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The Role of the Auditors in Post-Enron Era: An Overview

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Abstract:

The recent infamous corporate collapses in the US including Enron shattered the confidence of the investors on the audited financial reports which eventually called for revision of the role of the statutory auditors. In this context, this paper examines the latest statutes, statutory guidelines, common law guidelines (judicial pronouncements) relevant corporate governance code provisions, and code of ethics to sketch the role of the auditors in Post-Enron era. The paper identifies a duty of skill and care owed by auditors to audit client and regulatory bodies, but not to potential investors, creditors and possible takeover bidders. It is also evident that despite this fact, investors still rely on audited financial reports while making investment decision and that the poor quality of audit work did not only concern the lawmakers and regulators of the market, but also the professional bodies of accountants. The paper also revealed that the independence of the auditors is affected by a number of threats including self-serving threats. To address this, it is found that in various regimes including the United States and Bangladesh, statutory auditors are barred from engaging into a range of non-audit services.

1. Prelude

Financial reporting and disclosures provide the tools by which stakeholders can monitor and evaluate an organization's corporate governance practices[1]. But many corporate collapses in the recent

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[1] BEI Report (2004), “The Code of Corporate Governance for Bangladesh”, Bangladesh Enterprise Institute, Dhaka, Banglades, P.25

years have revealed significant fraudulent activity by directors and employees, often involving long-running wrong doing and usually on a massive scale. As noticed by Hannigan: "In most cases, these activities have gone undetected by company's auditors which raises issues as to: i) the manner in which auditors conduct an audit; and (ii) their liabilities in the event that the audit fails to detect wrongdoing or significant poor performance by the company such that the accounts give an erroneous picture of the company business"[2] .

Enron, which was one of the largest energy groups of the world, had grown at a phenomenal pace and some analysts were already predicting that it would be number one by 2001. Fortune magazine in early 2001 ranked Enron (on the basis of revenue) as seventh in the Fortune 500 with revenues over $100 billion. Unfortunately, in the same calendar year, the company admitted that there had been a number of financial reporting irregularities over the period 1997 to 2000. During 2001, it became apparent that a number of special-purpose entities (SPE was a trading concern created by Enron management to boost up reported profits) were not consolidated in the balance sheet. Consequently, earnings were substantially overstated and in late 2001, company filed for chapter 11 bankruptcy[3] .

As regards the auditors of Enron, Arthur Anderson was carrying out both audit and non-audit services, giving rise to a potential conflicts of interest. For instance, the audit part of the Arthur Anderson was found to be reluctant to upset Enron's management, because that would risk losing not just the audit services, but also non-audit services (such as management consultancy work). In 2001, the firm of Arthur Anderson received from Enron $25 million for audit services and $27 million for non-audit services.

[2] Hannigan, B. (2003), "Company Law", Oxford University Press, UK, P.519
[3] Blyth, A. (2003), "Get over It" Accountancy, February: Pp.7-35.

Arthur Anderson also acted illegally by shredding and deleting documents, and in May 2002, the lead auditor of Arthur Anderson admitted to obstruction of Justice[4] . The repercussions for Arthur Anderson were severe. Public companies lost confidence on Arthur Anderson switched to other audit firms for audit services.. Eventually, Arthur Anderson became one of the casualties of the Enron collapse. It had over $9 billion of turnover in 2001 with a reputation for outstanding auditing integrity and competence[5] . But, by the end of 2002, Arthur Anderson as an audit firm perished with its workforce reduced from 85,000 to 3,000 and barred from auditing in the US[6]

With the backdrop of other corporate collapses contemporary to Enron, pressures mounted on lawmakers of different legal regimes to come up with robust legal instruments to combat frauds and financial irregularities leading to insolvent liquidation of the publicly owned corporations. To deal with this, some new legislation, common law guidelines and corporate governance code provisions came into place in addition to older ones to guide the roles of the external auditor. Apart from these guidelines, some recent Code of Ethics as established by professional bodies of accountants was circulated that aimed at ensuring the independence of the auditors. In this context, this paper examines legal provisions, common law guidelines and recommendations of the corporate governance codes and code of ethics for professional accountants in order to identify the role of the auditors.

