APPENDIX 1B

BRIEF HISTORY OF AUDITING

LEARNING OBJECTIVE

9 Chronicle the historical development of auditing standards, including the criticisms of the profession and its responses.

Auditors have been around for a long time. As long as there has been civilization, there has been a need for some type of record-keeping to implement accountability. In fact, it was the need to keep records of ownership of quantities of goods that led to the development of writing and arithmetic. The first number systems and the first written words were developed as symbols to keep track of merchandise either collected as taxes or used in trade. It was centuries later that literature and mathematics evolved separately, far removed from this initial accountability application. For example, the first proto-Greek written script, Linear B, was essentially developed for keeping records of business transactions and palace inventories in Mycenaean Greece in 1400–1300 B.C. It was only in 800–700 B.C. that a further evolved writing system was used to record some of the earliest works of Western literature, the *Iliad* and the *Odyssey*. By then in Greece writing had evolved to the point of recording outstanding deeds and social events and not just commercial transactions. Similarly, accounting and measuring evolved into more abstract mathematics. This pattern of the gradual evolution of writing had been seen in many even earlier civilizations, starting with the Sumerians (3000 B.C.), the Egyptians (2500 B.C.), the first Indus River civilization (2500 B.C.) and the start of the Xia dynasty in China (2300 B.C.).

Auditing accompanied the development of accounting, and the first recorded auditors were the spies of King Darius of ancient Persia (522 to 486 B.C.). These auditors acted as "the King's ears" checking on the behaviour of provincial satraps. The word *auditor* comes from the Latin word "to hear" because in ancient times auditors listened to the oral reports of responsible officials (stewards) to owners or those having authority, and confirmed the accuracy of the reports. Over the centuries this role of auditors as verifiers of official reports evolved to include that of verifying written records. By 1500 A.D. double-entry bookkeeping had evolved to the point of being documented by Luca Pacioli of Italy in the first known book on accounting. Pacioli also recommended that the accounting records be verified by auditors. By the early 19th century auditors acting as independent outside experts were frequently called upon to investigate and report on business failures or to settle business disputes. Independence is a key characteristic of the auditor which we will discuss in some detail throughout this book. For now think of it as conditions necessary to obtain an objective appraisal of the subject matter at issue. If the auditor showed any bias in his or her investigation, or even if there was merely the suspicion of bias, the effectiveness of the auditor's report would be greatly reduced.

Modern auditing began in 1844 when the British Parliament passed the Joint Stock Companies Act, which for the first time required that corporate directors report to shareholders via an audited financial statement, the balance sheet. In 1844 the auditor was required to be neither an accountant nor independent, but in 1900 a new Companies Act was passed that required an independent auditor.

The first public accountants' organization was the Society of Accountants in Edinburgh, organized in 1854, and Scotland and England became the leaders in establishing the modern accounting profession. As a result of the British lead, the first North American association of accountants, later to become the Institute of Chartered Accountants of Ontario, was organized in 1879 in Toronto. The Quebec Order became the first legally incorporated accounting association in North America in 1880. The Canadian Institute of Chartered Accountants (CICA) began under federal incorporation laws in 1902. And the Certified General Accountants Association of Canada was incorporated by an Act of Parliament in 1913.

Following British precedents, the first legislation requiring audits in Canada was the Ontario Corporations Act of 1907. This was followed by the Federal Corporation Act of 1917. Until 1930 Canadian practice followed the British model, focusing on the procedures that were followed to process a transaction (transaction oriented); these procedures largely relied on internal evidence.

After the 1929 stock market crash and the Great Depression of the 1930s, Canadian practice was increasingly influenced by developments in the United States. U.S. practice had evolved since the late 19th century towards a process of collecting evidence as to assets and liabilities or what is frequently referred to as a balance sheet audit. As a result of extensive misleading financial reporting that contributed to the stock market crash of 1929 and the world depression of the 1930s, the U.S. passed legislation in 1933 and 1934 that greatly influenced auditing around the world. The U.S. Securities Acts of 1933 and 1934 created the Securities and Exchange Commission (SEC), which regulated the major stock exchanges in the United States. Companies wishing to trade shares on the New York Stock Exchange or the American Stock Exchange were required to issue audited income statements as well as balance sheets. In addition, because of the earlier problems with misleading financial reports of the 1920s, the emphasis switched to fairness of presentation of these financial statements, and the auditor's role was to verify the fairness of presentation.

