The issue of auditors independence has always been an important public concern and a matter of many debates, especially because of the fiduciary role played by the auditors in modern society.

“At the heart of the audit profession is a belief about human nature. Human being will speak the truth unless there is sufficient to be gained by being dishonest’. Many would disagree and argue that it is a partial view of human nature. However, if all the auditors were truly independent - the subject would not find such a prominent place in the code of conduct of every professional institute of the world.

The very fact that it attracts so much attention would indicate that auditors independence is so difficult to maintain.

Occasionally, the accountants have been accused of pursuing their narrow self-interest in disregard to professional ethics. It is alleged that “Auditors annually certify the numbers given to them by management and in their opinion unqualifiedly state that these figures ‘present fairly’ the financial position of their clients. The
auditors use their reassuring language even though they know from long and painful experience that the numbers so certified are likely to differ dramatically from the true earnings for the period.” (Berkshire Hathaway Inc. Annual Report to Shareholders 1985)

Considering the controversial nature of the subject, it is hardly surprising that the dramatic collapse of Enron Corporation, the seventh largest company in the United States (see box: The Enron disaster) has rekindled the debate and brought the issue of into sharper focus. Critics say that it has raised serious questions about the competence and credibility of the Certified Accountants. No doubt, sagas like this inevitably weaken public confidence on the profession. The situation calls for serious introspection and a relook at the ethical standards of the auditors.

THE ENRON DISASTER

In December 2001, in what is termed as the biggest bankruptcy in US history, Houston based trader of natural gas and power Enron Corporation filed for bankruptcy under Chapter 11 and downward restatement of earning of $500 million. Enron is believed to have created a special purpose vehicle, which involved setting up partnership firms to mask its losses. Its auditors (one of the audit and consultancy firm worldwide), also faced investigation by the Securities and Exchange Commission for fudging official documents and not being able to detect accounting jugglery undertaken by Enron. (the auditors blame Enron for not providing complete information).

Capital Market, Vol. XVI, Feb 4-17 2002

Auditing has been described as more of a practical discipline than an exact science. “An audit is the independent examination of, and expression of opinion on, the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation.”

A reading of the above definition would suggest that the auditor is responsible only to the appointing authority (i.e. shareholders) in deference of other interested parties. However, auditing is considered as a profession and the prime motive for professional conduct is service motive. Society confers upon a profession special rights because professional skills are service skills — that benefit the mankind. This makes independence the guiding principle of audit profession.

The IFAC guidelines on independence states that: “When in public practice an accountant should both be and appear to be, free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity”.

THE BROADER ROLE OF ACCOUNTANTS

So we find that the accountant derives his power and recognition from the society. Therefore, the professional accountant must accept his duty to the society at large and not only to a particular client. To continue with the IFAC code of ethics-

“Persons who pursue a vocation in which they offer their knowledge and skills in the service of affairs of others have responsibilities and obligations to those who rely on their work. An essential prerequisite of any group of such persons is the acceptance and observation of professional ethical standards regulating their relationship with clients, employees, fellow members of the group and the public generally.

Investors, creditors, employees and other sectors of the business community, as well as the government and the public at large rely on professional accountants for sound financial accounting and reporting, effective financial management and competent advice on a variety.
of business and taxation matters. The attitude and behaviors of professional accountants in providing such services have an impact on the economic well being of their community and country.

Professional accountant can remain in this advantageous position only by continuing to provide the public with these unique services at a level, which demonstrates that the public confidence is firmly founded. It is in the best interest of the worldwide accountancy profession to make known to users of the services provided by professional accountants that they are executed at the highest level of performance and in accordance with the ethical requirements that strive to ensure such performance.”

Simply stated, it means that the auditors should rise over the interest of their clients and be concerned about the broader interest of third parties as well.

**DOES INDEPENDENCE MATTER?**

“Human nature as it is”, proclaims the Code of Conduct of ICAI, “a man often places his personal gain above service. Therefore, persons who as individuals and as a class, are willing to place public good above their personal gain have enjoyed respect and honour.”

