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Who's to Judge? Understanding Issues of Auditor Independence Versus Judicial Independence

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Who's to Judge? Understanding Issues of Auditor Independence Versus Judicial Independence

Gary Kleinman, Asokan Anandarajan, and Dan Palmon

Abstract

We explore differences in the roles of auditors and judges in the United States, emphasizing the issue of independence for each group. We examine factors that influence the independence of US judges and auditors. We use examples to highlight the potential impact of various factors on each profession and explore how they are affected by differences in the nature of their responsibilities. Based on these examples, we find generalized lessons that are applicable to each profession and explore further questions that should be asked. While much research has been done on factors that could potentially influence auditor independence, no research to date has examined lessons that auditors can learn from the judicial profession with respect to independence in the United States setting, and vice versa. This paper is a contemplation of the different threats that exist to independence and the difficulty in achieving it in two differently structured fields where its attainment was important for achieving societal ends associated with the professional roles. We hope through this discussion and presentation to broaden the perspective of both professions (judges, auditors) by furthering their understanding of the independence dilemmas facing occupants of the other's role.

KEYWORDS: auditor independence, judicial independence, judicial conflict of interest, auditor conflicts of interest, actual independence, perceived independence

JEL Classification Codes: M42, K40

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1. Introduction and Objective

The issue of auditor independence is of ongoing research interest because independence is critical to an auditor's ability to perform essential functions in society. The same case can be made for judges. In this paper, we explore differences in the roles of United States auditors and judges with special emphasis on independence. We examine factors that influence the actual and perceived independence of auditors and judges, derive lessons therefrom, and speculate on further questions that should be asked. The importance of independence in appearance and fact for judges is mentioned in the American Bar Association's Model for Judicial Independence (American Bar Association [ABA] 2010), which states "Judges should maintain the dignity of judicial office at all times, and avoid both impropriety and the appearance of impropriety in their professional and personal lives." The Federal Court's Guide to the Judiciary similarly states in its first two canons that judges should be mindful of their independence and avoid actions that may impair the perception of their integrity (Guide to Judiciary Policy, 2010, presented by the Judicial Conference of the United States). Similarly for auditors, the ethics code of the American Institute of Certified Public Accountants (AICPA), Rule 101 states that "A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council" (AICPA, 2011, p. 52). It later notes that "It is impossible to enumerate all circumstances in which the appearance of independence might be questioned." The relationship between perceived and actual independence is presented in Table 1. As the table shows, individual judges/auditors may be perceived to lack independence when they actually have independence (Box 2), and be perceived to have independence when they lack independence (Box 3). Alternately, Boxes 1 and 4 show that perceptions and the actuality of independence may coincide.

TABLE 1: Perceived versus Actual Independence

	<u>Perceived Independence:</u>	
	<i>Impaired</i>	<i>Not Impaired</i>
<u>Actual Independence:</u> <i>Impaired</i>	Box 1: Take action that inappropriately favors client/defendant and ARE PERCEIVED to be taking action that inappropriately favors client	Box 3: Take action that inappropriately favors client/defendant but IS NOT PERCEIVED to be taking action that inappropriately favors client
<i>Not Impaired</i>	Box 2: Take action that appropriately favors client/defendant BUT IS PERCEIVED to be taking action that inappropriately favors client	Box 4: Take action that appropriately favors client/defendant BUT IS NOT PERCEIVED to be taking action that inappropriately favors client

This paper is motivated by the fact that auditors and judges should not only *be* independent, but should also be *seen* as independent. If this fundamental tenet is violated, the auditing profession and the external users of financial reporting, on the one hand, and judges and those who come before the judges on the other, will suffer. While much research has been done on factors that could potentially influence auditor independence, no research to date has examined lessons that auditors can learn from the judicial profession about independence. This is true as well for the judicial profession. It can also benefit from the experiences of the auditing profession. The objective of this paper is to examine what the two professions, as they are constituted in the United States, can learn from each other with respect to the issue of improving actual and perceived independence.

In dealing with issues concerning judicial independence, our intent is not to describe the various arrangements that govern judges at different levels in the system, but to discuss instances in which judicial independence might be imperilled.¹ We largely rely instead on the Guide to Judiciary Policy for a definition of threats to judicial independence, rather than referring back to the guidance of individual jurisdictions. The Guide to Judiciary Policy (2010) of the US Federal Court system (p. 3) states that “A judge should not allow family, social, political, financial, or other relationships to influence judicial conduct or judgment.”² We believe the five canons of the Federal Guide to Judiciary Policy encompass the four canons of judicial independence listed in the ABA’s Model Code of Judicial Conduct. Similarly, we do not refer to individual jurisdictions for information on whether judges are required to recuse themselves. Our goal is to discuss issues affecting judicial independence, not a particular level or institutional arrangement that might threaten or enhance judicial independence.

¹ Burbank (2003) notes that different criteria are often used for federal versus state courts with respect to judicial independence. For example, he notes that (p. 323) “*that attention to the different functions that courts perform, even within the same system, may lead one to consider whether they should be subject to different arrangements concerning judicial independence (and accountability)...*” He further notes, for example, that state courts perform different functions than federal courts or the US Supreme Court, and therefore should be treated differently. Specifically, he states that, “As an example, data gathered throughout the country by the American Judicature Society indicate that in at least ten states different selection systems are used for members of trial and appellate courts. [48.] Careful study of those state systems may reveal that one reason for the differences was their architects’ belief that different judicial functions warrant different degrees of judicial independence (and accountability).[49.]” Dealing with all the complications of federal versus state judiciary, appellate versus trial court, is beyond the goals of this paper.

² Note also that US Code Title 28, Section 455, also sets forth standards relevant to judicial independence for the *lower Federal courts*. While the US Supreme Court follows the law, it has never decided whether it is subject to the law (Roberts 2011) .

With respect to the auditing profession in the United States, the issue of auditor independence is of ongoing research interest because independence is critical to an auditor's ability to perform essential functions in society. In essence, an auditor evaluates the accuracy and adequacy of a client's accounting for its assets, liabilities, revenues, and expenses in order to give assurance to external parties on whether the financial statements prepared by the client are fairly presented in accordance with Generally Accepted Accounting Principles (GAAP). This audit function was first enacted into US law by the Securities Exchange Acts of 1933 and 1934, and was extended by the Sarbanes-Oxley Act of 2002 (SOX) to include audits of the client's internal control systems for publicly-held companies.

The Securities and Exchange Commission (SEC) is the most powerful regulator of auditor behavior in the United States for auditors of publicly-owned companies. The AICPA governs audits of non-publicly-owned companies, although the Public Company Accounting Oversight Board (PCAOB), which was created by SOX in 2002 and began operations in 2003, has adopted many of the AICPA's auditing standards. Within its own domain, the SEC's regulations trump those of the AICPA, an industry group. Generally, the AICPA's strictures on auditor behavior are milder than those laid down by the SEC or the PCAOB. Nevertheless, we have chosen to use the AICPA's Conceptual Framework for Auditor Independence as the basis for our discussion of auditor independence because of (a) its clarity and (b) the AICPA's historic role as the public face of the American accounting profession. It also presents an analytic framework for analyzing potentially independence-challenging situations and coming to a decision as to the existence of a serious independence issue. As the membership group for auditors of both public and private companies, the AICPA Code of Ethics governs the behavior of far more auditors than does the SEC or PCAOB alone. The AICPA's Rule 101 presents a set of principles and rules for auditors to use in deciding whether they can meet the obligation of General Standard 1 to be independent of that client. The AICPA's ethics rulings "summarize the application of Rules of Conduct and Interpretations to a particular set of factual circumstances." (AICPA, 2011, p. 10, Code of Professional Conduct and Bylaws) Taken together with the Code of Professional Conduct, the AICPA's conceptual framework presents a flexible system for accommodating and responding to circumstances that may arise in the practice of accounting and auditing (see AICPA, 2011).³ There is also considerable overlap between the independence rules of the SEC/PCAOB and the AICPA. Therefore, we do not feel the strength of our discussion is diminished.

³ In Appendix A, we demonstrate the *potential* usefulness of the AICPA Conceptual Framework for analyzing situations of concern to both auditors and judges.

This paper offers five contributions: First, we describe the institutional settings that govern and impact auditor and judicial independence in the United States. Second, we present in a common setting the economic factors that may influence the impartiality and independence of judges and auditors. Third, we present in a common setting the non-economic-factors that may impact the independence of judges and auditors. Fourth, we discuss Leonard Spacek's (1958) old notion of an Accounting Court in the context of auditor and judicial independence. Fifth, we speculate on further questions that can be asked and lessons that might be learned about professional independence.

The paper is arranged as follows: This section, section 1, is the introduction. In section 2 of the paper, we discuss the structure of the auditing and judicial professions. In section 3, we conduct a comparative analysis, by theme, of economic factors that may impact the independence of auditors and judges. In section 4, we discuss current, largely socially- and personally-based controversies with regard to judicial and auditor independence. Then, in section 5, we discuss Leonard Spacek's proposal for an accounting court and tie it in to the underlying concepts of judicial and auditor independence. In section 6, we discuss potential differences in the meaning of independence for auditors and judges, based on their intrinsically different jobs. In addition, we ask what each profession can learn about independence from the experiences of the other profession, and make recommendations. We also consider whether independence issues can be mitigated, or must be endured.

2. The Institutional Basis for Understanding Auditor and Judicial Independence in the United States

In this section, we discuss the concept of independence in both professions and the structuring of each. In both the judicial and auditing setting, the question is: What should the auditor be independent from? Or conversely, to what abstract concept should the auditor's loyalty lie? Who should the judge be independent from? Or conversely, to what abstract concept should the judge's loyalty lie? We pose the questions in this way in that an overriding loyalty to a concept, e.g., truth or justice, may overcome other influences on the auditor's or judge's decisions.

2.1. The structuring and loyalty of the judiciary

In the judicial field, judges are appointed/elected in order to stand in judgment of cases brought by parties seeking to gain (or avoid giving) succor from (to) the other, however defined. This is true at all levels of the judiciary. Often, one party to the lawsuit is a private individual seeking redress for some wrong. In other cases, one party to the lawsuit is the government or an agent of the government,

seeking to punish the other party. Specific arrangements that govern courts can differ depending on whether the court is a local, state, federal or US Supreme Court. In each case, though, the parties to the suit have the opportunity to present their evidence and arguments with respect to their preferred outcome. Given that the judge is a public employee, the parties do not directly employ or remunerate the judge via his/her pay package. Ideally, the judge can arrive at judgments based on an honest evaluation of the evidence presented. But what should guide that judgment? A desire to render justice. What should a judge be independent from in order to assure loyalty to justice, defined as a decision reflecting an objective assessment of the evidence and the harmony of the evidence with elements of the law? Judges should be independent of all stress-related factors and temptations that may lead them to give heed to factors other than the facts and relevant law before them. Accordingly, threats to the judge's independence diminish his/her ability to be loyal to the provision of justice itself. Given the important role that the judiciary plays in helping to assure the smooth functioning of civil society, and given the clear importance of the judiciary being held in high esteem by the public (see, for example, Peabody, 2011), judicial independence has historically been highly valued. That is, highly valued except when it has come under severe attack by those who dislike the opinions rendered or who feared opinions that might be rendered should the judicial branch seem beholden to an alien (i.e., not the attacker's own) ideology (e.g., Peabody, 2011; Burns 2009). The legal status of the judiciary and its purpose are set forth in the US Constitution. In the United States, the federal constitution established three branches of government: (a) the executive branch, led by the President; (b) the legislative or Congressional branch, and (c) the judicial branch. The US Constitution originally specified the establishment of a Supreme Court, with the US Congress having the power to establish other lower federal courts. The President has the ability to appoint justices to all the Federal courts with the consent of the Senate. The Congress has the power to establish courts, to fund or withdraw funding from the courts⁴, as well as declare topics off limit to review by the Supreme Court. It can, of course, impeach justices for failure to maintain "good behavior". The interplay between the branches of the federal government has caused much controversy over the years, especially in the early years of the Republic when institutional norms for acceptable behavior by and between the branches did not exist. The Supreme

⁴ Friedman (2011; p. 56, Kindle location 1476) notes that during the controversy over the repeal of the Circuit Court Act of 1802, a repeal through which the Republican Administration of Thomas Jefferson would have forced many Federalist judges out of office through the elimination of their positions, a leading Federalist congressman James Bayard asked, "Will you say...[t]hat the body whom they are to check has the power to destroy them?"

