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Diane H. Roberts

University of San Francisco, robertsd@usfca.edu

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Auditor's Independence: Increasing Expectations and Expanding Responsibilities in the Early 1930s

Introduction

A high level of audit quality is an important component of financial statement reliability and decreased information risk (ISB, 2000). Although audit quality is a function of many factors, auditor independence is a crucial element in securing user confidence both in contemporary times and the early 1930s. To enhance the credibility of financial reporting following the US stock market crash of 1929 an audit had to be conducted by an independent auditor and the meaning of auditor's independence has continued to evolve. The code of ethics did not contain an independence standard until the US Federal Securities Act of 1934 was passed; however, the concept of auditor independence as a crucial aspect of the value of an auditor's work was acknowledged in the discourse of the day.

A precise definition of auditor independence was not available in the 1930s and the Independence Standards Board (ISB) was still attempting to define auditor independence in contemporary times. The genesis of the ISB's three approaches (personal attribute, activities and relationship, and stakeholders) are evident during this period. In the 1930s the personal attribute approach was primal as character was considered the essential facet of professional ethics. Discussion surrounded the activities and relationships approach – should auditors be directors or owners of auditees? The importance of perceptions of stakeholders in the financial reporting process was beginning to be acknowledged. In both the post-depression and current period resolution

of auditor independence issues was needed to enhance investor confidence in the securities market. Increased financial statement reliability reduces the cost of capital to auditees, enhances the decision quality of financial statement users, and increases the effectiveness of allocation of resources in capital markets.

Parker (1994) identified the interrelationship between the profession's private and public interest in contemporary Australian accounting professional ethics. This paper extends this research to the American context (profession) and examines the period between the stock market crash in October 1929 and the fiftieth anniversary of the American Institute of Accountants (AIA) in 1937 in the United States. During this period the US Federal Securities Acts of 1933 and 1934 were enacted and accountants conducted a lively debate regarding the ethics of their profession with auditor independence as a recurring theme. Accounting practice in the 1930s had evolved due to increased recognition of the importance of an independent accountant's report for credit purposes, the merger and consolidation of small business units into larger corporations, and an increased amount of public ownership of stocks (Olive, 1929). Management advisory-type services were being offered and greeted with enthusiasm by the profession's leaders as a way to make accountants more professional and less strictly technicians (Andersen, 1970). Both the early 1930s and the current period feature increased technological advances and the need to enhance investor confidence.

Pressures in the investing environments of both periods are also similar. Robert Montgomery, outgoing president of the AIA, noted in 1937 that accountants "have to deal with conflicting elements, with the passion for quick profits and the assurance of safety" (AIA, 1937, p.83). SEC Chairman Arthur Levitt referred to a contemporary

investing culture of gamesmanship that is “an approach guided by short-term expectations and, quite frankly, driven by an imperative to exceed them” (Levitt, 2000, p. 1). In both periods there are concerns regarding how the basis of engagement and retention of auditors impacts auditor independence.

This paper explores the following questions. What was the impact of the enactment of the US Federal Securities Acts of 1933 and 1934 upon the independence facet of professional ethics in the 1930s? What was definition of independence in the 1930s: personal attributes, activities and relationships, or stakeholder approach? Does the discourse surrounding auditor's independence indicate an emphasis on the public interest or the private interest of accountants? What does the experience of accountants in the 1930s with the concept of independence tell contemporary stakeholders in the financial reporting process about the current independence crisis?

The remainder of this paper is organized as follows. The next section details the primary sources and is followed by a section describing contemporary theoretical conceptions of independence. The nature of the 1930's American audit environment is explored and the importance of a code of ethics for a profession is described. The nature of independence as an ethical construct in both pre- and post- the Securities Acts of 1933 and 1934 periods is investigated. The last section provides conclusions and limitations.

Primary Sources

The primary sources used are those that reflect the thoughts of the leaders of the profession in the early 1930s. Contemporary discussion of auditor independence is cited to provide a meaningful framework for analysis of historical thoughts on independence.

As the actual words of the past are cited, it should be noted that the language of the 1930s was not gender-neutral. Gender-neutral language will be used when not citing historical works.