In 1941, as a result of experience in the McKesson and Robbin's fraud case (discussed in Chapter 5), the SEC recommended references to "generally accepted audit standards (GAAS)" in the auditor's report and mandated more extensive reliance on external evidence. This created a need to better define audit standards and objectives. This process was begun in 1948 by the American Institute of Certified Public Accountants (AICPA).

U.S. Auditing

In the United States the early formal development of accounting and auditing were mixed together. Working with the Federal Trade Commission, the Federal Reserve Board and the New York Stock Exchange, the American Institute of Accountants (later renamed the American Institute of Certified Public Accountants) produced these bulletins designed to systematize accounting and auditing:

1917— Federal Reserve Board, "Uniform Accounting: A Tentative Proposal Submitted by the Federal Reserve Board."

1918— Federal Reserve Board, "Approved Methods for the Preparation of Balance Sheet Statements."

1929— Federal Reserve Board, "Verification of Financial Statements."

1934— New York Stock Exchange, "Audits of Corporate Accounts."

1936— American Institute of Accountants, "Examination of Financial Statements by Independent Public Accountants."

These first 20 years were marked by interest in both accounting and auditing and by cooperation between the American Institute and government agencies. In 1939 the American Institute went its own way by creating the Committee on Auditing Procedure to deal exclusively with auditing matters. This committee launched the Statements on Auditing Procedure series, the first of which (1939) was titled "Extensions of Auditing Procedure."

Generally accepted auditing standards, however, were not known by that name until 1947. Following an investigation of the McKesson and Robbins fraud in the late 1930s and the auditors' failure to detect it, the Securities and Exchange Commission in the United States passed a rule requiring auditors to report that their audits were "in accordance with generally accepted auditing standards." The Committee on Auditing Procedure got busy (after being delayed by World War II) and published in 1947 the "Tentative Statements of Auditing Standards—Their Generally Accepted Significance and Scope."

Standard-setting for auditors has been the responsibility of the American Institute ever since, although the names have changed. In 1972 the AICPA Auditing Standards Executive Committee replaced the Committee on Auditing Procedure, and the series of auditing pronouncements was renamed *Statements on Auditing Standards*. Following an extensive study by the Commission on Auditors' Responsibilities (Cohen Commission), the committee's name was changed to the AICPA Auditing Standards Board (1978), which remains the AICPA's senior technical committee on auditing matters. (The name of the series,

Statements on Auditing Standards (SAS), was not changed.) The Cohen Commission was formed at a time when auditors were coming under criticism from the U.S. Congress. In the early 1970s several spectacular business failures and alleged audit failures drew the attention of senators and representatives, and they proposed a federal takeover of the regulation of accounting and auditing. Accountants abhor federal regulation, and the Cohen Commission report paved the way for several reforms that defused the congressional concerns, including the creation of the AICPA private companies practice section and the SEC practice section. These were replaced by the *Sarbanes-Oxley Act* (SOX) oversight system in 2003.

These developments in the United States greatly influenced Canadian auditing as well as auditing in the rest of the world. For example, in 1946 the CICA began its own standards for financial statement disclosure in Bulletin #1. A series of bulletins were issued over the next 20 years covering accounting and auditing matters. In 1968 these bulletins were reorganized into a single volume called the *CICA Handbook*. Revisions and additions to the *Handbook* have been made with such regularity since then that in the 1990s the *Handbook* was split into two volumes, one containing the accounting recommendations (Sections 1000 to 5000), and another covering the assurance and related services recommendations (Sections 5000 and higher) for both the private and public sectors.

