3-1973

Independence

Gary A. Lidgerding

INDEPENDENCE

An Independent Study

Presented to

Professor Lyle C. Steinmeier

University of North Dakota

In Partial Fulfillment

of the Requirements for

the Degree

Master of Science

By

Gary A. Lidgerding

March 1973

TABLE OF CONTENTS

CHAPTER I

DEFINITION OF INDEPENDENCE

AICPA Statement

The American Institute of Certified Public Accountants provides as cogent an indication as may be found, of the nature of independence as it relates to professional accounting, in Rule 1.01 of its Code of Professional Ethics: "Independence is not capable of precise definition, but is an expression of the professional integrity of the individual. A member or associate, before expressing his opinion on financial statements, has the responsibility of assessing his relationships with an enterprise to determine whether, in the circumstances, he might expect his opinion to be considered independent, objective and unbiased by one who had knowledge of all the facts."[1]

The Code formalizes the independence requirement by stating: "Neither a member or associate, nor a firm of which he is a partner, shall express an opinion on financial statements of any enterprise unless he and his firm are in fact independent with respect to such

[1]American Institute of Certified Public Accountants, <u>Code of Professional Ethics</u> (New York, N. Y.: AICPA, 1970), p. 2.

enterprise."[2]

The criteria for insuring compliance with the independence requirements are defined further in Rule 1.01 of the Code: "A member or associate will be considered not independent, for example, with respect to any enterprise if he, or one of his partners, (a) during the period of his professional engagement or at the time of expressing his opinion, had, or was committed to acquire, any direct financial interest or material indirect financial interest in the enterprise, or (b) during the period of his professional engagement, at the time of expressing his opinion or during the period covered by the financial statements, was connected with the enterprise as a promoter, underwriter, voting trustee, director, officer or key employee. In cases where a member or associate ceases to be the independent accountant for an enterprise and is subsequently called upon to re-express a previously expressed opinion on financial statements, the phrase "at the time of expressing his opinion" refers only to the time at which the member or associate first expressed his opinion on the financial statements in question. The word director is not intended to apply to a connection in such a capacity with a charitable, religious, civic or other similar type of nonprofit organization when the duties performed in such a capacity are such as to make it clear that the member or associate can express an independent opinion on the financial statements. The example cited

---

[2]*Ibid.*

in this paragraph, of circumstances under which a member or associate will be considered not independent, is not intended to be all-inclusive."[3]

SEC Requirements

In addition to the requirements of the AICPA, the Securities and Exchange Commission has established the meaning of independent for the accountant certifying financial statements included in registration statements filed in compliance with the Securities Act of 1933 and the Securities Exchange Act of 1934. SEC Regulation S-X Rule 2-01 reads: "The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents or subsidiaries in whom he has, or had during the period of report, any direct financial interest or any material indirect financial interest; or with whom he is, or was during such period, connected as a promoter, underwriter, voting trustee, director, officer, or employee.

In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant

---

[3] Ibid.

and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission."

Substantial consistency of qualifying criteria is apparent between the AICPA and SEC versions of independence.

Ethical Responsibilities

In addition to the formal requirements set forth by the AICPA and SEC, ethical responsibilities are engendered by the nature of professional responsibility. John L. Carey alludes to this difference: "To sum up, independence has two meanings to the certified public accountant. First, in the sense of not being subordinate, it means an aspect of integrity, which is expected of all professional men, and enables them to accept responsibility. Second, in the warpower sense in which it is used in conjunction with auditing and expressing opinions on financial statements, independence means avoidance of any relationships which might, even subconsciously impair the CPA's objectivity as auditor."[4] The ethical concept of independence encompasses several distinguishable phases, identified and explained by D. R. Carmichael and R. J. Swieringa as:

> "(1) Professional Independence
> ...to attain professional independence the auditor must possess an approach and attitude which make him

[4]John L. Carey, Professional Ethics of Certified Public Accountants (New York, N. Y.: AICPA, 1956), pp. 20-21.

self-reliant and not subordinate to his client. Additionally, the auditor must be free from control or influence of management in making decisions based upon universal standards, specificity of professional expertise, and authority based on his expertise.

