Policies to Promote Auditor Independence: More Evidence on the Perception Gap

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Abstract

The extensive body of literature and research concerning auditor independence, the so-called cornerstone of the profession, has centered mainly on alleged threats to perceived independence or threats to actual independence. The objective of this study was to investigate accountants' and financial statement users' reactions to policies designed to enhance auditor independence. Multidimensional scaling techniques were used to measure the similarity or dissimilarity of the views of four separate groups: Big Eight auditors, non-Big Eight CPAs, bank loan officers, and certified financial analysts. Results showed that the four groups differed significantly in the extent of their support of fourteen policies discussed in the Cohen Commission Report as means to enhance auditor independence. The Cohen Commission's position on these policies was found to appear to be more aligned with financial statement users.

Introduction

The accounting profession has been besieged by "gaps." Briloff (1966) describes a "communication gap" in which what the accounting profession seeks to communicate is not what the public perceives. Mednick (1986) prescribes an approach to solving the "perception gap" "between the profession's understanding of its audit responsibilities and users' perceptions" of its responsibilities (p. 71). Recently nine new Statements on Auditing Standards, hailed as the "expectation gap" SASs, were issued in response to concerns about "changing public expectations about the role and responsibilities of independent auditors" (AICPA Strategic Briefings, 1988).

This article describes the results of a study of one aspect of the perception gap: the difference in the way auditors and financial statement users view matters relating to auditor independence. The article summarizes evidence supporting the existence of this perception gap and describes a study of this perception gap as it relates to attitudes toward specific policies designed to enhance auditor independence.

Evidence Supporting the Existence of an Expectations Gap

The earliest of the studies pinpointing the perception gap regarding independence was done by Briloff (1966), who sent a questionnaire to members of the financial community and the accounting profession. The questionnaire included questions about CPAs performing management services at the same time as the audit. It asked whether these dual functions were compatible with the auditor's traditions and independence and whether this duality should be encouraged. Not surprisingly, the results showed much more skepticism and concern within the financial community than within the accounting profession. About 49% of the members of the financial community felt that the auditor's performance of management services was incompatible with their traditions; only 22% of the accounting professionals agreed. About 58% of the financial community felt that performing management services was incompatible with auditor's independence and 54% felt that the duality of management and audit services should be restricted; again, only 22% of the accounting profession agreed.

Hartley and Ross (1972) surveyed members of three groups: AICPA members, Chartered Financial Analysts (CFAs), and chief financial executives (FEXs) of companies listed on the NYSE. Almost 40% of the CPAs felt that auditors' performance of management advisory services (MAS) decreased their independence while about three-fourths of the CFAs and a little less than half the FEXs shared this view. Likewise, the CFAs were less confident than were the FEXs and CPAs that the professional integrity of the auditor would help to assure auditor independence. Hartley and Ross also reported that CFAs "indicate great uncertainty or negative feelings on many . . . services but particularly on those unrelated to well-known accounting areas" (p. 46) such as, personnel recruitment and psychological testing services. The CPAs and financial executives were not concerned about most of the other MAS services.

Hartley and Ross also solicited responses to several proposals to enhance auditor independence. The CFA group tended to want disclosure of MAS activities and even small percentages of MAS fees to total fees from a client, whereas the CPAs and financial executives felt that the percentage of MAS fees was not relevant to independence and indicated strong opposition to disclosure of MAS activities.

Lavin (1976) surveyed AICPA members, bank loan officers, and research financial analysts concerning twelve auditor-client relationships. There were only two relationships about which the experimental groups did not have the same perception. First, the AICPA members felt that if auditors performed bookkeeping services for their clients, such service would impair their independence. The financial statement users perceived that auditor independence would not be impaired. Second, the financial statement users felt that the auditor's receipt of a 5-year promissory note in payment of the audit fee would impair the auditor's independence; the AICPA members "were evenly split in their opinion" (p. 47). In Lavin's study there were ten other auditor-client relationships for which the AICPA members and financial statement users demonstrated a consensus in their perceptions of independence.

Imhoff's (1978) experiment examined the perception of auditor independence when that auditor accepts employment with a client firm. The participants included AICPA members, bankers, and financial analysts. The experiment manipulated two variables: the position of the auditor in the accounting firm (supervisor or non-supervisor) and the length of time between his or her auditing the client and going to work for the client. On the whole, neither CPAs nor financial statement users were concerned about non-supervisor auditors accepting employment with clients, until the time lapse became less than six months. However, the CPAs and users differed significantly in their perceptions regarding an audit supervisor going to work for a client, with the users questioning the auditor's independence when the time lapse was eighteen months or less. The CPAs did not perceive a problem with independence until the time lapse was less than six months.

