THE ENRON–ANDERSEN REGULATORY REVIEW TO STRENGTHEN AUDITOR INDEPENDENCE

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Abstract

The crash of Enron in the US, followed by the worldwide collapse of its auditor, Arthur Andersen (Andersen), has shaken the business world. It was the biggest corporate collapse uncovered in business history. Since then, the investor and public's perception towards the accounting and auditing profession has been badly tarred. Following Enron –Andersen scandal, giant companies like WorldCom, Xerox and WasteManagement faced similar fate. Worst still, the auditors of all these companies are among the Big Fives (now Big Fours). Nevertheless, the reputation of most certified public accountant (CPA) firms are seriously confronting the problems of regaining public's confidence at post-Enron era. Among the major issues elevated was 'auditor independence' of the CPA firms. Arguments rest on the issue of auditor independence and factors like regulatory framework, and business pressures (also corporate governance) that are found to be major contributor to crashes of Enron like. In response to the scandal, the standard-setters, regulators, professions and other related bodies (in the UK and the US) emerged with constructive proposals, which aim to strengthen auditor independence (and corporate accountability). Though, new regulatory have been laid out, the success rate is yet proven. This paper review holds the regulatory scenario depicted in the UK and the US. This is after considering that most of the recent bankrupt cases and regulatory reviews are actively performed in both countries.

Introduction

Auditor independence issue is always in the limelight and has become serious and an aggressive debate at post-Enron crisis. The impact of (lack of) auditor independence can be extremely great to **audit quality**. Auditors are responsible to report honestly and provide the assurance to the shareholders concerning the reliability and accurateness of the clients' accounting policies and the 'true and fair' view of the financial statements. The Public Oversight Board (POB) emphasized that the members of certified public accountants (CPA) firms should protect the profession by being independence both **'in fact'** and **'in appearance'**. When auditors are becoming less independent from their clients, the opinions they provide might constitute biases as seen in the Enron-Andersen case. In this respect, the investors or the public expect the auditors to be entirely independent from the auditee, in order to justify their thrust. Impairment of auditor independence can occur in various conditions, for instance, an economic bond between auditor and their clients (fee dependent), intimate relationships with client, extending consulting or non-audit services or perform management functions.

To recall on Enron and Andersen's worldwide collapse in December 2001, the independence issue, regulatory framework and corporate governance practices become the paramount concern in most agendas. While the case was still under investigation, Andersen was

deliberately blamed for failing to detect and investigate Enron's questionable accounting practices, of which eventually brought the company into bankruptcy. Investor's and the public's confidence on auditor's attestation of the financial statements has deteriorated and caused lack of confidence in the capital market. Why independence becomes so important? Did the corporate disasters such as Enron were purely caused by audit failures? Will the proposals set out by the United Kingdom (UK) and the United States (US) regulators can successfully mitigate independence problems? The issue concerned now what is the new regulatory bills and would it work in the current intense environment where the audit operates.

The Regulatory System

Over the past three decades, government and regulators are constantly making improvements on auditor independence regimes to regain trust and to strengthen auditor independence, however, little is achieved. In the United Kingdom (UK), the development of accounting and auditing standards is by means of a **self-regulative system** and **principles-based** approach. In particular, professional bodies recognized by the Department of Trade and Industry (DTI) such as the Auditing Practices Board (APB) and Ethics Standard Board (ESB) are addressing auditor independence issue. The UK's accounting and auditing regulatory system appears to be a good model to other countries perhaps due to the existence of strong professionalism (Stevenson, 2002) where not many changes were called to the UK standards (CGAA, 2002). Ideally, APB is responsible to develop the future of auditing in the UK.

Meanwhile, in the US, the Securities and Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA) are largely responsible in regulating and monitoring the auditing practices in the country. The Independence Standard Board (ISB), which was set up by SEC and AICPA in 1997, is being recognized as the standard-setting body that develops independence concepts and standards. In particular, the US adopts more robust and more detailed regulations pertaining independence issue. On the other hand, the European Commission's (EC) Eighth Council Directive (Eighth Directive), which was adopted in 1984, delegates authority to Member States to ensure that statutory auditors are sufficiently independent from the client they audit (Stevenson, 2002).

