THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

# Briefing 05.03

## Audit methodology, risk management and non-audit services:

what can we learn from the recent past and what lies ahead?

**This Briefing is based on a P D Leake Lecture at Chartered Accountants' Hall, 14 May 2003**

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## Introduction

Accounting and audit firms, and in particular the large international firms which now dominate the large client audit market, have been transformed in the last 30 years from organisations, relatively modest in size and with a primary focus on audit and the provision of services closely associated with audit, to multi-national organisations providing a range of services categorised loosely under the umbrella of knowledge services. Over the same period there has been a perceived transformation in the role of audit from that of a periodic external check on the accuracy of a company's financial reporting toward a value adding function integrated within and contributing to the company's overall risk management profile.

In this time frame the auditing profession has been subject to a degree of criticism and questioning normally following a major corporate collapse or commercial failure, for example in the UK, Maxwell, BCCI, Lloyd's of London. However until recently criticism has largely been internalised and regulatory concern muted. This has changed dramatically in the last two years, in consequence of events in the United States where a seemingly unending saga of revelations of corporate financial engineering and accounting machination, much of it linked to the collapse of the dotcom hi-tech bubble, has led to accounting and accounting and audit firms being given a degree of prominence in the forum of public debate previously unheard of. Furthermore, it has aroused the interest of law makers and regulators, most notably in the United States with the passing last year of the Sarbanes-Oxley Act, but also in the United Kingdom, with the setting up by the government of the joint Treasury and DTI Co-ordinating Group, and in the European Union. This criticism has focused on the failure of auditors to control, identify and report on accounting manipulation, manipulation which in some cases has rendered financial statements almost meaningless.

A particular area of concern has been the closeness of the relationship between the auditor and the client and the effect that the extensive provision to audit clients of services other than audit has had on the independence of the external auditor. In the United States this concern has led to further restrictions on those services that audit firms can offer to their clients. In the United Kingdom, where the approach traditionally has been to focus on safeguards and controls within the audit firms rather than on specific prescriptions, the Co-ordinating Group has called for further examination of the issue of whether audit firms should continue to be allowed to provide non-audit services to their clients. No doubt too the European Union, which has in the past mooted the limitation of such provision to audit clients, will continue to monitor the situation closely. In this context then the ambition of this Briefing is to examine the interaction between the provision of non-audit services and the role of the audit in an attempt to illuminate aspects of that relationship and to provide insights which may be of value to policy makers and others. It seeks to do this by means of:

(a) consideration of the dramatic growth in the extent and range of non-audit service provision by accounting and auditing firms;

(b) exploration of the manner in which the perception and practice of audit has changed in recent years away from that of the monitor of the accuracy of company financial reporting to that of an enabling and facilitating function within the overall risk management profile of the client;

(c) discussion of arguments for and against continuing to allow the provision of non-audit services to audit clients with a particular focus on the interaction with the change in the audit approach and the generation of two way knowledge spillovers between audit and non-audit services;

(d) a brief case study review of these issues in the context of financial accounting and auditing at Enron and finally;

(e) some conclusions and consideration of policy issues.

## The growth of non-audit services

Accounting firms in both the United Kingdom and the United States have always provided services other than audit both to their audit clients and others. In the early years of the nineteenth century as accounting practices developed audit work was of relatively minor importance within the range of professional services offered, and it was not until the end of that century that audit came to be seen as the primary fee earner for accounting firms.[1] After 1900 although firms continued to offer a range of services to both audit and non-audit clients, the development of the professional audit, and the introduction of the statutory requirement for all limited companies to be audited, led to the audit function taking over as the mainspring of activity for the larger firms and this situation continued for much of the twentieth century.

In the United States the Second World War saw an extension of the range of services offered by accounting firms and it was there that consulting *per se*, as opposed to traditional non-audit services linked more closely to the financial statements as such, began to develop.[2] The AICPA's first committee on management services was formed in 1953, and in 1969 the AICPA adopted a resolution stating:

*It is an objective of the Institute, recognizing that management services are a proper function of CPAs to encourage all CPAs to perform the entire range of management services consistent with their professional competence, ethical standards and responsibility.*[3]

Accounting firms in the United Kingdom were perhaps slower to move away from their traditional audit base (although accounting and taxation services were important constituents of fee income for a number of firms large and small[4]). Nevertheless as the large firms in particular transformed themselves into multi-national multi-service providers the growth in the range and extent of non-audit services and their importance in terms of fee income grew dramatically. By the early 1990s only one of the then Big Six firms derived less than one half of its total United Kingdom fee income from services other than audit, and by the end of the decade non-audit services far outweighed audit in terms of fees for each of the then Big Five. Furthermore, the evidence suggests that the greater proportion of these services were being provided to audit clients with only 30% of the income accounting firms derived from their FTSE 350 clients being generated by statutory audit.[5,6] Similar developments took place in the United States; by the year 2000 audit accounted for just 30% of the revenues of the largest accounting firms – down from 70% in 1977. Consulting and other management advisory services represented half of fee income – up from 12% in 1977 (Levitt, 2000).

Recently there have been significant structural changes as the very large firms have divested themselves of all or part of their mainstream consulting businesses.[7] Andersen Consulting (now Accenture) finally divorced itself from Arthur Andersen in August 2000 after a long-running and acrimonious dispute. Ernst & Young spun off its consulting business to the Paris-based consulting and information technology group Cap Gemini in the same year, and KPMG floated KPMG Consulting in February 2001. PricewaterhouseCoopers sold its mainstream consulting business to IBM in 2002. However, very substantial areas of non-audit activity remain in the large firms and there is no doubt that they continue to provide equally substantial revenue streams to those firms.

