

## **In the Wake of Enron, Accountancy Professor Proposes Method to Make Auditors Accountable to Share Holders**

Over a year after the Enron story first hit the press, Wall Street, the White House, the Congress, the SEC, the Accounting Standards Board, and the public are still debating how to prevent such frauds in the future. Illinois Accountancy Professor A. Rashad Abdel-khalik proposed one method in a recent editorial in the *Journal of Accounting and Public Policy*. He suggested that one positive outcome of the Enron debacle could be the improvement of the process by which auditors are selected, retained, and compensated.

**Although, in theory, auditors are the “agents” of the shareholders, Abdel-khalik notes that in practice auditors speak of the firm’s management as the audit “client.”** Beyond that, the letter of engagement, the contract that spells out the hiring, retention, and compensation of the auditing firm, is exchanged between the auditor and the management of the firm to be audited. Abdel-khalik considers this the biggest fallacy in corporate governance today. In today’s business world, shareholders tend to sign over their proxies to the management or simply ignore their voting privileges, effectively handing over control of auditor-related decisions to management. That same management also decides which firm to engage as consultants.

### **Enron and measures of corporate performance**

Critics often assert that auditor independence is compromised when the chosen audit firm is also retained to perform consulting services. Abdel-khalik, however, argues that any such potential threat to audit independence arises from putting the de facto authority for hiring auditors into the same hands that hire consultants, that is, management. **He believes that audit independence can be achieved by removing from management’s domain the de facto authority to hire and compensate the auditor.** When different organizational units make decisions for the two distinct functions, auditors will be independent even if the same firm is employed to do the audit and consulting. Although much remains to be uncovered in the Enron case, it appears to have resulted in the management gaining greater power in comparison with shareholders. Accounting professors teach that one of the most direct ways of reducing the conflict of interest is to offer managers incentive plans designed to motivate them to take actions that can increase the shareholders’ wealth. A common way this is done is to offer performance-based stock options that should make the interests of management the same as those of shareholders. Enron’s top executives had that type of plan. However, there was a fatal flaw in the implementation of these plans, the performance measurement. We assume that the performance measurement reflects

actual results rather than wishful thinking and that there is a system of reporting and accountability in place that assures it. In Enron's case, executive incentive plans were based on the anticipated rise in share prices. In efficient capital markets, changes in stock prices reflect changes in the earning power of the entity. Under normal conditions, no one would question the appropriateness of using changes in market prices as a measure of corporate performance, but the investors in Enron did not know that the information reported in the financial statements does not reflect the true earning power of the company.

### **Audit “opinions” and assurance**

A necessary condition for efficient markets is availability of information, including financial reports that offer a fair and accurate measurement of what management has accomplished. Management produces financial reports, and the auditor's job is to affirm or question the veracity of these reports.

Auditors arrive at an “opinion” of a firm's financial reporting by collecting facts about key managers and about the company. Since the creation of the Securities and Exchange Commission in 1934, the external auditor's report has become the primary source trusted by investors. This arrangement has evolved because auditors are supposed to be independent of management, to be skeptical of management's representation of its financial situation, and to adopt professionally developed and tested accounting and auditing standards.

### **Auditing choice and management**

In today's business world, where the ownership of shares is spread widely and individual shareholders take little or no part in the life of the firm, it has become the fact that the management proposes an auditing firm to the board of directors, which rarely fails to endorse the proposal. It is also the board that exchanges the letter of engagement with the auditor detailing both auditor retention and compensation agreements. Although neither the SEC nor the accounting profession ever intended the external auditor to be the agent of management, actual practice places the duty of hiring the auditor and negotiating a fee squarely in the hands of the management of the audited corporation. Therefore, says Abdel-khalik, it strains the imagination to see the auditor as independent of management (even if the auditing firm is not also providing consulting). **Auditor independence depends on who is, in fact, responsible for appointing the auditor and setting audit fees.**

### **The Abdel-khalik proposal**

Abdel-khalik believes that the present system is so entrenched in current institutional arrangements that a different system must be devised to allow stockholders to exercise their rights in auditor-related decisions. He

believes that the corporate board of directors must be removed from the process of selecting and compensating external auditors. Instead, **he proposes that shareholders elect a Shareholders' Board of Trustees (SBT) whose sole responsibility is making decisions about external auditors**—about election, retention, and compensation. Abdel-khalik lists the features desirable in such a board.

- The SBT will be selected by shareholders without use of proxies;
- The board of directors will have no role in the choice of the SBT beyond acting as shareholders voting their shares;
- The SBT will have no executive duty other than selecting and deciding the compensation of the auditor;
- The board and the SBT will have no overlapping members;
- The SBT has the power to call for meetings with the auditors and to seek information about the company;
- The board will have no role in selecting or compensating the auditor;
- The auditor is accountable solely to shareholders through the SBT.

The strength of the proposal lies in the fact that the decision to hire an auditing firm to provide assurance about the firm's financial statements is vested in the SBT, while the decision to hire consultants is vested in the board of directors. Therefore, the auditor will be independent both in fact and in appearance. The proposal removes the board of directors from any decision related to the audit function of the external auditor.

In this setting, independence will be maintained even if the management hires the same accounting firm for consulting services because the decision to hire consultants is the responsibility of the board of directors. Furthermore, in this scenario, competition and the market for auditing services will drive the pricing for auditing services.

Another institutional unit can weaken the independence of the auditing firm. Corporate audit committees, like the external auditor, are intended to be responsible to shareholders. To be effective, the committees must maintain a degree of autonomy from the boards of directors. This is

extremely difficult under the present system. As with the choice of auditor, the board, in fact, chooses the members of the audit committee. It is little wonder that these committees generally follow the policies and goals of the board. **The establishment of the SBT, Abdel-khalik says, gives an opportunity to change the way that the corporate audit committee is selected.** He suggests that there are a number of scenarios possible from the SBT alone choosing the audit committee to their just having a say in the committee selection. One scenario that offers good balance would be shared power to appoint, that is, for the board to appoint two members and the SBT to appoint the other two, so that each pair could monitor the others.

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