

Debate

Auditor Independence Decisions

ISSUE: Is a year enough time to ensure auditor independence when an auditor takes a high-level position with a client firm?

The American Institute of Certified Public Accountants Code of Professional Conduct has adopted the principles of independence and objectivity as key requirements for its members. Being objective and unbiased is crucial to the auditing process. Consider the situation Arthur Andersen found itself in after the Enron scandal broke. Arthur Andersen had serious conflicts of interest because it was offering both consulting and auditing services to Enron. It is believed that this prompted auditors to overlook signs of misconduct because of the accounting firm's strong relationships to Enron and its dependence on Enron's business.

To try and prevent future accounting scandals, the Sarbanes-Oxley Act was passed to improve the accuracy and reliability of financial information and disclosures made to investors. Title II of the Act prohibits auditing firms from offering both auditing and non-auditing services to the same client. This is intended to reduce the risks of conflict of interest.

Another provision of Sarbanes-Oxley meant to preserve auditor independence is Section 206 of the act. According to Section 206 of Sarbanes-Oxley, it is illegal for a registered public accounting firm to perform auditing services if a high-ranking executive of the client "was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit." In other words, if an auditor takes a high-level position with a client and has worked on auditing the company within the past year, the accounting firm must resign as auditor of that particular client. In 2004 accounting firm Grant Thornton resigned from its position as auditor for People Community Bancorp after the bank hired one of the Grant Thornton's managers as its new CFO.

The reason for the rule is so the auditing firm's independence is not compromised. If auditors of an accounting firm believe they may get hired into a high-ranking position with a client, they will face a significant conflict of interest. They may in turn be tempted to ignore red flags of misconduct when auditing the company. It is very important that auditing firms avoid temptations that could cause it to favor a client in exchange for future rewards. Auditor independence is a major issue in accounting, and it is estimated that the Securities & Exchange Commission (SEC) receives at least one audit independence concern daily.

However, is a year enough time to ensure that objectivity criteria are being met? It is not unheard of for companies to hire managers that have worked on past audits into high-level executive positions with the firm. Lumber Liquidators, Inc., for instance, hired a former auditor that worked on its books in the past as its interim finance chief. Before taking the job as interim CFO, the auditor worked for Lumber Liquidator's independent accounting firm Ernst & Young (E&Y). In fact, it is estimated that 6 percent of approximately 3,000 companies have hired their former auditors to high level financial and accounting roles in their firms between 1985 and 2002.

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The situation with Lumber Liquidators fully complies with Section 206 of Sarbanes-Oxley as the auditor hired had worked on Lumber Liquidators' books more than 18 months prior. Yet many believe that a year is not enough time to ensure independence. They believe the 1-year rule should be extended to 5 years. Under this 5-year rule, E&Y would have had to resign as Lumber Liquidators' auditing firm. Supporters of the move feel that a longer period of time will significantly reduce independence issues. Because auditors have to make a number of subjective calls, the chances of being hired by the client in the future could seriously jeopardize their responsibilities to be accurate and reliable in their audit.

A 5-year rule would place additional pressure on auditors to think twice before taking a job with a client, as doing so would likely mean the end of the business relationship between the client and accounting firm. However, is it fair to pressure auditors from taking a good job with a client because it had once audited the firm's books? Is it acceptable to force an auditing firm to resign in this situation? Organizations that have hired their former auditors into high-level positions claim that these hires are desirable because they already have experience with the company. Additionally, companies want to hire the best talent they can find, and much of the talent in the accounting and finance profession works or has worked for public accounting firms. In Lumber Liquidators' case, a safety scandal involving Chinese-manufactured laminate flooring tarnished the firm's reputation, and hiring someone who has expertise in finance issues and who is already familiar with the firm could be a step toward improving the organization and its reputation.

There are two sides to every issue:

1. A year is not enough time to ensure auditor independence when a member of an audit team takes a high-ranking position at a client firm.
 2. It is acceptable for an auditing firm to continue its relationship with a client even after a member of the auditing team takes a high-ranking position with the client firm—as long as the 1-year requirement is met.
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