

Enron in auditing profession essay sample



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Introduction:

This paper seeks to analyse and discuss whether the changes made have achieved the goals intended after post-Enron in auditing profession. The analysis will start with the identification of the individual and the industry challenges created by the Enron crisis. Industry and Individual changes caused by Enron scandal to be followed by a discussion on its effect on people's confidence and the basis of the said loss of confidence in relation to supposed philosophy of an auditing firm. After presenting the effects of the Enron crisis, this will be followed by what response the authorities and profession as in terms of the goals intended after post-Enron in auditing profession. This will be followed by an understanding of the aim of the capital market in relation to firms using financial and future financial performance. The role of investors, creditors and other users will also highlight in what they do with the accounting information they get.

As the paper will be mainly talking about the effects of these changes in the Canadian perspective with US comparison, a discussion of how a strike a balance among market-based, self-regulatory, and legal mechanisms for promoting audit quality by the Canadian and US board will be included. This will be followed by a comparison of the two boards to identify could be done to enhance the attainment of their objectives. An attempt will also be made to find whether there exist reasons to doubt on the implementation of SOX Act. The last part will attempt to make conclusion based on matters presented in relation to the purpose of this paper.

1. Analysis and Discussion

2. 1 Industry and Individual changes caused by Enron Scandal

There is no issue that the scandal has created challenges to the industry and to individuals. According Hudak-David (2004), the professional life of the independent auditor has changed. Citing Gary Holstrum of PCAOB saying about the present for auditors to understand more than accounting, economics, and ethics as these auditors have to know marketing and an in-depth knowledge of a given industry.

The whole industry saw the Enron business crisis of 2000-2001 causing the enactment of the Sarbanes-Oxley (SOX) Act in 2002 and as well as the creation of PCAOB in January of 2003. PCAOB has the function of overseeing auditors of public companies for the protection of investors' interest and the public interest by requirement for informative, fair, and independent audit reports in their preparation. Being under the Securities and Exchange Commission (SEC), its functions include standards-setting, registration, inspection, investigation, and enforcement responsibilities has its funding coming from a levy on public companies based on their market capitalization (Hudak-David, 2004).

On the individual level challenges were seen in keeping with personal and professional competency requirements imposed by the post-SOX regulatory environment. Auditors are thus to better and more skills including but not limited to internal controls evaluation, fair value auditing, audit risk assessment and they will need the application of higher ethical standards and such requirements' need to updated periodically capitalization (Hudak-David, 2004).

2. 2 Effect of Enron on People's Confidence

Enron's effect on people's confidence is simply undeniable. Schilder (2002) made an expressed admission to that effect in the matter of implementation of rules and regulations, in way authorities make their supervision and financial system' functioning in general.

Schilder (2002) reminded about the great need of ethics from auditors which included rigid requirements for honesty and integrity yet the author was shocked about Arthur Andersen, being then a strong global firm, to have shredded the documents thereby destroying what the firm's has built in 90 years' time.

2. 3What are the goals intended after post-Enron in auditing profession?

The goals intended after post-Enron in auditing profession includes the issues mainly addressed the Sarbanes-Oxley Act (SOX). Depken, II (n. d.) in discussing The Impact of the Sarbanes-Oxley Act: Early Evidence From Earnings Management, concluded “ In response to the serious disservice to the capital market by a series of gross financial scandals, the U. S congress passed Sarbanes-Oxley Act in 2002 to improve the financial reporting quality, to strengthen corporate governance, to rebuild investors' confidence and to restore the order in the turbulent capital market. Since the study used an empirical measure of earnings management activities to explore early evidence of the effect of Sarbanes-Oxley Act on financial reporting quality, the researchers found evidence of a statistical significant decrease of earnings management activities after the passage of Sarbanes-Oxley Act. The study however suggested that the conduct of further studies about other

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aspects of the Sarbanes-Oxley Act on corporate governance, internal control and auditing quality.

The study found evidence a decrease in earning management activities after the passage of the SOX Act but as could be seen the conclusion of the authors are demanding more evidence to see a desirable effect on such areas as corporate governance, internal control and auditing quality.

It may be noted that to see an improvement of corporate governance (Brada, J. et. al., 1999; Francis, R., 2000) is rather difficult to measure as this could be very hard to establish a standard of measuring the same. How would one say that one company has better corporate governance? It is equivalent to absence of another crisis as what was caused by Enron scandal. Would a company which is continued to be trusted by investors presumed to have good corporate governance? Or would it be equivalent to readiness of the company to comply with government regulations?