Articles and editorials in *The Journal of Accountancy*, official publication of the AIA, from 1929 through 1937 that pertain to the issue of auditor independence are cited. A. P. Richardson had been both AIA secretary and editor of *The Journal of Accountancy* for 19 years when he retired as secretary in 1930 and assumed only editorial duties (AIA, 1938, p. 20). Richardson's book entitled, *The Ethics of A Profession*, was published by the AIA in 1931. It was a primer for a young accountant starting in practice and was based on editorial comments that had appeared in *The Journal of Accountancy*. As such the book represents the philosophical views of one of the Institute's leaders and its appendix contained the complete 1931 version of the Rules of Professional Conduct.

Arthur Andersen's published speeches include two speeches on ethics from the relevant time period (Arthur Andersen, 1970). The first is Andersen's speech on "The Accountant and his Clientele" given to the William A. Vawter Foundation on Business Ethics at the Northwestern University School of Commerce in 1932. The second speech was given to the AIA in 1935 and entitled "Present day problems affecting the presentation and interpretation of financial statements."

The AIA celebrated its fiftieth anniversary from October 18 to October 22, 1937, in New York City and published proceedings of the event. The proceedings include a short history of the Institute, speeches delivered at the various sessions, and transcripts of roundtable discussions of the significant accounting issues of the day.

Independence as an Ethical Tenet

The Independence Standards Board's *Conceptual Framework for Auditor Independence* includes three approaches to definition of auditor independence: personal attributes, activities and relationships, and stakeholders (ISB, 2000). The personal attribute approach views independence as a desired personal characteristic similar to competence, integrity, and objectivity. The activities and relationships approach acknowledges that stakeholders can rarely assess the auditor's personal attributes and observable external indicators of an auditor's independence are of value. The stakeholder approach notes that goals of auditor independence include investor confidence and enhanced financial statement creditability and thus this approach incorporates investor perceptions directly into the definition of independence.

Whether an auditor's independence is impaired or not from a particular circumstance is an important issue. Independence risk is the risk that in a specific circumstance an auditor's independence may be impaired (ISB, 2000). Under the personal attributes approach this risk is associated with the auditor's willingness or lack of willingness to perform a quality audit. Under the activities and relationships approach this is the risk that an activity or relationship may impair the auditor's willingness to perform a quality audit. The stakeholder approach to independence expands independence risk to include whether pressures and other factors are *perceived* to impair auditor's independence. Independence risk is reduced when safeguards or controls are in place to reduce the threats to auditor independence. What safeguards should be instituted to reduce this risk

to an acceptably low level is problematic and were debated by the profession and the fledgling SEC during the early 1930s.

Audit Environment of the early 1930s

Prior to the US federal securities laws of 1933 and 1934 audits were voluntary for corporations that were not in governmentally regulated industries. A survey of the 83 largest companies in 1933 found 87 percent did have audits and those that did not were often under governmental supervision, such as banks, utilities, or railroads (Barton, 1933). Seventy of the companies had outside auditors for an average of 18 years. Such voluntary use was significant as audits initially had a very different connotation than as an aid to investor confidence. At the inception of the AIA in 1887 an audit was perceived as evidence of suspected fraud, irregularity, or doubt about the entity's financial strength. Reluctance to have an audit continued so that in the 1900s audits were secret investigations and often conducted at night and on Sundays to maintain secrecy (AIA, 1937). Arthur Andersen noted that

“the outside accountant was considered merely as a checker of accounts and a detector of defalcations, who compiled financial statements for the use of those intimately connected with the business. It is not unusual for the client to judge the success of an accountant's work almost solely by the extent to which errors or irregularities were discovered” (Andersen, 1970, p 165).

Appreciation of the importance of an audit by investors, the New York Stock Exchange (NYSE), the Edison Electric Institute (a utilities industry association), and individual companies was growing by the 1930s (Barton, 1933). Companies were “moved by the exigencies of uncertain times” (Barton, 1933, p. 91) following the US

stock market crash in 1929 to adopt independent audits as a business practice. The NYSE required all new listings as of July 1, 1933, to have independent audits, citing investor regard of audits as a useful safeguard as the reason. To be truly valuable the NYSE determined that audits had to be adequate in scope and the responsibility of the auditor defined (Barton, 1933). A portion of the definition of the auditor's responsibility was a resolution of the meaning of independent in the term 'independent audit.'

