GET OVER IT

***Alex Blyth** looks at the longer-term repercussions facing the world of corporate reporting in the year ahead following the apocalypse that was Enron*

On 16 October 2001 Enron produced figures that revealed glaring accounting malpractices. This admission and similar scandals right across the spectrum of US business had huge repercussions for the world's stock markets and accountancy industries. The common factor in many of these auditing scandals was Arthur Andersen. In 2001 the 100-year old Arthur Andersen turned over $9bn and held a reputation for outstanding auditing integrity and competence. By the end of 2002 it had been barred from auditing in the US, had sold off almost all of its international operations to competitors, and had reduced its workforce from 85,000 to less than 3,000. The collapse was staggering and the implications for the UK accountancy industry were felt throughout 2002. While the remaining Big Four firms have dealt with many of the issues resulting from these seismic events, they have yet to confront the longer-term repercussions.

Final impact

It is difficult to gauge the true impact of the Enron and Andersen revelations. From the beginning of December 2001 to the beginning of December 2002 the FTSE 100 fell from around the 5200 mark to 3900. Almost every UK share index fell by a similar 25%. In the same way, Ernst & Young's growth slowed from 15% in the year to June 2001 to just 4% in the year to June 2002. However, the accountancy profession is quick to point out that not all of this can be attributed to post-Enron fall-out. Nick Land, Ernst & Young's UK chairman argues that: 'Although we are seeing a reduction in the award by corporates of non-audit services to auditors, there is no pattern to client drop-off, and this is all occurring within the context of an overall market downturn. Industries other than accountancy have been affected, and the concerns are as much about genuine revenue fall off as they are about issues of corporate governance.'

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There has been a sense that accounting malpractice is an issue for the US and that 'it couldn't happen here'. The Dow Jones Industrial Average has also lost around 25% of its value in the past year, indicating a global slowdown unrelated to the Enron and Andersen scandals. Indeed, those scandals have been mostly confined to the US, a fact many see as proof that the UK dealt successfully with issues of corporate governance in the wake of the Maxwell and Polly Peck scandals of the late 1980s. In the same way, the impact has been varied across different industries, as Nick von Schirnding, investor relations manager at AngloAmerican describes: 'Our products are physical commodities and our assets are extremely tangible. As a result we've been less affected than others. We have complete faith in our auditors, Deloitte & Touche. There have been no questions on the subject from investors, and we are confident that it simply isn't an issue for us.'

However, other finance departments have been less fortunate, spending the greater part of 2002 battling to maintain investor confidence in their businesses and their accounting procedures. To take just one example, Centrica was forced to issue a press statement on July 16th saying: 'The Board of Directors of Centrica plc has noted recent market speculation and dismisses any such speculation as being without foundation. The Board is confident that Centrica's accounting policies and their application together with its financial and risk management controls are entirely appropriate for its business.' This statement and the subsequent interim results halted a six-month slide in the share price from around 230p to 160p. The slide was halted, but has yet to be reversed. This struggle to maintain confidence amidst ongoing rumours of accounting malpractice is a story that will be familiar to many finance departments, and it is a struggle that has translated into a series of major challenges to the UK accountancy industry.

The first and most obvious challenge has

New rules?

2003 will see the publication of a raft of reports and reviews, each providing a new challenge for the industry:

The Higgs report, covered in the news section from p7, will focus on the role of non-executive Directors and is likely to form the backbone of the government's attempts to strengthen UK corporate governance. Questions persist over not only the likely effectiveness of NEDs on audit committees, but also their willingness to take on such an enhanced role.

The Accountancy Foundation review is due at the end of January. It has been considering the simplification of existing regulation, the balance between self-regulation and independent regulation, and the need for more non-accountancy professionals as regulators of the industry

The company law bill is at consultation stage and likely to come before Parliament in 2004. It proposes the most far-reaching reform of UK company law for decades, and includes a statutory requirement for companies with turnovers exceeding £5m to produce social/environmental reports.

Also in consultation throughout 2003 will be the FSA's review of listing rules. Under consideration here is the issue of compulsory audit firm rotation.

Finally, the government has not ruled out a competition investigation of the Big Four.

been dealing with a year of negative media coverage. For Roger Hughes, managing partner for Markets at PwC, this has been the most crucial aspect: 'In the initial media hysteria there was a lot of reporting done from a position of ignorance about auditing. The initial assumption was that non-audit fees was the story and the crux of the matter. We've had to do a lot of work to educate commentators. In the industry we all know that separating audit work from other functions would be highly damaging not only to firms such as PwC but to the public interest. Modern audits are highly complex and often you need to have non-audit specialists on hand. Much of the media initially failed to consider this implication of separating audit from non-audit functions. Over time we have been able to educate the media and by extension the public at large. That they are now much more aware of auditing issues can only be a good thing for the long term health of the industry.'

The industry has had to deal with questions not only from the media but also from its clients, as Tony Jones, finance director at Camelot, describes: 'The collapse of Enron, Tyco, and so on was a wake up call to corporate Britain. It has affected every company on some level. Many finance directors I know have conducted thorough reviews of their corporate governance procedures to ensure protection from high-level fraud. Without doubt, accountancy firms have been a key part of those reviews.' Although not a listed company, Camelot have clear incentives to produce transparent and accurate reports and so have taken these issues as seriously as anyone else. 'The board's main area of discussion has been our relationship with PwC. Among many issues, we have considered partner rotation suggestions and looked at whether or not PwC have enough opportunities to meet our independent directors. We have made no significant changes as a result of these discussions, but are entirely comfortable with our arrangements.' Most UK boardrooms have witnessed a similar process of concern and review followed by the conclusion that there is little need for action. As Michael Hughes, UK chairman of assurance at KPMG, puts it: 'The UK accountancy profession has not been diminished in the eyes of those who understand business.'

