

**Auditor Independence Debate:
A Critical Review of the UK and the US Responses and Proposed
Reforms to Strengthen Auditor Independence
in the Wake of
Enron-Andersen Scandal**

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Abstract

This paper argues on auditor independence and its safeguarding tools developed to preserve independence in the wake of Enron-Andersen debacle. Likewise, the safeguarding tools aimed to strengthen auditor independence and to secure public's confidence in the credibility of the accountancy and auditing profession. Auditor independence has always been difficult to define despite its continuous debate for over three decades. Since Enron, in addition to current tougher independence regulations, more calls demanding further reforms to strengthen auditor independence have been received. This study attempts to discuss the proposals to strengthen auditor independence argued in the UK and the US. In the UK, the Co-ordinating Group on Audit and Accounting Issues (CGAA) was set up under the Department of Trade and Industry (DTI) to coordinate works of reviewing UK regulation in the light of Enron. While, in the US, the Securities and Exchange Commission (SEC) and The American Institute of Certified Public Accountants (AICPA) perform major regulatory works in response to the collapse. The main proposals discussed in this paper include: ban of non-audit services, establishment of tougher regulation and appointment of auditors by the state or agency. Responses towards the proposals between the two countries vary. This has much to do with the differing approach in standard-settings. The viability and practicability of the proposals are discussed. The paper indicates that the proposals have their own strengths and weaknesses in its objective to achieve maximum independence. On one hand, the proposals may mitigate impairment of auditor independence in the first instant. On the other hand, there are great possibilities that any new standards or guidelines could appear obsolete within short period. Then, regulatory reviews and reforms need to take place continuously. The regulation on auditor independence has not sufficiently address the fundamental elements that genuinely affect independence. Other reasons for corporate failures need consideration as well. There is a need for further empirical research to analyze the implications of auditor independence regulation towards the perceptions of independence. This could contribute to a better regulatory process in effort to strengthen auditor independence and simultaneously boost capital market.

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CHAPTER 1

INTRODUCTION

Auditor independence issue has been in great debate over the last three decades. The issue is of paramount importance and still in the limelight especially after the Enron crisis. Auditor independence, in particular, is an important aspect of an auditing process. The impact of lack of auditor independence can be extremely great to the **audit process** thus affects **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**' (Lowe *et al.*, 1999). Hence, when auditors are less independent from their clients, the opinions they provide might constitute biases. If this is the case, the users of audited financial statements may not find the documents useful anymore. This would not attract the investors to invest in the company. In this respect, the investors and the public expects the auditors to be entirely independent from the auditee, in order to justify their trust.

Impairment of auditor independence can occur in various circumstances. Examples are such as: when auditors have an economic bond with their clients (attached to fees or fee dependent with clients), close relationships with client, extending consulting or non-audit services and being involved in client's management functions or decisions. Various safeguarding methods have been introduced to reduce potential risk of lacking of auditor independence. In fact many studies have focused on auditor independence by looking at different perspectives and recommended safeguarding methods to overcome the problem.

In the wake of Enron, the collapse of this multi-billion US based (energy) company has shaken the business world. Governments, politicians, regulators, critics, academics, investors, the public and the accounting profession itself raised auditor independence issue as their prime concern. While the case is still under investigation, Andersen is deliberately being blamed for failing to detect and investigate Enron's questionable accounting practices, of which eventually brought the company down to bankruptcy. In the turmoil of the destructive corporate failures, auditor independence and corporate governance practices have emerged as a critical issue. Investor's and the public's confidence towards auditor's attestation of the financial statements has deteriorated and this caused lack of confidence in the capital market.

Tougher independence regimes have been set over the past three decades to regain thrust and strengthen auditor independence. However, Van Der Plaats (2000) reckons that the issue is still a thorny one that it urges immediate attention. It is crucial that the regulators identify and ratify any mismatches between auditor independence regulatory framework and the appearance of independence in the real world settings. Criticism also has pushed the profession to reassess the purpose and future of auditing. It is therefore vital that regulators develop effective mechanisms to protect the appearance of auditor independence and restore the lost thrust in the profession.

Since auditor independence brings great impact into the auditing profession, it is crucial to alleviate the negative perceptions rested on the audit community. Thus, it is time that this dissertation reviews and analyzes the case of audit independence and works done by regulators to address this matter, particularly to strengthen auditor independence (real or perceived). Following the Enron-Andersen scandal, the regulators showed mixed reactions about the adequacies and effectiveness of existing regulation on audit independence. Vast

constructive proposals were put up in attempt to strengthen auditor independence (and corporate accountability) within today's complex business transactions. Among proposed reforms are: a ban or prohibition of non-audit services by auditors, enhancing the role of audit committee, mandatory rotation of audit firms, greater enforcement power by regulators, establishment of an independent body to select and hire auditor, greater disclosure of audit and non-audit services in the proxy statements and many others. The proposals were also meant to regain the investor's and public's confidence in the capital market. However, it is still doubtful whether the proposals could substantially preserve auditor independence both 'in fact' and 'in appearance'.

