

ENRON, ANDERSEN, AND THE EXPECTATION GAP: REASONS TO ESTABLISH NEW RELATIONSHIPS FOR AUDITING FIRMS

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Introduction

There is currently a crisis of confidence in the public accounting profession. The problems currently faced by the profession are related to various issues: some of which reflect internal values (or the lack thereof); others reflect perceptions and expectations by the individuals in public accounting and those outside of the field. This paper poses the idea that the current relationships existing between employees within accounting firms as well as between accounting firms and external parties may be important, but less recognized, underlying causes of the profession's problems. Current auditor relationships appear to be internally contradictory and out-of-sync with the demands of the investing public. Various provisions of the Sarbanes-Oxley Act are analyzed for their potential to support development of new relationships more appropriately aligned with professional and public needs as well as positive change in the organizational culture of public accounting.

Auditing Firm Organizational Culture and Psychological Contracts

An organization's culture reflects how managers and employees relate to each other, how decisions are made, and how work is accomplished. Culture helps mold the relationships of employees within the firm and with external parties. Part of a large public accounting firm's culture is derived from organizational training. After being hired, public accounting employees receive a variety of training experiences. Some public accounting training reflects necessary accounting, auditing, tax, and legal updates that not only keeps workers current in their field but also allows them to fulfill mandatory continuing professional education requirements for their practice licenses. Other training helps individuals learn or relearn organizational culture. This type of training helps people gain insight into the values and norms that abound within the firm. Such training can be viewed as organizational socialization.

Organizational statements of culture and values speak simultaneously to two audiences. On one hand, these statements express an image for consumption by the general public; on the other hand, the statements provide a set of "cues" regarding desired employee behaviors. Workers look to organizational culture and values statements to mold the personal behaviors over which the workers have some control.

Employees, given a lack of details about precise job performance, need to develop a rational assessment of the proper pathway to complete the work specified in the employment job description or assigned by a supervisor. This assessment typically results in a psychological

contract (PC) to reflect the relationship(s) between employees and their employers. Rousseau (1989:2) defined the psychological contract as the set of written or unwritten beliefs that an employee has about the terms (obligations and rewards) of his or her employment with the employer. No actual promises need to have been made for a PC to be in place, nor is it necessary that both employee and employer have the same perception of the contract (Niehoff and Paul, 2001). Psychological contracts are *personal* interpretations of what commitments mean; thus, two parties focus on different pieces of information in creating their understanding of their “mutual” contract.

Auditor Psychological Contracts and the Sarbanes-Oxley Act

Many of the companies connected to the wide-spread and financially devastating business scandals that took place during 2001 and the first half of 2002 were Arthur Andersen audit clients. In response to this onslaught of financial tragedies, Congress passed the Sarbanes-Oxley Act (“SOX” or “the Act”) to address accounting reform, improve corporate governance, and restore investor confidence. SOX potentially provides both the legitimacy and mechanisms necessary to support a broad reform in the relationships and psychological contracts that currently exist between and among auditors, auditing firms, the auditing profession, and audited clients.

Four types of relationships support the formation of psychological contracts: (a) individual to individual, (b) individual to overseers, (c) individual to membership group, and (d) individual to society (Rousseau, 1995). All of these relationships exist in the auditor-auditing firm-auditing profession-audit client interface and these relationships are functionally interdependent. Presently, this set of relationships seems to be both internally inconsistent as well as out-of-sync with the demands and expectations of the stakeholders to the audit process. This paper examines the various types of audit relationships and how Sarbanes-Oxley could provide a means by which to reconstruct a new set of relationships and psychological contracts that is more balanced and responsive to public needs.

Individual-to-Individual

Auditors exist in an environment of overlapping and potentially contradictory relationships—one between the individual auditor and his employer (the public accounting firm) via the other members of the firm and a second between the individual auditor and the audit client. The employing firm, using its own selective perceptions, is free to hold the presumption that its auditors operate at all times under independence and objectivity rules relative to audit engagements, and to base its relationship with employees on this presumption. Employees, aware of the rules of professional conduct, are free to interpret those rules within the context of their perceptions about the employing firm’s objectives relative to client engagements. Thus, in developing or adapting psychological contracts with the employer, individual auditors will try to ascertain whether the employing audit firm’s objective is to perform the best audit possible, to retain the audit client company, to increase audit revenues, to reduce audit billable hours, or to detect misleading, inappropriate or fraudulent accounting practices. The reality is that each of these objectives is reasonable—and yet potentially in conflict.