This dramatic growth in non-audit service provision, and in particular provision to audit clients, has heightened concerns as to the threat posed to auditor independence. In the United States Arthur Levitt, when SEC Chairman, noted that:

*As firms expand their product lines, consulting and other services may shorten the distance between the auditor and management. Independence – if not in fact, then certainly in appearance – becomes a more elusive proposition.*[8]

These concerns are not in themselves new. In the United States the Cohen Commission, which was set up in the aftermath of a series of accounting and audit failures in the early 1970s, was one of the first quasi-independent bodies to formally consider the issues involved.[9] In 1978 the SEC required disclosure of the percentage of fees for non-audit fees relative to audit fees and disclosure across category where provision exceeded 3% of the audit fee, together with disclosure of whether the board of directors or its audit committee had approved the non-audit services. However, these disclosure requirements were withdrawn in 1982, and it was not until 2000 that the SEC introduced the present requirements for disclosure of fees for audit services and non-audit services split by category between 'Financial Information Systems Design and Implementation' and 'Other'. In the United Kingdom in 1986 a DTI consultative document on the implementation of the Eighth Directive of the then European Community invited comments on the possibility of legislating to prohibit auditors from providing non-audit services for audit clients. No such legislation was introduced although the 1989 Companies Act enabled the introduction of the present requirement for disclosure of the aggregate amounts paid to auditors for non-audit services by means of statutory instrument in 1991.[10]

Under the 1989 Act the task of ensuring that audits by appointed company auditors are 'carried out properly and with integrity and a proper degree of independence' was effectively delegated to the Recognised Supervisory Bodies. For example, *The Guide to Professional Ethics of the ICAEW*, contains a number of provisions designed to prevent the offering of non-audit services to clients compromising independence. Audit and other recurring income from any one client is restricted to 15% of gross practice income (10% in the case of listed and other public interest clients).[11] In the provision of non-audit services care must be taken not to perform management functions or to make management decisions. For listed and other public interest clients an auditor should not participate in the preparation of the company's accounts and accounting records and reference is made to the need to take care when engaging in recruitment activity on behalf of a client. There are few outright prohibitions in the guide but there is a ban on a firm auditing any financial statements which 'include the product of a specialist valuation carried out by it or an associated practice or organisation' and some rather more technical restrictions with regard to the provision of corporate finance advice where the firm acts as auditor or advisor to two or more parties involved in a takeover subject to the City Code.[12]

In addition to the provisions of the Ethical Guide there is an Auditing Standard requirement that the audit committee considers the scale and nature of non-audit services provided to the company by its auditor.[13]

In the United States the actual regulation of non-audit service provision to audit clients was not, until recently, substantively very different from that in the United Kingdom although there were structural differences, for example the creation of the Independence Standards Board in 1996 (the Board was wound up in 2001), and the more specific regulatory interest of the SEC. One difference was a greater willingness of the SEC to proscribe specific services including services such as psychological testing, executive recruiting, public opinion polls, merger and acquisition services for a finder's fee and actuarial services. Although, under the chairmanship of Arthur Levitt, the SEC proposed significantly greater proscription, in the outcome the revised rules approved in November 2000 went primarily down the route of disclosure and audit committee approval with extension of prohibition only with regard to certain IT consultancy services, the provision of legal services and, for clients with assets in excess of $200m, provision of more than 40% of internal audit.[14] The passing of the Sarbanes-Oxley Act in July 2002 effectively put into law the SEC prohibitions and extended them to include a complete ban on the provision of internal audit. However, other services, which specifically include taxation services, can continue to be provided if they are pre-approved by the client's audit committee.[15]

## Change in the nature of audit

Whereas the dramatic growth in the provision of non-audit services can be directly observed it is more difficult to determine the extent and nature of the evolutionary change in the audit role. The formal audit requirements in terms of the provision of an opinion as to the truth and fairness of the view presented by the financial statements has not changed but in the 1990s there was an observable shift in the perception of the capabilities and benefits of audit – a shift accompanied and to an extent led by, changes in audit approach and methodology. A simplified paradigm of the historical development of audit sees development from substantive audit via system and audit risk-based approaches through to the business risk model espoused by the large firms today. The substantive approach was balance sheet oriented focusing on obtaining direct evidence to support the existence, ownership and valuation of the assets and liabilities in the balance sheet. As the size and complexity of business entities grew, and their internal systems of control and check became more extensive and more reliable, systems-based audit, in which confidence in the financial statement numbers was derived in part from testing the systems used to generate those numbers, came to the fore.[16] One attraction of this approach to the audit firms was the linkage to their developing consulting activities in particular those relating to the installation and management of IT-based financial systems.