Lofty ideas indeed. But are such nice words enough to motivate accountants to improve ethical standards. Hardly so. To encourage the auditors to practice independence, we must be able to show that it is in their best self-interest. The issue can be encountered both from economic and ethical perspectives.

**Economic Consequences:** If we consider the accountant as an economic man, he is motivated by self-interest, i.e. he wants to maximize his long term economic value or earning potential. And earnings of a person practicing a profession depend upon his reputation and the respect he commands. An accountant can gain reputation and command respect only by being ethical.

It is often observed that although all the auditors are members of the same institute and have similar professional qualification — reputation differs from person to person because of varying public perception about audit quality and independence. Translated into monetary terms, this may lead to increased income for the independent auditors, arising from higher value attached to the work performed by them.

By contrast, unethical behaviour may lead to loss of public trust and confidence. A client will not come to an auditor if he knows that his report carries no value whatsoever. Further, disciplinary action/other litigation may result in loss of future revenue and/or additional costs. The image of the profession as a whole also suffers due to loss of public confidence. It follows that adherence to professional ethics makes good business sense for the accountants.

**Ethical Consequences:** Apart from monetary considerations, a wrongful act causes mental strain. A person behaving unethically would suffer from remorse and lack self-respect from loss of credibility in his own eyes.

Then there is the well-known ‘slippery slope’ argument according to which - ‘if we take one step in a certain direction, we shall find ourselves on a slippery slope and shall slither further than we wished to go.’

**THREATS TO INDEPENDENCE**

The recent fiascoes underscore the need to strengthen the independence mechanism. There are a number of ways in which auditors independence may be impacted and it is impossible to list out all the areas of risk. However, a few areas causing potential threat are enumerated below:

1. Financial involvement with or in the affairs of the client
2. Appointment in companies as member of the Board, Officer, Employee etc.
3. Having family relationship with a client
4. Provision of other services to audit clients
5. Over dependence on a client for fees
6. Fees for professional services contingent upon specific findings or results
7. Acceptance of hospitality or other benefits from client
8. Former partner joining client
9. Actual or threatened litigation with client
10. Long association of senior personnel with audit client

RESTRICTIONS ON INDEPENDENCE

Having described the general threats to auditors independence, we may now look into a few controversial areas affecting the subject.

a. Appointment and removal: The Companies Act 1956 places the responsibility of appointment and removal of auditors on the shareholders. However, in practice, the directors exercise real power as the shareholders are generally expected to approve what the directors recommend. Besides, audit fees are also negotiated with the directors. Therefore, the directors are in a position to threaten auditors earnings and exert commercial pressure on their independence.

b. Provision of other services: The problem is worse in case of other services. For many audit firms, consultancy fees constitute a large proportion of income and it is the directors who decide about such engagements. A concurrent area of conflict arises when such other services are incompatible with the auditors primary responsibility. For example, if the auditors are involved in negotiating loan for a client company - they may be inclined to certify the financial statements that are acceptable to the company's bankers, rather than those presenting a true and fair view of its affairs.

c. Dependence on a single client: If the auditors are substantially dependent on a particular client for a proportionately larger share of income — their independence may be impaired, because loss of the client may endanger economic security and sometimes very existence of the firm.

In this regard the Hampel Committee remarked – “Our own impression is that audit firms have very strong commercial reasons for preserving all unblemished reputation for independence. But there may be a temptation to compromise on independence where an audit firm depends for a significant proportion of its income on a single audit client.” Apart from the effect on firm’s income, the impact of loss of a significant client may be all the more devastating for the individual partner responsible for the client.

d. Familiarity with client: Increasing familiarity with company management developed over long association may affect independence. The partners or audit staff may become so friendly with management that they tend to cooperate with the managers and do not want to imperil their career. The objectivity of a firm is also threatened if an officer of the client had been a principal or employee of the audit firm.

e. Cost factor: Sometimes, the company management is more concerned about audit cost than audit quality. Audit films are always under pressure to bring down the time and cost of audit. Since most of the firm overheads are fixed in nature (consisting of salaries and administrative expenses) which are difficult to reduce, the tendency is to economize on time. This may lead to cutting short generally accepted audit procedures.

f. Competition: Heightened competition within the accounting profession has enlarged the options for directors to replace one auditor with another easily. It has placed the auditors in a disadvantageous position vis-a-vis directors.

g. Opinion shopping: This involves the company management approaching other audit firms for opinion on a contentious issue, when they disagree with the present auditors’ views. If a second accounting firm supports the management’s arguments, the existing auditors position is weakened.

