management of the auditee. It could be a relationship or an investment. It could be a source of monetary or psychological rewards or dependencies. However, one type of interest is explicitly compatible with independence--any interest that is an incentive to truth-seeking and impartiality, that is, an incentive for a bias toward the truth (for example, the auditor's desire to preserve his/her good reputation, as discussed above, or the auditor's emotional investment in professionalism).

An important issue in arriving at a conceptually desirable definition of audit independence is how that definition relates to other terms that are also parts of discourse on, and regulation of, audit independence (e.g., objectivity, integrity, quality controls, and safeguards). Objectivity

means to be without prejudicial bias, so an independent person, as defined above, has no interests that would create an unacceptable risk of materially compromised objectivity. This relationship means that objectivity is different from independence. The two are closely associated, because objectivity can be impaired by interests, but objectivity and independence are not the same. Objectivity can be impaired by influences other than interests, that is, by influences other than lack of independence. Integrity, a moral quality, can influence objectivity. Moral flaws can cause biased behavior. However, integrity can also support objectivity. This is because independence and integrity function separately. Unbreachable integrity can maintain the maximum level of objectivity even when interests that create an unacceptable risk of material bias are present.

The auditor requirements for a quality audit are objectivity and competence. Objectivity can result from perfect integrity (despite impaired independence), perfect independence (despite impaired integrity), or some adequate combination of reasonable independence and integrity.

The basic apparatus for assuring reasonable independence consists of rules that prohibit interests that can create material bias, controls to ensure compliance, and safeguards to mitigate threats to independence from interests. This apparatus resides in a context of other controls designed to assure audit quality. Training in audit techniques is a quality control; it helps ensure audit quality. But only audit training that is explicitly designed to help ensure independence is an independence quality control. Safeguards are independence quality controls, but they are designed explicitly to mitigate the potential effects of interests on objectivity.

Safeguards sometimes operate directly on performance, as in the case of extra reviews of work performed on the audit. However, they may also operate by preventing parties that might have interests that could create bias from having an influence on an audit. If a party cannot have an influence on an audit, he or she cannot affect the quality of the audit. So-called fire walls that isolate parties with questionable interests from an audit fall into this category.

THE APPEARANCE ISSUE

A conceptual framework without the concept that appearance of independence should be a separate, self-sufficient cause for regulation will be quite different from a conceptual framework with that idea. The issue arises only when it is assumed an auditor can be independent in fact and have a different appearance, only when it is presumed that appearance of independence is not a natural consequence of independence in fact.

The threshold subissue is whether treating appearance of independence as a separate, self-sufficient cause for regulation is necessary to achieve the objective of independence. No one questions that the fact of independence is necessary to achieve the objective, so part of the inquiry on regulating appearances should be its effect on the role of the fact of independence. Confidence in auditors and auditing contributes to confidence in the capital markets. However, it does not follow that it contributes to the cost-effectiveness of the capital markets for auditors to have a reputation for independence disproportionate to what would be their due from the fact of independence. The fact of independence contributes to effective auditing, which improves the reliability of information and thereby the relationship between share prices and both the substance of corporate operations and corporate earning power. Assuming it is desirable to have a closer, rather than a more distant, relationship between the substance of corporate operations and share prices, what effect would treating appearance of independence as a separate, self-sufficient cause for regulation have on that relationship?

The appearance-for-its-own-sake position makes assumptions that should be fully explored before including the idea in the conceptual framework. Do investors evaluate the appearance or the fact of independence (as opposed to assuming independence based on assurances from

authorities and traditional roles)? If investors do not evaluate appearances (apart from the fact of independence), what is the purpose of rules exclusively designed to affect those evaluations? If investors and creditors do evaluate appearances (again, apart from the fact of independence), by what criteria and information do they perform the evaluations? Is a fair or thorough evaluation feasible? Since the costs of such evaluations would become costs of regulating independence, how would thorough evaluations affect the cost-benefit ratio for regulating independence?

Similarly, before including the appearance-for-its-own-sake position in the conceptual framework, the role of research should be fully explored. Is it feasible to use research on investors' perceptions as the basis for prohibitions for the sake of appearance alone? Does the prospect of such research invalidate other approaches to regulating auditors' appearances on the ground that they are arbitrary? How reliable and efficient would a research approach be?

