Editorial

Aida Sy*

Department of Economics and Finance,
School of Management,
Marist College,
Room LT101, 3399 North Road,
Poughkeepsie, New York, 12601, USA
E-mail: aida.sy@marist.edu
E-mail: Aida.Sy1776@gmail.com
*Corresponding author

Tony Tinker

Department of Accountancy,
Baruch College,
City University of New York,
One Bernard Baruch Way,
P.O. Box B12:225, New York, NY 10010, USA
E-mail: Anthony.Tinker@baruch.cuny.edu
E-mail: Tony.Tinker@gmail.com

Rule 3520: auditor independence and corporate fraud

The auditing standard, Rule 3520 which deals with the auditor independence states the following:

> "A registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period.
>
> Note 1: that under Rule 3520, a registered public accounting firm or associated person's has an independence obligation with respect to an audit client that is an issuer encompasses not only an obligation to satisfy the independence criteria set out in the rules and standards of the PCAOB, but also an obligation to satisfy all other independence criteria applicable to the engagement, including the independence criteria set out in the rules and regulations of the Commission under the federal securities laws.
>
> Note 2: Rule 3520 applies only to those associated persons of a registered public accounting firm required to be independent of the firm's audit client by standards, rules or regulations of the Commission or other applicable independence criteria."

Auditing is defined as a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing the auditor perceives and recognises the propositions before him

Copyright © 2013 Inderscience Enterprises Ltd.

for examination, collects evidence, evaluates the same and on this basis formulates his judgment which is communicated through his audit report.

Historically, the word 'auditing' has been derived from Latin word 'audire' which means 'to hear'. According to Dicksee, traditionally auditing can be understood as an examination of accounting records undertaken with a view to establishing whether they completely reflect the transactions correctly for the related purpose. In addition the auditor also expresses his opinion on the character of the statements of accounts prepared from the accounting records so examined as to whether they portray a true and fair picture.

The rule is in compliance with the definition and purpose of auditing, yet some corporations do not apply the above principles. Examples are the Phar-Mor and ENRON cases where the auditors clearly lacked independence.

Several investors in Phar-Mor filed a civil suit against the company's auditors, Coopers & Lybrand. A jury decided in 1996 that the accountants committed common law and federal securities law fraud by falsely representing that they had performed GAAP audits when in fact they had failed to do so.

The Enron scandal, revealed in October 2001, eventually led to the bankruptcy of the Enron Corporation, a US energy company based in Houston, Texas, and the de facto dissolution of Arthur Andersen, which was one of the five largest audit and accountancy partnerships in the world. In addition to being the largest bankruptcy reorganisation in American history at that time, Enron was attributed as the biggest audit failure.

Many executives at Enron were indicted for a variety of charges and were later sentenced to prison. Enron's auditor, Arthur Andersen, was found guilty in a United States District Court, but by the time the ruling was overturned at the U.S. Supreme Court, the company had lost the majority of its customers and had closed.

Ironically, KPMG audited the hundreds of SPE where ENRON hid massive off-balance sheet debt. Had this debt been consolidated into the Enron balance sheet, the markets would have panicked at the level of financial risk that was exposed. KPMG never alerted Arthur Andersen or the SEC as to this high risk jeopardy. It was the collapse of hundreds of SPEs that compounded the collapse of ENRON and was the subject of billions of dollars of subsequent legal settlements. The final twist in the unfortunate ENRON saga was that KPMG's audit revenues increased by some 17% in the year following ENRON's collapse (as KPMG cleaned up the clients that abandoned ENRON).

Investors, employees and shareholders received limited returns in lawsuits losing billions in default on pensions obligations and the dramatic decline in stock prices.

As a consequence of the scandal, new regulations and legislation were enacted to expand the accuracy of financial reporting for public companies. One piece of legislation, the Sarbanes-Oxley Act (SOX), increased penalties for destroying, altering, or fabricating records in federal investigations or for attempting to defraud shareholders. The act also increased the accountability of auditing firms to remain unbiased and independent of their client. Importantly, from an auditing standpoint, SOX revived the provisions of the Foreign Corrupt Practices Act (FCPA) 1977 that required firms to maintain proper systems of internal control (and that the auditor was required to examine and report as the status of these systems). Under section 401 of SOX legislation, senior executives and directors of client firms are required to certify that the systems of internal control were in proper order.