Shockley (1981) also compared the perceptions of CPAs and financial statement users. His study examined the effect on perceptions of independence of competition, MAS, audit firm size, and tenure of the audit-client relationship. There is no clear differentiation between accountants' and financial statement users' perceptions. Rather, the apparent differences are between the Big-Eight auditors and bank loan officers on the one hand and the non-Big-Eight CPAs and CFAs on the other.

The perception gap evident in these studies seems to be one of degree rather than of kind. That is, the two groups of professionals, auditors and others, do not appear to disagree on whether the threats to independence have the potential to impair independence, just on the degree to which they perceive that auditor independence may be impaired. Overall, the perception gap seems to be worse in the area of management advisory services (Briloff, 1966; Hartley and Ross, 1972) than in the areas of other types of auditor-client relationships (Lavin, 1976) and of auditor acceptance of employment with a client (Imhoff, 1978).

While a divergence is apparent in the views of financial statement users and accountants toward perceived independence, no empirical research has been done on whether these groups also differ in their views concerning what to do about the lack of auditor independence.

The Current Study

This study involved four separate groups: Big Eight audit partners (B8), non-Big Eight certified public accountants (CPA), bank loan officers (BLO), and certified financial analysts (CFA). Seventy professionals from a large metropolitan area were asked to indicate whether they agreed or disagreed with, or were undecided about, each of fourteen policies affecting independence and discussed in the Cohen Commission Report. Table 1 contains the fourteen policies as stated in the questionnaire, and Table 2 contains the frequency of each response to each policy. The Cohen Commission had stated its position on each of the policies, so it was possible to include the Commission as a "subject" in the analyses to ascertain whether the Commission's views appear to be aligned with a particular group.

The responses to the fourteen policies were used to find a measure of similarity between each respondent and every other respondent. (This methodology was adapted from Brown [1981] and Rockness and Nikolai [1977].) Figure 1 shows how similarity measures for all possible pairs of respondents on each policy were derived. For instance, a particular pair of respondents, subjects X and Y, would have a similarity measure for each of the fourteen policies. If this pair both agreed with a certain policy, then the disparity or "distance" between their responses would be assigned a value of 1 ("very similar" in figure 1). If they disagreed completely, the distance assigned was 9 ("very dissimilar" in figure 1). If their responses were somewhat similar, that is if one of the subjects in the pair was undecided, they were assigned a distance value of 5 ("somewhat similar" in figure 1).

The similarity and dissimilarity measures (1s, 5s, and 9s) between respondents were put in matrix form, as shown in Figure 2, with a 71x71 matrix (for 70 respondents and the Cohen Commission) for each of the fourteen policies. The fourteen matrices were then collapsed into a single proximity matrix using a root-mean-square transformation. This single matrix was used as input to a multidimensional scaling algorithm known as ALSCAL to obtain a mapping of the subjects in a subject space. This space shows the relative positions of the subjects on the policies as a whole.

Results

Figure 3 contains the actual configuration or subject space derived from the 71x71 matrix, showing the relative positions of each of the respondents in this space. The distances between the respondents in the space reflect the dissimilarity of the respondents' views on the policies. The closer two points are in the space, the more similar the attitudes of those two respondents.

Table 1
Policies Designed to Enhance Auditor Independence

1. CPA firms should be prohibited from offering formal, paid executive recruiting services to audit clients.
2. CPA firms should be prohibited from helping their former employees find employment with audit clients.
3. The annual financial statements should include a management report which discloses the nature of other services provided by its public auditor.
4. A government agency should approve, assign, and pay the auditors for firms registered on the public stock exchange.
5. Firms registered on public stock exchanges should be audited by a corps of government auditors.
6. Auditors should be selected and retained by an audit committee made up of independent (non-management) members of the firm's board of directors.
7. Auditors should be compensated from a pool of funds created by assessments against all audited companies or by taxes on securities transactions.
8. If a company changes auditors in a given year, the fact of the change and the reason for it should be disclosed in a management report accompanying the audited financial statements.
9. Audited firms should change or "rotate" their auditor every three to five years.
10. Public auditing firms should take steps to ensure that the personnel assigned to a particular audit are rotated so that the same auditors do not audit the same client for too many consecutive years.
11. Some audited firms release estimates of annual earnings prior to the audited financial statements. Such "early earnings releases" should include a warning that they are unaudited.
12. Some audited firms release estimates of annual earnings prior to the audited financial statements. This practice should be prohibited.
13. The term "low balling" describes a situation in which auditors obtain an auditing engagement by offering to perform the audit at a lower price than normal, expecting to offset lower initial revenues with higher audit fees in future audits. This practice should be prohibited.
14. Auditors should be prohibited from accepting gifts or favors of more than token value from clients.

