Understanding Real Exchange Rates

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Mention the term "exchange rate" and people will normally associate it with those reported in the news. Not that we can really blame them, for these are the most accessible to all of us. When we come to think of it, however, this category comprises merely a portion of the whole gamut of exchange rates referred to in economic literature. This type of exchange rate is called the nominal exchange rate, which defines the number of units of domestic currency one can get for one unit of foreign currency, or equivalently, as the price of foreign currency in terms of domestic currency. When we travel, this is the exchange rate quoted to us by banks as we purchase traveler's cheques. This is also the rate at which we convert our holdings of, let's say, US dollars or British pound sterling to pesos. Further putting things in perspective, this is the exchange rate we refer to when we talk about the evaluations which recently occurred in the ASEAN region as a result of the "regional currency crisis".

To treat the nominal exchange rate as a blanket term for all kinds of exchange rates is dangerous for it could lead to confusion, especially for the unwary. In reality, economists classify exchange rates in several ways and come up with several specific kinds of rates which sometimes can serve very specialized functions. The price of the Japanese yen in terms of pesos, for example, can be called not only a nominal exchange rate, but also as a bilateral nominal exchange rate, since it expresses the price of the currency of one country (the Japanese yen) in terms of the currency of another country (the Philippine peso). This is in opposition to the concept of a multilateral exchange rate concept wherein the price of one currency is expressed in terms of a weighted index based on the currencies of more than just one other country.

The nominal exchange rate concept remains significant today since we continue to utilize it for the analysis of a variety of problems, such as debt issues and the process of short-run market-clearing for countries adopting flexible exchange rate regimes. Nominal exchange rates (whether by nature bilateral or multilateral) are also normally the ones used in most analyses of "open" financial markets. However, for the investigation of certain other issues, such as trade and current account balances, the real exchange rate (RER) is the more relevant concept.

The Real Exchange Rate

The real exchange rate (RER) measures the relative price of two goods, as opposed to the nominal exchange rate which is a monetary concept that measures the relative price of two currencies. Given this nature of the RER, it has the ability to provide information on a variety of things, such as the soundness of a country's macroeconomic structure and changes in the competitiveness level of its exports. But despite the usefulness of the RER, it has one drawback: it is not directly observable and still needs to be computed.

To fully understand the concept, let us construct the RER between the United States and the Philippines. Assume that the Philippines produced only rice, and that the United States produced only corn. If the price of rice in the Philippines is P20 per kilo and the nominal exchange rate is P25 = $ 1, then the price of rice in US dollars (in the Philippines) is P20 x 0.04 = $ 0.80 per kilo. Next, compute the ratio of the price of rice in dollars to the price of corn in dollars. If the price of corn in the USA is $ 0.40, then the real exchange rate between the Philippines and the USA— that is, the price of rice in terms of corn — would be $ 0.80 / $ 0.40 = 2. This would mean that if currencies don't exist, the USA can buy 2 kilos of rice by giving us 1 kilo of corn.
But in reality, of course, the Philippines does not only produce rice (and the USA only corn), so that the real exchange rate between two countries should reflect the relative price of all goods produced in the Philippines in terms of all goods produced in the USA. It is important, therefore, to use not just the peso price of rice and the dollar price of corn but a peso index for all goods manufactured in the Philippines and a dollar index for all goods made in the United States. To do this, GDP deflators are used for each country since they are price indexes for the set of final goods and services produced in an economy. If the Philippines experiences a higher rate of inflation, its GDP deflator will be greater than the US GDP deflator, and this will make the price of Philippine goods in terms of US goods decrease. This makes US goods relatively more expensive and the Philippines just experienced a real depreciation, a decrease in the relative price of Philippine goods in terms of US goods in Philippine domestic markets. An opposite occurrence is termed a real appreciation.

At this point, it is relevant to point out that one of the reasons why the “concept” of the RER was invented was to remove the inflation component from the nominal exchange rate and isolate the real effects of exchange rates on trade. Indeed, it is of general agreement that countries do not improve their competitive situation when they experience a large nominal currency depreciation accompanied by a similar inflation rate. The nominal exchange rate and the price in currency of a country both determine the prices of its exports in terms of the currency of the importing country which then ascertains the level of demand for its exports (Grennes 1990).