An important development of standard setting in Canada was the adoption of Bulletins of the CICA in the Ontario (1953) and Federal Corporation Acts. In 1965 the Ontario Securities Act gave the Ontario Securities Commission (OSC) responsibility to regulate the Toronto Stock Exchange, Canada's largest. In 1972 an OSC Policy Statement mandated the use of the *CICA Handbook* to determine generally accepted accounting principles (GAAP). These requirements were soon incorporated in the *Ontario Securities Act* of 1978 and the *Canadian Business Corporation Act* of 1975. As a result of these developments, the status of *Handbook Recommendations* carries the force of law in Canadian reporting.

In contrast, the accounting and auditing standards developed by the American Institute of Certified Public Accountants (AICPA) and the Financial Accounting Standards Board (FASB) do not have comparable legal status in the United States. There, the SEC has the legal authority to set accounting standards for all the U.S. stock exchanges; however, the SEC had for the most part delegated this authority to the FASB and the AICPA.

The failure of two Alberta banks in the first half of the 1980s and the resultant enquiry by the Estey Commission in 1985 raised questions about the effectiveness of audit and accounting standards in Canada. In response, the CICA helped organize the Macdonald Commission, which enquired into the public accounting profession. The commission's report came out in 1988 with 50 recommendations for improving accounting and auditing practice to help reduce a perceived "expectations gap" between what the public expects of auditors and what auditors can deliver. As a result of these recommendations the CICA

THOUGHTS FROM "THE ACCOUNTING ESTABLISHMENT" (The Cohen Commission)

Selected Recommendations

Congress should exercise stronger oversight of accounting practices and more leadership in establishing proper goals and practices.

Congress should amend the Federal securities laws to restore the right of individuals to sue independent auditors for negligence.

Congress should consider methods of increasing competition among accounting firms for selection as independent auditors.

The Federal Government should directly establish financial accounting standards for publicly-owned corporations.

The Federal Government should establish auditing standards used by independent auditors.

Federal standards of conduct for auditors should prohibit representation of client interests and management advisory services for audit clients.

The Federal Government should define the responsibilities of independent auditors so that they clearly meet the expectations of Congress, the public, and courts of law.

Source: Staff Study by the Subcommittee on Reports, Accounting, and Management of the Senate Committee on Government Operations, 95th Congress, Document No. 95-34, March 31, 1977.

attempted to reduce the gap through promulgation of new standards related to the auditor's report, auditor responsibility for detecting fraud and documentation of internal control evaluations. These recommendations are covered in the relevant chapters throughout this text.

Similar expectations gap standards were developed in the United States as a result of business and audit failures there, especially with respect to the savings and loan industry. A fundamental difference between the U.S. and Canadian environments, however, is the extent of government involvement in monitoring the profession. In the U.S. there have been several congressional investigations in the last three decades, with pressure being exerted through the Securities and Exchange Commission, which acts as a regulator of the profession. In Canada, on the other hand, the government and regulators have for the most part relied on the CICA standard-setting process to address public concerns. However, Enron started a chain of events that has changed the dynamics of regulatory oversight of the profession everywhere.

The Post-Enron World and Its Effects on Auditing

As noted in the chapter many corporate scandals came to light in 2002. The levels of management compensation have been of particular concern. A common problem is management severance contracts worth tens of millions of dollars regardless of the reasons for dismissal, even in the face of criminal activity leading to bankruptcy of the firm. Even highly respected business leaders have been criticized for the size of their compensation. In September 2002, New York Reserve President William McDonough opined that executive salaries are hard to justify. He noted that corporate management earnings are now 400 times the average worker salary, whereas 20 years ago it was 40 times. Has America's management performance really improved that much in 20 years? Should accounting and auditing have some role to play in dealing with these increasingly important accountability issues? Where were the auditors in these companies? These are the questions everyone is asking about the profession in the post-Enron world.

