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Abstract

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The Swedish Management Audit - Could It Have Influenced the Enron Collapse?

The large accounting scandals that have taken place mainly in the United States have created an international debate on the roles of accounting and auditing and how they should be designed to protect the stockholders. In Sweden, the auditor shall, besides the examination of financial reports, also conduct an audit of the President's and the Board of Directors' management of the company. This Management Audit is mandatory for all stock corporations and underlies the decision whether to recommend the annual meeting of stockholders to grant the President and the Board discharge or not. This practice is not applied in the US where there is no time limit for their responsibility.

Our starting point is the Swedish Management Audit. To analyze its usefulness, we chose to compare Sweden with the United States whose auditing practices looks a bit different. We chose to use the Enron scandal to illustrate the possible advantages of utilizing a Swedish-type Management Audit. The main research question is whether the Swedish Management Audit could have influenced the lapse or the outcome of the Enron scandal.

To determine whether the Swedish Management Audit could have influenced the Enron scandal, we applied each of the eight steps a Swedish auditor carries out when performing a Management Audit to the Enron case. Our study shows that there were several problems in the control and management of Enron, which the auditor could have observed by conducting a Swedish Management Audit. Some of the interviewees pointed out that the auditors should also have noticed these problems under the American system if they had only done their job properly. However, the use of the Swedish Management Audit might have mitigated the outcome of the scandal by making the stockholders aware of the company's financial situation earlier.

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1. INTRODUCTION	4
1.1 BACKGROUND	4
1.2 PROBLEM DEFINITION	5
1.3 PURPOSE	5
1.4 DELIMITATIONS	6
1.5 DEFINITIONS AND TRANSLATIONS.....	6
1.6 OUTLINE	7
2. METHODOLOGY	9
2.1 WRITTEN SOURCES	9
2.2 INTERVIEWS	9
2.3 CREDIBILITY AND RELEVANCE OF SOURCES	10
3. SWEDISH AND AMERICAN AUDIT PRACTICES	12
3.1 SWEDEN	12
3.1.1 <i>Auditing in Sweden</i>	12
3.1.2 <i>What is the Swedish Management Audit?</i>	12
3.1.3 <i>Historical Background of the Swedish Management Audit</i>	13
3.1.4 <i>How to Conduct a Swedish Management Audit</i>	14
3.1.5 <i>Analytical Model</i>	16
3.2 USA.....	17
3.2.1 <i>Auditing in the United States</i>	17
3.2.2 <i>Financial Audit</i>	17
3.2.3 <i>Operational Audit</i>	18
3.2.4 <i>Compliance Audit</i>	19
3.2.5 <i>Sarbanes-Oxley Act of 2002</i>	19
3.3 SUMMARY AND INTERPRETATIONS	20
4. ENRON CORPORATION.....	22
4.1 HISTORICAL BACKGROUND.....	22
4.2 ENRON'S FINANCIAL STRATEGIES.....	23
4.3 FAILURES OF THE BOARD AND THE PRESIDENT	24
4.4 SUMMARY AND INTERPRETATIONS	26
5. INTERVIEWS	27
5.1 SWEDEN	27
5.1.1 <i>Interview - Helena Adrian, Authorized Public Accountant</i>	27
5.1.2 <i>Interview - Helena Herlogsson, Authorized Public Accountant</i>	29
5.2 USA.....	31
5.2.1 <i>Interview - Marcia Halvorsen, CPA</i>	31
5.2.2 <i>Interview - Jan Marton, CPA</i>	33
5.3 SUMMARY AND INTERPRETATIONS	34



6. ANALYSIS AND CONCLUSION	36
6.1 ANALYSIS	36
6.2 CONCLUSION.....	38
6.3 SUGGESTIONS FOR FURTHER STUDIES.....	39
REFERENCES	40
APPENDICES.....	43
APPENDIX A: INTERVIEW QUESTIONS	43
APPENDIX B: FLOW-CHART – ANALYSMODELLEN	44



1. Introduction

In this paper we are assuming that the reader has some previous knowledge of business economics corresponding to academic studies at the A/B-level as taught at Swedish universities. Throughout the text we have chosen to refer to the auditor as “she”.

1.1 Background

The large accounting scandals that have taken place mainly in the United States in the last few years have created an international debate on the roles of accounting and auditing and how they should be designed to protect the stockholders in the best way possible. In Sweden, FAR's *Recommendation on Auditing Matters*¹ states that the auditor shall, besides the examination of financial reports, also conduct an audit of the President and the Board of Directors regarding the administration and management of the company. This Management Audit is mandatory for all stock corporations and is unique for Sweden.