The most basic way of converting nominal rates into real exchange rates uses the idea of the Purchasing Power Parity (PPP) which defines the intercountry relative price level as a ratio of respective own-currency price levels (Officer 1990).

In its absolute version, this concept holds that the equilibrium real exchange rate between two currencies will take on a value which will equate purchasing power in the two countries involved. In its relative version, it states that the equilibrium real exchange rate must change so as “to offset differential inflation between the two countries and thus leave the real exchange rate unchanged”. (Williamson 1994).

This is the method that was used earlier and the real exchange rate is defined in this case as the nominal exchange rate adjusted for the difference between domestic and foreign inflation rates. However, alternative methods have already been introduced in the literature.

Researches done by Balassa (1964) and Kravis and Lipsey (1983) complain that if the PPP is used as the basis for transforming the nominal exchange rate into the real exchange rate, a problem is encountered due to the existence of a class of nontraded goods produced by an economy.

As a result, some studies today use the ratio of traded goods to those of nontraded goods as the measure of the real exchange rate. Moreover, sometimes an “effective exchange rate index”, the average real exchange rate between a particular country and the rest of the world, is constructed to represent the economy. Home goods become more expensive with increases in the RER and prompt consumers to substitute cheaper imports for domestically-produced goods (Dornbusch 1988). In addition, movements in the RER influence local production decisions as well as decisions to save and invest (Pfeffermann 1985). Third, there is a need to introduce some discipline into the analysis of the current account in a world that has many different exchange rate systems (Helmers 1988).

The Equilibrium Real Exchange Rate
The concept of the equilibrium real exchange rate is one of the most controversial in the field of exchange rate eco-
omics. The definition alone of what it is all about has already proven to be divisive. In fact, when John Williamson gathered articles for “International Financial Markets and Agricultural Trade” in 1990, he commented that:

“...to give some intellectual coherence to the enterprise, it seemed natural to limit the contributors to those with compatible intellectual views. Two views are of critical importance in this context.

First is the rejection of the still-common assumption in international monetary economics that markets have well-defined views of the equilibrium exchange rate determined by the fundamentals, even though economists are totally unable to make worthwhile estimates of where those equilibria might lie... [W]e do not believe that the market typically has a well-defined, rational expectations view of what is implied by the fundamentals. Sometimes the market may develop a very well-defined view that the rate being defended by the authorities is inconsistent with the fundamentals... but that is very different from claiming that the market always has a well-defined view of what the equilibrium rate is. It seems that there is typically a wide range within which the market does not know or care what the equilibrium rate is; what it cares about is where the rate may go in the next few minutes....

Our second point of agreement consists in rejecting the view that the best possible estimates of equilibrium exchange rates are provided by the criterion of purchasing power parity (PPP). We all believe that equilibrium real exchange rates can change over time, by enough to matter, as a result of changes in productivity (Bela Balassa’s ‘productivity bias’), the terms of trade, foreign asset positions, and underlying capital flows. (Williamson 1990).”

In addition to these issues, it can also be observed in the literature that several representations of the equilibrium real exchange rate are currently existing, each of which has a unique conceptual and methodological framework for computing the equilibrium rate: Williamson uses the fundamental equilibrium exchange rate (FEER), Peter Clark and several International Monetary Fund (IMF) economists utilize the desirable equilibrium exchange rate (DEER), Sebastian Edwards and Ibrahim Elbadawi write of equilibrium real exchange rates (ERERs) and Polly Reynolds Allen and Jerome Stein employ the natural real exchange rate (NATREX).

However, despite the differences in nomenclature, the similarities among the various representations of the equilibrium RER are considered to be far more important and have imparted several crucial characteristics of the real exchange rate. All the authors aforementioned conceive the equilibrium of the real exchange rate to be characterized by simultaneous internal and external balance. In addition, they all agree that this equilibrium value varies in opposition to the PPP claim that such a value would be a constant. Moreover, these group of economists concede that movements in this equilibrium value could possibly be caused by changes in capital inflows and terms of trade and that trends can be influenced by the occurrence of productivity bias or foreign asset accumulation (Williamson 1990).

