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Auditor Independence and Audit Risk: A Reconceptualisation

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ABSTRACT

The principles-based UK regulatory framework for auditor independence (ICAEW 2001), adopted in 1997, identifies threats to both to independence in fact and in appearance and the safeguards which control these threats. These principles are incorporated in the IFAC (2001) ethics framework. Drawing on six case studies of interactions involving significant accounting issues between audit engagement partners and finance directors in UK listed companies, we analyse the threats and safeguards to auditor independence in fact which are relevant to the outcome of each interaction. Poor outcomes arise where the safeguards are insufficient defence against the threats. Further examples of existing threats are identified and additional threats emerge, in particular an *urgency* threat, and a *loss of face* threat. Management motivation is found to be a key driver of pressure on an auditor. Threats to independence are found to arise in audit firms and these are not recognised in the current audit risk model. An extended risk model incorporating within-firm risk is suggested.

Keywords: independence; risk; threats; safeguards.

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1. INTRODUCTION

Independent audit of company financial statements is a key component of the regulatory framework which supports capital markets. Concerns are often expressed by regulators and other observers as to whether auditors are sufficiently independent and competent, particularly in the aftermath of corporate failures or material changes to previously approved audited accounts. The restatement of the Enron accounts and the collapse of Andersen following the obstruction of justice finding against the firm (SEC 2002) shows the devastating effect of loss of confidence in the integrity of an audit firm. Despite the lack of knowledge about independence in fact, Enron has severely compromised independence in appearance. Failure by auditors to identify and report on misleading financial information undermines the economic value of audit, which is damaging to all firms in the long run. Concerns have also been expressed about aggressive earnings management practices (Levitt 1998; APB 2001). However the most serious concern for regulators is that audit failures can also undermine the stability of the capital markets if users lose faith in the audit process.

Failure by auditors to detect a material error or misstatement in accounting information can arise from three main causes, two of which may be attributed to audit failure (Hall and Renner 1991). First, auditors may either fail to detect a material error or misstatement, or, having detected an error, fail to recognise it, because they have carried out a substandard audit, i.e. the auditors are incompetent. Second, auditors may identify a material error or misstatement and fail to report it or fail to persuade the directors to put it right, i.e. the auditors lack independence. Third, directors may deliberately deceive auditors. In cases of deliberate deception, auditors may not be held responsible for failure to detect a problem.

A key problem for both regulators and standard setters is that the audit *process* itself is unobservable. Only the participants in the process, i.e. auditors and the company management, know how decisions are reached. Because the process is unobservable , the regulatory framework which sets out requirements both for competence and independence of auditors must not only be effective as a working model for auditors to adhere to, it must also be capable of convincing those who rely on the audit service that they are adequately protected by the framework against auditors who are incompetent or who lack independence. For audit to retain its value to capital markets, the framework must be seen to protect the appearance of integrity in the audit process as well as the fact of it.

The difficulties of gaining access to real-life settings have also made it difficult for independent researchers to access information about competence and independence in fact (Dye 1991). Thus, the only *publicly* available evidence of auditors' actual performance arises from cases where audits have failed. As a consequence, research has concentrated on surveying *perceptions* about audit, i.e. independence in appearance (see, for example Bartlett (1997) in the US and Beattie et al. (1999) in the UK). More recently, researchers in the US have begun to carry out experimental studies that examine the influence on auditors' behaviour of a range of factors. These factors are of four types: individual characteristics, within-firm factors, client company factors and regulatory factors. See, for example, Shafer et al. (1999, 2001), DeZoort and Lord (1997), King (2002), Lord and DeZoort (2001), Thorne and Hardwick (2001) and Trompeter (1994). There are also a few recent studies that seek direct evidence of auditors' behaviour from real-life settings, using a questionnaire approach. The focus of these studies is auditor-client interactions generally, in particular the process of negotiation and the factors that influence the outcome (see Gibbins et al. (1999) and Nelson et al. (2002) in the US, and Beattie et al. (2000) in the UK).

The recent book *Behind Closed Doors: What Company Audit is really About* (Beattie, Fearnley and Brandt, 2001) exceptionally uses a detailed case study approach to analyse six real cases covering 22 audit interactions between finance directors (FDs) and audit engagement partners (AEPs). The overall objective of the study was to develop a grounded theory to explain what key factors influence the decision-making process when an auditor is confronted with difficult and contentious accounting issues. The cases were identified from the previous questionnaire study (Beattie et al., 2000) in which respondents were asked whether they were willing to be interviewed. Six FDs who indicated high levels of negotiation and discussion agreed to be interviewed and gave permission for their audit engagement partner to be interviewed, with the consent of the audit firm. The less litigious environment in the UK, compared to the US, makes research of this nature still possible.

The cornerstone of the process by which auditors decide on the scope of their work has been an internationally recognised risk model, which is incorporated into auditing standards e.g. in the UK in SAS 300 (APB 1995). This model enables the auditor to determine the scope of audit testing for error or misstatement in each client company by assessing the risk of error or misstatement arising in that company. In recent years, doubts have been expressed as to whether some of the current approaches to audit risk assessment adopted by large firms are fully compatible with the generally accepted risk model (Lemon et al. 2000). The International Auditing and Assurance Standards Board is revising its approach to audit risk and has recently issued exposure drafts on audit risk (IFAC 2002).

Concerns about the risk model have been paralleled by recent concerns about auditor independence, which started to emerge from the SEC (Levitt 1998) before the Enron and Worldcom scandals broke. The SEC revised its independence rules in November 2000 (SEC 2000). New independence frameworks have recently been issued by the European Commission (EC 2001) and the International Federation of Accountants (IFAC 2001). In the US, the Sarbanes-Oxley Act, passed in 2002 following the Worldcom scandal, has (amongst other provisions) introduced a new framework for oversight of listed company auditors in the form of the Public Company Accounting Oversight Board (PCAOB). The PCAOB will take responsibility for ethical standards to be used by accounting firms registered with it. In the UK, following a post-Enron government inquiry, responsibility for the setting of standards for auditor independence has been transferred to the Auditing Practices Board which is independent of the profession (Department of Trade and Industry 2003). There are also concerns about aggressive earnings management and the auditors' ability to prevent it (APB 2001) and there is a growing academic literature in relation to the identification and control of earnings management and the quality of financial reporting generally. These issues have arisen at a time when the drive towards global markets is encouraging regulators to seek convergence of accounting and auditing practices worldwide. The International Accounting Standards Board (IASB) is seeking wider adoption of its standards and the EU has issued a regulation requiring all companies listed in the EU to prepare their consolidated accounts under International Accounting Standards for financial years beginning on or after 1 January 2005 (EU 2002). The European Commission is also liaising with other governments in Europe in developing plans to adopt International Standards of Auditing from the same date (Co-ordinating Group on Auditing and Accounting Issues 2002).

Behind Closed Doors: What Company Audit is Really About (hereafter BCD) provides an analysis of six company case studies which show how accounting issues which arise during the audit process are resolved between audit engagement partners (AEPs) and finance directors (FDs). From these cases, audit quality is shown to be an holistic activity in which issues of competence, independence in fact and audit risk are inextricably linked. In this paper, we specifically explore risk and independence. Under current frameworks, independence and risk are regarded as separate issues. In UK standards, auditor independence is not factored into the audit risk model but appears in the profession’s ethical guide. More recently, the independence frameworks issued by the EC (2001), elements of which have been adopted in the UK, and IFAC (2001) do not refer to the audit risk model.

We argue that the regulatory framework should reflect the fact that risk and independence are linked. In this paper, we draw on the findings in BCD and we both reconceptualise the audit risk model and re-examine the threats and safeguards in the UK and IFAC independence frameworks. In reconsidering the relationship between independence in fact and audit risk we are able to identify more clearly where the key audit risks and threats to independence really lie. We also consider how independence in appearance fits into the framework. The paper can be seen as responding to calls by the Public Oversight Board’s Panel on Audit Effectiveness to ‘enhance’ the audit model (POB 2000).

The remainder of this paper is structured as follows. Part two is a review of relevant literature, both academic and professional. In part three we review the UK and IFAC independence frameworks. In part four, the main part of the paper, we analyse and discuss the interactions identified in BCD we consider the interactions identified in BCD in relation to the provisions of the UK and IFAC independence frameworks. In part five we consider the implications of this analysis for the audit risk model. Part six presents the conclusions.

