PRACTITIONER SUMMARY

A Current Evaluation of Independence as a Foundational Element of the Auditing Profession in the United States

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SUMMARY: This paper summarizes "Auditor Independence in the United States: Cornerstone of the Profession or Thorn in Our Side?" (Church, Jenkins, and Stanley 2018). Their paper maintains that while the concept of independence is theoretically appealing, it is fraught with practical problems. Church et al. (2018) analyze the current oversight of auditor independence in the U.S. and the need for auditor independence from the perspective of various parties involved in the financial reporting process. In doing so, the paper discusses implications and challenges affecting one or more of these parties. Finally, Church et al. (2018) evaluate alternatives to the current regulatory approach of prohibiting various auditor client relationships to manage auditor independence. The paper concludes that increasing audit committees' responsibilities for monitoring auditor independence, along with additional disclosure about threats and safeguards to auditor independence, is worthy of further discussion and debate as a path toward addressing the auditor independence conundrum.

Keywords: auditor independence; independence in fact; independence in appearance.
resultant rule changes have often been met with criticism. A recently published paper by Church, Jenkins, and Stanley (2018) entitled “Auditor Independence in the United States: Cornerstone of the Profession or Thorn in Our Side?” explores the concept of auditor independence from various perspectives, describes the problems and challenges associated with related regulations, and offers alternatives to the current regulatory approach. The purpose of this practitioner summary is to provide an overview of Church et al. (2018) and to promote further discussion within the profession about this important topic.

Auditor independence is comprised of independence in fact and independence in appearance. Independence in fact is associated with an auditor’s mindset and “entails self-reliance, such that professional judgment is not subordinated” (Church et al. 2018, 145). However, the auditor’s mindset is unobservable, which makes determining whether an auditor is independent in fact nearly impossible (SEC 2001). On the other hand, independence in appearance is focused on the nature of the auditor-client relationship, and is determined by whether others perceive the auditor to be impartial and free of conflicts of interest (SEC 2001). Church et al. (2018, 146) “contend that by prohibiting specific relationships, regulators exert their influence and create an illusion that auditor independence can be monitored and enforced.” However, regulators cannot guarantee that an auditor is truly independent, much less prove the assertion.

The current rules-based approach is beset by a number of conceptual and practical problems and challenges. Although some of these are unsolvable (e.g., the auditor’s state of mind is unobservable), other problems and challenges (e.g., balancing the profession’s commercial interest with its responsibility for protecting the public interest) can be addressed, either in whole or in part, through changes to current regulation. Church et al. (2018) conclude that eliminating independence rules and interpretations can address many of the problems and challenges surrounding the concept of auditor independence; however, such an overhaul is neither practical nor workable absent other changes. They suggest that increasing audit committees’ responsibilities for independence and providing additional disclosure about threats and safeguards surrounding auditor independence are alternatives worthy of further consideration and debate. Although there may be other alternatives, the proposed changes are believed to offer a reasonable means of addressing the independence conundrum within the current regulatory environment.

II. THE OVERSIGHT OF AUDITOR INDEPENDENCE

Today, numerous regulatory and professional bodies prescribe independence rules.¹ The primary responsibility for setting independence rules and monitoring compliance in the U.S. is shared by the AICPA, SEC, and PCAOB (refer to the top portion of Figure 1). Although each of these bodies arguably aims to strengthen auditor objectivity and credibility, such a fragmented regulatory environment increases the compliance burden for members of the profession and leads to conflicting requirements. Even the largest accounting firms face difficulty complying (Church et al. 2018). Moreover, independence rules are not static, but change to reflect shifting business, economic, and political conditions such that members of the profession must remain ever-vigilant for possible violations (O’Connor 2004). Nonetheless, many of the independence rules, and the concepts embedded in them, were written when the physical distances between clients and their

¹ For example, state boards and societies of accountancy, the American Institute of Certified Public Accountants (AICPA), Securities and Exchange Commission (SEC), Public Company Accounting Oversight Board (PCAOB), U.S. Government Accountability Office (GAO), U.S. Department of Labor, International Auditing and Assurance Standards Board, and International Ethics Standards Board of Accountants currently prescribe independence rules and standards.
The figure depicts the relationships among the different parties that are affected by auditor independence. The text within the boxes characterizes the role of independence for each party. The arrows indicate the interconnectedness among the parties. The differing shades of gray represent different parties’ knowledge into the makeup of audited financial statements. Information producers, oversight bodies, and information users are shown in decreasingly translucent shadings (i.e., darkening shades of gray), respectively, to emphasize the decreasing degree of insight that the parties have into information producers’ inner workings and behavior. The differing degrees of insight, in turn, impact the function of auditor independence for each party.
auditors were meaningful, data and information took time to access and process, and the ownership structures of business entities were simpler.