Edwards (1989a) identified the real variables (the external and internal ‘fundamentals’) affecting the value of the equilibrium RER and asserted the expected partial effects of each on the equilibrium RER under plausible assumptions. It was found out that a real depreciation of the RER is brought about by (1) increases in world interest rates, and (2) higher export taxes.

On the other hand, a real appreciation of the RER is caused by (1) foreign aid inflows, (2) capital inflows, (3) restrictions on imports caused either by an increase in import tariffs or a rise in quantitative restrictions, (4) higher export subsidies, (5) liberalization of capital accounts, (6) government financing of the budget deficit through foreign borrowing, (7) increases in government consumption of nontradables, and (8) productivity improvements in the tradables sector. The Edwards study was not able to come up with conclusive statements regarding the effect of terms of trade improvements on the equilibrium RER.

Zhou (1995) investigates how real exchange rates react to changes in real and nominal variables by using cointegration tests and the common stochastic trend approach. The results of the study reveal that while real variables have a significant and persistent influence on the variation of the real exchange rate, monetary disturbances only have short-lived effects. It was further found that of the several real variables assessed by the study, a world oil price shock has the most explanatory power, with a fiscal shock being the second.

Another research, which investigated the sources of real exchange rate movements, was written by Strauss (1995). In this study, the author explores the sources of the nonstationary process in the real exchange rate and permanent violations of purchasing power parity for 14 Organization for Economic Cooperation and Development (OECD) economies using Soren Johansen’s cointegration methodology and hypotheses tests. The findings propose that real exchange rates form a cointegrating relationship with both the price of nontradables and productivity differentials, and that purchasing power parity is cointegrated with the price of nontradables. It was further suggested that short-run real exchange rates are significantly influenced by the price of nontradables.

**RER Misalignments**

Real events in the economy, such as technological progress, movements in external terms of trade, and changes in
taxation, sometimes justify a change in the RER, as they reflect changes in the competitiveness of a country's exports. An occurrence of this type is considered an equilibrium phenomenon and does not require policy intervention on the part of the government. However, an unjustified departure of the actual RER from its equilibrium value sometimes occurs. Such an event has come to be known as a real exchange rate (RER) misalignment.

RER misalignment causes overvaluation which, in turn, results in severe welfare and efficiency costs. Overvaluation forces policy intervention in the form of foreign exchange and trade controls which adversely affect a country's economic performance. Furthermore, such controls also encourage the creation of strong lobbies which compete for the rents generated by these controls [Edwards (1989a)].

The actual RER responds both to real and monetary variables, although the equilibrium RER is a function of real variables only. Although a value for the equilibrium RER exists, the actual RER value does not necessarily have to be equal to this in order for misalignment not to occur. In fact, the actual RER does normally differ from its equilibrium level, at least in the short run. But persistent deviations of a different nature can generate large RER misalignments [Edwards (1989a)].

According to Lal (1991) RER misalignments arise from exogenous shocks in (a) capital flows and (b) terms of trade. Capital flows can induce foreign exchange windfalls and fiscal expansion. In addition, this research also observed that a budget deficit can originate if the government maintains exchange controls and does not sterilize the effects of the inflow of foreign exchange. Lal's explanation goes:

"With the rise in its foreign exchange reserves, given the time lag between the receipt of foreign exchange and its subsequent spending by private or public agencies, the government is advised to use these foreign exchange reserves for development purposes by running a budget deficit. Otherwise, it can decide to use the windfall for expanding public expenditure and run a budget deficit. With production remaining at its previous level, there will be a secondary trade deficit as well as excess demand for the nontradable good. This excess demand will lead to a rise in the price of the nontradable good (a further real exchange rate appreciation) until the nontradable goods market clears. This will also result in an excess demand for tradables leading to an unsustainable balance of payments deficit [Lal (1991)]."

The fiscal expansion resulting from an exogenous shock in capital flows can also result to RER misalignment. If governments are obliged to decrease expenditures due to a sudden contraction of foreign capital inflows (such as when their access to foreign credit is curbed), a balance of payments deficit may not necessarily result, but there will definitely be an excess supply and hence unemployment in the nontradable goods industry. This would mean that national output has fallen below its potential level. However, this fall in output is entirely due to the misalignment of the real exchange rate.

