AUDITOR INDEPENDENCE AND PUBLIC RESPONSIBILITY: AN EXAMINATION USING AN AGENCY THEORY FRAMEWORK

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ABSTRACT

The increasing size and number of CPA firm non-audit engagements of SEC registrant companies led former Securities and Exchange Commission (SEC) Chair Arthur Levitt to seriously question the potential loss of the auditor's independence. In response to these concerns and to the recent crisis of confidence in the accounting industry, the Big Five CPA firms have divested themselves of significant portions of their consulting practice or are in the process of doing so. The paper reviews the concerns lying behind the divestiture, focusing on CPA firms' perceived independence.

Agency theory serves as the conceptual model to evaluate the significance of the appearance of auditor's independence, which is critical to readers' confidence in reported financial information. The modern corporation's separation of ownership and management has created a situation where the agent dominates the principal. Principals are notably reliant on the auditor's independent assessment of management's report to shareholders. We conclude that the Big 5 CPA firms are properly divesting significant consulting engagements in order to preserve or restore public confidence in the profession.

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The fact and appearance of independence is the independent auditor's most fundamental distinguishing professional characteristic. Auditors should function as unbiased competent witnesses to the fairness of management-prepared financial statements and should thus avoid situations that could lead outsiders to doubt their independence (SAS No. 1). Independence drives the accounting profession, which survives on the public's faith in the integrity and objectivity of its opinion (Mednick and Previts, 1987). While auditors have long been forbidden to have financial interests in their audit clients, the increasing size and number of CPA firms' non-audit engagements have raised concerns of potential conflicts of interest that could compromise independent audit services.

The current crisis of confidence extends beyond the Enron debacle, as exemplified by the resultant, pervasive erosion of the public's confidence in the profession and Andersen's likely demise as a major, international audit firm. As Byrnes (2002) observes, "Accounting Failures are not new – just more frequent. Investors have lost close to $200 billion in the past half dozen years in earnings restatements and stock meltdowns following audit failures." The business press has identified many potential causes of lack of independence contributing to audit failure, including consulting activities, lack of auditor rotation, lack of forensic auditing, audit partners and staff moving to senior accounting and finance positions with prior audit clients.

In light of the Enron scandal, this paper considers some key issues regarding the client's financial power over independent auditors (Goldman and Barlev, 1974): the risk of auditing clients who pay massive non-audit fees to their auditors, and the public's perception of eroding auditor independence. We also examine the definition of "client" in the context of the modern public corporation and use agency theory as our conceptual model. Specifically, while boards of

directors, especially “independent” audit committees, should represent the shareholders’ (and creditors’) interests, they too often are beholden to their own and management’s interests, viewing their responsibilities to hire the independent auditors and to oversee the audit as “private” contracts. This relationship causes many CPA firms to focus their efforts on satisfying such audit committee members (e.g., not pressing them on difficult audit issues), so that they can perform next year's audit and sell them lucrative consulting and tax services. On the other hand, auditors working for local, state, provincial or national governments (e.g., Inland Revenue Service or Internal Revenue Service) generally focus their efforts solely on their primary responsibilities, auditing the propriety and reasonableness of reported tax liabilities.

We first show how the consulting vs. auditing conflict helped cause the Enron/Andersen and BCCI debacles. We next discuss the dominance of the public corporation in the economic functioning of our society and the consequent separation of ownership and control (leading to the need for audits for over 150 years). Finally, we show how Agency Theory provides a model to evaluate the above conflicts of interests, and recommendations for reform.

Management’s Financial Power over the Auditor

The relative lack of profitability of audit compared to consulting services has led to the consolidation of many large CPA firms. For example, many clients who perceive that audit services do not “add value” aggressively negotiate for low audit fees. But since they often view consulting activities as value additive, they often will pay higher, more profitable consulting fees. Unlike the audit market, this market grew dramatically until the Enron debacle. Prior to the Enron collapse, Hartz (2000) estimated that companies worldwide would spend up to $600 billion on e-business by 2003, with over 60% going to consultants.