This dramatic shift in attitudes towards auditors and corporate governance in general can be assigned to a specific watershed event—the bankruptcy of the energy company called Enron in December 2, 2001. The changes since then have been so substantial that the term post-Enron world is used to signify the completely altered corporate landscape that has developed since then. One of the reasons Enron had such a shock effect was that it was considered a "new economy" company that pointed the way to the rest of the energy industry as it headed into the new century. Enron was the "poster child" of the new economy company. It had been considered a highly innovative energy company, branching out into exotic areas of financial engineering related to energy usage such as weather derivatives. Some of these innovations were successful and have continued. But the majority appeared to have had little more substance than manipulating energy prices (as in California) or shell games with related parties, which deceitfully hid liabilities and losses by speculating on the direction of energy prices. Rather than an innovative energy company or new age hedge fund, Enron turned out to be more like a classic **Ponzi scheme**, relying, through deceptive promotions, on attracting ever more investors so the price of the company's shares would continue to be bid up.

The aspect of Enron that appeared to enrage the public most was that lower-level employees and others were strongly encouraged, even forced, to invest their retirement savings in Enron stock while top management were selling their shares based on insider knowledge of the disastrous real state of affairs. Total losses to shareholders amounted to over $60 billion (U.S.) and more than 6,000 Enron employees lost their jobs along with their retirement savings. As a result of Enron's bankruptcy, numerous lawsuits have been filed by the shareholders and creditors against Enron's management, its board of directors, its auditors (Arthur Andersen), and numerous financial institutions including America's biggest banks, which were suspected of arranging the sham transactions. In addition to the SEC, various state regulators have launched investigative probes against these same institutions.

Another casualty of Enron has been the accounting profession itself. Of course, the most immediate impact fell on Arthur Andersen, one of the Big Five accounting firms at the time. Right after Enron's bankruptcy, questions were raised about the effectiveness of its auditors, Arthur Andersen, because there was no official indication of serious problems at Enron until mid-October 2001, when it had to restate previously reported earnings. (Another characteristic of the post-Enron world is the number of such restatements skyrocketing across North America). Joe Berardino, managing partner of Arthur Andersen, tried to explain the apparent audit failure by attributing the problems to the vagueness of accounting standards and the complexity of Enron's financial statements. This explanation might have been more plausible if Andersen had not been involved in designing these very same transactions as part of their consulting work for Enron. The real problem seems to have been that Arthur Andersen lacked objectivity because it was auditing its own work.

The accounting profession and the public were shocked by revelations in January 2002 that Andersen was engaged in shredding many of its Enron audit documents. This began soon after the SEC announced its investigation of Enron accounting in October 2001, right after the first announcement of its restatements. Early in January 2002, the shredding practice was made public and on January 15, 2002, the partner-in-charge of the Enron audit, David Duncan, was fired by Arthur Andersen. He was later found guilty of obstruction of justice and testified against his former firm. On June 15, 2002, Arthur Andersen itself was convicted of obstruction of justice because of what the jury felt was a systematic effort within the firm to destroy relevant evidence about the true condition of Enron.

This conviction of a prominent auditing firm and its subsequent demise was unprecedented. The entire profession was tarnished by this fiasco involving one of its most reputable firms.

Even though Arthur Andersen's conviction was overturned by the U.S. Supreme Court in 2005 it had been largely destroyed as an auditing firm. Its clients left, concerned that they would be tainted by Arthur Andersen's shattered reputation. In a matter of months Arthur Andersen was reduced to a shell of its former self. A firm that at the beginning of 2002 employed 85,000 people worldwide and with a reputation for high integrity and excellence built over 89 years was essentially destroyed by the time of its sentencing on October 26, 2002. Now there are only the "Big Four" accounting firms and these "Final Four" are now struggling to redefine their roles in the post-Enron world.

Unfortunately, it was not only Enron that reshaped the auditing world. Enron was the seventh largest firm in the U.S. when it went bankrupt, at the time the biggest bankruptcy ever. But it was soon followed by another, even bigger bankruptcy—that of WorldCom on June 25, 2002. WorldCom had been the backbone of the Internet, carrying about half of all Internet traffic, and was America's fifth largest firm. Total estimated losses to shareholders were $180 billion and 17,000 employees lost their jobs. Arthur Andersen was WorldCom's auditor as well.

