

Independence Safeguards for Subsequent Client Employment

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ABSTRACT

Establishment of audit firm quality control policies, including the consideration of safeguards to ensure firm independence, is a responsibility within the audit profession. This research identifies the potential ability of audit firm safeguards to preserve independence in appearance and perceived audit quality when an audit engagement with a nonpublic client involves the practice of subsequent client employment of a previous audit firm employee. Gathering perceptions on the effectiveness of varying stringencies of three safeguards for maintaining independence occurs through a national sample of state board of accountancy members responding to a survey case experiment. Safeguard evaluation occurs on the current AICPA guidance and including the AICPA guidance with either a mandatory peer review or mandatory cooling-off period requirement. No significant difference is found between the options for maintaining independence or audit quality.

Keywords: subsequent client employment, state boards of accountancy, auditor independence, safeguards, revolving door practice.

INTRODUCTION

Attest services provided by Certified Public Accountants (CPAs) require that appropriate standards/requirements be in place over the attest process to enhance public acceptance of the service outcomes. One of the leading attest requirements for ensuring public trust is independence by an audit firm in regard to an audit client. Accordingly DeAngelo (1981) identifies independence, along with the auditor's technical ability, as critical elements to create the audit quality that is necessary for public confidence.

In the Code of Professional Conduct (CPC), the American Institute of Certified Public Accountants (AICPA) establishes the independence requirements that audit firms follow for nonpublic clients. The CPC provides guidance to auditors on how to maintain their

independence and cautions on how independence can be threatened (AICPA 2019, 1.210.010). Maintaining independence is achieved through controls, called safeguards, to mitigate or eliminate threats. Threats to firm independence include issues such as self-interest, undue influence, and familiarity.

The threats to independence are based on a relationship the firm may have to a client. One such relationship to potentially cause an independence threat is the subsequent client employment of an ex-auditor, which is commonly referred to as the “revolving door practice” (AICPA 2019, 1.279.020; Clikeman 1998; Geiger et al. 2008). This study addresses this issue by portraying a nonpublic client’s subsequent hire of their current audit firm’s ex-auditor to a key position in the client’s financial reporting process when the ex-auditor has previously served as a covered member of the audit engagement team on the client. The potential threat the revolving door practice brings is important for audit firms to understand as failing to eliminate or mitigate the threat to an acceptable level impairs independence and prevents the firm from being allowed to continue as the auditing firm for such clients (AICPA 2019, 1.200.001). Interestingly, prior research on the revolving door issue is mixed with several studies finding concern and others not identifying it to be of concern.

Recent research on the revolving door practice tries to understand how applying various firm safeguards aids in maintaining independence. These studies find that safeguards are effective at maintaining independence in the perception of audit report users. The current study expands the understanding of safeguard effectiveness with an analysis of a new audit report user group as suggested by Warrick and Booker (2017). State board of accountancy members address the topic through a between-subject design (BSD) case experiment.¹ The members evaluate whether the current AICPA guidance is sufficient or if more stringent safeguards are necessary for maintaining perceptions of independence and audit quality.²

LITERATURE REVIEW AND HYPOTHESES

Imhoff (1978) conducted the seminal study on the revolving door practice. In this context, he identifies that users of financial statements tended to be more critical of independence issues than CPAs. Users of financial statements began to see independence as problematic when the time of separation from audit firm to client hiring (the “cooling-off” period) was less than 18 months. The CPAs who participated in the study did not consider independence to be an issue until the cooling-off period was less than six months. Ahmad (2015) surveyed financial statement users in Malaysia and, consistent with Imhoff (1978), finds that independence in appearance is impaired with the revolving door issue, but this perception of impairment could be reduced by a

¹ This study follows the research design and similar research instrument as used in Warrick and Booker (2017). The case scenarios and safeguards evaluated are those used in Warrick and Booker (2017).

² Current AICPA guidance has five general criteria: any funding due the former employee is immaterial to the firm, former employee has a lack of financial or operational influence with the audit firm, contemplate possible modification to the audit plan, staff a proper engagement team, and possible review of the client’s subsequent audit (AICPA 2019, 1.279.020).

cooling-off period. Ahmad also finds that ex-auditors in supervisory positions were more likely to cause the perception of impaired independence than ex-auditors in non-supervisory roles. Similarly, Koh and Mahathevan (1993) find the perception of independence to be problematic with a shorter cooling-off period (six months) than a longer period (thirty months). Parlin and Bartlett (1994) find an independence concern with the revolving door practice through evaluation of the preliminary estimate of materiality (PEM). Their research indicates that the PEM is larger when auditors know the subsequent employment history on their client's controller.