According to Swedish legislation, the Board of Directors is, among other things, responsible for detecting any improprieties and unintentional errors in the accounting and management of the company.² The President sees to that the company's accounting complies with the Swedish Annual Reports Act and the Swedish Bookkeeping Act and that the management of assets is performed in a satisfactory manner. The President and all the Board Members must sign the annual report and, by doing so, they are responsible for that the report has been prepared in accordance with the law and generally accepted accounting principles. The role of the auditor is to evaluate whether the Board of Directors and the President have fulfilled their responsibilities. This underlies the decision whether to recommend the annual meeting of stockholders to grant the President and the Board discharge or not. By doing so the stockholders give up their possibility to claim damages. This practice is not applied in the United States where there is no time limit for the Board and President's responsibility.

One reason behind the Enron collapse was that the auditors did not perform their job as well as they should have and that they were rather seen as Enron employees than as external independent auditors.³ The scandal caused a huge decrease in confidence in the individual accounting firm, as well as for auditors in general. But fact remains that even if the auditors had done their jobs, the Board of Directors and Management mismanaged their duties and manipulated the figures to create a better impression of the company's financial status. By doing this, they allegedly stretched the law as well as broke the trust of the stockholders.

To prevent this kind of scandal from happening again, a new law, which went into effect in 2003, was enacted in the United States. This law, called the Sarbanes-Oxley Act of 2002 (from now on referred to as the Sarbanes-Oxley Act), has to be followed by all publicly held companies and leads to, among other things, that a Public Company Accounting Oversight Board (PCAOB) is appointed. This is done to increase the

¹ FAR (2003)
² FAR (1998)
³ Bryce (2002)



stockholders' confidence in the company and the stock market as a whole. The law also leads to that the President and the Chief Financial Officer becomes personally responsible for the accuracy of the company's accounting.

1.2 Problem Definition

In this thesis our starting point is the Swedish Management Audit. To analyze its usefulness, we chose to compare Sweden with the United States whose auditing practices look a bit different. We chose to use the Enron scandal to illustrate the possible advantages of utilizing a Swedish-type Management Audit. Consequently, we have divided our discussion into three main parts: Swedish auditing in general with focus on the Management Audit, American auditing and the Sarbanes-Oxley Act, and the financial strategies and failures of Enron. By considering the different opinions held by our sources we will try to present possible answers to the following questions. The answers will be presented in discussions in the subsequent theoretical chapters and in the *Summaries and Interpretations*.

- Sweden

Why is the Management Audit so important for the stockholders, the companies and the auditing firms? How is it being conducted? As the auditing of the Management in other countries has raised questions about the auditor's independence when she not only reviews the financial statements, but also the performance of the Management and the Board, we have also briefly looked into the analytical model. How does it seek to ensure the auditor's independence?

- The United States

We have focused on the different kinds of audits that are performed in American companies and for what purpose they are used. We do this with the intention of having a comparison between Swedish and American audits; do the American audits perform any of the tasks the Swedish Management Audit does? We also examine which measures are taken in the Sarbanes-Oxley Act to expand the protection of the stockholders and if the implementation of a Swedish-type Management Audit could have been an alternative to the legislation of Sarbanes-Oxley Act.

- Enron

To give a background to the scandal, we summarize the financial strategies that the Management of Enron used. What were their intentions? How did the Board of Directors and Management fail to perform their obligations?

1.3 Purpose

The discussions mentioned above lead to a reflection in the analysis chapter on whether the Swedish Management Audit could have affected the lapse or the outcome of the Enron scandal. Naturally, the intention of the analysis is to present some of the different opinions held by our sources and not an absolute truth.



1.4 Delimitations

We have chosen to limit ourselves geographically to a study of the differences in management auditing practices in Sweden and the United States. In terms of time limits, we have been looking at current laws and regulations and only made a brief review of the origins of the Swedish Management Audit.

Although the United States has been struck by several accounting scandals we have chosen only to discuss the affairs leading up to the bankruptcy of Enron Corporation. Here, the focus of our study lies in the actions of the Board of Directors and the President of the company. In the “court of public opinion”, it has been concluded that there was plenty of shady business going on within and between Enron and its auditor, accounting firm Arthur Andersen, but our center of attention rests on the Management Audit and what it might have been able to influence⁴. Consequently, we will not go into the failures of the auditors regarding their independence and autonomy. We could dedicate an entire thesis to this complex question on its own, and it has been done before. Therefore it has been left out of this paper.

We have also chosen to restrict ourselves to four interviews. Partly due to the limited scope of this study, but also due to the fact that it is not just authorized accountants who are qualified to comment on Enron and/or American accounting practices.