2. LITERATURE REVIEW

Audit risk and auditor independence

The established audit risk model in SAS 300 identifies the overall audit risk. This is defined as the auditor giving 'an *inappropriate audit opinion on financial statements'* (APB 1995)**.** This risk has three key components: inherent risk, control risk and detection risk. Inherent risk is defined as *'the susceptibility of an account balance or a class of transactions to material misstatement, either individually or when aggregated with misstatements in other balances or classes irrespective of related internal controls'*. Control risk is defined as *'the risk that a misstatement could occur that would not be prevented or detected and corrected on a timely basis by the accounting and internal control system'*. Detection risk is defined as *'the risk that the auditors' substantive procedures do not detect a misstatement that could be material'*. Inherent and control risk are risks which lie within the company itself. Detection risk lies with the auditors. The extent of substantive testing carried out by an auditor is a function of the assessment of the level of inherent and control risk within the company. A diagram of this risk model is shown in Figure 1.

Figure 1 about here

Some audit firms have refocused the way they assess risk and this has led to questioning as to whether the risk model as set out in the standards still holds. Lemon et al. (2000) review audit methodologies in large firms. They identify that some large firms are adopting what is called a *business risk* approach which replaces the combination of inherent risk and control risk. Business risk is defined as: *'the risk that the audited entity will fail to achieve its objectives'*. Business risk is therefore more closely aligned to the objectives of the business than those of financial statement audit. The audit process then narrows down the business risk assessment to focus on risks of material misstatement in the financial statements. This approach is seen as adding value to audit as it is may help management to improve business performance and manage their own risks (Eilifsen et al. 2002) but it does not change the overall audit risk.

Jeppeson (1998) suggests that one effect of the big firms making efforts to differentiate themselves and add value to audit by adopting the business risk assessment process is that they become more closely identified with the objectives of management, and they consequently risk compromising their independence. However some counter balance may be provided as, by using this approach, the auditor acquires a better knowledge and understanding of the business. Power (2000) continues this argument by suggesting that much greater responsibility for compliance is being forced onto the company through regulatory initiatives, particularly the developments in corporate governance requirements and risk management. If the role of the auditor becomes one of involvement in the design of compliance systems within the company, then independence from the company may become more difficult to achieve. This issue emerges as one of the factors for which Andersen were criticised in the Waste Management case (SEC 2001).

Over many years, practitioners and academics have struggled to find definitions for independence in the audit context. Perhaps the best known definition in the academic literature is that of De Angelo (1981, 186*) 'the conditional probability of reporting a discovered breach'*. Others include: *'the ability to resist client pressure'* (Knapp 1985); *'an attitude/state of mind'* (Schuetze 1994*)*; *'a function of character with the integrity and trustworthiness being key'* (Magill and Previts 1991). More recent definitions contained in pronouncements from various representative bodies of the profession world-wide extend the definition of a state of mind, for example, *'freedom from those pressures and other factors that compromise, or can reasonably be expected to compromise, an auditors' ability to make unbiased audit decisions'* (Independence Standards Board (ISB) 2000).

The UK's guide to professional ethics (ICAEW 2001, effective from 1 January 1997[1]) refers to integrity, objectivity and independence. No definition is offered of integrity and independence but objectivity is defined as 'the *state of mind which has regard to all considerations relevant to the task in hand but no other. It is sometimes described as* *"independence of mind"'*. Citron (2003) suggests that the UK framework does not focus sufficiently on third party perceptions of independence and ultimately promotes the profession's own view of auditor independence.

Interestingly, the IFAC definitions are more comprehensive. Independence of mind is defined as: *'the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism'*. Independence in appearance is defined by IFAC as: *'the avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, would reasonably conclude that a firm's, or a member of the assurance team's integrity, objectivity or professional skepticism had been compromised'.*

None of the statements defines integrity. EC (2001) claims *'integrity cannot be evaluated in advance'*. Some experimental researchers have studied the concept of 'integrity' by considering auditors' moral development. This research draws upon moral psychology to investigate the cognitive process underlying ethical reasoning and judgement formation. Ponemon and Gabhart (1990) use Kohlberg's stage model of moral development and ethical cognition to examine an auditor's implicit reasoning in the resolution of an independence conflict. This well-validated model distinguishes three levels of ethical cognition:

- *pre-conventional* – where the individual places self-interest well above the common interests of society and is sensitive to penalty attributes;
- *conventional* – where the individual conforms to the rules of society and is sensitive to affiliation attributes; and
- *post-conventional* – where the individual forms a judgement conforming to ethical principles and not to society's rules.

The findings of an experimental study using 119 audit partners and managers show that a systematic relationship between auditors' measured ethical cognition and hypothetical and audit conflict scenarios and their resolution of an independence conflict exists. (This in later confirmed in a study by Sweeney and Roberts (1997)). They also found that independence judgements are significantly influenced by factors relating to penalty and are less sensitive to affiliation factors (i.e. living up to what is expected by people).

Windsor and Ashkanasy (1995) extend Ponemon and Gabhart's (1990) study by including economic and personal belief variables, in particular client management bargaining power and belief in a just world, in addition to the level of moral reasoning development. Three styles of auditor decision-making emerged:

- *autonomous* – auditors who were responsive to personal beliefs and were more likely to resist client management power;
- *accommodating* – auditors who responded to both personal beliefs and client management power and who were least resistant to client management pressure; and
- *pragmatic* – auditors who were responsive to client management power, irrespective of beliefs.

These three styles correspond to individuals with high, mid, and low levels of moral reasoning, respectively.

The contingent influence of organisational culture, i.e., the moral atmosphere of the audit firm, is also being explored by researchers, although no clear results have yet emerged (Ashkanasy and Windsor, 1997; Sweeney and Roberts, 1997).

Ponemon and Gabhart (1990) also find a systematic relationship between ethical cognition and auditors' priority rankings of factors influencing auditor independence. In particular, subjects at the preconventional level of ethical cognition ranked freedom from pressure to retain client and existence of legal liability significantly higher than subjects at the conventional level. Falk et al. (1999) find, in an experiment carried out with students, that the biggest threat to independent behaviour is the risk of losing a client. This is consistent with Beattie et al. (1999) who find, from a questionnaire survey of UK AEPs and FDs, that the two most frequently cited factors which are perceived to undermine auditors' independence are: *'partner's income depends on the retention of a specific client'* and '*10% or more of the firm's total revenues come from one client'*. The two most frequently cited factors which are believed to enhance independence are: *'the existence of an audit committee composed of non-executive directors, the majority of whom are independent'* and '*big-six firm'*. (This survey was carried out before the Price Waterhouse/Coopers and Lybrand merger, and the Andersen collapse.) The implications for independence of there now being only four major firms are not yet fully understood.

ISB (2000) develops an independence risk continuum which relates the assessed level of independence risk with the possibility of compromised activity i.e. lack of independence in fact. The concept of varying degrees of independence risk is developed further by Johnstone et al. (2001). They argue that independence risk is a function of antecedent environmental conditions derived from direct and indirect incentives in judgment based decisions. Direct incentives are seen as direct financial interests including economic dependence. Indirect incentives are seen as interpersonal relationships and auditing one's own. Mitigating factors are seen as corporate governance, regulatory oversight, firm culture and individual auditor characteristics. These are very close to the definitions in IFAC (2001).

Earnings Management

Pressures on management to engage in aggressive earnings management in order to improve results can intensify the pressure on auditors. The APB (2001) is concerned that fraudulent reporting can result where earnings expectations cannot be delivered. The APB asks whether UK Auditing Standards should explicitly require auditors to identify pressures on management to deliver results, and to plan how to respond. In one of the very few studies which questions auditors' about their actual behaviour, Nelson et al. (2000) survey US audit partners, and find that auditors are able to prevent earnings management attempts (EMAs) in many cases. In certain circumstances, however, they may waive EMAs. These circumstances are where EMAs: decrease current period income; are governed by imprecise standards or are structured around precise standards (i.e. demonstrate creative compliance as described by McBarnet and Whelan (1991); are viewed as immaterial; or, are attempted by large clients. Although not specifically seeking evidence of earnings management, Beattie et al. (2000) find evidence, by surveying AEPs and FDs, of the frequency and subject matter of discussions and negotiations between both parties and many of the issues identified impact on reported earnings. While they find evidence that the auditor does influence financial reporting outcomes, the degree of independence exerted cannot be evaluated.

