

## **Impact of Embedded Buyer-Seller Relationship in Auditing Apparatus on Auditors' Independence**

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### **Abstract**

Buyer-Seller relationship is embedded in contemporary audit apparatus. Although auditors are engaged in quasi-judicial activities, controversy occurs as they are appointed and paid by the reporting entity. This scenario is further complicated when auditors are allowed to perform both attestation services and non-attestation services. In the face of such challenges auditors are more concerned with clientele retention and service continuation rather than independence. Moreover, auditors are paid by the clientele. In such a scenario achieving independence is a utopia. So this paper suggests that auditors should be appointed by regulators and same auditors/firms must not perform both audit and non-audit services. In formulating a roadmap to auditors' independence this commentary analyzes threats to independence from the Buyer-Seller perspective embedded in auditing.

**Keywords:** Buyer-Seller Relationship, Quasi-Judicial, Attestation Services, Non-Attestation Services

### **1. Introduction**

The accounting profession has been jeopardized by some unprecedented crises caused by high-profile business and audit failures like WorldCom, Enron, Cendant, Sunbeam and Waste Management. In Enron debacle the criticism of Arthur Anderson unearthed the fact that Auditor (Anderson) was a dominant client in the Auditee's (Enron) Houston office (Taylor and Todd et al. 2003). The above mentioned issues and concerns squarely lead to the question of upholding auditors' independence and reliability to serve public interest best. In this commentary we would like to unearth the mechanism so as to formulate a roadmap to repositioning the role of auditors and accountants in an ever changing corporate world.

### **2. Problem Statement**

Unfortunately, present day auditing apparatus does not have built-in characteristics that guard against the profession's losing integrity and independence. Auditors are involved in quasi judicial activities with a view to expressing an opinion whether the financial statements are prepared (by the clientele), in all material respects, in accordance with an identified financial reporting framework. Unlike judges the auditors are appointed and paid by the clientele. In this way, auditors' independence ends in smoke. In the face of the auditors' dependence on the clientele for payments and continuance in office, it is very unlikely that, as a separate institution, auditing profession will be able to uphold its viable existence with independence and objectivity.

However, outsourcing of internal audit teams and choosing to be with same audit firm for attestation services (external auditing) can seriously impinge on fair & just service delivery by the auditors and discount on independence in appearance. All these highlight the need for the separation of auditing and accounting and the intervention by third party (preferably the regulators), other than the audit client, to appoint auditors for protecting interest of the investors specifically and other stakeholders in general.

### **3. Underlying Assumption**

Service providers (auditors) cannot be independent of service receivers in a market setup where the receiver compensates the provider. It is evident in this line that the provider is like the producer of goods or services who sales his/her products to the customer for money. As a seller he/she is concerned with the product that goes to the buyer with due quality and price specification. Buyer (client) satisfaction is of supreme importance to the seller otherwise he/she may lose market. In such a setting it is unimaginable that the seller will be independent of the buyer especially when competition and the question of buyer satisfaction

are dominant. The present auditing apparatus resembles to this buyer-seller approach, which is why, thinking of achieving auditors' independence in such a buyer dependent market is not practically feasible. For the purpose of this commentary, the current systems of auditing; from appointment of auditors to the expression of audit opinion; is identified as a bumpy toward independence between auditor and clientele.

### 3.1 Buyer-Seller Relationship and Auditing

If we dissect the nature of Audit firms' activities we would find that it is highly characterized by the Buyer-Seller relationship found in the market place. Below is a critical analysis of the major activities of audit firms from the Buyer-Seller perspective. Before we proceed on, we need to construct the concept of Buyer-Seller in the context of auditing.

**3.2 Buyer-Seller Relationship/Approach:** An economic Relationship that does not requires independence between parties to the contract and occurs in a competitive market set up due to the seller's offering of goods and services to the buyer of such products in exchange of monetary or other economic consideration. Important elements of such relationship is further unearthed below:

- ✘ Seller tries to satisfy the buyer with competitive and alternative business strategies
- ✘ Retention of buyer/client is of utmost importance to the seller due to competition amongst sellers.
- ✘ Independence of the seller from the buyer is not vital as the seller is paid by the buyer and the buyer is dependent on the seller for the goods and services he/she receives.