RER misalignment can be caused by terms of trade changes. A deterioration in the terms of trade results when the foreign currency price of importables rise with the price of exportables and the nominal exchange rate remaining constant. When this happens, the production possibilities curve shifts inward, reflecting lower output for the economy. But since consumers can obtain the same amount of imports at a higher cost given this scenario, the nation's social indifference curve will shift upward. Now, whether the new equilibrium point implies a rise or fall in the real exchange rate will depend purely on the relative factor intensities in producing the goods.

Measuring RER Misalignments

Different approaches have been used by researchers in computing for RER misalignment as shown by the empirical literature on the topic. The relationship among these measures of misalignment will be discussed here.

The first approach used to measure RER misalignment computes the deviation of the actual RER from its equilibrium value. Under this approach, three
possible indexes for RER are used: (1) a real exchange rate index based on the predictions of purchasing power parity (PPP) theory; (2) a real exchange rate index based on the formal model of equilibrium RER determination developed by Edwards (1989a); and (3) a real exchange rate index still based on the formal model developed by Edwards but uses the premium of the nominal black market exchange rate over the official rate as a proxy for the RER misalignment [Ghura and Grennes (1993)].

The second approach used in measuring RER misalignment is based on an index of competitiveness developed by Ghose and Kharas (1993) which captures the effects of a whole set of bilateral price changes better than traditional RER measures. Although they agree that the RER should be measured by the ratio of the domestic price of tradables and nontradables, Ghose and Kharas point out that what is tradable and what is nontradable in a multi-good economy can be a very complex process. They argue that the common practice of focusing on international price changes between a given country and its competitors and/or its trading partners and subsequently adjusting for nominal exchange rate movements is inappropriate.

Two serious complaints were aired by Ghose and Kharas regarding the traditional measures of international competitiveness: (1) they ignore what is happening to third-party competitors, and (2) they fail to consider that differences in the degree of substitutability between goods from different countries are significant. Even if the Philippines does not trade much with Malaysia or Thailand, for example, the behavior of the Malaysian ringgit or the Thai baht is surely most relevant to Philippine competitiveness; yet these would not be reflected by the traditional trade-weighted RER index.

This measure developed by Ghose and Kharas is based on the Multiple Exchange Rate Model (MERM) by Artus and Rhomberg (1973) for developed countries, which is used to replicate with a single price movement in the RER the net effect on a country’s trade balance equivalent to that caused by the whole complex of exchange rate movements that have taken place over a given period. The prime qualities of this index are: (a) trading partners and third-party competitors are treated in a parallel fashion, and (b) the weights assigned to each bilateral real exchange rate depend on the substitutability of goods from different points of origin.

A third approach to RER misalignment determination improves the measurement of the equilibrium real exchange rate (ERER). Devarajan, et. al. (1993) came up with this index of misalignment which is a generalization of the tradables-nontradables model and incorporates imperfect substitutes for both imports and exports.

Within the framework of their model, the definition of the real exchange rate is consistent both with that of the PPP approach and the tradables-nontradables definition of Salter (1959) and Swan (1960). In addition, the measure that they were able to develop is capable of capturing a richer set of phenomena, including terms of trade shocks and changes in foreign capital inflows.

One of the issues addressed by this study of Devarajan, et. al. is the appropriate empirical definition of the real exchange rate. The real exchange rate has usually been defined as the relative price of tradable to nontradable goods. In empirical applications of the PPP approach, however, the usual practice uses an aggregate price index (such as the gross domestic product deflator) to measure domestic prices and a similar aggregate index for trading partners to measure world prices.

The study points out that one problem with this practice is that the measure of domestic prices includes not only nontradables but also tradables manufactured or purchased by the country. In addition, the price index used as a proxy for world prices includes not only tradables but also nontradables produced by the trading partners.

It was proposed in this research that instead of using standard aggregate price indexes, separate indexes for tradable and nontradable goods produced or sold in the country be used. But a difficulty that could be encountered with this method is the definition of nontradables. The classic Salter-Swan model defined the nontradable sector as one in which there are neither exports nor competing imports [Salter (1959); Swan (1960)].