3. THREATS AND SAFEGUARDS IDENTIFIED BY THE UK AND IFAC FRAMEWORKS

The UK framework identifies threats and safeguards to objectivity. Subsequent frameworks issued by the EC (2001) and IFAC (2001) take a similar approach on threats and safeguards but make more specific reference to the distinction between independence in fact and independence in appearance, thus explicitly recognising the importance of independence in appearance. UK, EC and IFAC frameworks identify five main threats to independence or objectivity. These are described below (ICAEW 2001):

a. *Self-interest threat:* arises from a financial or other self-interest conflict e.g. from a direct or indirect interest in a client or from fear of losing a client.
b. *Self-review threat:* arises from the apparent difficulty of maintaining objectivity and conducting what is effectively a self-review, if any product or judgment of a previous audit assignment or non-audit assignment needs to be challenged or evaluated in reaching audit conclusions.
c. *Advocacy threat:* arises from the apparent threat to objectivity if the auditor becomes an advocate for a client's position in any adversarial proceedings or situations. This may appear to be incompatible with objectivity.
d. *Familiarity or trust threat:* arises from the risk that the auditor may become over-influenced by the personalities and qualities of the directors and management and become too sympathetic to their interests. Alternatively the auditor may become too trusting of management representations so as to be inadequately rigorous in testing them.
e. *Intimidation threat:* arises from the possibility that the auditor may become intimidated by threat, by dominating personality, or by other pressures, actual or feared, by a director or manager or by some other party.

The UK framework identifies safeguards against independence threats which the IFAC framework expands and classifies as: those created by the profession (the practice environment); those created by legislation or regulation (regulatory safeguards and sanctions); and those involving third parties (client's audit committees, regulatory bodies or another firm). A fourth, ultimate, safeguard is the right to refuse to act. Table 1 lists the safeguards as shown in both frameworks. (They are matched against each other only in terms of generic source.) It may be observed that the UK framework refers at length to personal qualities and risks to individuals. IFAC goes into much more detail about the nature of safeguards within audit firms, describing firm-wide safeguards and engagement-specific safeguards. IFAC also describes safeguards within the audit client particularly focussing on audit committees and corporate governance whereas the UK framework makes little reference to this.

Table 1 about here

Although the appearance and fact of independence are distinguished in the definitions, importantly, the threats and safeguards do not indicate whether the fact or the appearance of independence is being addressed. Table 2 sets out the detailed threats and safeguards in the UK framework and highlights key additions made to these in the IFAC proposals. We classify safeguards as either 'regulatory prohibitions' or 'other safeguards'. IFAC sets out in detail the practice environment safeguards as identified in Table 1 so these have not been repeated in full in Table 2. They are referred to as 'practice environment safeguards'. The additional IFAC proposals are shown in bold italics.

Table 2 about here

From Table 2 it may be observed that the self-interest threat provides the largest number of detailed threats and prohibitions. One fundamental threat is not addressed - the underlying fear of losing the client. It may also be observed that intimidation is the threat which has the least prohibitions and other safeguards attached to it. We argue that threats which are subject to prohibitions are no longer threats either to independence in appearance or independence in fact. It is the threats which are not subject to prohibitions where the risks lie. These are: fear of losing the client; non-audit services; low fees; supporting the clients' interests; former partner working for the client; and intimidation.

4. ANALYSIS OF THE INTERACTIONS IN BCD

What BCD is about

In BCD, Beattie et al. (2001) analyse six case studies which cover 22 financial reporting outcomes agreed between the AEP and the FD using grounded theory methods. Six FDs of UK listed companies who indicated high levels of negotiation and discussion with their auditors in a questionnaire were approached for interview and all agreed to participate. An effort was made to select companies representing a range of company sizes, industry sectors and audit firms (Eisenhardt 1989).[2] FDs were asked to 'tell the story', from their perspective, of the discussions and negotiations with their auditors referred to in their questionnaire responses, and encouraged to raise any other issues they wanted to (Thompson 1988). The interviewer employed both neutral, conversational prompts and a laddering technique. This technique requires that the interviewer keeps asking 'why?', working backwards to antecedent conditions and forwards to anticipated effects (Brown 1992, 293). Where necessary, subsidiary prompts used were used. At the close of each interview, we asked the FD for permission to interview the audit partner with whom the discussions and negotiations had taken place. (Without the client's permission, no AEP would talk to us because of professional confidentiality rules.) All the FDs interviewed gave their consent. We asked the interviewee to effect an introduction to the AEP, before contacting the AEP direct and conducting a similar interview with them. (Further details about the interview approach used can be found in Beattie et al. 2001, 48-50.)

The outcomes are found to be influenced by a complex, interacting set of contextual factors, such as the level of integrity of the AEP, the quality of the primary relationship between the FD and the AEP, the company type and situation, the effectiveness of corporate governance, the clarity of accounting rules on the issue, and the level of audit firm support and quality control. Although many of these factors have been identified and studied separately in previous research, they have not previously been addressed as embedded within the real-life process of interaction between FDs and AEPs which ultimately leads to the production of a company's annual report and accounts. Conclusions are drawn from the empirical evidence in the case studies about how the incentives and behaviour of both directors and auditors influence the outcome of interactions. The key factor in judging an outcome is whether it fully complies with the regulatory framework or falls short, either through non-compliance or creative compliance.

From the company perspective, much is found to depend on the clarity of standards and on management's attitude to earnings quality. Management may be motivated to manage earnings by specific pressures, such as debt covenants, declining performance or the threat of a takeover.[3] Companies with a status and reputation to protect may be more cautious about engaging in aggressive accounting but may still do so if the motivation is sufficiently strong. It is found that compliance with corporate governance requirements does not necessarily guarantee good financial reporting outcomes. Ownership structure and the existence of a dominant chief executive can outweigh such safeguards.

From the audit firm's perspective, much can similarly depend on the clarity of standards, the materiality of the issue involved, and the sanctions available to the auditor and the company. The main sanction for the auditor is a qualified audit report or withdrawal from the assignment, and for the company, replacement of the auditor.

Three key factors from within the audit firm emerge as having significant influence on the quality of outcomes to interactions. The first factor is the personality of the individual partner (or *partner type*). Four partner types are identified from the cases and two more are hypothesised to exist. Those identified are: crusaders, safe pairs of hands, trusters and accommodators. Those hypothesised to exist are incompetents and rogues. The underlying driver of behaviour for an AEP is found to be the individual level of professional integrity. The second factor is the effectiveness of quality control procedures, broadly defined, within the audit firm. These procedures include recruitment, partner selection, technical support, back-up, training, evaluation and reward procedures, hot review and, critically, the matching of partner types to clients. The unhappy consequences of allocating an inexperienced partner to a company with a dominant chief executive who has a controlling interest in the company are amply shown by the evidence in BCD. The third factor is the quality of the primary relationship, i.e. the relationship between the FD and the AEP. A good primary relationship where both parties have high ethical standards is found to have a positive influence on quality of outcomes.

How the interactions in BCD relate to the IFAC and UK independence frameworks

The analysis in BCD focuses on the key influences emanating from within the company, within the audit firm and the primary relationship which affect the outcome of each interaction. BCD therefore provides a comprehensive analysis of the influences which affect the quality of each outcome analysed. In this paper, we shift perspective and analyse the independence dimensions associated with each outcome. It is worth emphasising that, as all these outcomes are factual events, the analysis relates to issues associated with independence in fact, not independence in appearance, and only concerns influences which are not subject to the absolute prohibitions set out in Table 2. The overall independence threats and safeguards in the IFAC independence framework (the safeguards are set out on the right hand column of Table 1) provide the analytical framework within which the interactions are examined. The IFAC framework for safeguards is used rather than the UK framework as it is more recent and is likely to be more widely applied. The threats are the same in both UK and IFAC frameworks. The interactions analysed are given the same identities as in BCD and are in respect of the six companies: NS plc, TJ plc, MP plc, CRA plc, RC plc and DA plc.

Table 3 summarises the 22 financial reporting interactions indicating the subject of the negotiation and the relevant threats and available safeguards as identified in the IFAC framework. The final two columns evaluate the effectiveness of the safeguard and report the final outcome of the interaction. Where an interaction involves a threat which is not specifically identified in the IFAC framework, this is shown in bold and underlined under the heading ‘nature of threat’. (For more details regarding the interaction issues and the negotiation process see BCD). The wider regulatory safeguards contained in the UK framework are not included in Table 3, since they apply to every outcome. They could, however, have a significant influence on behaviour. These safeguards include the UK’s system of monitoring the work of audit firms, disciplinary action by the profession, and enforcement role of the Financial Reporting Review Panel (FRRP) which publicises cases where directors were required by the FRRP to correct defects in their accounts.