The auditing/consulting connection created a breeding ground for conflict. As the complexity of transactions and accompanying complexity of auditing standards increased, management and independent auditors found more auditing issues on which to disagree. Such a debate easily becomes a power struggle: the auditor has the power to withhold an unqualified opinion, while management has the power to terminate consulting contracts and not renew the audit engagement. Auditors do not want to lose the work and the income, while management does not want to wave a red flag at the SEC, investors, and analysts by changing auditors. Simunic (1980) notes that auditors should recognize this interdependence of the auditee's and auditor's economic interests.

Shifting Balance of Audit and Consulting Services

In 1998, the then Big Six CPA firms earned over 40% of their revenue and an even larger share of their profits from consulting engagements (Clikeman, 1998). Prior SEC Chair Arthur Levitt (1999) noted that over the past 23 years, audit service revenues have declined dramatically as a ratio of total CPA firm revenues, which fell from 77% to 30% of firm revenues from 1977 to 2000. Concurrently, consulting fees rose from 12% in 1977 to 50% of total revenues in 2000. Bloomberg's (2001) recent study of 563 of the *Fortune 1000* companies showed that non-audit fees accounted for 73% of total fees paid to audit firms. The dominance of the Big Five is reflected in their auditing 557 (98.9%) of these 563 companies.

Given the increasing importance of consulting activity, Levitt warned CPA firms against using audit engagements as "loss leaders to obtain higher fee consulting services." He observed that CPA firms could lose their independence when they provide significant non-audit services to audit clients (Clikeman, 1998). But, the attractiveness of contracting with a single firm for both kinds of service is illusory. Firms often claim that they can offer services at a lower cost when

they provide both audit and consulting services; this is not supported by research. Simunic (1984) found that audit fees of clients who also purchase consulting services from their auditors are significantly higher than audit fees of clients who do not do so. These findings show that low audit fees often do not stem from "synergies;" rather, they help promote more profitable consulting engagements (Sikka, 2002).

The SEC initiated potential conflicts of interest investigations where CPA firms perform both types of services, as when Andersen paid $220 million to settle such claims in the Waste Management case (Schroeder, 2000). The early 1990's scandal involving Price Waterhouse (PW) and the Bank of Credit and Commerce International (BCCI) resulted from this same conflict of interests. The U.S. Senate's investigation of BCCI (Sikka, 1997) alleged that auditor independence was compromised because auditors received loans, financial benefits, housing and other benefits from the bank. Additionally, PW provided consulting services to the bank and advised them to move their treasury function from London to Abu Dhabi. This not only let the BCCI cut its UK tax liability, but ultimately also made it impossible for UK investigators to win access to crucial documentation to determine BCCI's criminality (Sikka, 2002).

Levitt questioned why many CPA firm partners auditing SEC registrants held financial interests in such clients. For example, Hewlett-Packard terminated PricewaterhouseCoopers (PWC) as their auditors due to PWC's potential loss of independence of a pending acquisition (Accounting Today, 2000). In response, the Big Five CPA firms opened their partners' and managers' investment portfolios to SEC review. At present all Big Five CPA firms have divested or are in the process of divesting their consultancy practice (McGough, 2000). Luke (2000) and other market observers note that the Big Five acted in advance of the likelihood that the SEC would force them to choose between their consulting and auditing businesses.

Conflict of Interest Concern

Levitt stated the CPA firms' increased importance of the management – CPA relationship and the public's interest in financial information raised much concern for auditors' independence related to this expansion of CPA-provided consulting services. Levitt thus suggested that CPA firms separate much of their consulting and audit services.

The management-CPA firm relationship is built on the profession's exhibited competency, integrity and objectivity. Auditors may be influenced, however, to not report deficiencies when auditing a system that their own firms implemented and designed (Simunic, 1984). The source of concern is not the natural growth of services but the active selling of non-audit services by firm partners. Some CPA firms discounted audit fees to grow the firms' consulting services. Reduced audit fees naturally lead to pressures to reduce audit time and services, and ultimately audit quality. Partners rewarded according to their ability to sell non-audit services create an appearance of impropriety and lack of independence.