Court under John Marshall instituted, at the Supreme Court level, a practice that existed at the lower, pre-Constitution levels (Friedman, 2009): the power of the Court to engage in judicial review of the constitutionality of laws passed by Congress. Later developments in US jurisprudence gave the federal courts the ability to supervise activities and overrule or confirm judgments made in the state courts (see Feldman, 2010, for example).

These developments have led some to argue that the Court was overstepping its constitutionally prescribed bounds. For example, judicial review of the constitutionality of legislation is not specifically mentioned in the constitution. Burns (2009), for example, argues that too much power has been assumed by the courts, specifically the US Supreme Court, with the latter having taken the nation down roads violative of the popular will, i.e., that the Supreme Court is violating the ideal of majoritarianism. Feldman (2010), in contrast, argues that the evolving relationship between the judiciary and the majority has become much more temperate since the Court's earliest decisions on Judicial Review (*Marbury v. Madison* 5 U.S. 137 1803), *McCulloch v. Maryland* (*McCulloch v. Maryland*, 17 U.S. 316 (1819), and the Dred Scott decision (*Dred Scott v. Sandford*, 60 U.S. 393 (1857)). He notes that the majority of the public seem largely satisfied with the way that the US Supreme Court's decisions have evolved over the years. Peabody (2011) argues that the delicate minuet between the three parties was built into the system, enabling the parties to enjoy a dynamic, evolving, relationship. The nature of this relationship has changed substantially over the years, with the structural weakness of the Court, e.g., its inability to command troops to enforce its decisions (*Worcester v. Georgia*, 31 U.S. [6 Pet.] 515 [1832], a decision that went unenforced because President Jackson refused to enforce it) becoming less problematic as the political branches became more supportive of the institutional authority of the US Supreme Court to make decisions with which the political branches disagreed (e.g., President Dwight Eisenhower's decision to enforce school desegregation pursuant to *Brown v. Board of Education* [347 U.S. 483 (1954)]).

The position of the Supreme Court specifically, but more generally all the courts, as being subject to pressures and threats from the other branches of government can be considered as a limitation on its ability to exercise its undiluted judgment due to its need to enlist the executive and legislative branches' assistance in enforcing its decisions. Clark (2010) calls this the dominant political science model of judicial independence. He argues that this model of judicial independence has received scant empirical support, in part because political pressures on the Supreme Court are often insincere. Clark (2010), consistent with Feldman (2010), argues for a constrained model that takes into account both the separation of powers and the willingness of the population to support court decisions. Clark argues that the court's institutional legitimacy

helps protect it from attack by the politically motivated. In both Burns' (2009) history of the court and that of Feldman (2010), the ability of the court to survive attack through clever manoeuvre is obvious. Accordingly, while politicians have vehemently disagreed with, and threatened the Supreme Court because of certain decisions (e.g., the Miranda warning case [*Miranda v. Arizona*, 384 U.S. 436 (1966)] and *Brown v. Board of Education*, etc.), Clark (2010) and Feldman (2010) argue that the public has become more sanguine about the role that the US Supreme Court and, by extension, the less powerful federal and state courts have played in the evolution of our democracy.

The growing levels of comfort of the public with the emerging role of the US Supreme Court is evident in the largely negative public and congressional response to President Franklin D. Roosevelt's 1937 court packing efforts. The attempt by President Roosevelt to alter the makeup of the US Supreme Court came after his earlier New Deal legislation was overruled by the US Supreme Court for overreaching the powers of the federal government vis à vis the powers of the states. President Roosevelt sought to add additional members to the Supreme Court whom he thought would be supportive of his program. Both political opinion within President Roosevelt's Democratic caucus in the US Senate and popular opinion were leery of going forward with this plan (e.g., Burns, 2009; Friedman, 2009). The plan was ultimately dropped after deft political manoeuvring by then Chief Justice Evan Hughes, a strategically timed retirement by a conservative justice, and a turnabout by the Court majority on other New Deal cases that came before the Court. While some may regard the outcome as proof of the Court's ability to protect its independence, others regard it as proof of the Court's susceptibility to political pressure.

The ability, or willingness, of the US Supreme Court to turn on a dime in 1937, as it were, in a situation in which it was threatened by the President and his power over the Democratic majority in Congress, highlights the independence issue. The court's structural vulnerability to having additional individuals (a) added to the Court at the whim of the President and a majority of both houses, (b) having decision-making power taken away from the Court under Article 3 of the Constitution, (c) having courts dismantled through legislation or the Congress's power of the purse, or (d) removing justices through impeachment, gives us a strong picture of the structural situation facing the federal judiciary. As in the Court Packing case of 1937, the courts are all too vulnerable to the power of other branches of government. The court packing case dramatically illustrates the willingness of the Court majority to surrender its self-perceived prerogatives in order to preserve the historic institution. These actions, then, represent both a

protection of judicial independence and the surrender of it to avoid greater harm.⁵ But it is not the only threat to judicial independence. As we will see, justices at all levels face additional independence threats.

2.2. The structuring and loyalty of auditors

What about auditors? Auditors have the responsibility under the Securities Exchange Acts of 1933 and 1934, Sarbanes-Oxley Act of 2002, etc. to render opinions on the concordance of their client's financial statements and, with respect to SOX, systems of internal control with relevant external criteria. For the financial statements, the external criteria are described in the US as Generally Accepted Accounting Principles (GAAP). For internal control, the external criteria are often the framework of internal control developed by the Committee of Sponsoring Organizations (COSO). In the US, the focus of independence rules set forth first by the AICPA in its Ethics Rule 101, and now also by the PCAOB, is that the auditor must be independent of the client firm. The auditor is legally accountable to the SEC for publicly-owned clients should it fail to be independent of that client firm. It is also legally accountable to the shareholders and certain other parties should it fail to be independent, whether the client is a publicly-held corporation or not.

An important structural difference between auditors and judges in the United States is that the client hires, pays, and can fire the auditor at will, leaving the auditor always mindful that his position is constantly in peril should he have an irreconcilable disagreement with the client. Given that the client can much more easily replace the auditor than the auditor can replace a client of any good size, it is clear to both parties where the power in the arrangement lies. Ball (2008), however, argues that there are countervailing influences on auditor behavior. Specifically, he states that the auditor should always be mindful that if the auditor is publicly found to have lost independence and a scandal ensues, then the reputational effects on the auditor's practice may be costly if current and potential clients seek another auditor's opinion.⁶ While seeking truth for its own

⁵ Feldman (2010) himself notes, however, that the US Supreme Court justices in 1937 did not discuss the reasons for their change of heart toward the Roosevelt era New Deal legislation.

⁶ This is consistent with Ball's (2008) argument that there are two sources of pressure on the behavior of auditing firms. Regulatory/political forces can act to forestall inappropriate auditor behavior, including independence loss. Market forces, which Ball sees as more powerful, can also constrain auditor behavior. Auditing firms, of course, are composed of auditing professionals. We note therefore that Ball (2008) does not mention internal forces stemming from the auditor's identification with the profession and its espoused ideals as having an impact on auditor independence-related and other behavior. For more on this, see Kleinman & Palmon (2001).

sake has great moral value, the potential impact of lost cash flow may be more convincing. The question then arises, if the auditor can be hired, paid, and fired by the client and at the same time must report on whether the client's financial statements and system of internal controls is satisfactory, then to whom must the auditor be loyal? Under US AICPA and PCAOB ethical standards, the auditor must be loyal to the truth!

The auditor cannot be loyal to the client since the client corporation is very often controlled by the client's management, even though the latter is technically a creature of the client's board of directors. It is often said that the auditor's client is the shareholders of the corporation, since the auditor is reporting to them on the faithfulness of the client's reporting of its stewardship of shareholder assets. Regrettably for the auditor, the auditor cannot know what the true preferences of the shareholders are, that is, he cannot know whether the shareholders as a body prefer honest versus dishonest reporting. Existing shareholders may be harmed should the auditor report that the client's statements are materially misstated since then their shares may drop sharply in price, reducing the shareholders' wealth. By contrast, the impact on prospective shareholders and creditors can be positive since they may choose not to buy shares or lend money to the firm. In addition, should the share price fall, the prospective shareholders can always buy shares at a reduced price. Of course it is impossible to prove the existence of prospective shareholders and creditors unless they act, but even within the group of existing shareholders, interests may differ since some may gain at the expense of others if negative news comes out about the corporation's financial reporting. This may happen, for example if there is a contest for control of the corporation. How does one know that such a contest is contemplated, though?

The auditing profession sees auditor independence threatened, with the threats largely based on economic or personal relationships (Gramling et al. 2010). The economic roots of the rules for auditor independence make sense for the audit of financial reporting, which is based on economic rationality and motivation. The AICPA Code of Ethics, and its Conceptual Framework, recognize this. Kleinman and Palmon (2001) conceptualized the auditor as being enmeshed in a complex web with each facet having the potential to pull the auditor, knowingly or not, in a direction that leads toward or away from independence. These forces included such internal forces as personality, career aspirations and motivations, as well as such external forces as the auditor's familial needs, professional affiliation, and work group, as well as the audit firm's cultural dynamics, bureaucratic and professional control systems, and the dynamic and historical relationship between the audit firm and its client. The auditor's independence is also said to be further impacted by its legal, regulatory, social, political, and task environment. Kleinman and Palmon (2001) noted, for

example, that an auditor may be influenced to take an excessively harsh view of a client's financial statement quality because the auditor fears a law suit or a reprimand from the SEC, even though an objective view of the financial statements might not support that opinion. Extraneous factors could exert pressure to act in favor of the client. These forces could be friends and relatives (especially if these parties had a third party interest in the financial success of the client). While the above mentioned factors are external, the forces could also be internal. This takes the form of other partners, who are familiar with the client and could coax or coerce the partner-in-charge (PIC), thus impairing his/her judgment. The countervailing forces include the continuing professional education (CPE) courses required by the AICPA and the review/concurring partner rules, which further instil the need to maintain professional scepticism, and also training in ethics and maintaining ethical standards.

In law, the identity of the parties immediately affected by a ruling is obvious.⁷ In auditing it is not. Accordingly, the auditor's obligation should be to the truth of the matter itself, and not to any specific group. In law, the "truth" emerges from the clash of adversarial lawyers presenting their arguments, their evidence, and themselves to the court. It should not emerge from considerations such as whether the attorneys are likable or not. Or whether the client is dressed appropriately for court. In accounting, "truth" is the correspondence of the firm's economic reality to the information presented on the financial statements, filtered through the strictures of GAAP. The auditor, in effect, becomes a judge who adjudicates the correspondence between the financial statements prepared by the client and the underlying economic reality of the firm. Like the client and the appropriateness of his/her dress in court, *discovered* "truth" in auditing should not change when an attractive member of the client's staff is assigned to serve as a liaison to the auditor's staff. Does it? The literature, but not the world of practitioner anecdotes, seems silent on these points. Both the judge and the auditor are human and subject to influences beyond the economic or familial ones described so often in the standards. We will explore these issues also.

A final structural issue that heavily impacts any independence-related comparisons between the judiciary and auditing is how they get paid. Bazerman and Moore (2011) argue that auditors are subject to a kind of motivated reasoning. They note that auditing as a profession can enhance its independence by forswearing provision of any other services to the clients other than auditing.