The stakeholder perspective or social significance of the audit function was just beginning to be acknowledged as articulated by Arthur Andersen in 1932:

“Because accountancy is a profession rather than just another line of business, it must assume responsibilities which go far beyond those imposed by the business function alone, for it has long been recognized that the published financial statements of corporations are clothed in a public interest and that the accountant has a responsibility to the public as well as to his client. This responsibility is based on social premises; it exists regardless of legislation, which serves only to focus attention upon it” (Andersen, 1970, p. 214).

The separation of management and ownership put management in a trustee relationship with shareholders and clients were having difficulty accepting the extension of accountants' responsibilities to outsiders. Management compensation was increasingly related to bonuses based on earnings and this created an ethical duty for the accountant to resist management's efforts to enhance current earnings through application of over liberal accounting policies (Andersen, 1970).

Evolution of Independence Rules in the 1930s

A code of ethics has been termed a “unique, dynamic record of the movement of an occupational group toward professional status” (Casler, 1964, p. 8) and was considered the most important attribute distinguishing public accounting from non-professions in a survey of members of the profession (Montagna, 1974). The code is notification that the profession will protect the public interest through technical competence and ethical business practices. Professional ethics has two aspects: professional attitude or demeanor and standards of professional conduct. The relative emphasis on each aspect has changed over time but the professional attitude was considered primal at the beginning of the 1930s as “ethics is a state of mind” (Richardson, 1931, p. 15).

Insert Table 1 about here.

The public interest aspect of the code of professional ethics focuses the orientation of the professional community towards social responsibility. Both the economic interests of clients and of third parties are to be protected and the nature of the client-professional relationship is delineated. The private or self-interest of the profession is intertwined with the public interest aspect of professional ethics (Parker, 1994). Parker defines private interest as “the latent motivation of ethical codes to protect the interests of the professional accounting body corporate and its individual members” (Parker, 1994, p. 509). Protection of the profession itself includes minimization of interference by outsiders, maintenance of social status and political power. The code also ensures exclusiveness of provision of audit services.

Pre-Securities Acts of 1933 and 1934 Independence

By June 1931, AIA had formulated ethics rules that covered the following 12 basic areas that did not include independence:

1. use of the title "Member AICPA"
2. certification of statements which contained essential misstatements
3. prohibition of a non-AICPA member from practicing in the name of a member
4. commissions
5. incompatible occupations
6. certification of statements not verified under supervision of an AICPA member
7. efforts to secure legislation without notification of the Institute
8. solicitation or encroachment on the practice of another member
9. offers of employment to employees of fellow members
10. contingent fees
11. advertisements, and
12. participation in activities of schools whose promotional activities were discreditable to the profession (Richardson, 1931, p. 155-159).

These rules of conduct are an implementation of the activities and relationships approach to professional ethics. The lack of an independence rule may be because independence was considered to be an aspect of one's character and thus not necessary to legislate through rules. In the conclusion of his book on professional ethics, Richardson states:

"Already the code of ethics of the Institute is higher than that of any other professional organization in America. The man who observes rigidly all the rules laid down in that code can look the world in the face. But there are thousands of men to who a written rule is unnecessary. Their innate sense of fitness enables them to distinguish between what should be and what should not be" (Richardson, 1931, p. 152).

It should be noted that Richardson's book was written after the stock market crash of 1929 but prior to the Securities Acts of 1933 and 1934. The personal characteristic view is advocated even though the United States had suffered the economic crisis of the Stock Market Crash of 1929.

The philosophy that independence was a manifestation of character and a mental attitude was embraced by accountants in the 1930s and termed independence in fact. Parker's (1994) private interest model of professional accounting ethics holds creation of a professional mystique that renders the profession immune to evaluation by outsiders to be a crucial private interest goal. Independence ascertainable only by the accountant allowed the profession to claim sole evaluation of a central facet of the profession and thus served the private interest of insulation from external monitoring.