(2) Audit Independence

...to attain audit independence the auditor must be independent of any self interest which might warp his judgement even subconsciously in reporting whether or not the financial position and net income are fairly presented. Independence in this context means objectivity or lack of bias in forming delicate judgements.

(3) Perceived Independence

...while perceived independence is widely recognized, the two-fold nature of this phase of independence is often ignored. ...the perceived independence of auditors as a professional group is something quite different from the perceived independence of an individual practitioner; the former is a matter of professional image, while the latter is an evaluation of singular circumstances. Accordingly, the appearance of independence should be recognized as a

> dichotomy, composed of individual perceived independence and group perceived independence."[5]

The concept of perceived independence creates its own areas of difficulty and will be further discussed in Chapter IV of this paper.

[5]D. R. Carmichael and R. J. Swieringa, "The Compatibility of Auditing Independence and Management Services - An Identification of Issues." The Accounting Review, October, 1968. pp. 697-698.

CHAPTER II

THE DEVELOPMENT OF INDEPENDENCE

Evolution of the Concept

The concept of independence did not receive a great deal of attention in the United States until the evolution of the Securities Acts of 1933 and 1934. A review of the American Institute's code of ethics as adopted in 1917 shows no rule on independence. It is only indirectly referenced in rule two which reads: "Do not express an opinion on financial statements which contain an essential misstatement of fact or omit anything which would amount to an essential misstatement."[1] The rules of professional conduct which were adopted by the Institute on May 16, 1929 included a similar requirement: "The preparation and certification of exhibits, statements, schedules or other forms of accountancy work, containing an essential misstatement of fact or omission therefrom of such a fact as would amount to an essential misstatement or a failure to put prospective investors on notice in respect of an essential and material fact not specifically shown in the balance sheet itself shall be, ipso facto, cause for expulsion or for such

[1]Thomas G. Higgins, "Professional Ethics: A Time for Reappraisal." The Journal of Accountancy, March, 1962. p. 30.

other discipline as the council may impose upon proper presentation of proof that such misstatement was either willful or the result of such gross negligence as to be inexcusable."[2] Again, no direct reference to independence is noted.

With the passage of the Securities Act, the concept of independence began to receive more consideration. The requirement for certification by independent public accountants was incorporated into the bill and the Council of the American Institute of Accountants subsequently passed a resolution on October 15, 1934: "... that no member or associate shall certify the financial statements of any enterprise financed in whole or in part by the public distribution of securities if he is himself the actual or beneficial owner of a substantial financial interest in the enterprise or if he is committed to acquire such an interest."[3]

In recognition of the expanding responsibilities placed upon the accounting profession and subsequent to the discovery of the McKesson and Robbins Fraud in late 1938, committees of the American Institute of Accountants and the New York Society of Certified Public Accountants made a joint statement at a meeting with the Attorney General of the State of New York: "Professional accountants, in sponsoring CPA legislation, adopting codes of ethics, and establishing standards of procedure, have assumed heavy responsi-

---

[2]Andrew Barr, "The Independent Accountant and the SEC." _The Journal of Accountancy_, October, 1959. p. 33.

[3]American Institute of Accountants, _Year Book_, 1935. p. 354.

bilities, and by statute and court decision additional responsibilities have been imposed upon them. All reputable accountants assume a responsibility to persons other than those who employ them. The greatest asset of a public accountant being his reputation for competence, care and integrity, it is essential that he guard that reputation with all diligence. The legal penalties imposed on accountants for fraud, deceit or gross negligence are so severe that no practitioner would deliberately risk incurring them."[4] The heavy responsibility for independence is acknowledged by the references to the code of ethics and professional reputation.

John L. Carey noted five American Institute rules related in part to the accountants independence which were effected in 1941: "Rule 5, on false or misleading statements; Rule 9, on contingent fees; Rule 13, on financial interest in a client's business; Rule 3, on commissions and brokerage; Rule 4, on occupations incompatible with public accounting."[5]

AICPA Official Statement - 1947

In 1947, the Council of the American Institute of Accountants adopted an official statement on independence. The final paragraph establishes the nature of independence: "Rule of conduct can only deal with objective standards and cannot assure independence. In-

---

[4]Andrew Barr, "The Independent Accountant and the SEC," p. 36.