The public interest is served when auditors ascertain that the financial statements fully and fairly disclose the results of operations, financial position, and cash flows. If CPA firms promote their economic self-interest in exchange for reduced audit quality and independence, a clear conflict with the public interest arises. Former SEC Chief Accountants Schuetze and Sutton have expressed concern for the actual or perceived lack of independence created by expanded consulting activities. Mitchell's (1989) survey found that 50% of shareholders and 33% of financial professionals perceived consulting to impair audit independence.

CPA firms use separation of services as a primary defense against possible lack of independence and audit quality. Internet equipment maker Cisco Systems recently agreed to pay $1.05 billion for a 19.9 percent share of KPMG, the nation's fifth largest CPA firm. KPMG said

that it would use the deal as a base to launch a long contemplated initial public offering of its consulting practice, with Cisco joining KPMG's board of directors (Cho and Telberg, 1999).

A recent New Jersey case (Fidelity Mutual Savings & Loan Association) involving management fraud found other problems of auditor independence. Case testimony indicated that the national Big Five firms have unwritten policies not to testify against each other; that they avoid engagements that might require them to criticize each another, and that they belong to the same liability insurance pool—that is, they share large damage awards. (Lavelle, 2000).

There is similar unease over the lack of independence of securities analysts (Morgenstern, 2001). Integrating stock brokerage and investment banking creates conflicts of interest because an integrated investment banking-brokerage firm earns income from investment banking activity for a corporate client while recommending stock purchases and sales to investor clients. The SEC has formed a 13-person board to study the potential lack of independent research payments received from the investment-banking arm of the firm.

Compensation of high-level corporate executives, including the chief financial officer, also affects the auditor independence issue. Pearl Meyer & Associates' year 2000 survey of large public corporation executive compensation reports that stock options constituted 51% of chief financial officers' (CFO) total compensation, up from 47% in 1999 (Marshall, 2001). Corporate executives, including CFOs, often maximize their economic self-interests by meeting short-term earnings expectations to drive stock prices and their own compensation, regardless of any long-term adverse effect on their employers. Moreover, Henry (2001) and Bartlett (1998) have criticized firms' aggressive financial reporting policies and earnings management, which create actual or perceived conflicts of economic interest between investors, creditors, and other stakeholders and those of top management, auditors and analysts.

Magnitude of Large CPA Firms' Non-Audit Practices

Based upon an analysis of two recent studies appearing in Accounting Today (2000a; 2001), Exhibit I indicates that large CPA firms garner huge revenue from their Management Consulting Services (MCS). Moreover, the Wall Street Journal (2002) found that 26 of the 30 companies comprising the Dow Jones Index spent up to ten times more on consulting than on audit fees. Revenue from MCS services exceed greatly revenues from audits, ranging from 123% for KPMG to a 432% for Andersen Worldwide. At Andersen, consulting revenue constituted 74% of total revenue. For the first 563 companies to file financial statements after February 5, non-audit fees were $2.69 for every dollar of audit fees (Byrnes, 1998). This disproportion provides reasonable cause for concern for the ability of the smaller audit practice to be independent and not constrained by concerns for the loss of consulting engagements.

Moreover, the recent SEC investigation of Andersen's audits of Enron, which led to its market value plunge of more than $75 billion in approximately one year, focuses on the MCS independence issue (Weil, 2001). The SEC has expressed concern for Andersen "passing" on millions of dollars of potentially significant audit adjustments (e.g., calling them immaterial).

Exhibit I also shows that before the Enron debacle, Andersen and Ernst & Young divested themselves of significant portions of their consulting practices. Given that the financial press continues to cite Andersen's significant consulting revenue versus audit revenue received from Enron, it is useful to examine income sources of the Big Five prior to the divestitures. Rank ordering of firm size by revenue sources demonstrates that Andersen's position as the largest accounting firm was dependent upon non-audit services. As an auditing firm Andersen, ranks fifth. For three of the Big Five, audit revenues were 35% of total firm revenue. For fourth-ranked Deloitte, audit services constituted only 30% of total revenue. For Andersen, audit

revenues were about half of the percentage of the other four accounting firms. Among all of the Big Five, auditing constituted, at best, 35% of total firm revenue.