In the 1930's business world personal reputation was considered a primary factor in determination of whether or not an auditor-client relationship impaired the value of the auditor's work. Bankers found a dual relationship of auditor and director or auditor and officer to be troubling unless "the reputation of the accountant involved was of such a high character that they felt reasonably certain the dual relationship did not work harmfully" (Hurdman, 1931, p. 302). Advertising was deemed inappropriate as "it is simply incredible that anyone would engage an accountant to do that sort of work without knowing something about the man engaged" (Richardson, 1931, p. 61).

Independence in fact may have been satisfactory when one was personally acquainted with accountant involved, yet was less reassuring when all one had to rely on were the three initials after an unfamiliar name—CPA. The meaning of CPA had not been very well established at this time and had been eroded by sales of meaningless CPA certificates with no questions asked by the National Association of CPAs, a competing professional society (Previts and Merino, 1979).

In an effort to improve the perception of the profession Frederick Hurdman (then president of the AIA) introduced the following resolution mandating auditor independence from the client in 1931.

Whereas the relations between a client in the form of a corporation and the auditor for that corporation should be one of entire independence, and

Whereas it does not appear to be practicable for the auditor consistently to hold a dual relationship as auditor and executive of the corporation, and

Whereas the public interest and confidence will best be preserved by complete separation of these two functions, therefore be it

Resolved that the maintenance of a dual relationship of director or officer of the corporation while acting as auditor of that corporation is against the best interest of the public and the profession and tends to destroy that independence of action considered essential in the relationship between client and auditor (Hurdman, 1931, 303).

This resolution was in the activities and relationships approach as it dealt with removal of an external indicator of lack of independence but was defeated in 1932. However, it did not address the full range of incompatible relationships as ownership of an audit client was not included. The profession's failure to pass the proposal was a strong indication of the depth of adherence to the independence as character doctrine or personal attribute approach to independence. Although not enacted, the resolution indicated an acknowledgment of the stakeholder approach as public interest and confidence are cited as reasons for adoption of the independence rule.

While Andersen felt an accountant's widened responsibilities called for increased ethical standards of professional conduct, in 1932 he did not view a partial ownership interest in a client as a barrier to an accountant's independence.

“To preserve the integrity of his reports, the accountant must insist upon absolute independence of judgment and action. The necessity of preserving this position of independence indicates certain standards of

conduct; *he should not have a financial interest in the business of any client of sufficient importance to him to influence his independent position and he should not accept business or social favors that might create an obligation which would make the maintenance of an impartial attitude difficult.*” (Andersen, 1970, p. 172, italics added.)

The amount of the ownership interest should be immaterial to the particular accountant and was to be left to the discretion of the individual accountant. This was only workable under a personal attributes approach to independence in which independence was an intrinsic characteristic of the accountant. This is in sharp contrast to the modern view as articulated by Arthur Levitt, “the golden rule of auditing: auditors cannot invest in their clients” (Levitt, 2000, p. 4).

Richardson’s views on independence were more modern in tone than those of Andersen. He advocated an activities and relationships approach and acknowledged that strict adherence to the personal attributes approach was not viable. He acknowledged the importance of the appearance of independence and suggested that auditors should never be directors of clients.

“Indeed, one might go farther and say that it would be unwise for an accountant to own stock in a corporation of which he is the auditor, because it seems safe to assume that an accountant who is a stock-holder naturally wants the company to present as favorable a report as may be, and it is only accusing the accountant of humanity to express the fear that, if a stock-holder, he may be inclined to look leniently on weaknesses.

This statement is generally regarded as a counsel of perfection. It is well known that many accountants own stock in the corporations of which they are auditors. Nevertheless, the argument against such ownership is absolutely sound, and the accountant who would avoid any imputation of evil would be wise to refrain from the purchase or possession of a security of any kind issued by a corporation by which he is employed as auditor. In many cases accountants have opportunities to acquire stock of corporations which they believe are about to make substantial profits, and it is asking a great deal of them to abstain from participation, but the principle remains the same. There should be no personal interest” (Richardson, 1931, p. 129-130).

However, it should be noted that some American accountants resented Richardson in the 1930s. Richardson was not an accountant nor an American and was considered to be elitist (Previts and Merino, 1979).