Table 3 about here

A number of interesting issues emerge from this analysis concerned with the threats, safeguards and quality of outcomes.

Intimidation emerges as the most frequent threat. It appears to have two clear dimensions. The first (and potentially the most serious) is where intimidation is accompanied by the underlying threat from management of removal of the auditor (NS3, MP2). This leads to the self-interest threat where the auditor may perceive damage to himself personally (Beattie et al. 1999) through loss of income and status, as well as economic damage to the firm. The second dimension is bullying, where directors may attempt to overcome the auditor's objections by employing aggressive behaviour without any underlying threat of removal from office (TJ2, TJ3). Intimidation with self-interest can also arise from within a firm where other partners may not support the stance a partner takes for fear of losing a client to the firm (MP2). Fee reductions can be obtained either by bullying, intimidation or both (NS3, TJ3).

The principal safeguard against bullying, which is not clearly articulated in the framework, is linked to the personal characteristics of the AEP and his ability to stand up to this form of intimidation (MP2). A further safeguard is the audit firm's partner selection procedures which should ensure that only robust individuals become audit partners. The safeguard against intimidation accompanied by threats of removal lies within the firm's quality control procedures and is a self-interest threat both to the firm and the individual partner. A further safeguard may come from within the corporate governance of the company (DA5), but corporate governance per se cannot be assumed to be a safeguard. A poor corporate governance structure, for example a dominant chief executive, or an aggressive management incentive scheme, can *increase* rather than diminish the threat to independence.

The *motivations* for intimidation are not addressed in the IFAC framework. APB (2001) identifies various motivations for directors wanting to report certain results, but a further motivation emerges from this analysis which is *face saving.* Directors may intimidate auditors to avoid disclosing or reporting events that show them to have made poor business decisions (MP1a, RC2).

While the examples given of threats in the IFAC framework are not intended to be comprehensive, they do not include some of the threats that arise in BCD. Three further examples of the *self-review* threat emerge from the analysis which we suggest should be included in the framework. First, an AEP gives wrong advice himself and then has to change position (TJ3). Second, the auditor overlooks a technical point and it is picked up by a technical review within the firm (DA4). (The safeguard against these two events is technical competence, both from the AEP personally and from within the firm.) Third, an AEP disagrees with an interpretation provided by a previous auditor (MP1). The safeguard against this lies in the regulatory framework, and within the firm's own ability to convince the client of the need for change.

Another serious threat to independence, which is not addressed by IFAC (2001), emerges from the *self-review* threat, but is not necessarily a precursor to it. This is the *urgency* threat. This can arise when issues emerge at a late stage, either as a result of audit procedures or from events within the company. Auditors find themselves under greater pressure and subject to intimidation to reach agreement rapidly on an issue when the reporting date approaches (DA4, TJ3). The safeguard against this lies within the quality control procedures of the firm and the ability of the individual partner to resist pressure.

Other less obvious examples of the *familiarity* threat also appear. Reference is made in IFAC (2001) to the situation where a partner in a firm moves to a client. The risks inherent in this situation emerge throughout TJ plc, but a more interesting example appears in RC plc where the FD had been senior to the AEP when they both worked for the same firm. Any previous relationship between an FD and an AEP clearly has the potential to influence the interactions between them and must be considered a familiarity threat. It is interesting that in both Waste Management case (SEC 2001) and at Enron, a significant number of senior staff within the company were formerly employed by the auditors. IFAC recognises this problem as an intimidation threat. Interestingly, the EC framework, which has recently been adopted as best practice in the UK, disbars an engagement partner from joining a client within two years of leaving the audit firm.

There are no examples in our cases of the *advocacy* threat.

Discussion of findings

Where the outcome of an interaction is fully compliant with the regulatory framework, the audit firm may be perceived to have achieved independence in respect of that specific interaction. Most of the interactions in our analysis show fully compliant outcomes and in these cases where auditors came under pressure from management, the safeguards in place have been sufficient to neutralise the threats.

We identify three types of unsatisfactory outcome: first, an accounting treatment with which the AEP did not concur but which was not a breach of UK GAAP (CRA3, CRA5); second, creative compliance with which the AEP concurred (TJ2, TJ3); and third, a clearly identified breach of the framework (TJ1, RC2) with which the AEP concurred. In CRA3 and CRA5, the outcomes were not as the auditor wished. Although he and his firm behaved independently, he had no support from the regulatory framework or from safeguards within the company to enforce his wishes. The option of a qualified audit report was not considered feasible because the issues were not a regulatory breach and were not material to the overall accounts.

In TJ2 and TJ3 the partner encouraged the company to engage in creative compliance. Also in TJ plc there was an outright breach of the framework in the overvaluation of stock (TJ1). In this case, the partner lacked independence as he knowingly permitted poor quality accounting. However in the TJ plc interactions, there are more threats to independence in each interaction than in any of the other cases, and the safeguards are much weaker. The safeguards within the company provide no support for the auditor and the firm's own procedures are not effective. Added to this there is an inexperienced, newly appointed partner.

In the other case where there is a breach (RC2) the company is large and fairly conservative. The partner's lack of independence in this case is more difficult to explain. It may be linked to the findings of Nelson et al. (2000) that auditors are more inclined to waive earnings management in larger companies where there may be less overall risk. BCD classifies this partner as a truster because he believes that the client is safe. Interestingly, the familiarity threat only arises in the two cases where the partners lack independence. One is classified as a truster and the other as an accommodator. The more robust partners are not likely to be influenced by such relationships.

Although all the outcomes in TJ plc are poor, as the partner gave way to intimidation, only one outcome in RC plc is poor. The others fully comply with the regulatory framework. The poor outcome was not visible from the published accounts. This partner would not allow the client to get away with observable non-compliance which could be picked up from the published accounts by the Financial Reporting Review Panel, which investigates visible cases of non-compliance in companies. He was, however, prepared to condone non-compliance which was not visible.

Another factor which emerges strongly is the varying degrees of pressure put on AEPs by management according to management's motivation. This is particularly evident in NS3, TJ3 and MP2. In NS3 and TJ3 the matter was important to the chairman, and in MP3 it was important to a senior director. In CRA5 the auditor was not under pressure because management simply refused to co-operate, knowing the matter was not material overall. In any one audit outcomes may vary, and it may be much more difficult to achieve a good outcome depending on the pressures put on the AEP by management. It is therefore critical for auditors to understand fully management motivation in relation to each specific issue, as well as taking an overall view of the risk profile of the client.

5. IMPLICATIONS OF FINDINGS

Revisiting the frameworks

We identify no examples of the advocacy threat in our case studies, as instances of advocacy do not arise from the interactions. The cases deal with the fact, not the appearance, of independence and how lack of independence in fact can lead to poor financial reporting outcomes.

Threats to the integrity of the audit *process* arise from auditors allowing clients to get away with poor financial reporting outcomes, i.e. lack of independence in fact. Unfortunately, these threats to independence in fact are muddled up in the framework with the problems of independence in appearance, particularly with regard to three key threats, self-interest, familiarity and self-review. Most independence frameworks (including the UK and IFAC) already disbar the obvious conflicts of interest which would undermine the *appearance* of independence and which could also, but not necessarily, undermine independence in fact if the safeguards were not adequately applied. These are: direct financial interest in a client (self-interest threat); a close friend or relative being involved in the management of a client (familiarity threat); and, involvement in the management of a client (self-review threat). Where an audit partner and a firm operated at the highest levels of integrity, even these threats need not undermine independence in fact, although the appearance would be unacceptable.

Two threats, intimidation and familiarity, which are already identified in the framework emerge from our analysis as key threats to good outcomes. Intimidation encompasses bullying, the threat of dismissal or both. The threat of dismissal is the fundamental self-interest threat for an auditor as it leads to economic loss and loss of face for the firm and very probably for the partner as well. The existence of a former relationship between the FD and the AEP in which the FD was dominant emerges as a key feature of the familiarity threat and this can also lead to intimidation.

Other issues emerge from our analysis which are not explicitly identified in the framework but which we believe need to be recognised. First, it is fundamental that the motivation of management is understood by the auditor in respect of specific issues as this can drive the intensity of intimidation threats. Second, urgency and face saving are not recognised as threats and the evidence indicates them to be significant. Third, the adequacy of a firm's own procedures is critical to the quality of outcomes, as are the personal attributes and level of moral reasoning of the individual partners. Fourth, poor quality or aggressive management also represents a threat. Fifth, the adequacy of the regulatory framework is also a key influence.