In most countries, professional standards and companies acts provide sufficient regulatory framework for the auditors and companies to follow. Above all, it is common in most countries to have acts that enforce public companies to have their financial statements being audited by qualified auditor. In the UK, the Companies Act 1985 requires all registered companies being subject to an annual external audit (Stevenson, 2002). The auditor's license to perform company audit may be revoked by a recognized supervisory body (RSB) if they fail to comply with auditing standards thus will be liable for legal action. The same is being practiced in the US, where the SEC requires all public listed companies to have their accounts audited by external auditors. Therefore, an auditor should provide their opinions on the accuracy and reliability of the client's financial statements, with objectivity, free from bias and refrain themselves from engaging in activities that could jeopardize independence.

Prominently, auditors are expected to be ethical and honest in their professional conduct of duties. Professional ethics is a set of rules to induce an attitude of mind within a person that serve as guidelines for professional members to follow. Codes of professional ethics were issued to preserve the public's confidence in the profession. The Guide to professional ethics of the Institute of Chartered Accountants in England and Wales (ICAEW) requires the

auditors to maintain integrity, objectivity and independence (Moizer in Sherer and Turley, 1997). Therefore, it is reasonable to say that all auditors must have set an 'independent mind' and are 'ethic-conscious' within themselves. However, Gietzmann and Sen (2002) questioned whether the auditors are sufficiently independent of their clients "in fact" and "in appearance" because auditing itself is no longer independent.

The Enron-Andersen Case

Enron's business failure discovered in December 2001 was said to be one of the largest collapses in business history involving $8.5b of hidden debt. Many viewed Enron's failure as a consequence of audit failure. The attention eyed on the auditor's (Andersen) malfunction to report or investigate the signs of doubtful accounting policies long practiced by Enron. Andersen was alleged for failing to detect and report such massive accounting fraud while auditing Enron's accounts.

Andersen has been Enron's auditor for over a long duration for about 20 years (since 1985). Andersen was reported to receive earnings of $52 million and this amount was expected to double up (*Consumer Federation of America*, accessed 15th August 2002). Andersen provides both external and internal audit services to Enron for several years. Andersen obviously violated two of the four elements identified by the SEC as impairing independence. SEC's Rule 2-01 (c)(4) specified internal audit services as one of the nine non-audit services[i], when provided to an audit client could impair independence.

More surprising is that Andersen even maintained a permanent office space in the Enron's building. In addition, Andersen's employees attended and joined many events organized under Enron's management. The sign of lack of independence (real and perceived) was clear. In this situation, the question is how could such significant error was not detected. On the clear surface, it is simply due to the large piece of **fee** generated from Enron and the **intimacy** between the two parties. Andersen might easily overlook on the client's compliance with relevant policies and requirements. Furthermore, Andersen has been auditing Enron for a long duration and become familiar with the company's accounting practices and policies.

Andersen's lucrative role in the company and the close personal relationship developed with Enron throughout their long tenure compromised Andersen's independence (*Consumer Federation of America*, accessed 15th August 2002). Andersen knew there were serious problems with Enron's financial statements but they signed it off anyway. What really went wrong is still the major question. The Enron - Andersen scandal has pushed the stock market down and it signals the importance of auditor's independence to a company. Consequently, this questions the adequacies and effectiveness of the existing audit independence regulation.

In defense to the accusations, the professionals from the Big 5 claimed that they remain highly ethical and adhere with ethical guidelines and standards. Unfortunately, most of the corporate failures cases involving large companies such as Enron, WorldCom, Xerox, Waste Management were closely associated with audit failures, which were performed by large accounting firms. In fact, auditors are legally responsible to provide users of the financial statements with objective opinions and the assurances of the company's performances.

Illustration 1 below summarizes among corporate failure cases, which involved all highly reputable and big CPA firms.