The issues on how to measure the improvement of internal control and auditing quality are also matter best left to companies having attained its purpose of its business. Internal control are matters within company policies and to whether the SOX has the effect of improving such internal control is still that will need a deeper analysis since these are things that cannot be known until there is a problem that has come out to indicate that in fact such internal control measures are not working.

2. 3. 1 The aim of capital market is to effectively allocate, scarce economic resources for which firms compete using financial and future financial performance.

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Depken, II (n. d.) posited that that the capital market is primarily aiming to effectively allocate, on the basis of past financial record and expected future financial performance, scarce economic resources for which firms compete. No efficient capital market would exist without reliance upon the accurate and reliable information provided by a corporation's governance and accounting system. Nevertheless since managers are to some extent rational and risk-averse, they tried to maximize their own wealth, managers are motivated to take advantage of the inherent lack of complete information between management and investors. This is the reason why these managers practice the technique of earnings management which involves making selective disclosure of information to maximize their utility or wealth. He further assumed that the corporate scandals of the late 1990s and early 2000s were debatably caused by such activities of management activity; hence the possible impairment of the short-run capital market efficiency (Depken, II, n. d.).

It may be noted that the author has asserted the fact that the efficiency of the capital market relies upon the accuracy and reliability of the information provided by a corporation's governance and accounting system but qualified by saying that to the extent that managers are rational, risk-averse, and maximize their own wealth, managers have substantial incentive to take advantage of the inherent information asymmetry between management and investors. The researcher thus noted that managers may selectively disclose information or opportunistically manage accounting information to maximize their utility or wealth, a technique called " earnings management." He was admitting in a sense that it is the capacity to selective disclosure of

information or management of the same with the motivation to increase wealth was the culprit. The author was not asserting that a weakness in the financial reporting that cause these managers to make the decision but the intention or motivation to make wealth, hence his conclusion about the significant decrease in earnings management activity may have to reconsider on which one was causing the more engagement to such activity, whether it is the desire the to have more wealth or it is the weakness of the reporting system.

By the Depken's statement that that the corporate scandals of the late 1990s and early 2000s were arguably the result of egregious earnings management activity and might have impaired the (short-run) efficiency of the capital market, implies admission of the desire to have more wealth regard less on whether financial reporting was more strict in requirement or not.

2. 3. 2 The investors, creditors and other financial information users closely monitor the earnings information reported by firm management in valuing stocks

Depken, II (n. d.) pointed out that the investors, creditors and other financial information users closely monitor the earnings information reported by firm management in valuing stocks of the company thus management has the change to engage in earnings management as strategy in deliberately manipulating a company's earnings so that the earnings match a pre-determined target. He also admitted that such activity of earnings management is a natural outcome of a principal-agent moral hazard problem

combined with the flexibility inherent in the Generally Accepted Accounting Principles.

He nevertheless non-acceptability of earnings management is acceptable such when made "abusive" as may be determined by the Securities & Exchange Commission especially about "a material and intentional misrepresentation of results". (Depken, II, n. d.). The investment community and regulators necessarily get noticed these events in the running of business entities and this fact was supported by a number of studies focusing on earnings management that have appeared in the accounting literature since late 1980s, when earnings management received more exposure. He forwarded a literature the late 1990s, citing works of Matsumoto, 2002; Burgstahler and Eames, 2003 that has generally indicated increased earnings management activities increased during the latter part of the twentieth century, that got had their endings on infamous accounting scandals during those times (Depken, II, n. d.).

For Depken, II then provided the absence of efficient capital market with out the accurate and reliable earnings information provided by the management. If such opportunistic manipulation of earnings information happens then malfunctioning of the capital market, there of be inefficient allocation of scarce economic resources and the necessary loss of investors' confidence.

2. 4. 1The need to strike a balance among market-based, self-regulatory, and legal mechanisms for promoting audit quality for both Canadian and US regulatory board.

A study by Pritchard, A. & Puri, P. (2006) concluded the need to strike the appropriate balance among market-based, self-regulatory, and legal mechanisms for promoting audit quality. The authors cited the roles of the CPAB of Canada and the PCAOB of the US in attaining this balance by overseeing the auditors of public companies in an effort to enhance the quality of audits for those companies.

Since this paper's aim also to make comparison on regulation of the provision under the two countries there is the need to point out at this point on difference of the two boards with CPAB more in self-regulation while PCAOB is more for governmental regulation.