⁷ There is always the possibility that, upon seeing a ruling holding individuals liable for a certain behavior, others will forebear engaging in that behavior due to fear of legal consequences or just an unwillingness to engage in an activity now labelled "wrongful". It is impossible to identify these individuals as well unless they announce themselves. Even if they do, of course, there is always the possibility that they would not have engaged in the behavior anyway.

Alternatively, and favored by the auditing profession, the auditors could seek to maintain their independence *despite* providing many non-audit services. Regrettably, Bazerman and Moore (2011) note that having a system that permits the latter is an invitation to trouble. As the authors note (p. 310), "...even honest auditors were incapable of independence within the current regulatory framework. This is not because auditors are any more corruptible than the rest of us, but simply because the human mind is so adept at interpreting ambiguous evidence." Whether judges or auditors are more "corruptible" across the board is an interesting structural issue. Judges, for example, are paid by the government and may not have their compensation reduced during their lifetime. Judges who need to run for office, however, may receive heavy campaign contributions from parties interested in one narrow topic, such as Judge Benjamin in the *Caperton vs. Massey* case (*Caperton v. A. T. Massey Coal Co.*, 129 S. Ct. 2252 [2009]: see US Supreme Court decision, No. 08-22 [2009]), who received massive campaign donations from Massey Coal's head, Don Blankenship. Mr. Blankenship was fighting litigation that was then destined to be heard before the West Virginia Court of Appeals, a court to which Judge Benjamin sought election. If the judge's independence was compromised due to the \$3,000,000 of campaign contributions that Blankenship spent on behalf of his election, perhaps it was only on this isolated issue. Auditors in the US, however, are paid by the firms that they audit. If money talks, then the structure of the relationship between auditors and clients is inherently problematic.

In sum, in this section, we have stated that the purpose of judicial independence is to promote the achievement of justice, and the purpose of auditor independence is to promote the expression of truth regarding the client organization's financial statements. In the next section, we compare auditors and judges based on specific economics-based themes or situations that may impair their independence. In the subsequent section, we will explore social and personal influences on judicial and auditor independence.

3. Comparative Analysis by Economics-related Themes

In this section we provide a comparative analysis of factors impairing auditor/judicial independence in the United States by economics-related themes, largely on the basis of factors impacting individual judges and auditors. We categorize these by theme as follows:

Acquisition of position as judge/auditor, comprising:

- *Campaigning/soliciting or seeking of position*
- *Election*
- *Appointment*

Education of judges/auditors

Compensation of judges/auditors

Cultural expectations

Conflict of interest and recusal

Accountability

Tenure

Discipline and removal

Acquisition of position of judge

3.1. Campaigning versus soliciting or seeking of position

In the United States, the auditing and judicial professions share a commonality that could affect independent judgment. Many judges must campaign for their positions, so they may potentially be biased in any cases involving their campaign contributors (e.g., Caperton vs. Massey, 2009). Auditors have to campaign too, although they call it “soliciting business” instead. The auditors solicit business in terms of new or continuing audit engagements, as well as consulting work. The case of Arthur Andersen may suggest a lesson for the legal profession in that when compensation reaches extreme levels, independence may be seen to have been lost. In the European model, judges are chosen by an appointed council, rather than having to campaign for their positions. In England for example, the Lord Chancellor’s department gathers information about potential candidates by making informal inquiries from leading barristers and judges. This is known as the secret sounding system. A potential judge must wait to be invited to the post. This system is designed to ensure that the judge will be impartial (see Burbank and Friedman, 2002, for detailed discussion). In other European countries, judicial vacancies are advertised, and candidates are selected by an appointed panel, eliminating potential future bias. The Caperton v. A. T. Massey case suggests that judges might be perceived as biased toward their campaign contributors in the same way that the Arthur Andersen case suggests auditors may be biased towards

their clients.⁸ The issues surrounding judicial and auditor independence, however, are more complex than just financial issues.

3.2. Election of judges

Judges, unlike auditors, may be elected. If so, this is an issue of potentially impaired independence unique to the judiciary. Judges may be influenced by the fear of electoral retaliation against unpopular decisions, thereby costing them their positions and the prestige and income that come with it. Also there is a fear that judges may compromise their independence by incurring obligations to those who provide financial support to their election campaigns. Aspin and Hall (1994) surveyed 645 trial judges and concluded that elections influence judicial behavior because judges are sensitive to public opinion. The *Caperton vs. Massey* case is a particularly egregious example of campaign financing and its *alleged* potential to influence judicial decision-making.⁹

It can be said that auditors are elected as well, since the appointment of auditors in the United States is frequently listed as an item for decision on shareholder proxy statements. The literature, however, shows that auditors put up on corporate proxy statements for reappointment are almost never turned down. Researchers have found that greater investor dissatisfaction results in greater likelihood of auditor dismissal (Krishnan and Ye, 2005). Thirty-two percent of the Krishnan and Ye company sample did not even seek investor ratification of auditor selection. Even with the ability of shareholders to vote to confirm auditor selection, this does not negate the fact that the recommendation for appointment comes from the board of directors, based on the recommendation of the audit committee. Gaining the acquiescence of the audit committee for initial appointment or renewal of appointment, then, is the point at which auditor integrity may fail, especially should the client send out subtle signals that they are “opinion shopping”. In the auditing context, opinion shopping means that the would-be client is seeking an audit firm that will agree to accounting treatments that may be suspect to other audit firms including the incumbent audit firm.

⁸ Jones (2011) discusses recent proposals in the European Union for auditors to be appointed by the state, not by clients themselves. The US, with its very different traditions, is unlikely to adopt a solution perceived as “statist”.

⁹ Justice Anthony Kennedy, who wrote the *Caperton v. Massey* decision, specifically noted that “...Justice Benjamin conducted a probing search into his actual motives and inclinations; and he found none to be improper. We do not question his subjective findings of impartiality and impropriety. Nor do we determine there was actual bias.”

3.3. *Appointment*

Goldman and Slotnick (1999) note that because each president of the US draws appointees *almost* exclusively from members of his own political party, the judges so appointed are in effect party functionaries on the bench.¹⁰ Hence there is the appearance of lack of perceived independence (Burbank and Friedman, 2002). Rowland and Carp (1996) analyzed over 57,000 published opinions of district judges appointed by Presidents Wilson to Clinton, and show that decisions of judges appointed by Democratic presidents have a more “liberal” stance, and decisions of judges appointed by Republican presidents have a more “conservative” stance. Whether this reflects a failure of “independence” or something more complex is open to debate. Kahan (2011), for example, noted that judges may come to their decisions via “motivated reasoning”, that is, “individuals are predisposed to fit their perceptions of policy-relevant facts to their group commitments.” (p. 2). They view the interpretive elements of cases in a way that leads the outcome of their deliberations to be consistent with that of groups to which they belong or aspire to belong. This suggests, of course, that the ideal of blind justice is not met, but rather that individuals are influenced by group memberships to rule in certain ways, whether this influence is conscious or not.

In the auditing profession auditors are appointed by the audit committee, but often at the suggestion of the management of the prospective audit client. This suggests that auditors will be receptive to the opinions of prospective client management. The AICPA Ethics Code, however, has a section on professional scepticism. Its intent is to try to assure that auditors do not feel obligated to their client, but instead treat all data provided with scepticism. The auditor gains a degree of technical skill by being trained for and having to complete the prescribed exams of the AICPA. The exams now require training and testing of ethics and awareness of the importance of maintaining independence. The auditor's (especially the partner-in-charge's) judgments concerning the conduct and conclusion of an audit can be influenced by other partners and colleagues. The auditor can also be influenced by family and friends. The AICPA emphasizes

¹⁰ With respect to the expectations of the appointer, the President, note for example the regrets that President Dwight Eisenhower reportedly voiced over the civil rights-related decisions of his appointee, Chief Justice Earl Warren (Burns 2010) (Burns, 2009). As Burns relates, though, stories like those regarding Eisenhower and Warren are relatively infrequent in the history of the Supreme Court. The reversal of course by the Supreme Court justices who routinely found Roosevelt's New Deal legislation unconstitutional until confronted with his 1937 “court packing plan” suggests that even justices appointed by others can be influenced if they feel, perhaps, that some critical aspect of their institution's powers/status/independence is at stake.

the importance of eliminating these influences and maintaining a robust degree of scepticism in making audit judgments. The SEC also acts as an important player in ensuring that auditors act in accordance with their unbiased professional judgment by its ability to punish and take punitive actions.

3.4. Education

Although most judges have extensive legal experience they do not receive formal education before appointment; basically they learn on the job.¹¹ This remains true even though judges may have spent many years as part of the bar, having passed that examination, seeing the administration of the courts from the other side of the bench, and undergoing continuing professional education as attorneys. The necessity for argument in the courts, as well as the importance of being able to marshal facts and quickly analyze one's legal opponents arguments should hone the ability of attorneys promoted to the bench to receive information with appropriate scepticism. Burbank and Friedman (2002), however, argue that judges' practiced ability to receive information with skepticism may not help them recognize skewed information in highly complex and esoteric fields. Hence, the appearance of private judicial education could compromise public faith in judicial independence.

Auditors need to have passed the board examination of the AICPA in order to meet at least that minimum qualification to practice accounting as a CPA. To be eligible, the individual must have a bachelor's degree with an accounting specialization and often has to meet a 150-credit hour education requirement. Furthermore, many states impose experience requirements before granting licensure.¹² Auditors also have to register for continuing professional education courses that keep them abreast of the latest developments. It can be argued that this type of stringent education may help auditors recognize skewed or biased information and promote skepticism in analysis of data and decision-making. Reviews of auditor decision-making (e.g., Nelson and Tan, 2005), however, are not uniformly supportive of this notion. It can be said that as uncertainty about the correct understanding of evidence grows, so will the susceptibility of the auditing and judicial practitioner to partisan influences. In both cases, though, as Kleinman and Palmon (2001) argued with respect to auditors, exposure to additional sources of information may lead the practitioner to develop greater attachments to the

¹¹ Note, however, that there is no constitutional requirement that US Supreme Court judges be lawyers.

¹² See <http://www.nasba.org/licensure/gettingacpalicense/> for links to state-level licensing information.

profession than to the firm and clients, and thereby result in greater resistance to independence-impairing influences.

3.5. *Compensation*

Burbank and Friedman (2002) note that judicial compensation has not kept pace with inflation, and could threaten independent decision-making. In *Williams vs. US*, (289 US Supreme Court 553 1933) it was argued that refusal (by the political branches) to fund keeping pace with inflation could potentially threaten the independence of the judiciary, since lack of financial resources may make the judge susceptible to having his/her judgment inappropriately influenced.¹³ Perceived adequate compensation may leave the judge content to remain on the bench, whereas inadequate compensation may lead him/her to consider opportunities elsewhere, and thus be reluctant to rule against a firm perceived as a potential future employer, should the judge decide to leave the bench.

In the case of auditors, a great deal of research has examined the circumstances that promote or detract from auditor independence. One of the factors deemed to impact auditor independence is compensation (e.g., Nelson and Tan, 2005; Kleinman and Palmon, 2001). In the auditing context, the fundamental independence problem stems from the nature of the auditor-client relationship in the United States: the client hires, pays and can fire the auditor as evaluator of the client's compliance with both GAAP and internal controls standards like COSO. Typically, and in accordance with SEC and AICPA requirements, auditors are expected to manage their affairs so as to remain independent of their clients. However, the importance of auditor independence, long a concern of the financial regulatory community and a topic of study for accounting academics, heightened as an issue for the public after the collapse of Enron and the revelation that its auditor, Arthur Andersen, received almost \$80 million a year in combined auditing (\$52 million) and consulting (\$27.5 million) fees (Weil, 2001). SOX (2002) has sought to remedy this by limiting the non-audit services that can be provided by the auditor, thus reducing a key threat that could impair independence. To the extent, though, that auditing is a commodity and margins are low, the auditor has to push volume growth in order to expand profitability, adding to the perceived penalty of losing a client.

