

## Before and After Enron: CPAs' Views on Auditor Independence

By Deborah L. Lindberg and Frank D. Beck

Auditor independence is often referred to as the cornerstone of the auditing profession because it is the foundation for the public's trust in the attest function. Although many have stated that the collapse of Enron has negatively affected the perception of auditor independence, we do not need to rely on anecdotal evidence alone. In October 2001, approximately two months prior to Enron declaring bankruptcy, an extensive survey instrument on auditor independence had been sent to 1,500 CPAs. After Enron declared bankruptcy in December 2001, the survey was sent to another 1,500 CPAs drawn from the same database.

The results indicated that CPAs' perceptions of the effects of non-audit services on auditor independence are more negative after the Enron bankruptcy. In addition, after Enron declared bankruptcy, CPAs held a more conservative view of whether a material transaction or event detrimentally affects auditor independence. Furthermore, the findings suggest that auditors perceive that non-audit services and other issues that threaten auditor independence detrimentally affect the public's perception of independence to a greater extent than they adversely influence actual independence.

### A Discussion of Auditor Independence

Auditor independence helps to ensure quality audits and contributes to financial statement users' reliance on the financial reporting process. Several major instances of misstated earnings prompted the SEC in 2000 to adopt rules prohibiting non-audit services inconsistent with auditor independence.

Auditor independence has long been couched in terms of independence "in fact" and independence "in appearance." An auditor who is independent in fact has the ability to make independent audit decisions even if there is a perceived lack of independence or if the auditor is placed in a potentially compromising position. Nonetheless, even when the auditor is in fact independent, one or more factors may lead the public to believe the auditor does not appear independent. This may cause users of financial statements to believe they cannot rely on financial information.

Because auditor independence in fact is a mental state, investors and other users of financial statements cannot accurately assess actual auditor objectivity; they can only evaluate an auditor's appearance of objectivity. Thus, even when an auditor acts independently in fact and issues an unbiased audit opinion, investor confidence is eroded if investors and other users of the financial statement information do not perceive that the auditor was independent in appearance. Arthur Andersen, Enron's former auditor, was perceived as lacking independence, because the accounting firm earned more revenue from non-audit services than from audit services. While independence in fact and in appearance are both required in order to achieve the goal of independence, the Enron debacle, and the negative publicity that the auditing profession received, may have altered the public's expectations.

### Policy Issues

**Economic bonding.** In 2000, the SEC adopted amendments to its rules governing relationships between independent auditors and their SEC clients. These rules identified nine non-audit services inconsistent with auditor independence. The rules regarding management functions and human resources were consolidated into a single rule, resulting in eight rules that were subsequently made into law by the Sarbanes-Oxley Act of 2002.

While the independence rules allow audit firms to offer consulting services such as information technology (IT) and internal auditing, those services are subject to certain restrictions. Among other things, the rules now require annual disclosure of audit firms' fees received for auditing, IT consulting, and all other services.

Many commentators have stated that the Enron bankruptcy has forever altered the public's view of auditor independence, because Enron's auditors had previously issued unqualified opinions on Enron's financial statements. Regulators and critics of the accounting profession view an audit firm's provision of consulting services to an audit client as a conflict of interest. There is also a stream of critical literature, dating from the early 1980s, which argues that the provision of most non-audit services threatens auditor independence, because an economic bond, which the auditor does not want to lose, develops between the client and the accounting firm.

The authors expected that CPAs would perceive the provision of non-audit (consulting) services to auditing clients as weakening auditor independence, more so after the bankruptcy of Enron than before.

## **Survey**

In October 2001, before Enron declared bankruptcy, the authors had developed an extensive survey instrument on auditor independence and sent it to 1,500 CPAs. After Enron declared bankruptcy, the survey was sent to another 1,500 CPAs drawn from the same database, asking their views on auditor independence.

Survey participants were asked to provide their opinions about issues that may impair auditor independence. For one set of questions, survey participants were instructed to provide their opinions about specific non-audit services on a scale from "definitely *weakens* independence in fact" (1) to "definitely *strengthens* independence in fact" (5). Respondents were also asked to provide their perceptions of how the same non-audit services affected independence in appearance. In a similar vein, participants were asked to provide their perceptions, in several different formats, of how several other issues affect auditor independence.