Support for Expanded Consulting Services by CPA Firms

But arguments exist for CPA firms maintaining consulting practices. Increased exposure to client management allows CPA firms to better assess management integrity (Goldwasser, 1999). Second, audit services provide significant revenue and need not be assumed to be a "loss leader." Third, following SEC demands, corporate governance has improved with the initiation of a greater percentage of non-management directors and establishment of audit committees. Fourth, SEC practice section members are required to establish independence policies. In fact, CPA firms maintain separate audit and non-audit divisions.

Tie's (1999) found that 99.7% of 15,000 SEC registrant statements were without problems. The SEC Enforcement Division initiated only four audit independence violations in 1999 (Steinberg and Van Brunt, 2000). Schroeder's (2000) POB study revealed no situations in which non-audit services negatively impacted the quality of audit services. In response to the "loss leader" concern, Tie's study of Big Five responses to an International Standards Board (ISB) inquiry found the gross margin on audit services to be greater than those of consulting services. However, Verschgoor (1998) found that users of audited financial information strongly prefer the use of separate CPA firms to perform audit and non-audit services. Financial analysts are more concerned than accountants with the appearance of a lack of independence created by significant non-audit services rendered by CPA firms (Reinstein and Lander, 2000).

The Audit Function as a Monitor of Management's Behavior

Independence forms the key historical cornerstone of the auditor's existence, as shown in the following outline of the history of the profession. The British Joint Stock Companies Act of

1852 first established the independent audit function. Management's providing inadequate financial information to stockholders initially led to a perceived need for independent audits, which consequently established the Chartered Accountancy profession. The audit function resulted from the separation of equity investors' ownership rights and effective management control. This separation arose from capital-intensive production in the post-industrial revolution. Capital-intensive production required equity capital investment that exceeded the savings of a few individuals. Equity investors no longer actively managed firms, had direct involvement in decision-making, or had access to accounting and other business information.

In a simple economy dominated by proprietorships and partnerships, owner-mangers were the masters or principals, closely aligning with the economic self-interests of equity investors and senior managers. Non-investor employees acted as the principal's agents. In public companies, the economic self-interest of investors (principals) and senior management (agents) need not be closely aligned. As Adam Smith observed in Wealth of Nations "servants do not husband the master's money as well as the master." Established over 150 years ago, the audit function recognized conflicting economic self-interest between managers and investors. Auditors were to serve as unbiased witnesses whose access to accounting information in place of and for the benefit of shareholders. Free markets and rational decision making in a capitalist economy requires full and fair disclosure of financial information. Thus, independent auditors expanding non-audit services should be evaluated in the context of the profession's raison d'etre.

Separation of Ownership and Control

Berle and Means (1939) major study of the then US's 200 largest corporations shows that they have concentrated control of a substantial portion of disbursed private savings under the control of a few men (senior management). Separation of traditionally combined ownership, and

control establishes a fiduciary relationship for those in control of the amassed wealth of many investors. Management's powers are not absolute; rather they are powers in trust. This shift of ownership form active to passive control of the instruments of physical production concurrently has relieved owners of responsibility. This, coupled with management's concentration of control has enabled society to demand that corporations serve the good of all society. "The modern corporation may be regarded not simply as one form of social organization but potentially…the dominant institute of the modern world" (Berle and Means, 1939).

Herman (1981), complementing Berle and Means's work, found that the full disclosure principle embodied in the legislation establishing the SEC most effectively reformed corporate behavior, calling disclosure policy an ideological virtue that is difficult to oppose and minimally disturbs power relationships. Disclosure requires corporations to provide new information flows to stockholders and other outsiders. Disclosure by itself involves no significant behavioral change; its effects are either through induced avoidance by management or actions by recipients. SEC disclosure requirements protect investors' and the public's interests.

Agency Theory

Independence, as we have seen, is basically a power issue: Who shall control the disclosure of information? The rationale of independent auditing is that it separates ownership from control. That separation leads naturally to agency theory, originally a 17th century legal concept of the relationship of the servant (agent) to his master (principal). Initially it focused on the servant's duties to the master and later expanded to include the master's liability to third parties for wrongful acts of servants while working on the master's behalf. This legal concept is an early recognition that agents may use their position to enhance their own self-interest to the principal's detriment.