The objective of this research is to explore the view of auditor independence concept and threats attached to it, and to evaluate the proposed reforms in the United Kingdom (UK) and the United States of America (US) to strengthen auditor independence in the wake of Enron. Thus, the analysis of the regulator's reactions on this issue aimed to highlight the essential criteria needed to improve auditor independence. In doing so, an analysis on the successfulness of the proposals and the auditing regime is included. This research is expected to be of great contribution to the existing knowledge involving auditor independence. The recommendations offered in this dissertation are could hopefully accelerate the efforts to promote better independence environment, to enhance public's confidence and safeguard the auditing/ accounting reputation as professional service providers. Furthermore, Comte (cited in Blackburn, 1994) believed that the existence of new knowledge could help bring new certainties and truths, thus, the emulation of improvements and contributions to the knowledge can be expanded over time.

This dissertation is further organized in the following orders. Chapter 2 explains the methodologies adopted in this research. Chapter 3, the literature review section, explains the

concept of auditor independence, ideas and arguments by other previous researchers and several threats to independence. Then, this section provides the overview of the UK and the US regulatory responses in the wake of Enron. Following that, Chapter 4 immediately covers the proposals recommended to strengthening auditor independence in both the UK and US. Simultaneously, some evaluation and analysis of the appropriateness or successfulness of the proposals are included. Additionally, this section offers some other possible alternative reforms to overcome independence problems. Then Chapter 5 presents a discussion to draw attention on the fact that auditor independence cannot be achieved only by adhering to a set of rules but actually involves incorporating the auditor's personal qualities and attitudes. Finally, Chapter 6 summarizes the essential points highlighted in this dissertation.

CHAPTER 2

RESEARCH METHODOLOGIES AND ITS LIMITATIONS

A library research is carried for this dissertation due to the desirability of completing the research within the stipulated time. The availability of vast resources and literature materials in the topic area from the university library and databases support the use of this method. An empirical research was not viable due to several limiting factors: time constraint to complete this research (within three months). It is also due to the unavailability of respondents for the interview and questionnaires sessions, and insufficient time to conduct data collection process, analysis of findings and interpretation of results. Therefore, to preserve the quality of this research, a library research was seen as the most appropriate.

A critical evaluation of the literature is adopted to explore the problems of auditor independence. The concept of critical approach is where theories are viewed and studied through time. In this critical evaluation, [the researcher] need to juxtapose different ideas from the literature review and form researcher's own opinions and conclusions (Saunders *et al.*, 2000). According to Clarke (1999), an evaluation research primarily evolves the merit, worth or value of an established policy or invention. This paradigm has been widely used by researchers to study the effectiveness of existing knowledge and its practicability. A critical evaluation research could provide syntheses and contributions to existing knowledge.

This study is also descriptive and interpretative in nature. In support of this method, Rittenberg and Covaleski (1999) states that descriptive method provides insights into what is happening. Meanwhile, an interpretative approach via analysis of main literatures helped the researcher to understand more about the research topic area. The use of previous research papers was among important sources of information. Among literature materials used were

government documents, published reports, books, academic journals, professional journals, magazines, and newspapers. Massive numbers of materials are available and accessible from the Albert Sloman Library (in the University of Essex). Since the issue was related to Enron's collapse and current debate of the independence issue, materials which were published within six months before writing this dissertation were closely scrutinized. The intention was to gather data about the mixed responses towards the collapse and recent debates concerning auditor independence.

The use of university databases and internet websites were essential in gathering relevant literatures in a wider context. Browsing through the websites allowed the researcher to gain quick access for information and to refine the topic area. To verify the validity and reliability of the literatures used, the information gathered went through a multiple checking process to ensure that the literatures posed several common ideas and arguments. Nevertheless, all sources of information (written publications or web-based information) offered excellent useful knowledge for this research.

The researcher, however, believed that this dissertation is incomplete without considering the limitations encountered throughout the research process. The researcher tried to maintain an independent mind when conducting this research to avoid influences and biases in evaluating the literatures. When investigating a topic that involves human attitudes and mind, it is difficult to evaluate and justify certain information that tends to be too subjective. Hence, this dissertation could pose less accuracy due to researcher's inability to provide an exact cumulative view that represents the government, the regulators or the practicing audit community. In this case, the researcher includes own reasoning and provides valid explanation to the researcher's stance concerning auditor independence issue.