Table 2
Frequency of Responses to the Policies in Task 3

	Group											
	B8 (22)			BLO (17)			CPA (19)			CFA (12)		
Policy	A	U	D	A	U	D	A	U	D	A	U	D
1	5	4	13	11	2	4	7	5	7	5	-	7
2	-	-	22	8	3	6	3	1	15	3	-	9
3	6	2	14	15	-	2	11	5	3	10	-	2
Subtot.	11	6	49	34	5	12	21	11	25	18	-	18
4	-	2	20	2	-	15	1	3	15	-	-	12
5	-	-	22	-	1	16	1	-	18	-	-	12
6	14	3	5	6	2	9	11	4	4	11	-	1
7	1	1	20	-	2	15	1	2	16	-	-	12
8	11	4	7	13	1	3	13	2	4	12	-	-
9	-	-	22	9	1	7	5	1	13	2	2	8
10	17	-	5	15	-	2	11	2	6	9	1	2
Subtot.	43	10	101	45	7	67	43	14	76	34	3	47
11	7	1	14	3	1	13	3	5	11	3	-	9
12	20	-	2	17	-	-	18	1	-	11	-	1
13	10	3	9	9	-	8	7	6	6	6	-	6
14	20	1	1	17	-	-	16	1	2	9	1	2
Subtot.	57	5	26	46	1	21	44	13	19	29	1	18
TOTAL	111	21	176	125	13	100	108	38	120	81	4	83
	36%	7%	57%	57%	5%	42%	41%	14%	45%	48%	2%	50%

A - agree; U - undecided; D - disagree

Figure 1
Possible similarity combinations for pairs of subjects

		Subject Y		
		Agree	Undecided	Disagree
Subject X	Agree (with policy)	(1) Very similar	(5) Somewhat similar	(9) Very dissimilar
	Undecided (about policy)	(5)	(1)	(5)
	Disagree (with policy)	(9)	(5)	(1)

Figure 2
Matrix of proximities among subjects

	Subjects	1	2	3	4	5	. . . 71
Subjects	1						
	2						
	3						
	4						
	5						
	.						
	.						
	.						

Some of the respondent groups appear to cluster together in the subject space. For example, the upper right quadrant is dominated by the B8 (with 6) and CPA (with 5) groups while only two BLO subjects and no CFA subjects are located there. The lower right quadrant is dominated by the B8 respondents (11) but includes only half as many CPA or CFA respondents and no BLO respondents at all. The lower left quadrant contains approximately equal numbers from each group. Finally, the upper left quadrant is dominated by the BLO group (10) and only one B8 respondent.

While most of the BLO group is in the upper left quadrant, almost all of the CFA group is in the two lower quadrants. Half the B8 group is in the lower right quadrant. The CPA group is nearly equally divided among the four quadrants. There is more diversity in the responses of the CPA group than in the other three.

Overall, the four groups differ in their responses to the policies. A Kruskal-Wallis one-way ANOVA test of the coordinates of the subjects, along both axes, confirms the difference among groups. The four groups differ significantly (at .0001) along dimension 1 and also along dimension 2, although a little less significantly (at .024).

Table 3 shows the average coordinates of each group and of the Cohen Commission along each dimension. These averages place the "average" B8 and CPA respondents in the upper right quadrant (although the B8 average is just barely into this quadrant due to the number of B8 respondents in the lower right quadrant). The "average" CFA respondent is in the lower left quadrant and the "average" BLO respondent is in the upper left quadrant. Note that the Cohen Commission as a "subject" is in the upper left quadrant, closer in its views to financial statement users than to accountants.