The 1980s saw the widespread adoption of audit approaches based on the audit risk model, as first set out in US auditing standards in SAS 39, in which the overall risk of an audit failure in terms of an inappropriate opinion was modelled as the product of the likelihood of error occurring in the financial statements, the likelihood of client systems preventing or detecting that error and the likelihood of audit tests detecting any otherwise undetected error. In recent years the firms have sought to further revise and refine their audit procedures to incorporate a wider assessment of risk and have shifted the focus away from audit risk *per se* toward client risk and client risk management practices. The extensive rhetoric accompanying and publicizing this change has portrayed it as an evolution in keeping with, and necessitated by, environmental changes in the economy and in ways of doing business. Audit has become a 'risk based, strategic systems, methodology' fit for 'the economy of the 21st Century'.[17]

Notwithstanding the widespread acceptance of a business risk or a value-added approach to audit there is rather less agreement, or indeed evidence, as to its application or indeed how radical a departure it is from previous audit practice.[18] In a study designed to add to knowledge of how the business risk approach is operationalised, Lemon *et al.* (2000) identify the main structural components of the business risk audit approach to be:

(a) A consideration of business risk in the general sense of the risk that the entity will fail to achieve its objectives.

(b) A greater focus on acquiring knowledge of the client's business and a more structured approach to the gathering of relevant information.

(c) A wider perception of the organisational framework away from the narrow perspective of the picture represented in the financial statements.

(d) A closer alignment with the management's view of the entity and a closer co-operation with management in the conduct of the audit and the setting of audit objectives.

In terms of evidence gathering the business risk approach may be seen as placing more emphasis on the testing of high level managerial controls and less on more detailed controls. These high level controls include relevant aspects of the control environment and corporate governance as well as controls over process. The extent of substantive testing is reduced (Power, 2000) but in its place analytical procedures are given enhanced prominence as being 'consistent with the auditor's desire to understand the entity's business rather than simply prove the financial statement figures'.[19] In turn the nature of analytical procedures has become more sophisticated with, it is claimed, the greater use of new analytic software, broader-based data sets and benchmarking.

The business risk approach – and indeed the whole concept of the delivery of assurance services over and above audit – has been closely associated with the parallel rise in the provision of services other than audit. Jeppesen (1998) refers to the expansion of the scope of audit as a 'reinvention' of audit[20] and claims that the focus on risk and strategic objectives has led to a blurring of the traditional distinction between auditing and other services provided by the accounting and audit firm. 'To some extent auditing has become consulting and it makes increasingly little sense distinguishing between the two as the boundary between them is eroded by the 'reinvention' of auditing',[21] a view echoed by a North American large firm partner who stated: 'there is a continuum in the whole audit advisory services area. I don't think it's any more possible to define discrete breakpoints.' (Boritz and Cockburn, 1998, p.142.)

## Threats from non-audit service provision[22]

### *Enhanced fee dependence*

In the United Kingdom and the United States auditors are 100% fee dependent upon their clients irrespective of whether or not non-audit services are supplied. The loss of an audit client will result in the loss of that stream of income which will in turn have implications for the firm and also, as is increasingly being recognised, for the fortunes within that firm of the individual managers and partners associated with that client.[23] There are however cogent reasons for believing that pressures on auditors to acquiesce to inappropriate client accounting procedures are greater when the accounting firm also benefits from substantial non-audit service revenue from that audit client. Although there is relatively little direct confirmatory empirical evidence, there is a strong perception that the loss of an audit client is also likely to lead to the loss of the stream of associated non-audit services – services which are conventionally perceived to be more profitable than audit *per se*. In forming an opinion or not as to the suitability of a client's accounting practices an audit partner – or the team of partners which is likely to be associated with a decision to qualify or threaten qualification of a set of financial statements – is unlikely not to be mindful of the overall fee income which the client represents to the firm.[24]

Indeed critics of the profession in the UK and the United States have alleged that accounting firms 'low ball' tenders for audit, i.e. price the audit below cost, for the purpose of gaining access to lucrative non-audit services and quote specific examples where incoming auditors have undercut the outgoing auditors in respect to the audit fee and then benefited from a very substantial rise in subsequent non-audit service fee income.[25, 26] Of course individual cases may be driven by specific factors and the wider empirical evidence to support this view is not necessarily compelling. Nevertheless, it would be naïve to believe that individual auditors and audit firms can entirely divorce themselves from such considerations when making operational and pricing audit decisions.

### The audit of work carried out by other members of the accounting firm

Concerns as to auditors being put into situations where they are effectively auditing their own work have been raised primarily in respect to situations where the audit firm has been responsible for advice on or the actual installation of client financial and related systems. The worry is essentially that the auditor will either be reluctant to probe too far into the operation and output of such systems or, if they find evidence that they are malfunctioning, will be reluctant to report this finding to client management or to a wider audience. However, although the concerns have traditionally been couched in terms of financial system provision conflicts of interest could arise across a range of non-audit service provision within what is termed the integrated audit of today, including *inter alia* internal audit, taxation, personnel selection, corporate finance. Evidence as to how significant a problem this is has been scarce although Sikka and Willmott (1995) in their review of the DTI Inspectors' report on Roadships Limited in 1976 noted that after examining the quality of audit by the auditor the Inspectors concluded:

*We do not accept that there can be the requisite degree of watchfulness where a man is checking his own figures or those of a colleague .... For these reasons we do not believe that (the auditor) ever achieved the standard of independence necessary for a wholly objective audit.*[27]

And much more recently the accounting and corporate governance experts testifying before the US Senate Committee on Governmental Affairs investigation of the role of the Enron directors were graphic in their description of the shortcomings of the integrated audit approach:

*not only for diluting the outside auditor's independence, but also for reducing the effectiveness of an outside audit by allowing the auditor to audit its own work at the company. Mr Sutton called it a 'terrible idea' while Mr Campbell called it a 'horrible practice' and I do not think it should be permitted.*[28]

