Tampere University of Applied Sciences

The Role of Audit Firms in Fraud Detection Against the Backdrop of Potential Conflicts of Interest

Jonathan Hucke

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ABSTRACT

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Most of the financial and economic crises in recent history have not just had major negative implications on the economic situation of industrial and developing countries and their peoples but have also been accompanied by spectacular corporate collapses and bankruptcies. Two of the most prominent victims are former telecommunications firm WorldCom and the investment bank Lehman Brothers. WorldCom went bankrupt during the burst of the tech bubble in 2002, and Lehman collapsed at the height of the financial crisis in 2008. What both companies had in common were their contentious accounting practices and the failure of their respective auditors who neither detected WorldCom's accounting fraud nor reported Lehman's accounting gimmick. Both auditors, Arthur Andersen and Ernst & Young, faced heavy criticism in the wake of the collapses; and the auditing profession in general has been under close scrutiny ever since.

This research aims to examine the role of audit firms in general but also specifically in fraud detection, especially against the backdrop of potential conflicts of interest these audit firms might face during their work. The purpose was to develop solutions which, if implemented, can eliminate conflicts of interest in audit and improve audit quality. The data were collected by using a mixed-method approach which incorporates both qualitative and quantitative data. When it comes to market research methods, secondary data was gathered from reliable and renowned sources.

The research results show that audit firms occupy a crucial role in the world economy since companies rely on their work in order to conduct their business operations efficiently, Moreover, the failure of audit firms can have devastating effects for themselves, their clients, and their clients' stakeholders. The research also suggests that audit firms can get entangled in numerous different conflicts of interest that can arise from various controversial constellations.

However, the research has also shown that a number of measures have been implemented by different countries in recent years in order to combat conflicts of interest and improve audit quality. Furthermore, additional potential measures and solutions that can help improve audit quality and fight conflicts of interest are presented in this thesis.

Key words: audit, accounting fraud, conflict of interest, audit quality

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GLOSSARY

AICPA	American Institute of Certified Public Accountants
Big Four	Term used for the four largest accounting/auditing firms (Deloitte, PwC, EY, KPMG) which also offer consulting, tax, and other professional services to their clients
CEO	Chief Executive Officer
CFO	Chief Financial Officer
COO	Chief Operating Officer
CMA	Competition and Markets Authority
CPA	Certified Public Accountant
EU	European Union
FRC	Financial Reporting Council
FY	Fiscal Year
GAAP or US GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
IT	Information Technology
MP	Member of Parliament
PCAOB	Public Company Accounting Oversight Board
SEC	US Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standard
SME	Small/Medium-Sized Enterprise
SPE	Special Purpose Entity
UK	United Kingdom
US	United States

1 INTRODUCTION

1.1 Thesis Background

Numerous financial and economic crises have rattled the world economy in the last two decades, including the dot-com bubble in the early 2000s, and the global financial crisis from 2007 to 2009, followed by the eurozone debt crisis which lasted for the following decade. The year 2020 will forever be linked with the novel coronavirus, which first appeared in China but has become a global pandemic as it spread all over the world. This pandemic has already caused a downturn on the world economy and is expected to cause a deep and long recession or even depression in large parts of the world over the next months or even years.

When looking at the economic crises that occurred in the 20th and 21st centuries, it is highly unusual that such a crisis is triggered by a virus or other unsystematic causes. Most of the recent financial and economic crises, such as the dot-com bubble and the financial crisis of 2007-2009 were instead caused by excessive speculation and risk-taking by financial companies and other businesses. Therefore, these crises can be considered as crises which had systematic causes.

Economic crises and recessions always tend to have the same consequences, namely a drop in spending and consumption, a decrease in GDP, surging unemployment rates as well as bankruptcies and collapses of companies of any size. Major corporate collapses are often particularly eye-catching, especially when the company in question is a renowned, globally operating brand with tens of thousands of employees. This was especially evident when Lehman Brothers, then one of the largest investment banks in the world, collapsed and filed for bankruptcy in September 2008 during the peak of the financial crisis. Live-TV pictures from employees leaving the Lehman office in New York City went around the world and let millions of people in front of the screens sympathize with people who had just lost their jobs due to the bank's overly risky business practices.

Many people, including outsiders, know that most corporate collapses happening outside of economic and financial crises have their roots in general corporate

mismanagement. However, what many people do not know is that the same also holds true for bankruptcies occurring during economic crises. A substantial number of companies that have gone under in economic crises have had financial problems even before the crisis, however, the public was often unaware of these underlying issues. Therefore, the deeper causes of some major corporate collapses, for instance Lehman's, are barely known to people outside of the affected industries. These causes will be discussed in more detail in this thesis.

This thesis will also shed light on other protagonists that have been frequently involved in major financial scandals and corporate bankruptcies: the auditors.
Even though they mainly do background work, audit firms play a crucial role for the companies they audit, and also for these companies' shareholders and other stakeholders. As the researcher experienced firsthand during his internship at Deloitte, the largest of the so-called "Big Four" companies, auditors must follow strict rules, regulations, and guidelines during the work they perform for their clients. These rules and regulations were put in place by regulators to ensure an auditor's integrity and neutrality during the audit which are imperative when it comes to delicate duties of audit firms such as fraud detection.

However, as it is often the case, not all rules and regulations work properly in practice which opens the door for misconduct. Auditors have come under more and more scrutiny and criticism in recent decades due to precarious roles some of them have played in financial scandals but also due to their overall business models. The Big Four in particular have been criticized heavily for their business practices and for being prone to conflicts of interest. The role of conflicts of interest in audit is a major issue because such conflicts clash directly with an auditor's obligation of being neutral and upright, which, by definition, requires immunity to conflicts of interest. The role of conflicts of interest will be discussed extensively in the upcoming chapters in order to develop efficient solutions for eliminating potential situations of conflict of interest in audit.

1.2 Objectives, Purpose and Research Questions

All stakeholders of a company, including employees, customers, suppliers, financial institutions, and shareholders rely on the company's auditor to render an accurate verdict on the financial statements provided by the company. The fundamental requirement for an accurate verdict is that the auditor is entirely unbiased. Therefore, regulators in some countries have already tried to put certain regulations in place to ensure integrity, and rein in uncertainty and conflicts of interest.

Since these measures have not proven to be entirely effective, though, the main research objective of this thesis is to find out what can be done to prevent potential conflict of interest situations from arising, and to develop specific solutions in different forms and magnitudes in order to solve this issue.

Moreover, this issue goes hand in hand with the secondary research objective which is to examine whether these solutions can help in improving overall audit quality. Since the issues of audit quality, an auditor's unbiasedness and conflicts of interest are tightly linked to each other, the goal is to find solutions capable of solving both issues, eliminating potential situations of conflict of interest, and improving an auditor's integrity and thereby enhancing the quality of audits.

The potential solutions will also be based on the findings from four case studies to be conducted in this thesis. These case studies deal with four corporate collapses including a focus on the respective auditor in each case and the role the auditor played in these events.

Here is, once again, the main research objective:

- ➔ What can be done to prevent potential conflict of interest situations in audit from arising?

The secondary research objective, as mentioned above, is:

- ➔ Will these solutions have a positive impact on overall audit quality?

The following research questions will be examined as well. They are supposed to support the main research objective and tackle a wider range of issues:

- ➔ What is the broader relevance of auditing for companies, their stakeholders, and the overall world economy?
- ➔ Have there been any fraud scandals or bankruptcies where audit firms have played a precarious role?
- ➔ What types of conflict of interest situations might auditors face?

1.3 Thesis Structure

This thesis follows a simple and coherent structure. In the next chapter, which is chapter 2, the theoretical framework is outlined. The theoretical framework gives the reader an overview on the audit industry. This overview includes a description of what audit is and what an auditor's occupational profile looks like. Different types of auditors will be discussed as well. Moreover, the wider relevance of audit will be explained in the theoretical framework. This includes an examination of an auditor's role in fraud detection as well as the relevance of auditors for companies and markets. Chapter 2, the theoretical framework, also deals with the differences and links between audit and consulting and explains why the links between these two fields are important for the research in this thesis.

Chapter 3 first deals with the research methodology and includes a review on different types of data collection methods, research methods and research approaches before shifting to this particular research and explaining which methods were used in this thesis.

Chapter 4 of this thesis consists of different types of potential conflict of interest situations that auditors might encounter during an audit. This includes conflicts of interest within an audit team or department itself, but also between different business units of the same company, e.g. audit and consulting. Other conflict of interest forms will be discussed as well.

In chapter 5 multiple financial scandals from this century are analyzed. These analyses all deal with collapses of major companies, like Lehman Brothers or

Enron, and have a special focus on the respective auditors and the role they played in these corporate collapses.

The discussion in chapter 6 is built on chapter 5 and focuses on the similarities and differences of the case studies analyzed in chapter 5.

In chapter 7, recommendations are given on how to prevent potential conflict of interest situations from arising. These recommendations include potential solutions that are rather simple to implement as well as solutions which can be described as radical and very hard to push through.

The thesis ends with a conclusion in chapter 8.

2 THEORETICAL FRAMEWORK

2.1 The Audit Industry

Auditors play a critical role in the business environment since companies of all sorts and sizes as well as their stakeholders rely on an auditor's unbiased verdict on the financial statements provided by the audited organization. In order to render an unbiased verdict, an auditor is obliged to strictly follow particular rules and regulations which are often specific to the country the audit is performed in. However, there are also accounting regulations such as the International Financial Reporting Standards (IFRS) or the Generally Accepted Accounting Principles (GAAP or US GAAP) which are commonly used by organizations and auditors around the world.

IFRS are issued by the IASB, an independent body of the IFRS Foundation, and set common rules so that financial statements are comprehensible and comparable around the world (Palmer 2020). IFRS are the most commonly adopted accounting standards worldwide and offer a standardized way for organizations to depict their financial statements. According to the IFRS Foundation (2018), the International Financial Reporting Standards are required for use in 144 countries in the world, as of April 2018, which make IFRS by far the most widely used accounting standards.

In addition to IFRS, most countries also have national accounting principles in place. These national regulations are often used by private, small, and medium-sized organizations, since in many countries the use of IFRS is required only for public companies. However, private companies and small and medium-sized enterprises (SMEs), respectively, are more and more moving their financial reporting method from national regulations to IFRS as the use of IFRS gets more common. Using the International Financial Reporting Standards as the primary reporting method is especially attractive to SMEs who aim to attract investors in the future since going public would require these companies to use IFRS as their financial reporting method. Companies that do not intend to go public, though,

are likely to stick to the national accounting principles. This way they can avoid extensive changes to their accounting and financial reporting procedures.

In addition to IFRS, the second widely used accounting principle is the Generally Accepted Accounting Principles. The GAAP is the accounting standard issued by the Financial Accounting Standards Board, a US standard-setting body, and is determined by the US Securities and Exchange Commission as the accounting standard required for use by companies in the United States. Even though the GAAP is occasionally used in other parts of the world as well, it is mainly used in the United States, whereas the majority of countries around the world have shifted towards using the IFRS as their main accounting standard.

Even though IFRS and US GAAP share many similarities, they also have one striking difference. According to an analysis by the SEC (2011), the IFRS has more of a principles-based approach, whereas the US GAAP can be described as more rules-based since it contains more detailed and specific requirements than IFRS. This implies that companies which operate in countries that have adopted IFRS as the accounting standard have a bit more freedom in preparing their financial statements than their counterparts in the United States. American companies, on the other hand, have to adhere to the stricter GAAP rules.

2.1.1 The Role of an Auditor

After the client has provided the financial statements according to the required regulations mentioned above, it is the auditor’s job to deliver a verdict on whether the financial data is accurate. During an audit, the auditors examine whether the respective financial reporting standards have been applied correctly, and whether the financial statements give a realistic picture of the organization’s actual financial situation. In this context, it is important to note that an auditor cannot provide absolute guarantee that no reporting mistakes have been made by the client. However, the auditor can determine with reasonable assurance that the client’s financial statements are free of any major misstatements. To achieve impeccable accuracy would be highly impractical since this would involve examining every

single invoice and document. This would be patently impossible due to time restrictions. By drawing samples, the auditor can, however, rule out egregious mistakes or get a hold of potential fraud situations.

An important term to know related to the auditor's role, especially in fraud detection, is the so-called *expectation gap*. The expectation gap has a variety of different, yet similar definitions. According to Diolas (2019), the term is often defined as the difference between what the public expects from the auditing profession and what the auditing profession actually provides. He, however, defines it as the difference between what the general public thinks auditors do and what the general public would like auditors to do (Diolas 2019). The expectation gap shows that the actual role of an auditor is misperceived by the public. Multiple financial scandals and corporate collapses where auditors have been accused of major mistakes and of being unable to communicate the affected companies' financial problems to investors, to the public, and to other stakeholders, have led to the misperception that it would be the auditor's job to provide a verdict on a company's financial situation and health. However, the auditor's role is precisely not to draw any conclusions on a company's financial situation but just to assess whether the financial statements provided by a company are true and accurate.

In addition, and in relation to examining a company's financial statements, an auditor has to fulfill a variety of duties. These duties include elements of both working behavior as well as ethical behavior. When it comes to ethical behavior, the auditor must always comply with auditing standards (Cleartax 2019). An auditor is tied to the relevant regulations during the audit and is always obliged to follow them. Two other key aspects of proper ethical behavior, according to Cleartax (2019), are confidentiality and professional skepticism. Auditors must treat all documents, figures, and other information about his clients as confidential. The mantra within audit is that everything that is being discussed about the client must stay within the audit team. No information may be given to outsiders, regardless of their role and position. Disclosure of confidential information is prohibited not just to relatives and friends but also to other non-involved audit colleagues and even partners, the de facto owners of the Big Four. When it comes to professional skepticism, the auditor must be alert to potential mistakes and

fraud in the company's financial statements (Cleartax 2019). Professional skepticism also includes having the mindset to scrutinize and challenge all information and documents provided by the client. Auditors are not supposed to easily accept any explanation given by the client. Instead they must assess whether the given information sounds plausible and realistic.

This aspect is linked to a critical working behavior duty of an auditor, namely making inquiries. If any document or information provided by the company catches the auditor's attention or leads to ambiguity, the auditor is obliged to reach out to management and inquire about the issue at hand. Furthermore, the auditor is obliged to inquire about other, more general issues, such as the organization itself and is operations, according to GRF (n.d.), This will be discussed in section 2.1.2 in more detail.

Another crucial duty of an auditor is the detection and reporting of fraud. According to the American Institute of Certified Public Accountants (AICPA), the national professional organization of CPAs in the United States, an auditor is responsible for performing an audit to obtain reasonable assurance about whether the financial statements of a company are free of material misstatement caused by fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute assurance that material misstatements are detected. (AICPA 1972.) In other words, the auditor has the responsibility to detect fraud which must then be reported to the client's management and to the responsible authorities charged with governance.

When talking about the role of auditors, it is important to differentiate between different types of auditors whose roles vary slightly. The most common type of auditor is the external auditor. The external auditor is mandated by the management of an organization to perform an unbiased examination the organization's financial statements and has no other ties to the company it has been hired to audit. Another common group are the internal auditors. The internal auditor is employed by an organization and is assigned with overseeing whether the company aligns with all bookkeeping rules and regulations, and whether it handles its finances in an orderly fashion. According to the Chartered Institute of Internal

Auditors (n.d.), the professional body in the UK dedicated to internal audit, internal auditors act as a combination of auditors and consultants for their employer. As auditors they evaluate the effectiveness of the company's risk management, governance, and internal control processes. In addition, they also fulfil the role of consultants since they develop solutions to improve those internal processes.