Illustration 1: Summary of corporate failure cases uncovered in recent years[ii]

Company name and its allegation	Auditor
Enron is alleged for using special purpose vehicles of $8.5bn deals to hide real level of debt.	**Andersen**
WorldCom has treated over GBP3.8bn revenue costs (network maintenance) as capital expenditure to inflate profits.	**Andersen**
AOL Time Warner is being questioned for its revenue recognition practices, including the barter deals.	**Ernst & Young**
Xerox is alleged to have recorded $6.4bn of long term leases as immediate revenue.	**KPMG**
Global Crossing exaggerated revenues through the use of telecoms capacity swaps.	**Andersen**

This corporate failure problem may not entirely due of auditor independence failure alone but also the ineffectiveness of **corporate governance**. In fact, corporate governance does not only revolve the directors or board members but also the auditor's roles to enhance good governance in an organization. Although existing **audit procedures** is sound enough to ensure maximum audit quality, but sometimes failed to detect misappropriations. Some loopholes need repairs. This has been the case where management carefully hid the document papers that may lead to detection of fraud or money laundering.

Extreme **commercial pressures** also could induce companies to undertake activities outside legal context for instance: an aggressive acquisition policy, mismanagement, and misappropriation of assets and flawed accounting practices. Currently, government and regulators are heavily reviewing the existing **corporate governance's regulatory framework** and make necessary recommendations to improve the rules. Moreover, the **audit committee** (AC) did not play an effective intermediary role between the auditor and client, and the AC did not effectively oversee the auditor's work.

The AC should be given more authority and power to require auditors to report and discuss on the findings of the audit. The roles of external audit, internal audit and AC are highly recognized in corporate governance. The **inadequacy** of existing financial accounting and auditing **rules** also contributes to the corporate crisis. The Financial Accounting Standard Board (FASB), in fact, is facing the challenges to produce strong rules in a timely fashion when there are oppositions from large corporations and accounting firms (*Consumer Federation of America*, accessed 15th August 2002).

Threats to Auditor Independence

It is widely known that one of the major threats (**real or perceived**) to auditor independence is the provision of **non-audit** or other **consulting** services to audit clients. It is clear that impairment of independence could easily occur regardless of the environment where the audit operates. The nature of auditing itself incorporates a relationship between the auditor and their client, which is very difficult to separate. Considering the fact that auditors are exposed

to such threats, which are difficult to avoid, it is reasonable to say that impairment of auditor's independence might always exist as long as there is a relationship between the auditor and the auditee. However, this opinion is not justified at this point of time.

Issues of auditors offering multiple services (thereafter non-audit services) to their existing audit clients are highly associated with independence. These non-audit works offered by the CPA firms were said to have contributed to most of the corporate failure cases. These non-audit services account for almost two-third of an audit firm's income. Apparently, these audit firms seem to be dependent with their clients by means of the audit fees received. However, the question of impairment of auditor independence is not relevant anymore when these services are extended to **non-audit clients**.

Typically, in Enron-Andersen scandal, the shocking collapse was viewed due to the following reasons:

i. The auditor accepted **non-audit engagement** altogether with the **audit engagement** though this might jeopardizes their reputation and independence.
ii. The **intimate relationship** between the auditor and client generated strong perception that Enron's collapse was due to auditor's inability to be independent. Such intimacy may put the auditor in a difficult situation of whether or not to set up an investigation to query any doubtful accounting policies practiced by the client.
iii. The auditors being **fee dependent** with their client. Their heavy reliance on the fees could easily reduce their ability to give impartial judgment and objectivity when providing audit opinions. In most situations (concerning audit engagement), auditors are reluctant to risk their huge share of revenue derived from audit services and income from the non-audit services.
iv. Long audit tenure with a client tends to develop a situation of **over-familiarity** with the client's internal control system and business environment or surrounding. Thus, auditors tend to overlook on any conflicting activities or deficiencies of the internal control system.

Not surprisingly, this also explains why audit client could affect the fee income of the auditors by threatening to remove or replace the auditor in the next audit. When auditors receive significant fee income from their client, it would dilute their incentives to maintain independence (Gietzmann and Sen, 2002).

The UK and The US Regulatory Responses on Auditor Independence Issue in Post-Enron

The discovered failures of the reputable high profile companies indeed provoked the debate among the government, regulators, standard-setters and professional bodies. This urged these parties to emerge with proposals to solve or at least minimize to the problem. As in the UK, the financial accounting and auditing rules are seen as sufficient but some standards need to be reviewed (CGAA, 2002). Regulatory reviews are intended to improvise audit independence regime and to curb further corporate failures. The DTI expects further changes to be seen in the accounting and auditing regulatory regime, as well as the company law.