### The relationship with management

Perhaps the greatest threat to auditor independence deriving from the provision of non-audit services to audit clients lies in terms of the implications for the relationship between client management and the auditor and the effect that this has in turn upon the audit approach. For much of the twentieth century, in the United Kingdom at least, the wider perception of the auditor was that of a quasi-judicial monitor of the accuracy of client financial reporting. Although the audit firm was economically dependent upon its clients, auditor independence was strengthened by relatively low levels of competition for existing clients and the greater relative importance of the professional bodies both in the wider commercial world and vis-à-vis the audit firms themselves. Relationships between company management and the auditor appear to have been more formal and more distant than they are today. However, whereas in the United Kingdom the company auditor is *de jure*, if not necessarily *de facto*, appointed by the shareholders and the audit report is addressed to the shareholder, as a consultant the accounting firm acts in a capacity similar to that of any outside contractor. It provides a service to company management, it is essentially at the behest of company management and almost inevitably comes to perceive the company client from the viewpoint of management rather than that of a dispassionate outside observer/monitor. This is likely to exacerbate a situation where the interests of the outside shareholders, to whom the auditor is reporting, but whom lack personification as the auditor has no direct contact or dealings with them, consciously or sub-consciously become subordinate to the interests of ‘the client’, i.e. client management who have a clear personification and frequently a similarity of background, socialisation and training as the senior members of the audit team.[29]

## Potential benefits from non-audit service provision

### Knowledge spillovers and enhanced audit quality

The very rapid expansion in non-audit service provision to audit clients may be seen as indicative of real economic benefits arising from the joint provision of such services because of economies of scope. These economies of scope are normally characterised as knowledge spill-overs (Simunic, 1984). To intervene in the market by prohibiting the provision of non-audit services to audit clients would then reduce economic efficiency.

Although the success of accounting firms in marketing non-audit services to their clients is undoubted, as demonstrated by the rapid growth in fee income deriving from such services, the exact nature of the relevant economies of scope/knowledge spillovers is perhaps less easy to establish. Antle *et al.* (1997) suggest that:

*Because auditing, tax work and consulting generate knowledge of clients’ organizations, processes and problems, it is intuitive that there exist economies of scope in auditing and these non-audit services...While quantitative estimates of economies of scope are not available, the success of accounting firms in competing in consulting markets is testimony to their existence.*[30]

However, empirical research has found it difficult to pin down these advantages in terms of reduced audit fees associated with a higher level of non-audit services – indeed the majority of pricing studies suggest that firms which purchase a high level of non-audit services from their auditors pay rather more than average for their audits. Ezzamel *et al.* (2002) suggest that this positive association may be explicable in terms either of client specific differences, for example organizational complexity, or ‘of events giving rise to the purchase of more audit and non-audit services rather than in terms of direct economic linkages between the cost functions for audit and non-audit services.'[31] While definitive interpretation of the empirical evidence is fraught with complications, given that audit is generally considered to be a service with an inelastic demand function, the existence of a positive association between the pricing of audit and non-audit services provides little, if any, support for the argument that there are extensive economic benefits arising from joint provision of audit and non-audit services.[32]

A linked argument, albeit one at a slight remove, is that the provision of non-audit services enhances the auditor's knowledge base and enables them to carry out a better quality audit. Whereas professional writers and the professional bodies have focused on independence as a mental construct others, for example Wolnizer (1987), Power (1997), have identified the need for auditors to have a knowledge base, whether pre-existing or as a result of search and evidential inquiry, which enables them to form an independent opinion as to the quality of financial reporting. In the absence of such knowledge an audit is likely to degenerate into no more than an acceptance of management representation and be of correspondingly little value. As business activity becomes ever more complex as a consequence of globalisation and expansion of markets for services and products,[33] then it is the provision of non-audit services which both adds value to the client and provides the auditor with the essential understanding of the mode and nature of the client's activities, an understanding which will underpin the audit opinion.

Such a viewpoint of course fits comfortably with the picture painted above of 'business risk audit' as a value adding activity situated within the client's overall risk management strategy with a focus on the overall control and corporate governance environment, knowledge of the business and a key assessment of management integrity, and also within the framework of assurance services and consulting as a continuum with few defining break points.

## Enron and Andersen: a brief case study

This section comprises a brief review of certain of the arguments and issues discussed above in the light of what is now known about the relationship between Andersen (formerly Arthur Andersen) and its client Enron. Although this is just one, perhaps extreme, example it is nevertheless contended that even a brief review can provide a number of insights as to how the relationship between a large firm and a large audit client operates in practice and how this relationship is mediated by – perhaps determined by – the provision of non-audit services.