While the above studies indicate a threat to independence from subsequent client employment, the following studies do not indicate such a threat. Geiger et al. (2005) investigate the practice as it relates to earnings management. They find no significant differences in earnings management activities by corporations who hire ex-auditors as compared to corporations who did not hire ex-auditors. Additionally, Geiger et al. (2008) determined that the market reacted positively to corporations that hired ex-auditors. Through a qualitative study involving corporate executives and bank loan officers in Malaysia, the revolving door practice is identified with little effect on the perception of independence impairment; conversely, it can be seen as sending positive information on financial reporting ability (Sori and Mohamad 2008). Dart and Chandler (2013) find that institutional investors show minimal concern over independence when client employment occurs.

More closely related to the current study are the findings of the following three projects. Wright and Booker (2010) use members of state boards of accountancy to determine what cooling-off period time frame results in an improvement of the perception of independence. They find that periods over one year generally improve independence in appearance with these members. Wilson (2017) evaluates perceptions of independence with nonprofessional investors and varying safeguard forms. Wilson identifies safeguard options as peer review and cooling-off as being similar in effectiveness for maintaining independence. Warrick and Booker (2017) study the relationship of the revolving door practice to independence with the evaluation of bank loan officers. The results indicate that safeguard options are not significantly different from each other with each being effective through similar confidence ratings.

This study extends Warrick and Booker (2017) to determine how their selected safeguards affect state board of accountancy members' perceptions of independence with regard to subsequent client employment. The hypotheses below are as listed in Warrick and Booker 2017:

"H1: There is no difference between the perceived independence obtained with (1) the current AICPA guidance for maintaining independence for the revolving door practice and requiring the AICPA guidance plus (2) a mandatory peer review safeguard or (3) a mandatory cooling-off period safeguard for auditors of nonpublic companies.

H2: There is no difference between the perceived effectiveness for audit quality obtained with (1) the current AICPA guidance on independence for the revolving door practice and requiring the AICPA guidance plus (2) a mandatory peer review safeguard or (3) a mandatory cooling-off period safeguard for auditors of nonpublic companies.

H3: There is no difference between the perceived effectiveness to merit the allowance to audit in a revolving door practice situation obtained with (1) the current AICPA guidance and requiring the AICPA guidance plus (2) a mandatory peer review safeguard or (3) a mandatory cooling-off period safeguard for auditors of nonpublic companies.”

METHODOLOGY

State board of accountancy members provide responses to the BSD case experiment. Three separate email requests were sent to the potential subjects to encourage participation. Only subjects not responding were sent additional requests. The email provided a short description and link to SurveyMonkey, the platform for delivering the research instrument and the instructions for proper completion.

The BSD experiment presents information on a nonpublic company, Best Valve Company (BVC) and their auditor, Focus CPA (Warrick and Booker 2017). BVC requests a facilities improvement loan based in part on three years of financial statements audited by Focus CPA firm. A potential independence-threatening relationship is depicted between BVC and Focus CPA where BVC hires away a Focus audit manager to be its controller. Specifically, the former Focus employee participated as the engagement manager on one or more of the three audit reports prior to joining BVC. This revolving door practice situation is addressed by Focus taking one of three potential safeguard options to handle the client hiring its ex-employee. Subjects read their randomly assigned case option then answer four questions addressing the confidence they place in Focus’s independence, audit quality, and allowance to audit.

Participants

This study uses state board of accountancy members as representative users of private company audited financial statements. Three hundred sixty-four board members were selected to participate in the study from a listing of the National Association of State Boards of Accountancy.

Sixty-two usable responses were received and considered for analysis (17% response rate). The panel of respondents was informed on public accounting and the regulatory process. Sixty-nine percent of the respondents have three or more years of board experience. Sixty-nine percent of the group also have public accounting experience with 77 percent of these participants having 10 or more years in public accounting. A CPA license is held by 87 percent of the respondents.

Variables and Data Collection

The experiment uses three potential safeguard options as the independent variable to portray the audit firm process for handling a revolving door hire. In the case presentation, the only manipulation given represents the potential safeguard options. The three options are referred to as “AICPA,” “Peer Review,” and “Cooling-off” (Warrick and Booker 2017). The audit firm adhering to the current AICPA rules for nonpublic clients is the first safeguard. Indicating that the firm follows the current AICPA rules combined with a mandatory peer review requirement is the second option. This option is indicative of having the completed audit selected for an external compliance review to monitor for the firm following the AICPA rules. The final safeguard offered indicates the firm follows the current AICPA rules combined with a mandatory one year removal from participation with the client engagement (thus establishing a cooling-off period). This option is intended to reflect the current rule a firm with a public client would need to follow to maintain independence.

Dependent variable data collection occurs on the basis of the AICPA suggestions for independence research considerations (AICPA 1997). The three conditions are evaluated with four questions after the given case scenario. The dependent variable questions are:

- (1) How confident are you that Focus CPA is independent?
- (2) In regard to audit quality, how confident are you the audited financial statements are free from unintentional misstatements?
- (3) In regard to audit quality, how confident are you the audited financial statements are free from intentional misstatements?
- (4) Did Focus have sufficient independence to be allowed to conduct the audit?