Figure 1 from Church et al. (2018) summarizes the current role of auditor independence for the primary parties involved in the financial reporting process and the relationships among the parties. It is included herein as a framework for organizing the discussion. Key observations about the different oversight bodies’ roles in regulating auditor independence are summarized in the top portion of Figure 2 (from Church et al. 2018).

The AICPA and Auditor Independence

The AICPA is the primary professional organization representing the accounting profession in the U.S. It performs many roles for the profession, including oversight of auditor independence. The AICPA has a vested interest in endorsing the virtues of independence as it promotes auditors' moral character and the profession as serving the public interest (Church et al. 2018). The profession's assertions of independence can be legitimized by showing auditors' compliance with the AICPA's many related rules and interpretations (Preston, Cooper, Scarbrough, and Chilton 1995). Ultimately, independence helps the profession maintain its monopoly on public company audits and to continue to serve as an independent monitor of and a gatekeeper to the securities markets (Sikka and Willmott 1995; Sikka 2009; Watts and Zimmerman 1983).

There are a number of problems and challenges related to the AICPA's oversight of auditor independence. In addition to providing self-oversight, the AICPA serves as an advocate for the profession, which results in the AICPA having a bifurcated allegiance to its members and financial statement users. Compared to members of the profession, financial statement users and government regulators are less cognizant of the costs and practicalities of establishing independence (Kinney 2005; Palmrose 2010). Furthermore, the AICPA's rules-based approach to operationalizing independence is fundamentally flawed. It does not establish independence in an operational manner; rather, the AICPA prohibits certain auditor-client relationships and auditor-provided nonaudit services that, by definition, impair independence. As a consequence of this approach, independence can never be affirmed, only negated (Church et al. 2018). In addition, compared to government regulators, the AICPA has been less willing to prohibit nonaudit services and less progressive in calling for actions to bolster independence, both of which are moves that would further limit the profession's profit potential. Church et al. (2018, 150) emphasize that “the schism between the profession's commercial interests and its duty to protect the public's interest comes to the forefront in considering self-oversight versus government oversight.”

The SEC, PCAOB, and Auditor Independence

The SEC and PCAOB are broadly responsible for protecting investors and ensuring accurate information flows associated with U.S. public companies. They establish and monitor auditor independence as a means to facilitate the functioning of U.S. securities markets. As such, the responsibilities of these oversight bodies transcend the narrower objectives of the AICPA. As government regulators, both bodies are particularly leery of the colossal economic losses that can result from large-scale financial reporting failures such as the one that accompanied the collapse of Enron. As a result, they may over-prescribe auditor independence rules to help bolster financial reporting quality and public trust in the financial markets (Kinney 2005). Church et al. (2018)
The figure summarizes key observations about the primary parties affected by auditor independence, which are more fully discussed in Sections I, II, and IV of the paper. Overlapping boxes are applicable to more than one party. The differing shades of gray are indicative of the degrees of insight that the parties have into information producers’ inner workings and behavior. Darkening shades of gray reflect decreasing degrees of insight.
emphasize that a significant difference between government oversight and self-oversight of auditor independence is that government regulators focus less on the expected costs and more on the expected benefits of tightening independence rules as compared to the AICPA.

There are a number of problems and challenges related to the oversight of auditor independence by the SEC and PCAOB. Similar to the AICPA, government regulators have pursued a rules-based approach. Proscribing certain auditor-client relationships does not ensure that auditors are independent in fact and may actually reduce audit effectiveness and efficiency under certain conditions (e.g., Knechel 2016). Likewise, violations of independence rules do not necessarily imply reduced audit quality (Gramling, Jenkins, and Taylor 2010). Church et al. (2018) also observe that government regulators are incentivized to frame auditor independence as a “problem” that needs to be addressed and to keep something as fundamental as auditor independence at the forefront of public discourse. By doing so, government regulators legitimize their existence, demonstrate their value in the marketplace, appease constituents, and secure resources.