While external and internal auditors are the two most common auditors, there are also other types of auditors which are not as well known to the public. These include forensic auditors and government auditors. External auditors already play a major role in fraud detection, however, there are also auditors that are special experts in the field of fraud detection and fraud investigation. These auditors are called forensic auditors. According to Tardi (2019), a forensic auditor is hired when a company or a law enforcement organization suspects illegal activities, such as fraud, bribery, or conflicts of interest going on in a company. The forensic auditor conducts an investigation within the affected company and collects evidence on a variety of issues, such as identifying what fraud was committed, if any, determining who committed the fraud, as well as ascertaining the period in which the illegal activity was committed (Tardi 2019). This evidence is later laid out in a report issued by the forensic auditor and might also be presented in court if the case is prosecuted.

The fourth and final major group of auditors is the government auditor. Government auditors examine the financial statements of government agencies and ensure that public resources are spent correctly according to all rules and regulations.

2.1.2 The Procedure of an Audit

The widespread perception about the procedure of an audit is that the auditors merely do an annual audit of the client's books either at the client's premises or at the audit firm's offices, and just examine whether the financial statements provided are true, accurate, and free of major misstatements. Even though this description is accurate and can be described as the main part of an audit, it is only one part of how an audit is conducted.

Usually an audit is carried out in two parts at an interval of a few months. The first part of the audit process is called the pre-audit. The pre-audit is conducted before the closure of the financial period and serves multiple purposes as the author learned while working for Deloitte. As already mentioned in chapter 2.1.1, the auditor is obliged to make inquiries to management about general issues within the organization, such as working procedures, logistics and other operations. These inquiries about the operations within the organization are usually done during the pre-audit and can be called process mapping. The purpose is to get to know the organization and its operating practices as well and as explicitly as possible. Having detailed knowledge about the client is essential for a successful audit.

Furthermore, the pre-audit is used to determine and classify certain risks regarding material misstatement that might occur during the main audit. Thereby, the auditor evaluates the risk of potential misstatements for all audit fields, and classifies the risks as significant, high, medium, or low, depending on the specific approach of the audit firm. The auditor then uses the information he gathered about the organization through interviews and observation to develop an efficient overall audit strategy that will appropriately respond to the assessed risks (Burke n.d.).

The main purpose of an audit is the examination of an organization’s financial statements. This duty is carried out during both the pre-audit as well as the main annual audit, which is normally conducted a few months after the pre-audit and around the time the client closes its financial period. While some business transactions that have been finalized in the earlier part of a fiscal year can already be audited during the pre-audit, most of the audit fields can only be audited after the closure of the financial period. Therefore, the majority of the client’s business transactions is subject to audit during the main official audit.

All items on the balance sheet and on the profit and loss statement are required to be examined. These items are called audit fields, and they are listed in detail below.

<u>Balance Sheet – Assets</u>

➔ Current assets

- Cash and cash equivalents
- Marketable securities
- Inventories
- Accounts receivable
- Other assets

➔ Non-current assets

- Property and plant
- Equipment
- Investments
- Intangible assets
- Goodwill
- Other assets

<u>Balance Sheet – Liabilities</u>

➔ Shareholder's equity

- Issued Capital
- Capital Reserve
- Retained earnings
- Net Profit/Loss

➔ Current liabilities

- Accounts payable
- Accrued expenses
- Unearned revenue

➔ Non-current liabilities

- Long-term debt
- Other long-term liabilities

<u>Profit and Loss Statement</u>

- Revenue
- Cost of materials and services
- Staff costs
- Depreciation, amortization
- Other operating expenses

- Interest income
- Interest expenses
- Income taxes
- Profit/loss before and after taxes

The general audit strategy can be described as follows: Assets are examined for overstatement and liabilities are examined for understatement. This means that the auditor tests for all the different assets whether the figures presented by the client are higher than the actual asset figures. The liabilities, on the other hand, are tested for understatement, meaning the auditor examines whether the liabilities provided by the client are lower than the actual liabilities.

All of the above listed items and audit fields, respectively, are examined in the main audit, albeit with different strategies. For instance, when checking the client's bank balances, the auditor contacts the banks the client claims to have an account at and asks for a confirmation of the exact balance at a particular date. However, for some audit fields, for instance revenues, it is impossible for the auditor to verify every single business transaction of the client. For these audit fields, the auditor proceeds by drawing enough samples to verify that the client did not post non-existent or fraudulent business transactions. In order to verify business transactions and the financial data provided by the client, the auditor must always collect enough and trustworthy evidence from the client itself or from other parties, for example business partners or government authorities. The auditor must then determine whether the collected evidence, such as orders, invoices or documents from the tax authorities are reliable and can be used to support and verify the financial data provided by the client.

After examining all relevant audit fields, the auditor concludes the audit by delivering a presentation of his findings to management, writing an official report and delivering the auditor's opinion, which is a certification from the auditor that the financial statements provided by the client are accurate.

2.1.3 The Key Players

The audit industry has been dominated by a small group of companies since the 20th century, and that domination has continued until today even though the composition of that small group has changed, especially in recent decades. For most of the 20th century, these firms were known as the Big Eight, reflecting the dominance of the eight largest firms in the sector. These eight firms were Arthur Andersen, Arthur Young, Coopers & Lybrand, Deloitte Haskins & Sells, Ernst & Whinney, Peat Marwick Mitchell, Price Waterhouse, and Touche Ross. (Wootton & Wolk n.d.). A series of mergers at the end of the 20th century reduced that group to only five companies, the so-called Big Five. These companies were Deloitte, PricewaterhouseCoopers, Ernst & Young, KPMG and Arthur Andersen. The collapse of Arthur Andersen in 2002 in the wake of the Enron scandal further reduced that group to four companies. These are Deloitte, PricewaterhouseCoopers (PwC), Ernst & Young and KPMG which continue to dominate the audit sector until today.

These four companies, the so-called Big Four, are called professional network companies since they do not just offer auditing and accounting services to their clients but also a range of services in other fields such as consulting, corporate finance, tax and legal matters. Even though these four companies nowadays generate the majority of their revenue and profits with their management consulting units as well as with other advisory work, audit remains their core business and a major source of income. Figure 1 below shows Deloitte's revenue distribution in FY2019 as an example.

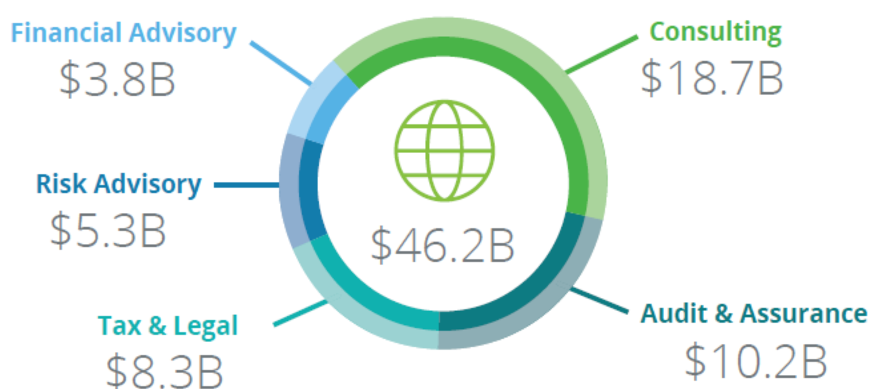

FIGURE 1. Deloitte's global revenue in FY2019 by business unit (Deloitte 2019).

Deloitte, the largest company of the Big Four, is particularly successful in the consulting sector, since it generates around 60% of its revenue with its consulting unit and other advisory services, according to the firm's annual report for FY2019 (Deloitte 2019 and FIGURE 1). Nevertheless, the chart above also shows that audit is still an important source of revenue for Deloitte even though its share of the company' total revenue has dropped in recent years.

The Big Four, namely Deloitte, PricewaterhouseCoopers, Ernst & Young and KPMG are often grouped together and compared to each other. They are all offering the same services to their clients, they are all private companies that have implemented the same organizational and owner structure, and they are similar in size, all attributes which make these companies easy to compare.

Their dominance in the audit industry is not hard to see when looking at the number of clients they audit among major publicly listed companies.

TABLE 1. Number of companies listed in major stock indices audited by the Big Four (Pakaluk 2017; Financial Reporting Council 2019; Peterson 2017)

Stock Market Index	Number of Companies listed in the Index	Number of Companies audited by the Big Four
S&P 500	500	497
FTSE 100	100	100
DAX	30	30

These numbers are a clear and obvious indicator of how the Big Four control the audit sector. According to Pakaluk (2017), as of 2017, the Big Four audit 497 companies of the S&P 500, a stock market index that measures the stock performance of 500 large companies in the United States. In the United Kingdom the Big Four are even more dominant, as all 100 companies of the FTSE 100, a stock market index of the 100 largest companies in the UK, are being audited by the Big Four, according to the Financial Reporting Council (2019). In Germany, the situation is similar. All 30 companies listed in the DAX stock index, an index that

tracks the largest Germany companies, are audited by Deloitte, PwC, EY and KPMG (Peterson 2017, 41).

This dominance is considered problematic by a number of regulators, governments, and experts, some of which have already implemented measures to disrupt the supremacy of the Big Four. These measures will be further examined in section 4.2 of this thesis. Some have even called for the Big Four to be broken up. Regardless of the measures already in place or about to be put in place to curb the influence of the Big Four, their prevalence leaves smaller audit firms frustrated. In April 2018, Grant Thornton, the second largest of the non-Big-Four audit firms announced that it would withdraw from bidding for FTSE 350 audit tenders in the UK due to being without a chance against the Big Four in bidding processes (Bhaskar & Flower 2019, 14).

Other audit firms besides the Big Four and Grant Thornton include BDO, RSM, Crowe Horwath and Nexia International. These companies, including Grant Thornton are too small to seriously compete with the Big Four. The annual revenues of each of these companies add up to around $5 billion per company, which is a puny one-ninth to one-sixth of what each of the Big Four makes per year.

2.1.4 Relevance for Companies and Markets

Audit plays a crucial role for all companies, their stakeholders, and remains a key part in capital markets. Therefore, audit has a broad relevance in the world economy. The important role of an auditor in the economy is supported by the fact that almost all relevant companies in the world are required to have their financial statements examined by an independent third party, the auditor.

Even though the auditor is hired by the company’s management, and on paper, performs the work for the client organization, the auditor’s work might actually be more important for the company’s stakeholders than for the client company itself. Obviously, the client needs the auditor’s opinion and certification, respectively, in order to do business in an efficient way. However, it is mostly the company’s stakeholders who rely on the verdict of an independent auditor that the financial

statements are true and accurate. These stakeholders, which include investors, financial institutions, employees, suppliers, and customers, among others, need reasonable assurance that the audited company's finances can be trusted.

Especially banks and other financial institutions rely on an auditor's opinion in a major way since certified financial statements are usually one of the main requirements a company must fulfil when applying for a bank loan. Banks do not give loans to companies who fail to show certified financial statements with the auditor's opinion. That mostly concerns companies above a certain size threshold. Some banks, however, even require a certified auditor's opinion from smaller companies who are not required by law to be audited. The intention of receiving a bank loan is also one of the main reasons why some small companies have their financial statements audited voluntarily even though they are not required to do so by law. Moreover, the bank loan aspect is one the few occasions where the client company benefits directly from the auditor's work since bank loans are the main source of outside capital. Every company requires borrowing to finance its projects and daily operations, and the auditor's opinion is key in getting the necessary outside capital from banks.

Another group of people who rely heavily on the auditor's opinion, are the investors. Major investment firms, such as Blackrock, as well as small investors need assurance from auditors about a company's financial statements before entrusting any company with their money. This is also where the auditor's relevance for capital markets comes into play. A company which is either embroiled in a financial scandal or unable to get a certified auditor's opinion will both lose money from current investors withdrawing and not attract any new investors. This can be observed in the ongoing case of Wirecard, a German fintech company, whose cash balance for 2019 was inflated by €1.9 billion, as its auditor EY was unable to find any evidence that this money actually exists. On the day Wirecard communicated this issue to the public, its share price plunged by 67%, according to Thomson & Bloomberg (2020), which means that billions of euros of market capitalization have been wiped out. This shows the immense clout an auditor has on companies and the capital markets.

While Wirecard was later forced to declare bankruptcy, it is far from being the first time that an auditor’s findings led to a major shakeup on the markets. In the case of WorldCom, a former telecommunications giant that filed for bankruptcy in 2002 after an accounting scandal, it was even the company’s internal audit department which uncovered that the company had inflated its assets by more than $3.8 billion (Berenson & Romero 2002). This makes the WorldCom scandal including the firm’s subsequent stock price plunge and bankruptcy, which will be analyzed in more detail later in the thesis, another prime example for the crucial role of the auditor, and the influence audit has on companies and capital markets.

2.2 Audit and Consulting

When examining the role of audit in fraud detection against the backdrop of potential conflicts of interest, it is vital not just to understand the details of what audit is and the role audit plays in the economy, but also to make sense of the relationship between audit and consulting. The links between audit and consulting have been mentioned by many as one of the prime sources of conflicts of interest, therefore, the relationship between these two fields must be examined in detail.

As explained in chapter 2.1.3, there are obvious links between audit and consulting. The most apparent links are provided when looking at the business model of the Big Four. The Big Four make their living by offering both audit and consulting services to their clients. However, Deloitte, PwC, EY and KPMG, and their audit departments in particular, also play an important role in the economy and in society, especially when it comes to detecting fraud and other illegal actions by their clients’ management groups.

However, the Big Four do not just inspect their clients and look for mistakes or flaws in their accounting practices, they also offer their clients a wide range of consulting services that encompass a variety of different fields, such as management consulting, tax advisory and transaction advisory. The business practice of offering both audit and consulting services has led to criticism from regulators and government officials, among others, and has placed the Big Four under im-

mense scrutiny in recent years and decades. However, the mere fact that companies offer both audit and consulting services to their clients is not criticism-deserving in and of itself. The intra-company links between audit and consulting become a problem only if conflicts of interest arise, which can impair audit quality. Nevertheless, it is crucial to understand the connections between audit and consulting, and also how these two fields differ.

The connections as well as the differences are discussed in more detail hereafter, followed by a classification of why the connections between audit and consulting are of high importance for this research.

2.2.1 How they are linked

Even though audit and consulting are entirely different business fields that do not share a lot of similarities, they are still linked to each other, and, in some cases, these links can be quite tight. One example where the links between audit and consulting are very tight is internal audit. As described in chapter 2.1.1 of this thesis, internal auditors are employed by organizations to check the company's risk management and internal control processes, and to examine whether the company aligns with all bookkeeping rules and regulations. However, internal auditors do not just examine a company's internal processes, they also develop solutions for improving these processes. Therefore, internal auditors basically act as a combination of auditors and consultants for their employer (Chartered Institute of Internal Auditors n.d.).

The work of internal auditors is commonly called "value-added auditing". This term is derived from the above-mentioned occupational profile of an internal auditor who is not just obliged to review internal risk management and control processes but also expected to offer solutions for improvement. These solutions, if applicable and efficient, provide added value to the company which explains why internal auditors conduct value-added auditing. The shift in internal auditing from pure auditing to a mix of auditing and consulting is seen as a major change in the audit sector. According to Hutchins (n.d.), there has always been a sharp separation between auditor and auditee when it comes to consulting, since auditors

were always expected to be independent, and this independency was impaired if the auditor also offered consulting assistance. While this still holds true for external auditors, internal auditors are nowadays expected to offer consulting help to their employers.

The second obvious connection between audit and consulting is shown by the business model of the Big Four which is made up of offering not just audit services to their clients but also consulting services. Even though many countries have implemented rules that prohibit the Big Four from offering audit and consulting services to the same client, links between the audit and consulting arms within the Big Four remain. Many Big Four employees in all business sectors (audit, tax consulting, management consulting, financial consulting) are equipped with a vast network of business relationships with (former) clients as well as with colleagues from other departments. These relationships obviously help the companies to drum up business across all departments. Moreover, the employee turnover within each Big Four company is very high. Employees frequently change jobs from audit to consulting, and vice versa, which means that due to their business relationships they have knowledge about specific clients which they can use in another business department.

Having this insider knowledge can have the advantage of creating more business with this specific client, however, it has also led to criticism and suspicion of potentially creating conflicts of interest. These situations will be discussed in more detail in chapter 4.