Eleven-point Likert-type scales (zero to ten) are used to measure the confidence variables as “not confident” to “confident.” “Yes” or “No” is used as the measure for the allowance variable.

Statistical Methods

The mean ranks across the groups for the dependent variables “confidence in independence” and “audit quality” are compared using the Kruskal-Wallis test. To evaluate for any difference in “audit quality unintentional” versus “audit quality intentional,” the paired samples t-test is used. The chi square test is used to evaluate the dependent variable of “allowance to audit.”

RESULTS

Test results from the experiment are shown in Table 1 (Appendix). Respondents address hypothesis one by dependent variable question one above. Test results reveal a p-value of .723, therefore no statistical difference is associated with the safeguard forms in maintaining independence in appearance. All the safeguard forms offer above moderate confidence as indicated with a mean average of 6.59 or higher for firm independence.

Questions two and three address hypothesis two. The test results for audit quality free of an unintentional misstatement reveal a p-value of .856 and the results for audit quality free of an intentional misstatement reveal a p-value of .685. Both results indicate a statistical nonsignificant difference for confidence in audit quality. All the safeguard forms offer above moderate confidence as indicated with a mean average of 6.91 or higher for audit quality. The means for unintentional and intentional related to each safeguard are further evaluated for a difference. The test results for a difference in mean value for AICPA, Peer Review, and Cooling-off reveal p-values of .229, .334, and .770 respectively. The nonsignificant difference emphasizes, holding all things equal, the revolving door practice appears no more threatening for fraud versus the general technical ability of the audit firm.

Respondents address hypothesis three in dependent variable question four. Test results reveal a p-value of .842, therefore no statistical difference is associated with the safeguard forms for maintaining sufficient independence in appearance to allow the firm to perform the audit. More than three-fourths of the respondents associate sufficient independence being reached with each safeguard form.

The failure to reject any of the hypotheses indicates that the current AICPA requirement is prudent and as effective as other possible increased restrictions for maintaining independence and audit quality when considering subsequent client employment. The results are in alignment with the Warrick and Booker (2017) findings noting that bank loan officers' perceptions indicate no difference in stricter safeguard forms versus the AICPA guidance. These along with Wilson (2017), Geiger et al. (2008), and others indicate that the public company cooling-off requirement may not be necessary for maintaining the perception of independence in the nonpublic environment.

CONCLUSION, LIMITATIONS, AND FUTURE RESEARCH

This study develops additional understanding of nonpublic audit client safeguards for independence and client employment. Through the experiment, state board of accountancy members' rate three varying safeguard options similarly for ability to maintain independence in appearance and audit quality. They also perceive all the safeguards sufficient to allow an audit firm the continued opportunity to conduct the client audit. These results provide guidance to the requests of researchers to have closer monitoring of auditor procedures for better public accountability of the audit process, independence, and the public trust (Bazerman & Moore, 2011; Sikka et al., 2018). Furthermore, the profession can use the results as support for the effectiveness of the current AICPA guidance on the topic.

The study has limitations. With the study only evaluating perceptions of state board of accountancy members, the results may not represent the other varying types of users of audit reports. The study response rate is moderate which may imply nonresponse bias affecting the generalizability of the research. To reduce the possibility of limited responses, multiple attempts to encourage participation were executed. The ability to offer a realistic situation with all desirable facts is limited in an experimental case.

However, care was taken in the development of the research instrument to give realistic facts and circumstances.

Future studies on the topic can include the willingness of CPAs to apply additional safeguards and how to implement those safeguards. There could also be additional studies with other subjects, such as audit clients.

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APPENDIX

Table 1

Summary of state board members' perceptions of independence, audit quality, and decision on allowance to audit.

Groups	Independence ^a	Audit quality (unintentional) ^{a,c}	Audit quality (intentional) ^{a,c}	Percentage allowing audit ^b
AICPA	6.59 (2.86)	7.18 (2.22)	6.91 (2.22)	77.3%
Peer Review	7.40 (1.84)	7.87 (1.12)	7.67 (1.40)	80.0%
Cooling-off	7.36 (2.25)	7.56 (1.73)	7.52 (1.58)	84.0%
Significance of overall differences across groups	p = .723	p = .856	p = .685	P = .842

^a Mean (standard deviation) as measured on a scale of 0 (not confident) to 10 (confident). Results of Kruskal Wallis tests.

^b Percentage of participants that answer "yes" to allow audit versus not allow. Results of the chi square test.

^c Mean comparisons of audit quality for unintentional and intentional misstatement is assessed using the paired samples t test. Statistically nonsignificant differences are obtained for the comparisons (AICPA: p = .229, Peer Review: p = .334, Cooling-off: p = .770).