The IFAC framework assumes reliance on the audit firm and the company's corporate governance as factors which represent safeguards to independence. These factors, and the moral development and personal qualities of the individual partners can also be threats and need to be recognised as such. A particular concern for any audit firm must be the risk that a partner will put his own interests before those of the firm or that, as in the case of MP2, not all partners will support the stand taken by a partner where it could lead to the loss of a major client. A further risk for a firm is that an inappropriate partner is allocated to a client. TJ plc is an example of risks of this type where a newly promoted partner was allocated to a client where the CEO/chairman was known to be a bully and also had a controlling interest in the company.

We argue that obvious conflicts of interest, which are already the subject of prohibitions, should be clearly distinguished in the frameworks from threats which are not the subject of prohibitions and have to be managed. Being already prohibited the former class of threat cannot undermine independence in fact. The threats which remain relate to self-interest, intimidation and to a limited extent, familiarity. The self-interest threats are the risk of losing the client, low fees, the provision of other non-prohibited services and identifying too closely with the client. The intimidation threats are bullying by the client and the problems of former partners or senior staff from the firm being employed by the client. All these threats have to be addressed from within the firm's own procedures, subject obviously to regulatory requirements and external oversight.

Our findings indicate that the frameworks do not explicitly set out how fundamental threats to independence in fact should be managed. A further key problem which is not explicitly addressed in the framework is that of partner selection, i.e. ensuring that partners have the personal attributes to be able to stand up to difficult clients, given appropriate support within the firm.

Revisiting the risk model

On the basis that obvious conflicts of interest should be addressed before a client is taken on by a firm, our thesis, based on the analysis presented in this paper, is that independence in fact and independence in appearance should be conceptually de-coupled and that independence in fact should be factored into the audit risk model. Audit risk is defined as the risk that the firm will give an inappropriate opinion, and the risk model underpins the concept of audit quality. But the model stops at detection risk, i.e the point at which the firm identifies a problem. Identifying a problem does not mean that an appropriate opinion will be given. If the firm or partner lacks independence in fact for whatever reason, they may not deal properly with issues which emerge during the audit and an inappropriate opinion may be given. As well as arising in the BCD examples, this problem is also apparent in the Waste Management case (SEC 2001). A further issue for the risk model emerges to a limited extent in TJ3 where wrong advice was given. We suggest that poor quality technical advice, given in a current year, also increases independence risk because it may generate late adjustments and the subsequent urgency increases intimidation. We believe that the risk model should be extended to add the additional risk of the firm failing to deal properly with issues which emerged. The failure to recognise the significance of issues which have been detected during the audit is a competence risk, which does not emerge from this study but which is referred to by Hall and Renner (1991). Without these risks the model does not properly address the risk of the auditor giving a wrong opinion.

In addition to the inclusion of independence and competence risk into the risk model, we also suggest that the model should be divided explicitly into the risks which arise from the client and the risks that arise from the firm in order to reflect the way in which the independence framework recognises the safeguards. In terms of the client based risk this should include *motivation* risk as this is key to the understanding of directors' behaviour. We also break down the risk to specific periods and transactions to recognise that the auditor may be subject to more pressure in specific accounting periods, and in relation to specific transactions depending on management motivation. Our revised risk model is shown as Figure 2.

Figure 2 about here

6. CONCLUSIONS

Based on six case studies of interactions between AEPs and FDs published in BCD (2001) we analyse 22 interactions to identify the threats and safeguards to auditor independence in fact which are relevant to each outcome. Poor outcomes are found to arise where the safeguards are insufficient defence against the threats. Additional threats to those specified by IFAC (2001) emerge from the cases, particularly urgency, and face saving and other important examples are found of familiarity threats and self-review threats. Management motivation is found to be a key driver of pressure on an auditor, and intimidation is found to be the most frequent threat. Yet intimidation receives the least attention in the independence frameworks. The frameworks do not recognise that threats can arise from within the audit firm and that corporate governance is not necessarily a safeguard. Threats which arise from within the audit firms are not recognised in the current audit risk model. An extended risk model model is therefore suggested which recognises the totality of audit risk since the current model only extends to the detection of issues and not their satisfactory resolution, nor does it include management motivation.

It is also suggested that the conflicts of interest and other threats to independence which are the subject of prohibitions should be treated separately in the framework, so that the management of key threats and safeguards which undermine independence in fact, (i.e provision of other services, fees, the risk of losing the client, intimidation and bullying, and former senior staff in the audit firm holding senior positions within a client) are more rigorously addressed.

ENDNOTES

[1] The UK's framework was developed in 1996 by the Chartered Accountants Joint Ethics Committee (CAJEC) and was subsequently incorporated into the ethical frameworks of the UK Institutes of Chartered Accountants.

[2] In analysis of this type, the recommended optimum number of cases is four to ten (Eisenhardt 1989).

[3] These pressures were acknowledged by the interviewees in the case studies. Others widely recognised to exist include management evaluation and compensation.

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Table 1: Overall safeguards per UK and IFAC frameworks

Overall safeguards per UK framework	Overall safeguards per IFAC Framework
1. Safeguards within the practice environment: a. Training encourages integrity and objectivity. b. Audit Engagement Partners (AEPs) should have sufficient regard for their careers and reputations to be encouraged towards objectivity and use of safeguards. c. Strong peer pressure within audit firms (AFs) and mutual reliance on integrity for partners to protect their personal reputation and avoid litigation. d. AFs should protect their reputation and not allow members of firm to risk it for short term benefit. e. Firms should have internal procedures and controls over the work of individual principals (see note 1). f. Difficult judgments should be reinforced by consultation (see note 1). g. Internal procedures could include: adequate training and encouragement to share concerns; involvement of additional principal; rotation of AEPs and staff; evaluation of clients before acceptance; review of all re-appointments; overall control environment- ethical training, staff appraisal, well maintained internal control system (see note 1). h. Additional review and rotation needed where additional safeguards deemed necessary.	**1. Safeguards within the practice environment:** *Firm-wide safeguards* a. Firm leadership that stresses importance of independence and acting in the public interest. b. Policies and procedures to monitor and implement quality control. c. Documented independence policies; identifying and evaluating threats and safeguards. d. Internal policies and procedures to monitor independence and quality control. e. Internal policies and procedures which enable identification of interests or relationships. f. Policies and procedures to prohibit individuals not part of audit team from influencing audit. g. Timely communication of policies and procedures and regular training. h. Means of advising professional staff of clients from which they must be independent. i. Policies enabling staff to communicate concerns about independence. *Engagement-specific safeguards* a. Involving an additional professional accountant unconnected with the assignment to review work done, from inside or outside the firm. b. Consulting a third party, such as a committee of independent directors, a regulatory body or another professional accountant. c. Rotation of senior personnel. d. Discussing independence with the audit committee or others charged with governance. e. Disclosing to the audit committee, or others charged with governance, the nature of services and the extent of fees. f. Policies and procedures to monitor, and possibly restrict, revenue from a single client. g. Policies and procedures to ensure members of audit team do not take management decisions. h. Removing staff from the audit team where relationships or financial interests threaten.
2.**Regulatory safeguards and sanctions** a. Profession's ethical code. b. Disciplinary procedures. c. State delegated monitoring procedures (see note).	**2. Regulatory safeguards and sanctions** a. Education, training and experience requirements for entry. b. Continuing education requirements. c. Professional standards, monitoring and disciplinary processes. d. External review of quality control system. e. Legislation governing independence requirements

Table 1: Overall safeguards per UK and IFAC frameworks

3. Involvement of a third party such as a client's audit committee, a regulatory body or another firm.	**3. Involvement of a third party such as a client's audit committee, a regulatory body or another firm.** a. When management appoints AF, persons other than management ratify or approve the appointment. b. Auditee employs sufficient high quality staff so that AF not requested to make managerial decisions. c. Internal procedures ensuring objective choice in commissioning non-audit engagements. d. Corporate governance structure, such as audit committee, provides oversight and communications regarding AF's services. e. Regular communication between AF and audit committee regarding relationships which might bear on independence. f. AFs to establish policies and procedures relating to independence communications with the audit committee and communicate in writing at least once a year. Matters to be decided by the firm.
4. Refusal to act where no other course available. The perception of the public that auditors' objectivity may be threatened is not of itself a reason to refuse appointment.	**4. Refusal to act where no other course available.**

Note 1:The requirements for monitoring independence, consulting on difficult issues and compliance reviews are a requirement of the UK audit regulations compliance with which is assessed as part of the legally required monitoring procedures. Non- compliance can result in restriction or loss of license to audit.

