Advanced audit principles and practice

Finance

Executive Summary

The recent financial crisis has led to a great deal of discussion about the role of the auditor and whether the increased regulations are now effective in reducing the chance of further difficulties of this type, in the future. By looking at the collapse of both Enron and Lehman Brothers, it can be argued that the ineffectiveness of the auditing profession and, in particular, the lack of independence between Arthur Anderson and Enron, were seen to be critical factors in the downfall of Enron. Bearing this in mind, there have been some fundamental changes to the auditing regulations, in order to rebuild investor confidence and also to ensure that there is much less chance of similar problems occurring, in the future.

Introduction

Thefailureof Enron in 2001 resulted in a dramatic shift in the approach to auditing, in the UK (Fazdly & Ahmad, 2004). The collapse was largely due to the relationships between Enron and its auditors, where Enron was audited by Arthur Andersen LLP which was Enron’s main client. Arthur Andersen provided substantial non-audit related services and worked attentively with the management to create procedures for suppressing the real figures for the financial statements. Questions that have arisen following the collapse of Enron and discussion were had over whether or not the auditing undertaken offered the level of certainty that is necessary for an effective economy (Alleyne & Howard, 2005).

Overview of Changes in Audit Regulations

Following on from the collapse of Enron, the UK government established the Coordinating Group on Audit and Audit and Accounting Issues (CGAA) which comprises of high level groups of regulators and ministers looking at auditing. The matter was also deemed to be relevant in the US and, in 2002, legislation came into force in USA, where the Sarbanes-Oxley Act introduced, announcing changes to the regulation of financial practice and corporate governance. It contains 11 titles which aim to protect shareholders and stakeholders from creative accounting, fraud and embezzlement practices in US corporations. The act is monitored by the Securities and Exchange Commission (SEC), and places deadlines for compliance and publishes the rules' requirements. The aim of the Act is go through legislative audit requirements and to protect investors by advancing the accuracy and reliability of corporate disclosures. Nevertheless, it covers matters such as launching a public company, accounting oversight board, audit independence, corporateresponsibilityand enhanced financial disclosure. The assumption of the Sarbanes-Oxley Act is that the regulations apply equally, as is makes no difference between US and overseas registrants.

The CGAA in the UK was set up by the Chancellor of the Exchequer and the Secretary of State for Trade and Industry, and is made up of high level group of regulators and ministers with the authority for managing the review of the regulatory framework. The foremost matters included in the review are audit independence and making recommendations for change. It was noted at the outset that auditing is a vital part of the accounting framework which then sustains the capital markets and legitimises the financial statements. The main concept is to reassure the shareholders and stakeholders that the corporation's financial statements are true and fair. Furthermore, it will add credibility and reliability to the financial statements, meaning that an auditor should be competent and independent.

As a result of this, the CGAA has made several significant changes in relation to the rotations of audit partners and key audit staff (Church and Zhang, 2006). There is no obligation for the UK listed companies to change auditors after a number of years in office. Nevertheless, where the same audit engagement partner acts for an audit client, for a protracted period of time, threats are likely to occur, as a result of familiarity (Hussey, 1999). Consequently, the UK regulatory obligations are that, for listed corporations, the audit engagement partner cannot perform for more than seven years and cannot return to that role for further five years.

The International Federation of Accountants (IFAC) was also developed as regards to the Code of Ethics for Professional Accountants. This is principally in line with the present UK approach to audit independence, which is directing on the threats to audit independence and the safeguards. Furthermore, audit responsibilities have developed from looking at straight-forward error and giving true and fair audit opinion to the establishment of a value-added services for consumers and regulators; services consist of reporting on internal control deficiencies, identifying business risks and even providing guidance on these risks. Consequently, auditors are expected to be articulated in accounting and reporting standards and requirements, as well as in diverse areas varying from the technological to the legal aspects of business andfinance. In this context, pressure on the audit function is increasing, due to audit related corporate failures and new regulations (Dunn, 1996).

As part of the review and as a direct result of the collapse of Enron, the concept of auditor independence and the way in which providing non-auditing services impact on the level of independence came under particular scrutiny (IAS Plus 2002). As a result of this, five key areas have been looked at within the area of audit and review of the regulatory framework. This entailed, firstly, the need to increase transparency where disclosure is concerned; secondly, looking at all the potential threats to independent, auditing; thirdly, looking at issues associated with non-auditing services and how they should be managed; fourthly, looking at international variations, recognising that they could create difficulties in harmonisation if not achieved; and finally, the requirement to identify the role of the audit committee within these organisations.