[5]John L. Carey, Professional Ethics of Public Accounting (New York, N. Y.: American Institute of Accountants, 1946), p. 14.

dependence is an attitude of mind, much deeper than the surface display of visible standards. These standards may change or become more exacting but the quality itself remains unchanged. Independence, both historically and philosophically, is the foundation of the public accounting profession and upon its maintenance depends the profession's strength and its stature."[6]

AICPA Rule 13 - 1961

This pronouncement on independence was the last major change in the Institute's rules on independence until 1961 when, after much discussion among the membership, Rule 13 was adopted. This rule said: "A member or associate, before expressing his opinion on financial statements, has the responsibility of assessing his relationships with an enterprise to determine whether, in the circumstances, he might expect his opinion to be considered independent, objective and unbiased by one who had knowledge of all the facts."[7] This rule recognizes the necessity for independence in appearance as well as in fact.

The amending of the Code of Professional Ethics of the AICPA stated Article 1 Section 1.01 in very similar language to SEC Regulation S-X. Thus, except for differences of interpretation on indi-

---

[6]John L. Carey, Professional Ethics of Certified Public Accountants (New York, N. Y.: American Institute of Accountants, 1956), pp. 31-32.

[7]John L. Carey, The Rise of the Accounting Profession (New York, N. Y.: AICPA, 1970), p. 191.

vidual cases the theory contained in the two statements was consistent.

New Code Considerations

The content of the code has remained the same until the present time. A new code is presently being evaluated by the AICPA. In addition to a restatement of the concept of independence and some individual interpretations of cases, three additional prohibitions would be added to the present rule: "(1) Any joint closely held business investment with a client or any of its management which is material in relation to the members or his firm's net worth; (2) any loan to or from a client or any of its management; and (3) service as a trustee for any pension or profit-sharing trust of a client, or service as a trustee or executor for a deceased client where the trust or estate has a direct or material indirect financial interest in a client."[8]

The tentative revisions reflect the continuing recognition of the importance of independence to the accounting profession.

---

[8]Thomas G. Higgins and Wallace E. Olson, "Restating the Ethics Code: A Decision for the Times." The Journal of Accountancy, March, 1972. pp. 35-36.

CHAPTER III

PROBLEMS AND APPLICATIONS

AICPA and SEC Reporting Requirements

Article 1, Rule 1.01 of the AICPA's Code of Professional Ethics is very specific on the independence requirement for reporting. The rule states that: "Neither a member or associate, nor a firm of which he is a partner, shall express an opinion on financial statements of any enterprise unless he and his firm are in fact independent with respect to such enterprise."[1] The requirement may be enforced by reprimand, suspension or expulsion by the national and state professional societies and possible suspension or revocation of the C.P.A. certificate in many states.

The Securities and Exchange Commission also provides specific penalties for a lack of independence, under Rule 2(E) of the Commission's Rules of Practice: "The Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice of and opportunity for hearing in the matter (1) not to possess the

---

[1]American Institute of Certified Public Accountants, Code of Professional Ethics (New York, N. Y.: AICPA, 1970) p. 2.

requisite qualifications to represent others or (2) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct or (3) to have willfully violated or willfully aided and abetted the violation of any provision of the federal securities laws, or the rules and regulations thereunder."[2] The necessity of compliance with independence requirements is evidenced by the specific language of the rule.

Ethical Conflicts

Ethical conflicts concerning independence arise from the fact that independence is more easily defined than applied. Thomas G. Higgins, the former chairman of the AICPA's committee on professional ethics stated it this way: "There are actually two kinds of independence which a CPA must have - independence in fact and independence in appearance. The former refers to a CPA's objectivity, to the quality of not being influenced by regard to personal advantage. The latter means his freedom from potential conflicts of interest which might tend to shake public confidence in his independence in fact."[3] Thus, the accountant must avoid circumstances and relationships which could cause an observer to question his independence, even though no such compromise actually existed.