1.5 Definitions and Translations

Definitions

AICPA - American Institute of Certified Public Accountants, the national professional organization for all Certified Public Accountants.⁵

CPA - US Certified Public Accountant, credential conferred by a state or similar governmental jurisdiction that authorizes the holder to practice as a certified public accountant in that jurisdiction.⁶

FAR - the professional institute for authorized public accountants, approved public accountants and other highly qualified professionals in the accountancy sector in Sweden.⁷

PCAOB - Public Company Accounting Oversight Board, oversees and investigates the audits and auditors of public companies, and sanctions both firms and individuals for violations of laws, regulations and rules.⁸

SAS - US Statements on Auditing Standards, issued by the Auditing Standards Board to provide CPAs with guidance regarding the application of Generally Accepted Auditing Standards (GAAS).⁹

⁴ Bryce (2002)

⁵ AICPA Homepage (22/5/2003)

⁶ Ibid.

⁷ FAR Homepage (23/4/2003)

⁸ AICPA Homepage (23/4/2003)

⁹ AICPA Homepage (22/5/2003)



- SEC - US Securities and Exchange Commission, an agency of the federal government that regulates the public trading of securities. The SEC has the authority to establish accounting and auditing regulations but defers to the Financial Accounting Standards Board and the Auditing Standards Board.¹⁰
- SPE - Special Purpose Entity, created for a limited purpose, with a limited life and limited activities, designed to benefit a single company.¹¹ It may take any legal form including a corporation, partnership or trust.¹²
- The Yellow Book - auditing rules for government entities published by the federal government in the United States.¹³

Translations¹⁴

Generally Accepted Accounting Principles (GAAP)	God redovisningssed
Generally Accepted Auditing Standards (GAAS)	God revisionsssed
The Swedish Management Audit.....	Förvaltningsrevision
The Swedish Annual Accounts Act	Årsredovisningslagen
The Swedish Association of Auditors	Svenska Revisorsamfundet
The Swedish Auditor's Act	Revisorslagen
The Swedish Auditor's Report.....	Revisionsberättelse
The Swedish Bookkeeping Act	Bokföringslagen
The Swedish Companies Act	Aktiebolagslagen
The Swedish Supervisory Board of Public Accountants	Revisorsnämnden

1.6 Outline

2. Methodology

The chapter describes how we conducted this study and discusses the credibility and relevance of the sources used. Our starting point is the hermeneutic view, which considers knowledge to be relative. This is relevant for our study, as we are not trying to find one absolute truth but rather present different possibilities.

3. Swedish and American Audit Practices

This theoretical chapter is divided into two parts. First, Swedish auditing in general and the Management Audit in particular are described. Second, American auditing is summarized, and we take a closer look at the different kinds of audits in the US. We also study the Sarbanes-Oxley Act.

4. Enron Corporation

We look into Enron Corporation and what the scandal was all about. First, we examine the Management's financial strategies and what they tried to achieve with them. Then we examine the Board of Directors to see what they did, or did not, do.

¹⁰ Ibid.

¹¹ Redin (2002)

¹² Powers et al. (2002)

¹³ Government Auditing Standards Webpage (16/5/2003)

¹⁴ All the Acts mentioned here can be found in *FAR Samlingsvolym*



5. Interviews

The interviewees' opinions and thoughts on the subject matter are included in this chapter. How important do they think the Swedish Management Audit is? In their opinion, could it have changed the course or outcome of the Enron scandal? What do they think of the Sarbanes-Oxley Act?

6. Analysis and Conclusion

The final chapter includes the analysis of the main question, stated in the purpose. The analysis is based on the theoretical chapters as well as on the interviewees' opinions and our own thoughts on the matter. The paper ends with suggestions for further research.



2. Methodology

The chapter describes how we conducted this study and discusses the credibility and relevance of the sources used. Our starting point is the hermeneutic view, which considers knowledge to be relative. This is relevant for our study, as we are not trying to find one absolute truth but rather present different possibilities.

2.1 Written Sources

As a first phase of our research we consulted GUNDA and other databases provided by the Economics Library at Göteborg University. These databases provided information on all the different topics of our study.

*FAR's Samlingsvolym*¹⁵ was used in order to see how the Management Audit is regulated within Sweden today. This was followed by studies of articles and books on the topic. There has been very little written about the Swedish Management Audit; for instance, we could not find any previous theses on the subject matter and therefore we had to rely on FAR's publications to a large extent. Research was also done regarding the auditing process in the United States and we studied textbooks treating auditing trying to find a practice corresponding to the Swedish Management Audit.