As is well known until its spectacular demise Enron was one of the fastest growing and apparently most successful of US corporations. It was formed by merger in 1985 its core business then being the transportation of gas by pipeline. In the late 1980s and early 1990s Enron began to take advantage of the deregulation of the utilities industries to participate in and promote markets for the future supply of gas and other energy related products. It also expanded worldwide into the UK and mainland Europe, South America and India. In the late 1990s the primary engine of Enron's growth and apparent profitability was what was termed in the corporation's financial statements as 'wholesale services'.[34] These included not only the buying and selling of contracts for the supply of power but also strategic investments, whether from start-up or by acquisition, in energy and technology related businesses. Unfortunately Enron's operating performance came under pressure because of increased competition in the market for future contracts and also because many of its overseas projects were unsuccessful. As one analyst put it (*ex post*):

*All of the attempted diversifications proved to be fiascos. By 2000, Enron ended up with $10-$15 billion (about one-third) of its real asset base mostly dead in the water.*

Although the rapid appreciation of many of its 'hi-tech' investments allowed Enron to mask this lack of success elsewhere, when the hi-tech bubble burst Enron suffered accordingly. From a high of $90 in August 2000 there was a slow but persistent slide in its share value prompted by concerns as to the quality of Enron's earnings and the solidity of its balance sheet, and no doubt exacerbated by significant stock sales by senior executives. This became a headlong fall after the resignation of the Chief Executive Officer in August 2001, followed by the reporting of a $618m quarterly loss in October 2001 (as a result of writedowns totalling $1.01 billion), the news that the SEC was investigating possible conflicts of interests, and the admission in November 2001 that profits had been overstated by $600m since 1997. The associated adverse publicity led to increased margin calls by counterparties to its trading contracts. Haemorrhaging cash and having failed in its attempt to merge with its smaller Houston-based competitor Dynegy, Enron filed for bankruptcy in December 2001.

Slowly, and very much overshadowed by the more newsworthy aspects of the subsequent fallout, for example the appearance of top management at Senate and Congressional hearings, the collapse of Enron's auditors Andersen following their prosecution for the destruction of documents, the arrest of key executives on charges of fraud, has emerged a fuller picture of how Enron systematically manipulated the picture shown in its financial statements. It is only with the release, in March this year, of the second interim report of the court appointed Examiner in Bankruptcy that we have a much more complete picture of the extent to which Enron went to manage its earnings, cash flows and key credit ratios for the immediate purpose of maintaining both its stock price and its investment grade credit rating. Specifically this report identifies the use of questionable accounting treatment in the final set of fully audited financial statements for the year ending 31 December 2000 as being responsible for 96% of reported income, 105% of reported funds flow and also enabling debt to be stated in the balance sheet at $10.2 billion not $22.1 billion.

### The audit approach

There is a less complete picture of the nature of the audit than of the accounting manipulations[35] but we do know both that Andersen saw itself as carrying out an integrated audit and that it provided a wide range of services other than audit. It acted as internal auditor to Enron and was also vitally involved in assisting Enron in respect to accounting issues giving advice as to the setting up of the now notorious Special Purpose Entities (SPEs) which facilitated and acted as vehicles for much of the manipulation.[36] It also on occasion provided valuation services, valuations of key importance given the extensive use made by Enron, of mark to market accounting.

From its own perspective Andersen correctly characterised Enron as a high risk client and was keenly aware of what it termed the aggressive nature of its client's accounting procedures. For example, with reference to nine identified high risk accounting practices employed by Enron a note written in 1999 by the engagement partner in preparation for briefing the Enron Audit Committee stated: 'Obviously, we are on board with all of these, but many push limits and have a high "others could have a different view" risk profile.'[37]

*Fee dependence*

Enron were large fee providers to Andersen and those fees rose sharply over the period of their connection. Although non-audit service fees only just exceeded audit fees ($27m as compared with $25m in 2000) Andersen were clearly aware of the overall figure when, at a client retention meeting held in February 2001, they discussed the possibility of the combined total rising above $100m and the implications for independence thereof.[38] Notes of the meeting (see endnote 38 for a link to the full text) state:

*We discussed whether there would be a perceived independence issue solely considering our level of fees. We discussed that the concerns should not be on the magnitude of the fees but on the nature of the fees. We arbitrarily discussed that it would not be unforeseeable that fees could reach a $100 million per year amount considering the multi-disciplinary services being provided. Such amount did not trouble the participants as long as the nature of the services was not an issue.*

Although detailed figures are not to hand, in fee terms Enron was almost certainly the largest client of Andersen's Houston office and doubtless the remuneration, career prospects and status of the partners and other senior staff in that office, especially those with responsibility for the engagement, were perceived to be closely connected with the fortunes of that client.

*The audit of one's own work*

As noted above although concerns have frequently been expressed as to the potential threat to independence there has been relatively little evidence to substantiate these concerns. Enron provides a wealth of indicative evidence to show that this threat can be very real and furthermore one which is not just confined to situations involving the installation of financial systems.

In regard to Andersen's role as internal auditor (a function now proscribed by Sarbanes-Oxley) there is little information available either as to the nature of the work carried out or the extent to which Andersen as external auditor relied upon that work. However, the association of Andersen with many of the accounting transactions which Enron used to manage and manipulate their financial statements is documented in both the Powers Report and the Report of the Bankruptcy Examiner. Essentially the picture that emerges is of Andersen, in a consulting capacity, assisting its client to go to the limits of what it perceived to be US GAAP and then being incapable, in an audit capacity, of either enquiring more deeply as to whether the client had overstepped US GAAP – as for example in Enron's failure to establish a genuine 3% outside equity interest in certain SPEs – or of stepping back to take an overall view as to whether the financial statements did 'present fairly in accordance with US GAAP'.