The auditing profession is characterized by such a buyer-seller relationship. In case of attestation services this relationship clouded by so-called quasi-judicial nature of activities and need for independence and is embedded in the fact that the auditor is paid and engaged by the reporting entity. Whereas in case of non-attestation services this is explicit as the requirement for independence is not necessary in the terms of service. Mautz, (2003). In both cases the apparent dependence of the audit firm on the audit clientele is evident in the fact that the reporting entity compensates the auditor. Nevertheless the close relations developing from non-attestation services can influence the reporting entity to appoint auditors from the same firm from which they have received non-attestation services or to appoint the non-attest accountant as attest accountant in latter period. In all such cases independence of auditor is destined to be shattered.

| Activities                                   | Nature  | Remark   |
|--|---|--|
| <b>Attestation Services:</b>                 | A type of assurance service in which the audit firm issues a written communication that expresses a conclusion about the reliability of a written assertion of the reporting business entity.   | <b>Buyer-Seller characteristic is embedded in the relationship with the clientele.</b> |
| (a) Audit of Historical Financial Statement  | <p><b>Function of auditor</b><br/>                     Quasi-Judicial in Nature. Expresses an opinion about whether the financial statements are in conformity with established criteria.</p> <p><b>Relationship with the Clientele</b><br/>                     Appointed and compensated by the clientele. Deemed to be independent of the clientele.</p> |  |
| (b) Review of Historical Financial Statement | <p><b>Functioning of auditor</b><br/>                     Also quasi-judicial in nature with moderate level of assurance.</p> <p><b>Relationship with the Clientele</b><br/>                     Same as found in (a)</p>   |  |
| <b>Non-Attestation Services:</b>             | Services other than Attestation services. Auditors' independence from management is not necessary for discharging this type of responsibility.  | <b>*Independence is not of any concern.</b>  |
| (a) Accounting & Bookkeeping Services        | Audit firms prepare financial statements of business organizations and even in some instances potential clients. Compilation  | <b>**Explicit Buyer-Seller relationship is evident.</b>                                |

|   |   |  |
|---|---|--|
|   | reports are prepared by the audit firms.  |  |
| (b)Tax services                           | Audit Firms prepare corporate and individual tax returns for both audit and non-audit clients.              |  |
| <b>(c) Management Consulting Services</b> | <b>Firms provide certain services that enable their clients to operate their business more efficiently.</b> |  |

However, the audit profession suffers from a number of built-in anti-independence factors. These are:

1. The apparent financial dependent of the auditor on the auditee
2. The emphasis on service to management, and
3. The mixing of audit and non-audit services
4. Close relationship of Public Accounting and Business

However, the push for growth of non-audit services and the ambiguity of independence in appearance as an achievable objective, have led to suggestions that this objective be de-emphasized or abandoned altogether because of a lack of solid empirical evidence of its importance (Kenny, 1999). All these create an environment that jeopardizes independence in fact and makes achieving independence in appearance highly unlikely.

#### 4. The Roadmap to Separation

The following two steps may be taken to remove institutional impediments to auditing.

##### 4.1 From Client based auditing to Regulator appointed auditing.

If auditors are appointed by the reporting entity, their independence will be lost at the ultra dependence on client for payments and continuation of services. Auditors are engaged in quasi-judicial functions. They attest the entity's justification (through corporate disclosures) of the utilization of alternative scarce societal resource. So to ensuring social justice on auditors' part; they must not be appointed by the client (entity). Auditors are to be appointed preferably by regulators like SEC or The Central Bank (if the entity is financial institution) and compensated by the state apparatus. The state can direct the reporting entity to submit fees for this purpose. In this way the buyer-seller type relationship does no longer appears as auditors are dependent on the regulators for continuation of services and payment for their services.

##### 4.2: Separated Attestation and Non-Attestation Services

There is incompatibility between attestation and non-attestation services. Chowdhury, I. (2005) mentioned that for the good of the profession auditing must be recognized as a specialty separate from the remaining function of the public accountants. The public accountant should perform no other functions for their client. Again those who perform other functions should not engage in opinion audit. So, same audit firm or same auditor should not be allowed to participate or perform Attestation (external auditing) and/or Non-Attestation services (consultation and others) for different auditee or for the same auditee in different period. Those who are interested in attestation services would go for Regulator appointed auditing service and those interested in non-attestation services would opt for being appointed by the client and not allowed to be in attestation service simultaneously.

#### 5. Conclusion

Corporate debacles of last decade and recent financial crisis have seriously questioned the independence of external auditor appointed by the publicly traded firm. Audit profession will lose its luster if consultancy services override the attestation services. Apart from this a great number of people banks on the report issued by an external auditor. With these two steps in mind, the institutional impediments towards auditors' independence from the audit clientele can be removed. This is because; the auditors are no longer appointed and compensated by the client and the embedded Buyer-Seller type of relationship does no longer exist. Nevertheless, the separation of Attestation (external auditing) and/or Non-Attestation services effectively minimizes threats to auditors' independence. All these reduce the previously existed

vulnerability of auditing independence. But it must be remembered that full fledged empirical studies should be taken to generalize the concept outlined in this commentary.

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