2.2.2 Differences

As already mentioned in chapter 2.2.1, external auditing and consulting are entirely different fields of business, have very different goals, and their respective professional practices differ considerably. Whereas auditors examine the financial statements of organizations, consultants develop and implement solutions to specific business problems faced by organizations. The difference between auditing and consulting can also be described in the way that auditors provide a

retrospective examination, whereas the work of consultants is more forward-looking (van Twist, van der Steen, de Korte & Nuijten 2015, 6).

Another major difference between auditing and consulting is the fact that consultants enjoy more personal and professional freedom when carrying out their work. Since consultants do not have to follow any official laws, rules, or regulations, they do not face any limitations within the bounds of business ethics when it comes to creativity or freedom at work. Auditors, on the other hand, are always obliged to follow the rules implemented by the responsible regulators to ensure full integrity and objectivity. These rules include not just the adopted accounting standards, such as the IFRS or the GAAP but also country-specific laws regarding economic crime, taxation, and financial reporting.

The reason why consultants enjoy much more personal and professional freedom while conducting their work than auditors is obvious and another major difference between auditing and consulting. Whereas all public companies are required by law to have their financial books audited, and many other organizations must have their books audited in order to obtain a bank loan, the decision to hire consultants is entirely a company's own choice. Companies can have a variety of reasons for calling consultants for help, for instance the need to stop the trend of diminishing revenues, the need for a plan of how to cut costs, or how to avoid as much tax as possible. Even though these are all legitimate business problems that need to be addressed, they are not called for by law to be solved, whereas an audit, in most cases, is required by law.

2.2.3 Relevance for Research and Analysis

Why are the connections between auditing and consulting relevant for this research? The explanation is obvious. This thesis and the accompanying research examine the role of audit in fraud detection against the backdrop of potential conflicts of interest, and the relationship between audit and consulting plays an integral part in this issue. A company offering audit and non-audit services, for instance consulting help, to the same client within a short period of time is a prime example where potential conflicts of interest can occur. A substantial part of this

research and thesis will be devoted to the questions of how the relationship between audit and consulting can bring up conflicts of interest in audit firms, and how these situations can potentially be eliminated.

Furthermore, it is crucial to investigate the possible effects of potential conflicts of interest on audit quality. Is it possible that close links between audit and consulting impair audit quality? Are audit firms prone to overlooking, perhaps even deliberately ignoring, indications of fraud or other illegal activity due to superior business interests, such as the prospect of future consulting deals? In order to examine these questions as thoroughly as possible, it is important to recur to historical evidence instead of mere expert opinions. The history of multiple events involving the relationship between audit and consulting in fraud cases is analyzed in detail to find out the extent to which conflicts of interest might have impaired audit quality.

Moreover, analyzing the effects of the relationship between audit and consulting on fraud cases and audit quality is key in order to develop efficient solutions for tackling this issue. The solutions provided in the final part of this thesis are designed to eliminate or at least reduce the possibility that conflicts of interest arise in audit. What's more, these solutions which are based on the findings made in the analyses of the before-mentioned historic events, aim to reduce the impairment of audit quality as well as tackle the issue of a too close and cozy relationship between audit and consulting.

The fact that the analysis as well as the solutions are partly based on the relationship between audit and consulting emphasizes that this relationship is a backbone of this research, and fundamental to its execution.

3 RESEARCH METHODOLOGY

3.1 Data Collection Methods

Basically, there are two different data collection methods a researcher can use when writing a thesis, namely qualitative research, or quantitative research. However, another common strategy is using a mixed method, which combines both the quantitative and the qualitative methods. In essence, that means a researcher can choose between three different data collection or research methods.

When looking solely at the two basic data collection methods, qualitative and quantitative research, it is crucial to understand the key differences between the two methods. The differences of these methods are significant as they relate to different research intentions. Quantitative research is broadly characterized by collecting and analyzing numerical data, values, and charts. Qualitative research, on the other hand, is centered around verbal expressions and their interpretations. In qualitative research, the means of obtaining the research data are, among others, own observations, and interviews. The data obtained by these observations and interviews is classified as qualitative data.

When performing quantitative research, interviews are rarely used since quantitative data focuses on numerical values and statistics. A common tool for gathering quantitative data, however, are surveys. According to Streefkerk (2019), these surveys would need to have closed or multiple-choice questions, while open questions are more associated with qualitative research.

Another key difference between the two research methods is the number of respondents needed in order to produce reliable data and results. According to Streefkerk (2019), qualitative research requires only few respondents, while quantitative research requires a substantial number of respondents. The reason for this difference is that when it comes to quantitative data, a lack of respondents would lead to only a small sample size. Therefore, the data would neither be reliable nor representative for larger populations. Qualitative data, however, is

reliable regardless of how many people were to get interviewed, since in a qualitative approach, the data can even stem a single person's own observations.

A researcher can also choose to use a third research method, namely a mixed method. The mixed approach collects and combines both qualitative and quantitative data in the same research. According to Creswell and Clark (2007, 5), mixed methods research is a research design with philosophical assumptions as well as methods of inquiry. As a methodology, it involves philosophical assumptions that guide the direction of the collection and analysis of data and the mixture of qualitative and quantitative approaches in many phases in the research process. Its central premise is that the use of quantitative and qualitative approaches in combination provides a better understanding of research problems than either approach alone. (Creswell & Clark 2007, 5.)

This definition of Creswell and Clark implies that using a mixed method is more efficient in the research process than using one of the two methods alone. This view is supported by other researchers as well. According to Hurmerinta-Peltomäki and Nummela (2006), using one method alone would only provide a limited view of the whole picture when studying complex issues. When combining methods, qualitative methods may provide in-depth understanding of the variables that lead to quantitative numerical findings. Furthermore, the mixed-method approach may also be used to improve validity of research (Hurmerinta-Peltomäki & Nummela 2006).

3.2 Market Research Methods

Market research and data collection are crucial parts of the analytical process and the overall writing process in theses. In market research, there are two different methods used, i.e. the data to be collected can be grouped into two different categories, namely primary data, and secondary data. These two labels already indicate the most important difference between the two market research methods. Whereas primary data is data which is collected for the first time by the researcher himself, secondary data is defined as data which has already been collected by others and is often in the public domain.

A key difference between primary and secondary data is related to their usage for specific research problems. According to Surbhi (2016), primary data is collected by the researcher himself, specifically for the purpose of addressing his particular research question. This allows the researcher to gather very specific data tailored to solve and fulfil the researcher's wants and needs. Secondary data, on the other hand, has already been collected by others, and is therefore readily available if it is not proprietary data. Secondary data, however, may or may not be directly related to the researcher's current problem (Surbhi 2016). Therefore, the researcher must evaluate the secondary data in terms of whether it helps him solve his research problem.

Another key difference between primary data and secondary data is the potential sources used to collect the data in combination with the effort required to acquire the data. The most common strategies for collecting primary data are interviews and surveys. According to Wolf (2016), interviews provide the opportunity to gather detailed insights from experts and insiders about certain topics of interest, such as the interviewee's business or competitors. Another source for collecting primary data are surveys that can be sent to people or companies whose expertise, knowledge or opinion are relevant to the researcher's research problem. Compared to interviews, surveys have the advantage that the researcher is able to collect a higher amount of data since a survey can easily be sent to a high number of potential respondents whereas an interview is usually targeted at only one or a few respondents.

All in all, collecting primary data requires more effort and is much more time-consuming than the collection of secondary data. For primary data collection, the researcher must look for suitable interview partners, must come up with pertinent interview questions in regard of his research objective, or compile a survey that eventually produces meaningful results. Secondary data is usually easier to obtain. There are a lot of potential sources that provide useful secondary data for many research topics and purposes. Moreover, many of these sources are available online and for free which means that researchers in many cases are able to find useful data with limited effort. According to Wolf (2016), there are a variety of sources a researcher can use to find secondary data, including government

statistics, company websites and trade publications. Government statistics can be a comprehensive source for gathering information on a variety of economic trends and data, whereas company websites provide plenty of company-specific information, such as product offerings or annual reports with the company's latest financial results. (Wolf 2016.)

In summary, it can be stated that both market research methods, primary data, and secondary data, can be very useful for any given research. Before deciding on which method to use, however, the researcher must be aware of the advantages of each market research method, in order to find the most efficient one for his research needs. The collection of primary data has the advantage that it can be tailored to explicitly meet the research-specific needs, whereas secondary data must be evaluated thoroughly in terms of its usefulness to address the research problem. On the other hand, secondary data can be advantageous because it is less time-consuming to obtain and requires less effort than primary data to be found and analyzed.

3.3 Research Approaches

All in all, there are three different types of research approaches, the deductive research approach, the inductive research approach, and the abductive research approach.

According to Dudovskiy (n.d.), a researcher would be using a deductive research approach if he were to formulate hypotheses that need to be confirmed or rejected during the research process. Like all research methods and approaches, the deductive research approach requires the researcher to collect reliable data to test the hypotheses. According to Saunders, Lewis & Thornhill (2012), the collection of data is then used to evaluate the researcher's propositions or hypotheses. To sum up, a deductive research approach is used when a researcher wants to test the validity of hypotheses or assumptions he had formulated before the research.

The second commonly used research approach is the inductive research approach. As opposed to the deductive research approach, the inductive research approach does not include the formulation of hypotheses as part of the research process. Instead, the researcher postulates research questions and objectives that need to be answered and achieved, respectively (Dudovskiy n.d..). Data collection is necessary in the inductive research approach as well, however, the data is used in a different way than it would be in the deductive research approach. As mentioned above, the collected data in the deductive research approach is used by the researcher to test the hypotheses he had formulated before starting his research. In the inductive research approach, however, data collection is used to identify themes and patterns, and to explore a phenomenon (Saunders, Lewis & Thornhill 2012). This phenomenon to be examined is named in the research questions and objectives raised by the researcher. Furthermore, the inductive research approach leads to the emergence and building of new theories after carrying out the research (Saunders, Lewis & Thornhill 2012), whereas the theories in the deductive research approach are known in beforehand.

The third commonly used research approach is the abductive research approach. According to Bryman & Bell (2015, 27), the abductive research approach differs from the other two research approaches in so far as the research starts with surprising facts or puzzles, and the research is devoted to explaining them. Data collection, however, has the same purpose as in the inductive research approach. According to Saunders, Lewis & Thornhill (2012), data in abductive research is collected to explore a phenomenon, and to identify themes and patterns.

3.4 Methods used in this research

After illustrating and outlining the details of all research and data collection methods, market research methods and research approaches, it is crucial to know which of the methods are suitable to use for specific research purposes. This helps in determining the correct methods for this particular thesis and research.

When it comes to data collection methods, there are three options to choose from, as mentioned in chapter 3.1. These are qualitative research, quantitative research, and a mixed-method research, which incorporates both the qualitative and the quantitative approach. In this research, a mixed-method research is used for data collection due to several reasons. First, as Creswell and Clark (2007) pointed out, the use of quantitative and qualitative approaches in combination provides a better understanding of research problems than either approach alone. Therefore, using a mixed-method approach eliminates the limitations which would be faced if only one approach would be used. The mixed-method approach allows for the utilization of not only large amounts of data but, even more important, the utilization of different types of data, such as numerical data, statistics and also written reports of experts and insiders.

The second reason for using a mixed-method approach is the nature of this research. Examining the role and impact of audit firms, and thus, a limited number of companies in certain, one-off events as well as in the broader economic context requires a research approach that combines both official numbers and statistics (the quantitative approach), as well as the analysis of already published reports and other written work (the qualitative approach). However, there will be a slight focus on qualitative data since there are four case studies to be conducted, and case studies tend to be more qualitative than quantitative by nature.

With regard to market research methods, there are two types of data that can be collected and used in a research. As mentioned above in chapter 3.2, data can be classified as primary data and secondary data, with primary data being collected by the researcher himself, and secondary data being readily available to the researcher. In this research, secondary data is used as data source for multiple reasons. First, the research topic fits the use of secondary data better than the use of primary data. Examining the role of auditors in fraud detection in combination with conflicts of interest requires very specific expertise of people that know the respective industries. Especially the case studies require the views and knowledge of people that were either actors in or ardent observers of these cases. In order to use primary data, these individuals would have to be contacted in person. However, that is not feasible within the limits of this research, which means that conducting in-depth interviews or surveys is ruled out. Consequently,

secondary data is to be used in this thesis. Moreover, there are a lot of useful secondary data available since the research topic, namely audit, fraud and potential conflicts of interest has evoked a lot of public interest in recent years. These reasons, namely the wealth of data already available, the impracticability to obtain reliable primary data as well as time constraints make secondary data the most suitable market research method for this thesis.

As for the research approaches, there are three different approaches to choose from, namely the deductive approach, the inductive approach, and the abductive approach. The deductive approach is primarily concerned with the formulation of hypotheses which are then tested during the research process. The inductive approach, however, is about formulating research questions and objectives that are to be answered and achieved, respectively, in the research process, whereas abductive research, according to Bryman and Bell (2015) deals with explaining surprising facts or puzzles. Since the research questions and objectives mentioned in chapter 1 form the foundation of the research process in this thesis, the natural choice of research approach is the inductive approach. This research is dedicated to developing solutions to a particular research objective, namely, how to eliminate situations of conflict of interest in audit. In addition, a number of underlying research questions were designed to help accomplishing the research objective. Having a main research objective as well a number of research questions are prime features of an inductive research approach which makes this approach the one to use in this thesis.

4 AUDIT AND CONFLICT OF INTEREST

4.1 Potential Situations of Conflict of Interest

As discussed at length in the previous chapters of this thesis, neutrality, objectivity, and independence are cornerstones of the auditor’s profession. However, there are certain circumstances in the audit industry that cannot just impair an auditor’s independency but also potentially lead to conflicts of interest which, in turn, can reduce audit quality.

Potential situations of conflict of interest in audit can have many different origins. Most of them occur either within the affected audit firm or audit division, for instance in the audit department of a Big Four company, or at the interface of audit and consulting departments within an organization, such as the Big Four. These four companies, Deloitte, EY, PwC, and KPMG, are especially prone to finding themselves in conflict of interest situations due to their business model which seeks to reconcile audit and consulting. Even though conflicts of interest can also occur within an audit department, it is mostly the peculiar relationship between audit and consulting units within the Big Four that have led to conflicts of interest in the past. Moreover, the contentious business model of the Big Four of offering both audit and consulting services has also put regulators in many countries on notice, and has elicited new laws and regulations aimed to eliminate or at least reduce the risk that situations of conflict of interest arise.

The fact that the occurrence of conflicts of interest is particularly likely at the interface of auditing and consulting should, however, not overshadow other potential situations of conflict of interest in auditing, for instance within the audit department of a Big Four company. These and other situations of conflict of interest are discussed in more detail in this chapter. Moreover, measures implemented by different countries to reduce or eliminate conflicts of interest in audit are presented in this chapter as well.

4.1.1 Within the Audit Department

Conflicts of Interest in audit do not just occur when consulting interests come into play. Their emergence is also possible within an audit department or an audit team when dealing with a client. One potential conflict of interest situation becomes obvious when looking at who the auditor actually serves. The constellation is potentially contentious. According to Ketz (2020), the auditor serves the public interest and the client's stakeholders, such as investors and credit institutions, while at the same time being bound to the client's management. That means that the auditor, even though he is hired and being paid by the company's management, does not serve this management. The audited annual report is of more significance to a company's stakeholders, such as customers, shareholders, and banks. On the other hand, the client's management pays the auditors for their work which makes the company the client, at least on paper. This constellation is what leads to a conflict of interest for the auditor (Ketz 2020). Auditors might prefer to build a positive relationship with the client's management instead of only serving the public and the client's stakeholders. However, having such a mindset would lay bare an auditor's conflict of interest, and could eventually impair the auditor's objectivity and the quality of an audit.