CHAPTER 3

LITERATURE REVIEW

3.1 Background

Enron's business collapse in December 2001 involving \$8.5b of hidden debt, was one of the largest corporate collapses in the history that had provoked global concern on the **controversial auditor independence** issue. Later, Andersen's (Enron's auditor) worldwide collapse due to this catastrophe, adds misery to the crisis. The important point to note is that Enron's business failure is viewed by many as the consequences of the audit failure. Andersen's failure to report or investigate the signs of doubtful accounting policies practiced by Enron has made independence debate more ironic. An auditor is expected to maintain independent and objective mind when giving opinions on the client's financial statements. Nevertheless, the crash of Enron casts greater doubt whether auditors (especially large CPA firms) are actually independent from their clients or not. More aggravating is that public's confidence in the auditor's work has deteriorated and this affects the efficiency of the capital market (CGAA, 2002; Swanger and Chewing, 2001).

In defense to the accusations, the professionals from the Big 5 (now Big 4) claimed that they remain highly ethical in performing their work, and adhere with ethical guidelines and standards. Unfortunately, the evidence of corporate failure cases involving large public companies, i.e: Enron, WorldCom, Xerox, Waste Management were closely associated with audit failures performed by large accounting firms. Despite aggressive developments in independence regulatory provision over the past decades, evidence of success is little. Even with tougher and more forceful standards, breach of audit independence provisions continues.

To date, there has been vast amount of research done, which argues on auditor independence issues from many differing perspectives. For example, Gorman and Ansong (1998), Lowe *et al.* (1999), and Swanger and Chewning (2001) investigated the perceptions of auditor independence from the eyes of the users of the financial statements. Jeppesen's (1998) studies focused on developments of independence concept, while Van Der Plaats (2000) studies encompassed on the regulatory concept of auditor independence. Stevenson (2002) conducted a study of statutory auditor independence across the UK, France and Italy. But indeed, these researchers concurrently suggest that auditor independence is a never-ending issue that they seek continuous review and efforts to improvise the profession's regulatory framework.

In most countries, professional standards and companies acts provide sufficient regulatory framework for the auditors and companies to follow, in particular, the requirement that enforces public companies to have their financial statements being audited by qualified auditor (Dunn, 1996). In the UK, the Companies Act 1985 requires all registered companies being subject to an annual external audit (Stevenson, 2002). The latter'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. In this respect, the auditor's duty is to provide impartial judgment and objective opinions on the accuracy and reliability of the client's financial statements. They also should refrain themselves from engaging in activities that could jeopardize independence.

In the UK, 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 development via **self-regulative system** and **principles-based** approach appears to be good role model for other countries. This is due to the existence of strong professionalism, strong optimism and transparency (Stevenson, 2002) that not many changes were called to the UK standards (CGAA, 2002).

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 to address independence matters by developing independence concepts and standards. In particular, the US adopts more robust and more detailed regulations to mitigate independence problems (CGAA, 2002).

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). Hence, due to its ongoing importance to the profession and capital market, the questions of auditor independence becomes critical in the UK, the US and internationally.

One considerable aspect is the argument saying that the failure of audit mechanism has much to do with the complexity of businesses in the globalized economy. It is commonly understood when pressures to keep good business are

mounting, there will be conflicts between doing the right things. Auditors may be tempted to override the law in order to survive (secure their audit income) in such competitive market. If so, addressing independence issue without taking into account the business environment in any regulatory review will not improve the situation anyway. This explains why Raspante (2002) predicted that the auditing profession would be living in negative reputation for some time to come after the Enron-Andersen scandal.

In the light of Enron debacle, there were many proposals set out by standard-setters, regulators, profession and other interested parties (in the UK and the US), in attempt to strengthen auditor independence. Whether the proposals would be successful or not is another matter to discuss. However, several questions pertaining to auditor independence deserve consideration:

- Why is independence very important?
- Did the corporate disasters such as Enron were caused genuinely by audit failures?
- What should be done to strengthen auditor's independence and regain the investor's or public's confidence towards the credibility of the profession?
- Will the proposals set out by the UK and the US regulators to strengthen auditor independence, in the light of Enron, able to mitigate independence problems? What are the possible reasons for its success or failure?
- Are there other alternative reforms that might be introduced?

Perhaps, the answers can be discovered after going through subsequent chapters.