Other Independence Aspects of the 1930s' Code of Professional Ethics

Although there was no independence rule in the 1930s' Code of Professional Ethics the solicitation, incompatible occupations, and the contingent fee rules related to the concept of independence.

Solicitation or encroachment on the practice of another member was a controversial rule in the code of ethics as it generated considerable correspondence to the *Journal of Accountancy*. Solicitation was seen to have an independence aspect:

“A solicited engagement places an accountant in a queer position to the client. The client is very apt to feel that he has employed the accountant just as he would employ a bookkeeper, and therefore, that he is entitled to dictate the manner in which the accountant shall perform his work and the sort of report he shall render” (Franke, 1930, p. 363).

Such dictation was considered an unacceptable accounting practice but the discussion primarily revolved around poaching of another's client as the most important solicitation issue. During this period in the profession's development, professional ethics were needed to regulate behavior within the profession and not just to protect to the public. Some rules were for the protection of the profession's self-interest and not necessarily the public interest.

The text of the incompatible occupations standard read as follows: “No member or associate shall engage in any business or occupation conjointly with that of a public accountant, which in the opinion of the executive committee or the council is

incompatible or inconsistent therewith” (Richardson, 1931, p. 158). Proscription of the accountant’s services was an attempt to elevate the perception of accountants’ professional status rather than to achieve or strengthen independence. “It does not add to the dignity and standing of a profession to have it made part of a hodgepodge of activities” (Richardson, 1931, p. 128).

In Richardson’s advice on office selection, the young accountant was advised to not save money by performing work in exchange for office space. Richardson notes “it does take something from the self-respect and complete independence, which are essential to professional success, if one becomes the salaried servant of another” (Richardson, 1931, p. 12). Self-respect is an innate quality of the individual, not legislated by passing a rule of conduct, and independence is referred to in the same manner as self-respect.

The contingent fees standard read “No member or associate shall render or offer to render professional service, the fee for which shall be contingent upon his findings and the results thereof” (Richardson, 1931, p. 156). Three of the four reasons Richardson cited to support the ban were variations on the theme of just-monetary reward for an accountant’s services. The concern was that the work would not have a satisfactory result and the accountant would thus not receive any compensation. The fourth reason advanced was “the accountant worthy of his calling is entirely impartial” (Richardson, 1931, p. 101) and not an advocate. Protection of the accountant’s private interest rather than the public interest. The ban on contingent fees continues to be a contemporary facet of audit independence as the SEC’s concern is that such an arrangement results “in the

auditor having a mutual interest with the audit client in the outcome of the work performed” (SEC, 2000, p. 2).

Post-Securities Acts of 1933 and 1934 Independence

The AIA passed an independence standard in 1934 when governmental and financial press pressure made its passage almost involuntary (Previts and Merino, 1979).

The AIA’s adopted version of the independence standard read as follows:

“Resolved, 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” (Carey, 1937b, p. 243).

The dual relationship of auditor and director was not banned in this standard, nor is a complete ownership interest ban instituted. The standard also did not address incompatible services offered by accountants. The profession still primarily endorsed the personal attribute approach as very few external indicators of potential independence conflicts were banned. At the AIA’s fiftieth anniversary banquet, Clem W. Collins, AIA president-nominate, observed that among the Institute’s noted accomplishments was that “Rigid codes of ethics have been adopted” (AIA, 1938, p. 165).

Then, as now, the SEC did not endorse the personal attribute approach, but instead favored an activities and relationships approach. SEC rule 650(b) was instituted in 1934 and read as follows:

“The commission will not recognize any certified accountant or public accountant as independent who is not in fact independent. An accountant will not be considered independent with respect to any person in whom he has any substantial interest, direct or indirect, or with whom he is

connected as an officer, employee, promoter, underwriter, trustee, partner, director, or person performing similar functions” (Carey, 1937b, p. 244).

The SEC rule is more comprehensive than that adopted by the AIA in the same year as it banned substantial ownership of a client and incompatible relationships such as director. The rule covered both financial and employment relationship aspects, as did a recent SEC proposal for modifying independence rules (SEC, 2000).