III. WHO NEEDS AUDITOR INDEPENDENCE?

External users and information producers benefit from auditor independence (refer to the bottom and middle portions of Figure 1). Key observations about the different parties’ needs for auditor independence are summarized in the bottom and middle portions of Figure 2.

**External Users’ Needs for Auditor Independence**

Within the framework of Church et al. (2018), information users are parties external to the reporting entity, and represent third-party beneficiaries who rely on auditor independence to uphold financial reporting quality. Information users are concerned with auditor reliability as a way to strengthen financial reporting quality. Auditor independence is a component of auditor reliability, but it is not the only component (e.g., Taylor, DeZoort, Munn, and Thomas 2003). Users are mindful of the quality of an auditor’s work and are concerned with matters such as independence, integrity, expertise, firm resources, and other factors that impact audit quality. The extent to which users are concerned about independence, however, is unresolved. Likewise, the role of independence in appearance is unsettled, with empirical evidence being mixed.

**Information Producers’ Needs for Auditor Independence**

Information producers such as company management and the audit committee are internal to the reporting entity and have direct access to internal information. For information producers, auditor independence promotes the credibility and quality of audited financial statements. In addition, auditor independence is necessary to comply with regulatory requirements and to fulfill fiduciary responsibilities. Independence rules provide a means to ensure that such obligations are satisfied. Independence rules are also intended to foster unbiased and impartial behavior on the auditor’s part, promoting financial reporting quality.

However, independence rules create a number of problems and challenges for information producers. For example, the rules can lead to suboptimal contracting. The client may be forced to hire a second-best nonaudit service provider, voiding knowledge spillovers and potentially increasing cost (e.g., Gaynor, McDaniel, and Neal 2006; Schneider, Church, and Ely 2006; Knechel 2016). Furthermore, while compliance with independence rules suggests independence in appearance, compliance does not ensure independence in fact. Notably, auditor-client
interactions occur on an ongoing basis, which leads to social bonding and potentially undercuts independence. Relatedly, information producers’ need for independence, as compared to other auditor attributes, is unclear. In spite of the significant problems and challenges, the infrequent occurrence of outright audit failures suggests that independence in fact is functioning and effective (e.g., Francis 2004).

**IV. ALTERNATIVE APPROACHES TO THE AUDITOR INDEPENDENCE CONUNDRUM**

Figure 3 recaps the fundamental problems and challenges that undermine auditor independence, impacting oversight bodies, information producers, and information users. This
figure includes nine issues that affect one or more of these parties, and classifies each as being in a conceptual and/or practical domain. Alternatives to the current regulatory approach that address some of these problems and challenges are described below. The three alternatives discussed are: eliminating independence rules and interpretations, increasing audit committees’ responsibilities for independence, and providing additional disclosures surrounding auditor independence.

**Eliminating Independence Rules and Interpretations**

Some prior work argues that auditor independence, as currently operationalized by regulators, is impossible to achieve (e.g., Bazerman, Morgan, and Loewenstein 1997; Bazerman, Loewenstein, and Moore 2002). A potential remedy is deregulation. Specifically, regulators could eliminate the countless rules and interpretations and revert to the profession’s earlier approach and maintain the concept of independence as an overarching principle that guides auditor behavior. This remedy addresses several of the problems and challenges shown in Figure 3.³ Research shows that market forces shape auditor behavior and reward high levels of audit quality. However, such market forces may be inadequate at protecting users of audited financial statements. In the past, deregulation of the audit profession, such as allowing the provision of currently prohibited nonaudit services, has been blamed for weakening auditor independence and degrading audit quality (e.g., Kinney 2005; Salterio 2008). Furthermore, even in today’s environment with a multitude of independence rules in place, concerns remain that auditors’ commercial interests too often take precedence over auditors’ responsibility to protect the public interest. Church et al. (2018) conclude that eliminating independence rules and interpretations is neither practical nor workable, absent other changes.