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This confidence has not prevented them from searching self-examination Michael Hughes describes how KPMG have worked to ensure the continuing quality of their audit work: 'Zero Audit Failure is our global mantra, and has been restated clearly as the number one job of all our partners. We have run a number of internal quality initiatives, and there have been a number of training sessions on the agenda that may not have been there before Enron.' Despite initiatives of this sort Nick Land argues that the UK accountancy industry is by and large comfortable with itself: 'In the wake of Andersen we would have been foolish not to have looked at ourselves and considered whether something similar could happen to us. We've done this and may make a few minor tweaks, but overall we are confident that there is no need for wholesale changes to our modus operandi.'

Sherron Watkins, Enron whistleblower extraordinaire

Legislative and regulatory changes

While the media can be educated and clients reassured, government and regulatory bodies are often a great deal harder to influence. The UK government took these issues very seriously, with Patricia Hewitt telling the Commons in July 2002: 'The world's capital markets rely on timely,

true and fair financial reporting, underpinned by high standards of auditing and accounting. But we have all been shocked by the major corporate failures we have seen in the US at Enron and WorldCom. It is incumbent on government to be vigilant and take the necessary action where required.' However, the interim Hewitt report is hardly a radical agenda for change. There will be a five, rather than seven, year rotation of lead audit partners, and a two-year cooling off period before an auditor can move to a client. The Financial Reporting and Review Panel is to be encouraged to be more proactive, and the Foundation is to have its first review brought forward, considering appointing a higher proportion of non-accountancy personnel to its panel. There is likely to be a tightening of the non-audit services that can be provided by an auditor, but most reforms will focus on enhancing the role of non-executive directors. Crucially, Hewitt's report managed to sidestep the controversial decision on the issue of audit firm rotation.

The accountancy industry has been impressed by the government's response. 'On the whole, the proposed reforms are all good, sensible stuff, says Land. However the tone is very different when it comes to the response from US legislators. Roger Hughes believes that: 'The Sarbane-Oxley report, signed into US law in July 2002, is potentially very dangerous. Whilst European governments have taken a considered and reasonable approach, the US government rushed out this report for political reasons. There are parts that won't translate to Europe and others that could be highly damaging to the quality of auditing services. For instance, we are happy to accept the UK government's proposal to rotate lead audit partners every five years, but to rotate all partners every five years would be disastrous, mainly because it can take up to four years to understand the complexities of a company's audit process.' Whilst the initial storm has been weathered by the industry, it is becoming clear that over the longer term there is much work to be done to ensure that legislation remains considered and effective.

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Threats from other industries

Perhaps the greatest threat to the industry lies in changes to analysts' perceptions of company reports. Investors in companies such as Enron, and WorldCom lost vast amounts of money. Whilst they may not question the integrity of the remaining Big Four, they may come to question whether or not traditional financial reports are the best way to assess a company's true worth. Land agrees that this may become a problem: 'When you reduce an industry from five main players to four this is bound to shake it up a little. When you do this in the context of a storm of speculation about the integrity of the industry as a whole it is very likely that it will give external competitors some opportunities at the edges.'

The first of these seems to be in the rise of social and environmental reporting. Since the mid-1990s an increasing number of companies have been attempting to portray themselves as ethical and responsible members of society. Initially in response to consumer pressure and branding success stories such as the Body Shop, this has gathered momentum in the past twelve months as several major investment bodies including the Association of British Insurers and the National Association of Pension Funds have announced that they expect to see social reports from the companies in which they invest. As a result, according to recent research by ERM, 79 out of the FTSE100 companies now produce social reports either as part of, or alongside, existing financial reports.

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Often companies will fill these reports with unaudited findings from research agencies, leading some commentators, such as David Barr, Director-General of the Market Research Society, to believe that auditors are becoming less essential for corporate reporting: 'These reports provide crucial information for analysts. They give analysts a full-rounded picture of a company, covering more than just financial information, and enable them to gauge the true worth of a company. Since the Enron and Andersen scandals, market research agencies are finding that they have a growing role in the compilation of these reports. Auditors are now perhaps less trusted than market researchers.'

In the same way, credit ratings agencies claim to provide analysts with alternative data. Alan Banks, chief executive of CoreRatings argues that: 'Credit ratings agencies and auditors have co-existed for a long time and it is likely that there will continue to be a place for both. However, Enron and Andersen have made people considerably more interested in credit ratings than was previously the case. We look simply at issues of financial risk and, unlike auditors, have no conflicts of interest. We can be useful to investors because we provide them with information that auditors aren't compelled to cover. During 2002 an increasing number of investors have begun to give credit ratings greater consideration, perhaps at the expense of company reports. We see this as a trend that is likely to continue.'

Although, in the longer term auditors may find themselves losing revenue to producers of newer forms of reporting, there seems little evidence that this poses an immediate threat. These dangers of legislative change and external competition still loom large in the minds of those at the top of the UK accounting profession and the impact of Enron and Andersen will be felt for some time to come. However, as Roger Hughes points out, we can have every confidence in the industry's ability to respond to these challenges: 'What many observers seem to ignore is that there is no one who has a greater interest in getting audits right than the people who are legally liable for them and who earn their living from them.'