The two theses we found useful as sources are related to the Sarbanes-Oxley Act, the Enron collapse and the analytical model. We used these for providing a brief background and summary on three very complex subjects. They also gave us ideas on where to look for more information.

As the Sarbanes-Oxley Act is a fairly new addition to the American legislation, the information had to be collected from the Act itself and articles analyzing it. The procedure was the same when researching the Enron scandal. Since there are not yet many books available on this subject, the information mainly came from articles, working papers and governmental sources on the Internet.

2.2 Interviews

We chose to gather empirical data by conducting interviews, using the qualitative method as we were not looking for statistical analyses but were rather interested in the interviewees' thoughts on the matter. We carried out four interviews, as opposed to using questionnaires or only doing one or two more in-depth interviews. This way we have been able to get more detailed answers than a questionnaire would have provided and the factor of unexpected decline was eliminated. A list of open questions was drawn up in advance, but we were also able to add questions during the discussion following the structured interview and, if seen fit, expand the treated subjects. We also sent follow-up questions via email to two of the interviewees.

¹⁵ FAR (2003)



As there is a lack of people with specific knowledge of the Swedish Management Audit, the auditing process in the US and the Enron affair, we have tried to gather opinions from several different sources, each with his or her special competence. Of the interviewees, two are active as auditors and the other two have worked in the field but are now teaching. A presentation of the interviewees is provided in chapter 4 and the questions asked can be found in Appendix A.

The interviews each lasted about half an hour and were conducted at the interviewees' offices. A brief introduction to the subject and a list of questions had been sent in advance to the respondents. All interviews, except with Ms. Halvorsen who is American, were conducted in Swedish and the English translations of direct quotes have been done in accordance with FAR's Swedish-English dictionary.

2.3 Credibility and Relevance of Sources

The Swedish Management Audit is an old phenomenon but over the years very little has been written about it. For us to be able to gather some information about the subject, we have been forced to use some quite old books. These have mainly been theoretical books, and some facts might have changed, but we have done our best to double-check the information, either with other books, articles and the current legislation or with our interviewees. All books on American auditing are, or have been, used as literature for university courses in and outside of the US, which we think is a sign of their trustworthiness.

As the Enron scandal was discovered in 2001 and the Sarbanes-Oxley Act came only last year, there have not yet been many books written about either. For that reason, we have to a great extent had to use articles from different magazines. Bryce has been criticized in an article¹⁶ regarding how he portrays Sherron Watkins as an opportunist. We have, however, only used his book, *Pipedreams*, for background information and we thus feel that this criticism is not relevant here.

FAR sets the auditing standards in Sweden and their material is therefore considered reliable. As with the other material, we have tried to double-check old information to see if it still is relevant. *FAR INFO* is a newsletter with analyses and comments from experts in taxation, business law, accounting and auditing, whereas *Balans* is a magazine with free debates on the same subjects. The articles in *Balans* are mainly written by accountants, auditors and other freelance writers and not by employees at FAR. It must be taken into account that these articles usually consist of someone's opinions and might not have been proven by a scientific research paper. Worth mentioning is the fact that *Balans* is our only source for the main part of the section on the history of the Swedish Management Audit, which might influence the chapter's credibility. For the translation of certain names and accounting terms, both from the Swedish references and interviews conducted in Swedish, we have used FAR's Swedish-English Dictionary.

¹⁶ Texas Monthly (April 2003)



We have also used specialist magazines, for which the same conditions regarding credibility and relevance applies as for *Balans*, well renowned international newsmagazines, daily Swedish and American newspapers and newspapers focusing on business news. Common to all of them is that they are not scientific publications, but still considered having high credibility within their different domains. We have assumed that the theses used as sources hold high quality as they each have been examined and approved independently by two professors.

We have examined our sources carefully and selected relevant and competent interviewees; therefore we believe that this paper holds a high degree of credibility. The reader should be aware of the lack of more recent written sources on the subject of the Swedish Management Audit and also be conscious that the Enron affair is very complicated and that not all of it has yet been cleared up.



3. Swedish and American Audit Practices

This chapter is divided into two parts. First, Swedish auditing in general and the Management Audit in particular are described. Second, American auditing is summarized, and we take a closer look at the different kinds of audits in the US. We also examine the Sarbanes-Oxley Act.