¹³ Note, however, that the US Constitution and many state constitutions forbid nominal judicial pay from being reduced during the judge's term in office.

3.6. *Cultural expectations*

Unlike auditors, the list of potentially damaging influences on judicial behavior with respect to cultural and political influences is much greater. This is a reflection of the differences in societal roles between auditors and judges. It also represents a constant source of difficulty for judges who truly seek to make independent decisions because they may not even be aware of the influence of the social and political milieu on their judgments, or even how their own world view shapes their decisions in ways that might be different from other judges. Experts in the philosophy of law note that conservative judges (or liberal ones) who decide in accordance with the expected wishes of those who appointed them to the bench are being independent because that is the way that they, themselves, see things.¹⁴

Dworkin (1986) argues that individuals may disagree about empirical fact, but the facts are easily determinable if the evidence is available. Individuals may also disagree about what the law *says*, but that is determinable by reading the law. A much more significant disagreement arises with regard to what the law *means*, i.e., how to interpret the written law. What is its meaning? Bases for decisions in auditing, in contrast, are clearer, relatively speaking. In the United States, GAAP is often accused of having a check-the-box quality, in which much professional judgment is squeezed out. Auditing issues, though, can also reflect narrow bases for decision (e.g., Does the claimed client asset exist, is its value easily determinable, and is it owned by the client?), as well as more judgmental issues (What is the proper valuation of a financial institution's loan loss reserves?). Even in the more judgmental areas, areas more subject to client influence (Kleinman et al., 2010), there is a known lower bound on what the reserve should be (zero). Furthermore, in the auditing and accounting arenas, issues of interpretation are not shrouded in the vagaries of historically bound, philosophic and culturally-laden language as, for example, are issues of personal privacy. Nor do auditors consider the intent of past scholars and practitioners in analyzing the meaning of words in GAAP or the auditing standards. Courses in accounting history, and now even theory, are a rarity in accounting curricula. This may reflect important differences between the bases of auditor versus judicial decision-making and the inferences one may draw with respect to each one's independence in a given situation.

¹⁴ Feldman (2010, Kindle location 3670-3673) noted that to Felix Frankfurter: "Disinterest could be proven only by way of sacrifice—the sacrifice of voting against one's political preferences."

3.7. *Conflict of interest*

The Guide to Judiciary Policy (2010: p. 3) states that “A judge should not allow family, social, political, financial, or other relationships to influence judicial conduct or judgment.” While SOX (2002) and AICPA code of conduct state that auditors should not audit companies that employ their close relatives in meaningful positions, judges are subject to greater levels of constraint than auditors are; constraints that are more difficult to measure and whose influence is more difficult to evaluate. Judges, like auditors, are enjoined not to let family and financial relationships affect their judgments. For example, Rule 3.11 of the ABA Model Code states that judges are not permitted to engage in otherwise permitted financial activities that could interfere with properly doing their judicial tasks, involve the judge in transactions or relationships with those likely to appear before him/her, or violate other code provisions.

The AICPA presents a conceptual framework to help members decide on matters concerning independence when making decisions not explicitly addressed by the Code of Professional Conduct. It is based on the premise that a member's relationship with a client should be evaluated to determine whether it poses an unacceptable risk to the member's independence. The conceptual framework notes that if a threat cannot be successfully mitigated or eliminated, then independence is threatened (AICPA, 2011).

3.8. *Recusal*

When should one recuse oneself? The *Caperton v. A. T. Massey Coal Company* case and other explorations of the judiciary (e.g., Liptak, 2006) highlight problems with the judiciary with respect to recusal. In the *Caperton* case, West Virginia State Supreme Court Justice Brent Benjamin refused to recuse himself in a case against his major campaign contributor, Massey Energy. The firm's CEO, Don Blankenship, had contributed \$3,000,000 to Benjamin's campaign against his opponent, incumbent Justice McGraw. According to the US Supreme Court decision, Massey spent “more than the total amount spent by all other Benjamin supporters and three times the amount spent by Benjamin's own committee.” (See US Supreme Court decision, No. 08-22 [2009], p. 3). In this case, Justice Benjamin refused to recuse himself, and voted twice to dismiss *Caperton's* case against Massey. Benjamin did note though that he had voted against Massey Energy in several other cases. In the auditing profession recusal is required by AICPA guidelines. These state that if auditors have relatives or former employees working in a managerial capacity at their clients' offices, or alternatively, if the auditor has worked before in any capacity in the client's office, the auditor must

withdraw from the engagement. In addition, auditing firms are not allowed to audit a client if litigation has been instituted between them.

Roberts (2011) notes that under certain circumstances, federal judges must recuse themselves in accordance with Title 28, Section 455, of the US Code. Roberts cites the code as stating (p. 7) that “a judge shall recuse in any case in which the judge’s impartiality might reasonably be questioned.” That is a vague injunction, although the standard of judgment is that of a “reasonable person who is knowledgeable about the legal process and familiar with the relevant facts.” More specific criteria are also listed by the statute, however. In making this determination, judges have the option of consulting scholarly literature, reading learned treatises, and seeking input from colleagues and others. Ultimately, for justices below the rank of the Supreme Court, a decision not to recuse is appealable to higher courts, just as in the state case of *Caperton v. A.T. Massey*, Judge Benjamin’s refusal to recuse led to an appeal to the US Supreme Court. When a US Supreme Court justice refuses to recuse him/herself, however, the appellant wishing recusal has no recourse to appeal the justice’s decision.

3.9. Accountability through statistical reports

In the judiciary there are reporting systems that provide descriptive statistics on the judiciary (Burbank and Friedman, 2002). Burbank and Friedman note that this can impact accountability and hence independence. Burbank and Friedman (2002) note that while the purpose of most reporting systems is to describe processing activity by an entire court, the fact of reporting such data may exert some pressure on judges to change their behavior to conform to that of their peers. In the auditing profession there are no reporting systems that compare an auditor’s decisions and provide descriptive statistics (see Gramling et al., 2010 for a detailed review of the auditor independence literature). The PCAOB does, however, inspect a very small proportion of Big 4 audits every year, and a selection of other audits, based on the PCAOB’s risk assessment procedures. While the PCAOB publishes a summary of its inspection results for each firm inspected,¹⁵ highlighting areas of concern other than in the quality control areas of the firm’s practice (an area subject to special disclosure rules), it is difficult to generalize from the PCAOB’s reports to the inspected firm’s practice as a

¹⁵ Available at <http://pcaobus.org/Inspections/Pages/PublicReports.aspx> as of 11/20/2011.

whole.¹⁶ Auditors, unlike justices, do face an active plaintiff's bar that seeks to capitalize on perceived or claimable auditor mis-or-malfeasance, but these efforts often fail or end in settlements whose details are never made public. Recent changes in the law impacting the ability of third parties to sue audit firms (e.g., the 1995 Private Securities Litigation Reform Act), however, have resulted in a diminution of legal claims against auditors. That and the continuing loss of information due to sealed settlements of cases leave the public unaware of whether firms might be systematically losing independence, resulting in audit failures.

Aside from the statistical reports noted above, judicial opinions are frequently published and made available through the media, Westlaw, etc. With the publication of these reports, the reasoning of the justices involved becomes public knowledge, allowing the interested polity to analyze the reasoning against the facts in the case and the filed briefs, as available. Individuals can, therefore, assess the validity of the judge's decisions. Furthermore, in jurisdictions in which judges are elected, the media and the public can compare the judicial decision with campaign finance records, and come to their own determination as to whether the judicial decision is supported by (i) the facts, and (ii) a solid chain of reasoning, as judged from the standpoint of the perceiver.¹⁷ Currently, audit reports are made available, but the standard audit report reveals little of the audit firm's chain of reasoning, consisting of boiler plate terminology prescribed by the relevant PCAOB/AICPA standard. Accordingly, the audit report shows whether the financial statements are believed to be fairly stated; whether the client firm receives a going concern opinion; etc. If an auditor decides to provide a paragraph presenting the emphasis of a matter, the auditor's concerns are made manifest. Based on *current audit reporting rules*, therefore, much less is usually known about the auditor's chain of reasoning in accepting a client estimate as valid than the reader would know about the judge's written claim as to his chain of reasoning. This failure to present more detailed information to interested stakeholders may hinder stakeholders' ability to come to some conclusion about

¹⁶ In its 2011 exposure draft regarding new measures to promote auditor independence, entitled *Concept Release on Auditor Independence and Rotation*, for example, the PCAOB wrote, "...[T]he Board continues to find instances in which it appears that auditors did not approach some aspect of the audit with the required independence, objectivity and professional skepticism. The Board addresses audit failures on a case-by-case basis through its inspection and enforcement programs. At the same time, it is also considering whether other approaches could foster a more fundamental shift in the way the auditor views its relationship with its audit client."

¹⁷ In addition to public scrutiny, appeals courts frequently opine on the quality of lower court reasoning, and members of judicial panels (e.g., appeals courts and the US Supreme Court) often critique the reasoning used by other members of the court in their opinions.

the validity of the auditor's reasoning and, therefore, to some conclusion about any relationship between the amount of the audit fee and the auditor's willingness to accept a perhaps dubious client loan loss estimate. While the PCAOB currently is exploring potential changes to the audit reporting model that would result in much greater published analysis by the auditor, these prospective changes are controversial with details yet to be worked out (see PCAOB 2011b). Whether this additional exposure of auditor reasoning would improve audit quality, consistent with US Supreme Court Justice Louis D. Brandeis's oft quoted statement that sunlight is the best disinfectant (Grumet, 2003), remains to be seen. Individuals can, of course, determine a conclusion beforehand and then, using motivated reasoning, come up with reasons that support that conclusion afterward (e.g., Kahan, 2011; Kleinman et al., 2010). To the extent that individuals are seduced by the intended conclusion to believe in the reasoning they develop to support that conclusion, the individual themselves may not know whether they are "independent" or not!

3.10. Tenure

Limitations on a state judge's tenure have allowed voters to remove judges for unpopular decisions, but Rowland and Carp (1996) note that limitations on a state judge's tenure do not affect a judge's decisions. Traditionally, it has been argued that judges with long or lifetime appointments may be more independent of political changes since their careers on the bench are largely assured once they are sworn in. By contrast, with respect to judges without long tenure, judicial elections may lead special interest groups to support their preferred candidate with money, endorsements, and other campaign support in the expectation that the winner will favor their position (Liptak, 2006).¹⁸ Hence, there is a potential for strong political influence with "election selection". In fact, it could be argued that, in the case of judges without a long tenure who have to face elections, political forces affect both the election and the appointment of judges. If the political forces are strong enough, incompetent judges can be elected or appointed at any level except perhaps the Supreme Court.

In the United States there is no guarantee that an auditor will always continue auditing any particular client firm. Often, however, incumbent auditors remain in that position for many years. It has been argued that this impairs auditor independence in that the auditor fears losing the economic rent gained (e.g., De Angelo, 1981) by auditing a client whose systems and procedures are familiar and

¹⁸ The Prosser v. Kloppenburg 2011 race for the Wisconsin Supreme Court is a dramatic, recent case in point (e.g., Davey, 2011).

need only incremental effort to ascertain whether the systems have changed and whether they will continue to operate effectively. This situation is said to threaten the independence of the auditor, according to De Angelo (1981), because the auditor may be reluctant to lose that economic rent, with economic rent defined as the difference between the ongoing audit fee and the reduced level of auditing cost due to knowledge of the client systems gained during previous audits. Another reason that allowing the auditor to maintain incumbency with a particular client may threaten the auditor's independence is a growing psychological accommodation to the demands of the client with the result that independence is slowly lost, even though the auditor does not realize that such is the case (see Kleinman and Palmon, 2001). The question of how, and whether, to limit auditor incumbency (on the individual auditor level) was addressed by the Sarbanes-Oxley Act of 2002. Audit firm partners-in-charge were required to switch off the audit after five consecutive years. More recently, the PCAOB issued an exposure draft (PCAOB, 2011) on the issue of requiring client firms to switch audit firms periodically. The PCAOB (2011, p. 10) noted: "By ending a firm's ability to turn each new engagement into a long-term income stream, mandatory firm rotation could fundamentally change the firm's relationship with its audit client and might, as a result, significantly enhance the auditor's ability to serve as an independent gatekeeper".