---

[2]"SEC Accounting Series Release No. 126." The Journal of Accountancy, September, 1972. p. 83.

[3]Thomas G. Higgins, "Professional Ethics: A Time for Reappraisal." The Journal of Accountancy, March, 1962. p. 31.

The moral dilemna involved in the ethical aspect of independence is typified in a letter to the editor of The New York CPA by Steven Chan:

> "It is almost hypocrisy for the profession to continually emphasize the independence of the CPA in relation to his client when there are powerful, and perhaps in many instances, irresistible counter-pressures. For smaller clients, accountants are usually engaged primarily to counsel on tax minimization, prepare returns and represent the client before the Internal Revenue Service. These partisan activities, which are an important tie between client and accountant, cannot avoid influencing the relationship with respect to auditing services. In the case of public companies and other larger clients, the size of the fee can exert pressure on the "independent" accountant. In both large and small companies, tax considerations take precedence over accounting theory."[4]

So, in addition to avoiding the appearance of a lack of independence the accountant must constantly evaluate his client relationships to avoid compromising his personal independence. Only through the continual satisfaction of both the personal and public aspects of independence can the ethical conflicts be controlled.

Contemporary Areas of Conflict

The major contemporary areas which create conflicts regarding application of the independence concept fall into three categories: (1) auditor performing tax services, (2) the auditor as a bookkeeper, (3) auditor performing management services.

---

[4]Stephan Chan, "Can the Independent Accountant Always be Independent?" The New York CPA, February, 1968. pp. 85-86.

Tax Services

The first of these, Tax Services, is subject to the Code of Professional Ethics according to Opinion No. 13 of the Code which reads in part: "It is the opinion of the committee that the Code of Professional Ethics applies to the tax practice of members and associates except for Article 2, relating to technical standards, and any other sections of the Code which relate only to examinations of financial statements requiring opinions or disclaimers."[5] The basic difficulty arises from the possible necessity of the CPA representing his client before the Internal Revenue Service. In such capacity his independence is subject to question since, in a sense, he is acting as an advocate for the client. However, further in Opinion No. 13 the Code states: "In tax practice, a member or associate must observe the same standards of truthfulness and integrity as he is required to observe in any other professional work. This does not mean, however, that a member or associate may not resolve doubt in favor of his client as long as there is reasonable support for his position."[6] Thus, subject to appropriate criteria for insuring independence, the AICPA feels there is no real problem. They have codified this feeling in Opinion 12 of the Code where they say: "In summary, it is the opinion of the committee that there is no ethical reason why a member or associate may not properly perform

[5]AICPA, Code of Professional Ethics. p. 25.

[6]Ibid.

professional services for clients in the areas of tax practice or management advisory services, and at the same time serve the same client as independent auditor, so long as he does not make management decisions or take positions which might impair that objectivity."[7]

Write-up Work

There is a variance of opinion between the SEC and the AICPA regarding write-up or bookkeeping services and their relationship to the auditors independence. While the AICPA has published no formal opinion on the subject, the committee on professional ethics has endorsed the following statement from the Institute publication "Special Reports - Application of Statement on Auditing Procedure No. 28": "Writing Up Records. Small businesses often have inadequate records. The independent auditor may be required to write up the books or make numerous adjusting entries and prepare the financial statements. The independent auditor is not necessarily lacking in independence simply because he has performed these services...."[8] This viewpoint is consistent with an earlier evaluation by both the committee on auditing procedure and committee on professional ethics. Carman G. Blough reported their findings:

> "As stated in their reports to the council of the American Institute of Certified Public Accountants, both committees have been in agreement that if a

---

[7]Ibid.

[8]John L. Carey and William O. Doherty, "The Concept of Independence - Review and Restatement." The Journal of Accountancy, January, 1966. p. 46.