In the 1930's, University of Chicago economist Ronald Coase (1937) expanded this concept to a theory of the firm, viewing the firm as a nexus of contracts among individual managers--each acting to maximize his own economic self-interest. Jensen and Meckling (1976) and Fama (1980) extended Coase's work, defining its economic concept as a relationship in which one or more persons (principals) engage another person (agent) to perform a service for the principal. Their work analyzes the conflict of economic self-interest between an owner-manager and outside investors.

In agency theory the pursuit of economic self-interest provides an entrepreneurial dynamic in contrast to a static hierarchy. Thus, the business firm is an elaborate collection of stated and understood agreements between superiors and subordinates and among managers of the same organizational level. Perceived inter-dependence and monitoring activities constrain self-interest. Internal controls and accounting information are two major monitoring activities. Reliable accounting information is critical to internal operational decision-making. Thus, the importance of the internal audit function.

Adam Smith recognized the potential conflict of economic self-interest between shareholders (principals) and managers (agents).

> The directors of such (joint stock) companies, however, being the managers of other people's money than their own, it can both be well expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. Negligence and profusion therefore, must always prevail more or less in the management of the affairs of such a company. (Wealth of Nations, Book V, Ch.1).

Controlling the agents' (managers') tendency to channel benefits to themselves to the principals' (outside shareholders') detriment creates agency costs which should be controlled by monitoring and bonding activities , e.g., auditing, formal control systems, budget restrictions and incentive compensation systems. From this perspective, audits and accounting controls exist to

serve the principals' needs. The agency theory view is reflected in recent financial and general media discussions of the Enron debacle.

Directors as Agents of the Shareholders

By extension, the nexus of contracts concept relates to inter-relationships of outside shareholders, the board of directors, senior management and outside auditors. While boards of directors (i.e., the firm's legal policy-making body) should control management behavior, management control of the proxy machinery disenfranchises small stockholders, given the wide dispersion of shareholders (Herman, 1981). While the SEC's demand for more outside directors and independent audit committees can be viewed positively, this does not necessarily result in independent behavior of directors who, as managers of other large corporations, have shared managerial values and were chosen by individuals heavily influenced by senior management. From a classic concept of property rights, shareholders are the principals, the directors are agents of the shareholders and principals to senior management (agents). However, this is not necessarily consistent with the social dynamics of large corporations.

In 1999, an SEC commission recommended that all public firms use audit committees consisting solely of financially literate independent directors, at least one with accounting or financial management expertise (Byrnes, 2002). Such outside directors should address issues regarding conflicts of economic self-interest among directors. The SEC and major institutional shareholders, mutual funds, and pension plans have encouraged reducing the number of management directors, especially those whose potential interests conflict with investors'. Thus, directors are reasonably considered as the shareholders' (principals') agents who, like management, can have conflicting economic self-interests. The countervailing power provided by developing and enforcing SEC regulations should control such conflicting self-interests.

While corporate governance has improved significantly, the balance of power remains with agents (management and management appointed directors) not the principals (shareholders).

In fact, CPAs have never had complete independence because management hires, recommends retention, negotiates services to be provided and pays the external auditor (Cheney, 1997). Since management usually selects individuals to serve as members of the board of directors, the agent selects the principal's representative and the independent witness to the fairness of the financial statements prepared under management's direction. The vote to retain directors selected by management and to reappoint the auditors is limited to acceptance or rejection of management's choice. In fact, management solicits proxies, which are normally readily given. Shareholders' voting rights are usually rather perfunctory. The only check on management is a hostile takeover.

Takeovers, however, usually follow a period of poor earnings and depressed stock prices, with shareholders usually bought-out at a depressed price per share. The structural principal-agent relationship favors the agent, thereby constraining the auditor's independence.