The PCAOB also noted the potential importance of limiting the ability of the client firm to remove the auditor prior to the expiration of any imposed limit on the audit firm's incumbency. Taking such a step would provide the auditor with a term certain, similar to the conditions facing judges once elected and in office, barring impeachable wrongdoing.

3.11. Discipline and removal

The US Federal Constitution (Article III, Section 1) authorizes removal of life tenured judges and other officials by impeachment for failure to maintain good behavior. In the case of auditors, the SEC is the most powerful regulator of auditor behavior in the United States for auditors of publicly-owned companies. The AICPA governs audits of non-publicly-owned companies. The PCAOB has the power to discipline or otherwise call auditors to account publicly after requested review of such attempts by the SEC. While the imposition of such sanctions on both auditors and judges in the United States is relatively rare, the ability of congress on the one hand, and the SEC/PCAOB on the other to put such sanctions into effect, if believed required, may act as a constraint on individual auditor/judge behavior.

These tools of removal are available given perceived and proven bad behavior, e.g., judges taking bribes, or, with regard to auditors, through proven

lack of independence. The potential for such punishments acts to maintain auditors and judges in their roles, including the intended maintenance of independence. The ability to prove a failure to maintain independence, especially when a judge's judgments involve areas where, as Dworkin (1986) terms it, the "law runs out", is another issue. Similar constraints on the ability to evaluate the independence of auditors' judgments arise when auditing decisions need to be made on issues in which large elements of judgment are present, for example, the evaluation of the market value of complex securities (for example, PCAOB, 2011a, released on 8/16/2011.)¹⁹

Table 2 summarizes factors that are relatively more supportive of auditor or judicial independence.

TABLE 2 Panel A (Factors favoring the Judiciary vis-à-vis Auditors with respect to perceived independence.)

Judiciary	Auditor
<p><i>Determination of laws</i> Guidance with respect to actual and perceived independence provided by Guide to the Judiciary (2010).</p> <p>Based on the lawsuit, all parties have the opportunity to present evidence and arguments in front of a jury. In essence, bases for judicial decision-making are set by precedent based on prior verdicts under the common law, and by statute under statutory law. This results in limited latitude in interpretation. The area for judicial "creativity" lies in situations where, as Dworkin (1986) states, the "law runs out".</p>	<p><i>Determination of laws</i> Guidance with respect to actual and perceived independence provided by AICPA (Rule 101) SEC and PCAOB. Auditors are legally responsible to the SEC for publicly owned clients.</p> <p>Interested parties do not have the opportunity to present evidence and arguments in front of key accounting regulators (equivalent to judges) other than write letters expressing opinions. GAAP allow auditors latitude in the interpretation of accounting principles and standards causing concern to interested parties. Hence, Leonard Spacek's call for an accounting court more than half a century ago. This court never materialized.</p>

¹⁹ Recently, for example, Ernst & Young was fined \$2,000,000, for accepting client estimates of sales return reserves based upon a non-GAAP method. When Ernst & Young's initial acquiescence to this flawed method was challenged by an internal Ernst & Young review, the individuals involved decided to accept the client preference for sales return reserves based upon another faulty, non-GAAP compliant method (PCAOB, 2012).

Judiciary	Auditor
<p>A judge can arrive at his or her judgments based on evidence presented. There is no violation of perceived independence when the evidence is clear and the wording of the statute is clear.</p> <p>“Truth” emerges from adversarial lawyers presenting cases and the judges’ decisions based on the evidence presented and the relevant law.</p> <p>Remuneration Interested parties do not directly employ or remunerate judges. Compensation is determined by the government.</p> <p>Identity of parties The identity of parties immediately affected by a ruling of a judge is obvious.</p> <p>Statistical reporting Data is kept on court verdicts and reports are prepared and disseminated. This may keep judges “on their toes”, especially with regard to showing that their independence is not impaired.</p> <p>Recusal Federal constitution authorizes removal of even tenured judges. This threat may keep judges “in line”.</p> <p>Tenure Lifetime appointments, as to the federal judiciary, may result in greater ability to be independent.</p>	<p>Greater latitude in interpretation mentioned by Spacek in 1958 could result in perceptions of impaired independence</p> <p>“Truth” comes from auditors, based on GAAP that generally allow latitude in determining the “truth”.</p> <p>Remuneration Interested parties (client companies) directly employ auditors and also determine their remuneration thus exacerbating perceptions of impaired independence.</p> <p>Identity of parties The identity of parties immediately affected by the decision of an auditor with respect to the financial position of a company is not obvious. Auditors’ obligation is to the truth of the matter not to any specific groups.</p> <p>Statistical reporting There is no such reporting for auditors, thus releasing pressure, but also allowing a mind-set with more latitude.</p> <p>Recusal The SEC has power to act as an arbiter in conjunction with the PCAOB. However, the SEC does not intervene as frequently.</p> <p>Tenure Since tenure is currently determined only by the client, independence could be impaired.</p>

TABLE 2 Panel B (Factors favoring the Auditors vis-à-vis Judiciary with respect to perceived independence.)

Judiciary	Auditor
<p><i>Assuming the position</i> If judges need to campaign for their positions, their independence may be impaired due to anticipated electoral retaliation against unpopular decisions. It has been concluded that judges could come to their decision by “motivated reasoning”, that is, make decisions to meet popular electoral demand. Hence, on a relative basis, there could be impaired independence vis-à-vis auditors.</p> <p><i>Learning while working</i> Judges are not trained for their job. They learn “on the job”, so there is a fear that independence may be impaired due to lack of experience as the judge progresses through a learning curve. While judges may be required to take CPE as attorneys, the adversarial nature of legal practice may result in it being mute on the importance of judicial independence.</p> <p><i>Tenure</i> Since judges may have to be elected and the length of their tenure is based on how many elections they can win, independence could be impaired.</p>	<p><i>Assuming the position</i> No elections are held to assume the position of auditor of a company. The auditor hence lacks “motivated reasoning” and could potentially make decisions that do not cater to the demands of the client.</p> <p><i>Learning while working</i> Auditors are trained for their respective roles. The AICPA requires that auditors pass exams. Even after they obtain their professional certification, they have to follow continuous professional education programs (CPE) and remain up to date on the latest policies, procedures and ethical standards with respect to the issue of maintaining independence.</p> <p><i>Tenure</i> Since tenure is currently determined only by the client, independence could be impaired. So we have parity with the judiciary which may also face this issue.</p>

4. Current Controversies Concerning Judicial and Auditor Independence

4.1. Social concerns

In this section, we describe current controversies that are relevant to judicial and auditor independence. These controversies illustrate independence issues and threats discussed earlier, and also highlight the complexities facing judges and auditors in a world where their behavior can raise questions about their independence.

Judges and auditors exist in social milieus. Some of their many associations may be viewed as indicating independence threats. A case in point is the Sierra Club's request that Supreme Court Justice Antonin Scalia recuse himself from a court case involving Vice President Cheney and the Sierra Club, which illustrates differences in the institutional setting of justices and auditors. In this case (see, for example, Liptak, 3/21/2004), Justice Scalia and his son accepted a ride on Air Force Two with Vice President Cheney. The purpose of the one-way trip (the Scalias took a commercial airplane back) was to enjoy two days of duck hunting in Louisiana. There was, at that time, a case before the US Supreme Court in which the Sierra Club asked the Court to rule that Vice President Cheney should disclose records of meetings that he held in 2001 with energy industry lobbyists to discuss the setting of a new US energy policy. The Bush White House refused to release the records of these meetings and the names of attendees, claiming that this release was not required under existing federal statutes. By 2004, this case had reached the US Supreme Court. Upon learning of Justice Scalia's trip with the Vice President, the Sierra Club asked Justice Scalia to recuse himself from the case, given that his independence may have been compromised by accepting the free flight with the Vice President. In addition, there were allegations that the Vice President and Justice Scalia may have had opportunities to discuss the case privately. Justice Scalia denied any impropriety, including discussing the case with Cheney. Furthermore, Justice Scalia noted that the round trip price for air travel to and from Louisiana was \$567, the price he paid for the ticket back to Washington after the duck hunting trip. The Justice noted that he could hardly be bought for that amount of money, and further stated, "My recusal is required if, by reason of the actions described above, my 'impartiality' might reasonably be questioned." And "Why would that result follow from my being in a sizable group of persons, in a hunting camp with the vice president, where I never hunted with him in the same blind or had other opportunity for private conversation? The only possibility is that it would suggest I am a friend of his" (see Scalia, 2004). Can, or was, a Supreme Court Justice's opinion purchased for

so small an amount of money? If so, what can one say of audit firms that receive millions of dollars in fees from large clients for audit opinions? This is to say nothing of the millions of dollars in fees that large clients may pay the auditor for non-audit, consulting, or tax work. Certainly, though, even very small audit clients may pay significantly more than \$567 for an audit. Can audit firms be bought so cheaply as well? Is it possible that Justice Scalia (or an auditor) *only thought he was not being bought*? A significant institutional feature of being a judge is that the judge is not allowed to receive emoluments from participants in a case before the court. In the case of Supreme Court Justices, each justice is required to decide whether any circumstance impairs their independence, requiring them to withdraw from the case (Roberts, 2011). Auditors in the United States, by contrast, are expected to receive payment for services rendered by the clients *and still reveal to third parties whether the financial statements and internal control systems* are acceptable under GAAP and under the internal control framework adopted by the client corporation (usually that of the Committee of Sponsoring Organizations, or COSO.)

Family relationships raise potential threats to the independence of both auditors and judges. These threats may be real or perceived. Such concerns have been raised with respect to the activities of conservative activist Virginia Thomas, the wife of Supreme Court Justice Clarence Thomas (see Calmes 2010).²⁰ In 2009, Virginia Thomas started a non-profit conservative organization, Liberty Central, whose goals are to oppose Obama's "leftwing tyranny" and, as the *New York Times* put it, protect "the core founding principles of the nation." Her group is allowed to, and does, accept large anonymous donations since it is a 501(c) (4) corporation under the IRS Code. As such, it is required to limit its political activities to less than half of its total activities. Liberty Central's acceptance of large sums of money raises issues with respect to whether Virginia Thomas' husband, Justice Thomas, might become aware of the source of the donations and whether he would then suitably recuse himself from sitting on cases involving these funding sources.