Building and maintaining a positive relationship with the client's management is also the source of the second potential conflict of interest situation within an audit firm's audit practice. An auditor must always be independent and exercise professional skepticism, as discussed in chapter 2.1.1. However, audit firms must naturally keep their business interests in mind which include acquiring important clients or at least not losing them. When an auditor's role collides with his business interests, a conflict of interest arises. In practice, that means an auditor might condone financial misstatements or questionable accounting practices which may even end up as fraudulent, when he frets that uncovering them would worsen the client relationship or even lead to losing the client to a competitor. The fear of losing a client, and therefore not uncovering material misstatements of fraud is a blatant conflict of interest, and can have devastating effects on the auditor, the client, and its stakeholders.

Another potential situation of conflict of interest concerns the personal and professional ambition of a single member of an audit team. The Big Four are known to suffer from a high degree of employee turnover, and it is not uncommon for the employees of the Big Four companies to join a client's management team. The Big Four employee already has a business relationship with the client's management, knows the client and its internal processes, and can bring a fresh view and new ideas to the company. These aspects make Big Four employees enticing as potential new employees for their clients. However, according to Banks (2004, 145), such a situation can be an origin for a conflict of interest, since an auditor who is interested in working for the client in the future, could ignore audit standards or misstatements by the client in order to maintain a positive relationship with the client, and stay attractive to the client when it comes to a potential future employment contract. Such a behavior would represent an obvious conflict of interest since the auditor were to put his personal interests over those of the client's stakeholders which he is supposed to serve.

4.1.2 Audit vs Consulting

Even though conflicts of interest can possibly occur within an audit department or audit team, it is the connection between audit and consulting which is prone and more likely to lead to conflicts of interest or at least raise suspicions in that regard from regulators and the public. Audit firms might prefer to be too cooperative during an audit tolerating questionable accounting practices in order to not risk losing the client when it comes to potential consulting gigs in the future.

In order to assess this risk, it is important to understand two key aspects. First, audits, for the most part, are mandatory and must be conducted in accordance with certain rules and regulations. Consultants, on the other hand, are allowed to carry out their work with more freedom, and do not have to abide by any strict rules set by regulators and governments. Second, it is crucial to understand the business model and especially the current revenue structure of the Big Four. While the business model, namely offering both audit and consulting services, has already been discussed in detail, the revenue structure of the Big Four must

be examined as well. The revenues of the Big Four in FY 2019, subdivided into the respective business units, are shown in the chart below.

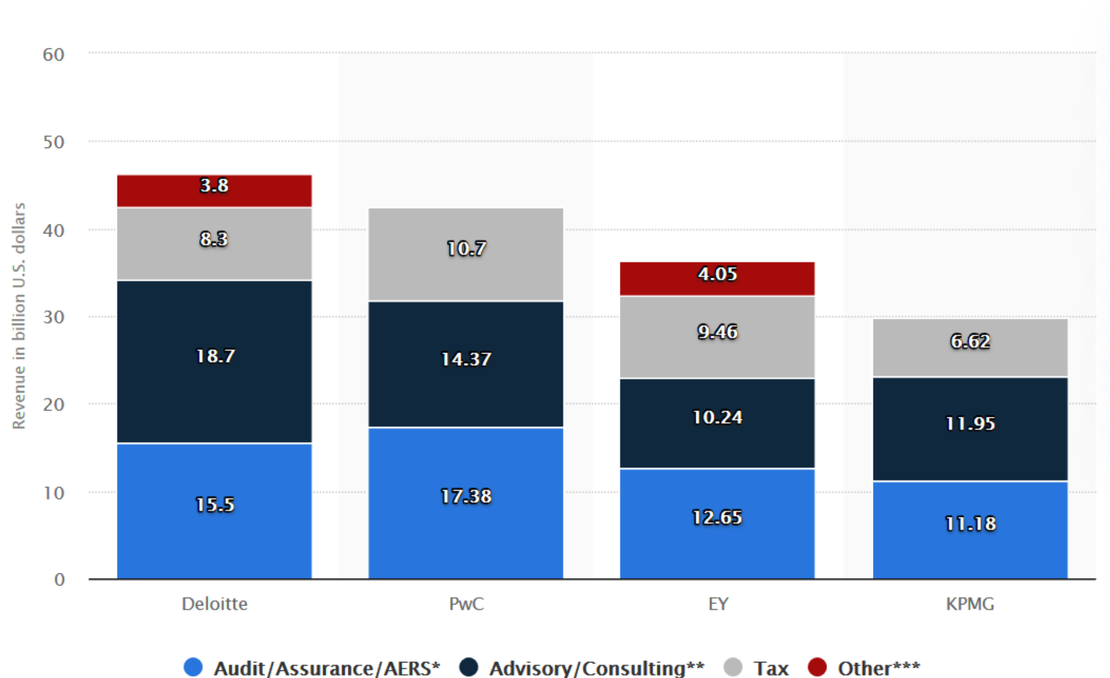

FIGURE 2. Revenue of the Big Four in FY2019 by function/business unit (Mazareanu 2019).

The chart shows that all of the Big Four generate a majority of their revenue with their consulting-related activities, which also include tax consultation, financial advisory (Deloitte), and transaction advisory services (EY). Deloitte in particular relies heavily on its consulting services with only 33% of its revenue earned from auditing and 67% from consulting. Whereas the differences in the other three firms are not quite as high, with PwC earning 41% from audit and 59% from consulting, EY earning 35% from audit and 65% from consulting, and KPMG earning 38% from audit and 62% from consulting, it still shows that all of the firms generate a comfortable majority of their revenues with their consulting departments.

That brings up the following question: Why are the revenue shares per business unit relevant for the issue of conflicts of interest? The figures show that consulting has morphed into the main source of income for the Big Four whereas their original business idea, audit, has taken a back seat. The revenue distribution shows that the assumption and source of a potential conflict of interest mentioned earlier in this chapter, namely the fear of an audit firm to lose out on potential future consulting mandates due to being too meticulous during an audit, and maybe

even being tempted to cover up irregularities cannot be denied. Having to potentially decide between the crucial job of properly conducting a statutory audit and the much more lucrative consulting work shows an obvious conflict of interest. This issue has generated a lot of attention and even ire in recent years and decades and has led to numerous attempts of regulation from governments which will be discussed in more detail in section 4.2.

While the fear of losing potential consulting fees is the most blatant potential source of conflicts of interest between audit and consulting, there is also a second situation that could potentially cause a conflict of interest. Such a situation arises when auditors evaluate systems or structuring advice that were put in place by their non-audit colleagues in the same company (Crockett, Harris, Mishkin & White 2004, 32). An auditor's independence can for instance be tarnished if he audits tax avoidance models which were outlined and implemented by the audit firm's tax department. That means the audit firm basically examines its own work which is a prime example for a conflict of interest.

4.1.3 Other

While the business relationship between the audit and consulting departments of the same company as well as certain circumstances within an audit department, such as conducting an audit as diligently as possible versus the fear of losing a client, are the best-known situations that can cause conflicts of interest, there are also other, less-known conflicts of interest that can occur.

A potential conflict of interest regarding the audit firm PwC was discovered during the investigation into the collapse of Carillion, a former British construction services company. Even though the Carillion collapse is analyzed in detail in a case study in chapter 5, the type of conflict of interest PwC faced in this case is worth mentioning in this chapter as well. According to Chapman (2018), PwC first worked as a consultant for Carillion before taking on an advisory role for the company's pension fund trustees a few months later when the trustees were in a dispute with Carillion about money that was to be paid into a retirement scheme. Advising one party and collecting high fees before switching and starting to advise

this party's counterpart immediately raises the question whether PwC did their best when advising either party or whether there was a conflict of interest which would definitely be conceivable.

Potential conflicts of interest can also be found in forensic auditing. In 1998, KPMG was hired to perform a forensic audit or investigation, respectively, on the financial books of the company Livent Inc. (CNN Money 1998). KPMG was then sued by the company's former executive Garth Drabinsky, who himself was an existing tax client of KPMG at that time. According to Moosa (2015), Drabinsky argued that KPMG cannot not be allowed to act against his interest by performing a forensic investigation against him since he himself was a client of the company. This situation definitely represents a conflict of interest since KPMG obviously had access to confidential information and data of its clients, in this case Drabinsky. KPMG could have used this data against Drabinsky in the forensic audit which exemplifies the conflict of interest. According to Moosa (2015), the court agreed with Drabinsky, and prohibited KPMG from performing the forensic audit.

All of these examples show that a myriad of conflicts of interest can arise within audit firms. For many years, governments and watchdogs have therefore been trying to rein in the influence of audit firms, especially the Big Four. In order to achieve that goal, regulators have put in place certain measures in recent years aimed at eliminating or at least reducing conflicts of interest in audit. These measures are discussed in more detail in the upcoming chapter.

4.2 Measures implemented to ensure an Auditor's integrity + Eliminate Conflicts of Interest

The company structure and the business model of the Big Four have been under scrutiny for many years now. The Big Four's reputation among national governments and regulators has suffered by financial scandals and collapses of several major organizations, such as Enron and WorldCom, where audit firms have either failed or played a precarious and contentious role. Thereby, the failure of audit

firms has contributed to the devastating implications these corporate collapses had, including employees losing their jobs and investors losing their savings.

These accounting frauds either went unrecognized for too long or were uncovered too late. In their wake, the governments and regulatory agencies began to examine the general business model of the Big Four of offering both consulting and auditing services, making the firms prone to allegations of conflicts of interest. As mentioned in chapter 4.1, a number of national governments and regulators have, in recent years and decades, put rules in place and laid out and implemented regulations meant to improve audit quality and to eliminate or at least reduce conflicts of interest in audit.

The regulations and measures that were drafted and implemented by the regulatory agencies in the United States, in the member states of the European Union and in the United Kingdom are discussed in more detail in this chapter.

4.2.1 Measures implemented in the US

In the early 2000s the business and finance sectors in the United States were rattled by a number of high-profile companies committing accounting fraud and subsequently filing for bankruptcy. These corporate collapses which include Enron's bankruptcy in December 2001 and WorldCom's bankruptcy in July 2002, erased billions of dollars in market capitalization and cost tens of thousands of jobs. In response to these accounting scandals and business failures, the United States enacted a new law, the Sarbanes-Oxley Act, in July 2002 only nine days after WorldCom filed for bankruptcy. The law was meant to protect investors by setting rules regarding the regulation of audit firms and accounting practices in companies, among other issues. All in all, the Sarbanes-Oxley Act comprises of eleven sections, with each section providing rules for a specific issue, such as enhanced financial disclosures or corporate and criminal fraud accountability.

Section two of the Sarbanes-Oxley Act is devoted to the issue of auditor independence. The auditor independence section of the Sarbanes-Oxley Act (Public Law 107-204 2002, 27-31), published by the PCAOB, an institution created by

the Sarbanes-Oxley Act to oversee the audits of public companies, tackles a range of issues, including limiting non-audit services to audit clients, mandatory rotation of audit partners, and other matters concerning conflicts of interest.

Section two of the Sarbanes-Oxley Act is further divided into nine sub-sections, with each sub-section addressing one issue related to auditor independence. The first sub-section (Public Law 107-204 2002, 27-28) prohibits audit firms from offering a number of different consulting services, such as management functions, human resource services and investment banking services, to its audit clients. Even though the Sarbanes-Oxley Act does not specifically state that it prohibits firms from offering all consulting services to audit clients, the specified prohibitions encompass most consulting services the Big Four have been offering up to that point. While this law led to some progress, loopholes still remained and were exploited by the Big Four to maintain their business model. Especially since the financial crisis a few years later, the Big Four started to acquire smaller consulting firms. These acquisitions greatly contributed to the size and sway of the Big Four today.

Another measure to combat conflicts of interest which came into force through the Sarbanes-Oxley Act is mentioned in another sub-section of section two. This sub-section states that an audit firm is not allowed to perform an audit for a client if that client's CEO, CFO or a person in a similar position has been working for the audit firm within one year prior to the start of the audit (Public Law 107-204 2002, 30-31). In effect, that prohibits an auditor from switching to a client and hiring the same audit team he used to work in. This clause is designed to not just limit conflicts of interest but also reduce the coziness between auditor and client, and thereby, increasing the independence of the auditor. This measure is not the only one designed to reduce the coziness between auditor and client, though. The Sarbanes-Oxley Act also includes a section that implements a rotation of audit partners. According to the law (Public Law 107-2024 2002, 29), the audit partner, i.e. the person in charge of an audit must be substituted after 5 years on that audit team which is a useful measure to prevent the audit partner and the client from getting too close to each other.

4.2.2 Measures implemented in the EU

Even though the major accounting scandals of the 21st century have occurred in the United States, those scandals as well as the Big Four business model's vulnerability to conflicts of interest have also prompted EU regulators to take action in regards to audit quality and the protection of investors. Therefore, the European Union has adopted several measures designed to combat conflicts of interest in audit.

Similarly to the United States, the EU has implemented a rotation at the audit partner level. In 2006, the EU ordered its member states to ensure that key audit partners responsible for carrying out an audit must step down from this audit engagement after a maximum of seven years in charge (Directive 2006/43/EC, 18), in order to enhance auditor independence by reducing the coziness in the relationship between auditor and client. In 2014, the European Union followed that up by introducing a mandatory audit firm rotation and thereby expanding its rotation rules. The issue of implementing audit firm rotation has also been discussed in the United States, however, such a rule was never adopted. According to the EU, implementing this measure helps reducing conflicts of interest in audit by preventing the relationship between auditor and client from getting too close. This issue is noted down in article 17 of the EU directive in question which states that a company must appoint a different auditor after 10 years the latest (Regulation 537/2014 2014, 21).

The EU also devoted itself to the most pressing and contentious issue when it comes to conflicts of interest in audit: the relationship between audit and consulting. According to Article 5 of Regulation 537/2014 (2014, 10-11), audit firms, such as the Big Four, are prohibited from offering certain non-audit, i.e. consulting services, such as tax, valuation, human resources or management services to their audit clients during the period in which the audit is carried out as well as during the financial year preceding the aforementioned period. This means, however, that the EU did not tackle a key issue discussed earlier in this paper. One of the potential conflict of interest situations in audit is, as mentioned earlier, the fact that an auditor might not examine the client's financial statements as thoroughly as required since that might impair the relationship to the client and might lead to

the loss of potential consulting mandates in the future. The problem is that consulting mandates are much more lucrative for professional service companies than audit mandates. The European Union apparently did not consider this issue at all while working on the regulation, at least it is not mentioned in the final version of the regulation, meaning that an audit/consulting firm is allowed to offer consulting services to a former audit client immediately after dropping the audit mandate. Therefore, a prime source for conflicts of interest has not been dealt with and can hence still be exploited by audit companies.

Another measure implemented by the EU and laid out in Regulation 537/2014 is setting a limit to fees paid for non-audit services other than those mentioned in the previous paragraph which audit firms are prohibited from offering to audit clients anyway. In order to ensure auditor independence and reduce the appeal of high consulting fees, the EU decided to cap fees for non-audit services offered to audit clients (Regulation 537/2014 2014, 9). According to the regulation (2014, 9), these fees are capped at 70% of the average of the fees paid by the client for the audit in the last three years.

The measures implemented by the European Union include a number of useful methods to improve auditor independence and reduce the risk of conflicts of interest. The measures, however, are not profound enough to eliminate situations of conflict of interest. In fact, they ignore one of the most obvious sources of conflicts of interest, namely an audit firm’s apprehension of being too thorough in its audit, and thereby worsening the client relationship, and potentially losing out on future consulting work for that client. An effective measure would have been to prevent audit/consulting firms from offering consulting services immediately after concluding the audit for the same firm by implementing a waiting period of a few years before the audit firm can offer consulting services to former audit clients. If the EU is in fact eager to eliminate conflicts of interest and improve investor protection, there is still a lot of work to be done.