A flavour of how this relationship operated can be obtained by one or two quotations from the Bankruptcy Examiner's Report and from the Powers Report. For example with reference to what he terms the FAS 140 transactions (the 'sale' of assets to a non-consolidated SPE while continuing to mark to market a return swap on the asset – which enabled Enron both to recognise a profit on the disposal and operating cash flows while effectively retaining control of the asset) the Examiner notes:

*Enron carefully designed its FAS 140 technique with advice from Andersen and Enron's lawyers, with the goal that the asset transfer would qualify for sale treatment under GAAP despite the fact that sale treatment did not reflect the economic substance of the transaction. In fact, Andersen discussed the basic template for the FAS 140 technique with SEC staff accountants in 1999, who indicated that non-consolidation of the SPE and sale treatment were consistent with existing GAAP.*

A far more critical view is taken by the Powers Report in its review of transactions between Enron and another set of SPEs 'the Raptors'. The report notes that:

*Enron's use of the Raptors allowed Enron to avoid reflecting almost $1 billion in losses on its merchant investments over a period spanning just a little more than one year*[39] *(from the 3rd quarter of 2000 through to the 3rd quarter of 2001).*

and continues:

*It is particularly surprising that the accountants at Andersen who should have brought a measure of objectivity and perspective to these transactions, did not do so...there is no question that Andersen accountants were in a position to understand all the critical features of the Raptors and offer advice on the appropriate accounting treatment. Andersen's total bill for Raptor-related work came to approximately $1.3m. Indeed there is abundant evidence that Andersen in fact offered Enron advice at every step, from inception through restructuring and ultimately to terminating the Raptors. The Andersen workpapers we were permitted to review do not reflect consideration of a number of the important accounting issues that we believe exist.*[40]

A final example which illustrates both the nature of Enron's accounting and the manner in which Andersen facilitated highly aggressive and questionable financial reporting is that of the Blockbuster 'transactions' – here as documented by the Report of the Bankruptcy Examiner.

In July 2000 Enron announced a 20 year exclusive deal with Blockbuster, an entertainment company, to supply videos on demand. This announcement was aspirational in nature as Enron did not have the technology to deliver videos on demand on a commercial basis and Blockbuster held no rights over such videos. Notwithstanding this a 45% interest in the contract was sold, via a subsidiary, to an unconsolidated SPE for $57m based on an Andersen supplied valuation for the contract of $120-150m. This enabled Enron to recognise $53m in earnings and $57m in operating cash flow.

In March 2001 the exclusive agreement with Blockbuster was terminated and a new press announcement as to an intention to initiate discussions with various parties for the purpose of delivering movies, games, television programming and music via the Enron Intelligent Network. Although the 45% interest had been sold to the SPE, Enron had executed a total return swap which entitled it to all the future proceeds from the activity sold. Enron marked this swap to market (thereby effectively continuing to mark to market the 'sold' asset within its accounts). Based on initiating discussions on wider access to the 'Enron platform' the total return swap within the FAS 140 structure was written up by a further $58m. Again this swap was 'monetised', i.e. it was 'sold' to another unconsolidated SPE on a similar basis to which the original asset had been sold, thereby enabling income and cash flow of $58m to be recognised. No contracts for the delivery of movies, games, television programming or music emerged and by late summer 2001 Enron decided to shut the business down. As the Examiner in Bankruptcy noted:

*Thus, within the space of about one year, this investment which resulted in Enron reporting $111 million of gain and $115 million of funds flow from operations in the fourth quarter of 2000 and the first quarter of 2001, proved to be worthless.*[41]

## Conclusions and policy perspectives

Changes in audit methodologies reflect to an extent changes in technology, relative costs, the nature of financial reporting, perceptions as to the auditor's role etc. The major audit firms take the position, some more forcefully than others, that the accounting technology and internal control systems of their large clients are such that there is little purpose or value in conducting the type of detailed transactions or systems-based audit that used to take place. Indeed some commentators have suggested that in the not too distant future the traditional financial audit will be effectively redundant as companies report financial data on-line and as in-built controls eliminate the potential for transaction-based error. In the meantime audit has reinvented and repositioned itself to fit more comfortably into an added value role within the overall assessment and management of risk for the benefit of the company and its stakeholders. This in turn gives added prominence to the provision of additional services over and above audit to the client – services which enhance the quality and efficiency of audit by adding to the information available to the auditor.

Unfortunately such an approach carries significant dangers in terms of enhanced threats to auditor independence, threats which, as illustrated above, may far outweigh any perceived benefits from an integrated audit approach. There is no doubt that the provision of extensive consulting services provided significant spillover benefits to Enron's auditors. Although not necessarily aware of every detail of Enron's manipulations, it is incontestable that Andersen were in possession of detailed information – because of their consulting activities – as to the financial engineering that was taking place. Such information is likely to have been costly and time consuming to obtain if Andersen were not acting in a consulting capacity. However, few would argue that this led to a superior quality audit – as auditors Andersen willingly accepted a whole range of accounting treatments at the limit of US GAAP which taken together turned the financial statements into a meaningless farrago and rendered the audit opinion thereon worthless. It is true, with the benefit of hindsight, the quite extensive note disclosures – many of which appear to have been at the behest of Andersen – should have been accorded more attention by analysts and others, but they were not. One is inevitably drawn to the conclusion that as an example of the business risk audit approach Andersen's audit of Enron failed both in terms of contributing to the client's overall risk management profile and in the more prosaic role of coming to an appropriate opinion on the financial statements offered to the capital markets and to other stakeholders.

From a policy making perspective if the quality of external audit is thought to be important the question is whether the professionalism and/or economic self interest of individual auditors and audit firms can be relied upon to deliver that quality within the context of the modern approach to audit.