Profession's Reaction to the SEC's Independence Rule

The personal attribute approach to independence and ethics was still held by accountants after the Securities Acts of 1933 and 1934. Among seven essential traits for a successful accounting career was a character of the highest ethical standards (Nissley, 1937). Although a highly ethical accountant is necessary for the protection of the public interest, ethical behavior by the accountant was also seen to have a private interest aspect. It was noted that for “a public accountant to perform his work dishonestly would be to commit vocational suicide” (Nissley, 1937, p. 114).

The SEC did not accept this argument and held the rather skeptical attitude expressed by James M. Landis, then SEC chairman, in a speech: “The impact of almost daily tilts with accountants, some of them called leaders in their profession, often leaves little doubt that their loyalties to management are stronger than their sense of responsibility to the investor” (Nissley, 1937, p. 101). This reaction had some validity as the profession articulated its disagreements with the SEC in *The Journal of Accountancy* on the topics of dual auditor-director relationships and ownership interests in clients.

The profession considered there were three acceptable exceptions to the ban on dual auditor and director status. These three exceptions were in the cases of (1) closely held corporations, (2) auditors employed by a bank to make a credit examination, and (3) non-profit organizations (Carey, 1937a). The profession's conclusion on the dual relationship issue was that "it can not flatly be said to be wrong in all cases, is clearly a thing to be avoided whenever possible" (Carey, 1937a, 245).

Both the SEC and the AIA versions of independence banned a 'substantial' financial/ownership stake in a client, but exactly what was substantial was a subject of debate. One percent of an accountant's net worth was the rule implemented by the SEC (Carey, 1937b). The profession did not consider this a fair rule as accountants were "recruited from those in moderate circumstances whose incomes are relatively large in relation to their fortunes" (Carey, 1937b, p. 410). Hurdman considered it unlikely on a practical basis that an accountant would risk the potential future earnings and goodwill by making an inappropriate decision swayed by stock ownership in a client (Hurdman, 1931), an affirmation of the personal attributes approach to independence.

It is difficult to reconcile acceptability of an unsubstantial stock ownership in a client with the independence aspect of the 1930s ethics code ban on commissions. The prohibition included giving commissions to secure engagements and receiving commissions from stationery purveyors and other providers of services to clients. Commissions were prohibited as "a professional man who would give his best services must be absolutely uninfluenced by external matters" (Franke, 1930, p. 360). Ironically, the profession acknowledged the possibility of influence or loss of independence from

recommendation of a seller of business products but simultaneously felt an ownership interest in a client would not create a similar conflict.

Use of insider information in reorganizations, underwritings, new issues and stock dividends was also deemed to reduce independence as it placed the accountant in the position of receiving a favor from management (Hurdman, 1931). Hurdman concluded that no fixed rule regarding stock ownership could be instituted but did note that the accountant

“should keep in mind the necessity at all times of preserving an independent relationship and so arranging his investments that he does not take advantage of the public or permit any hoped-for gain in market values to influence in any degree his impartial review and presentation of the facts” (Hurdman, 1931, p. 304).

In the post 1933 and 1934 period, thinking on the issue of acceptability of ownership in clients was divided as exemplified by the two-tier independence rules of SEC and non-SEC practicing accountants. The AIA did not have a rule banning ownership but the Securities Acts of 1933 and 1934 “refused to recognize the certificate of a certified or public accountant who is employed by or is financially interested in the enterprise whose accounts he certifies” (Andrews, 1934, 59). Correspondence between the two requirements was not achieved until issuance of *Opinion No. 12: Independence* by the AICPA’s Division of Professional Ethics in 1961 (AICPA, 1970). Adherence to the personal attribute approach spanned the Atlantic as upon learning of the ownership prohibition English accountants expressed surprise that the Americans would “permit the inference that their integrity might be impaired by the dual relationship” (Carey, 1975, p. 80).

Engagement of Auditors

The SEC ban on a substantial ownership interest in a client to achieve auditor independence was seen by the profession to lead to the issue of who hired the auditor. “It is a short step from this point to the proposition that the public accountant must not owe his selection, and hence his opportunity to earn his fee, to the very management whose accounts are under audit” (Andrews, 1934, p. 59). The concern about who hires and fires the auditor in the 1930s is similar to the contemporary call for increased power and action on the part of the audit committee.