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[4] Squires et el, (2003), "Inside Arthur Anderson: Shifting Values, unexpected consequences" New Jersey: Financial Times, Prentice Hall, P.16

[5] supra note 3, P. 35

[6] Wearing, R. (2005), "The Case of Corporate Governance", Sage Publications 2005, London, p.77

2. Statutory Provisions Relating to the Role of Auditors

An auditor's primary role is to make a report to the company members on the annual accounts of the company. The auditor's report must clearly state whether, in auditor's opinion, annual accounts:

"Give a true and fair view –

(i) in case of individual balance sheet, of the states of affairs of the company as at the end of the financial year,

(ii) in case of individual profit and loss account, of the profit or loss of the company for the financial year,

(iii) In the case of group accounts, of the state of affairs at the end of the financial year of the undertakings included in the consolidation as a whole, so far as concerns member of the company"[7] .

The auditor must report on the company's annual accounts whether in his opinion the information given in the directors' report for the financial year for which the account is prepared is consistent with those accounts[8] . For the quoted companies, the auditor in his audit report on the annual accounts of the financial year must report the members of the company that the auditable part of director's remuneration report has been properly prepared in accordance with the act[9] . The form and the content of auditor's report is the subject of extensive professional guidance which requires that the preparation of the financial statements is the responsibility of the directors while the auditor's responsibility is to audit those statements. On the basis of types of opinion, there are generally,

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[7] Companies Act (2006), United Kingdom, Available at, French, D. (2007), "Blackstone's Statutes on Company Law", Oxford University Press, Oxford, UK, Section 495.

[8] supra note 7, Section 496

[9] supra note 7, Section 497

two types of audit reports such as clean report and qualified report[10] .

The Companies Act, 1994 of Bangladesh also require that "the auditor's report shall state whether in his opinion and to the best of his information and according to explanation given to him, the said accounts give information by this Act in the manner so required and give a true and fair view-

> (a) in case of the balance sheet, of the state of affairs of the company as at the end of its financial year;
> (b) in case of profit and loss account, of the profit or loss for its financial year"[11].

The Companies Act, 1994 further requires that the auditor's report shall also state-

> "(a) whether he has obtained all the information and explanation which to the best of his knowledge and belief necessary for the purpose of his audit;
> (b) whether, in his opinion, proper books of accounts as required by law have been kept by the company so far as appears from his examination of those books and proper return adequate for the purposes have been received from branches not visited by him;
> (c) where the company's balance sheet and profit and loss account properly dealt with by the report are in agreement with the books of accounts and returns"[12] .

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[10] suypra note 7, Section 495-4
[11] Companies Act (1994), Bangladesh, Available at, Zahir, M. (2005), "Company and Securities Law", The University Press Limited, Dhaka, Bangladesh, Section 213-3
[12] supra note 11, Section 213-5

3. The Common Law Guidelines Regarding the Roles and Liabilities of an Auditor

One of the most contentious issues in recent years has been the extent of any duty of care owed by the company's auditors to the company, shareholders and others who read and rely on the audited accounts[13]

While there is much case law on matters involving auditors, the general trend is a reluctance to find that a professional adviser owes a common law duty of care to a non-client[14] . However, a number of common law decisions outline the auditor's liability to client and regulatory authority. In *Hedley Byrne & Co Ltd v Heller & Partners Ltd*, it is noted that the assumption of auditor's responsibility depends upon the relationship between parties, which may be general or specific to the particular transaction, and may or may not be contractual in nature[15] . In *Electra Private Equity Partners v KPMG Peat Marwick*, it is observed that where there is such an assumption of responsibility is a matter to be considered objectively[16] . In respect of auditor's duty of care to a regulatory authority it is held in *Law Society v KPMG Peat Marwick* that accountants who carry out specific obligations under a statutory requirement to do so owe a duty of care to the regulatory authority to whom they report[17] .