The appearance-for-its-own-sake concept should not be included in any conceptual framework unless the relationship of that concept to both the objective of independence and desirable concepts of independence is determined and spelled out. Appearance of independence does not, at least in any way that has been identified, affect objectivity, audit quality, integrity, or information risk.

CONCEPTS OF EVALUATING INDEPENDENCE AND REGULATIONS

The root question in evaluating audit independence is whether an interest creates an unacceptable risk of material bias. One approach to answering this question is the reasonable or prudent person concept. This legal notion is based on determining what a hypothetical figure, a fictional person with knowledge of all the facts and circumstances, would conclude. The regulator in effect uses the fictional reasonable person as the yardstick with which to judge audit independence, effectively asking, "Would the reasonable person with all the facts and circumstances conclude that the interest presents an unacceptable risk of material bias?"

Regulators' judgment is another approach to determining whether an interest creates an unacceptable risk of material bias. Under this approach, regulators consider all input available, including research, and make determinations based on their best judgment of the public good. An advantage of the regulators' judgment approach over the reasonable person approach is that the former is obligated to have direct contact with research and the input of those who participate in the rule-making process. It is difficult to justify determinations without the benefit of all relevant knowledge from available research, experience, and commentary. Under the ISB's sunshine-oriented structure, it will be expected to make available the rationale for its conclusions. The rationale will be weaker if it is open to the charge of ignoring relevant, accessible knowledge.

Still another approach is to attempt to base regulations on investor opinion. However, this too would be vulnerable to the accusation that available research, experience, and commentary was being ignored. Moreover, it is not established that investors who are not invited to volunteer opinions for surveys or in focus groups actively evaluate independence. Nor is there reason to believe they are aware of independence issues, the rules and controls that have been used in the past, or available research and analysis. Conversely, investors who become a sounding board, with repeated sessions on independence and information not formerly available, cease to be representative of the group from which they were originally selected.

Evaluations of independence will be made more or less difficult by the applicability of the regulatory prohibitions. Firms typically contain personnel who cannot influence any audit and others who cannot influence various particular audits. Is the objective of audit independence served by applying regulatory prohibitions to these parties? This is partly a cost-benefit question. The cost of applying prohibitions both to parties who can influence the audit and to parties who

cannot, but are in the same firm, is greater than the cost of applying the same prohibitions only to parties who can influence the outcome of the audit. In addition, the concept of safeguards is hard to justify unless within the firm some group is defined as those who can affect the outcome of the audit. For example, if a prohibition applied to the whole firm, review would cease to be valuable as a safeguard, because the party performing it would be a member of the firm. Fire walls would have no logic if those on both sides of the fire wall were equally covered by a regulatory prohibition.

PRINCIPLES FOR REGULATING INDEPENDENCE

Since the ISB is mandated to create a principles-based set of standards, the principles should be part of the conceptual framework. The set of principles below is designed to be consistent with the independence objective, arguments, and concepts presented above. It therefore does not contain principles pertaining to appearance of independence.

1. Audit independence improves the cost-effectiveness of the capital markets by reducing the likelihood of material bias by auditors that can undermine the quality of the audit.
2. Auditor interests that present an unacceptable risk of material bias should be prohibited, except as necessary to fulfill principle 4.
3. For purposes of audit independence rules the "auditor" is a party in the audit firm who can influence the outcome of an audit.
4. No rule intended to help ensure audit independence should result in costs to affected parties exceeding the benefits it can provide in improving the quality of the audit.
5. Regulators considering an audit independence rule should evaluate all the reasonably foreseeable, significant, potential effects of the rule, not just its potential effect on the auditor's objectivity.
6. Rules to help ensure audit independence should be consistent with one another.
7. Regulators considering rules to help ensure audit independence should be aware of the effect of other means of reducing the information risk of investors and creditors.
8. No auditor interests immaterial to audit independence should be prohibited unless the prohibition is justified by administrative cost savings greater than the nonadministrative costs that would be imposed. Interests should be considered immaterial if they present so low a risk of impaired objectivity or present a risk of such slight impairment in objectivity that they cannot reasonably be assumed to affect the quality of an audit.