Public and regulatory sentiment in the 1930s was expressed by Milo R. Maltbie, chairman of the New York public service commission

“Auditors who are selected by officer are much less inclined to be independent than those selected by stockholders, which is the English plan. In other words, the value of an ‘independent audit’ depends more upon the standing of the auditors and the thoroughness of their investigation than upon the fact that the auditors are not upon the regular staff of the utility which they are investigating” (Barton, 1933, p. 98).

However, by the end of 1933, only the states Massachusetts and Pennsylvania had enacted corporation laws that required the auditor to be selected by the stockholders (Andrews, 1934). United States Steel Corporation had voluntarily had its auditors selected by the stockholders and this was seen to anticipate “future emergencies by establishing the auditors as independent advisors of the stockholder, co-equal for that purpose with the management itself” (Andrews, 1934, p. 60).

Debate centered on two methods of selection of auditors termed the director method and the shareholder method (Richardson, 1932). The director method was predominately used in the United States. The directors, an elected board of management,

appointed auditors without shareholder oversight to investigate what management had done and the auditor thus received fees from management. The shareholder method was a legal requirement in England and the auditors were elected at the annual meeting by the shareholders themselves. The true owners of the company were deemed to select their independent investigator, “who might almost be called also an arbiter” (Richardson, 1932, p. 321).

In an editorial in *The Journal of Accountancy*, the AIA endorsed the shareholder plan in 1932 (Richardson, 1932) as did Arthur Andersen (Andersen, 1970). An effect of method of auditor engagement on the auditor’s willingness to perform a quality audit (a personal attribute approach) was acknowledged.

“Of course, in theory the identity of the actual employer is immaterial, but everyone knows that it is a harder task to criticize the one who is responsible for the engagement than it is to attack an employee of the client” (Richardson, 1931, p. 134).

The shareholder method had additional independence advantages. The auditors had the right to attend and address the shareholders meeting and state their case before being dismissed (Hunt, 1935). Under the director method, there was no forum in which an auditor who resigned an engagement due to disagreements with management could explain the reason for the resignation. (Nissley, 1937). In England the auditor was also obligated by law to include in his/her certificate whether or not the directors had satisfied the auditor’s needs for information (Hunt, 1935) which reduced the possibility of limits on the scope of the audit.

Some of the impetus for discussion of the English method came from the profession’s desire to avoid governmental or bureaucratic control of auditing and

auditors. A governmental commission to appoint auditors was viewed as unlikely to be free from political interference, with a corresponding negative impact on an auditor's independence (Hunt, 1935).

Conclusion

Independence is a central aspect of professional ethics for accountants. Levitt states "Independence is at the core of the profession, the very essence that gives an auditor's work its value. It is the space and the freedom to think, to speak, and to act on the truth. And truth is the lifeblood of investor confidence" (Levitt, 2000, p. 1).

Insert Figure 1 about here

As the timeline in Figure 1 illustrates, the accounting profession's strengthening of auditor independence lagged behind governmental regulation. The decade of the 1930s was ushered in by the Stock Market Crash of 1929, an economic crisis that featured some accounting scandal aspects. The profession introduced a rather weak independence standard that prohibited some dual auditor-corporate executive relationships but did not ban ownership in an audit client. This weak standard was not passed and the SEC enacted its own stronger standard that did include a ban ownership in an audit client. The profession reluctantly reacted with a weaker standard and another accounting scandal occurred. The McKesson & Robbins fraud of 1939 is outside the

scope of this paper, however, the lurching from accounting scandal to accounting scandal depicted in the timeline is all too familiar in recent times.

The personal attribute approach to conceptualizing independence was the American profession's choice in the 1930s. There was a strong belief in the fitness of the individual accountant and much written in the *Journal of Accountancy* about the negative, long-term economic consequences for the unethical accountant. The lack of success that was deemed to result from unethical practice was considered a sufficient deterrent to protect the public and thus additional rules or legislation were unnecessary. Without the proper ethical character that is assumed under the personal attribute approach the other approaches have significant potential for failure. Is it possible to enact enough safeguards to protect the public from an accountant with a truly unethical character? The Enron experience suggests it is not.