Enron and WorldCom were not Arthur Andersen's only problem audits. Throughout 2002, every week seemed to reveal a new corporate scandal involving deceit in audited financial reporting. Although Arthur Andersen was not the only one involved, it accounted for a disproportionate number of these companies, including Global Crossing, Waste Management, Sunbeam, and the Baptist Foundation of North America (the largest non-profit bankruptcy ever—$570 million in losses).

The Andersen fiasco brought into prominence the issue of whether the accounting profession was properly regulated. The issue of the extent of self-regulation is part of a larger one dealing with the extent of government involvement in the marketplace, including its regulation of accounting services. Under the activist leadership of former SEC chief Arthur Levitt, from 1993 to 2001, the SEC attempted to increase government regulation through rules to enhance the independence of auditors and the standard-setting process. Levitt felt that increased revenues from their consulting services compromised auditor independence—a contention strongly denied by the profession. The profession resisted Levitt's attempts to reduce consulting services. It lobbied the U.S. Congress to restrain the reform efforts of

Levitt's SEC. These lobbying efforts were overwhelmed by post-Enron events, however, and most of Levitt's initiatives have now been incorporated in SOX.

The accounting profession is also being affected by wider efforts to rein in American corporations. Besides the regulators and new legislation, some ambitious, politically minded government officials in the U.S. are also having a strong influence on American capitalism. Most notably, New York Attorney General Elliot Spitzer has, since Enron, aggressively made use of an 80-year-old state law (Martin Act) that gives him authority to investigate and prosecute fraud without proving intent. The *Martin Act* was the model for the U.S. federal laws that led to the creation of the SEC in the 1930s.

Spitzer used the *Martin Act* to investigate the conflicts of interest inherent in Wall Street banking practices. On April 28, 2003 he announced a settlement with Wall Street's largest banking firms in which they agreed to pay a record $1.4 billion in fines. The fines were to settle charges that the bank's research arms (analysts) made fraudulent buy recommendations in order to support the bank's underwriting businesses. In May 2002, Merrill Lynch was fined $100 million for misleading investors with overly optimistic stock tips.

"Self-regulation has been an abysmal failure," said Mr. Spitzer. "It has not done anything to protect investors."[7]

If this kind of thinking becomes more widespread, increased government regulation in corporate affairs seems inevitable. And self-regulation of professional groups involved in corporate accountability is thus becoming more problematic. Even market forces seem to be suggesting this. Before SOX the number of accounting firms had been reduced from the "Big Eight" to the Final Four in about two decades. If this trend continues, we could end up with a monopolistic dominance by one firm at some point in the near future. If so, the government would be heavily involved in regulating accounting, possibly taking over the audit function entirely. This is not as radical a change as it might have seemed pre-Enron because about a third of the economy is already audited by public sector auditors such as provincial auditors and the Auditor General of Canada. Interestingly, public sector auditors have a much better media reputation than private sector auditors, especially since the events post-Enron.

One good aspect of the media attention is that never before have accounting and auditing issues been given such widespread public scrutiny. Suddenly everyone seemed to find accounting and auditing of critical importance to the markets and society. It is thus probably more a question of when, rather than if, there is more government regulation. Much depends on the future course of the economy. If we return to the prosperity of the1990s, the current round of business and accounting failures will have less effect on regulation than if business conditions were to worsen, resulting in more Enrons and WorldComs.

In light of this background, what may we conclude? First, it should be recognized that self-regulation is increasingly being viewed as a failure. This is probably because of market failure—audit services have too much of a "public good" attribute, so as auditing becomes more valuable to society, it can expect to get more regulated. This is discussed further in Appendix 1C.