4.2.3 Measures implemented in the UK

The US and EU authorities are not the only protagonists to draft and implement measures aimed at improving auditor independence and reducing the risk of conflicts of interest. A number of regulators and governments around the world have recognized the risks associated with a lack of auditor regulation and independence and have therefore implemented similar measures as the EU and the US to ensure auditor independence.

One of those countries is the United Kingdom. Since the UK withdrew from the EU only on 31 January 2020, it was still a member when the EU presented and implemented Directive 2006/43/EC and Regulation 537/2014 in 2006 and 2014, respectively. Therefore, the rules laid out by the EU were adopted and integrated into British national law. In addition, the FRC, the audit regulator in the UK, has recently started to introduce new measures aimed at improving auditor independence. According to Hallas and McKeon (2020), the FRC has decided that providing non-audit services closely linked to an audit which are offered to audit clients is subject to approval by the audit client's audit committee in order to ensure that these non-audit services do not interfere with auditor independence.

The usefulness of this measure is hard to assess, after all it was announced only in December 2019. Another measure to improve auditor independence was announced by the FRC in July 2020 which has the potential to have a major impact on the entire audit industry and especially on the Big Four. In fact, Kinder (2020) thinks that the decision marks the largest shake-up of the audit industry in decades. According to Kinder (2020), the FRC has decided the Big Four must consummate an operational split of their audit units which includes, among other aspects, producing separate financial statements for the audit unit. While the FRC has now gone further than any other government or regulator in terms of breaking up the Big Four, this step can be only seen as a part-break-up. According to Kinder (2020), this measure is short of a full break-up, though, which would have been achieved by a spin-off of audit units into independent legal entities.

4.2.4 Conclusion

The results in chapter 4 show that governments and regulators have already put in place a number of different measures to enhance auditor independence and reduce the risk of conflicts of interest in audit. However, the measures have so far not yielded satisfactory results as demonstrated by the collapse of British construction and facilities management services company Carillion in 2018 which also led to more radical methods being announced by the FRC, such as the separation of audit units which was discussed in the previous paragraph. That being said, regulators still have a lot of potential options to further improve auditor independence, for instance a further break-up of the Big Four or imposing higher fines for misconduct than so far. These measures or solutions will be discussed in more detail in chapter 7 of this thesis.

5 ANALYSIS

So far, the research has been all about general information on the audit sector, the relationship between audit and consulting as well as conflicts of interest which might arise in audit, and measures implemented to prevent these conflicts of interest from arising. However, in order to assess whether the described conflict of interest situations have actually occurred in reality and whether the devised and implemented measures tackle the actual problems related to conflicts of interest in audit, it is crucial to examine meaningful real-world data and historic events.

This is done by conducting case studies of certain events in the past where auditors have been criticized for conflicts of interest, failure to uncover fraud, and other misconduct. In order to assess an auditor's role in fraud cases and whether there have been cases where auditors have had conflicts of interest, four different case studies are conducted in this chapter.

First, the so-called Enron scandal is discussed. Enron was an American energy company that filed for bankruptcy in 2001 after committing accounting fraud by manipulating its accounts. A special emphasis is placed on Enron's then-auditor, Arthur Andersen, which collapsed in the wake of the scandal. The second case study is about the WorldCom scandal. WorldCom was an American telecommunications company which had overstated its assets by $11 billion. The fraud was discovered by its internal auditors and led to the firm's bankruptcy in 2002. The third case study takes a deeper look into what is likely the most famous corporate collapse in history, the bankruptcy of Lehman Brothers, a former American bank. Lehman hid over $50 billion in loans disguised as sales. However, neither the company nor its management was ever convicted. The fourth and final case study examines the collapse of Carillion, a former British construction and facilities management services company that filed for bankruptcy in 2018 after experiencing financial problems. This case is not a fraud case, but it is still interesting due to the role of the Big Four. All of the Big Four had done business with Carillion at some point, and their conduct has been heavily criticized by British politicians after Carillion went bankrupt, with some even calling for the Big Four to be broken up.

5.1 Case Study: The Enron Scandal & Arthur Andersen's subsequent collapse

5.1.1 Introduction

When examining the case of Enron's demise which occurred in 2001, there are two parties that need to be looked at, Enron itself as well as Enron's long-time auditor, Arthur Andersen. Enron was an American energy company founded through a merger between two smaller companies in 1985. Enron expanded rapidly in the 1990s which is well-documented by its marvelous revenue growth. According to Enron's 1998 annual report (Enron 1999), the corporation's revenue had risen from $13.3 billion in 1996 to $31.3 billion in 1998, a growth of around 135 percent. The revenue growth to year 2000 is even steeper. According to Enron's 2000 annual report (Enron 2001), it posted revenues of $100.8 billion in 2000. Compared to 1998, this figure amounts to a growth of around 222 percent, and compared to 1996, the revenue growth is an absolutely astonishing 658 percent. Those growth numbers are unprecedented. The revenues of $100.8 billion in 2000 were enough for Enron to be ranked as the seventh-largest American company by revenue, according to the Fortune 500 list of 2001 published by CNN Money (2001), well ahead of Wall Street giants, such as Bank of America, Morgan Stanley and Wells Fargo who are among the largest and most profitable companies nowadays.

After posting a record growth, the company collapsed in 2001 after it had committed accounting fraud by keeping huge debts off its balance sheet, leading to thousands of employees losing their jobs as well as investors losing billions of savings. Enron was not the only company to collapse in the wake of the scandal, though. Arthur Andersen, Enron's auditor, was the second major company to perish after the fraud scandal was discovered. Arthur Andersen failed to either detect or disclose Enron's fraudulent actions and was later convicted for obstruction of justice. The verdict led to Arthur Andersen ceasing its audit business.

The following analysis screens the role of all the scandal's relevant players, such as Enron, its executives, and Arthur Andersen. A special emphasis is placed on Arthur Andersen's conflicts of interest while auditing Enron's financial statements.

5.1.2 Case Breakdown

The Enron case or Enron scandal can be described without exaggeration as one of the biggest bombshells in corporate America's history. As mentioned above, Enron was the seventh-largest American company by revenue in 2001, the year of its collapse. According to Scipioni (2019), the meltdown of Enron is the seventh-largest American corporate bankruptcy ever. The bankruptcies ranked ahead of Enron's, however, all occurred after 2001, meaning that Enron's collapse was the largest ever at the time it happened, with Enron having amassed assets of $65.5 billion (Scipioni 2019). How did it come to that? How did a company which had posted incredible growth numbers in prior years collapse that quickly? Were the reported figures fake?

The roles of four different protagonists are to be examined in this case. Three of them were executives of Enron, CEO and Chairman Kenneth Lay, COO Jeff Skilling who became the CEO half a year before Enron's collapse and CFO Andrew Fastow. The fourth player in this case is Arthur Andersen, Enron's auditor, back then one of the so-called Big Five, the five largest auditing companies, along with Deloitte, PwC, Ernst & Young and KPMG. According to Thomas (2002), Skilling, who was hired by Lay in 1990, created an efficient business strategy for Enron after the company was indebted following the merger in 1985 that had created the firm. This strategy helped the company rake in higher profits than its competitors which led to Enron's steep rise.

One aspect which played a major role in Enron's rise as well as in in its demise was the company's sophisticated accounting practice which even experts had trouble understanding and figuring out. One part of this accounting practice is called mark-to-market accounting. According to Thomas (2002), Enron incorporated mark-to-market accounting in the mid-1990s and used it on an unprece-

dented scale for its trading transactions. In mark-to-market accounting, companies must adjust outstanding energy-related contracts on their balance sheets to fair market value, booking unrealized gains or losses to the income statement of the period in question (Thomas 2002). What this basically means is that Enron was able to book estimated profits as actual profits. The issue here was that energy commodities such as gas often do not have defined prices. Therefore, companies like Enron are allowed to use their own valuation models which obviously makes the financial numbers hard to comprehend for outsiders. An example where Enron could have used the mark-to-market method is building an asset such as a power plant. Enron would have been allowed to book the projected profits in its books even though the plant has not made any money yet. In case Enron were to make a loss or a less than projected profit with its plant, the company would proceed by moving the asset to another corporation's books. Thereby, the loss and the resulting debt would not show up in Enron's books.

This brings us to the second part of Enron's accounting practice which ultimately, along with the mark-to-market accounting system led to the company's demise. This second aspect of their accounting practices was the use of special purpose entities (SPEs). According to Thomas (2002), these SPEs were the corporations Enron transferred its assets and debt to, a system mentioned in the earlier paragraph. It is important to note here that just as the mark-to-market system the use of SPEs is not illegal. However, Enron violated the generally accepted accounting principles by performing illegal activities when it came to booking SPE transactions in their books. According to Thomas (2002), Enron not just made these SPEs opaque by capitalizing them with a variety of assets and liabilities as well as complex derivative instruments, they broke the law by deceptively increasing receivables and shareholder's equity after issuing common stock in exchange for a note receivable. Furthermore, they should have consolidated some of their SPEs which were run by Enron's CFO Andrew Fastow, into their financial statements but failed to do so (Thomas 2002).

Enron's opaque accounting practices had already raised suspicions in 2000 and 2001 which had led to a stark decrease of the company's stock price. These suspicions instigated an investigation by the SEC. This investigation combined with a restatement of the financial statements from multiple previous year which added

millions of losses and liabilities to Enron's financial statements caused a further decline of Enron's stock price, according to Thomas (2002). These circumstances along with a failed merger with a smaller competitor ultimately led to Enron declaring bankruptcy in December 2001.

Which role did Enron's auditor, Arthur Andersen, play in this scandal? Arthur Andersen did not detect the sophisticated fraud schemes used by Enron, and instead issued unqualified reports of Enron's financial statements, meaning that according to Arthur Andersen, Enron's books were free of significant material misstatements. According to Millon (2003), Arthur Andersen should have alerted Enron's board and the investing public of the company's misleading financial statement disclosures. Millon's sentiments are shared by Powers, Troubh and Winokur (2002) who issued a report that addresses the transactions made between Enron and its SPEs. In this report, Powers, Troubh and Winokur (2002) write that Andersen did not fulfil its professional responsibilities in connection with its audits of Enron's financial statements.

Whether Arthur Andersen just failed to detect these egregious fraud schemes due to their complexity or even deliberately ignored them, is unclear and has never been clarified. Arthur Andersen's extensive connections to Enron at least suggest the assumption that the auditor might have acted on purpose since the available data reveal apparent conflicts of interest. Arthur Andersen was not just Enron's auditor, it also held consulting contracts with the energy company. According to Glater (2002), Arthur Andersen was paid about $27 million for consulting and $25 million for audit services by Enron in 2000, the year before Enron's collapse. The conflict of interest when auditing and consulting the same company has been discussed at length in this research. Therefore, it could have very well been possible that Arthur Andersen was afraid of losing consulting fees if it were to make Enron's fraud public.

Furthermore, it is at least conceivable that Arthur Andersen feared to lose Enron as an audit client as well. According to Healy and Palepu (2003), the audit fees paid by Enron accounted for roughly 27 percent of the audit fees of public clients for Arthur Andersen's Houston office. That means the Houston office of Arthur Andersen, and thereby its employees, were highly dependent on the audit fees

paid by Enron. This could have led to Andersen fearing to lose Enron as their audit client if it were to uncover and report fraud, making the conflict of interest obvious. There is also another reason why Arthur Andersen could have been afraid. It is conceivable that Arthur Andersen was worried that reporting Enron's accounting fraud could have resulted in the energy company's collapse. A collapse also would have led to Arthur Andersen losing Enron as one of its biggest clients. Either way, Arthur Andersen must have suffered from a conflict of interest during the Enron audit.

5.1.3 Aftermath & Conclusion

The Enron scandal had widespread implications on a lot of protagonists. Enron itself which had been the seventh-largest American company by revenue (see section 5.1.1), went bankrupt shortly after the scandal unfolded. Arthur Andersen was convicted for obstruction of justice in 2002 after it had shredded documents related to the Enron scandal, according to CNN Money (2002). This conviction led to Arthur Andersen surrendering its accounting licenses, according to the Wall Street Journal (2002), effectively putting the firm out of business. The conviction was overturned by the US Supreme Court in 2005 which ruled that it is unclear whether Arthur Andersen officials knew what they were doing when they shredded the documents, according to Waldmeir (2005). Therefore, it could not be proven unequivocally whether Arthur Andersen really tried to obstruct justice. The ruling in theory made it possible for Arthur Andersen to resume operations. However, Arthur Andersen was unable to do so since the company had lost almost all of their employees after ceasing operations in 2002. Moreover, the Enron scandal had ruined Arthur Andersen's reputation too much.

The Enron scandal also had implications on the general business of auditing firms since the scandal was one of the key reasons for devising and implementing the Sarbanes-Oxley Act (see section 4.2.1). The Sarbanes-Oxley Act prohibits auditing firms from offering a variety of consulting services to its audit clients in order to boost auditor independence and prevent conflicts of interest. Since the con-

sulting contracts Arthur Andersen had with its audit client Enron represent a conflict of interest, the Sarbanes-Oxley act thereby aims to tackle a key deficiency in the Arthur Andersen and Enron case.

To sum up, one could say that Arthur Andersen failed in the Enron case since it did not detect the fraud schemes used by Enron. However, it cannot be said with absolute certainty whether Arthur Andersen just did not see the fraud or whether the company deliberately ignored it due to its conflicts of interest. It is obvious, though, that Arthur Andersen had conflicts of interest such as the high consulting fees of $27 million paid by Enron in 2000 and the dependency of Andersen’s Houston office on Enron as a client since Enron accounted for 27% of the office’s audit fees (see section 5.1.2) which could have resulted in Arthur Andersen fearing to lose Enron as a client if the fraud were made public.

Arthur Andersen’s conflict of interest regarding the audit versus consulting issue could have been prevented if the Sarbanes-Oxley Act or other rules to boost auditor independence had been issued earlier than they ultimately were. If such rules had been in place back then the conflict of interest could have been prevented, however, it remains unknown whether these rules would have prevented the Enron scandal and the subsequent collapse of Arthur Andersen since, as mentioned above, it is unclear whether Arthur Andersen’s conflict of interest prevented the firm from uncovering and reporting the fraud or whether they just did not detect it.

5.2 Case Study: The WorldCom Scandal

5.2.1 Introduction

The late 1990s and the early 2000s will forever be affiliated to what many assume to be one of the greatest inventions in human history: the internet or the World Wide Web, respectively. Additionally, the early rise of the internet is inextricably linked with the dotcom bubble, also called the tech bubble, that occurred in the late 1990s, and the consequent economic recession in the early 2000s. Bubble

is the term for a phenomenon where an asset, in this case a stock, is priced much higher than its actual value. According to Hayes (2019), the dotcom bubble was a rapid rise in US technology stock equity valuations fueled by investments in internet-based companies.

The rise and fall of technology companies is exemplified by the growth of the NASDAQ index, a stock market index that is known for its focus on IT companies. The NASDAQ had risen five-fold between 1995 and 2000 and had reached its peak of 5,048.62 in March 2000, however, this steep rise was followed by a steep decline for the next two years where the NASDAQ lost 76.81 percent of its value (Hayes 2019). Thereby, the NASDAQ index had almost returned to its pre-bubble value.

This plunge is commonly called the tech bubble burst and had major implications on a range of IT and communications companies, with some of them losing a majority of their value and experiencing financial difficulties and others collapsing entirely. One of the companies to go bust was WorldCom, at the time one of the largest American telecommunications companies. WorldCom was not just hit by the tech bubble burst, though. The company dealt a deathblow to itself by committing accounting fraud on a large scale. What is special about the WorldCom fraud scandal is that it was not uncovered by external auditors, investigators, or authorities but by the firm’s in-house internal auditors whose role is examined in more detail in the following case breakdown.

5.2.2 Case Breakdown

The US auditing and accounting industry had just recovered from Enron’s accounting fraud scandal that was uncovered in October 2001 and resulted in the company’s bankruptcy two months later when the industry got hit by an even bigger accounting fraud around half a year later. The American telecommunications company WorldCom confessed to overstating its assets by more than $11 billion, making the WorldCom scandal the largest accounting fraud in American history (Hayes 2020).