For the disputes where there is no relationship between the auditor and the claimant but the claimant alleges that the parties are sufficiently proximate to give rise to a duty of care on part of the

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[13] supra note 2, P. 520

[14] *Bank of Credit and Commerce International (overseas) V Price Waterhouse* (1998), BCC 617

[15] *Hedley Byrne and Co Ltd V Heller and Partners Ltd* (1963), 2, All ER 575

[16] *Electra Private Equity Partners V KPMG Peat Marwick,* (2001), 1, BCLC 589

[17] *Law Soceity V KPMG Peat Marwick* (2000), 4, All ER 540

auditor, the decisions of '*Caparo Industries v Dickman'* is considered as a leading authority. The House of Lords concluded that in order for duty of care to arise, there must be :

> "(i) reasonable foresee ability of damage;
> ii) a relation of sufficient proximity between the party owing the duty and party to whom it is owed;
> (iii) the imposition of duty of care should be just and equitable in all the circumstances"[18].

It is relatively easy to establish the first element, a foreseeability of damage if accounts are negligently audited. The third element, the 'just and reasonable' consideration was imposed by the court in order to prevent forseeability alone giving rise, in the famous words of Cardozo CJ in *Ultramares Corpn V Touche*, to 'liability in an indeterminate amount for an indeterminate time to an indeterminate class'[19] .

Most discussion was focused on the second element, as to whether on a particular set of facts there is a relation of sufficient proximity for the duty to arise. In *Caparo* Lord Oliver identified the circumstances which should exist in order to establish the necessary relation of proximity between the person claiming to be owed the duty (advisee) and the advisor :

> "(i) the advice is required for a purpose, whether particularly specified or generally described, which is made known, either actually or inferentially, to the advisor at the time the advice is given;
> (ii) the advisor knows either actually or inferentially, that his advise is communicated to the advisee, either specifically or as a member of an ascertainable class, in order that it should be used by the advisee for that purpose;

[18] *Caparo Industries Plc V Dickman* (1990), 1, All ER 568
[19] *Ultramares Corpn V Touche* [1931] 255 NY 170

(iii) it is known either actually or inferentially, the advice so communicated is likely to be acted upon by the advisee for the purpose without independent audit;
(iv) it is so acted upon the advisee to this detriment"[20] .

The key elements of the doctrine of proximity are the auditor knows (whether actually or inferentially) that his report will be communicated to a person (whether individually or as a member of a class) especially for a particular purpose and that there will be reliance on it.

The House of Lords made some significant conclusions in *Caparo*, which are regarded as landmark guidelines while assessing the auditor's liability to various parties. To denote the auditor's responsibility to shareholders, the House of Lords concludes that the purpose of audit is to enable the shareholders as a body to exercise informed control of the company[21] . It follows that auditors do not owe a duty of care to members of the public at large who rely on the audited accounts to buy shares; or to an individual shareholder in the company who wishes to buy more shares in the company since an individual share holder is in no better position than a member of public at large[22] . Likewise auditors owe no duty of care to possible takeover bidders [23]. In another case law, it is held that the auditors owe no duty of care to existing or future creditors who extend credit on the strength of audited accounts[24]

[20] supra note 18
[21] supra note 18
[22] suprpa note 18
[23] *McNaughton Paper Group Ltd V Hicks Anderson and Company Ltd* (1991), BCLC 163.
[24] *Al Saudi Banque V Clark Pixley* (1989), 3, All ER 361

4. Quality Audit Report and Independence of Auditors

Although three-fold classification is established in *Caparo* for assessing the auditor's duty of care, the users of accounting information usually prefer to see that auditor's report bears such a quality that it would not at least mislead them while taking business decisions. To ensure quality, like other professions, an auditor must obtain required professional qualification as supervised by recognized supervisory bodies. Belcher considers this qualification as a device to control quality and argues that shareholders and other users of financial statements never discover the quality of audit service unless unqualified audit report is followed by the collapse of the company[25] . In some recent corporate collapses, it is found that the auditors have carried out both audit and non-audit services which essentially gave rise to a potential conflict of interest. It is mentioned earlier that in Enron, Arthur Anderson (auditing firm) has been found reluctant to upset Enron's management by giving qualified opinion on company's financial statements because that would risk losing not only just the audit services but also the lucrative non-audit services [26]. Belcher terms this infamous collapse as the failure of two markets - the market for company information and market for audit where capital market was not able to exert pressure on the company to produce accounts that were not misleading in one hand and the audit market was not able to exert pressure on Enron's auditors to qualify the report on those misleading accounts on the other [27].