Table 2: Detailed threats and safeguards per UK independence framework (ICAEW, 2001) with additional IFAC (2001) proposals shown in bold italics

Overall threat	Component parts of each threat	Regulatory prohibitions	Other safeguards
1.Self-interest: financial or other conflict e.g. direct or indirect interest in a client; fear of losing a client.	a. Undue dependence on an audit client, for an audit firm (AF), office of AF or individual partner.	More than 15% total recurring fees from one client or 10% from listed or other public interest client forbidden. ***No level set for prohibition.***	AEP to review with 2nd partner support: where income is >10% for any client or >5% for listed or public interest client; where one office or one partner is dependent on one client for income.
	b. Loans to or from a client; overdue fees; guarantees for debts.	Loans and guarantees forbidden, except financial institutions in normal course of business.	Principal in AF to review overdue fees to establish if it constitutes a loan. ***Discuss with audit committee.*** ***Disclose outstanding fees.***
	c. Hospitality or other benefits received from a client .	Prohibited unless of modest value.	None, no guidance on modest value. ***Discuss with audit committee.*** ***Practice environment safeguards.***
	d. Actual or threatened litigation between AF and the client. (See also 2.b. sharpened form of advocacy.)	AF prohibited from acting where negligence writ issued by client.	Impact of other litigation to be decided by AF. ***Disclose to audit committee.*** ***Practice environment safeguards.***
	e. Participation in the affairs of a client. ***Family and personal relationships (also recognised as familiarity and intimidation threats).***	Partner prohibited from acting if he is an officer or employee of the client, or a partner or employee of such a person (in UK prohibited by s.27 1989 Companies Act); no-one in AF should be involved in the audit if employed by client within two previous years; may not act as company secretary. ***No one on audit team should have close family member in a position to influence audit.***	Self-interest threat identified where closely connected person to partner employed by the client but no prohibition. ***No-one should take part in audit if employed by the client during the period under review.*** ***Practice environment safeguards.*** ***Practice environment safeguards.***
	f. Principal or senior employee joining client ***Continuing threat if client's director, officer or senior manager has been on audit team. (also recognised as familiarity and intimidation threat).***	Individual to be removed from audit team. Judgments to be reviewed. ***Individual may not participate in the affairs of the firm.*** ***Any benefits individual receives from AF must be pre-determined. No material indebtedness***	***Practice environment safeguards.***

Table 2: Detailed threats and safeguards per UK independence framework (ICAEW, 2001) with additional IFAC (2001) proposals shown in bold italics

Overall threats	Component parts of each threat	Regulatory prohibitions	Other safeguards
1.Self-interest: continued	g. Mutual business interest. ***Defined as joint ventures; jointly marketing combined services and products; one party distributing or marketing the other's products, (also recognised as intimidation threat).***	Prohibited.	
	h. Partner has beneficial interests in shares and trusts holding shares in clients. ***Partner or immediate family member in the same office as the lead engagement partner has direct financial interest in client.*** ***Other client service personnel or immediate family member direct financial interest in client.***	Prohibited except for insurance policies, pensions or investment trusts. ***Prohibited.*** ***Prohibited.***	
	AF has beneficial interests in shares or trusts holding shares in clients, or firm's pension fund has shares in clients.	***Prohibited.***	
	Member of the audit team or immediate/ close family member of the audit team has material interest in an audit client. i. Trusteeships, nominee holdings and bare trusts holding shares in clients.	***If immediate family member remove individual from audit team.*** Prohibited for AF or closely connected person where trust holds > 10% shares in public interest company. In other cases trustee may not act as engagement partner. ***Prohibited where trustee a beneficiary of the trust; where the interest is material; where the trust exercises significant influence over the client; where there is significant influence over investment decisions.***	***Practice environment safeguards.***

Table 2: Detailed threats and safeguards per UK independence framework (ICAEW, 2001) with additional IFAC (2001) proposals shown in bold italics

Overall threats	Component parts of each threat	Regulatory prohibitions	Other safeguards
1.Self-interest: continued	j. Voting on audit appointments.	Prohibited for principals or employee of AF holding shares in company.	
	k. Pressures from other parties: connections; associated firms; outside influences employees.	No employee should be used on any audit who would be excluded from the role of auditor.	Other conflicts left to the firm to identify and decide upon.
	l. Provision of non-audit services (NAS) to audit clients (also a self-review threat, see 2.a below). ***Holding or exercising authority on behalf of the audit client; preparing source documents or originating data evidencing the occurrence of a transaction; determining which recommendation of the AF should be implemented; reporting in a management role to those charged with governance.*** ***Holding custody of client's assets; supervising client employees in their normal activities.***	Total fee including NAS must not be > 10% for public interest companies or 15% for others. ***No limit set.*** ***Prohibited.*** ***Prohibited.***	AF to review with 2nd partner support: where income is >10% for any client or >5% for listed or public interest client; where one office or dependent on one client for income. ***Discuss with audit committee.*** ***Practice environment safeguards.***
	m. Fee quoted is lower than charged by other firms.	None.	AF must demonstrate that appropriate staff and time assigned to client and all regulatory requirements adhered to.
	n. Contingency fees. ***Also advocacy threat.***	Prohibited for audit work, reporting assignments, due diligence and similar non-audit roles incorporating professional opinions and expert witness assignments. ***Prohibited for audit work or fees which form part of the audit engagement.***	***Discuss with audit committee.*** ***Practice environment safeguards.***

Table 2: Detailed threats and safeguards per UK independence framework (ICAEW, 2001) with additional IFAC (2001) proposals shown in bold italics

Overall threats	Component parts of each threat	Regulatory prohibitions	Other safeguards
2. Self-review: apparent difficulty of maintaining objectivity and conducting what is effectively a self-review, if any product or judgement of previous audit or non-audit assignment needs to be challenged or re-evaluated in reaching an audit conclusion.	a. Provision of other services to audit clients (as in 1.l above). Provision of expert services, including valuations, which affect amounts or disclosures in the financial statements.	AF should not prepare accounts and accounting records for public interest companies. None ***Prohibited where the valuation concerns matters material to the audit and involves subjectivity.***	AF to take care where it has designed or recommended systems or controls that audit relies on. Suggests using different staff. Decisions and safeguards to be documented. Materiality to be considered. AF to consider key issues associated with threat Possible separate reporting lines and additional review procedures ***AF may provide bookkeeping services to subsidiaries and divisions of listed companies subject to safeguards.*** ***In other cases practice environment safeguards.***
	***Provision of legal services to audit clients.*.**	***Audit team should not be involved in provision of legal services.***	***Practice environment safeguards.***
	Lending staff to an audit client.	***Staff must not make management decisions, approve or sign documents or commit the client.***	***Client safeguards.***
	Design and implementation of financial information technology systems that generate information for financial statements.		***Firm and client safeguards.***
	Internal audit services.	***AF personnel must not act as client management.***	***Firm and client safeguards.***
3. Advocacy: a practitioner becomes an advocate for a client's position in any adversarial proceedings. ***Also self-review threat***	a. AF supports client's interests.	None.	Professional person is required to strive for objectivity in all professional work.
	b. *Sharpened* form of advocacy: more committed and protagonist. (See also 1.d. actual and threatened litigation.), such as promoting shares or adopting extreme position on accounting principles, tax or other matters of professional judgment.	Recommendation or promotion of shares prohibited; leading a corporate finance team responsible for recommending or promoting shares prohibited. ***Prohibited where amounts involved are material to the audit and subjectivity is high (acting in tax matters not prohibited.)*** ***AF prohibited from committing client to terms of a corporate finance transaction.***	AF to decide on what is an extreme position. In some cases recommend that other advisors are sought. ***Practice environment safeguards.***

Table 2: Detailed threats and safeguards per UK independence framework (ICAEW, 2001) with additional IFAC (2001) proposals shown in bold italics