This case study of the WorldCom scandal examines in detail the rise and the fall of WorldCom, the main protagonists in the fraud case, such as the company's executives, its internal auditors, its external auditors, namely Arthur Andersen, and the reasons why the fraud was committed. In addition, the implications and the aftermath of the scandal are discussed.

The late 1990s are known as the period of growth of the internet. This growth led to increasing demand for communications services, and one of the companies that benefitted in a major way from it was the telecommunications company WorldCom. According to Wray, Finch and Treanor (2002), WorldCom grew quickly by carrying out 70 deals, such as acquisitions, within only four years, as Wall Street became more and more interested in IT companies. The rapid growth of WorldCom is illustrated by how its stock price evolved over time (Figure 3).

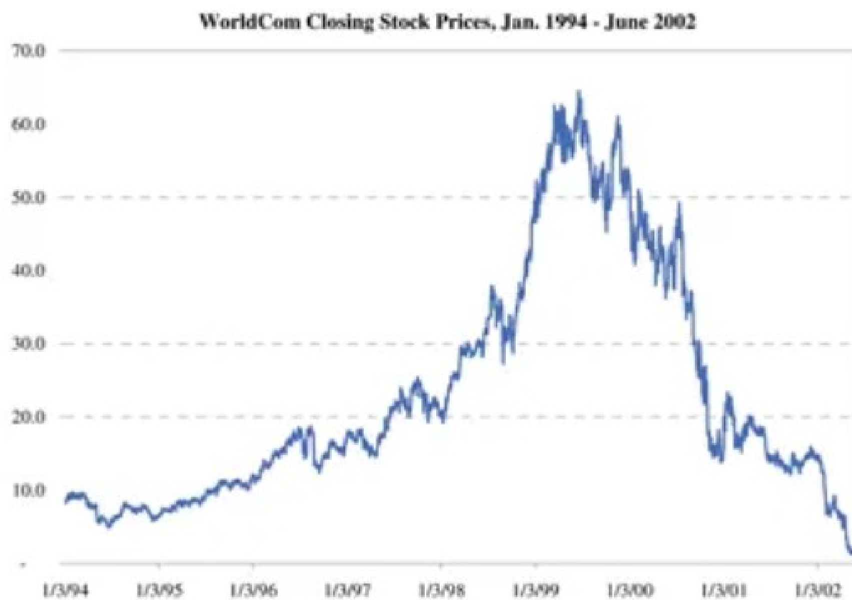

FIGURE 3. Performance of WorldCom's share price between January 1994 and June 2002 (Begin to Invest 2017).

Figure 3 shows the rapid growth WorldCom experienced in the late 1990s as the internet became household. WorldCom's stock price rose steadily but quickly from $10 per share in January 1994 to around $30-35 in late 1998 and early 1999, respectively. Then, the share price jumped to around $64 per share in late 1999,

increasing the market capitalization to approximately $180 billion (Wray et al. 2002). Amid the post-millennial tech-bubble burst, WorldCom was one of many technology companies whose share price crashed. What differentiated WorldCom's decline from that of other technology companies was that the decrease of WorldCom's share price was further exacerbated by the revelation of its accounting fraud scandal.

The burst of the tech bubble led to diminishing earnings for most technology companies accompanied by a declining share price. In order to disguise its diminishing earnings and to prevent a collapse of its share price, WorldCom developed an illegal strategy to inflate its assets, thereby committing accounting fraud. The doctored financial numbers were then used to lead the company's investors and other stakeholders to believe that the company's financial position was much better than what it actually was. According to Hayes (2020), WorldCom developed a fraud system where expenses made by the company were recorded in the books as investments. That means that expenses were capitalized, i.e. recorded as assets. That not only led to inflated assets but also to inflated profits, as WorldCom reported a profit of $1.4 billion in 2001 instead of a loss (Hayes 2020). The inflated profits arise since while operating expenses must be subtracted from revenue immediately, the cost of capital expenses, such as WorldCom's, can be spread over time, thereby inflating the company's profits (Tran 2002).

All in all, WorldCom inflated its assets by $11 billion, according to Kottasova (2015). The fraud was orchestrated by CEO Bernhard Ebbers, CFO Scott Sullivan, controller David Myers, and general accounting director Buford Yates who were all sentenced to prison terms.

Even though the fraud system used by WorldCom was not a very sophisticated one, the company's external auditor Arthur Andersen failed to recognize and uncover it. Arthur Andersen, the auditor that also failed to uncover the fraudulent accounting methods of Enron, was convicted for obstruction of justice shortly before the WorldCom scandal was uncovered. However, Arthur Andersen was obviously still entrusted with auditing WorldCom's financial statements, and its failure to uncover WorldCom's fraud might have brought down the company even if it had survived the Enron scandal (Eichenwald 2005).

Instead, the fraud scandal was uncovered by WorldCom's internal audit team. As mentioned in section 2.1.1, the internal auditor is employed by an organization and is assigned with overseeing whether the company aligns with all bookkeeping rules and regulations, and whether it handles its finances appropriately. WorldCom's internal audit department's vice president Cynthia Cooper was the driving force behind uncovering and reporting the massive fraud committed by her boss, CFO Scott Sullivan, and others.

As Cynthia Cooper reports in her own book, she and her subordinates had found several entries in the company's accounting servers where large amounts of money had been transferred from the income statement to the balance sheet in 2001 and in the first quarter of 2002 (Cooper 2009, 231-233). These findings raised suspicions and accelerated the execution of her team's audit. Neither CFO Scott Sullivan nor other executives were able to provide satisfying explanations for these accounting transactions, and after Cooper and her team had found fraudulent transactions worth more than $3.8 billion in total, WorldCom's audit committee concluded that fraud had been committed, and WorldCom's board of directors demanded the resignations of CFO Scott Sullivan and controller David Myers (Cooper 2009, 262-264).

5.2.3 Aftermath & Conclusion

WorldCom filed for bankruptcy in July 2002, shortly after the accounting fraud scandal was uncovered and made public, putting 20,000 employees out of work. In addition, shareholders lost about $180 billion due to WorldCom's collapse, making it the largest bankruptcy in US history at the time, according to the BBC (2005). The company's executives who were responsible for carrying out the fraud, namely CEO Bernhard Ebbers, CFO Scott Sullivan, controller David Myers and general accounting director Buford Yates were all sentenced to prison terms. WorldCom was able to resume operations after its bankruptcy had been processed and was acquired by its competitor Verizon in 2006.

Arthur Andersen’s failure to uncover the fraud scandal had no direct implications on the auditor itself since the company had already surrendered its accounting licenses after the Enron scandal and shortly before the WorldCom scandal was uncovered. However, according to American journalist Kurt Eichenwald (2005), Arthur Andersen would have been brought down by the WorldCom scandal had the company managed to survive Enron’s collapse. What the WorldCom case shows, though, is what a crucial role a company’s internal audit team can play. Cynthia Cooper’s internal audit team eventually managed to detect the fraud system implemented by their bosses which probably placed Cooper and her team into quite a dilemma. In the end, however, Cooper stood strong on the issue and made the fraud public.

Just like the Enron scandal, the WorldCom scandal was a key event that led the US Congress to initiate the Sarbanes-Oxley Act. Since the law was enacted only nine days after WorldCom had declared bankruptcy, it appears that the WorldCom collapse represented the final straw for the American lawmakers to act when it came to auditing and accounting. The Sarbanes-Oxley Act set new rules for auditors and for the accounting procedures within companies and sought to protect investors. It seems unlikely, however, that the Sarbanes-Oxley Act could have prevented this fraud from happening, since the executives’ actions already were illegal at the time and remain illegal.

5.3 Case Study: EY’s Role in the Collapse of Lehman Brothers

5.3.1 Introduction

In 2007, the housing bubble in the US, which was created by low interest rates and subsequent high rates of homeownership, burst. Once the interest rates rose again, many homeowners defaulted on the loans they had taken for their houses, since they could not afford to repay these loans due to the higher interest rates. High amounts of missing repayments led to the collapse of a number of major lenders in 2007 and early 2008, including the financial institution New Century

Financial and the bank Bear Stearns. The collapse of Lehman Brothers, an American investment bank, in September 2008, marked the peak of the United States financial crisis in 2007-2008. This financial crisis triggered a worldwide economic crisis, the so-called Great Recession, the worst economic crisis since the Great Depression in the 1930s.

While there were numerous banks and other financial institutions that went bankrupt in 2007 and 2008, Lehman Brothers was by far the biggest name to go bust. At the time of its collapse, Lehman was the fourth-largest American investment bank (Wiggins, Piontek & Metrick 2014, 1), and one of the country's largest companies in any sector. Moreover, its $691.1 billion is assets at the time of its bankruptcy made it the largest corporate collapse in American history, as of 2019 (Scipioni 2019).

When Lehman Brothers started to feel the effects of the financial crisis on its financial situation, it developed a scheme called Repo 105 in order to manipulate its balance sheet. The Repo 105 scheme was an accounting loophole which allowed Lehman to classify short-term loans as sales, according to Kenton (2020). This scheme, even though it was legal, was developed by Lehman in order to conceal its debt and the company's actual financial situation. Thereby, Lehman Brothers deceived its investors, the rating agencies, and other stakeholders.

This case study examines how exactly Lehman Brothers took advantage of the Repo 105 scheme, and what role the bank's auditor Ernst & Young played in this system.

5.3.2 Case Breakdown

The roots for the financial and economic crises in 2007-2009 can be traced back to the recession in the early 2000s in the United States. This recession was triggered by the bursting of the dot-com bubble (see sections 5.2.1 and 5.2.2), a number of accounting fraud scandals, including those of Enron and WorldCom, as well as the 9/11 terrorist attacks. According to Singh (2020), the Federal Reserve, the US central bank, reacted to this recession by lowering the interest rate

to one percent in June 2003. Lowering the interest rate is obviously a move to boost the economy by encouraging people to spend their money instead of saving it. The low interest rates led to an increasing number of people taking cheap loans to buy houses. This caused home ownership rates and housing prices to increase, creating the so-called housing bubble. There were two problems, though. A considerable amount of the people taking loans actually posed a credit risk to banks and could only do so because the interest rates were so low. The second problem was that many of these loans were adjustable-rate loans, meaning that if interest rates were to be increased, the repayments for borrowers would have increased, too.

When the interest rates were eventually increased, many of the high-credit-risk-borrowers could not handle the higher interest rates and defaulted on their loans (Singh 2020). This phenomenon is called the bursting of the housing bubble. These high amounts of outstanding loan repayments led to many lenders and financial institutions getting into financial trouble. Some of them, including the insurer AIG and the mortgage companies Freddie Mac and Fannie Mae, were bailed out by the US government while others, such as the investment banks Bear Stearns and Lehman Brothers had to file for bankruptcy.

While Lehman's financial problems caused by excessive risk-taking and rising delinquency rates of its borrowers were ultimately laid bare to the public by its bankruptcy, the bank had already been determined to conceal its actual financial situation already long before its collapse. The bank had developed a scheme, called Repo 105, to disguise loans, i.e. liabilities, as sales in order to deceive their investors and other stakeholders. This scheme was supposed to delude investors and other stakeholders into believing that the company's financial situation is better than it actually was.

Before going into the details of what Repo 105 transactions are and how Lehman Brothers used them, it is important to note and remember that even though the scheme was devised to deceive investors and the public, it was not illegal in the UK where Lehman posted Repo 105 transactions which were later consolidated into the bank's overall financial statements. In the US, this practice is illegal, however, Lehman did not commit fraud since it applied the scheme in the UK. Lehman

used to call it an accounting gimmick, and the company legally used a loophole in the law to implement the Repo 105 system. Furthermore, it is important to differentiate between Lehman's Repo 105 and a standard repo. Repo is an abbreviation for repurchase, which is a common financing model in banking. According to Wiggins and Metrick (2019), a repo is essentially a short-term loan that is secured by a collateral that the borrower delivers to the lender. The borrower then agrees to repurchase the collateral when it repays the loan (Wiggins & Metrick 2019). The repo transactions increase the balance sheet total since the borrowed cash is posted in the assets, and the liabilities or short-term loans obviously increase by the same amount. Classifying these transactions as sales, as Lehman did, is usually not allowed.

However, according to Wiggins and Metrick (2019), the SFAS 140, which took effect in 2000, provided accounting and reporting standards for distinguishing transfers of financial assets that are sales from transfers that have to be booked as liabilities. In order to count as a sale, the transferor, in this case Lehman, must not maintain effective control over the transferred assets. Since the SFAS 140 only mentions a collateral of 2% of the transferred sum as the amount where the transferor retains effective control over the transferred assets, Lehman concluded that if it posed a collateral of 5% (therefore Repo 105), it would not maintain effective control over the assets, and would therefore be allowed to book the transaction as a sale. Lehman proceeded to receive an opinion from an UK law firm which confirmed that Lehman's proposed Repo 105 scheme complied with US GAAP (Wiggins & Metrick 2019.). Thereby, the Repo 105 was legal and ready for use by Lehman Brothers.

While Lehman Brothers used the Repo 105 transactions already well before the financial crisis started, the company took the use of Repo 105 to new heights once it became clear that many financial companies, including Lehman, were experiencing financial difficulties during the financial crisis. Lehman mainly used the Repo 105 transactions ahead of releasing its quarterly reports, when it for instance had around $50 billion in Repo 105 transactions in its books in each of the first two quarters of 2008, and then went on to borrow money shortly after quarter-end in order to repurchase the securities and book them on the company's balance sheet again. Thereby, the investment bank deceived its investors and the

public since the reported financial statements did not give an accurate picture of the bank's actual financial situation.

So, what about Lehman's auditor, Ernst & Young? According to the official examiner of Lehman's bankruptcy, Anton R. Valukas (2010, 1,032), there is sufficient evidence to determine that Ernst & Young failed to meet professional standards in its audit of Lehman Brothers. This failure includes a number of mistakes made in regard to Lehman's Repo 105 transactions. The first mistake happened when Ernst & Young were told by Matthew Lee, a whistleblower from Lehman, that the bank used end-of-quarter Repo 105 transactions to deceive the public. According to Valukas (2010, 1,036), Ernst & Young would have been obliged to report the existence of Repo 105 transactions to Lehman's audit committee since the transactions were unusual. However, the auditor failed to do so even though unusual accounting practices require disclosure to the company's audit committee.

Moreover, Ernst & Young failed to take proper action when the company was told that Lehman's financial statements may be materially misleading due to the timing and volume of the Repo 105 transactions, according to Valukas (2010, 1,032). This proper action would have included the issuance of a modified review report that describes inadequacies (Valukas 2010, 1,041), as well as communication of the issue to senior management, including the recommendation of changes (Valukas 2010, 1,045). Ernst & Young, however, failed to do both.

Lehman Brothers declared bankruptcy in September 2008. However, the bankruptcy was caused by the bank's excessive risk-taking, by customers defaulting on their loans, and by the overall financial and economic crisis. The bankruptcy was not caused by Lehman's accounting issues.

5.3.3 Aftermath & Conclusion

After Lehman Brothers declared bankruptcy in September 2008 a number of officials and experts demanded consequences for Ernst & Young due to the assumption that the auditor failed during the audit of Lehman. In December 2010, more than two years after Lehman's collapse, then-attorney-general of the state

of New York, Andrew Cuomo, filed a lawsuit against Ernst & Young, accusing the audit firm of misconduct and helping Lehman mislead investors in the years leading up to the financial crisis (Scannell 2010). According to Gara (2015), the lawsuit was solved by a settlement, in which Ernst & Young agreed to pay $10 million to Lehman bondholders, after the state of New York had initially sought $150 million from Ernst & Young. The audit firm was not forced to admit any wrongdoing and continues to deny any misconduct related to the Lehman case (Gara 2015).