The notion that rules should be mutually consistent, principle 6 above, should be applied as well to the principles of audit independence. They too should be consistent with one another.

It is unlikely that a conceptual framework worthy of the profession's heritage will emerge without a frank admission that past independence concepts--to the extent they existed at all--left much to be desired. Those who revere the profession's history may find the admission difficult, but it would be in the best traditions of independence.

ADDED MATERIAL

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A PERSPECTIVE ON THE COSTS OF AUDIT INDEPENDENCE

Some costs of audit independence are incurred by the audit firm directly (e.g., the cost of

monitoring adherence to independence policies and the cost of the review of the independence quality control during peer review), others by regulators and the profession as a whole (e.g., the cost of developing SEC or ISB independence requirements), and others by clients (e.g., foregone scale and scope economies). They are put in perspective by considering how the costs to the national economy would vary if audit independence varied from zero to total. To approximate zero audit independence, assume the auditor is an employee of the auditee, deeply in debt, with stock options in the auditee. To approximate total audit independence, assume auditors were selected at random, had no nonaudit relationships to management or other company personnel, were paid from general tax revenues, and had no other financial or nonfinancial interest in the client. The two figures discussed below illustrate the effect of moderately and highly costly audit independence. Both assume the auditors are thoroughly competent.

The horizontal axis is the degree of audit independence; the vertical axis is the cost to the economy from capital transactions involving auditing (e.g., the cost investors and creditors insist on for the level of information risk they assume when they extend capital, the ripple-effect costs of their decisions on the economy, the costs of lost economic opportunity from capital misallocation, and the cost of auditing, including the cost of audit independence). Each figure has three curves: (1) costs from capital transactions involving auditing except the costs of audit independence (labeled, for convenience, "capital market cost"), (2) costs of audit independence, and (3) the total of the two. In each case, the optimal level of audit independence is determined by the lowest point on the total cost curve.

The cost of audit independence in Figure 1 rises gradually and at its peak is modest (compared to the peak of other costs to the economy associated with audited capital transactions). At zero audit independence, total cost (and drag on the economy) is at its maximum because investors and creditors assume very high information risk and raise their demanded price for capital considerably, thereby reducing capital formation and investment. Costs are also incurred when capital is misallocated because of misleading disclosure that would be thwarted by high quality auditing. On the other hand, with total audit independence (and the assumed maximum level of auditor competence) the information risk is very low, and there are negligible costs to the economy associated with lack of audit independence. The total cost curve is at a minimum when audit independence is high, but still short of total independence--which is therefore the optimal level of audit independence.

Figure 2 assumes that it is very costly to achieve audit independence (compared to the other costs to the economy associated with audited capital transactions). The rapidly rising cost of audit independence pushes the total cost to the economy up radically. The result is that the optimal level of independence is much lower than it was in Figure 1.

The two figures are based on assumptions and are illustrative only. But they strongly suggest that discussions of audit independence must be concerned with the cost of achieving various levels of independence. This cost is the key variable in optimizing the contribution to the cost-effectiveness of the capital markets by audit independence.

Because audit independence does involve some costs, there is a point beyond which additional audit independence generates negative returns to the economy.

Auditing is not the sole contributor to the reliability of financial information and the reduction of information risk for investors and creditors. The quality of the information that goes to investors and creditors can be improved at several stages in its course to the distributed financial statements. The better the accounting system, including the personnel who control it, the more reliable the financial information that will go to investors and creditors; the more effective the

audit committee, the better the quality of the information that goes to investors and creditors; and the more effective the independent auditor, the more reliable the financial information that will go to investors and creditors. Moreover, the auditor's contribution can be improved by expenditures to assure competence, diligence, and integrity as well as by expenditures to assure independence. It might on occasion be wiser to spend dollars intended to achieve more effective capital markets on improving auditor competence rather than on increasing audit independence. Similarly, the necessity for regulatory spending on improving the auditor's contribution should be seen in light of all the elements that can reduce information risk to investors.