Overall threats	Component parts of each threat	Regulatory prohibitions	Other safeguards
3. Advocacy: continued	***Provision of legal services such as contract support, mergers and acquisition advice and assistance to client's internal legal departments.***	***AF should not act as advocate for client in significant litigation. AF should not act as general counsel for legal affairs to audit client.*** ***Audit team should not be involved in provision of legal services.***	***Practice environment safeguards.***
4. Familiarity or trust: becoming over-influenced by the personality or qualities of the client and being too sympathetic to their interests, or too trusting.	a. Taking management decisions (see also 1.e. participation in the affairs of a client).	AF taking management decisions prohibited. AF prohibited from acting as actuary for insurance company. AF should not make final decisions on client staff appointments. ***Final decisions on client staff appointments also seen as intimidation threats.***	AF to ensure any advice given is accepted by directors as their own judgments. AF to decide whether expert second opinion needed where AF designs systems affecting operations on which commercial success of company depends.
	b. Acting for a prolonged period of time.	Audit partner prohibited from acting for listed company audit for >7years. May not take on role again for 5 years (but not precluded from other involvement with client).	***Practice environment safeguards.***
	Family and personal relationships.		***Practice environment safeguards.***
	Former partner working for client.	***None in respect of familiarity.***	***Practice environment safeguards.***
5. Intimidation: being intimidated by threat, dominating personality, or other pressures – actual or feared, by the client or another party.	None.	None.	None.
	Family and personal relationships.	***See 1. f.***	
	Mutual business interest.	***See 1. g.***	
	Former partner working for client.	***None in respect of intimidation.***	
	Recruitment of staff for client.	***See 4.a.***	

Table 3: Allocation of overall independence threats and safeguards as identified by IFAC (2001) to interactions from BCD

Inter action	Subject	Nature of threat	Availability of safeguard	Effectiveness of safeguard	Outcome
NS1	Going concern; auditor threatened audit report qualification if refinancing not obtained.	Possibility of ***intimidation*** but client did not threaten.	***Regulatory framework*** clear on going concern. Partner adhered to ***firm's safeguards*** for risk management; procedures strong.	Safeguards **effective**; company recognised auditor had no choice.	Accounts delayed until finance acquired; qualified report avoided without disagreement.
NS2	Off balance sheet finance; incoming partner discovered finance leases accounted for as operating leases.	***Self-review***: former partner had allowed creative accounting.	***Regulatory framework*** clear following change to lease accounting by FRS 5. ***Company safeguards:*** new directors, more conservative culture, effective audit committee.	Safeguards **effective**; also in the company's interests to avoid creative accounting as more finance needed.	Accounting corrected to comply with framework.
NS3	Recently appointed company chairman wanted reduction in audit fees; tender threatened.	***Intimidation and self-interest:*** risk of losing client; possibility of reduction in audit quality.	***Practice environment safeguards*** clear on maintaining quality. ***Company safeguards:*** FD had high integrity; did not want reduction in audit quality.	Safeguards **effective**; partner adhered to firm's procedures.	Fees reduced; no change to quality.
TJ1	New computer system identified material stock over-valuation.	***Intimidation:*** dominant, bullying chairman/CEO, uncooperative FD; FD also intimidated by chairman; both bullied newly appointed inexperienced AEP; chairman unwilling to provide in full for stock write off and report loss. ***Self-review:*** previous partner had allowed problem to continue. ***Familiarity:*** FD formerly a partner in the firm.	***Regulatory framework*** clear: SSAP 9 'lower of cost or net realisable value' for stock. ***Company safeguards:*** No safeguards. ***Practice environment safeguards:*** technical backup available (but not used).	Safeguards **not effective**; no safeguards in company. firm's own procedures did not adequately enforce framework.	Chairman agreed to write off stock but only over three years; non-compliance with regulatory framework because accounting policy as stated was not followed and SSAP 9 breached.

Table 3: Allocation of overall independence threats and safeguards as identified by IFAC (2001) to interactions from BCD

Inter action	Subject	Nature of threat	Availability of safeguard	Effectiveness of safeguard	Outcome
TJ2	Classification of loss making product development costs under FRS 3.	***Intimidation:*** dominant, bullying chairman did not want to comply with FRS 3 to show loss making activities on face of P/L account; FD did not stand up to chairman. ***Familiarity:*** FD formerly a partner in the firm.	***Regulatory framework*** clear about disclosure of loss making activities; FRRP or audit monitoring could identify non-compliance. ***Practice environment safeguards:*** technical back-up available. ***Company safeguards:*** no effective safeguards.	Safeguards **partially effective**; Firm's technical back-up procedures prevented breach of FRS 3; firm suggested that client add extra columns to the P/L account as this treatment not forbidden by FRS 3.	Presentation in P/L account emphasised profitable activities; creative compliance but no breach.
TJ3	Classification of restructuring costs under FRS 3.	***Intimidation:*** dominant bullying chairman did not want to comply with FRS 3 to show restructuring costs above the line as group was making a loss; FD did not stand up to chairman; FD left auditor to take blame. Further ***intimidation*** and ***self-interest*** caused by FD demanding a reduction in fee after AGM; AEP concerned about losing client. ***Self-review:*** AEP originally gave wrong advice; major row when advice changed at late stage; technical errors increased ***intimidation***. ***Familiarity:***FD formerly a partner in the firm. **<u>Urgency threat: Much greater pressure when issues come up at last minute.</u>**	***Regulatory framework***: FRS 3 clear about disclosure of restructuring costs; FRRP or audit monitoring could identify non-compliance. ***Practice environment safeguards:*** technical back-up available. ***Company safeguards:*** Non-executive director involved in discussion.	Safeguards **partially effective**; FRRP threat used; Firm's technical back-up procedures did not prevent original wrong advice but supported AEP's change of view and prevented breach of FRS 3; firm encouraged client to add extra columns to the P/L account as not forbidden by FRS 3; non-exec sided with chairman; firm agreed to reduce fee but process undermined AEP to the extent he considered withdrawing from client.	Extra columns in P/L account emphasised profitable activities; creative compliance but no actual breach.

Table 3: Allocation of overall independence threats and safeguards as identified by IFAC (2001) to interactions from BCD

Inter action	Subject	Nature of threat	Availability of safeguard	Effectiveness of safeguard	Outcome
MP1 (a)	Agreeing fair value provisions on acquisition	***Intimidation:*** pressure on auditor because board did not want to appear to have overpaid for acquisition and directors of subsidiaries did not want to look incompetent. **Face saving a motivation for the board in this case.**	***Regulatory framework*** clear but final valuations judgmental; ***Company safeguards:*** conservative culture; FD and chief accountant had high integrity. ***Practice environment safeguards:*** quality control procedures within firm.	Safeguards **effective**;CFO and chief accountant supported auditor in reaching agreement; FRRP deterrent to other directors.	Acceptable fair values negotiated.
MP1 (b)	Qualification of opening balance sheet in newly acquired subsidiary.	***Intimidation:*** group does not want qualified report because of reputation damage. ***Self-review:*** different interpretation of regulatory framework from previous firm of auditors. **UUUUUUUUUUUUUUUUUUUUUUUUUUUUUAdditional dimension to self-review. Could be another firm's opinion or opinion shopping**	***Regulatory framework*** clear on need for qualification but not over nature of qualification; auditor's judgement required. ***Practice environment safeguards:*** quality control procedures within firm. ***Company safeguards:*** strong audit committee; FD and chief accountant had high integrity; conservative culture.	Safeguards **effective;** AEP supported by firm's own procedures and by integrity of chief accountant and FD; despite not wanting qualification, audit committee supportive.	Audit report qualified – disclaimer.
MP2	Changing method of income recognition in group treasury function; improving internal control in group treasury function.	***Intimidation:*** auditor criticising management; pressure to back off; risk of loss of client. **Face saving threat** ***Self-interest threat*** within firm and to partner personally; Some partners wanted him to back off. **Intimidation from within firm**	***Regulatory framework*** not clear, judgement issue. ***Practice environment safeguards:*** quality control procedures within firm; Partner had high integrity. ***Company safeguards:*** strong audit committee; FD and chief accountant had high integrity; conservative culture.	Safeguards **effective;** partner supported by Chief Accountant, CFO, CEO and audit committee, but opposed by directors and managers he criticised; despite firm's quality control procedures, some opposition within firm because of risk of losing client; this was ignored by partner. .	Changes made by company to meet criticisms.

Table 3: Allocation of overall independence threats and safeguards as identified by IFAC (2001) to interactions from BCD

Inter action	Subject	Nature of threat	Availability of safeguard	Effectiveness of safeguard	Outcome
CRA1	Agreeing fair value of property on acquisition.	No apparent threat.	***Regulatory framework*** clear but judgmental; Not material. ***Practice environment safeguards:*** quality control procedures within firm; partner had high integrity.	Safeguards **effective**; because item not material to company, company agreed with auditor's suggestion.	Changes made by company in accordance with auditors' wishes.
CRA2	Fair value of landfill sites on acquisition.	No apparent threat; no real difference of opinion.	***Regulatory framework*** clear but judgmental; no specific guidance on landfill sites. ***Practice environment safeguards:*** quality control procedures within firm; partner had high integrity. ***Company safeguards:*** fairly conservative but opportunistic culture; don't want criticism.	Safeguards **effective;** both sides seeking best solution.	Both sides agreed on best estimate of value.
CRA3	Depreciation on landfill sites.	No apparent threat.	***Regulatory framework*** clear but judgmental in application. ***Practice environment safeguards:*** quality control procedures; partner had high integrity. ***Company safeguards:*** fairly conservative but opportunistic culture; don't want criticism; audit committee existed.	Safeguards **not effective;** auditor did not like depreciation policy; judgment issue and auditor not supported by board.	Depreciation policy remained as company wished.