The problem is that the public will never know whether Justice Thomas is aware of the source of Liberty Central contributions, or whether he is appropriately recusing himself. According to current practice, it is up to the Supreme Court Justice to decide whether to recuse, and there is no appeal mechanism available to the public. By contrast, AICPA Rule 101 requires recusal

²⁰ See Greenhouse (2011) for an analogous case involving the activities of Judge Stephen Reinhardt's wife. Reinhardt was asked by anti-gay marriage groups to recuse himself from the California Proposition 8 case because his wife was Ramona Ripston. Greenhouse notes that Ms. Ripston served as head of the American Civil Liberties Union of Southern California. This organization fought for extending the right to marry to same-sex couples.

in certain circumstances involving the employment of an audit team member's spouse. For example, if the spouse is a key decision-maker for the client firm, or in position to influence the creation of the financial statements, the auditor cannot participate in the audit. An important question for us, then, is whether there are substantial differences in ethical sensitivity and the perception of conflicts of interest between auditors and justices that leave the recusal decision up to a Supreme Court Justice, but not lower court justices, yet denies an auditor the same power. While the Calmes article notes Liberty Central's claim that it has "internal reviews and protections" to prevent problems for Virginia Thomas and/or her husband, auditors are well aware of the fragility of controls and the possibility of their failure. Otherwise, if internal reviews were sufficient, would we need external auditors? Perhaps one can argue that there is something substantially different in the practice of law and auditing that leads judges to enjoy this privilege. While there is, as Calmes (2010) notes, a federal law that "requires justices to recuse themselves in a number of circumstances where real or perceived conflicts of interest could arise, including in cases where their spouses could have a financial interest....the decision to step aside is up to each justice; there is no appeal from the nation's highest court." Not all justices, of course, have the ability to decide for themselves whether to recuse from a case. Certainly the judge in the Caperton vs. Massey case chose not to recuse only to find his choice overturned by a court composed of Supreme Court justices whose own decisions to recuse are not open to question by a higher authority unless it is deemed a breach of good behavior while in office, and therefore subject to impeachment under Article III of the US Constitution. The institutional arrangements governing the auditing profession leave judgment on an auditor's discovered failure to recuse up to agencies (PCAOB, AICPA, SEC) that are not part of the auditing firms and, in the case of the PCAOB and SEC, the profession. Leaving aside the extreme step of Congress impeaching a justice for nonrecusal, justices are answerable only within their profession. The judicial system, of course, is a creature of the US Constitution's Article III. A traditional belief in judicial independence and the high esteem in which justices are typically held also serve to protect justices when they refuse to recuse.²¹ The auditing profession, in contrast, has no such high-toned origin, or ability to appeal to deeply ingrained popular beliefs about allowing individual auditor decision-making in this regard. In this respect, the auditor has fewer and weaker defenses against assault than the judiciary.

²¹ Note Justice Kennedy's deference to Judge Benjamin's self-evaluation of his lack of bias in the Caperton v. A.T. Massey case.

We have noted above that scholars of the courts observe the tendency for Presidents to appoint members of their own party, people who share their own beliefs, to the bench, presumably in the hope that a shared set of beliefs will motivate the justice's future decisions. In doing so, the President manages to project his social and policy beliefs, as relevant to judicial decisions. Choosing cronies, even exceptionally talented cronies, may indeed help the President project their shared beliefs forward for decades after the President has left office. Regrettably, as in the case of US Supreme Court Justice Abe Fortas, it may also lead to issues of judicial independence. Fortas had a relationship with President Lyndon Johnson going back to the days when President Johnson used Fortas' services to ensure that his election to the US Senate was not overturned due to alleged balloting irregularities. Fortas continued as a Johnson adviser while sitting on the Supreme Court. Indeed, it is claimed that he even co-wrote President Johnson's 1966 State of the Union address. It was further alleged that Fortas had a phone on his desk that was a direct line to the White House (e.g., http://en.wikipedia.org/wiki/Abe_Fortas.) Serving as an adviser to a sitting President of the United States on issues that might come before the court is problematic. The gained knowledge of other justice's preferences might be useful to a President planning legislation that those justices might be called to rule upon. It could be seen to violate the separation of powers enshrined in the US Constitution.²² It is a well-known phenomenon, however, for auditors to *jump ship* and join audit client firms after the auditor has last worked on an audit for that client. Recently, there was a controversy surrounding Justice Elena Kagan as to whether she should have recused herself from matters that were soon to come before the US Supreme Court concerning the Obama Affordable Care Act and the Arizona immigration law case. The reason for the controversy was Justice Kagan involvement in these cases while serving as President Obama's Solicitor General (Mak, 2011).²³ The issues for both Fortas and Kagan revolve around whether they were sitting in judgment over matters that they may have influenced during the matter's development.

A key feature of auditing education is that an auditor must not sit in judgment on his/her own work. Auditors are barred under AICPA rules, for

²² Justice Fortas was ultimately forced to resign due to his relationship with Louis Wolfson, an industrialist accused of stock manipulation, and because of Justice Fortas' receipt of \$15,000 of lecture fees from American University. Those funds had been provided by Fortas' former law partners and clients, individuals who might appear before him at some future date (http://www.ca6.uscourts.gov/lib_hist/Courts/supreme/judges/fortas/af-bio.html).

²³ Justice Thomas was also under pressure to recuse himself from the Affordable Care Act litigation as well (see, for example, Hardin, 2011). Since we discussed him elsewhere, we do not include him in this discussion.

example, from setting up or maintaining the books of a corporation in a decision-making capacity and then auditing those books. The perceived threat to the auditor's independence is that the auditor may be reluctant to report a mistake in the books that he/she set up or maintained. Similarly, if an audit firm hires someone away from its audit client, it should not assign that person to audit their former employer. While it can, of course, be argued that the person left the client and assumed a new professional identity upon joining the CPA firm, the appearance of independence remains endangered, and thus the person would most likely be barred from the audit. It is possible in both cases that the discussion within the court or the audit team would be enriched due to the knowledge and experience gained by judges who recuse themselves and auditors barred from auditing clients with whom they have had prior relationships. In fact, that experience would be more salient in an auditing context than in the judicial decision-making context.

Under the judicial contest theory, judges and juries are to make decisions based on the facts presented to them during the trial. Limiting the bases for decision to the facts adduced in court allows both sides to see and contest information and arguments provided by the other side, with neither side of the argument affected by the availability of information not subject to such contest. The aim of judicial decisions is the attainment of justice, stemming from a due process, i.e. influenced process. Allowing one-sided information from either side to tilt the scales of justice in its own favor violates that presumption of due process and fair consideration. The decision-making process in auditing differs substantially. Auditing is an investigative profession whose task is to employ techniques embodied in the PCAOB's or AICPA's auditing standards in order to determine the truth of the matter. These standards explicitly encourage the gathering of information from all sources in order to come to a judgment about the state of the financial statements and/or the internal control system. Accordingly, auditors engage in their own wide-ranging search for information relevant to the audit. This search begins when the auditor first considers pursuing or accepting an engagement with the client, through the decision to accept, and finally to carry out the engagement. The auditor is not restricted to gathering information just from the client or client-approved agents, but rather from any source that the auditor believes can offer reliable, persuasive information. Accordingly, it seems something of a contradiction for an auditor to fail to assign to an audit an individual who has his/her own prior knowledge of the client, including having worked for the client. Similarly, it seems something of a contradiction for the auditing rules to ban the advantages that hiring such an individual would provide.

Given that judges and auditors approach the matter before them from different standpoints (judges from a weighing of the *formally presented* evidence

alone, and auditors from *both* investigation and weighing of the evidence), why do both professions argue for recusal of individuals who have suspect knowledge? But that may be a mistaken formulation. The issue may not be the knowledge. One potential issue is the relationships that give rise to the knowledge. Auditors, like justices, may be subject to the pull of old relationships. Barring individuals from auditing the work of former co-workers helps rule out the impact of such relationships on their judgment. Justices routinely deal with the same lawyers in case after case, even though the defendants or plaintiffs may be different. Requiring only official evidence, easily contested by the other side, enables the judge to set off one side's claims against the other, giving both the chance to try to sway the judge in their preferred direction. In addition, the history of having worked on relevant issues before and having taken positions on them in the course of that work may make coming to more independent judgments more difficult. This is not an issue if one comes to the position-taking from the same role as before (e.g., as an auditor or a judge), but it is if one has switched roles and is in effect reviewing one's own previous work undertaken in an earlier, different role, or an outcropping of that work. It may be easier to confront one's former work associates with unpleasant verdicts or conclusions. Confronting oneself with the realization of one's own mistakes may be more difficult.

4.2. Social interaction

Here we discuss work-related social interactions and their impact on the individuals involved. In the auditing profession, for example, the AICPA enumerates taboo relationships when members of the auditor's family are working for the client in key positions, thereby presumptively diminishing the auditor's actual or perceived independence with respect to that client. Auditors, of course, are under no social restriction in their interactions with client management. Indeed, a private discussion with a KPMG partner during the week of October 11, 2010 revealed that audit firm staffers are actively encouraged to engage in some level of social interaction with client personnel. There are differences, of course, in the relationship between judges and the litigants appearing before them, versus the relationships among auditors, their clients, and stockholders/creditors. Judges, according to some (e.g., Justice Roberts) play the role of umpire deciding between competing parties. By definition, one party's win is the other's loss. US auditors are hired by client management to report to the stockholders on whether the client's financial statements are fairly stated in accordance with GAAP. Auditors act on behalf of the stockholders, but may face dismissal if they report that their client has misstated its financial statements. Accordingly, being sociable with the client facilitates the auditor's ability to continue auditing the client effectively. However, the shareholders are often anonymous, faceless entities whose names

are listed on a computer disk controlled by the transfer agent for the firm's stock. It is impossible to socialize with anonymous individuals. Socializing with client management, however, is much easier. Indeed, the audit firm's rainmaking (i.e., client-generation) process includes joining civic groups and other organizations in the hope of making contacts with CEOs and other managers who may be amenable to changing auditors. As Kleinman and Palmon (2001) note, auditors can become enmeshed in a web of relationships that subtly influence their judgment. Clearly, judges socializing with attorneys may become similarly enmeshed. Social influence is ubiquitous, and both auditors and judges are only human. Justices at least have the contest of evidence and argument to help them push aside the potential decision taints stemming from prior or concurrent friendly associations. Auditors do not.

4.3. Internal-to-the-person drivers of behavior

The influence processes that act upon justices and auditors extend beyond the social ones we have discussed above, and the more practical, economic issues we discussed in the previous section. The auditor independence literature largely focuses on economic and relationship influences that may impact the auditor in the conduct of the audit (see Gramling et al., 2010 for a review of the normative literature, and Kleinman and Palmon, 2001 for a review of the social psychological literature.) The judicial independence literature pays attention to a wider arena. For example, now Supreme Court Justice Sotomayor came under severe criticism for stating that she believed that "a wise Latina" (Newman, 2009) would "often reach better decisions than a white male without similar experiences." As Senator Cornyn said, "The focus on sex and race, and saying that there may be different outcomes depending on who the judge is...antithetical to the whole idea of the rule of law." But can one be independent of one's background? For example, if an auditor is raised in a family that made its fortune in the textile industry, and learned its norms, should the auditor evaluate the books of an unrelated individual's textile mill? Can an auditor take steps that would result in the undermining of a member of his/her own social class, however narrowly or broadly defined? With regard to auditor independence, the notion of "class traitor" is never discussed. But should it be? Furthermore, should an auditor be barred from conducting an audit or rendering an audit opinion because the owner of the company was from the same ethnic group? We have never seen this argued before, but if the argument that partiality to one's own origins undermines a judge's ability to render an independent verdict or fairly oversee a trial, why shouldn't that reasoning apply to auditors as well? That is, should an auditor be barred from an audit because he/she might hesitate to render an opinion disruptive to a firm owned or controlled by his/her own minority or majority group? Or is

that a reason that he/she should be placed there? Would auditors or judges necessarily be sensitive to the potential impact of their own biases on their decisions? Judge Sotomayor was clearly sensitive to the issue of ethnicity, regardless of its effect on perceptions of her (future) fitness to sit on the US Supreme Court. Would auditors similarly see the impact of their identification with their ethnic group on the objectivity of decisions that they make? Or, failing to do so, would they just let the unnoticed influences impact their decisions? Can the objective audit marked by independence, as defined here, be truly achieved? We have never seen issues of ethnicity and independence loss raised in the auditor independence literature, even in work that has extensively explored the relationship of personal characteristics and independence (e.g., Kleinman and Palmon, 2001).