The aforementioned settlement reached in 2015 was not the first settlement Ernst & Young reached with its accusers. In 2013, Ernst & Young agreed to pay $99 million to Lehman investors who had accused Ernst & Young of helping Lehman misstate its financial records (Brown 2013). Just as they did after the settlement with the state of New York, Ernst & Young denied any wrongdoing after reaching the settlement with Lehman's investors, according to Brown (2013).

The lawsuits filed by investors and the state of New York were not the only implications of the Lehman accounting issue. In addition, the SEC launched a probe in order to find out more details about Lehman's Repo 105 scheme as well as standard repo systems used by other banks (Politi 2010). According to Gallu (2012), however, the SEC investigators did not find any evidence of wrongdoing by Lehman related to the bank's accounting practices and Repo 105 in particular. This investigation result more or less confirms that Lehman's Repo 105 transactions were legal.

5.4 Case Study: The Role of the Big Four in Carillion's Collapse

5.4.1 Introduction

Carillion was a British construction and facilities management company that filed for bankruptcy in January 2018. At the time of its collapse, the company, which was founded from a demerger in 1999, was the second-largest construction firm

in the UK with around 43,000 employees and annual revenues of £5 billion (Lindsay 2018). Carillion was well known in the United Kingdom for being awarded a plethora of public sector contracts. In addition, the construction company has taken in a number of reputable projects, such as building the façade of Buckingham Palace and the Channel tunnel (Plimmer, Arnold and Pickard 2018). The fact that Carillion was awarded so many public sector contracts meant that the company had a close relationship with British politics. Therefore, the company's collapse caused ripples in both the country's government and political opposition.

The Carillion case became an even more important and hot topic in the British public, and especially in politics, due to the role the Big Four (Deloitte, PwC, KPMG and EY) played in Carillion's collapse. All of the Big Four were doing work for Carillion, either at the time of the collapse, in the years leading up the collapse, or both. According to Consultancy.uk (2018), three of the four companies, namely Deloitte, KPMG and EY were doing work for Carillion at the time of its collapse, while PwC had had consulting contracts with Carillion in the past, and was therefore the only company eligible to administrate Carillion's insolvency for which PwC was paid £150 million.

Deloitte had been Carillion's internal auditor for quite some time, while KPMG was the company's external auditor, and EY had consulting contracts with Carillion. These relationships made the three companies ineligible for administrating Carillion insolvency due to potential conflicts of interest (Consultancy.uk 2018). Therefore, PwC was the only Big Four company allowed to handle Carillion's insolvency.

The heavy, and at times opaque, involvement of the Big Four in Carillion's collapse led to harsh criticism. Several British members of parliament demanded sweeping consequences and changes which went as far as calls for the Big Four to be broken up. These demands were never put into action, though. However, slightly less sweeping consequences were announced in July 2020 when the Financial Reporting Council, Britain's accounting and auditing regulator, announced that the Big Four would have to outline plans for an operational split of their audit units (see section 4.2.3). This decision is thought to be triggered by

questions about audit standards at the Big Four in the wake of several corporate collapses, including Carillion's (Kapoor & Iacone 2020).

5.4.2 Case Breakdown

The three companies studied in the previous case studies above involve companies that tried to deceive their investors and the public by either committing massive accounting fraud or, in the case of Lehman Brothers, applying an accounting gimmick. In addition, the role of each company's auditors, Arthur Andersen and Ernst & Young, respectively, was examined in detail. The Carillion case boasts considerable differences, the most notable one being that Carillion did not commit accounting fraud. Instead, Carillion collapsed due to poor financing, including failed projects that caused high losses for the construction company.

Nevertheless, this case is useful to examine the role of an auditor and the role of the Big Four in particular, since all of the Big Four either were doing work for Carillion at the time of its collapse or had done work for Carillion in the past. Moreover, the Big Four either experienced or at least faced the threat of conflicts of interest while doing business with Carillion; and the firms were accused of trying to feast on their client. The perceived misbehavior of the Big Four also led to the implementation of a new rule by the FRC (see section 5.4.1) aimed at reducing or eliminating conflicts of interest.

As mentioned in section 5.4.1, Carillion was the second-largest construction company in the United Kingdom and collapsed in 2018 after already being in financial trouble in years prior, especially in 2017. According to Pooley, Pickard and Cumbo (2018), Carillion's crisis started in 2017 when the company issued a profit warning and made public that it was losing money on key contracts, would have to write off £800 million, and that debt was rising. This announcement led to the departure of then-CEO Richard Howson and to the crash of the company's share price. All in all, Carillion's share price dropped by 90 percent in 2017; moreover, the company was groaning under a debt pile of around £1.5 billion, including a pension deficit of £587 million, which ultimately led to Carillion's collapse (Pooley et al. 2018).

The insolvency of a major British company, such as Carillion, naturally attracts a lot of public attention in the UK. What further contributed to this attention, and also led to outrage, especially in politics, were the Big Four and the role they played in Carillion's demise. All four companies had done extensive work for Carillion starting from the year Carillion was founded, 1999, until the company's collapse. KPMG had been Carillion's external auditor since 1999, while Deloitte had been Carillion's internal auditor since 1999 as well. EY and PwC were hired by Carillion at various points in time to provide consulting work for the construction company.

All of this work was well paid for. According to Sembhy (2018), the Big Four earned a total of £71.6 million from Carillion for their work since 2008 alone, meaning Carillion paid an annual average of £7.16 million to the Big Four for audit and consulting services. These extraordinary high payments, from which PwC pocketed £21.1 million, KPMG £20.2 million, EY £18.3 million, and Deloitte £12 million, outraged several British members of Parliament, including Labour MP Frank Field who accused the Big Four of feasting on what was soon to become a carcass, i.e. Carillion (Sembhy 2018). The Big Four, however, were not the only companies criticized for misbehavior before Carillion's collapse. According to Craven (2018), Carillion itself came under fire as well, especially from MP Frank Field who criticized that Carillion's management asked for a £10 million emergency loan one day after it had paid out £6.4 million to advisors, including EY who had received £2.5 million. The request was later rejected which sealed Carillion's liquidation.

Back to the Big Four. They were not just criticized for cashing in on an already struggling company. Several of them have come under scrutiny for having apparent conflicts of interest while or after doing work for Carillion. According to Plimmer (2018), EY was hired by HS2, the company responsible for delivering the new British high-speed rail line, for assessing the financial health of Carillion while simultaneously giving financial advice to Carillion itself. This situation was described by Atul Shah, an accountancy professor at the University of Suffolk, as a serious conflict of interest (Plimmer 2018), which is understandable given the

constellation that EY is likely to be equipped with confidential knowledge on Carillion's finances, and then potentially using that knowledge to do work for HS2 on Carillion's finances.

PwC is the second Big Four company that has been accused of having a conflict of interest related to Carillion. PwC was hired by Carillion's pension trustees in order to protect members' interests amid Carillion's mounting financial difficulties after having previously done consulting work for Carillion (Chapman 2018). While this constellation already calls into question PwC's ability and drive to strive for the best possible outcome for Carillion's pensioners, PwC's situation got even more curious and contentious. While the contract with Carillion's pension trustees is still on, PwC was hired by the British government as special managers to assist in Carillion's liquidation process with the role of securing the best possible outcome for all of Carillion's creditors while ensuring that public services continue (Marriage & Thompson 2018). Thereby, PwC was in the situation of, on the one hand, trying to secure the best possible outcome for Carillion's pensioners while on the other hand, trying to secure the best possible outcome for all creditors. Since fulfilling both obligations was hardly likely, PwC was in an obvious conflict of interest here.

5.4.3 Aftermath & Conclusion

Carillion's collapse obviously had major negative, and in some cases, financially devastating effects on a number of different company stakeholders, such as employees, pensioners, lenders, and investors. Moreover, as already mentioned throughout the case study, the Big Four who were all involved in Carillion's collapse, were scorched by British politicians which ultimately prompted consequences for the business model, albeit not very serious ones.

The consequences of Carillion's liquidation were serious for the company's stakeholders, though, including for the employees. Even though most of the company's 19,000 or so employees' jobs were saved by transfers to suppliers, there were still around 3,000 redundancies within a year after Carillion's collapse (Scott

2019). In addition to the employees, Carillion's lenders were also adversely affected by the company's demise. The large banks HSBC, Barclays, Santander, Lloyds, and the Royal Bank of Scotland suffered huge money-losing businesses by lending money to Carillion, according to Bradley (2018). The banks had provided £930 million of loans to Carillion, including emergency loans of £140 million four months before Carillion's collapse (Bradley 2018). According to the BBC (2018), Barclays had the smallest exposure of the five banks with losses of £127 million. Investors also lost a lot of money as Carillion had once been worth £2 billion (Mooney 2018).

The Carillion case also had consequences for the Big Four who faced harsh criticism for the work they did for Carillion, and for their role in the company's demise. According to Neate (2019), MPs, such as Rachel Reeves of the Labour party, called for a full break-up of the Big Four in the wake of Carillion's corporate failure in order to tackle conflicts of interest and improve audit quality. However, these plans have not been implemented so far. Instead, the Financial Reporting Council, Britain's accounting and auditing regulator, has come up with a different measure aimed at reducing conflicts of interest and improve audit quality. As mentioned in sections 4.2.3 and 5.4.1 of this thesis, the FRC told the Big Four in July 2020 to outline plans for an operational split of their audit units (Kinder 2020), a move thought to be triggered by Carillion's collapse (Kapoor & Iacone 2020).

However, it is still way too early to judge whether this move will be efficient or not. Outlining the plans will take some time, as will the actual execution of the operational split, if it in fact will be imposed. It will likely take a few years before the actual split is carried out, meaning that it would probably take a few years even after the split to realistically judge whether the FRC's measure is proven useful or not.

6 DISCUSSION

6.1 Analyzing the Differences and Similarities of the Cases

Since these four cases, Enron, WorldCom, Lehman, and Carillion, are different in terms of the overall impact of these collapses, management misbehavior, whether fraud was committed or not, how it was committed, and other aspects, there are very few similarities that are shared by all four of these cases. One aspect that definitely is, is that the Big Five (which include Arthur Andersen) were heavily involved in all of these collapses. Even though they were not always found guilty of failure or other misbehavior, such as the Big Four in the Carillion case, they nevertheless played a major role that incurred criticism.

A good example is that the Big Four have advised Carillion for years but the company still experienced financial difficulties that ultimately led to its insolvency. In the Lehman case, EY neither admitted any wrongdoing nor was any wrongdoing found during the investigations. However, Lehman's bankruptcy examiner, Anton Valukas, later found enough evidence to conclude that EY had failed in its role as Lehman's auditor. The Enron and WorldCom cases show more obvious misbehavior by Arthur Andersen who audited both companies. Both Enron and World Com used fraud schemes to inflate their financial numbers and to mislead investors. Arthur Andersen failed to detect either accounting fraud; in WorldCom's case the fraud was even uncovered by the company's internal audit team.

Also, in general, the Enron and WorldCom cases are the two cases that share the most similarities. Both companies committed accounting fraud, in both cases the auditor, Arthur Andersen, failed, and in both cases the accounting fraud is what ultimately caused the companies to declare bankruptcy. This short summary also shows the differences between these two cases and the Lehman Brothers collapse. While it is true that Lehman Brothers also deceived its investors and the public by manipulating its financial numbers, it did so legally by applying an accounting gimmick. Even though the implementation of such a gimmick is ethically questionable, the bank, unlike Enron and WorldCom, did not commit any accounting fraud. Therefore, the company could not be found guilty of any illegal activities

by authorities. Another difference between Lehman and the other two companies is that Enron's and WorldCom's collapses were caused by their accounting practices. Lehman's bankruptcy is not in any way related to the company's accounting issues but solely on the bursting of the US housing bubble and the ensuing financial crisis.

The Carillion case is very different from the other cases analyzed in the sense that the company was not guilty of any fraudulent or morally questionable behavior. The company just broke down due to a poor financial situation which was likely caused by bad management decisions and not by accounting issues, accounting fraud or other schemes to deceive investors and the public. What makes Carillion's collapse special, however, is the curious role of the Big Four which for years have done expensive consulting work for Carillion. This work apparently did not put Carillion in a position to improve its market standing and financial situation.

6.2 Conclusion

These cases, especially those of Enron and WorldCom, have shown that it is remarkable how far some executives are willing to go in order to present a healthy financial situation and to stay atop a major company. If necessary, some executives, such as Enron's and WorldCom's are apparently ready to risk going to jail for decades since they must have known how severe the penalties for serious accounting fraud are before developing their fraud schemes.

What the case studies of Enron, WorldCom, Lehman Brothers, and Carillion have also shown is not only the importance of proper accounting practices and flawless financial books but also the importance of auditors. Especially the Enron and WorldCom cases have shown the crucial role of auditors and the devastating effects failed audits can have. The failure of Arthur Andersen to detect the fraud schemes of Enron and WorldCom ultimately led to investors losing billions of dollars, employees losing their jobs but also to the collapse of Arthur Andersen itself. Moreover, the WorldCom case has also stressed the role of internal auditors who

can also become crucial, especially when the external auditor fails. In World-Com’s case the company’s internal auditor detected the accounting fraud and made it public after Arthur Andersen was unable to find any fraud.

Furthermore, these cases have shown how important effective legislation is when it comes to auditor independence and conflicts of interest. This is shown by the Enron case in particular where Arthur Andersen was not just Enron’s auditor but was also doing consulting work for the energy company, and therefore had an obvious conflict of interest. This conflict of interest likely played a role in Arthur Andersen’s decision to not disclose Enron’s accounting fraud as it might have feared to potentially lose out on future consulting contracts with Enron. In order to prevent these conflicts of interest in the future, many governments around the world have enacted laws or put in place other measures to protect investors and other company stakeholders. Therefore, after all, these scandals and corporate collapses might have had some positive effects as well.

7 RECOMMENDATIONS

These fraud scandals and business collapses bring up some important questions. What can be done to avoid such major companies from going bankrupt? What can be done to reduce or even better, completely eliminate conflict of interest situations in audit and consulting? What can be done to improve audit quality and press audit firms to detect and publish accounting fraud?

While section 4.2 shows that governments and regulatory agencies have already implemented measures in recent years aimed at improving audit quality and preventing conflicts of interest from arising, there are still many more options available for governments to deter auditors from committing misconduct. Moreover, while some regulatory agencies, such as those of the US and those of the EU have been committed to solving the issue of the Big Four and conflict of interest, other countries have not shown the same dedication.

In this section, multiple different possibilities which could all have a positive effect on auditor independence and audit quality are discussed. Some of these recommendations have been implemented sparingly in different countries but are not in wide use around the world. Moreover, the recommendations differ in their severity. While some of the recommendations do not project major implications on auditing firms, some others would indeed do. Recommendations with profound ramifications include for instance a potential break-up of the Big Four and would have the potential to adversely affect the Big Four’s business model and profits.

7.1 What can be done to improve Audit Quality and prevent potential Conflict of Interest Situations in Audit from arising?

There are a number of potential measures that could be implemented in order to improve auditor independence and reduce the risk of conflict of interest. These measures are discussed in more detail below.

7.1.1 Mandatory Auditor Rotation

Mandatory auditor rotation means that companies which have their financial statements audited must change their auditor after a previously specified number of years. In most countries where the rule has been put into effect the period usually has a length of around 5 years. Mandatory auditor rotation is meant to enhance auditor independence by reducing coziness between audit team and client management, as discussed in chapter 4 of this thesis.

Of course, the effectiveness of this rule is hard to measure but the idea of not letting the relationship between auditor and client management get too close makes sense and appears effective. Despite this rule's perceived effectiveness and relatively easy implementation, especially compared to other potential measures discussed in the following sections, not many countries had adopted it, as of 2015. Cameran, Negri and Pettinicchio (2015), accounting professors and researchers who analyzed the implementation of the mandatory auditor rotation rule around the world, found out that few industrial countries had put the rule into effect, as of 2015. Even though some European countries implemented the rule shortly after the EU instructed their member states to do so, other industrial countries, such as the United States, Canada, and Singapore have not implemented audit firm rotation, instead opting for audit partner rotation (Cameran et al. 2015, 6-7).