Agency Relationships of Auditors to the Corporation

Independent auditors are agents engaged to serve on behalf of the board of directors. Technically, shareholders vote through proxies to engage and re-appoint the auditors. This process, much like the selection of directors, tends to be more ceremonial than substantive, but, since directors recommend auditor appointments. Auditors themselves should generally decide the specific nature and scope of audit services, but report formally to the board of directors. Here, the auditors take on the role of "agent" and the board of directors, "principal." Such boards help minimize potential management constraints on the auditors, as when strong independent boards of outside directors would be more supportive of auditors than boards dominated by

inside directors or those closely aligned with management. The SEC's requests for audit committees comprised of outside directors is another monitoring activity to control agency costs.

Accounting firms performing both audit and non-audit-consulting services can be viewed as having two distinct agency relationships with the corporation. As auditors, their relationship is with the board of directors (acting as agents of shareholders) and their function is to independently verify that management-prepared financial statements provide full and fair disclosure of results of operations and financial condition in conformity with generally accepted accounting principles (GAAP) and SEC regulations. As providers of non-audit consulting services, accounting firms act under management direction in providing information technology, tax planning, operations studies or other services related to the operation of the client business. In contracting for such services, the accounting firm functions as an agent of management, which could inherently conflict with the stockholder's (i.e., principal's) needs.

Accounting firm managers acting as rational economic individuals will maximize self-interest, i.e., firm-wide income. If non-audit services provided materially greater firm income, the audit firm's management will normally strive to increase the firm's size and profitability by providing the greatest possible volume of such services. But an implicit moral hazard arises when accounting firms offer management both audit (i.e., independent verification of management's financial disclosures) services and consulting services. When an auditor (acting as the board's agent and, in turn, the shareholders') discovers a financial reporting problem and insists that management correct it, management could retaliate by threatening to curtail purchasing the accounting firm's non-audit services. The segment of the accounting firm acting as the agent of management could experience some threat of reduced income. Enforcing proper financial reporting probably will not increase accounting firm income while reduced purchases

of non-audit services will reduce accounting firm income. The principal (management) agent (consulting services group) relationship can be used to constrain the principal (directors, shareholders) agent (audit group) relationships, which presents a more subtle response than opinion shopping or changing auditors. Management must disclose changes of auditors, which sophisticated users of financial information may view as a negative reflection on management and the board of directors, while reduced purchases of non-audit services has minimal visibility.

Accounting firm partners' protestations that "professionalism" allows separation of these two activities is inconsistent with normal individual economic behavior. The agency relationship with the board of directors and the separate agency relationship directly with management generate a mutual agency conflict among partners within the accounting firm.

The consequences of this conflict of interest have a societal impact. Reliable transparent financial reporting is fundamental in creating efficient capital markets, by reporting reduced uncertainty and perceived risk, and thus lowering the cost of capital. The substantial public participation in the securities markets, directly or through mutual fund based retirement savings, expands the public interest in reliable financial statements. Thus, auditors should expand their focus from the narrow legalistic perspective as agents of the board of directors to agents of investors and other public company stakeholders.

Examples of Breakdowns of the Audit Model: BCCI, Enron and Other Debacles

The audit profession has witnessed much recent bad press and a resultant decline in stature, primarily due to the Enron matter. For example, Andersen has lost many audit clients and faces bankruptcy, while several bills are pending to forbid CPA firms from performing consulting work for their audit clients or having their retired partners assume positions of high financial responsibility with their audit clients. However, CPA firms have too often ignored the

implications of many audit failures and have focused on selling consulting services, rather than on performing more competent audits, which Briloff (1994) calls "benign neglect."

For example, nearly 25 years ago the New York Stock Exchange's Cohen Commission and the U.S. Senate's Metcalf Report (Read, 1993) stressed the dangers of CPA firms focusing on their consulting rather than auditing practices, especially recognizing that the government gave the auditing profession a public trust monopoly. Similarly, Puxty, Sikka and Willmott (1997) found that about a decade ago, the United Kingdom's four principal accounting bodies (i.e., Institute of Chartered Accountants of Scotland, Institute of Chartered Accountants in England and Wales, Association of Chartered Certified Accountants and Chartered Institute of Management Accountants) advocated issues to help their own parochial interests, rather than the public's, during the development of the Auditing Practices Board's *The Future of Auditing*.