Moreover, even if no trade is noted in a sector, it is still possible that that sector could be classified as a tradable sector. Thus, if faithfulness to this original definition of the nontradable be observed, there would be only a few nontraded sectors and any resulting price index for nontraded goods reflects only a tiny share of GDP.

It was also brought up by Devarajan, et. al. that the Salter-Swan model does not distinguish between exports and imports. At the sectoral level, exportables and import substitutes are substantially different from each other. Furthermore, in developing countries, exportables are usually primary goods or light manufactures whereas imports consist largely of intermediates and capital goods for which there are limited domestic substitutes. If these two types of goods are aggregated into a single tradable sector, there will be a distorted view of how a country adjusts, for example, to a change in its international terms of trade.

**Misalignments, Economic Performance, and Competitiveness**

Real exchange rate behavior occupies an important position in modern day policy evaluation and design. A growing number of researches support the view that there is a strong link between RER behavior and economic performance as these gather mounting evidence from Latin American, Asian and African countries. Increasing references are being made today to RER stability and correct exchange rate alignment as crucial conditions for improving economic perfor-
have resulted in dramatic deterioration in their agriculture sectors and their external accounts. He further cites that inappropriate exchange rate policy brought about the dismal outcome of the Southern Cone (Argentina, Chile, and Uruguay) economic reforms and free-market policies during the late 1970s. Cottani, et. al. (1990), in examining how RER behavior and economic performance affect each other, indicated that a strong negative correlation across countries exists between performance indicators and two measures of RER behavior, instability and overvaluation. To the extent overvaluation undermines the profitability of exports and provides a deterrent for other countries to import from the country with an overvalued rate, overvaluation strikes at the core of the development process. Exports are not only important in economies where they make up a large share of national output or employ a sizable proportion of the labor force; they are vital since, in developing countries, foreign exchange availability is considered a main determinant of the overall level of economic activity (Ghura and Gremes 1990), (Pfeffermann 1985).

Pfeffermann (1985) recognizes that overvaluation stimulates demand for foreign exchange as it is made relatively cheaper, especially when people believe that the existing overvalued rate cannot be maintained for long. This will trigger them to buy more foreign exchange to take advantage of its low price.

Furthermore, this leads to increased consumption of imported products. If increased protection results from a rise in imports, the problems of the economy exacerbates, as this would cause more overvaluation. The two are mutually reinforcing: overvaluation generates pressure for protection against imports; protection against imports perpetuates overvaluation.

It should be pointed out here that there are times when the RER is allowed to appreciate and maintained at “ Disequilibrium” levels in developing countries, usually when severe domestic pressures result in inflation. Since this overvalues the RER, governments must take measures to curb imports and must decide whether to reduce economic activity through restrictive monetary and fiscal policy, or through quantitative import controls.

The first option, if pursued long enough, is clearly inimical to growth while the second course of action would misallocate resources. Governments can, of course, use reserves to finance the deficit in order to accommodate the appreciated exchange rate but then this is clearly unsustainable after a time. On the
other hand, if government chooses to borrow from abroad, overvaluation can be sustained. However, this is considered to be a more dangerous situation as this simply maintains the overvalued RER for a considerable length of time without curing the structural deficiencies of the macroeconomy (Pfeffermann 1985).

Some studies point out the possibility of misalignment leading to a decline in imports. As misalignment worsens, export earnings decline and the current account deficit grows. In the absence of external financing of imports, governments may raise restraint of imports (through tariffs and quotas) to prevent the depletion of its foreign exchange reserves. Overvaluation, then, can lead to quantitative restrictions which further raises the cost of imports. This shows that government responses to misalignment cause imports to decline (Ghura and Grennes 1993), (Pfeffermann 1985).