The activities and relationships approach was favored by the SEC and implemented in the US Securities Acts of 1933 and 1934. The profession was forced to follow suit by enacting its own independence standard that banned relationships that would have the appearance of a lack of independence. There remained significant differences of opinion between the SEC and the profession regarding what extent of relationships should be banned and what type of safeguards should be implemented. Dialog in contemporary independence rule promulgation suggests this difference of opinion continues into the present time.

The stakeholder approach to independence was in its infancy in the 1930s. The extensive nature of public investment in corporations and the growth of investing

opportunities and business size created new groups of users of financial statement information that had legitimate interests in the validity of the information provided.

Modern auditor independence rules proposed by the SEC find a lack of independence when any of four main principles are violated. These principles are (1) mutual or conflicting interest with the audit client, (2) audits his or her own work, (3) functions as management or an employee of the audit client, or (4) acts as an advocate for the audit client (SEC, 2000). Many of the practices condoned by the code of professional ethics in the 1930s such as client ownership and directorship violated all four of these principles. Indeed, Richardson, noted

“Taken as a group, accountants are too much inclined to subservience. They have not the independence which is founding some of the older professions. The individual client is far too great a factor. These things, however, are incidental to the period of transition, for it must be reiterated that accountancy as a profession is young and has not yet reached the dignity and stability of full age” (Richardson, 1931, page 137).

In the 1930s the character versus rule-based independence debate was quite strong. In 1929 there was no independence rule and there was significant resistance to enacting such a rule. In 1934 a rule was enacted in response to government pressure to enhance investor confidence. An additional aspect of the importance of stakeholder impressions is that the amount and complexity of specialized knowledge that is accounting and auditing increased dramatically in the intervening years (between 1929 and 1934). Increased specialized knowledge concentrated in the hands of professionals (greater expertise) created a need for increased trust on the part of the readers of the financial statements. This increased trust is necessary as the users of the financial

statements lack the knowledge to evaluate the results of the accountants' expertise and thus there is an increased need for ethics and assurance of ethical behavior.

In contemporary times published discussions of accounting ethics feature the public interest overtly and are silent as to the private interest aspects (Parker, 1994). In the 1930s the private interest aspect was often the primary aspect remarked upon in the *Journal of Accountancy*, the profession's publication. Parker (1994, p. 508) notes "the role of ethics in protecting the private interest represents a vital component of the accounting profession's ongoing commitment to ensuring its own survival." Although accountants in the 1930s were faced with an unprecedented increase in governmental regulation and fought for their private interest, the public interest was served simultaneously.

Resolution of the auditor independence issue is paramount as it is directly related to the issue of trust. As accounting knowledge becomes more extensive and specialized users of financial information must rely more on the ethics of the experts, the auditors. If auditors do not resolve this issue, it could have profound impacts on the capital markets, the profession, and result in "a culture that would not be able to utilize its own knowledge, due to pervasive distrust of its knowers" (Hardwig, 1994, p. 90).

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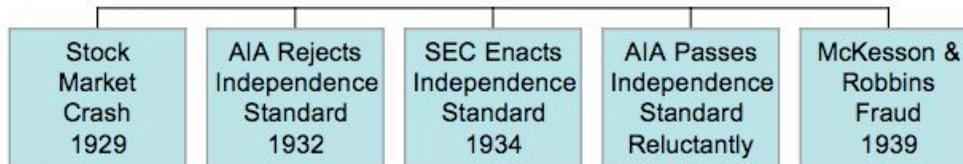
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Table 1
Public Versus Private Interest

	Public Interest	Private Interest
Definition	Protect Society	Protect Profession
Components	Protect economic interests of clients	Control of profession by the profession (self control)
	Protect economic interest of third parties	Maintain Professional Authority and Autonomy
	Client-profession relations	Exclusiveness
	Community orientation - Social responsibility	Socio-economic status preservation

Figure 1
1930's In Review



- Economic Crisis/Accounting Scandal
- Profession Fails to Act
- Government Regulates
- Profession Reacts
- Next Economic Crisis/Accounting Scandal