In addition to the situations existing between an individual auditor and the employing auditing firm, an auditor is also a party to an additional relationship with audit client management. This relationship is based on the following simplistic summary of the cooperative association: the client corporation engages in and accounts for transactions that create the

financial statements; auditors examine the financial statements and the underlying data to assess fair presentation based on the guidance provided under accounting rules and standards; the desired result of this process is an unqualified audit opinion for the client. The fewer adjustments that need to be made to the financials and the more quickly (thus, less expensively) the audit can be performed, the more satisfied the audit client is with its chosen auditing firm (and individual employee auditors), the more likely it is that the auditing firm will retain the client and the individual auditors will have continued future employment, and the stronger the auditor-auditing firm-audit client relationship becomes. An auditor may find it difficult to interpret or fit elements of the relationship within priority parameters if the auditing firm is sending mixed messages.

Three provisions of Title II (the independence section) of Sarbanes-Oxley will radically alter the current individual auditor-to-individual auditor relationship. First, the partner in charge of an audit engagement must be rotated every five years. This provision should alter the relationship between the auditor and the audit client. Auditors in the upper-ranks will recognize that there is a “term limit” on their client relationships and therefore potentially have a lessened incentive to agree with potentially inappropriate accounting practices simply to maintain “good” (i.e., friendly, continuing, and profitable) audit client relationships.

A second item in the independence section of the Act states that an auditing firm is barred from doing any audit work for a client if that client has hired, into an executive-level position, a member of the auditing firm who worked on the client's audit within the past year. SOX recognizes that audit firm alumni bring to their new positions substantial knowledge of how the audit engagement is planned and implemented, including details of audit testing that could be used to circumvent the audit process. Thus, this prohibition additionally reduces the incentive to maintain that “good” relationship mentioned previously.

Third, SOX has established that certain non-audit services may no longer be provided by registered public accounting firms to their audit clients. This restriction should dramatically reduce one of the primary internal conflicts existing in the auditor-auditing firm-corporate client relationship. The perceptions of duties, obligations, and promises will change significantly if all parties to the relationship share the view that the auditor is, in fact and appearance, independent to the audit client. It must be clear that audit objectives are to provide the services of determining the fair presentation of the financial statements and to help support the efficiency of the capital markets, not “to keep the client happy” or “to gain additional client fees.”

Auditor-to-Overseer

In the accounting profession, work relationships are subject to interpretation by outside third party overseers who should be able to look past the self-serving biases of the principals and assess the underlying scope of the relationship. Relative to the auditors, auditing firms, and audit client companies, some of the pre-Sarbanes-Oxley overseers included the Public Oversight Board (an independent body funded by members of the SEC Practice Section of the American Institute of CPAs), the Independence Standards Board, the Securities and Exchange Commission, state licensing boards of accountancy, and external peer review teams (supervised by the Quality Review Division of the American Institute of CPAs)—providing a combination of public and professional oversight. Although these overseers are fluent in the language of accounting and would typically be familiar with the implications of audit relationships, the intimacy that these bodies shared with the auditing firms and their members might have been viewed as making the oversight function less than candid—especially in regard to the investing public. In the United States, regardless of the parties engaged in professional relationships, the ultimate overseer is the legal system. But in cases of dispute, the judiciary must rely on

information that is supplied in the highly specialized language of accounting and auditing. Consequently, the capability of the courts to determine the complex meaning of the terms of the contractual relationship may be limited and, as such, the courts could be viewed as poorly suited to the overseer role.

Sarbanes-Oxley created the Public Company Accounting Oversight Board that is designed to be independent from the auditing profession. The PCAOB's function is to oversee public company audits through stringent registration, standard setting, inspection, and disciplinary programs. Given its separateness from the involved parties and its diverse composition, the Board holds promise as a new overseer that can both interpret the meaning of the relationships between auditors, auditing firms, and corporate clients and monitor the behaviors of the parties for conformity to the ideas of independence in fact and appearance. If guided by the spirit (rather than simply the letter) of the law, the PCAOB could become an effective sounding board for the formulation of, and sentry to, new relationships that would be both internally consistent as well as responsive to the demands of the investing public.

Auditor-to-Membership Group

When members of a group or profession have sufficient opportunity for interaction to form common perceptions, a shared (or group) psychological contract emerges among those members. The greater the depth to which the members share a common PC, the more likely it is that such a contract will be relied upon, that the members will reinforce each other's—and new members'—perceptions of that contract's terms, and that there will be social pressure within the group to conform to the PC's elements, thereby institutionalizing the group psychological contract and perceptions.

Much of the current group psychological contract among auditors is based on a high regard for the detailed knowledge of complex and continually updated auditing and accounting rules under which these individuals conduct their professional tasks and exercise their auditing expertise. The knowledge set both empowers and protects auditors in their various contradictory relationships with corporate managers, since managers depend on the auditors' wisdom to ascertain the fairness of the organizational financial statements. The current group contract among auditors builds on the shared value of more, rather than fewer, complex rules in order to institutionalize the status of the profession and to cement the bond among group members.