The regulatory framework in the UK was therefore developed in a much more robust manner, in order to ensure that the type of close-knit relationship experienced in Enron does not reappear and that organisations are placed under the appropriate level of scrutiny, in terms of their financial activities. This was also recognised to be important, not only from the point of view of achieving genuine independence and robustness within organisations, but also to increase consumer confidence. Moreover, in the current economic crisis, there are concerns that organisations might behave in an unscrupulous manner and therefore developing a regulatory framework which offers security to investors will be a critical part of the long-term recovery of the UK economy (Salter, 2008).

Reactions of Audit Firms to Regulatory Change

As a result of the changing regulatory structure, clear changes that have emerged within auditing firms, across the UK. Many of these changes have taken place in order to comply with the new regulatory standards. However, by identifying the way in which the auditing firms are changing their working procedure, it is possible to obtain a greater understanding of how influential the recent changes to the auditing practices in the UK have been on the economic recovery (Byrne, 2001).

Substantial changes have happened in relation to the operation of auditing firms. The main change is that there is a greater requirement when it comes to auditor independence and this is seen as a crucial solution to the previous problems faced by auditing firms handling the management of an organisation. One of the main findings which emerged in Enron was the fact that the auditing firm Arthur Andersen and was so reliant on Enron for many of its projects and income, that it was not prepared to challenge the directors and was therefore highly unlikely to undertake a full and comprehensive audit. Regulatory changes have stepped in to prevent the amount of non-auditing services reaching such a high level that this type of independence is jeopardised (Collins, 2006).

Another issue which has emerged from the regulatory changes is the fact that many auditing firms found themselves infinancial difficulties. These firms, therefore, looked at ways of making the auditing process easier by standardising the approach and using common practices which would enable them to use checklists, in order to plan and record the auditing questions. Whilst this was an effective way of operating, in many cases, it did result in a lack of thoroughness. Furthermore, by increasing the level of regulation and the expectations that would emerge from a thorough audit, auditing firms have had to change the fundamental method of operation, to comply with these increased regulatory standards (ACCA, 2010).

The regulations not only look at how each individual auditing firm operates but also look at the interaction between the auditing firms and institutions such as the Financial Services Authority, thus requiring a much higher level of interaction between the auditing firm and the large corporation and the FSA, to ensure greater scrutiny of particular accounting practices. The most notable change, however, when it comes to regulations is the replacement of Scheduled 2 of the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements), which places a much greater reliance on disclosure relating to non-auditing services, so that issues relating to independence can be more transparently analysed.

On the whole, however, it can be seen that auditing firms have looked towards changing their operations, both internally and externally. This is in recognition of the fact that, in order to achieve economic recovery, it is necessary for the public and investors to be able to trust the auditing profession to give a true and accurate reflection of the financial statements within a particular organisation. By recognising that the FSA has become much more involved in the interaction between auditing firms and the regulators, this has required auditing firms to become much more transparent in their operations, both as a result of regulatory changes, but also as a result of changing markets demands (Sukhraj, 2010).

Further changes have been made as a result of the Companies Act 2006 which requires greater disclosure of financial statements and, in particular, areas such as the level of director remuneration and a more thorough statement from the auditors in relation to the contents of the financial statements. All of these changes have had a fundamental impact on the work of the modern day auditor.

Enron and Lehman – A Comparison

Enron and Lehman Brothers proved that corporate governance is vital to successful business and social welfare and after Enron filed for Chapter 11 bankruptcy, in 2001, further evidence appeared of corporate governance weaknesses and fraudulent activities. It is recognised that shareholders and stakeholders can be corrupted by a firm's status and success; however, according to economic and finance theory, this should not happen due to them being rational economical agents. A serve lack of transparency in Enron's balance sheets meant that no one was aware of this and other off-balance-sheet liabilities, until it was too late (The Economist, 1 November 2001). The main accusation covered fraud and material misstatement in the company's financial reports. Even though Enron's annual reports indicated financial prosperity, it was clear that Enron's management knew a lot more than it was letting on (Kroger, 2004). Ultimately, the fundamental reason behind the collapse of Enron was on account of deceiving financial statements, as they modified the data to show a successful performance. Enron was audited by Arthur Andersen, for over 20 years, and it was responsible for verifying that the financial statements were true and fair, as well as providing credibility and assurance for the shareholders and stakeholders (Fusaro and Miller, 2002).

Although lack of audit independence was considered to have an impact on the collapse of both Enron and Andersen, the latter also provided internal, external and consulting services, where 70 % of the work was non-audit related. Previous Andersen staff had worked for Enron, as well, and the relationship between the consumer and auditor was too informal. There was no audit rotation, because Anderson had been working with the same client, for over 20 years, this familiarity was a particular threat to their independence. It was also argued that this would increase the level of self-interest threats. Arthur Andersen provided internal audit services to Enron, as well as external; therefore, this influenced the audit independence and integrity, as the duties of the external auditor are to review the internal auditor’s work and form an opinion, and based on that, Andersen refused to acknowledge the fraud and manipulation, while giving a true and fair review (McLean and Elkind, 2003).