3.1 Sweden

3.1.1 Auditing in Sweden

All stock corporations in Sweden are required to submit themselves to an audit, regardless if they are listed on the stock exchange or not. This obligation includes a financial as well as a managerial audit. The general meeting of shareholders chooses the auditor and her commission is to examine the company's annual report, its accounts and its administration. This study is to be carried out according to generally accepted auditing standards and requires the auditor's independence, competence and professional confidentiality.¹⁷

Applicable laws are the Companies Act, Annual Accounts Act and the Auditors Act, which contains the analytical model further discussed in chapter 3.1.5. The Supervisory Board of Public Accountants supervises the auditing profession and special interest organizations include the Swedish Institute for the Accountancy Profession and the Swedish Association of Auditors.¹⁸

A Financial Audit is based on the company's accounts and its annual report. The auditor's main task is to scrutinize the numbers and accounting practices of the audited firm in order to discover any irregularities or illegal earnings management. In turn, the purpose of the Management Audit is to determine if the President and the Board of Directors have acted against the Company Act or if they have behaved in a way that will make them legally responsible for damages.¹⁹ This is also the basis for the discharge from liability. The inspection concludes in an official document, called the auditor's report, which is to be presented at the annual meeting of stockholders.

3.1.2 What is the Swedish Management Audit?²⁰

The Management Audit is largely based on a review of the internal control in the company. By going over the routines, the auditor can determine whether the President and the Board have fulfilled their duties. The main objective of the Management Audit is to help the auditor to decide whether she can recommend the general meeting of stockholders to discharge the President and the Board from responsibility.²¹ By doing this the stockholders give up their possibility to claim damages, a practice that does not exist in the US. This includes determining whether a Board Member or the President has acted

¹⁷ Balans no. 12 (2002)

¹⁸ Dagens Industri (17/9/2002)

¹⁹ FAR (1986)

²⁰ This discussion is largely based on FAR (1986 and 1998)

²¹ Swedish Companies Act, Ch. 10, 30§ (1975)



in contravention of the Companies Act²², which states that a Board Member or President who deliberately or through negligence causes damage to the company has to compensate for the damage. The President can also be liable if he has exposed the company to any unjustified large risks without the possibility of bringing any correspondingly large advantages. The auditor also determines the Management's compliance with the Annual Accounts Act and the Bookkeeping Act to determine if published interim reports follow regulations and are adequate and if the accounting makes it possible to follow the result and financial position of the company. To see that the Management really does what it is hired to do, the auditor also checks that it follows the company's by-laws.

The decision whether the Board and President have acted in the best interest of the company or not also includes their ability to find enough information and process it correctly to be able to make a decision. As long as the decisions are well founded, the Management cannot be blamed even if the project turns out to be bad for the company.

Since 1999, the Companies Act²³ specifies certain crimes that the President or a Board Member might commit. If the auditor finds out about any of these during the audit, she must report it to the Board and then resign from her assignment within two weeks.

One of the most common problems with auditing is that the auditor does not know enough about the company.²⁴ This might lead her to make the wrong decisions and to review wrong parts of the company, i.e. not the parts where most mistakes are being made. This can be avoided by conducting a better Management Audit. Through the review of the internal control, the auditor gets a greater knowledge of how the company and its Management work. An external Management Audit report can also help to balance long-term performance by highlighting circumstances that are beyond a manager's control. This can include a weakening national economy, which affects the company negatively.²⁵

3.1.3 Historical Background of the Swedish Management Audit²⁶

The Swedish Management Audit has been around for quite a long period of time. It was first developed in the 17th century when the ownership and the management of companies were separated. This created a need among the owners for information about how their investment was being managed and it became increasingly more common as the number of stockholders amplified.

In the 18th century it became progressively more common for the auditor to grant the Management discharge and the Management Audit was a part of the investigation leading up to this. By inspecting the premises in person, reviewing documents other than financial information and through a critical study of administrative measures, the custom of the Management Audit developed. In the Swedish Company Act of 1895, which was the first legislation to regulate stock corporations, it was stated for the first time that the

²² Swedish Companies Act, Ch. 15, 1§ (1975)

²³ Swedish Companies Act, Ch. 10, 38§ (1975)

²⁴ Adrian (14/4/2003)

²⁵ Managerial Auditing Journal (2000)

²⁶ Balans no. 1 (1984)



auditor has an obligation to review the Management. However, this Act was lacking a clear definition of the Management Audit and its purpose and there was no specific model to follow, as was the case for the Financial Audit. A definition was not added until the middle of the 20th century.

The Company Act of 1944 clearly states that the main purpose of the Management Audit is to uncover or prevent any illegal or indefensible measure taken by the Management and describes how this is to be done. The auditor was not only obliged to protect the interests of the company and its owners but also its creditors and the public interest. However, in the Company Act of 1975 the clear definitions of the Management Audit were gone. Instead, the text refers to the continuous observation of generally accepted auditing standards.²⁷

The Management Audit has been growing in importance as the economy changes.²⁸ During the time when most Swedish companies operated within the industrial sector, the primary focus for the auditor was the balance sheet in order to see that the assets and liabilities were properly entered. As the economy slowly shifted in the 1960s and on, many companies became more customer and service oriented and the auditing procedures changed with it. The focus moved towards being more income statement oriented in order to see what had actually happened in the company during the year. As the so-called “new economy” boomed in the late 1990s, with companies’ assets centered on their human resources and competence, the Management Audit became even more relevant. As many of the companies within this new line of business have a low solidity and often very risky projects, the Management Audit is a good tool to check up on the Management’s risk awareness and competence.