Researches have also shown how misalignment affects the level of saving and domestic investment. Agarwala (1983) observed that, on the average, lower saving rates are reflected in developing countries with high levels of distortions in their RERs. This is heightened in economies where governments confronted with inflation and adopting fixed exchange rates cope by restricting interest rate levels and reducing the returns to savers. Moreover, Ghura and Grennes (1983) explain that domestic investment falls in the presence of RER misalignment due to increased uncertainty. Investors are less willing to commit current funds to projects with uncertain future returns. Edwards (1989a) noticed that RER misalignment also generates massive capital flight, which may be optimal from a purely private stance, but becomes an actual cost from the point of view of social welfare.

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A closer look on auditor independence

By Enrico Baluyut and Ricardo Danlag, Jr., Faculty Members, Department of Accountancy and Manuel Medina, MSA Student

Auditor independence is a complex issue and one that has far-reaching implications for both the accounting profession and the public in general. The primary role of the auditor is to attest independently to the fairness of financial statements presentation as prepared by management, whether for submission to pertinent government agencies like the Securities and Exchange Commission (SEC) and the Bureau of Internal Revenues (BIR) or for the consumption of investors and stakeholders. This means that the auditor’s signature is an imprimatur of his expression of an objective opinion as to the propriety of the financial statements prepared by management in terms of compliance with the generally accepted accounting principles. Here, it is assumed that there is no question about the technical competence of the auditor.

For the auditor to provide a useful service to the readers of accounts, he or she must be both technically competent and independent. A technically competent auditor is an individual who has the necessary expertise or proficiency to discover all the material errors and omissions present in a set of unaudited accounts.

An independent auditor is an individual who will disclose all the errors and omissions that have been discovered and which affect the view presented in the financial reports. The question to be addressed, therefore, is not whether auditors will discover errors and omissions, but whether they report the errors and omissions that they discover. Thus, it is the independent auditor’s impartial or unbiased “second look” at the management-prepared financial statements that gives confidence particularly to investors that those statements are reliable and can provide a credible framework for investors’ decisions.

Concepts

Independence is the most critical quality of an auditor relating to integrity, objectivity and strength of character to be maintained in all matters relating to his assignment. Independence has two very important aspects, namely:

1. Independence in fact. This is the “should be free of any interest” aspect. The auditor should have actual independence in mental attitude in his/her role of lending credibility to the financial information.

2. Independence in appearance. This is the “appear to be free of interest” aspect. The auditor should have perceived appearance of impartial attitude in the eyes of the public.

The two foregoing aspects are dependent upon the following three personal attributes:

1. Integrity. This refers to the auditor’s...
observance of accepted standards of honesty which must be observed in all his professional decisions and actions.

2. Objectivity. This refers to the maintenance of a fair and unbiased attitude in the exercise of one's professional judgement.

3. Strength of character. This refers to the ability to withstand pressure and, at all times, to be uncompromising in maintaining one's integrity and objectivity.

The auditor should have perceived appearance of impartial attitude in the eyes of the public.

Independence in Appearance

Independence purports to achieve the following objectives:

1. To enhance reliability of the accounting or financial information.

2. To help provide objectivity that permits the profession to perform its attestation and monitoring functions effectively.

3. To serve as the basis on which auditing derives its authority and acceptance.

4. To serve as a "public watchdog" requiring complete fidelity to the public trust.

It is evident that there can be no definitive measure of auditor independence. Independence is an attitude of mind and hence impossible to quantify with any degree of confidence. How then can we see how independent auditors can be expected to be?

Regulatory and Ethical Requirements

1. GAAS. Generally Accepted Auditing Standards have been adopted by the ASPC and approved by the Philippine Institute of Certified Public Accountants (PICPA), Board of Accountancy (BOA), and the Professional Regulation Commission (PRC). Specifically, the provision on independence is included as part of the General Standards, 3.2 to wit: In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.

2. Code of Professional Ethics (PD 692). The particular provision is included in Section 14 of Part II B - Rules Applicable to CPAs in Public Practice. It cites situations independence will be considered to be impaired.

3. IFAC Code of Ethics for Professional Accountants. A particular section in the code indicates some of the specific situations with commentaries that would lead to doubting the independence of a professional accountant in public practice. Included are the following:

- Financial involvement
- Appointments in companies
- Provision of other services to audit clients
- Personal and family relationships
- Receipt of recurring fees
- Contingency fees
- Acceptance of goods and services/ undue hospitality
- Ownership of the capital
- Former partners
- Actual or threatened litigation
- Long association of service personnel with audit clients


Current Issues and Concerns

The concern right now is whether the public's confidence in audited financial information can be maintained in the face of the following recent trends in the auditing profession:

1. the declining financial importance of the audit function to audit firms.