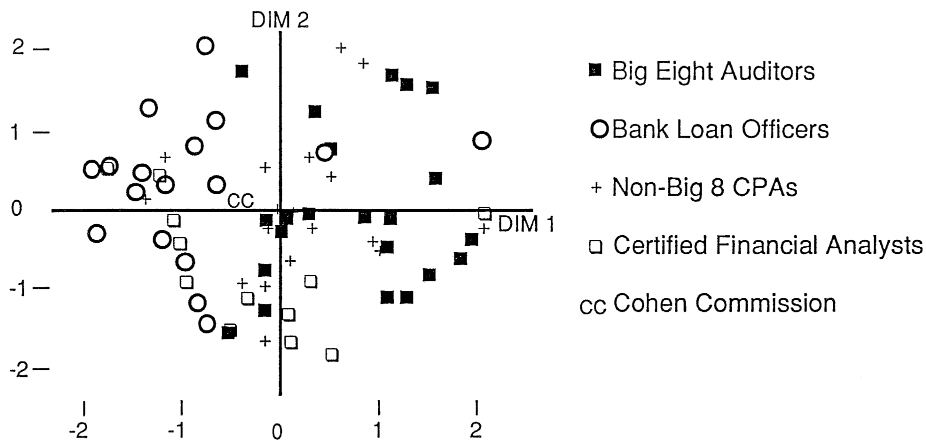

Figure 3 — Subject Space of all Respondents

Table 3
Average Coordinates

	B8	BLO	CPA	CFA	Cohen Commission
Dimension 1	.75	-.89	.11	-.30	-.53
Dimension 2	.01	.32	.15	-.72	.04

The summary of responses in Table 2 shows that the two accountant groups tend to disagree with the fourteen policies while the loan officers tend to agree with them. The financial analysts were about evenly divided in their responses. The remainder of this section examines the reactions to each of the policies individually and by the category assigned to it by the Cohen Commission Report.

The reaction to the first policy is interesting since personnel recruitment services are now prohibited to CPA firms who are members of the SEC practice section of the AICPA. In spite of that, the B8 and CPA groups still mostly disagree with this prohibition. The two user groups are on opposite sides of the fence on this issue; the bank loan officers support the prohibition of recruitment services while the financial analysts do not.

All of the B8 group disagreed with policy two prohibiting placing employees with audit clients. The only group that agreed with this prohibition is the loan officer group, and then not by a great majority.

Policy three generated a great deal of support among the BLO, CFA, and CPA groups. Only the B8 group disagreed as a whole, perhaps because it may be more greatly affected by a policy that would require a management report to disclose the nature of other services rendered to a client by an accounting firm.[1]

The reactions to policies four and five show that none of the groups supports government involvement in external audits, either in the capacity of performing audit committee responsibilities or in the more direct capacity of actually auditing registered companies.

Not surprisingly, most respondents agree with the idea of an independent audit committee's hiring auditors (policy six). Only the loan officer group had a majority disagreeing with this policy.

Policy seven, like four and five, is too drastic a change to garner much support. Only two respondents agreed that auditors should be compensated from a pool of funds created by taxes, and these two, surprisingly, were accountants.

The reaction to policy eight is very positive among financial statement users who might feel that disclosure of auditor changes would be more accessible in a management report than in an 8-K filing.

Reactions to policies nine and ten show that while most respondents felt that rotation of audit personnel is a good idea, required rotation of audit firms is probably going too far.

The response to policies eleven and twelve is rather inexplicable. Sixty-seven percent of the respondents overall did not believe that "early earnings releases" should be labeled unaudited. In contrast, ninety-four percent of the respondents agreed that release of estimates of annual earnings prior to the audited financial statements should be prohibited.

Nothing definite can be said about policy thirteen, "low balling." A few more respondents wanted to prohibit low balling than did not. Interestingly, this is the policy about which the CPA group was most undecided, perhaps because of its potential impact on the ability of non-Big Eight firms to be competitive.

Almost all the respondents (89%) agreed with policy fourteen that receipt of more-than-token gifts or favors should be prohibited. (Indeed, the Code of Conduct does just that.)

The Cohen Commission Report divided the policies discussed in that report into the following three categories: 1) Restricting services provided by public accounting firms that might be incompatible with the audit function (Numbers 1, 2, and 3 in Table 1); 2) Protecting the auditor from management influence (Numbers 4, 5, 6, 7, 8, 9, and 10); and 3) Assuring that public accounting firms are managed in a manner that provides the necessary internal support for the independence of individual partners and staff (Numbers 11, 12, 13, and 14). Table 4 shows the percentage of each type of response obtained for each of the groups (and the Cohen Commission) for each category. For instance, with three policies in category one, there were 66 possible responses from the twenty-two B8 partners; 17% of them were AGREE while 74% of them were DISAGREE.