3.1.4 How to Conduct a Swedish Management Audit

The Management Audit is usually conducted in two steps.²⁹ To begin with, it is good to talk to the people working in the company. This includes the people at the low levels of the company as well as the middle- and top managers. By doing this, the auditor gets a survey of how the company is being managed in real life as opposed to on paper. She also determines if the managers are liked and if the general opinion is that they are doing a good job. And if not, what is wrong? The employees usually trust the auditor and let her know things that would not be discussed with the manager. By talking to the employees and receiving information, which is not part of any report, the auditor often gets a sense of where to look and what to examine more closely.

²⁷ Swedish Annual Accounts Act, Ch. 10, 7§ (1975)

²⁸ Adrian (14/4/2003)

²⁹ Ibid.



The second step in the audit is the more formal one. This is where the auditor goes through the paperwork and examines if it has been properly managed. According to FAR,³⁰ there are all together eight steps to follow, in no specific order, when performing a Management Audit:

1. To determine whether there have been damages to the company, which can lead to liability for damages for the President and the Board, the auditor firstly has to conclude that there is essential financial damage. This is done by establishing the present and future effects of the damage on profitability, liquidity, financing et cetera. This way she can see if there are any threats to the company's going concern and/or regular development.
2. In concluding if the damage to the company was caused deliberately or by negligence, there are several factors for the auditor to take into account, e.g. was a Board Member or the President favored in an improper manner? Was the underlying material on which the decisions were founded good enough? Did the President or a Board Director exceed his or her powers? Was the decision a breach of the law or the Companies Act?
3. Does the company have suitable planning and control systems? This is established by examining how useful the budgets and estimates are and if they, for example, are controlled by follow-ups and costing. If the company does not have these aids, how extensive is the need for it?
4. To find out if the company has a good internal control to produce complete accounting records and to dispose of the resources according to the President's and Board's intentions, the auditor summarizes the review of the internal control that was made during the planning-stage of the audit. She also checks if there have been any violations of the routines.
5. By verifying the internal control and reviewing that the information given corresponds to the posted figures, the auditor can make sure that the company performs their obligations regarding taxes.
6. Is the accounting carried out properly in order for the Management to get a correct view of the result and the financial position? To control this, the auditor goes through the bookkeeping to see how the different items are posted and why.
7. Does the company have a satisfactory insurance contract? In order for the contract to be adequate it needs to have insurance for the Board and cover all the company's operations. The amount of assets on the insurance forms also needs to be accurate.
8. The last step is to check whether the Board and the President follow the Companies Act in all other senses, e.g. about liquidation and the company's by-laws. The auditor checks if the interim reports have been properly submitted and if they comply with the law. She is, however, not required to examine if the interim report is financially correct.

³⁰ FAR (2002)



3.1.5 Analytical Model

A new Auditors Act was introduced in Sweden on January 1, 2002. One of the additions to this law was an analytical model³¹ to be used for guaranteeing the independence of the auditor. This was done in the aftermath of the severe accounting scandals that have caused the public to question the credibility and autonomy of the accounting firms. The implementation of the new Auditors Act made Sweden the first country in the world to require by law that its auditors follow the Analytical Model. The following passage is based on a bachelor's thesis by Christoffersson et al.³²

The past way of working for Swedish accountants when trying to establish disqualification included taking into account different prohibitions and bans listed in the Company Act. The Analytical Model, however, has as a first step the analysis of possible threats against the auditor's impartiality and, as a second step, measures to remove these threats. It is the auditor herself who has to make these judgments and the model has therefore been criticized for not producing a reliable outcome. According to the legislators this menace is removed by requiring the auditor to carefully document her analysis. This is done so that the Swedish Supervisory Board of Public Accountants and courts of law will be able to verify if the auditor in fact has followed the directives of the model.

The model consists of four steps. As a first measure, the auditor must examine whether or not disqualification as defined in the Company Act applies. If not, she must analyze whether bias, vested interest, personal relationships or any other risks that threaten her independence and credibility exist. She must also look into the unique circumstances of each case. If, during the first two steps, she finds anything to criticize, she must take action to remove those threats, and when not possible to do so she must resign from the assignment. Lastly, it is important that all analysis, examinations and measures are thoroughly documented.

