

CHAPTER 1

INTRODUCTION

Auditor independence issue has been in great debate over the last three decades. The issue is of paramount importance and still in the limelight especially after the Enron crisis. Auditor independence, in particular, is an important aspect of an auditing process. The impact of lack of auditor independence can be extremely great to the **audit process** thus affects **audit quality**. Auditors are responsible to report honestly and provide the assurance to the shareholders concerning the reliability and accurateness of the clients' accounting policies and the 'true and fair' view of the financial statements.

The Public Oversight Board (POB) emphasized that the members of certified public accountants (CPA) firms should protect the profession by being independence both '**in fact**' and '**in appearance**' (Lowe *et al.*, 1999). Hence, when auditors are less independent from their clients, the opinions they provide might constitute biases. If this is the case, the users of audited financial statements may not find the documents useful anymore. This would not attract the investors to invest in the company. In this respect, the investors and the public expects the auditors to be entirely independent from the auditee, in order to justify their trust.

Impairment of auditor independence can occur in various circumstances. Examples are such as: when auditors have an economic bond with their clients (attached to fees or fee dependent with clients), close relationships with client, extending consulting or non-audit services and being involved in client's management functions or decisions. Various safeguarding methods have been introduced to reduce potential risk of lacking of auditor independence. In fact many studies have focused on auditor independence by looking at different perspectives and recommended safeguarding methods to overcome the problem.

In the wake of Enron, the collapse of this multi-billion US based (energy) company has shaken the business world. Governments, politicians, regulators, critics, academics, investors, the public and the accounting profession itself raised auditor independence issue as their prime concern. While the case is still under investigation, Andersen is deliberately being blamed for failing to detect and investigate Enron's questionable accounting practices, of which eventually brought the company down to bankruptcy. In the turmoil of the destructive corporate failures, auditor independence and corporate governance practices have emerged as a critical issue. Investor's and the public's confidence towards auditor's attestation of the financial statements has deteriorated and this caused lack of confidence in the capital market.

Tougher independence regimes have been set over the past three decades to regain thrust and strengthen auditor independence. However, Van Der Plaats (2000) reckons that the issue is still a thorny one that it urges immediate attention. It is crucial that the regulators identify and ratify any mismatches between auditor independence regulatory framework and the appearance of independence in the real world settings. Criticism also has pushed the profession to reassess the purpose and future of auditing. It is therefore vital that regulators develop effective mechanisms to protect the appearance of auditor independence and restore the lost thrust in the profession.

Since auditor independence brings great impact into the auditing profession, it is crucial to alleviate the negative perceptions rested on the audit community. Thus, it is time that this dissertation reviews and analyzes the case of audit independence and works done by regulators to address this matter, particularly to strengthen auditor independence (real or perceived). Following the Enron-Andersen scandal, the regulators showed mixed reactions about the adequacies and effectiveness of existing regulation on audit independence. Vast

constructive proposals were put up in attempt to strengthen auditor independence (and corporate accountability) within today's complex business transactions. Among proposed reforms are: a ban or prohibition of non-audit services by auditors, enhancing the role of audit committee, mandatory rotation of audit firms, greater enforcement power by regulators, establishment of an independent body to select and hire auditor, greater disclosure of audit and non-audit services in the proxy statements and many others. The proposals were also meant to regain the investor's and public's confidence in the capital market. However, it is still doubtful whether the proposals could substantially preserve auditor independence both 'in fact' and 'in appearance'.

The objective of this research is to explore the view of auditor independence concept and threats attached to it, and to evaluate the proposed reforms in the United Kingdom (UK) and the United States of America (US) to strengthen auditor independence in the wake of Enron. Thus, the analysis of the regulator's reactions on this issue aimed to highlight the essential criteria needed to improve auditor independence. In doing so, an analysis on the successfulness of the proposals and the auditing regime is included. This research is expected to be of great contribution to the existing knowledge involving auditor independence. The recommendations offered in this dissertation are could hopefully accelerate the efforts to promote better independence environment, to enhance public's confidence and safeguard the auditing/ accounting reputation as professional service providers. Furthermore, Comte (cited in Blackburn, 1994) believed that the existence of new knowledge could help bring new certainties and truths, thus, the emulation of improvements and contributions to the knowledge can be expanded over time.

This dissertation is further organized in the following orders. Chapter 2 explains the methodologies adopted in this research. Chapter 3, the literature review section, explains the

concept of auditor independence, ideas and arguments by other previous researchers and several threats to independence. Then, this section provides the overview of the UK and the US regulatory responses in the wake of Enron. Following that, Chapter 4 immediately covers the proposals recommended to strengthening auditor independence in both the UK and US. Simultaneously, some evaluation and analysis of the appropriateness or successfulness of the proposals are included. Additionally, this section offers some other possible alternative reforms to overcome independence problems. Then Chapter 5 presents a discussion to draw attention on the fact that auditor independence cannot be achieved only by adhering to a set of rules but actually involves incorporating the auditor's personal qualities and attitudes. Finally, Chapter 6 summarizes the essential points highlighted in this dissertation.