> CPA is in fact independent and if he has performed all the auditing procedures necessary to supplement the information obtained through keeping the books, he should be entitled to express any opinion he may have formed."[9]

The SEC views the matter differently. In SEC Accounting Series Release No. 126 they state: "The Commission is of the opinion that an accountant cannot objectively audit books and records which he has maintained for a client. The performance of these services, whether accomplished manually or by means of computers and other mechanized instruments, ultimatley places the accountant in the position of evaluating and attesting to his own recordkeeping."[10] The Commission will usually rule out work on the underlying records and postings to the general ledger. They justify this position on the grounds that is a reasonable safeguard to protect the interests of the enterprises.[11]

Management Services

The most controversial area of independence related material, judging from the volume of discussion in accounting literature, is related to the auditor who performs management services. The AICPA, in Opinion No. 14 of the Code of Professional Ethics, that: "It is the opinion of the committee that all the provisions of the Code of

---

[9]Carman G. Blough, Practical Applications of Accounting Standards (New York, N. Y.: AICPA, 1957), p. 67.

[10]"SEC Accounting Series Release No. 126." p. 84.

[11]John L. Carey and William O. Doherty, "The Concept of Independence - Review and Restatement." p. 46.

those rules solely applicable to the expression of an opinion on financial statements."[12] The provisions of Opinion 12, previously noted in regard to tax services also apply. Thus, the independence requirements must be met when performing management services.

The potential conflicts between management consulting and the CPA's factual independence were summarized by Arthur A. Schulte, Jr. as follows:

> "Although not the official decision-maker with the obligation of the final decision (choice), the CPA, as a consultant, does actively participate in the decision-making process. This participation provides two sources of potential conflict with the CPA's actual independence. On the one hand, management might surrender its authority to choose from among alternatives (decide) to the CPA and the CPA might accept the offer of this authority. In such a case, the CPA, in effect, becomes the decision-maker and thereby impairs his factual independence.
>
> On the other hand even assuming that management does not surrender its authority to make the decision to the CPA, the very involvement of the CPA in the management decision-making process creates pressures which may lead to an impairment of his independence.
>
> The CPA, as a consultant, may, in effect, become an employee of his client, especially in acting as the client's controller. This relationship would impair his independence.
>
> Finally, the CPA, as a consultant, might act as an advocate for his client during an engagement. This role places a burden on the CPA's disinterestedness toward his client which could, under certain circumstances, become excessive."[13]

---

[12]AICPA, Code of Professional Ethics. pp. 25-26.

[13]Arthur A. Schulte, Jr., "CPA's Independence Affected by Management Services?" The New York CPA, January, 1967. p. 38.

In response to several articles written regarding possible loss of independence while performing management services and surveys performed by Drs. Abraham Briloff and Arthur Schulte which indicated a potential problem the AICPA in 1966 formed an ad hoc committee on independence. The final report of this committee, issued in 1969, contained the following observations:

"One of the most significant finds of the committee is the lack of substantive evidence that the rendition of management services by CPA's has impaired independence in fact. Reference has already been made to Dr. Schulte's inquiry of state boards of accountancy, resulting in responses from 44 boards, not one of which had ever had a case involving independence of a CPA where management service was a factor. The committee also made inquiries of representatives of the Securities and Exchange Commission and were informed that they knew of no such cases in their experience.

...however, as indicated earlier, there is some evidence that some users believe there is an appearance of lack of independence. It seems clear to the committee that whatever problem exists is in this area. ...it seems clear that the ethics committee intended to sound a warning to members to proceed at their own risk, rather than to define situations in advance which were to be prohibited. This was wise in our opinion. Questions involved in possible appearance of lack of independence are potentially countless in number. Each case must be considered in the light of all the circumstances."[14] The question of independence while performing management services is thereby recognized as best related to individual cases and the problem primarily related to avoiding the appearance of a lack of independence.

AICPA and SEC Summaries Reference

The judgement as to lack of independence regarding any of the requirements, whether it be financial interest, client employee, recordkeeper or management consultant, must be made on the facts as they relate to the particular case. The AICPA has published a Summary of Ethics Rulings with a chapter on independence,[15] and the SEC has listed fact situations in accounting Series Releases Numbers 47, 81, and 126. These should be consulted as examples only for consideration of situations involving independence.

---

[14]"Final Report of Ad Hoc Committee on Independence." The Journal of Accountancy, December, 1969. pp. 51-52.