As mentioned above, the model has been criticized for not being fully reliable. The opinions amongst Swedish auditors vary. Some say it is now easier to decline assignments with reference to the law, something that serves the public interest. Others mean that this is not a very objective model and therefore it is ineffective. And it does not make the establishment of disqualification any easier for accounting firms with clients connected to the US, as the American Securities and Exchange Commission (SEC) does not recognize the model.³³

³¹ Appendix B

³² Christoffersson et al. (2002)

³³ FAR INFO no. 1 (2002)



3.2 USA

3.2.1 Auditing in the United States

The American auditing system is largely state-based. Each state has a different system for certifying accountants, but the CPAs have to follow the national auditing standards and accountant regulations that are set by the American Institute of Certified Public Accountants (AICPA). The Institute publishes Statements on Auditing Standards (SAS), which are mandatory for all CPAs to follow, and Audit Guides, which relate to certain industries and are used as guidance for the members of the AICPA.

In their first SAS in 1947, the AICPA set ten auditing standards, which have evolved into Generally Accepted Auditing Standards (GAAS). These have since been modified to reflect changes in the auditors' environment, but are still focused on the financial part of the auditing. The other SAS are considered interpretations of the GAAS and are "*minimum standards of performance for auditors*"; the auditor then applies "*sound professional judgment*" when deciding how to act.³⁴

The legislation concerning companies on the state level does not set high demands on auditing. However, all listed companies must also follow the Securities Act of 1933 and the Securities Exchange Act of 1934. These acts state that companies must hand in a year-end closing that has been audited by a CPA to the Securities and Exchange Commission.³⁵

3.2.2 Financial Audit

The Financial Audit also incorporates some of the tasks included in the Swedish Management Audit. An example of this is an assessment whether or not the company is a "going concern".³⁶

Another common feature between the Swedish Management Audit and the American Financial Audit is the understanding of the client's internal control. This is done in order to determine which controls that exist within an entity and is done in the planning phase of the audit. The internal control examination includes ensuring that the following categories work in a manner intended: effectiveness and efficiency of operations, reliability of financial reporting and compliance with applicable laws and regulations. The purpose is to determine if the Management's directives are properly communicated and if the reports to Management are accurate, timely and complete with the necessary information to form the basis for management decisions. The auditor then evaluates the internal controls in order to assess the risk that they will not prevent or detect a material misstatement in the financial statement. This so-called control risk has a direct impact on the auditor's work. If it is considered low, a less detailed audit is required to audit the account balances, as the auditor has evidence that the accounting systems are generating reliable financial information.³⁷

³⁴ Messier (1997)

³⁵ Balans no. 6 (1975)

³⁶ Halvorsen (09/5/2003)

³⁷ Messier (1997)



The auditor goes through the different accounts and checks that assets, debt and equity are fairly and accurately valued. The purpose of the audit is according to Arens and Loebbecke³⁸ “to determine whether the overall financial statements are stated in accordance with specified criteria”. These criteria normally consist of the Generally Accepted Accounting Principles (GAAP), but cash basis or other bases can also be used, depending on which organization is being audited.

3.2.3 Operational Audit

The Operational Audit is not mandatory in the United States and has therefore no generally accepted standards, as is the case for the Financial Audit. It is usually a cost/benefit – decision whether or not it will be executed. Many small companies may not need an Operational Audit as the costs associated with the audit exceed the advantages earned.

The objectives of the Operational Audit are to measure the company’s efficiency, effectiveness and performance. In doing so, there will hopefully be an increase in profitability, a more efficient allocation of resources and an improved communication, all of which are the Management’s responsibilities. The Operational Audit is also done in order to try to identify possible problems at an early stage. According to Glezen³⁹ it can be regarded as a form of constructive criticism as the results are usually only reported to the Management, not to any external users.

When studying a company’s operations and performance there are no well-defined criteria to follow such as the US GAAS, but Arens and Loebbecke suggest four areas to look at:⁴⁰

- Historical performance (have things gotten better or worse compared to before?)
- Comparable performance (how are things compared to other internal or external entities?)
- Engineered standards (for example time and motion studies)
- Discussion and agreement (between different levels of Management and the auditor)

Some authors distinguish between Operational and Management Audit. According to this distinction, an internal auditor performs the Operational Audit whereas an *independent* external auditor executes the Management Audit.⁴¹ Others are of the opinion that both an internal or external auditor can perform an Operational Audit.

Management in the US has traditionally opposed the Operational Audit. It has expressed concerns that they cannot do their job properly with someone looking over their shoulder.⁴² Another opinion is that the Management itself is not the most reliable source when it comes to collecting data in order to monitor management.