On hindsight, we find that Enron’s auditors might have been caught in a bind on many of the above counts (see box: Conflict of Interest)

Enron paid its auditors $52m in 2000 - $25m for auditing and $27m for consulting services. The success of the audit firm and the size of its pay packets depended crucially on Enron, its biggest single client until the company sacked them in January this year. Accountants face the same temptations to play dangerous games as their clients, whose accounts departments are often filled (as they were at Enron), with their auditors ex-employees. They all know how to play.

The Economist, March 9th 2002
SAFEGUARDING INDEPENDENCE:

From the discussion so far, the issue boils down to the question that — can the auditors be truly independent in their reporting function, when they are economically dependent on their clients for livelihood? How can this dilemma be resolved?

A number of proposals have been put forward to safeguard auditors independence and empower them to withstand pressures to compromise. Some of the suggested safeguards have already been implemented in many countries, while some others have generated further controversy.

i. Ceiling on fees from a client: In some countries an attempt is made to limit the auditors economic interest on a single client by restricting the fees received from the client to a certain percentage of total income. The idea is - the auditors will be less dependent and consequently less influenced by economic factors in discharge of their duties.

ii. Restriction on other services: Similar argument is mooted for prohibiting auditors from providing additional services to audit clients. This will also mitigate the problems associated with conflict of interest while providing other services as mentioned earlier.

Contrarily, it is argued that auditors can render certain services in a cost-effective manner due to the knowledge gained during audit. Any pitfall in the process may be taken care of by assigning different teams for audit and other services and building a ‘Chinese Wall’ between respective functions. Some suggest that the matter may best be left to be decided by Audit Committee of the Board.

In a move towards preserving independence, ICAI has recently imposed restrictions to the effect that the fees received by its members from other services should not exceed the amount of audit fees from the same company/PSU etc. having turnover above the threshold limit. There is also a statutory requirement of disclosure of remuneration paid to auditors for non-audit services in the annual accounts of companies.

iii. Rotation of auditors: Another interesting suggestion is prescribing an upper limit on the number of years for which an audit firm may continue as auditors of a company. The obvious advantage is that the auditors would know that they will be replaced anyway on expiry of their term and therefore would be less susceptible to management pressures. Moreover, the fear of the new auditor discovering deficiencies in audit work will be an additional incentive to improve audit quality and preserve independence.

Again, the proposal is resisted by accounting community on the ground that it would involve high set-up cost every time the new auditors take over. The client may also get upset with continuous change in audit staff. Further it has been noticed that the probability of auditors making a significant error is much higher in the first year, when they are less familiar with the systems and procedures of the company. It is also suggested that the purpose may be served by rotating the partner in charge of a particular audit, as recommended by the Cadbury Committee.

iv. Independent appointing body: In some cases (like bank audit and audit of PSUs) appointment of auditors is decided by independent authorities (such as RBI or CAG). It is suggested that similar procedure may be adopted for company audits too. A statutory body may be set up under the Department of Company Affairs, which would be responsible for appointment of auditors and determining their fees - thus reducing the power of Directors.

v. Restriction on removal: The Companies Act 1956 provides for certain safeguards for unjustified removal of auditors. Special notice is necessary for appointing a person other than the retiring auditor. On receipt of such notice the retiring auditor can make a representation and request for its notification to the members.

