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Enron as a symptom of audit process breakdown: can the Sarbanes-Oxley Act cure the disease?

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Abstract

Andersen's deficiency in the Enron case mainly involved an unwillingness to stand up to Enron management regarding accounting issues. This is a critical phase of the audit; however, it is only one phase of an audit. This paper presents a model of the auditor's misstatement detection and reporting process, which consists of three steps: (1) awareness of the transaction, (2) recognition that the transaction's accounting treatment results in a misstatement, and (3) a willingness to modify the audit opinion to disclose the nature of misstatement if management does not correct the misstatements. For an auditor to best serve the public interest, he or she would need to carry through all three steps of the model. Five recent financial statement misstatements are then addressed: Sunbeam, Cendant, Waste Management, Enron and Worldcom. What emerges from a review of these recent cases is that the failure point in the misstatement detection and reporting process varies among these cases and there are often multiple points of failure, suggesting the need for multiple approaches to improving the process. The Sarbanes-Oxley Act, passed largely as a result of the Enron failure, attempts to improve the audit process for public companies in the US. The relationship of the act's provisions to the misstatement detection and reporting process, and their potential efficacy in preventing cases similar to the recent frauds are addressed. From this analysis, the paper concludes that most of the audit-related provisions of the Sarbanes-Oxley Act are concerned with strengthening auditor independence. Because other aspects of the audit model have been responsible for some recent frauds, the Act may be treating the symptoms of the audit breakdown which appear to have caused the Enron failure, while missing an opportunity for more meaningful legislative reform of other aspects of the audit process which are associated with other recent frauds.

Keywords: Sarbanes-Oxley Act; Enron; Audit process; Fraud detection and prevention; Auditor independence

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1. Introduction

Recent legislative action in the US (the Sarbanes-Oxley Act; US Congress, 2002) has sought to strengthen the audit process principally through prohibitions on certain types of consulting services and by transferring professional disciplinary authority from the principle professional association to a public body not dominated by members of the accounting profession. The main focus of audit process enhancement embodied in the Sarbanes-Oxley Act is an attempt to strengthen external auditor independence. While such reform may be necessary, there are other aspects of the audit process which recent audit failures suggest may also be in need of reform.

The purpose of this paper is to examine five recent high profile frauds which have caught the attention of both the investing public and the US Securities Exchange Commission (SEC). The main US legislative initiative, the Sarbanes-Oxley Act, is examined in light of the circumstances surrounding recent financial statement frauds and audit failures. The potential effectiveness of the Sarbanes-Oxley Act in preventing future similar occurrences is then presented.

The remainder of this paper is organized as follows: first, a discussion is presented of the process whereby an auditor "catches" a material misstatement which would cause him or her to modify the audit opinion (i.e., the auditor's misstatement detection and reporting process). Next, a discussion is presented of several recent high profile financial statement frauds and/or audit failures, and how these situations may reflect a failure to adhere to good audit processes. Next, the provisions of the Sarbanes-Oxley Act are discussed, together with an indication of how the Act's provisions relate to the auditor's misstatement detection and reporting process. This is followed by a discussion of the potential for the provisions of Sarbanes-Oxley to prevent the types of failures in the audit process exemplified by the recent cases. The paper concludes with a summary.

2. The auditor's misstatement detection and reporting model

The model presented in Fig. 1 represents the auditor's actions during the course of an audit and how those actions help to prevent misstated financial statement from being used by the investing public.[1]

2.1. Step 1

The first step in the misstatement detection model is for the auditor to select a "problem" transaction for examination. During the course of an audit, the auditor takes samples of transactions for which he or she will then gather further evidence. Because the auditor provides only reasonable assurance that the financial statements are free of material misstatement (AICPA, 2001, § 316.01), the auditor will not test all the transactions. The nature of the client should affect the number of transactions the auditor examines, as well as the type of evidence the auditor gathers to substantiate the transactions. However, because the

[1] This model was influenced by Fig. 2 in Beattie et al. (2002).