In the US, the SEC and AICPA play vital roles in responding to this matter. The approach taken by SEC is more robust and detailed as compared to the UK practices. The SEC revised

independence rule includes detailed requirements on the provision of non-audit services. At that point, the SEC believed that the new rule provides sufficient safeguarding steps to prevent compromise of audit independence, however, they expect to revise the rules from time to time. In the post-Enron, the SEC revisited its auditor independence requirements to analyze the adequacies of existing rules and to propose necessary changes or additions to the rules.

In the UK the Companies Act 1989, Section 30[iii], covers the regulation and supervision of auditors. This is seen as a sufficient provision and guidance for the auditors and companies to follow. However, in the wake of Enron, the DTI agrees that further changes to the accounting and auditing regulation, and the company law are desirable. Hence, the guideline above all requires accountants (auditors) to maintain an independent mind and remain competent during their performance of professional duties. However, those guidelines are open to various interpretations, thus making it difficult to define.

The UK regulators are seriously discussing the issue though there is no evidence showing that Enron's case has no relation to the deficiencies of UK regulations. However, the corporate crises in the US could hit the UK and pose serious implications to the UK profession. In the wake of Enron, the Co-ordinating Group on Audit and Accounting Issues (CGAA) was set up on 27 February 2002 under the DTI to ensure that there was comprehensive work programmed to be undertaken by individual regulators, and avoiding unnecessary overlap. The CGAA was also required coordinate the review and evaluate the adequacy of the UK's current regulatory regime for statutory audit and financial reporting (CGAA, 2002).

Accordingly, the CGAA has segregated task that relevant regulatory or professional bodies need to undertake in addressing auditor independence issue. The summary of work done by UK regulators to review their respective area is available in **Table 2**. Considering the works done (See Table 2), it is clear that the UK regulators were seriously responding to audit related matters in an aggressive manner. Active involvement of various relevant regulatory bodies and standard-setters (e.g: FSA/ ESB/ ICAEW) shows that the UK is committed to ensure that its regulatory framework is working efficiently and effectively.

Table 2: Summary of Reviews and Actions Proposed by UK Regulators to Strengthen Auditor Independence (adapted and reproduced from CGAA Interim Report, 2002)

Lead Body	Review/ Task	Remarks/ Comments
ESB (Accountancy bodies, DTI, FSA)	The Ethics Standard Board (ESB issued a consultation paper "Setting the Agenda for Ethics" on 28 May. Auditor independence is the major focus of this paper.	The paper discusses the approach to the setting of ethical standards for accountants and raises most of the audit independence issues (e.g: non-audit services, auditor rotation, employment with audit clients)
FSA (ESB/ RB/ DTI)	The FSA address the Review Listing Rules on principal independence issues in relation to listed companies.	The specific issues to be considered might be on auditor rotation or mandatory re-tendering, and the split of audit and non-audit work. However, the review of the listing rules might take from 18 months to 2 years.
Review Board (ESB/ FSA/ DTI)	Review Board (RB) studies of non-audit services, in particular: (i) conceptual (spectrum of services from audit through consultancy to identify which are legitimately audit related services); (ii) statistical audit fees and non-audit fees (both auditors and third parties); (iii) behavioral (views on non-audit services provision from auditors, clients, users of accounts and audit committees	This would provide valuable input into ESB's work and into FSA Review of Listing Rules.
Review Board (ESB/ FSA/ DTI)	Review Board studies on audit switching by listed companies and costs associated with rotation: Analysis of the costing and pricing policies adopted by the large accountancy firms.	This could supplement ESB's work and FSA's Review of Listing Rules.
CCAB	Review of EU Recommendation on Statutory Auditor Independence, consideration of implementation of requirements and update of ethical standards and guidance, and liaison with the Ethics Standards Board of the Accountancy Foundation.	Working on the revised standards and guidance which is due in mid 2003.

ICAEW	• Mandatory rotation of auditors through reviews of public reports and academic research papers • Review the provision of non-audit services • Consideration by Council of proposal to encourage early implementation of the EU Recommendation in areas such as cooling off periods.	
Professional bodies in conjunction with DTI and ESB (FSA also interested)	Implementation of UE recommendation on audit independence. This is formally promulgated by the Commission in May.	This becomes an opportunity to revisit existing professional ethical guidance on auditor independence, in particular to revisit rules governing provision of non-audit services. Recommendation also paves the way for fuller disclosure of fees for non-audit services and for tighter restrictions on employment of auditors by former client companies.
Auditing	An Audit Review Working Party is reviewing CIMA's position on auditor independence.	