Should the PCAOB institute significant new pronouncements, the auditing profession could be faced with substantial retraining activities. In such an instance, it would be useful for that training to focus, in addition to specifics on new reporting procedures, on supplying auditors with extensive expertise in ethics, especially the ethical responsibility to the **true** audit client: the investing public. Superior ethical knowledge is what could emerge as an additional bonding force among auditors. A new ethics-based group psychological contract could be developed among auditors and the profession that institutionalizes a norm of both knowing what to do and doing the right thing.

In addition to the knowledge set, another predominant element of the profession's group psychological contract is an abhorrence of the concept of mandatory auditing firm rotation. The primary contention is that mandatory rotation will dramatically reduce audit quality because of the substantial learning curve needed for auditors to become not simply acquainted or conversant with, but accomplished in, the corporation's operating environment, risks, and technical accounting policies and procedures. Even without compulsory rotation, it is presumed that new

hires and the normal attrition of personnel within a given auditing firm should help provide a periodic fresh perspective on the audit engagement.

Arguments defending mandatory audit rotation are as numerous as those against. It is seen as an effective way to eliminate some of the cozy relationships that develop as auditors maintain their client lists over multiple years. Knowing that the successor auditor might readily find the failures of a predecessor auditor might reduce the possibility of overlooking accounting irregularities or signing off on controversial accounting procedures; obviously, a continuing auditor would be less likely than a new auditor to reverse a accounting position taken in a prior year on a client's accounting transactions. There would likely be a boost in the confidence of the investing public—an expectation that auditor independence in appearance may extrapolate to mean higher audit quality.

SOX leaves the possibility of mandatory rotation of auditing firms available as an optional course of action. If mandatory auditor rotation were to be instituted, it would be necessary to include a safeguard to prevent companies from “opinion shopping” among the audit firms. One possibility is to use the tradition of law in which lawyers essentially “draw” a judge for a case—the audit client would never be certain which auditing firm would be the next one chosen. Thus, it would be possible that an audit firm could essentially be both the predecessor and successor auditor. Also, the length of time for the rotation would need to be set long enough that an auditing firm could amass and properly process the cumulative audit knowledge base and expertise about the corporate client that would allow an effective and efficient audit to occur.

One important consequence, good or bad depending on perception, of mandatory rotation is that the process is likely “to draw attention to the limited choice of audit firms available to larger companies” (Evans, 2002)—making corporate clients and the investing public acutely aware of the potential for disaster should additional auditing firms merge or become nonviable. This problem will be especially perverse for companies operating in a niche environment. Additionally, compulsory rotation may have a profound negative impact on whether the small accounting firms that audit countless smaller publicly traded companies would be able to retain clients (Countryman, 2002).

Auditor-to-Society

The audit objective is to provide “reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud” (ASB, 1997). The investing public's concept of an audit's purpose, however, is that auditors search for and discover problematic situations, not just report on the data provided by the audit client. Thus, the psychological contract between the auditor and society is founded on a faulty premise: the expectation gap that exists between what the public believes that auditors do and what auditors and the auditing profession believes they can do, looms large. Regardless of the facts that the majority of audits are performed with care and expertise and that the majority of executives are honest, the lack of public trust in what the auditing profession does is like a cancer that is metastasizing.

A final difficulty with the auditor-to-society psychological contract can be seen in how each defines the term *client*. Auditors and auditing firms would typically point to the entity whose financials are being audited as the client; however, society is more likely to accept the definition that the client is actually “the person or company in its relationship to a lawyer, accountant, etc. engaged to act in its behalf” (McKechnie, 1977). It is essential, therefore, that the psychological contract be revised to reflect and clarify to all concerned the true audit client—

which is **not** the firm whose financial statements are being audited, but rather society and its market participants.

Individual Behavior Needs to Change

The dismemberment of Arthur Andersen LLP created a huge pool of unemployed accountants and auditors. Many of these individuals have already been, and many others hope to be, absorbed by the remaining public accounting firms. Such an infusion of people has created a generalized concern as to whether the ex-partners and staffers will “take their bad habits with them when they move on” (Weber, 2002) and whether the old psychological contracts will be resurrected in new locations.

Some optimism can be gained from the fact that an organizational culture must naturally die with the demise of that organization. However, if one views organizational culture as DNA, it must be noted that when a body dies, fragments of its DNA remain and even if not truly viable, then they are at least identifiable. Moreover, while individual human beings are radically different, one from another, almost 99% of human DNA is identical throughout the species. Thus, a pessimistic consideration must be whether an analogous proportion of similarity exists in the attitudes, values, and beliefs among the individual members of the accounting profession and/or among the other public accounting firms. In other words, although Arthur Andersen LLP and its employees have been used throughout this discussion, it is possible that a similar, catastrophic collapse could have happened at any of the large public accounting firms. This issue requires that the discussion move from the aggregate level of organizational culture to the individual level of worker psychological contracts.