Lehman Brothers had fragile corporate governance arrangements which failed to safeguard it against even moderate risk taking and this was seen to be central to the collapse (Porter et. Al. 1996). The fundamental reason for the failure was the misconduct of the audit firm which was Ernst & Young and the work of the board in conjunction with the auditors. The similarities between the collapse of Enron and the collapse of Lehman Brothers could be seen in the areas of audit risk and auditors giving incorrect audit reports. Lehman Brothers filed for many reasons, corporate governance failures were the most important, especially risk management. Lehman Brothers failure and other failures that happened in the financial crisis will, in turn, spawn a new wave of corporate governance (Greer & Tonge, 2006).

Detecting Fraud and Errors

A key question which has emerged from both the collapse of Enron and Lehman is to expand the role of the auditor when it comes to detecting fraud, within the organisation. Investors may well believe that the auditors should in fact be in a position where they are required to investigate and identify any potential, fraud that may exist within the financial position of a particular company; however, the matter is not so clear when specific auditing requirements are looked at (Cosserat 2004).

This distinction can be seen as the expectation gap which exists between what the public and investors believe that the auditors are doing and what they are actually required to do. ISA 240 which looks at the auditors' responsibility to consider fraud in the audit of financial statements clearly indicates that it is the responsibility of the management team to deal with issues relating to fraud, by establishing control systems within the internal accounting processes that would detect fraud (HM Treasury, 2010). The auditor simply has the role of establishing that no material level of fraud has been omitted from the financial statements and is not responsible for the prevention of fraud, in the first place, but rather insuring that any instances of fraud are accurately reported to the public. This simple distinction is particularly important when it comes to public perceptions, and although auditing practices are seen to be linked to the collapse of Enron and Lehman Bros, the reality is that the management teams need to take an increased level of responsibility and it cannot simply be said that the auditors failed in their duty.

Reporting on Business Going Concern

As noted in previous sections of this report, an audit report onfinancial statementdoes not necessarily provide a full and frank disclosure of the position of the organisation. However, the precise role of the auditors has been somewhat muddied and one particular criticism which has emerged following the high-profile collapse of Enron and that of Lehman Bros was the lack of going concern opinion being presented by Arthur Andersen when auditing Enron for the last time (Porter, 1997).

Regulatory changes now require auditors to " perform audit procedures designed to obtain sufficient appropriate audit evidence that the event at the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified" (Auditing Practices Board, 2004, p. 3). This discussion of going concern reporting can therefore be seen to be inherently important to the role of the auditor when identifying a threat to the solvency of a company. The role of the auditor is to identify that the financial statements have been prepared in a way that involves consistently applying accounting policies and that any judgements made as a result of management understanding has been done in a reasonable and prudent manner. It does not require a statement as to whether or not the business is likely to remain solvent over a prolonged period of time and a lack of going concern statements presented on behalf of Enron was potentially a real negative, in terms of the role of the auditors in this large organisation (Swartz and Watkins, 2004).

In the case of Enron, it could be argued that the collapse of the organisation was as a result of poor managerial decisions and not necessarily as a result of fraud and error and therefore it is questionable whether the auditors would have a role in identifying the underlying problem. Despite this, there is a strong argument to suggest that had the auditors been required to give a going concern statement, it may have been possible that the investors were alerted to the problems within Enron, at a much earlier date (Venuti et. al 2002).

Actions of Arthur Andersen and Ernst & Young that could have Avoided Litigation

Both auditing companies suffered substantial problems as a result of the collapse of Enron and Lehman Bros. In the case of Arthur Andersen, its role in failing to identify the problems within Enron could have been seen as fundamental to its ultimate collapse, with Ernst & Young being charged for professional negligence, as a result of its role in the Lehman collapse (Ruddock et. Al 2004). This presents a potentially difficult situation for auditing companies and the discussion of what Arthur Andersen and Ernst & Young could have done differently has been the subject of much recent debate.

Conclusions

One particularly obvious issue that has arisen during the analysis of how Enron failed is the fact that its auditor, Arthur Andersen, gained a large amount of revenue from Enron in relation to non-auditing services. Therefore, by allowing itself to become so reliant on Enron, Arthur Andersen put its auditing team in such a situation that it was unlikely to be able to undertake its activities with sufficient independence. The individual auditors themselves were, therefore, under an almost impossible level of pressure to keep the directors of Enron happy and also to ensure that they used their subjective abilities, so as to maintain the strength of relationships between the entities (Vanasco et al 1997).