The CGAA reported that UK's existing accounting and auditing standard were seen to be compatibly more effective than in the US. The regulatory approach of UK has been a role model for many countries because the practices are of greater compliance with international accounting standards, shows strong flexibility and strong professionalism (Stevenson, 2002). Though there is no serious call for a major change in the current standards, the CGAA (2002) reported that there have been calls for further changes in the UK's regulation. Reviews are needed within the areas of provision of non-audit services, mandatory rotation of auditor or audit partner, and enhancing the roles of audit committee (CGAA, 2002).

Meanwhile, the US opted for a more detailed and robust response. Similar to the UK, their central mission was to improve the auditor independence and to prevent episodes like Enron and WorldCom from occurring again. Despite tougher and detailed SEC's new rules on auditor independence, which became effective on 5 February 2001, the rules were viewed as inappropriate. The rules received many criticisms from the professional practitioners because from their view the rules did not appropriately consider the fundamental factors associated with audit failures due to lack of independence. After Enron, the SEC and AICPA took response and revisited its independence rules to analyze and identify deficiencies in existing rules and standards. In its revisits, the SEC proposed that the audit committee must first

approve the non-audit services provided by the auditor and further restrictions to the provision of non-audit services. However, the SEC still does not see the idea for a blanket ban of non-audit services, nor the mandatory rotation of audit firm.

The **Sarbanes-Oxley Act of 2002** (in the US) has been signed into law and the Investigations and Disciplinary Board exists with the authority to monitor accounting firms and penalize lawbreakers. Unfortunately, the Sarbanes-Oxley Act is still not strict enough in its requirements. For example, Section 201 pertaining to the provision of non-audit services imposed additional restrictions to such services. However, some flexibility exists where certain exemptions can be granted upon discretion of the Board (**refer Table 3**). Therefore, the prime objective to restore independence may not be achieved with the existence of such exemptions.

Table 3: Summary of Sarbanes-Oxley Act of 2002: Rule in Relation to Auditor Independence (reproduced from AICPA, accessed 2nd November 2002).

Section 3: Commission Rules and Enforcement	A violation of Rules of the Public Company Accounting Oversight Board ("Board") is treated as violation of the '34 Act, giving rise to the same penalties that may be imposed for violations of that Act.
Section 103: Auditing, Quality Control, and Independence Standards and Rules.	***Auditing standards***. The Board would be required to "cooperate on an on-going basis" with designated professional groups of accountants and any advisory groups convened in connection with standard-setting, and although the Board can "to the extent that it determines appropriate" adopt standards proposed by the groups, the Board will have authority to amend, modify, repeal, and reject any standards suggested by the groups. The Board must report on its standard-setting activity to the Commission on an annual basis. The Board must require registered public accounting firms to "prepare, and maintain for a period of not less than 7 years, audit work papers, and other information related to any report, in sufficient detail to support the conclusions reached in such report." The Board must require a 2nd partner review and approval of audit reports registered accounting firms must adopt quality control standards. The Board must adopt an audit standard to implement the internal control review require section 404 (b). This standard requires the auditor to evaluate whether the internal control structure and procedures include records that accurately and fairly reflect the transaction of the issuer, provide reasonable assurance that the transactions are recorded in a manner that will permit the preparation of financial statements in accordance with GAAP, and a description of any material weaknesses in the internal controls.
Section 201: Services Outside the Scope of Practice of Auditors; Prohibited Activities.	It shall be 'unlawful' for a registered public accounting firm to provide any non-audit services to an issuer contemporaneously with the audit, including: (1) bookkeeping or other services related to the accounting records or financial statements of the audit client;