The ethnicity/partiality issue is one of positive valence, that is, the push to benefit someone of one's own background or the object of sympathy. Negative valence issues also exist, and these also may challenge the ability of judges and auditors to be loyal to the goal of justice on the one hand and truth on the other. For judges, there are clear ethics guidelines. In the recent case of *US v. Loughner*, federal judges assigned to Arizona's Tucson division were barred from presiding over the prosecution of Jared Lee Loughner in the attempted assassination of US Representative Gabrielle Giffords and the murder of US District Judge John Roll, a man who had known most of the federal judges in Arizona. Ethics rules required Arizona judges to recuse themselves because the association between the judges and Judge Roll may predispose the judges (consciously or not) to act against Loughner. The auditing profession, in contrast, does not have specific ethics guidelines requiring auditors to recuse themselves from providing audits for specific clients, clients toward whom the auditor *potentially* might have a conscious or unconscious animus. The emphasis in auditing is always not to favor the client against the trend of the evidence. Except for Kleinman and Palmon's (2001) work, we have not seen discussions about being predisposed against a client. This, of course, presumably stems from the auditor's being paid by that client. As Kleinman and Palmon (2001), point out though, an auditor could always seek to sabotage one client in order to gain an engagement with a rival. While this may seem self-destructive, the evaluation of self-destructiveness may lie in the eye of the actor, not the beholder. Judges and justices are used to dealing with the consequences of irrational behavior. Perhaps, then, they are more alert to the potential for their own behaviors to be affected by irrational impulses. Auditing, in contrast, follows the rational decision-making model implicit in *homo economicus*. Given motivated reasoning, an auditor may convince him/herself that what others see as irrational is rational. The AICPA's Rule 101 does list specific family and third-party relationships defined to impair auditor independence; it does not, however, directly address a situation like this. But does

that mean that this problem does not exist? This is an issue that should be considered by audit standard-setters.

Even if one can be independent of one's background, can one be independent of one's basic way of relating to the world? And is it even required? If a person is empathetic, is that a problem that disqualifies a person as a judge? Or as an auditor? In the *New York Times* article cited above (Newman, 2009), Senator Leahy, in discussing Judge Sotomayor, is quoted as saying (emphasis added) "*President Bush talked about empathy when he nominated a Republican to the Supreme Court. You know, the fact is her answers are these. Ultimately and completely, the law controls. And she has the experience and the cases to be a mainstream judge. Anything else is nitpicking.*"²⁴ Republican Senator Jeff Sessions is quoted as countering with "When you show empathy for one party, you necessarily show a bias against another group." Do (or may) auditors show empathy for their clients? How about empathy for the client's employees below the top managerial level, or only for the shareholders? If shareholders, would that be current or prospective? These groups may have antithetical interests. In the judicial arena, it is accepted that empathy will affect judicial judgment. Otherwise, why would Presidents Bush and Obama list empathy as a criterion for their judicial nominees? Empathy is unacceptable for auditors because it has obvious negative implications for some stakeholders in the auditor-client world: management, current or future shareholders, and creditors. As Senator Sessions argued, empathy for one party creates a bias against the other group(s) involved.

Both judges and auditors play roles that have broad societal implications. However, the auditor's role is constrained to the financial/economic sphere, affecting the presumed usefulness of corporate financial statements to external parties as they make their capital allocation decisions. Efficient capital allocation is important in channeling investments toward their most effective use, and thereby promoting economic growth and national wellbeing. The judicial role, by contrast, encompasses enforcing the statutes and common laws that affect the social, cultural, and political environment. Accordingly, the probable impact of a loss of judicial independence is much broader than a loss of auditor independence,

²⁴ Leahy's argument assumes that the law is cut and dried, leaving little room for interpretation and judgment. Whether the law "controls", and the nature of law, is a subject for discussion elsewhere (e.g., Dworkin 1986). US GAAP is replete with illustrations and "check the box" guidance. So are US auditing standards, in contrast to the International Standards on Auditing used elsewhere (Maastricht Accounting, Auditing and Information Management Research Center, 2009). How much room still remains for interpretation, though, can also be a matter of dispute. And if room remains, in what ways can judgment be diverted from some hypothetical straight-and-narrow? And for what reasons, conscious or unconscious? Indeed, what constitutes a legitimate diversion?

since the economic environment is only a subset of the larger world in which we live. Given the greater impact of judicial decision-making, compared to audit decision-making, we ask: What can the auditing profession learn from the judicial profession? Judges appear to be subject to high levels of societal and political constraints. Should auditors be subject to this type of scrutiny? This issue could be important, for example, with respect to accepting new audit clients. Clients may tend to choose auditors who share their racial or religious background. Is this a problem for auditors?

5. Accounting Courts, Courts and an Integration of Perspectives

Both justices and auditors face requirements for objectivity and independence. Each faces pressures from individuals and groups who have preferences with respect to the outcomes of decisions to be made. Leonard Spacek stated that the auditing profession is structured in a way that does not meet the needs of the various stakeholders who are impacted by the auditor's reporting decision (Spacek, 1958). Auditors currently make determinations as to the fairness of a company's presentation of its financial statements, and state their decision in a brief paragraph. They do not generally meet the readers face to face to answer questions or discuss the financial statements of the company involved. Spacek noted that (in his day) there was no place where the basic criteria of accounting principles can be discussed. Hence, the need for an accounting court. Nor was there a place where agreement on basic premises or purposes can be argued. In a court of law, rules are determined when plaintiffs bring issues to court and, based on the judgment, new rules and precedents are set. Spacek said that this is not available in the accounting profession. Hence, he noted that some accounting principles may be wrong or inappropriate in specific situations, but there are no procedures to discuss and obtain a final ruling on the utility of a particular accounting rule. Spacek noted that the public accountant's primary responsibility is to express an opinion on the fairness of the results of the operation of a corporation and its related financial position, but nowhere do we find the criteria or even an attempt to set criteria as to what constitutes, for example, fair presentation of income. He said, "Look through the bulletins issued by the accounting organizations and you will find very few, if any, criteria consistently applied. Instead of standards of measurement, attention is focused on techniques. Most documents are overburdened with procedural comment on how to handle certain transactions, but little is said about the effect sought, and still more important why." He noted that the legal profession's objectives are well defined. It is not so in accounting. Furthermore, due to precedents set in court cases via the ruling of judges, future decision-makers are fully cognizant of the *impact* of

certain laws and *why* these laws were necessary. This does not hold for accounting principles.

Spacek's notion of an accounting court is important because it would give auditors and clients a venue within which accounting disagreements could be argued and decided upon by a presumably neutral decision-making body. Such an institution, along with safeguards for the auditor's tenure with the client should the auditor win the case, could provide strong arguments to the client as to why the auditor's preferred position, if it wins, should be adopted. Similarly, should the auditor lose, the auditor would be protected against charges that it "caved" to the client in order to protect its tenure with the client. Furthermore, as Spacek argued, having such a court in existence enables the building up of a body of evidence as to how different accounting principles and methods are working in practice, and allowing their further refinement. This body of evidence is currently lacking. While the Financial Accounting Standards Board (FASB) does follow due process in gathering comments on proposed standards, the comment letters often lack real world specificity. The fact that they are tendentious is not the issue. So would probably be the arguments presented to the accounting court. The FASB comments, however, are neither publicly collected nor stored over time, as are judicial decisions. Instead, the problem with the FASB comment letters is not that they are not maintained with the same rigor as are influences on judicial decisions, it is that they are often vacuous. When letters are presented to the US FASB, there is no penalty for making a vacuous argument. Such arguments could be made because they pleased a client or brought a desired public notice to the letter filer. Or, indeed, because the filer of the comment letter did not believe that the comment letter was vacuous. When presented to an accounting court, however, arguments would have real world consequences and would be vigorously challenged by the opposing party. Each side would be aware that its argument would receive intense scrutiny by the other side and by the accounting court itself. Furthermore, given the role that the record of the court, confidentiality considerations aside or dealt with through production of a redacted record, would play in further developing accounting standards, each side would be aware of the importance of its argument.

Instituting such an accounting court would enable the auditing profession to acquire some of the benefits to independence that inhere in the judicial system. A presumably independent decision-maker would be available to resolve disputes. This decision-maker, like judges in the courts, could make decisions without having to be paid by one of the contestants to the decision. In that sense, it would be independent of both sides. Furthermore, selection of the accounting court decision-makers could be accomplished through the activities of a foundation, much like appointments are made to the FASB. While the FASB is not a paragon for making independent decisions, and has been interfered with by the US

Congress over the years (e.g., Kleinman and Hossain, 2009) , the use of a sharply adversarial process by the accounting court as well as the narrow gauge of each of its rulings (i.e., one company and one issue at a time) may serve to protect it from such interference.

6. Conclusion

Independence in fact and appearance are important components of society's belief in the usefulness of both the auditing and judicial professions. In this paper we discuss various influences that can impair the independence of judges and auditors. The two professions are intrinsically linked and each plays a key role in society: auditors ensure financial regularity and judges ensure that justice is dispensed. In addition, they are expected to see that both the reality and the perception of independence are achieved.

The issues involving the enactment of each profession's role are profound. There is more consensus on the role and characteristics of the auditor than for the role and characteristics of the jurist. The auditor's role is limited to evaluating whether the client corporation's financial statements comply with GAAP. Accordingly, there are no expectations about the level of empathy the auditor may, or should, have with the client or with those who may be adversely affected, for example, when the auditor issues a going concern opinion. We know of no research involving whether an auditor's ethnicity impacts the auditor's judgment on a client's compliance with GAAP. This statement, of course, is not meant to imply that having a diverse auditing workforce is not desirable. It means that its impact should be better understood through more research. Rather, having a diverse auditing workforce may meet other societal goals, such as equal opportunity in the auditing profession. The comments by Justice Sotomayor about a "wise Latina" suggest that ethnic identity can be a valued component of judicial judgment. Discussions in the 1960's over whether there should be a "Jewish" seat on the US Supreme Court, or the more current discussion of whether a retiring African-American Supreme Court Justice should be replaced by another African-American reveal the continuing concerns in American political culture about the bases of judgment used by US jurists.

For the auditor, the auditing decision should always be to comply with GAAP, and that compliance is laid out in standards published by the PCAOB for public companies or the AICPA's Auditing Standards Board for private US companies. Perhaps the auditing profession gains by avoiding the issues that surround judicial nominees, issues that stem from the broader social, political and cultural role that jurists play. Unfortunately, concerns about the adequacy of the job that auditors currently do may be problematic enough that expanding the auditor's role will only introduce issues that exceed the auditors' training and

capabilities. However, by ignoring the impact of social and political influences on the auditor's decision-making, the auditor independence researcher ignores factors that might affect auditor judgment. Perhaps auditors do worry about the impact of issuing a going concern opinion on the fate of client personnel. Perhaps auditors also become concerned about the effect of their decisions on society. Seeing these concerns within the world of the judiciary is easier than seeing them in the world of auditors. This does not, however, mean that such concerns should be dismissed. We believe that the auditing field should consider the need to extend the domain of auditor independence research to the social and political domains in order to explore auditors' understanding of the relationship between their work and the broader polity to which they belong. Since auditors are embedded in a broader social system, it would be interesting to explore how the characteristics of auditors affect their susceptibility to societal claims on them. This could lead to greater understanding of factors that affect auditor independence, based on factors that affect judicial independence.