## **Tests of Economic Bonding**

To test the economic bonding hypothesis, the authors predicted that the post-Enron respondents would be more negative toward a particular non-audit service on independence in fact and independence in appearance than the pre-Enron respondents. Differences existed between CPAs surveyed before and after the Enron bankruptcy for independence in fact on nine out of the 10 non-audit services surveyed. The largest difference was the effect that the provision of internal audit services by an audit firm has on independence in fact. The provision of management functions, broker-dealer services, or legal services concerned CPAs as well, both before and after the Enron bankruptcy. Financial information systems design, the non-audit service for which no significant difference existed pre- or post-Enron, was perceived as the least problematic for the maintenance of independence in fact.

CPAs' opinions regarding the effect of audit firms providing non-audit services to clients on independence in appearance grew more negative for only five of the 10 non-audit services surveyed. The largest difference was for the provision of internal audit services. In addition, after the Enron bankruptcy, concern about independence in appearance was greater if the audit firm also provides bookkeeping or legal services, financial information systems implementation services, or appraisal valuation. The results, summarized in Exhibit 3, also indicated that providing non-audit services is more of a concern for independence in appearance than for independence in fact.

## **The Role of Materiality**

Materiality is an issue that accountants and auditors have long grappled with. There are no pronouncements that specify a dollar amount to use as a materiality cutoff, or that help determine whether an item is material. Rather,

professional standards state that the determination of materiality is a matter of professional judgment, and should be based on such factors as the size or nature of an item, the expected users of financial information, and the cumulative effect of items under consideration. Thus, materiality judgments are subject to much subjectivity. Since Enron, the financial press has extensively covered materiality issues. Because of reactions by CPAs to such negative publicity, the authors expected CPAs would take a more conservative view of materiality after Enron declared bankruptcy. In other words, all other factors remaining the same, the Enron debacle has motivated CPAs to lower their materiality threshold.

### **Tests of the Role of Materiality**

One survey question asked participants to indicate whether the materiality of the amount of non-audit fees impairs independence in fact and in appearance. The results show that CPAs did lower their materiality threshold for nonaudit fees impairing independence after Enron. This is another indication of the validity of the economic bonding hypothesis before Enron.

Furthermore, a factor analysis identified nine items that were related to each other, including materiality, dollar amount of waived audit adjustments, client audit revenue, estimation of a valuation allowance, outsourcing of internal audit services, low-balling of initial audit fees, potential for non-audit revenue, compensation for referrals, and contingency fees. Because these items were part of an underlying and unmeasured concern with the effect of dollars on auditor-company relations and independence, the authors performed the same test on the other eight items tested regarding the materiality of non-audit fees.

The difference between CPAs' concerns over independence in fact before and after Enron was statistically significant for five of the nine items, including materiality. CPAs surveyed after Enron were also more concerned that the size of audit clients affected independence in fact, as well as about the outsourcing of internal audit services, the potential for non-audit revenue, and compensation for consulting referrals of non-audit services. There was no difference in views of independence in fact pre- and post-Enron, (once experience, firm size, and gender were held constant), regarding the effect of the size of waived adjustments, the estimation of valuation allowance, or low-balling of fees.

Regarding independence in appearance, CPAs had a more conservative view of whether a material transaction or event detrimentally affects auditor independence in appearance after Enron. The differences were statistically significant for eight of the nine items, all expressing more concern after Enron. The strongest differences were for the materiality of non-audit fees, the outsourcing of internal audit services, the potential for non-audit revenue, and compensation for consulting referrals of non-audit services. Interestingly, the differences between pre- and post-Enron CPAs were greater when asked about independence in appearance than independence in fact.

### **Perception and Reality**

As discussed, an auditor is considered independent in fact if she has the ability to make independent audit decisions even if there is a perceived lack of independence or if the auditor is placed in a potentially compromising position. Even when the auditor is in fact independent, however, one or more factors may lead the public to conclude the auditor is not independent. Many commentators on the Enron debacle note that perception becomes reality where auditor independence is concerned. If perception becomes reality for CPAs, too, there would be no statistically significant difference between their perceptions of independence in fact and in appearance before and after Enron.

### **Tests of Independence Perceptions**

A series of paired difference t-tests demonstrates that respondents were more concerned about many non-audit services and audit practices affecting independence in appearance than they were about those same issues

affecting independence in fact. Of the 31 tests performed on the responses before the Enron bankruptcy, 29 were statistically significant and indicated more concern about independence in appearance. Twenty-eight of the 31 tests were statistically significant after Enron and more concerned about independence in fact.

Among respondents, concern over a certain issue affecting independence in appearance increases directly with concern over the same issue affecting independence in fact. The average concern for each issue was higher for those surveyed after Enron declared bankruptcy than it was for CPAs surveyed before.

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