Similar problems were seen to be present regarding Ernst & Young, and its relationship with Lehman Bros. Although the collapse of Lehman Brothers did not destroy Ernst & Young, it certainly had a negative impact, with Ernst & Young having to fight its corner in the US Supreme Court. When looking at the collapse of Lehman Brothers, however, it was found by the Supreme Court that Lehman Bros did not in fact violate accounting rules; therefore, whilst there were some questionable practices being undertaken by the management team at Lehman Brothers, this was not sufficient to require the auditors to behave in a different manner or to have reported differently. It seemed, therefore, that Ernst & Young had done nothing wrong, but a lack of thoroughness in its audit and the reputational damage that the collapse did to the accountants was not helpful to the longevity of the firm, going forward (Tackett et al 2004).

References

ACCA, 2010, Value regained: restoring the role of audit in society (1-10), viewed April 12th 2011, Alleyne, P. & Howard, M. (2005). An exploratory study of auditors' responsibility for fraud detection in Barbados. Managerial Auditing Journal. 20(3): 284-303

Auditing Practices Board, 2004 International Standard on Auditing (UK and Ireland) 560: Subsequent Events. London: APB

Byrne, P (2001) Auditor independence: an update (Online)

Available at: http://www. accaglobal. com/archive/2888864/3124

Collins, D. (2006). Behaving Badly: Ethical Lessons from Enron. Dog Ear Publishing, LLC

Cosserat G, W. (2004) Modern Auditing; Chichester England, John Wiley & Sons Ltd

Church, B, K, Zhang, P (2006) A Model of Mandatory Auditor Rotation (online) Available at:

http://papers. ssrn. com/sol3/papers. cfm? abstract_id= 874884

Dunn, J (1996) Auditing Theory and Practise, 2nd edition, Essex, England PearsonEducationLimited

Fazdly, M. & Ahmad, Z. (2004). Audit expectation gap. Managerial Auditing Journal. 19: 897-915

Fusaro, P. and Miller, R. (2002). What Went Wrong at Enron: Everyone's Guide to the Largest Bankruptcy in U. S. History. John Wiley & Sons

Greer L & Tonge, A (2006) Ethical foundations: a new framework for reliable financial reporting Business Ethics: A European Review, Vol 15 Issue 3, Page 259–270

HM Treasury, 2010. A new approach to financial regulation: judgement, focus and stability. London: The Stationery Office

Hussey, R (1999) The Familiarity Threat and Auditor Independence, Vol. 7 Issue. 2 pg 190-197 Corporate Governance, Blackwell Publishing

IAS Plus (2002) Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence

Available at: http://www. iasplus. com/iosco/iosco2. pdf

Kroger, J, R, (2004) " Enron, Fraud and Securities Reform: An Enron Prosecutor's Perspective". University of Colorado Law Review, Available at SSRN: http://ssrn. com/abstract= 537542

McLean, B. and Elkind, P (2003). The Smartest Guys in the Room. New York: Portfolio Trade

Porter, B., Simon, J & Hatherly, D., (1996), " Principles of External Auditing", John Wiley & Sons Ltd
Porter, B. (1997). Auditors' responsibilities withrespectto corporate fraud: a controversial issue, in Sherer, M. and Turley, S. (Eds), 3rd ed., Current Issues in Auditing, Paul Chapman Publishing. London, Ch. 2: 31-54.

Ruddock, C. M. S, Taylor, S. J, Taylor, S. L., (2004) Non-Audit Services and Earnings Conservatism: Is Auditor Independence ImpairedAvailable at:

http://papers. ssrn. com/sol3/papers. cfm? abstract_id= 303343

Salter, M. (2008). Innovation Corrupted: The Origins and Legacy of Enron's Collapse. HarvardUniversity Press.

Sukhraj, P 2010. Thinking about disclosure. Accountancy Magazine, February, p. 22–23.

Swartz, M. and Watkins, S (2004). Power Failure: The Inside Story of the Collapse of Enron. Broadway Business

Tackett, J & Wolf, F, Claypool, G (2004) Sarbanes-Oxley and Audit Failure; A critical Examination, Managerial Auditing Journal, Volume 19, Issue 3

Vanasco, R, R, Skousen, C, R & Santagato, L, R (1997) Auditor Independence: An International Perspective, Managerial Auditing journal, Vol 12 Issue 9

Venuti, E; Holtzman, M. P, and Basile, A, 2002, Due professional care in cases of high engagement risk. CPA Journal. Vol. 72, no. 12