

## INDEPENDENCE OF ARTHUR ANDERSEN

The writ against Arthur Andersen noted in the 'Was Arthur Andersen negligent?' update alleged Arthur Andersen was not independent. This month's reporting by the press on evidence given before the royal commission into the collapse of HIH Insurance has also noted some independence issues that will now be discussed.

In late 2000, Arthur Andersen considered resigning from the audit of HIH Insurance. They thought the integrity of the client was fair, did not believe losses reported in draft accounts were fairly stated and did not wish to do the audit anymore. However, they did not resign because they thought it would be hard to resign from the audit of a company that had been recently reported to the Australian Securities Investment Commission (Main 2002, p. 4). No further explanation was given on this point. Arthur Andersen also removed an audit partner at the request of HIH insurance (Ryan 2002, p. 3).

The most significant independence matter brought before the royal commission related to sale of non-audit services to audit clients. The effect of auditors selling non-audit services to audit clients has been the most controversial area in the whole debate on audit independence. The Federal Government's proposed reforms in this area rely on the provisions of ICAA's (2002) Professional statement F1: Professional independence, and have been criticised as being too lightweight. (See last month's edition of *Current Affairs in Auditing* for details of these criticisms.) It will be interesting to see how the royal commission views these matters and whether they express recommendations in this area that cause the Federal Government to review its proposed reforms on this area.

A former country manager of Arthur Andersen told the royal commission that the performance of Arthur Andersen partners was partially measured 'by their ability to cross-sell services across the firm' (Ryan 2002, p. 3). This partner had obviously never read the auditing practice standard on independence.

The profession has long defended auditors selling non-audit services to audit clients by arguing that no instance of the relationship between the provision of non-audit services and substandard auditing has been shown. Recently evidence has surfaced indicating that this argument is flawed. The amount of fees received for the sale of non-audit services by Arthur Andersen for Enron was a significant reason why they retained this doubtful client. (See April's edition of *Current Affairs in Audit* for details.)

Recently, Frankel et al. (2001) conducted a study that found firms whose auditors provided a high level of non-audit fees to total fees are more likely to report small positive earnings surprises and small increases in earnings and small profits. These firms also reported larger income increasing and income decreasing discretionary accruals (p. 22). The findings are consistent with the proposition that these firms adopted an earnings management approach.

### References

Frankel RM, Johnson MF and Nelson KK 2001, *Auditor Independence and Earnings Quality*, Research Paper Series, Graduate School of Business, Stanford University, Research Paper No. 1696, July.

Institute of Chartered Accountants in Australia 2002, Professional statement F1: Professional independence, ICAA Member's Handbook, June issue.

Main A 2002, 'HIH auditors wanted to resign', *The Australian Financial Review*, 26–27 October, p. 4.

Ryan C 2002, 'Andersen's impartiality "not an issue"', *The Australian Financial Review*, 29 October, p. 3.