2. the increase in provision of non-audit services, and

3. the growing number of business relationships between auditors and their audit clients.

For example, some management have outsourced to auditors services related to the following: internal audit function; tax compliance; human resources; performance of the business's basic operations, such as sales, marketing, product development, operations, and their financial and administrative departments.

As a matter of fact, there were two private sector studies based in the US
that have reported continuing concerns about the objectivity and independence of auditors, namely:

1. The Public Oversight Board’s Advisory Panel on Auditor Independence, known as the Kirk Panel concluded in its September 1994 report that important steps should be taken to enhance the objectivity and strengthen the professionalism of independent auditors.

2. The AICPA Special Committee on Financial Reporting, known as the Jenkins Committee, observed in its 1994 report that users are concerned about current pressures on auditor independence.

The increased number of situations in which outside auditors perform both attest and extended audit services for clients raised questions about the potential impact on auditor independence. As a result, the American Institute of Certified Public Accountants (AICPA) saw it fit to revise its Code of Professional Ethics under Rule 101 to provide new professional guidance on this matter. The changes established more specific guidelines for planning and performing extended audit services for existing attest clients. As in the previous ethics rules, best practices were effectively codified, reaffirming that these services would not impair independence with respect to attest clients, so long as the auditor does not act or appear to act as a member of the client management. The new guidance applies equally to extended audit services performed for clients when all or part of an existing internal audit department is outsourced or for a newly created audit function.

Attributes of an independent auditor

- Integrity - the auditor’s observance of accepted standards of honesty which must be observed in all professional decisions and actions
- Objectivity - the maintenance of a fair and unbiased attitude in the exercise of one’s professional judgement
- Strength of character - the ability to withstand pressure and to be uncompromising in maintaining one’s integrity and objectivity

Prior researches, commentaries and articles made

There have already been a good number of researches made on the topic of independence. Commentaries and articles expounding on the issue highlight the importance and relevance of the independent but they differ as to the degree or level of independence.

In an earlier study by Dykxhoorn and Sinning (1981), the matter of perceptions of foreign auditors (specifically the German Auditors) concerning independence vis-à-vis compliance with the SEC requirement that auditors be independent was comprehensively tackled. The results of the survey showed that, overall, most German auditors take a less stringent view of independence compared with the SEC positions.

Another commentary (Wallman 1996) proposes to take an alternative approach study advanced the notion that the inquiry should be on whether a particular set of circumstances creates a dependency that could bias auditing judgements. The alternative approach in the author’s belief would effect a change in thinking about independence issues from what is allegedly consistent with a public duty, to what is in the public interest.

Situations and questions relating to independence

The following situations on ethics topics particularly independence have
been raised by AICPA members in the US. These situations may or may not impair the auditor’s independence depending on the circumstances. DECIDE:

1. A member is a trustee of a life insurance trust for an audit client’s stockholder. The trust’s only asset is an insurance policy and the cash proceeds will go to the client’s children.

2. May a member serve as trustee for a client’s pension or profit-sharing trust without impairing independence with respect to the client?

3. Is a member’s independence impaired with respect to an enterprise’s pension or profit-sharing trust if the member serves on the enterprise’s board of directors?

4. A member and his or her client are considering investing in a business together. The member would own 25% of the business and the client would own 50%. If the member’s investment in the business would be material to his or her net worth, would independence be impaired with respect to the client?

5. The father-in-law of a CPA firm’s partner has a financial interest in an audit client. Although the financial interest does not allow the father-in-law to exercise significant influence over the client, it is material to his net worth. Would this relationship impair the firm’s independence?

6. The sister of a partner in one-office CPA firm is the chief financial officer of a review client. Would this relationship impair the firm’s independence?