Given that symbols, language, slogans, stories and practices help create an organizational or a professional culture, it is obvious that accountants and the accounting/auditing profession are rich in a tradition of “secret” ways and words, a phenomenon of training and experiences that “outsiders” do not understand. The culture of public accounting firms or the auditing profession is, like all organizational or professional cultures, an aggregate phenomenon. It cannot and will not change until there are fundamental changes in the values and beliefs of the individual members. And it appears that change is absolutely essential given that, even prior to all of the recent difficulties in the auditing profession, the inability of auditing firms to obtain and retain professional personnel was pointed to as being indicative of the declining attractiveness of auditing as a career (POB, 2000: 172)

Changes in organizational culture are, however, incredibly difficult because, given any lengthy period of exposure, the culture has become second nature to the participants. It is essential that the cultural components are inventoried and the gaps between what the culture is and what it should be are identified. One of the most effective ways to adjust culture is to “keep the ritual, change the value,” in which a value is distinguished as “a preference of one end-state over another” (Mallak, 2001). For auditing firms and the auditing profession, this culture change could be a pervasive one that retains the current rituals which underlie audit performance through good faith, trustworthiness, independence, and professionalism but changes the value that has apparently preferred client retention to public information dissemination. Culture is, to a point, an underlying source for the problems in the auditing profession—but the culture troubles have likely been precipitated by the psychological contracts that pervade the auditing world.

Conclusion

Regardless of organizational statements about core values, the beliefs of individual auditors are best viewed through the psychological contracts that have evolved between auditors and employers or corporate management, auditors and overseers, auditors and the profession, and auditors and society at large. This discussion has examined the current set of auditor relationships and psychological contracts and has found them to be internally contradictory and incompatible with the needs and demands of the investing public. Each of the relationships needs to be reformulated if the accounting profession is to emerge from its current state of dishonor. Without such fundamental change in professional values and beliefs, mobile auditors when moving from firm to firm will, deliberately or not, carry with them some or all of the dysfunctional behaviors that have already proven fatal to Arthur Andersen.

Similar to organizational cultures, psychological contracts (because they provide vital psychological affirmation and predictability to their adherents) are extremely resistant to change. The perceived forces for and benefits of change must exceed the expected costs of changing and the perceived benefits of the status quo. Such a revisualization is not normally apparent or available to those whose perceptions have created, or reinforced, the current situation. It takes an outside force to influence change in something so fundamental as one's professional values and beliefs.

For better or worse, the Sarbanes-Oxley Act provides such an outside force. This Act, in and of itself, should be viewed as a positive step in the revision of current psychological contracts because it paves the way for an important refocus on the actual client served by the audit process—a focus that turns away from the corporation and towards the investing public. The various provisions of the Act mandating independence, accountability, and transparency in the audit function create new realities that effectively invalidate many of the auditing profession's current relationships and psychological contracts. A recognition of the true audit client means that the auditor's role will be reassessed: the auditor and the audit firm do *not* work for the corporation that pays the audit fee but, instead, are hired to provide evaluation and judgment of financial statements to the external stakeholders. A new and much healthier set of relationships and psychological contracts can then be developed that support investor interests rather than personal relationships between auditor and auditee company. Such an objective will likely result in the audited firm needing to exhibit a higher degree of financial statement transparency to obtain the desired unqualified audit report and could even result in the disclosure of problems that the client company would prefer not to have exposed.

The challenge is to provide a motivational force within the individuals comprising the profession to develop new relationships and psychological contracts that build on the values expressed in the Act. If this challenge is seized aggressively, the benefits to the accounting profession, and the society at large, are potentially enormous. Dominant “corporate interests on Wall Street and in the accounting profession ... continue, both directly and through the help of well-placed allies in Congress, to exert enormous pressure on the rule-making process” (Labaton, 2002). These influences can generate both positive and negative impacts on the relationships within the auditing profession. It will be necessary to fully integrate both the letter *and* the spirit of Sarbanes-Oxley with new and appropriate relationships psychological contracts reflecting the norms of fair dealing, good faith, trust and professionalism throughout the audit profession to generate

- a radical reduction of conflicts of interest between auditors and corporate managers;

- placement of functions and accountabilities where they logically and ethically belong;
- provision of incentives for corporations to proactively eliminate questionable accounting practices or poor internal control systems;
- promotion of economic recovery by increasing investor information and confidence;
- restoration of the legitimacy of and trust in the audit profession in the eyes of the public; and
- support for healthy organizational cultures to emerge and sustain the “Final Four” public accounting firms.

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