The first major regulation of the profession occurred with the passage of the SEC Acts in the 1930s. SOX is an extension of this process. But SOX had been anticipated by Arthur Levitt for several years before the fall of Enron. Levitt was in the vanguard trying to improve auditor independence by limiting the amount of non-audit services that could be provided by the auditing firms. Levitt realized early on that any initiative to improve the profession would not be fully effective if auditors had conflicts of interest in fulfilling these expectations with other services provided to the client. This was a primary concern of SEC chair Arthur Levitt throughout the 1990s as revenues from consulting services climbed while those from audit services declined. Although Levitt made little progress, due to strong lobbying efforts by the accounting profession, his concerns were vindicated when Enron and Arthur Andersen imploded. By the end of his term in early 2001, he had been able to limit

[7] Boroff, Philip, "Could have nailed Merrill Lynch for fraud, Spitzer says: Attorney General stopped short of indictment to reform Wall Street." *Financial Post*, Sept. 26, 2002. FP11.

only certain kinds of consulting services, but he did manage to require that consulting service fees be disclosed. The disclosures for the year 2000 showed that public U.S. companies paid their auditors three times more for non-audit services than for audit services. This revelation shocked many investors and several initiatives were begun to develop standards of independence for the profession. However, these initiatives were overwhelmed by events after Enron. Until Enron, the profession had claimed that there was little evidence that audit independence was being impaired. After Enron, WorldCom, and the signing of SOX by President Bush on July 30, 2002, many forms of consulting are now banned for audit clients. In addition, SOX created the new accounting oversight board, PCAOB, in place of the AICPA's pre-existing board. SOX now bans certain types of consulting and tax services to audit clients. These restrictions are discussed later in this book. More regulations will likely be passed by the SEC and PCAOB. The passage of SOX, however, meant that previous self-regulatory mechanisms were superseded by the new Public Company Accounting Oversight Board (PCAOB). Among this Board's many duties is regular inspection and disciplining of registered public accounting firms. Registered accounting firms must comply with auditing, ethics, and related practice quality control standards designated by the Board, and must submit to quality control inspection by the Board. Whether the Board will go as far as all the recommendations listed by the Cohen Commission remains to be seen.

So, the issue seems to be more a matter of not whether but how quickly the profession will be regulated. As noted earlier, much depends on the future state of the economy: a return to prosperity will slow the pace of regulatory change. Another important factor is the activism of regulatory officials—for example, Arthur Levitt and Elliot Spitzer can be viewed as activist regulators. If capital markets continue to falter then the reform process will gather further momentum. In particular, the way SOX is interpreted and implemented will reflect the extent of activism.

This possibility of further activism has thrown the accounting profession into further turmoil because of increased uncertainty about the future role of the U.S.'s PCAOB. It has been a time of dramatic change for the profession. In less than a year after Enron's bankruptcy filing, the managing partners of all the remaining firms retired and younger partners were moved up because of the drastically changed audit environment. For example, the SEC has been questioning the accounting at more than half of the Fortune 500 companies since the Enron fiasco. The auditors are also called into these discussions to justify financial statements they audited. The number of resulting restatements is at unprecedented levels (250 restatements of corporate earnings, representing 3 percent of listed companies in 2002 versus 92 in 1997 versus 3 in 1982). On January 29, 2003, the SEC filed a civil fraud complaint against one of the Big Four firms for allowing Xerox to inflate its revenues by $3 billion between 1997 and 2000. All the Big Four firms are being sued by client executives and U.S. tax authorities for mass marketing questionable tax shelters to their corporate client executives. This has raised questions about what kind of future accounting firms have.[8] The "accountants" this *Fortune* article discusses are those from the pre-Enron world. We know from our review of the history of accounting that accounting and civilization go together. The real issue introduced in this Appendix is to what extent accountants need to be regulated, especially with respect to the mix of services they should be allowed to provide.

REVIEW CHECKPOINTS

1.38 What single event can be said to have prompted the development of generally accepted auditing standards?

1.39 Identify the major changes to the auditing profession since 1945.

1.40 Summarize the effects of SOX on the audit profession.

[8] Kahn, J., "Do Accountants Have a Future?," *Fortune,* March 10, 2003, p. 115.