Two major audit failures arose in large part from CPA firms performing consulting work. First, BCCI's audit failure began when, in 1986, Ernst & Whinney (E&W) demanded that it do all BCCI's audit work, and that BCCI improve its management style, and its systems and controls. This, presumably, would lead to consulting opportunities for E&W. Instead, BCCI chose Price Waterhouse (PW) to audit all of its entities, but PW found that by 1990 BCCI was in financial peril. And, when the Abu Dhabi government apparently agreed to underwrite BCCI's troubled loans, PW "passed" on BCCI's financial statements. Seiler notes that PW informed BCCI's management of such audit problems, while not disclosing these issues in the financial statements seems like PW "was serving two masters, which is a big contradiction to what an auditor should be doing" (Berton, 1991). In any event, BCCI hired PW as legal consultants to help defend itself against a money-laundering indictment (MacDonald, 2001).

While PW later admitted that it shouldl have issued a different type of audit opinion, it justified its actions by claiming that doing so would have led to a "run" on BCCI's assets, thereby hastening its demise. Moizer (1995) stresses that PW did not consider that withholding this "bad news" would bring the entire auditing profession into disrepute. The BCCI debacle led to billions of dollars of losses. The U.S. government also sought hundreds of millions of dollars of fines against BCCI, including against two prominent directors of its U.S. operations, Clark Clifford and Robert Altman, who were, respectively, former U.S. Secretaries of Defense and Treasury. The government claimed that these members serving as BCCI's lawyers, investors and fiduciaries inherently created conflicts of interest (McGee and Potts, 1991).

The Enron matter arose when Enron changed its focus from primarily delivering and brokering energy domestically to focus on three new business areas: water, international brokerage of energy and broadband transmission of communications. While Enron's stock jumped significantly at first when it entered these new markets, all three endeavors soured, causing its stock to plummet. To maintain its reported profitability and buttress its stock price, Enron began to "cook its books." For example, Enron allowed its management to establish Special Purpose Entities (SPEs) where "outsiders" were to hold a 3% control, which allowed Enron to shift its liabilities "off the books." Enron even recognized gains on phony transactions to these SPEs, although its own management controlled this "3% rule" and no real wealth was created. Enron also failed to report many other related party transactions, and paid over $5 million to its "independent" auditor, Andersen, for advice on how to establish such SPEs. Andersen also received $25 million in audit fees and $27 million in consulting fees, and hoped that its professional fees would soon reach $100 million.

These events led to Enron's filing bankruptcy in late 2001, causing nearly $70 billion of debt and equity losses, criminal indictments of Andersen, and the virtually certain demise of one of the oldest and most respected CPA firms in the world. Congress, the AICPA, and virtually all of the audit profession now expect CPA firms to no longer be allowed to perform consulting work for its publicly traded audit clients.

Suggestions

Using agency theory might have minimized many issues involved with the Enron scandal, which involved, in part, financial statement readers receiving inadequate financial information discussing such areas as: off-balance sheet financing, especially those with Enron executives and other related parties; and exceptional/unusual transactions, especially those that its auditors "passed" as immaterial. Moreover, other problems arose in the areas of auditors' remuneration, especially the high professional audit, tax and consulting fees; and directors' compensation, perks and other fringe benefits, especially for audit committee members.

Enron investors might have been able to limit their losses if they had been privy to information available to management, the audit committee, and the entire board of directors. Enron and Andersen could have simply had followed some UK communication requirements such as a UK director’s separate report (which appears before the auditors’ opinion and financial statements), that the auditors analyze for consistency, which discloses such items as: a review of the business’ developments; an opinion of the adequacy or inadequacy of its dividend policies; names of all directors for the year, and their “interests” in the company and its subsidiaries; a Statement of Directors’ Responsibilities (e.g., the company selecting suitable accounting policies, applying them consistently, stating whether applicable accounting standards were

followed and disclosing adequately such departures from such appropriate GAAP); and emerging issues of interest to financial statement readers, e.g., effects of the Euro.