	(2) financial information systems design and implementation; (3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports; (4) actuarial services; (5) internal audit outsourcing services; (6) management functions or human resources; (7) broker or dealer, investment adviser, or investment banking services; (8) legal services and expert services unrelated to the audit; (9) any other service that the Board determines, by regulation, is impermissible. The Board may, on a case-by-case basis, exempt from these prohibitions any person, issuer, public accounting firm, or transaction, subject to review by the Commission. It will not be unlawful to provide other non-audit services if they are pre-approved by the audit committee in the following manner. The bill allows an accounting firm to "engage in any non-audit service, including tax services," that is not listed above, only if the activity is pre-approved by the audit committee of the issuer. The audit committee will disclose to investors in periodic reports its decision to pre-approve non-audit services. Statutory insurance company regulatory audits are treated as an audit service, and thus do not require pre-approval. The pre-approval requirement is waived with respect to the provision of non-audit service for an issuer if the aggregate amount of all such non-audit services provided to the issuer constitutes less than 5 % of the total amount of revenues paid by the issuer to its auditor (calculated on the basis of revenues paid by the issuer during the fiscal year when the non-audit services are performed), such services were not recognized by the issuer at the time the engagement to be non-audit services; and such services are promptly brought to the attention of the audit committee and approved prior to completion of the audit. The authority to pre-approve services can be delegated to 1 or more members of the audit committee, but any decision by the delegate must be presented to the full audit committee.
Section 203: Audit Partner Rotation.	The lead audit or coordinating partner and the reviewing partner must rotate off of the audit every 5 years.
Section 204: Auditor Reports to Audit Committee.	The accounting firm must report to the audit committee all "critical accounting policies and practices to be used… all alternative treatments of financial information within [GAAP] that have been discussed with management… ramifications of the use of such alternative disclosures and treatments, and the treatment preferred" by the firm.

Section 206: Conflicts of Interest.	The CEO, Controller, CFO, Chief Accounting Officer or person in an equivalent position cannot have been employed by the company's audit firm during the 1-year period proceeding the audit.
Section 207: Study of Mandatory Audit Rotation of Registered Public Accountants.	The GAO will do a study on the potential effects of requiring the mandatory rotation of audit firms.
Section 301: Public Company Audit Committees.	Each member of the audit committee shall be a member of the board of directors of the issuer, and shall otherwise be independent. 'Independent' is defined as not receiving, other than for service on the board, any consulting, advisory, or other compensatory fee from the issuer, and as not being an affiliated person of the issuer, or any subsidiary thereof. The audit committee of an issuer shall be directly responsible for the appointment, compensation, and oversight work of any registered public accounting firm employed by that issuer. Each audit committee shall have the authority to engage independent counsel or other advisors, as it determines necessary to carry out its duties.

The Sarbanes-Oxley Act of 2002 received great amount of criticisms since it was first announced because it did not seem to incorporate the root problem to independence in it. Nevertheless, any changes made to the rules should be supported with strong evidence that the changes can mitigate independence problems. Within this context, tougher disciplinary actions could, therefore, induce and motivate the auditors to refrain themselves from engaging in any unethical activities. Furthermore, the CPA firms fear that they may lose their clients if they face disciplinary actions.

There were also concerns about the possibility that interference by the US government in the regulatory process could eliminate self-regulatory system. This received criticisms from regulators, professional bodies and practitioners because the critics viewed the SEC and AICPA rules as too complex and boost the audit cost. This would bring more confusions and detriment the audit practicing community.

Discussion

The basic safeguarding tools to protect independence are: the **law** and the **standards** that auditors need to adhere, otherwise they pose the risks of facing legal liabilities for providing misleading information to the users of the financial statements. Nevertheless, an auditor may

be tempted not to reveal certain information which came into conflict with the client's reputation but they will do this within limits where all the standards and guidelines has been satisfied. Thereby, this is legal as far as the auditor is concern. The auditors also fear that they might be replaced in the next audit or most probably, a lower audit fee is offered in the next engagement. The risk of losing a client is costly. Hence, when the auditor faces such pressure, it could put the person into a difficult position whether to disclose all information or ends up transmitting selected information only. At this point, auditors must remember that their accountability is due to the interested parties who are the shareholders, investors, and other stakeholders and there is no direct obligation to the audit client.

The call for strong auditing independence regulatory framework has long been empirical as found in many literatures. Van Der Plaats (2000) points out that crisis involving auditor independence started with some SEC cases (of company failures) for breaching SEC independence rules and also audit firm's compliance with the rules. There was an immediate call for the regulators to review its rules and impose tighter compliance requirements (Stevenson, 2002; Van Der Plaats, 2000). Greater enforcement on accounting and auditing rules is seen as essential to ensure that the rules work effectively to eradicate independence problem. Disciplinary actions through legislation were among the radical proposals recommended by various parties.