Some place their confidence in professional values to ensure that auditors will deliver that quality, for example an interview-based research study within professional firms carried out on behalf of the AICPA (Burke, 1997) concluded that:

*there appears to be a strong norm both within these firms and throughout the profession, for maintaining independence as a means of providing clients with the best possible audit service and, in the larger scheme, providing financial statement users with the most accurate information with which they can make decisions. It would seem then, that auditors who uphold the norms of objectivity and independence will be recognized, to a large extent, informally by their peers and their supervisors, and to a somewhat lesser extent, perhaps, by their profession, for their contribution to supporting what are the underpinnings of our free market economy.*[42]

Others are more sceptical and argue that as over the years the importance and influence of the professional accounting associations has diminished, whereas that of the multi-national accounting firms has increased, traditional professional attitudes and values have all but disappeared. Their place has been taken by an attitudinal set with a heavy emphasis on short-term economic considerations. They would point to a culture and framework in the large firms of management by objectives focused primarily on continuous earnings growth.[43] The importance of the firms in imparting values and professional attitudes in the United Kingdom at least can be seen in a study of large firm trainee accountants (Anderson-Gough *et al.*, 1998), which concluded that their subjects' notions of professionalism were largely negotiated by the organisation for which they worked.

Professional considerations apart there are economic incentives acting to maintain auditor independence. Economic models suggest that firms will give up apparent short-term gains from non-independent behaviour so as to build up their reputation over the longer term which will in turn bring future economic returns (Watts and Zimmerman, 1981). As the firms grow in size the penalties attached to the discovery of non-independent behaviour increase because there is more reputational capital at risk (Wilson and Grimlund, 1990). Antle *et al*. (1997) noted that partners' financial capital in each of the (then) Big Six firms in the United States at the end of 1996 exceeded $3.5 billion – all of which could be put at risk if a firm engaged in non-independent behaviour. They also highlighted the importance of actual and potential litigation against accounting firms in providing powerful incentives for firms to avoid systemic independence violations. They concluded:

*Taking a holistic view, we have found that auditors have many incentives to protect their independence. Legal liability is significant, and any firm that would damage its independence risks an avalanche of litigation. Auditors have substantial investments in reputations, audit technology and methodology and directly in their financial stakes in accounting firms.*[44]

In many ways the fate of Andersen *post* Enron illustrates very clearly the risks attendant to non-independent behaviour. It is likely that the collapse of Andersen has influenced and will continue to influence the attitudes and actions of partners in the remaining large firms, irrespective of any further regulation that may be put in place. However, it is by no means clear that reliance upon economic forces alone is necessarily the most efficient mechanism for maintaining auditor independence. To a greater or lesser extent over the last 25 years all the large firms have been drawn into accounting and auditing cause célèbres. None of these *pre* Enron appeared to have any but the most marginal effect upon the standing and growth of the firms. The nature of the audit service is such that it can take a long time, if ever, before sub-standard auditing is exposed to the light of day and in such circumstances the short-term pressures on accounting firms, and more particularly on individual partners and managers, may again result in an unacceptable level of non-independent behaviour. One clear policy implication is that if it is not thought worthwhile to grasp the nettle and severely restrict, or even prohibit entirely, the provision by auditors of non-audit services to their audit clients,[45] then it is likely to be necessary to maintain a legal environment within which parties that have suffered as a result of inadequate auditing have a realistic chance of redress through the courts.

## Appendix

**Break down of fees for audit and non audit services for a sample of 306 quoted non-financial UK companies**

| *Analysis of total payment to auditor by audit firm* | *Total (AF and NAS) 2001* | *NAS as % of total 2001* | *Total (AF and NAS) 2000* | *NAS as % of total 2000* | *Mean total payment 2001* | *Mean total payment 2000* | *Number* |
|---|---|---|---|---|---|---|---|
| Arthur Andersen | 60,269 | 65.3% | 47,284 | 62.2% | 1,629 | 1,278 | 37 |
| Deloitte & Touche | 79,500 | 67.5% | 75,162 | 66.8% | 2,092 | 1,978 | 38 |
| Ernst and Young | 131,407 | 67.4% | 125,309 | 65.7% | 3,369 | 3,213 | 39 |
| KPMG | 145,220 | 69.6% | 152,069 | 71.3% | 1,936 | 2,028 | 75 |
| PricewaterhouseCoopers | 317,670 | 75.6% | 305,365 | 75.3% | 3,309 | 3,181 | 96 |
| Other firms | 6,004 | 31.4% | 6,193 | 40.6% | 286 | 295 | 21 |
| | **740,070** | **70.0%** | **711,382** | **70.0%** | **2,419** | **2,325** | |

*Source:* 'Perceived auditor independence and firm valuation' Working Paper, Gwilliam, Holland and Lane, UW Aberystwyth, April 2003.

## Endnotes

[1] Fee schedules for Whinney, Smith and Whinney (a forerunner of what is now Ernst & Young) show that in 1870 insolvency work amounted to more than 90% of total income and it was not until 1900 that auditing services generated more than 50% of the firm's income.

[2] Although Pitt and Birenbaum (1997, p.17) note a wider range of consulting activity including what would now be considered to be management advisory services going back to before the First World War in the United States. McKenna (2002) discusses the distinction between external financial audit and the provision of advisory services at the time of the Securities Acts in 1933 and 1934.

[3] Previts (1985) at p.94.

[4] For example in the Lloyd's insurance market it was commonplace before the reforms of the 1980s for the (then) relatively small panel auditors to provide both accounting and audit services to managing agents and syndicates.