[15]AICPA, Summaries of Ethics Rulings (New York, N. Y.: AICPA, 1970), pp. 1-42.

CHAPTER IV

CONCLUSIONS AND RECOMMENDATIONS

The issue of independence is still very much alive in the accounting profession. The fact that questions are being asked and assumptions being challenged indicates a healthy attitude of searching for better answers to the questions regarding independence.

There has been little written on independence in other than the accounting profession's literature. This is good; it leads one to believe that the public basically believes that the accountants are independent, and that the profession is monitoring its own activity as it should be.

Evaluation of the concept of independence should continue to be performed. Since each case adds new evidence to the consideration, and recognizing that the ethical aspects of independence are not precisely defined, the profession cannot afford to discontinue its examination of independence. Continuing vigilance is necessary to protect both the profession's and the public's interest.

SELECTED BIBLIOGRAPHY

Books

Blough, Carman G. Practical Applications of Accounting Standards. New York: AICPA, 1957.

Carey, John L. Professional Ethics of Public Accounting. New York: American Institute of Accountants, 1946.

____________. Professional Ethics of Certified Public Accountants. New York: American Institute of Accountants, 1956.

____________. The Rise of the Accounting Profession - 1937 to 1969. New York: AICPA, 1970.

____________, and Doherty, William O. Ethical Standards of the Accounting Profession. New York: AICPA, 1966.

Summaries of Ethics Rulings. New York: AICPA, 1970.

Periodicals

Barr, Andrew. "The Independent Accountant and the SEC." The Journal of Accountancy, October, 1959. pp. 32-37.

Briloff, Abraham J. "The Responsibilities of the CPA for Fair Corporate Accountability." Financial Analysts Journal, May-June, 1966. pp. 51-55.

Carmichael, Douglas R. and Fritzemeyer, Joe R. "Lack of Independence - Some Reporting Problems." The Journal of Accountancy, August, 1972. pp. 79-81.

____________, and Swieringa, R. J. "The Compatibility of Auditing Independence and Management Services - An Identification of Issues." The Accounting Review, October, 1968. pp. 697-705.

Chan, Stephen. "Can the Independent Accountant Always be Independent?" The New York CPA, February, 1968. pp. 85-86.

Engel, Lee. "The CPA as a Management Advisor." The Office, July, 1969. pp. 16-20.

"Final Report of Ad Hoc Committee on Independence." The Journal of Accountancy, December, 1969. pp. 51-56.

Hartley, Ronald V. and Ross, Timothy L. "Mas and Audit Independence: An Image Problem." The Journal of Accountancy, November, 1972. pp. 42-51.

Higgins, Thomas G. "Professional Ethics: A Time for Reappraisal." The Journal of Accountancy, March, 1962. pp. 29-32.

____________, and Olson, Wallace E. "Restating the Ethics Code: A Decision for the Times." The Journal of Accountancy, March, 1972. pp. 35-36.

Patten, Ronald J. and Nuckols, John R., Jr. "Competence and Independence - the Issue of Management Services." The Texas CPA, April, 1971. pp. 22-31.

Schlosser, Robert E. "An Historical Approach to the Concept of Independence." The New York CPA, July, 1969. pp. 517-527.

Schulte, Arthur A., Jr. "CPA's Independence Affected by Management Services?" The New York CPA, January, 1967. pp. 32-41.

"SEC Accounting Series Release No. 126." The Journal of Accountancy, September, 1972. pp. 83-89.

Seidman, William. "The End of the Great Green Eyeshade." The Journal of Accountancy, January, 1972. pp. 51-55.

Sharaf, Hussein A. and Mautz, R. K. "An Operational Concept of Independence." The Journal of Accountancy, April, 1960. pp. 49-54.

Sterling, Robert R. "Accounting Power." The Journal of Accountancy, January, 1973. pp. 61-67.

Titard, Pierre L. "Independence and Mas - Opinions of Financial Statement Users." The Journal of Accountancy, July, 1971. pp. 47-52.

Other

AICPA. *Code of Professional Ethics*. New York: AICPA, 1970.