7. May a member receive a gift from a tax client without violating the Code of Professional Conduct?

8. A staff member’s father owns a single unit in a condominium association, the value of which is material to his net worth. The father is not a dependent of the staff member. Is the firm’s independence impaired if the staff member participates in the audit engagement of the condominium association?

9. Assuming the same facts as in the preceding number, if the value of the condominium unit is not material to the father’s net worth, may the staff member participate in the audit engagement?

10. A tax manager in a multi-office CPA firm owns shares of stock in a review client and has transferred them to a blind trust. If the manager is located in the office of the firm that performs the review engagement, will the firm’s independence be impaired after the transfer, even if the manager does not participate in the engagement?

11. A member’s client has requested a review of its financial statements for the year ended June 30, 1995. The client owes fees to the member’s firm for consulting services performed during the year ended June 30, 1994. Will the prior year’s unpaid consulting fees impair the member’s independence with respect to the current year’s review engagement, even if the client has not yet been billed for the consulting services?

12. A partner in a CPA firm is on the board of directors of an entity during May and June, 1995. If the entity wishes to engage the partner’s firm to perform an audit for the year ended June 30, 1995, may the firm accept the engagement if the partner resigns from the board before the firm’s acceptance of the engagement?

13. A member’s spouse is employed as an accountant by a client. Would this relationship impair the independence of the member or member’s firm?

14. A member’s client has not paid fees for tax services provided during the past two years. Would the member’s independence be impaired with respect to the client’s current-year audit?

15. A member has been asked to perform bookkeeping services for an audit client, including printing the client’s presigned checks. Would the performance of the bookkeeping services impair the member’s independence?

16. A member has been asked to perform payroll preparation services for an audit client, which include preparing and signing payroll checks using either a laser printer or a client-provided signature stamp. The member also is responsible for mailing the checks to employees or authorizing a transfer of funds from a client bank account to employees’ bank accounts. Would such services impair the member’s independence?
Implications of Lack of Independence in the Auditor's Report

It is the auditor's "professional judgement" that will eventually be used by the CPA in deciding whether each above situations will impair his independence, be it in fact or in appearance. An advice though is in order. If there is doubt don't do it.

If and when the auditor concluded that his independence will probably be impaired, then he/she must refrain from pursuing the engagement because doing otherwise will violate the standards on independence. If the engagement has been concluded, but before the issuance of the report, then the auditor must disclaim his opinion because of lack of independence.

Conclusion

The investor's or the public's ability to assess the extent of an auditor independence relative to the client's management may be enhanced by considering the following:

a. Structure and Procedures of Accounting Firms. Auditing firms should rethink their organizational structures, focusing on auditor's public responsibility. Auditing firms should be organized such that the national monitoring agencies are independent of practicing partners. They should have full information about the facts and circumstances and advise engagement partners of what is the most appropriate accounting given the scenario.

b. Auditors, Board of Directors and Audit Committees. Auditors should be more forthcoming in communicating first with the audit committee and then with the full board. The audit committee should expect the auditor to express independent judgement about the appropriateness of the company's accounting practices, receive the auditor's reasoned opinion of management's preference, and review the auditor's fees.

c. ASC-SEC-Accounting Firms Relations. Accounting firms' submission to standard setter should be developed in isolation from pressure from or on behalf of clients. Communications to the SEC should not come jointly from the big firms. Moreover, individual firms should be careful in how they communicate their views to their clients and the public at large. The SEC should be a standard s-ter of last resort, acting only if the profession is unable to do what is necessary in a timely fashion and even then, only after appropriate due process. Likewise, SEC should take the lead in helping the profession reduce its exposure to unwarranted litigation.

There have been many suggestions for other ways of improving the independence of an auditor. Among them are: rotation of audit appointments to prevent an auditor from becoming too involved with a client; peer review such as for one audit firm to review another's audit working papers to ensure that the audit report was justified by the evidence collected; independent audit appointment and fee setting body which would supervise the appointments of auditors and determine their fees.

The last suggestion will definitely strengthen independence, but the difficulty is obtaining acceptance from either the audit profession or their clients, neither of whom show any enthusiasm for the idea.

Another suggestion would be a Quality Review by the Board of Accountancy, but there has been lukewarm acceptance currently on this proposal.