The easiest judicial independence issues to resolve are those that arise from the jurist's economic, financial, or personal independence from litigants. The AICPA conceptual framework on independence provides a valuable tool for thinking about such issues for both auditors and clients. In doing so, auditors and justices will examine the threats to their independence and the factors that mitigate the level of those threats. Of course it is important that auditors and justices work hard to avoid fooling themselves as to how independent they will ultimately be, given the factors at play. However, due to their broader social role and the wider bases for acceptable decision-making, judges face greater challenges than auditors do. We believe that the desired characteristics of a jurist are in dispute. Often it seems that judges are asked to be independent of themselves, including elements of their emotional makeup (e.g., empathy), and even their life experience (including ethnicity). As Kleinman and Palmon (2001) argued with regard to auditors, it is unlikely that jurists can achieve this level of independence any more than auditors can. Thus, the argument over the interaction between judicial background and judicial decisions may boil down to whether the judge has ever said anything that could lead someone to infer that he/she is not, to paraphrase Senator Leahy above, letting "the law control". At the same time, auditors do not look at *all* kinds of factors that may impinge upon their mental independence in the way that judges are asked to do. Auditors, in fact, do not address social factors at all or factors of empathy or antipathy. We suggest that auditors learn from the judicial branch that these factors may also impinge on the auditor's capacity to render an unbiased judgment on the client's financial statements and internal control system. While auditors have historically seen their role as limited to the financials and the use of those financials in the allocation of capital, the broader impact of these financials must also be understood.

It is possible, of course, that we ask too much from all parties concerned. Individuals can no more dismiss their personal emotional makeup completely than they can ignore the size of a client fee or the level of a campaign contribution. Similarly, while we believe the AICPA conceptual framework can provide important tools for both auditors (currently) and judges (prospectively) for gaining a handle on the independence issues that confront them, the possibility of self-deceit, or as Kahan (2011) called it, self-motivated reasoning, is too strong. Perhaps we should abandon the attempt to procure some ideal of independence and hope to achieve a “satisficing” level of independence. Kleinman and Palmon (2001, p. 7) described what they called a “zone of independence” and the level of required independence in this way:

Total impartiality is probably too much to require. Rather a range of partiality should be permitted around a totally impartial mental stance. While the auditor is within that range, he should be considered ‘independent’ in attitude. The size of that range (or independence zone) should be the limit to which partiality can be taken before behavior will differ from that which would be expected if the individual did indeed maintain an attitude of total independence.

Ultimately, the importance of exploring factors that may affect auditor or judicial independence stems from the need for members of each profession not only to exercise self-control, but also to understand what needs to be controlled. As Jacques Barzun (1984, p. 102) wrote, “what all professions need today is critics from the inside, men and women who know what conditions are and also the arguments and excuses, and...can offer...a new vision of the profession.” We hope to stimulate thought on these issues, as related to auditor and judicial independence.

Appendix A

1. The Accounting Profession's Approach to Independence Issues

In auditing, independence guidance is provided by AICPA Rule 101, which presents a set of principles and rules for auditors to use in deciding whether they can meet the obligation of General Standard 1 to be independent of that client. The AICPA's ethics rulings "summarize the application of Rules of Conduct and Interpretations to a particular set of factual circumstances." (p. 9, AICPA, 2011) Taken together, the AICPA has constructed a flexible system for accommodating and responding to circumstances that may arise in the practice of accounting and auditing. This flexible system is presented in the AICPA conceptual framework that underlies the AICPA's own ethical code on independence.

The AICPA's conceptual framework was developed by its Professional Ethics Executive Committee (PEEC). It describes the concepts upon which the AICPA's independence interpretations and rulings should be based, splitting independence into two categories.

- ***Independence of mind:*** According to section .06 of the code, this is the state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment.
- ***Independence in appearance:*** Section .06 of the code describes this as the avoidance of circumstances that would cause a reasonable and informed third party with knowledge of all relevant information, including the safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of the auditor has been impaired.

The purpose of the conceptual framework is to help members decide on matters concerning independence when making decisions that are not explicitly addressed by the Code of Professional Conduct. The AICPA's conceptual framework is based on the premise that a member's relationship with a client should be evaluated to determine whether it poses an unacceptable risk to the member's independence. Paragraph .04 of the conceptual framework describes risk as the possibility that a relationship would compromise (or would be perceived to compromise) a member's professional judgment when rendering an attest service to the client. In essence, this is the risk that the member would not be independent or would be perceived not to be independent. The AICPA recommends steps to prevent circumstances that would threaten a member's ability to express professional judgments independently. The conceptual framework emphasizes that risks should be brought down to an "acceptable" level, but even when the risk is considered acceptable, the PEEC specifically states that the AICPA could act to prohibit attestation. For example, AICPA members cannot audit firms in which they hold an immaterial financial interest, even though the argument could be made that an immaterial financial interest should not affect professional judgment.

The professional standards of the AICPA require independence for all attest engagements. The AICPA's risk-based approach involves two steps:

Step one: Identify and evaluate the threats to independence both individually and in the aggregate.

Step two: If the identified threats are unacceptable, then the member should analyze existing safeguards and determine whether existing safeguards are sufficient to mitigate the risk. A threat is defined by the code (paragraph .05(2)) as being sufficiently mitigated by safeguards if, after safeguards have been applied, it would be unreasonable to believe that the threat would still compromise the auditor's professional judgment

Many circumstances (or combination of circumstances) can threaten independence. It is impossible to identify every situation that creates a threat. However, seven broad categories of threats should always be evaluated when threats to independence are being identified and assessed. According to the AICPA (paragraphs .13 through .19), these are:

1. **Self-Review Threat:** This threat occurs when members review, as part of an attest engagement, evidence resulting from their own, or their firm's nonattest work.
2. **Advocacy Threat:** This threat exists when a member has represented a client in US tax court, or has promoted the client's securities as part of an initial public offering.
3. **Adverse Interest Threat:** This occurs when a member expresses an intention to initiate, or has initiated, litigation against the client, or vice versa.
4. **Familiarity Threat:** This threat occurs in the presence of a long standing relationship between a member and a client. Examples of such relationships include a member of an engagement team having a spouse in a key position in the client's firm, providing the client with attest information over a long period of time, having served in the client's firm in a managerial capacity, or simply having been being a close friend of a key member in the client's firm
5. **Undue Influence Threat:** Undue influence can occur if the client threatens the member over a disagreement on an accounting principle, pressures the auditor to reduce the number of tests to be done, or gives significant gifts to the auditor.
6. **Financial Self-Interest Threat:** This occurs when a member has a loan from the client or owns ten percent or more of the client's outstanding equity securities. It can also occur in the presence of excessive reliance on revenue from a single client or if a member has a material joint venture with the client.

7. **Management Participation Threat:** This occurs when a member establishes internal controls for the client, or has previously been responsible for hiring, supervising, or terminating the client's employees.

The Code of Conduct discusses different safeguards that could mitigate or eliminate threats to independence. Safeguards can range from partial to complete prohibitions of the threatening circumstance to procedures that could counteract the influence of a threat. The Code of Conduct (paragraphs .22-.25) discusses three broad categories of safeguards. They are:

1. Safeguards created by the profession, legislation or regulation

These include education and training on independence, the establishment of professional standards, legislation governing independence requirements and competency requirements required by professional licenses.

2. Safeguards implemented by the attest client

These include established policies to achieve fair financial reporting by the client; governance structures implemented by the client; and the client's policies on how to deal with the attest auditor to avoid impairment of independence.

3. Safeguards implemented by the firm

These include the firm having documented internal policies and procedures that are detailed, cogent, and strictly applied.

Next, we suggest lessons that the AICPA code of conduct has for the judicial profession. In this section, we address only areas in which threats to auditor and judicial independence overlap. The Guide to the Judiciary includes social and political threats to judicial independence that are not considered in the AICPA code. These areas are discussed in the concluding section.

2. Application to the Judicial Profession

The majority opinion in *Caperton v. A. T. Massey* argues that judges should be alert to the probability of bias in making a decision as to whether to recuse themselves from a case. Here, we apply the AICPA's Conceptual Framework to the problem of calculating a probability of bias.²⁵ We suggest that an integration of the probability of bias framework could be integrated with the AICPA's conceptual framework of defenses and threats by following the following steps.

²⁵ Of course, perceptions of likelihood of bias are highly individual and are subject to various cognitive biases that prejudice the ability to self-assess how a judicial decision-maker is likely to be affected. Discussion of cognitive biases is beyond the scope of this article.

Step 1: Independence of mind and appearance

Identify all possible threats to judicial independence. This could involve whether a plaintiff or defendant is related to or worked for the judge. It might also include the potential threat to the judge's independence if a former intern practices before the judge he clerked for.

Step 2: Are the existing safeguards sufficient to mitigate the risk of losing independence? Different jurisdictions may treat the following situations differently.

- Plaintiff or defendant having contributed to the judge's campaign (Caperton v. A. T. Massey case as an example of a case in a state court. The US Supreme Court majority opinion described this case as an extreme circumstance, however.)
- Judges having a close association with the plaintiff or defendant in an employer or employee capacity
- Judges having a close association with a jury member

Based on this analysis, categorize the threats to a judge's independence. The threats could include but need not be limited to:

Self-review threat: Has the judge ever worked for the plaintiff or defendant? For example, US Supreme Court Justice Elena Kagan has recused herself from a series of cases that she had worked on in her prior post as US Solicitor General.²⁶ This suggests that Elena Kagan believes that there is a high probability of being biased should she preside over such a case. In contrast, Justice Kagan has declined to recuse herself from the Obamacare court case even though there is some evidence that she had a limited relationship to the case. Based on a revealed preference theory, and making the critical assumption that her preference is to be independent, this suggests that she does not believe that there is a high probability that she would be biased toward the position of the Obama administration, for which she served as Solicitor General. Justice Kagan has not explained her refusal to recuse from the case. Justice Kagan may feel that several factors mitigate against the probability that she will, on balance, be biased against the plaintiffs in the Affordable Care Act case.

²⁶ See Mukasey (12/05/2011) for a discussion, and his opinion, on the so-called Obamacare recusal controversy, one which involves Justices Kagan and Thomas. We focus on Kagan here because she is alleged to have some direct involvement in the legal side of Obamacare's development. Found at <http://online.wsj.com/article/SB10001424052970204012004577070162911944188.html> on 02/09/2012.

Accordingly, if there is some positive probability that she may be biased because of her limited participation in the development of the Affordable Care Act while Solicitor General, that may be outweighed in her mind by her greater exposure to counterarguments against the act from those opposed to it, as well as her assumption of the role of US Supreme Court Justice, a distinct change in role from that of zealous advocate to impartial arbiter.

Similar analyses could be performed for such threats as:

Advocacy threat: Has the judge ever represented the plaintiff or defendant before becoming a judge?

Adverse interest threat: Has the judge ever been sued by the plaintiff or defendant?

Familiarity threat: Does the judge have a close relative or friend among the jurors in a pending case

Undue influence threat: Has the judge been coaxed or coerced into a decision by actions of the plaintiff or defendant?

Financial interest threat: Does the judge own stock in a company that is the plaintiff or defendant in a case?

Are there mitigating factors for each of these that allow continuance in the case (as long as such continuance is not barred by the applicable rules governing judges in particular jurisdictions)?

Mitigating factors might include, for example, the time it takes from the point at which the judge represents a particular defendant or plaintiff to the point at which the case comes before the judge. Is there some ideal amount of time, again assuming that sitting on the bench for a case is permissible otherwise? That may be a matter of individual differences. Similar discussions could be had about the other potential threats.

Additional mitigating factors might include having third parties decide on questions of conflict of interest or the potential for bias. Furthermore, knowing that one's decision in a case is potentially subject to appeal, including accusations of bias on appeal, may act to dissuade justices from sitting on cases in which it is argued that they are biased or have a high potential for bias. Having one's opinion overturned because of an alleged flaw in the application of the law is one thing. Justices however, like other individuals, are very unlikely to appreciate being accused of unethical behavior. Judges, therefore, may choose to recuse if they believe that there is a high probability that a judgment against a party would be appealed, charging bias. Appeals, of course, cost money and therefore judges may believe that there is a higher probability of bias claims being made by wealthier parties. The potential variety of mitigating factors is immense. The ability to weight them against each other exists only in the minds of the individual making the decision. Accordingly, there is no conflict-free result. Just as in any judicial case, one side or the other will always go away disappointed.

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