What and When Will the Next Steps Be?

If one were to consider the face-value activity that has occurred since the Enron scandal; such as the congressional hearings, resulting legislation, and formation of the PCAOB, one may conclude that enough has been done to reduce the risk to an acceptable low level that a scandal similar to Enron happens again. But has enough really been done? The conflict of interest between the client and audit firm engaged to report on the internal controls and financial statement of the client still exist. We are fooling ourselves if we think enough has been done and is being done currently to prevent another Enron fiasco. The PCAOB has enhanced the independence rules to some degree to help reduce this risk, but it is not enough.

This conflict of interest is at the heart of what happened with Enron; and unfortunately, in today's society it is hard to find leadership in a firm willing to quit an account on principle and/or issue a modified opinion when required per standards for fear of losing the account. This is exactly why additional measures are warranted because we can't rely on the majority of leaders in today's society to do the right thing legally, ethically, and/or morally on their own accord. Is it going to take another scandal the magnitude of Enron to get Congress (or now, the PCAOB) to move on removing the conflict of interest between independent auditors and their clients?

As I read in various Wall Street Journal articles printed prior and just after the Enron scandal, individuals and governing bodies of authority warned the SEC years prior to the Enron scandal that changes were needed. One such article noted that Arthur Levitt, chairman of the SEC in the Clinton administration, had called for reform in the 90's before the accounting scandals broke out; and before these scandals, his suggested reforms seemed unreasonable; but after the Enron scandal, these suggested reforms seemed more than reasonable. A March 5, 1996 Wall Street Journal article titled, "Who is Going to Audit the Auditors?", talked about companies, including Enron, who were taking cost cutting measures by outsourcing their internal audit departments to their own auditors. According to the article, The Institutes of Internal Auditors wanted double duty stopped and warned the SEC that double duty can lead to major problems. Instead of listening to these expressed warnings by these individuals and governing bodies of authority and taking proactive measures to prevent such problems, the SEC apparently did nothing and it took the Enron scandal and a resulting act of Congress to make a move that was reactive in nature. Let's please learn from what is now history and be proactive going forward. By putting the PCAOB in-charge of assigning the audits of these publicly held corporations and paying the auditors versus allowing these publicly held companies to pay the auditors directly, the conflict of interest is removed and true independence is obtained, thus greatly reducing the risk of another scandal such as Enron from occurring. A step such as this is what the public needs to have the right amount of real (not false) assurance to invest in the capital market.

However, removing the existing conflict of interest isn't the only additional step needed to reduce the risk to an acceptable level that the fraudulent activity the size of Enron occurs again. Objectivity is a major component of independence. You can't be considered independent if you lack objectivity. There is a natural tendency for the professional skepticism that needs to be applied each year to ensure the investors receive the quality audits they deserve to dissolve over a period of years in serving the same clients as complacency sets in with these recurring clients and objectivity becomes lacking. I observed this exact lack of objectivity and thus lack of professional skepticism of engagement team management at both the Big 4 and regional accounting firm level where the client was a recurring client for numerous years. Section 203 Audit Partner Rotation of the SOX Act required amendment to Section 10A of the Securities Exchange Act of 1934 by adding the following: (j) Audit Partner Rotation – it shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for that audit) or the audit partner responsible for reviewing the audit has performed audit services for that issuer in each of the previous 5 fiscal years of that issuer. However, this amendment doesn't address the other members of the engagement team who have served the same client for 5 years or longer, but it should.

Third year seniors , managers and senior managers with Big 4 firms, especially those who start their audit career with the same Big 4 firm, more than likely have served the same clients since the beginning of their time with the Big 4 firm, thus they already have at least 5 years in these clients before they reach the partner level. Seniors, managers and senior managers handle the majority of the planning and supervise the fieldwork testing, in addition to performing their own testing on the more complex areas. These individuals work directly with client management as well as client accounting personnel and make the day-to-day decisions in fieldwork testing; and as such, must apply the right amount of professional skepticism to ensure a quality audit in –line with auditing standards, which the investing public deserves. It's not just the audit partner needing this professional skepticism, thus the mandatory 5 year rotation should apply to the entire engagement team and not just the audit partners.