Bazerman, Moore and Loewenstein (2002, 8) also mention mandatory audit firm rotation as a useful means to improve auditor independence and audit quality. The three authors even go a step further in their proposal. They argue that auditors should not just have limited contract periods, but the length of these periods should be fixed as well, meaning that the contracts cannot be prematurely terminated by the client. The authors argue that auditors are in danger of being dropped by their clients if they deliver an unfavorable audit. This situation leads to auditors trying to make their clients happy, thereby losing independence and being biased (Bazerman et al. 2002, 8.).

This view is supported by Mostafa Mohamed and Hussien Habib (2013) who researched the lack of auditor independence in Egypt. According to the authors,

mandatory audit firm rotation has a positive effect on audit quality, and the rotation rule can overcome the issue of auditor independence and improve audit quality (Mostafa Mohamed and Hussien Habib 2013).

7.1.2 Auditor Liability

Another measure to deter auditors from turning a blind eye while auditing clients' financial books could be to raise auditor liability, i.e. financial penalties for misbehavior or failure. While audit firms can already be fined by national regulatory agencies for negligence or failure, these penalties are usually minuscule in relation to the companies' profits. Significant financial penalties that actually hurt audit firms could be effective in trying to improve auditor independence and audit quality. The financial penalties imposed on audit firms, such as the Big Four, have mostly been benign in recent years which basically means that even if an audit firm commits serious mistakes or acts negligently during an audit it does not have to fear considerable fines.

This has been proven by the amount of penalties handed out to auditors in recent years. One example is the case of Lehman Brothers. As mentioned in section 5.3.2, Anton Valukas, the Lehman bankruptcy examiner, concluded that Ernst & Young failed to meet professional standards during its Lehman audit. Ernst & Young, however, was never outright fined. Instead, the auditor was sued by investors, and ultimately agreed to pay a total of $109 million in two separate settlements (see sections 5.3.2 and 5.3.3). According to McCool (2010), Ernst & Young received $150 million in fees from Lehman as the bank's auditor from 2001 to 2008. This means that despite EY's apparent failure in the role of Lehman's auditor, it still yielded the auditor a huge profit of $41 million. Moreover, the $150 million in fees amount to less than one percent of EY's global annual revenue (McCool 2010) which shows that the $109 million EY had to pay are far less than one percent of its global annual revenue, and does not financially hurt the company at all.

The issue of minuscule fines is even more obvious when looking at the Big Four's failures when auditing smaller companies. One example is Deloitte's audit of its

client Aero Inventory. According to Brown (2016), Deloitte was found guilty of failing to meet professional standards in its audit of the British firm which was put into administration in 2009. Deloitte acknowledged misbehavior and had to pay £4 million in fines in 2016 (Brown 2016). Comparing this fine to Deloitte's financial results in FY 2016 in the UK shows how small the fine of £4 million actually is. In FY 2016 Deloitte's revenues in the UK totaled around £2.7 billion (Deloitte 2016). Therefore, the fine amounts to only 0.15 percent of the company's revenues, hardly noticeable.

These two cases alone show the urgency of changes when it comes to company liability in auditing, namely that fines for failure and misbehavior must be increased so that they actually hurt audit firms. This view is supported by Pratley (2019) who argues that the Financial Reporting Council's findings of one in four audits failing to meet standards demand fines for audit firms that actually hurt. Pratley (2019) agrees that financial penalties for auditors are too low and cites as evidence that the FRC can impose a maximum fine of only £10 million which does not bother companies like PwC whose profits in the UK in 2018 were £935 million.

The demand for higher liability is also shared by other researchers who think that the high risk of facing litigation and liability lead to higher auditor independence and audit quality. Among these researchers are Davis and Simon (1992) who found evidence that auditors increase effort and become more conservative when faced with the risk of litigation and higher liability. Being held liable for audit failure would not just lead to high costs but would also damage the audit firm's reputation (Davis and Simon 1992).

The above-mentioned results show that audit quality is not unlikely to improve when auditors are facing the threat of higher liability. Therefore, increased auditor liability can contribute to higher auditor independence and improve audit quality.

7.1.3 Let Investors choose the Auditor

Hitherto, the common practice is that auditors are appointed by the client company's management even though auditors primarily serve the client's stakeholders, especially its investors, and the public (Ketz 2020). This curious situation is prone to lead to a conflict of interest for the auditor since even though the auditor is being paid by the client's management, he does not serve the management. Since audit firms are being paid by the client's management, some auditors might prefer to build a positive relationship with the client's management instead of serving the client's shareholders and other stakeholders by conducting a thorough and professional audit. Having such a mindset, however, would make the conflict of interest obvious, and could eventually impair the quality of the audit. Auditors should not be bound to the client's management if they must fear to lose this audit mandate or potential future consulting mandates from this client if the audit is conducted too thoroughly for the client's liking.

That brings up the question of how to eliminate this potential conflict of interest situation. One option that would make a lot of sense is to let a company's investors choose and appoint the auditor, or at least ratify the management's choice of auditor. The current situation shows that auditors are still accountable to client management even though they primarily serve the client's investors. Moving the duty of appointing the auditor from management to investors would shift an auditor's accountability. From then on, the auditor would be bound to the investors that are served by an auditor's work anyway.

This means there are two slightly different options on the table. The first one, letting investors ratify the auditor chosen by the company's management, would be only a minor tweak to the current practice, whereas the second option, letting investors actually choose and appoint the auditor, would be a major shift compared to the current process. Ronen (2010) supports the first option. He argues that all public companies should have an annual shareholder vote where the shareholders would have to ratify the auditor.

Coffee (2019, 541), however, declares that giving shareholders a greater role in selecting and removing an auditor is the only way that would work when wanting

to eliminate audit failures. He supports the above-mentioned hypothesis that auditors should be made more accountable to investor in order to serve them better, and mentions the option of giving investors more say in selecting and removing an auditor as a means to make that happen (Coffee 2019, 541.). The plan includes that a minority of shareholders could nominate an alternative auditor that a majority of shareholders could opt for in a proxy contest, a process that would be repeated once a year (Coffee 2019, 551). According to Coffee (2019, 552) such a process would have the positive effect of audit firms not seeing audit as an inferior business compared to other services. He argues that competition for the favor of clients' investors encourages auditors to invest in their reputation for toughness and rigor (Coffee 2019, 552). Therefore, letting investors choose a company's auditor could improve audit quality.

In summary it can be stated that the fact that auditors are appointed by the client's management can lead to conflicts of interest, since auditors are thereby bound to the client's management, instead of being bound to the investors even though they primarily serve the investors. This issue could be alleviated by letting a company's investors pick an auditor instead of leaving this task up to company management. This would make auditors accountable to the people and firms they actually serve. Auditor independence would be improved, and the risk of conflict of interest reduced since auditors would not have to fear being stripped of the audit mandate if they conduct a thorough audit. This could have a positive effect on audit quality as well.

7.1.4 Operational Split within the Big Four

The three possible solutions that have been discussed so far are rather benign recommendations which could have a positive effect on audit independence and audit quality but would not have a huge effect on the business model of the Big Four. The fourth possible solution, the operational split of the Big Four, however, would be a major turning point in the audit industry, especially for the Big Four. The key aspect of an operational split of the Big Four would be that the audit and the non-audit services, such as consulting and tax, are split into two separate legal entities.

The possibility of an operational split has been a point of discussion in the UK in particular due to a number of corporate insolvencies in the country, such as Thomas Cook and Carillion, where the Big Four have been accused of either negligent audits or having conflicts of interest. In December 2018, the Competition and Markets Authority (CMA), the UK's primary competition and consumer authority, put forward a proposal which included a split of the Big Four into audit and advisory businesses to improve audit quality (CMA 2018). Consequently, the UK parliament seized the CMA's proposal and further formulated three different possibilities of a split (UK Parliament 2019) which obviously could be adopted by other countries as well.

According to the UK parliament (2019), the first option is called governance separation, and consists of an internal arrangement to separate the running of the audit practice from the rest of the firm. The proposal says that the audit business would have its own chairman and CEO but finances including profits would be shared between audit and non-audit businesses, according to the UK parliament (2019). The fact that finances and profits are not separated between the different departments shows that the governance separation would not be a clear-cut separation. The UK parliament (2019) argues that the lack of separation shows that governance separation does not go far enough in delivering audit independence.

The second proposal by the UK parliament is called operational separation and is more radical than the governance separation in the sense that the audit and non-audit businesses have separate economic interests and finances, such as assets and profits (UK parliament 2019). Moreover, the operational separation leads to the audit business not just having its own CEO but also its own fixed staff, including partners whose movement between audit and non-audit businesses is restricted (UK parliament 2019). The UK parliament (2019) argues that the financial separation improves transparency and delivers independence.

The third and most radical option proposed by the UK parliament is the structural separation which would split the audit and non-audit businesses into two separate and independent legal entities (UK parliament 2019). This split would mean that any audit firm above a certain site threshold would be prohibited from offering

non-audit services in the UK which would make it a clear-cut split. The structural separation would solve the most pressing needs, such as transparency and auditor independence, according to the UK parliament (2019). The structural operation could also make conflicts of interests in audit less likely since economic interests of the consulting business would not have to be considered anymore.

In July 2020, the FRC, Britain's accounting and auditing regulator, finally announced that the Big Four would have to outline their plans for a split of the audit and non-audit businesses (Kinder 2020). However, according to Kinder (2020), the FRC does not demand a full break-up, meaning a structural separation which would have split the audit and non-audit businesses into separate legal entities. However, the FRC decision includes a financial separation of audit and non-audit businesses (Kinder 2020). This would make the split an operational separation, and therefore, in line with the second most radical proposal by UK parliament.

Murphy and Stausholm (2017) support the quest for an operational split of the Big Four. They argue that the interaction between tax and audit services, which are both provided by the Big Four, creates a conflict of interest which must be tackled either by a complete break-up which is further discussed in section 7.1.5 or by ring-fencing tax and audit services from each other (Murphy and Stausholm 2017, 29). This would represent an operational split within the Big Four.

All of the three proposed options by the UK parliament for an operational split of audit and non-audit businesses in the Big Four could have positive effects on auditor independence, audit quality, and on reducing the potential of conflicts of interest. The UK is the first country to announce plans for an operational split of the Big Four (Kinder 2020). If the rules that will probably be implemented in a few years prove effective in tackling the above-mentioned issues, then other countries could be encouraged to follow suit in developing similar plans.

7.1.5 Breaking up the Big Four

The most radical idea for eliminating conflicts of interest and improving audit quality would be a complete break-up of the Big Four into smaller companies. While

the structural separation, the most radical of the proposed operational splits discussed in section 7.1.4, would conserve the Big Four companies, albeit with separate audit businesses, a complete break-up would create entirely new companies. These companies would compete with the then smaller Big Four audit firms. The increased competition could lead to all audit firms, including the Big Four, putting in more effort into audits and fraud detection since a higher number of competitors would make it easier to remove an auditor who does not consistently produce high-quality audits.

Creating more competition in the audit sector could be helpful in improving audit quality. Ronen (2010) proposes increased competition among audit firms as a possibility to improve audit quality. However, he does not think that natural transition into a more competitive environment is particularly likely due to the existing entry barriers in the auditing sector in the form of the Big Four whose reputation and scale are just too large in order for new smaller companies to compete (Ronen 2010). A break-up of the Big Four is mentioned by Coffee (2006) who thinks that US Congress would have the power to break up the Big Four into smaller companies.

Edward Craft, partner at the British law firm Wedlake Bell, has an idea how the break-up of the Big Four could be achieved in the UK. He thinks that the British authorities could force the Big Four firms to sell half of their clients to the next tier of auditors which he thinks could create a big ten of accounting firms (Huber 2011). Even though this suggestion would not present an actual break-up of the Big Four, it would create more competition in the auditing sector by reducing the size of the Big Four while at the same time boosting smaller audit firms.

While entirely breaking up the Big Four might sound attractive to the most radical reformers, it is highly unlikely to happen since such a procedure would be a huge intervention in the economy and the financial markets. Moreover, it is completely unclear how a complete break-up would go ahead and be accomplished. Would for instance each Big Four firm be split into two companies of the same size? If yes, how would this separation be carried out in practice? Or would each Big Four firm have to sell a certain amount of their audit clients to smaller, already existing

competitors, as mentioned above? Furthermore, even though it might seem logical, there is actually no evidence to suggest that increased competition leads to improved audit quality and the elimination of conflicts of interest. All of these aspects show that a complete break-up of the Big Four is highly unlikely, if not impossible, and suggest that it would not be the best option when trying to improve audit quality.

8 CONCLUSION

There was a range of research questions that formed the base of this thesis and the research. These research questions were formulated before the start of the research process. The primary and secondary research questions were what can be done to prevent potential conflict of interest situations in audit from arising, and whether these solutions will have a positive impact on audit quality. The thesis is mainly supposed to answer those questions. However, there also were additional research questions aimed at supporting the main research objectives. These were about the wider relevance auditing has for companies, their stakeholders, and the overall economy; as well as the types of conflict of interest situations auditors might face; and whether there have been any fraud scandals or bankruptcies in the past where auditors might have been involved directly.

The research results show that auditors play a crucial role for all companies, their stakeholders, and the world economy. Presenting accurate financial statements and subsequently receive a certified opinion from the auditor is crucial for all companies, especially for larger companies and public companies, since a certified auditor's opinion is required for most companies in order to receive bank loans or raise money from investors. Since carrying out operations without borrowed money is close to impossible, most companies need to borrow money which they are only able to do if an auditor signs off their financial statements. This shows how much different parties, including company management, banks, and investors rely on the work of an auditor, and stresses the importance of an auditor's work.

The research has also shown that auditors have been involved in a number of major accounting scandals and corporate bankruptcies since the start of the 21st century where the auditors either failed to exert the required professional diligence or got entangled in conflicts of interest. These scandals and bankruptcies did not just have devastating effects for the companies in question but also for the respective auditors, especially for the former audit firm Arthur Andersen which collapsed following the bankruptcy of its audit and consulting client Enron after being caught up in a conflict of interest.

When it comes to conflicts of interest, there are a number of situations and constellations that can cause or lead to conflicts of interest in audit. While they can also occur strictly within the audit sector, such as an auditor having cozy relationships with client management or fearing the loss of an audit client if auditing this client's financial books too thoroughly, the main source of conflicts of interest is the relationship between audit and consulting. Since multiple major companies, such as the Big Four, offer auditing as well as consulting services, the occurrence of conflicts of interest related to the relationship between audit and consulting is particularly likely. This situation is exacerbated by the fact that consulting mandates are much more lucrative than audit contracts which can lead to audit firms setting their audit business aside in favor of their consulting business. This can lead to low-quality audits and the emergence of conflicts of interest since audit firms might fear that too diligent audits and the publication of fraud can lead to the loss of a potential future consulting mandate from this audit client.

Many countries, including the EU countries and the US have recognized this issue, and implemented rules, including bans on offering consulting services to audit clients, aimed at combating conflicts of interest. While these steps point in the right direction, there are a lot of additional options that could be exercised in order to improve audit quality and prevent conflicts of interest from arising. As mentioned in section 7 of this thesis, these options include some with only minor implications but also options with major implications. Mandatory auditor rotation and increasing auditor liability can be considered as rather mild options without many implications for the business model of the Big Four. A structural split of the Big Four in audit and non-audit businesses as well as the creation of more competition by breaking up the Big Four into smaller companies, however, would be potential solutions with severe and widespread implications.

While some of these options do not automatically guarantee high-quality audits and the elimination of conflicts of interest, and the efficiency of other potential solutions mentioned is totally unknown, they at least represent possible options in trying to tackle these pressing issues. These potential solutions would be worth trying if the rules and regulations already implemented in recent years do not prove effective.

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