The absolute failure of the audit firm to detect the frauds by the company directors shatters the confidence of investors on audit reports to a great extent which virtually questions the integrity of

[25]Belcher, C.A. (2006), "Audit Quality and Market for Audit: An Analysis of UK Regulatory Policies" Bond Law Review, VOL.18, Issue 1, Article 02, P.5
[26] supra note 2, P.79
[27] supra note 25,P.5

the accounting profession. The professional bodies of accountants also had concerns on how to revive the credibility of the profession. To this end, International Federation of Accountants (IFAC) published a Code of Ethics for professional accountants which weighted much on the independence of auditors[28] .The code of ethics presented the idea of two types of independence of auditors such as independence of mind and independence of appearance. They are as under:

> "Independence of mind permits arriving at an informed and reasoned opinion without being affected by the factors that compromise integrity, professional scepticism and objectivity of judgment[29] .
>
> On the other hand, independence in appearance which requires avoiding facts, circumstances and instances where an informed third party could reasonably conclude that integrity, objectivity and professionalism has or may have been compromised".

The IFAC Code identifies five types of threats that might affect the independence of auditors. These are self-interest threats, self-review threats, advocacy threats, familiarity threats and intimidation threats. These threats as explained by the code are as follows: "

a. Self-interest threats, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include (i) direct financial interest or materially significant indirect financial interest in a client, (ii) loan or guarantee to or from the concerned client etc.

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[28] IFAC Code (2005), "International Federation of Accountants Code of Ethics for Professional Accountants" Available at Internet: http://www.ifac.org/members/downloads/2005_cod

[29] supra note 28

b. Self-review threats, which occur when during a review of any judgment or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (i) when an auditor is having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.

c. Advocacy threats, which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes.

d. Familiarity threats are self-evident, and occur when auditors form relationships with the client where they end up being to sympathetic to the client's interests. This can occur in many ways: (i) close relative of the audit team working in a senior position in the client company, (ii) former partner of the audit firm being a director or senior employee of the client, (iii) long association between specific auditors and their specific client counterparts, and (iv) acceptance of significant gifts or hospitality from the client company, its directors of employees.

e. Intimidation threats, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees"[30] .

[30] supra note 28, Section 100.10

However, in order to reduce the aforesaid threats to an acceptable level, the code recommends the safeguards which fall into two broad categories such as: i) safeguard created by the profession, legislation, or regulation; and ii) safeguards in the work environment [31].

To ensure the independence of the auditors by the way of reducing possibility of above mentioned threats, Sarbanes - Oxley Act of the US restricts the auditors from providing a range of non-audit services to a client , which includes :

- ❖ Book-keeping or any other service related to maintaining accounting records or financial statements of the audit client.
- ❖ Financial information systems design and implementation.
- ❖ Appraisal or valuation services, fairness opinions, or contribution-in kind reports.
- ❖ Actuarial services.
- ❖ Internal audit outsourcing services.
- ❖ Management or human resources functions.
- ❖ Broker, dealer, investment adviser, or investment banking services.
- ❖ Legal and other expert services unrelated to audit.
- ❖ Any other service that the Public Company Accounting Oversight Board may determine to be impermissible [32].

To this end, Combined Code Guidance of the UK (2003) urges the audit committee to recommend to the board the company's policy in relation to provision of non-audit services. The code does not

[31] supra note 28, Section 100.11-100.12

[32] Sarbanes and Oxley Act (2002), Available at Internet: http://fl1.findlaw.com/news.com/ndocs/docs/gwbush/sarbanesoxley072302pdf