Additionally, according to Clause 8 of Part I of the First Schedule to the Chartered Accountants Act 1949, an accountant must not accept the position as auditor previously held by another chartered accountant, without first communicating to him in writing. The underlying objective is that the member should be able to safeguard his own interest the legitimate interests of the public and the independence of the existing accountant.

vi. Accounting standards/guidelines: Accounting Standards and Auditing and Assurance Standards have a salutary effect on auditors independence by prescribing precise treatment and audit procedure to be followed under particular circumstances. Both company management and auditors would realize that any other audit firm would have to abide by the same standards/guidelines and reach similar conclusions.

vii. Peer review: Another internationally accepted norm is peer review - essentially a quality control procedure designed to ensure that overall quality of audit is maintained throughout the profession. Under this system, audit working papers of a firm are reviewed either by a panel of experts set up by the professional institute or by another independent audit firm. ICAI has already implemented peer review process with effect from 1st April 2003.

One drawback of the system is the additional cost involved in the process. (It may be pertinent to note that another audit firm of big five league carried out peer review of Enron’s auditors and gave it a clean chit).

viii. Audit Committee: Audit committee can be an
important instrument for improving auditors independence by providing a buffer between the audit firm and company management and promoting healthy debate on accounting matters. However, effectiveness of the audit committee would depend upon the independence of non-executive directors.

Clause 49 of the SEBI listing agreement and section 292A of the Companies Act 1956 made it mandatory for companies fulfilling specified criteria to constitute audit committees.

ix. User Education: More often than not, users of the financial statements have a very high and unrealistic expectations about the audit process. Therefore, there is a simultaneous need to educate the users about the objective and scope of audit and the responsibilities of the management regarding maintenance of accounting records and internal control.

PROFESSIONAL ETHICS AND ICAI:
The Institute of Chartered Accountants of India has always urged its members to exemplify highest moral discipline in performance of their function. Mr. R.C. Cooper, past president of the Institute, professed the Institute’s views on the subject way back in 1963.

“Ethics is a state of mind and there may be some act where, though it may not strictly fall under one of the items of the Schedule (to the Chartered Accountants Act 1949), may be one which may not be proper by any moral or ethical standards. In the larger interest of the institute, the Council exhorts all members to search their heart and conscience whenever in doubt, and thereby assist towards the maintenance of high principles of professional conduct established by the Council.

The highest standard of ethical behaviour can only evolve from the conduct of the members and the Council feels that whenever the members are confronted with two interpretations on a matter relating to professional conduct — one ethical and the other legalistic - they would adopt the stricter interpretation than the more liberal one, even though the latter may be perfectly legal.’

In this backdrop, the Auditing and Assurance Standard on ‘Basic Principles Governing an Audit’ reiterates the spirit of IFAC guidelines and delineates the qualities of an auditor as under:

“The auditor should be straightforward, honest, sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.”

Part I of the Second Schedule specifically stipulates that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he -

* Fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary to make the financial statement not misleading.
* Fails to report a material mis-statement known to him to appear in a financial statement with which he is concerned in a professional capacity.
* Is grossly negligent in conduct of his professional duties.
* Fails to obtain sufficient information to warrant the expression of an opinion or his exceptions are sufficiently material to negate the expression of an opinion.
* Fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances.

Further, in the Vision 2010 adopted by the Institute, ‘Integrity and Independence’ have been cited as the core values for the Chartered Accountant’s to emulate.

There appears to be no flaw in the rules. They are comprehensive enough. The problem lies in practice and enforcement. The code of conduct and guidelines, if followed by the members in letter and spirit, would go a long way in safeguarding auditors independence.

INDEPENDENT BY CHOICE:

Although Chartered Accountants in general have performed their responsibilities well, it must be admitted that aberrations do take place. Such cases get wide publicity in today’s news hungry world and a barrage of criticism follows. Of late there is a growing tendency on the part of users of financial statements to blame the auditors for everything - from failure to detect fraud to stunning business collapses. All these have increased the pressure on the accounting profession tremendously.

Unless the issues surrounding auditors independence are resolved satisfactorily, it will have serious implications for future of the audit profession and cast a shadow on the auditor’s credibility.

As has been proved - the benefits of ethical behaviour would most certainly outweigh the gains to be made by being unethical. Chartered Accountants must learn their lessons from the happenings in other countries and rededicate themselves to the service of the society at large. The ongoing controversy should strengthen the resolve of the members to be ethically responsible towards various stakeholders in the society.