Section 207 of the SOX Act required a study of mandatory rotation of registered public accounting firms by the Comptroller General of the United States to be completed and reported to Congress and the Senate before the end of 2003. The Comptroller General responsible for this study and resulting report was and still is David M. Walker. David became the seventh Comptroller General of the United States and began his 15-year term when he took his oath of office on November 9, 1998. However, between 1989 and 1998, Mr. Walker worked at Arthur Andersen LLP, where he was a partner and global managing director of the human capital services practice based in Atlanta, Georgia. So how does this former Anderson partner go about studying the potential effect of a mandatory audit firm rotation to help the House and Senate decide on the whether or not to make audit firm rotation mandatory? He polls the accounting firms and SEC registrant executives (i.e. CFOs and audit committees), the very same type professionals who caused the Enron downfall (& other scandals of the early decade) in the first place. How objective can their responses be? Per the GMO reported results, the majority of accounting firms and SEC registrants do not want mandatory rotation. Who would have thought such an outcome in this survey would result? Anyone who is a business person and understands the mindset of these industry executives and public accounting leaders would not be surprised by these results. Thus, one could say that a conflict of interest existed in asking these professionals for their opinion on the subject of mandatory firm rotation. Although no-one will come right out and say it, one of the main reasons the majority polled do not want this mandatory rotation is because it makes business and life more difficult for them and could hurt their own bottom line. They just do not want to make the sacrifices necessary to protect the investing public.

Two somewhat laughable responses reflected in the GMO reported survey results is the expressed concern that increased cost would result due to increased dominance by a few and the expressed concern that the first year with a new auditor would result in a lower quality audit, which could lead to missed material misstatements. First, the Big 4 already dominate the market of SEC registrants. A mandatory audit firm rotation should open up this market to fairer competition and reduce the dominance that currently exists, and thus benefit the SEC registrant in the long run. Having spent some time with smaller accounting firms which heavily compete for clients, I have first-hand knowledge that it appears to be common practice to expect additional fees from the client in the initial year of engagement to cover the warranted additional testing and considerations in the first year and the long term contracts (engagement letters) reflect this with lower estimated fees in the 2nd and subsequent years. Sure the first year with a new auditor might be a little more costly, but the long-term contracts should keep audit fees down with increased competition. Secondly, auditing standards for which all independent auditors in the United States are required to abide by dictate that auditors must have the knowledge of the industry and specific accounting issues or be able to obtain that knowledge during the course of the audit to competently complete the audit. Additionally, audit standards concerning risk (SAS 47and now SAS 107) requires the auditor to reduce to an acceptable low level the risk that material misstatements will go undetected in the course of their audit, thus the higher risk that comes with a new client is reduced with the additional time and testing required with an initial audit. With this in mind, a quality audit is as obtainable with the new successor auditor as it is with the predecessor auditor, who may lack the professional skepticism due to its possible lack of objectivity after serving the client for many years. These Big 4 firms have been serving the same audit clients for up to as many as 50+ years. As such, the PCAOB should consider a mandatory firm rotation from anywhere between 5 and 10 years after the initial audit for the protection of the investing public.

Approximately four years has past since the Comptroller General's release of its report on its study of mandatory audit firm rotation in which it stated that more time was needed to determine the effectiveness of existing implementation of the Sox Act to consider such a step in greater detail. How much more time is needed before the next steps are taking? In a March 4, 2003 Review of FASB Action Post Enron and WorldCom Hearings by the House of Reps. – It was stated, "Sarbanes Oxley represents a positive 1st step, but it will not make a real impact unless it is vigorously implemented." I believe it is time for the next steps in this continuous process to reduce the risk that another scandal the size of Enron happens again. Don't you?