

Who Audits the Auditors?

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It has become an all too familiar story: a company rides the *new economy* stock market boom to record highs and then crashes to earth. This time, however, is different. While Enron's shareholders may bemoan the 95 percent drop in the value of their shares over the last year, Enron's size and unique position within the energy industry insure that we will all share the pain. Worse yet, the cause of Enron's current problems, fraudulent financial statements endorsed by a *big five* accounting firm, is just the most recent example of a trend which threatens the viability of our financial system.

Enron trades 25 percent of the country's electricity and natural gas. The travails of the largest energy trading company in the world will disrupt our energy markets and may result in higher fuel bills this winter as utilities scramble to replace broken Enron contracts. The banks who guaranteed billions of dollars of Enron contracts via letters of credit are at risk and may need to be bailed-out. This comes on top of \$4 billion of bank financing consumed by the failing company since the inception of the crisis last summer. Some economists worry that these problems may initiate a ripple effect, delivering a shock to both the financial and energy markets. While Enron's financial statements are notoriously complex, one does not need to be a securities analyst to understand what caused the company's demise; one only need understand the concept of conflict of interest. A rule prohibiting auditors from soliciting non-auditing business from the companies they audit would eliminate this conflict of interest.

Our economy is predicated on the transparency of financial statements, guaranteed by supposedly independent auditors, in Enron's case, Arthur Andersen. Andersen consistently endorsed Enron's financial statements. As recently as April of this year, Andersen opined that the financial statements "present fairly, in all material respects, the financial position of Enron Corp." Seven months later, Enron revised five years of financial statements, erasing \$586 million of income and revealing a tawdry web of insider dealing. To date, Enron's implosion has wiped-out \$64 billion of shareholder value. As the saying goes, a billion here, a billion there, pretty soon we're talking real money.

Unfortunately, Enron is not unique. We have recently seen many companies, Waste Management, Sunbeam, MicroStrategy and Cendant to name a few, practice financial chicanery which should have been exposed by the auditors. The problem is getting worse. Data collected by the Securities and Exchange

Commission (SEC) show that in 2000, 156 companies restated their financial statements destroying \$31.2 billion of shareholder value, up from 142 restatements in 1999 (costing shareholders \$24.2 billion) and 116 restatements in 1998 (costing shareholders \$17.7 billion). All of these companies have financial statements endorsed by independent auditors, most by one of the big five accounting firms.

While good corporate governance requires outside directors to select the *independent auditor*, in reality, auditors report to management. Over the years, auditing has become a low margin business which functions as a loss leader for more lucrative consulting work. New SEC data show that 73% of total fees companies paid to their auditors were for non-audit services. It turns out that Enron is one of Andersen's largest clients: last year Enron paid Arthur Andersen \$52 million, less than half of this was for auditing. Auditors competing for lucrative consulting contracts are not in a position to aggressively question management's financial statements. As a result, we have an ongoing stream of financial restatements and surprises, corroding the credibility of our markets.

Interestingly enough, the Financial Accounting Standards Board, the organization charged with establishing and improving financial reporting standards, has not addressed the conflict of interest problem. The SEC weighed-in on the issue last year by adopting amendments to Rule 2-01 of Regulation S-X1; the new amendment now requires companies to disclose how much they pay to their auditors for non-auditing services. While disclosing the magnitude of the problem is helpful, clearly it is not enough.

What is needed is a prohibition of auditors soliciting consulting business from the companies they audit. There is a precedent for this: the bond rating agencies, Moody's and Standard & Poors, have self-imposed rules prohibiting them from consulting to the companies they rate. By now it is clear that the *new economy* is really the same old economy, and old-fashioned conflict of interest is still a problem to be reckoned with. Do we need yet another financial meltdown before taking action to protect the integrity of our economic system?