Table 3: Allocation of overall independence threats and safeguards as identified by IFAC (2001) to interactions from BCD

Inter action	Subject	Nature of threat	Availability of safeguard	Effectiveness of safeguard	Outcome
CRA4	Accounting for interest on leases on long term fixed plant.	***Potential self-review for future:*** auditor wanted to get principles right. **Urgency threat:** no time to research matter properly.	***Regulatory framework*** not clear on treatment of interest; company and auditor came up with widely different figures. ***Practice environment safeguards:*** quality control procedures and technical backup; partner had high integrity. ***Company safeguards:*** fairly conservative but opportunistic culture; don't want criticism; audit committee existed	Safeguards **effective;** Auditor argued for provisions based on firm's technical knowledge.	Additional provision made at auditor's request until matter resolved in later year when company view vindicated.
CRA5	Charging current costs to restructuring provisions with which auditor disagreed.	**Threat from lack of guidance in regulatory framework.**	***Regulatory framework*** not clear on accounting treatment; item not material enough for judgement qualification. ***Practice environment safeguards:*** quality control procedures and technical back up within firm; partner had high integrity. ***Company safeguards:*** fairly conservative but opportunistic culture; don't want criticism; audit committee existed.	Safeguards **not effective;** nothing in regulatory framework to support auditor; auditor did not agree with accounting treatment but not supported by audit committee or board.	Accounting treatment disapproved of by auditor retained.

Table 3: Allocation of overall independence threats and safeguards as identified by IFAC (2001) to interactions from BCD

Inter action	Subject	Nature of threat	Availability of safeguard	Effectiveness of safeguard	Outcome
RC1	Accounting for businesses to be sold on under FRS 7.	No apparent threat; outcome was to the benefit of the company; interpretation of a new standard.	***Regulatory framework*** clear on accounting treatment. ***Practice environment safeguards:*** quality control procedures and technical back up within firm. ***Company safeguards:*** fairly conservative but opportunistic culture; no desire to be criticised; audit committee existed.	Safeguards **effective;** company changed position when realised to their advantage.	FRS 7 fully complied with.
RC2	Agreeing the accounting treatment and the level of provisions for stock and defective products in an acquisition.	***Intimidation:*** implicit pressure on auditor because group did not want to show large fair value adjustments. ***Familiarity:*** previous relationship where FD more senior than AEP (see also TJ case). **Loss of face threat.**	***Regulatory framework*** clear; ***Practice environment safeguards:*** quality control procedures and technical back up within firm. ***Company safeguards:*** fairly conservative but opportunistic culture;. no desire to be criticised; audit committee existed.	Safeguards **not effective;** auditor able to bypass quality control procedures; company wanted accounting treatment.	Auditor allowed company to breach FRS 6.
RC3	Accounting for post acquisition re-organisation costs.	Possibility of ***intimidation threat;*** FD wanted to include re-organisation costs in goodwill calculation.	***Regulatory framework*** clear. non-compliance could be visible to FRRP. ***Practice environment safeguards:*** quality control procedures and technical back up within firm.	Safeguards **effective;** auditor threatened qualification.	FRS 7 fully complied with.
DA1	Accounting for assets on disposal of businesses.	No apparent threat.	***Regulatory framework*** clear but judgmental. ***Practice environment safeguards:*** quality control procedures and technical back up within firm. ***Company safeguards:*** FD had high integrity; strong non-exec director.	Safeguards **effective;** consensus reached.	Accounting treatment fully compliant.

Table 3: Allocation of overall independence threats and safeguards as identified by IFAC (2001) to interactions from BCD

Inter action	Subject	Nature of threat	Availability of safeguard	Effectiveness of safeguard	Outcome
DA2	Accounting for assets on acquisition of business.	No apparent threat.	***Regulatory framework*** clear on accounting records, not clear on depreciation of acquired assets. ***Practice environment safeguards:*** quality control procedures and technical back up within firm. ***Company safeguards:*** FD had high integrity; effective audit committee.	Safeguards **effective.**	Accounting records improved and accounting treatment complied with auditors' wishes.
DA3	Disclosure of acquisitions, disclosures and bid costs under FRS 3.	No apparent threat.	***Regulatory framework*** clear: ***Practice environment safeguards:*** quality control procedures and technical back up within firm. ***Company safeguards:*** FD had high integrity; effective audit committee.	Safeguards **effective.**	Presentation agreed and not misleading.
DA4	Last minute adjustments to the accounts (cash flow and leasing).	**Urgency:** possibility of greater pressure on auditor because of lateness. ***Self-review:*** auditor had not picked up points before.	***Regulatory framework*** clear. ***Practice environment safeguards:*** quality control procedures and technical back up within firm. ***Company safeguards:*** FD had high integrity; effective audit committee.	Safeguards **effective;** firm's review procedures effective; late adjustment, i.e. urgency threat; did not become a problem because of integrity of FD.	Adjustments made in a rush.
DA5	Chairman's attitude to goodwill.	***Intimidation:*** dominant, bullying, chairman didn't like rules.	***Regulatory framework*** clear. ***Practice environment safeguards:*** quality control procedures and technical back up within firm. ***Company safeguards:*** FD had high integrity; strong non-executive director; effective audit committee.	Safeguards **effective;** non exec supported auditors.	Correct treatment adopted.

Table 3: Allocation of overall independence threats and safeguards as identified by IFAC (2001) to interactions from BCD

Inter action	Subject	Nature of threat	Availability of safeguard	Effectiveness of safeguard	Outcome
DA6	Compliance with the Cadbury Code and other non-mandatory disclosures.	No apparent threat: auditor insisted company drafted their own disclosures to establish responsibility and ownership.	***Regulatory framework*** clear; ***Practice environment safeguards:*** quality control procedures and technical back up within firm.	Safeguards **effective;** firm forced company to prepare own material.	Company complied with guidelines.

Figure 1: The current audit risk model (Auditing Practices Board, 1995)

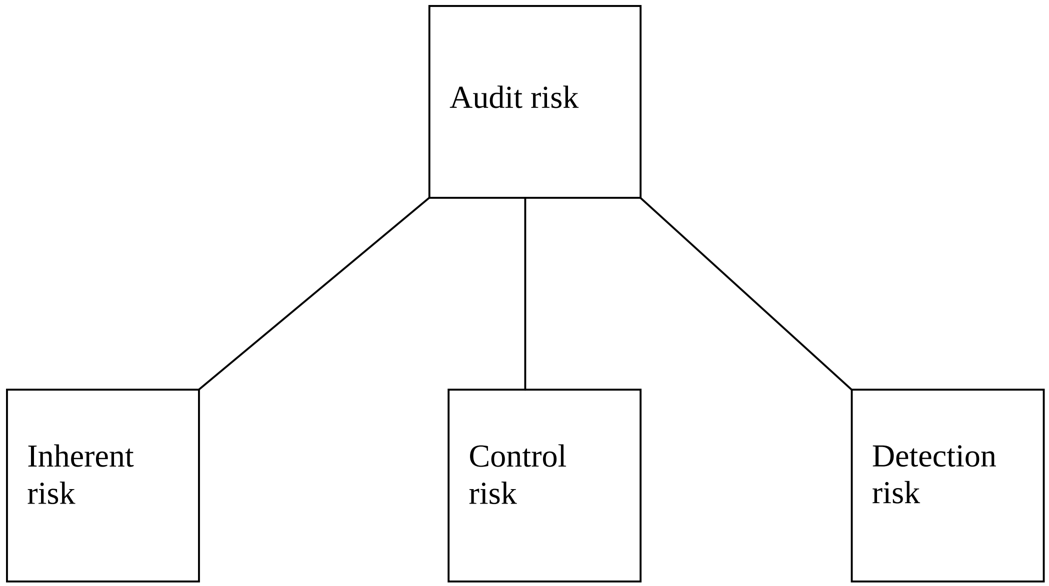

Figure 2: Our revised audit risk model