Some US firms have significantly changed their disclosure policies, in light of the Enron debacle. For example, GE has greatly increased its accounting disclosures, and offered to make such statements "as large as the New York City telephone directory, if necessary." Lilly's 2001 Annual Report now contains a Section entitled "Critical Accounting Policies" to address what its Chair's Letter to the Stockholders calls a method to more broadly address the "basic integrity of the financial reporting of U.S. firms." However, while this Section discusses such general issues as accounting for sales rebates, discount accruals and acquired in-process research and developments, the report does not disclose ranges of dollars or probabilities associated with such disclosures. In any event, we must applaud this trend as a "good start."

Communicating Directly to the Client

The client consists of investors and creditors who supply capital to the company. While auditors should communicate adequately in their engagement and management representation letters and have open discussions with the audit committee, no formal mechanism exists that assures any of this information reaches investors or creditors. Simply put, Enron's investors probably had little chance of coming in contact with the management representation letter or the engagement letter, or to become privy to the auditor discussions with the audit committee. While small investors might have heard from management and might have read the company's audited financial statements, such financial statements and their accompanying disclosures lack the frank and open discussions that the auditor and audit committee must undertake.

One solution is to add a summary of certain available auditor/audit committee communications and other critical auditor/management communications that are not currently

disclosed to investors in the financial statements. This communication could be accomplished through a letter from the audit committee to the company's investors, which would accompany the audited financial statements. This audit committee letter might include key items such as contradictions between audit evidence and management representations; a summary of the aggregate affect of unadjusted corrections considered immaterial by management and the auditor; the quality and aggressiveness of the company's accounting policies and estimates; auditor's judgments about the quality and acceptability of the company's financial accounting principles; the consistency of the accounting policies and their application; the clarity and completeness of the financial statements; the "quality" of client disclosures (*aggressiveness* or *conservatism*); and other information needed to communicate recognized risks and concerns.

Again, the UK experience suggests additional disclosures in an audit committee letter, such as the names of all directors for the year, and their "interests" in the company and its subsidiaries; directors' remuneration; Group Accounts that help restrict opportunities for off balance sheet financing; unusual transactions and other evidence of a company facing significant changes and other uncertainties; and emerging issues of interest to financial statement readers.

Summary & Conclusions

During his chairmanship, Levitt expressed much concern for the prospective conflict of interest and loss of independence posed by CPA firms providing greatly expanded non-audit services for SEC registrants. While prior research has not statistically found that CPA firms have a pattern of rendering inappropriate or non-rigorous audits to gain consulting contracts, some notable exceptions have arisen. There is a question of whether the loss of independence is one of fact or appearance. Discerning this matter is perhaps more important now than it ever was considering Enron's collapse `and the lack of confidence in the accounting industry in general.

Levitt found that about half of PWC's 2,700 partners, including 31 top executives, owned investments in corporate audit clients, in violation of SEC auditor independence rules (MacDonald and Schroeder, 2000). Similarly, the SEC recently found that KPMG failed to detect a financial fraud of a client that KPMG had invested in heavily (Michaels, 2002). These events do not bode well for the independence of the audit profession. Nelson also found, based upon an analysis of 4,200 recent SEC filings that audit firms will more likely accept their clients' "questionable" accounting practices, e.g., in such areas as discretionary reserves when such clients are major users of the CPA firms' consulting services (Elstein, 2001).

Agency theory provides an organizational framework to help discuss the serious concerns regarding the perceived conflict of interest within, in particular, the Big Five accounting firms. Separating ownership and control of public companies gave rise to an agency issue where the traditional master-servant relationship was reversed and the agent (management) became dominant over the principal (shareholders). Thus, the independent audit function was established to make agents more accountable to the principals. From an agency perspective, the appearance of auditor independence is crucial to instill confidence in the fairness of management-prepared financial statements. The non-systemic lack of auditor independence does not lessen the reader's concern for and confidence in an unbiased audit opinion regarding increasingly complex financial statements. Other factors such as aggressive accounting practices, greater management discretion in interpreting complex reporting standards and increased public participation in equity markets increase the need for public confidence in the fairness of financial statements. The Big Five firms are moving in the right direction by divesting their non-audit practices to focus on the core of the profession: rendering opinion audits.

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