[5] *Accountancy*, October 2000, p.10.

[6] More recent figures, with analysis by firm, for a large sample of quoted UK companies are shown in the Appendix.

[7] Essentially what Barker (2003) terms the 'big-ticket IT consulting operations'.

[8] Levitt (2000).

[9] The Commission (which although set up under the auspices of the AICPA considered itself to be independent of that body) found that no prohibition of non-audit services was warranted. Indeed the Commission recommended that professional standards should require that public accounting firms establish policies and procedures to assure that knowledge gained from other services is made available to the partner in charge of the audit so that the partner can consider its implication for the audit function. (Cohen Commission, 1978).

[10] Buijink *et al*. (1996) note that in Europe similar disclosure requirements exist in Ireland, Norway, Denmark, Belgium and Italy. More recently the European Commission has recommended disclosure and breakdown across the range of services provided (EC, 2002).

[11] See Buijink *et al*. (1996) for details of income restrictions across EU countries (pp. 76-77).

[12] In June 2002 ICAEW endorsed the European Commission independence recommendations. See *Accountancy*, November 2002, p.132 for Best Practice Guidance.

[13] See Statement of Auditing Standards, SAS 610 *Communication of audit matters to those charged with governance*, (APB, 2001).

[14] 'After careful consideration of the arguments on all sides, and for the reasons discussed below, we have determined not to adopt a total ban on non-audit services, despite the recommendations of some, and instead to identify certain non-audit services that, if provided to an audit client, render the auditor not independent of that client.' (SEC, 2000).

[15] The text of the Act is available at **http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=107_cong_public_laws&docid=f:publ204.107.pdf** an AICPA summary is available at **http://www.aicpa.org/info/ sarbanes_oxley_summary.htm** see also **http://www.sec.gov/news/press/2003-9.htm** for the SEC's more detailed guidance as to the interpretation of the Sarbanes-Oxley provisions.

[16] Higson (1997).

[17.] KPMG (1999, p.4) quoted in Humphrey *et al*. (2003).

[18.] As Humphrey *et al*. (2003) note *Auditing Through a Strategic-Systems Lens: the KPMG Business Measurement Process* (Bell *et al*., 1997) although widely regarded as an important technical expression of the new philosophy of auditing (Power, 2000) is in fact 'short on detail as to specific audit procedures introduced or modified by business risk audit methodology'.

[19.] Lemon *et al*. (2000).

[20.] p.525.

[21.] p.526

[22.] This and the following section are closely based on Canning and Gwilliam (2002). For an extensive survey of the literature surrounding the provision of non-audit services to audit clients see Beattie and Fearnley (2002).

[23.] See Gwilliam (1987, p.104), Trompeter (1994) for discussion of incentives facing individual partners and aspiring partners within accounting firms.

[24.] The SEC heard evidence as to the 'subtle but powerful psychological factors [that] skew the perceptions and judgments of persons – including auditors – who have a stake in the outcome of those judgments.' (SEC, 2000). See also Bazerman *et al*. (1997).

[25.] For example, Sikka and Willmott (1995).

[26.] Similar concerns were expressed by a number of parties giving evidence to the SEC hearings ahead of approval of its new independence rules (SEC, 2000) and indeed previously by the then Chairman of the SEC, Arthur Levitt, in a speech in 1996: 'The auditing function should be the very soul of the public accounting profession, not a loss-leader retained as a foot in the door for higher-fee consulting services' (quoted in Pitt and Barenbaum, 1997 at p.50 fn.109).

[27.] p.9.

[28.] Report 107 – 70, July 2002, 'The Role of the Board of Directors in Enron's Collapse', p.58.

[29.] 'As the auditor becomes increasingly involved with the audit client and its managers, the auditor is more likely to perceive himself as part of the management team and place less emphasis on his or her primary loyalty to investors.' (SEC, 2000).

[30.] p.ii.

[31.] p.13.

[32.] Although a recent study by Whisenant *et al*. (2002) using a different form of modelling on US data following the introduction of the disclosure requirement in 2000 suggests no relationship between fees for audit and non-audit services.

[33.] For example, the enormous growth in the markets for financial derivatives and for contracts and trading in the future supply of energy and related services (as pioneered by Enron).

[34.] Income (before interest, minority interests and taxes) from Wholesale Services rose by 133% from $968m to $2,260m between 1998 and 2000 whereas income from gas transportation and electricity generation combined increased just 15% from $637m to $732m.

[35.] See Gwilliam and Jackson (2003) for discussion of aspects of the accounting manipulations.

[36] For example, 'Andersen billed Enron $5.7million for advice in connection with the LJM and Chewco transactions alone, above and beyond its regular audit fees.' (Powers Report, p.5).

[37] US Senate Investigations (2002, p.17).

[38] See **http://energycommerce.house.gov/ 107/pubs/andersenmemos.pdf**

[39] p.132.

[40] p.132.

[41] p.32.

[42] p.5.

[43] See Dirsmith *et al*. (1997), Brierley and Gwilliam (2001).

[44] p.31.

[45] As for example recommended by Canning and Gwilliam (2002).

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# Briefing 05.03

## Audit methodology, risk management and non-audit services:

what can we learn from the recent past and what lies ahead?

**This Briefing is based on a P D Leake Lecture at Chartered Accountants' Hall by David Gwilliam, 14 May 2003**

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