As a consequence to the corporate crisis, the **UK and US regulators** were aggressively carrying out the **review and analysis** on the adequacies and effectiveness of their existing regulatory framework. The UK may not need major alteration to its requirements but they are making every effort to **tighten** the standards as safeguarding steps to avoid incidents similar to the US. Though UK's have received many compliments pertaining to its high quality standards, there are other areas needs refinements. Meanwhile, the US may need to overhaul their regulatory framework to improve the whole economic system of the country. The continuous bankruptcy cases in the US are worrisome that a review on the entire regulation was called.

At present, auditor's independence (in appearance) is justified through their compliance with standards and ethical guidelines. Perhaps, an independent body such as APB in the UK or ISB in the US should be given more responsibility to monitor auditor's activities, develop standards or guidelines relevant to independence, ensure compliance with the standards and conduct research/ investigation to study areas pertaining to auditor's motivation towards independence.

The problem with the proposed reforms was the inability to counteract the fundamental problems of independence whether they are 'real' or 'perceived'. No matter how tough and stringent the rules are, if the auditors (individual or firm) do not naturally have an ethical mind or ethic-conscious, their act does not reflect the characteristics of an independent person. If forceful rules were set without taking into view the evidence of independence abuse and market failure, eventually not much can be achieved. Regulators should identify and understand the differing motivation of auditors and audit quality drivers when regulating auditor independence. Any rules can be **manipulated** by anyone because humans have the **incentives** and are free to do so.

Imposing stricter auditing standards do not guarantee to improve independence. Indeed, the auditing community must demonstrate their incentives for exercising balanced professional judgment. However, excessive enforcement could be detrimental to the performance of

auditors. The profession's opportunities to grow and develop might be impossible because they are bounded by too many requirements. The regulation, which is complex and not characterized by strong evidence of justification, would fail. Understanding the **underlying problems** and **reasonings** attached to auditor independence in social life need to be addressed in a regulatory process.

Every effort by the government and regulators to strengthen auditor independence must be encouraged. Without full support and cooperation from the auditors, all means of regulatory requirements and policies will be useless. When the idea of visualizing the success of capital market is cohort, then, all parties including government, practitioners, directors or management, shareholders and stakeholders will benefit from the good and ethical business practices. This is not only to eliminate (or at least minimize) the independence problem but also to promote good corporate governance, where both are equally important.

The Significance of this Paper for Future Research

Despite analyzing independence reviews of the UK and the US, this paper indeed intends to highlight the significance of this paper in relation to what is being generally practiced world wide including Malaysia. In accordance to the release of New By-Law on Professional Independence issued by the Malaysian Institute of Accountants (MIA) on 1 July 2004, shows that Malaysia is seriously attending to this issue as it affects the practices adopted especially in mega companies (particularly companies listed on the Malaysian Stock Exchange Board). The Malaysian experience of Perwaja Steel is a case that was seen to be a failure audit as well as its governance. Then, the Malaysian Institute of Corporate Governance (MICG) also plays its important role together with other regulatory bodies: (The Malaysian Accounting Standard Board, MASB, the Securities Commission, SC, The Institute of Internal Auditors Malaysia, IIAM, to name a few) to address this matter. Though this paper focuses on the UK and US context, however, the independence issues discussed are globally prominent. It is possibly that a focus on Malaysian or Asian context of audit independence issues follows this paper in future.

Notes

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[1] The nine non-audit services identified by SEC are (1) Bookkeeping or other services related to the audit client's accounting records or financial statements (2) Financial information systems design and implementation (3) Appraisal or valuation services or fairness opinions (4) Actuarial services (5) Internal audit services (6) Management functions (7) Human resources (8) Broker-dealer services (9) Legal services.

[2] '2002: A Very Bad Year', Student Accountant, ACCA, September 2002: 9.

[3] Section 30 of the Act defines a recognized supervisory body (RSB) as the body that maintains and enforces rules pertaining to (1) the eligibility of persons to seek appointment as company auditors and (2) the conduct of company audit work.

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