categorically prohibit auditors from providing non-audit services to a client but it urges the audit committee to ensure that provision of such non-audit services does not impair auditor's independence and objectivity[33] . In this regard, the Chandra Report identifies a list of prohibited non-audit services like Sarbanes-Oxley Act, but it allows the auditors to provide tax consultancy services subject to prior approval of the audit committee[34] . BEI Report also significantly considers the provision of non-audit services as an obstacle to independence of auditors. In the view of non-availability of sufficient number of tax consultants in Bangladesh other than practicing accountants, like the Chandra report, it makes a relaxation to tax work. For the clients to whom auditors provide any non-audit service, the code suggests to disclose both audit and non-audit fees to shareholders[35] . Consequently, in response to heated debate in both domestic and international arena on barring statutory auditors from engaging in non-audit services, the SEC of Bangladesh prohibits external auditors from supplying a number of non-audit services, such as, appraisal or valuation services or fairness opinions, design and implementation of financial information system, book keeping or any other related services, broker or dealer services, actuarial services, internal audit services, and any other services determined by the audit committee[36]

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[33] Combined Code Guidance (2003), "Audit Committees: Combined Code Guidance" a Guidance by FRC–The Group chaired by Sir Robert Smith Submitted to Financial Reporting Council (FRC) London in Dec. 2002 and Published in Jan, 2003.
[34] Chandra Report (2002), "Chandra Report on Corporate Audit Governance", India, Available at Internet:
//D.\WINNT\Profiles\Administrator\Desktop\Upload files\Chandra Report.htm
[35] supra note 1, p.27
[36] SEC Notification on Corporate Governance, 2006, Bangladesh

5. Implication of Smith Report, Sox Act, and Common Law Guidelines on Bangladesh

At present, Section 210(3) of Companies Act 1994 of Bangladesh enables the company to remove the statutory auditors on the ground of dishonesty, lack of capacity, and disqualification by an ordinary resolution of the members. However, section 211 of the Act provides that in order to remove the retiring auditor, a special notice is required to serve prior to the meeting and the resolution has been passed but the current Act does not spell out who may give the notice. Apart from the statutory provisions, Institute of Chartered Accountants of Bangladesh (ICAB), the professional body of the accountants and auditors in Bangladesh also takes into account the cases of unethical acts of the auditors and are found to take some disciplinary actions in the past. Moreover, the Common Law Pronouncements which are mostly delivered in apex courts of the UK and the US bear equal significance in case of Bangladesh because as like as the UK and the US, Bangladesh also established Common Law legal system where the courts are empowered to pronounce law through their verdicts.

As far as the provisions of Smith report of the UK and Sarbanes-Oxley Act of the US are concerned, both have been proved very effective with regard to combat accounting scandals as the aftermath of adoption of the Smith report by the Combined Code of the UK (2003) or enactment of SOX act (2002), no significant corporate collapse occurred. The positive sides of the both documents are both discourage very strongly the supply of any non-audit service to the audit client as this might invite the conflict of interest. Unfortunately, till date in Bangladesh, there is neither the Companies Act 1994 nor any other Security Regulation barred the Bangladeshi auditor from providing non- audit services. As a result, the auditors of Bangladesh like Arthur Anderson of the US will get difficulties to give qualified opinion in the annual report of the company for self-serving interests.

5. Conclusion

It is revealed from the above discussion on the role of the external auditor that auditor's failure to play an objective role by means of giving qualified opinion on fabricated financial reports raises question on the integrity of accounting profession. To perform audit work independently, legislative instruments as well as Corporate Governance Codes restrict the auditors from providing any non-audit services. To create an independent premise for auditors, legal provisions and corporate governance code provisions require the rotation of audit firm or audit team after a specific tenure[37] .

After the collapse of Enron, as an immediate response to protect investors and public interests from self-serving interests of the auditors, a harsh statutory measure has been taken in the US where Sarbanes-Oxley Act 2002 has brought audit firms and audit works under the scrutiny of Public Company Accounting Oversight Board (PACOB). Further, to revive the lost reputation of the accounting profession, professional bodies of Accountants and auditors also have taken some initiatives by means of circulating auditor's codes. To gain the trust worthiness of the stakeholders these codes expect the auditor to maintain some moral values. To meet the demand of the new age, the auditors should pay proper attention to these obligations. Otherwise, it is the market that would take its own action in due course. In this regard, the ultimate fate of the Arthur Anderson (which was barred from US audit market) could be an appropriate reference to those auditors who want to respond rationally to the demand of market forces.

[37] supra note 32,Section 203 & supra note 34, Recommendation 2.4