**Increasing Audit Committees’ Responsibilities**

SOX significantly enhanced the oversight responsibilities and resources of public company audit committees. One practical alternative to the current regulatory regime is to build upon this strengthened oversight arrangement and allow the audit committee greater responsibility and flexibility for managing auditor independence. For example, the audit committee could be empowered to approve currently prohibited nonaudit services if, in the audit committee’s judgment, the services did not inappropriately jeopardize the auditor’s independence and offered economic benefits to the company’s shareholders. While some observers may view this alternative as naїve, there is evidence that some audit committees would likely be in favor of this option (see Gramling et al. 2010). This remedy does address several of the practical concerns presented in Figure 3; however, the approach hinges critically on the diligence of the audit committee (DeZoort, Hermanson, Archambeault, and Reed 2002).⁴ Evidence suggests that audit committees are, on average, more diligent today than they were before the implementation of regulatory reforms mandated by SOX (Cohen, Krishnamoorthy, and Wright 2010); however, concerns persist that

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³ For example, this approach avoids the need to define independence negatively, which in turn avoids the infinite regress of rulemaking, the flaws that plague rulemaking, and the need to closely monitor compliance. The approach also eliminates the potential negative side effects of prohibiting various auditor-client relationships.

⁴ This alternative could allow an audit committee to choose a level of independence that is appropriate for the company and balance independence for expertise and other factors as appropriate (Knechel 2016). In doing so, the audit committee can assess whether matters such as social bonding between management and the auditor is a concern. The arrangement also avoids the negative side effects of independence rules identified in the literature (e.g., suboptimal contracting and nullifying knowledge spillovers).
some audit committees fail to fulfill their oversight responsibilities (e.g., Beasley, Carcello, Hermanson, and Neal 2009). To address these concerns, Church et al. (2018) highlight two additional changes to the current oversight arrangement that can help further improve the audit committee’s effectiveness: (1) greater involvement from the internal audit function in monitoring the independence of the external auditor and (2) greater disclosure of audit committee activities related to auditor oversight. Involvement from the internal audit function may take a variety of forms such as a request for internal auditors to examine and report on interactions among management and other company personnel with members of the audit team that might bear on the auditor’s independence. With regards to the second change, we note that there is a growing number of audit committees that voluntarily disclose information about their oversight of the external auditor (EY 2018). This trend is encouraging.

**Providing Additional Independence Disclosures**

Public disclosure is a viable mechanism for informing information users about auditor independence. In addition, the accountability and public scrutiny that is associated with public disclosure can deter independence impairments by encouraging information producers to more carefully evaluate auditor independence (SEC 2001). Church et al. (2018) suggest that, going forward, additional disclosure that elaborates on auditor independence threats and safeguards is a feasible means for addressing many of the practical problems and challenges listed in Figure 3. This approach aligns well with recent and contemplated changes by regulators and current trends in voluntary disclosure noted above. Although, Church et al. (2018) explain that there is a risk that increased disclosure does not achieve the desired outcome. Prior work calls attention to the idea that individuals often fail to adequately discount advice from biased experts such as auditors, even when conflicts of interest are disclosed (Cain, Loewenstein, and Moore 2005). Under certain conditions, disclosure can actually increase bias (e.g., by reducing feelings of guilt) and reduce responsibility for adverse outcomes (e.g., via the caveat emptor or “let the buyer beware” principle). Some find that disclosure also can induce gamesmanship that could reduce overall audit quality (Dranove and Jin 2010). Despite these drawbacks, Church et al. (2018) assert that additional disclosure can offer potential advantages over further rules and interpretations. Potential drawbacks to the disclosure approach to managing independence should, to some extent, be offset by complementary assurance mechanisms that have been put in place since the passage of SOX. The public disclosure of other audit quality indicators being considered by the PCAOB (2015) also would reduce the likelihood of “gaming” the system and reducing overall audit quality by focusing excessively on independence at the expense of other important audit and auditor attributes.

**V. CONCLUDING REMARKS**

Church et al. (2018) provide a robust discussion of the challenges and complexities associated with auditor independence. They suggest that the current trajectory of ever-expanding rule-setting is not sustainable for the profession. Instead of continuing under the current regulatory regime, Church et al. (2018) offer two possible alternatives. First, they suggest leveraging the increased resources and authority of audit committees under SOX to allow the audit committee greater responsibility and flexibility for managing auditor independence. Second, they suggest that additional disclosures about threats and safeguards to auditor independence may be informative for interested parties. The combination of these two approaches is worthy of further consideration.
for addressing a number of the problems and challenges associated with the current regulatory regime.

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