2. 4. 2 The advantage of PCAOB over the CPAB

The PCAOB being a quasi-governmental agency created by federal legislation depends from public companies for funding as against CPAB's funding from auditing firms. Thus The PCAOB enjoys more independence than CPAB from the accounting industry because of the difference in funding (Pritchard, A. & Puri, P., 2006).

CPAB as self regulator whose funds come from accounting firms as less independence especially in the light of having a number of accountants among its members. It is but natural to see the source of the funding to have created conflicts of interest that compromises the integrity of the institution and investor confidence which is supposed to be protected.

2. 4. 2 What should be done with CPAB?

The solutions seem obvious for CPAB. The source of funding must come from

other sources than the accounting firms and the members accountants to the board should be discouraged or prohibited (Pritchard & Puri, 2006).

2. 4. 3 The need for transparency from CPAB's and PCAOB's activities

Problems for regulation are not found with CPAB alone as there are requirements from both to improve regulation. One is to improve transparent of their activities to the public, so as to enhance their accountability but which must be balanced in relation to the litigation risk faced by inspected audit firms, that authors suggested making the reports inadmissible in court. This must be made in legislation to attain validity (Pritchard & Puri, 2006).

2. 4. 4 Self-regulation promises to be more carefully tailored to the needs of Canadian

Despite the difference between the two board, Pritchard, A. & Puri, P. (2006) still found self-regulation to be more carefully tailored to the needs of Canadian companies than direct government regulation practice by the US, but the authors emphasized the need for the self-regulators to ensure the credibility of that self-regulation which could be accomplished by legislation. The proposed legislation should make CPAB to have greater power and independence than it now has, but it should exclude requiring CPAB to take over the standards for audits currently set by the CICA. .

2. 4. 5 Draft standard in 2002 on the independence of members in relation to theirclients

Canada's accounting instructions may be observed to have reacted positively with the Enron's case. Thus McSween, P. (n. d) cited CICA's <https://assignbuster.com/enron-in-auditing-profession-essay-sample/>

publishing a draft standard in 2002 on the independence of members in relation to their clients which was incorporated into the rules of professional conduct of each provincial institute/order in 2004. The act was of course to prevent the scandal.

2. How far really has PCOAB gone in its seriousness of the implementation of the rules?

In response to this, Peterson (2005), cited that as far as hat as far as the SEC and PCOAB are concerned, all seems to getting right with the post-Enron situation as they tell these non-complying managements ultimately comply under pain of penalties under the SOX Act except for the several reasons for doubting explained below:

There are companies that fails to submit within given deadlines under requirements of existing regulation, thus SEC has granted to lobbyists another year to comply (Peterson, 2005). Another instance is the leaders of the large accounting firms having proclaimed a virtuous cleansing of their client lists, under the scrutiny of Sarbanes-Oxley. Peterson (2005) cited reports about increase in turnover rates among the 14, 000 public companies in the United States but this has still left a small effect on the Big Four' s capitalization. Still another instance that has created is PCAOB's announcement on permitting certain tax services for audit clients which was hailed without irony as a victory for the profession (Peterson, 2005).

What needs to be remembered in the Enron's case is the loss of the auditor's independence is considered to be the cornerstone of the auditing profession (Lindberg, D. and Beck, F. 2007) so that permitting additional tax practice by

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PCAOB may be a sign of decreased independence because of the conflict of interest.

3. Conclusion:

This paper has analysed and discussed whether the changes made have achieved the goals intended after post-Enron in auditing profession and it found that there were not many changes as evidenced by the fact the affected companies of the SOX were later or not yet ready to comply with the requirements of the law.

Since this paper mainly talked about these changes in the Canadian perspective with US comparison, many things that needed to be done under Canadian perspective such legislative support of CPAB and ensuring that its funds will not come from accounting firms to enable to discharge effectively its function. While there are doubts as to affectivity of the changes a proven decrease in earnings management activity as proven by research may indeed show achieving to certain extent the purpose of the changes. Given the sleeping with deadlines and other factors for the full compliance and the extension granted by authorities of companies requesting may speak of the attitude of some quarters to less control by regulation. Legal regulation is admitted not only the sole determined for quality audit as the market could eventually bring its own power by bringing another scandal as long as the incentive to increase wealth is there as desire for more wealth knows no limits.

In an effort to improve regulation members of auditing industry have been pushing to for the imposition of legal limits on liability for bad audits but is

feared to be discredited unless they are supported by people who clearly care about investors, not just auditors (Norris, 2007). This would mean that improved financial reporting is not just the responsibility of auditors. The auditors are just one face of the problems certain groups of people have their roles to play.

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