The B8 partners generally support (65%) the policies designed to assure that public accounting firms are managed in a way to provide support for auditor independence (category 3). These partners tend to disagree with both of the other types of policies: restricting services (with 74% responding DISAGREE) and protecting the auditor from management influence (66% DISAGREE). The results for the non-Big Eight accountants are similar although not as extreme. This group's strongest disagreement was with policies designed to protect the auditor from management influence (57% DISAGREE). This category calls for drastic change in the nature of the profession--more direct government involvement in auditing and required auditor rotation --so it is not surprising that the accountants would resist this type of policy. What is surprising is that the majority of the responses in this category from the two user groups are also DISAGREE responses, showing that user groups do not support such drastic change in the nature of the accounting profession.

The BLO group agrees with restrictions on services (67%) as strongly as with effective internal management policies in the accounting firm (68%). The CFA group shows less agreement with these two types of policies (50% and 60% respectively).

The CPA group had the largest percentage of UNDECIDED responses, as high as 19% for the restriction of services and 17% for the internal accounting firm management policies.

The most extreme responses in each of the three response categories reflect the following attitudes: the B8 partners disagree with restricting services (74%), while the loan officers agree with accounting firms implementing policies to support auditor independence (68%) and restricting services (67%). For all respondents, a perception gap is most evident in the area of restriction of services. Table 5 shows the percentages of AGREE responses for each of the three policy categories and each of the groups. Less than half of the two accountant groups would agree with restricting services while 50% or more of the user groups would agree to restriction of services. The extremes are farthest apart for this category: 17% of the B8 partners would restrict services while 67% of the BLO group would; this is a 50% difference. For the other two categories of policies, not only is the range of percentages smaller, but the groups are all on the same side of the center, above or below 50% agreement. All of the groups show less than a 50% agreement with "protection" policies, while all of them show greater than a 50% agreement with "support" policies.

Table 4
Percentage Responses by Policy Classification

	Group											
	B8 (22)			BLO (17)			CPA (19)			CFA (12)		
Policy	A	U	D	A	U	D	A	U	D	A	U	D
1	17%	9%	74%	67%	10%	23%	37%	19%	44%	50%	-	50%
2	28%	6%	66%	38%	6%	56%	32%	11%	57%	40%	4%	56%
3	65%	6%	29%	68%	1%	31%	58%	17%	25%	60%	2%	38%
TOT.	36%	7%	57%	53%	5%	42%	41%	14%	45%	48%	2%	50%

1 = restriction of services
2 = protection from management influence
3 = management of accounting firm to support independence

Table 5
Order of the Groups in Agree Responses

Policy					
Restriction of Services	B8 17%	CPA 37%	CFA 50%	BLO 67%	Range 50%
Protection from Management Influence	B8 28%	CPA 32%	BLO 38%	CFA 40%	Range 12%
Management of Accounting Firm to Support Independence	CPA 58%	CFA 60%	B8 65%	BLO 68%	Range 10%

Table 6
Order of Preferences by Group

	B8	BLO	CPA	CFA
1.	Support 65%	Support 68%	Support 58%	Support 60%
2.	Protect 28%	Restrict 67%	Restrict 37%	Restrict 50%
3.	Restrict 17%	Protect 38%	Protect 32%	Protect 40%

One can also look at these agreement percentages in terms of preferences by ordering the percentages by groups as shown in Table 6. For example, all of the groups show their greatest agreement with the "support" policies. However, the BLO, CPA, and CFA groups seem to prefer, overall, the "restrict" policies over the "protect" policies. In contrast, the B8 group agrees with the "protect" policies overall more than with the "restrict" policies.

Conclusions

This study suggests that professional groups differ in their perceptions of policies designed to enhance auditor independence. However, the only perception gap that could potentially impact the accounting profession is the one regarding restriction of services. A majority of the two user groups favor restriction of services. There is only minority support for drastically changing the nature of the accounting profession (through the "protection" policies), and this is only the third preference of both the user groups. There is substantial agreement with the "support" policies among all groups, showing that all are interested in the accounting profession's maintaining its autonomy and self-regulation to some extent.

What the profession has most to fear, in the apparent perception gap demonstrated in this study, is outside pressure to restrict services. Since there is a continuing public interest in maintaining the independence of the auditing profession, the profession needs to be more responsive to the concerns of financial statement users and perhaps voluntarily take some actions to restrict itself before governmental bodies begin to respond to the interests of financial statement user groups.

Footnote

1. Hillison and Kennelley in "The Economics of Nonaudit Services," *Accounting Horizons*, September 1988, suggest that disclosure of nonaudit services may lead to a warranted "curtailment in the purchase of nonaudit services" (p. 39).

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