³⁸ Arens & Loebbecke (1997)

³⁹ Glezen (1994)

⁴⁰ Arens & Loebbecke (1997)

⁴¹ Cook & Winkle (1976)

⁴² Management Review (1977)



3.2.4 Compliance Audit

This type of audit is mainly executed within regulated industries or entities that receive funding from the government.⁴³ It exists to determine whether a company's transactions and events conform to internal rules and policies as well as to external laws and regulations and might answer questions such as: Are they submitting the required reports? Do they keep within their spending limits? For a private company this might include whether wage rates comply with minimum wage laws or if accounting personnel are following the procedures set up by the company controller.⁴⁴

In general there are more compliance requirements for governmental companies than for privately owned ones.⁴⁵ According to the Single Audit Act, the governmental companies are required to follow the Yellow Book Standards in addition to some specified additional audit obligations.⁴⁶ For example, public sector schools have extensive regulations set by government authorities that need to be followed.

As with the Operational Audit, the results of the Compliance Audit are mainly reported to internal users and not widely spread outside the organization. Since the Management is the user of the information, internal auditors employed by the company itself often perform this kind of audit. However, when determining whether an entity that receives funding from the federal government is complying with specific laws and regulations an examination by an external CPA is required.⁴⁷

3.2.5 Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act is a "*public company accounting reform and investor protection act*"⁴⁸ which was legislated as a reaction to the Enron scandal. It is applicable for all companies that are listed on the public stock exchanges or on their way to being listed in the US, regardless of the nationality of the company. The law aims at restoring the investors' faith in the stock market and seeks to guarantee that the content of the financial reports complies with reality.⁴⁹ This will be carried out through four main measures:

- Stricter demands on the information given to the stock market
- Stricter demands on the auditor's independence and professionalism
- Demands on internal structures for auditing and the information flow to the market
- More severe punishments for breaking the law

To ensure that the auditor is independent, the law fundamentally bans the auditor from performing other services than auditing for their clients. It also stipulates that there must be an audit partner rotation, i.e. there is no time limit for how long a company can keep its auditing firm, but the auditor in charge must be changed every five years. It is quite common that companies recruit their accounting personnel from their auditing firm.

⁴³ Halvorsen (09/5/2003)

⁴⁴ Arens & Loebbecke (1997)

⁴⁵ Glezen (1994)

⁴⁶ Arens & Loebbecke (1997)

⁴⁷ Ibid.

⁴⁸ Sarbanes-Oxley Homepage (29/4/2003)

⁴⁹ Balans no. 1 (2003)



Therefore the auditor can no longer audit a company where any of the key persons within the Management or financial department worked in the auditing firm less than a year before the audit.⁵⁰

In order to make the financial reports more reliable, the law requires the President and the Chief Financial Officer (CFO) to sign the annual report and interim reports, thereby certifying that they have reviewed it and that it to the best of their knowledge are correct and not deceptive. If a report from a previous year must be corrected or restated, the CFO and President must pay back any bonus payments and compensation based on the company's misstated financial result. It is not until the implementation of this law that it became illegal to deceive the auditors in order to hide a fault in the accounting.⁵¹

Companies listed on the NYSE must have an Audit Committee consisting of independent members of the Board of Directors; i.e. they cannot be employed by or be in other ways dependent on the company. This committee supervises the accounting and control systems, decides which external auditor to use and then monitors their work. The Sarbanes-Oxley Act expands this requirement to all listed companies, regardless which stock exchange in the US they are listed on.

The new act also appointed a supervising body, the Public Company Accounting Oversight Board (PCAOB). This board, made up of five full-time members, oversees and investigates the audits and auditors and sanctions both firms and individuals for violations of laws, regulations and rules. It also regulates the relationship between the auditor and the company being audited.⁵² By doing this, the stockholder's confidence in the company and the stock market as a whole is meant to increase.

The American accounting system is to large extent rules based; i.e. the system has detailed rules for how to perform the accounting, instead of principles on which the accountants can base their decisions. This, however, may change. The Sarbanes-Oxley Act requires the SEC to study the accounting system to see how long it will take to achieve a "*principles based system*".⁵³ Nevertheless, this is not very sought after by the auditors. After the Enron crisis, the Big Five accounting firms⁵⁴ demanded more rules and blamed regulators for failing to supply them.⁵⁵

3.3 Summary and Interpretations

Even though there is no requirement to perform a so-called Management Audit in the United States, parts of the Swedish-type inspection of Management are performed during the Financial Audit and the planning of it. However, there do not seem to be such articulate directions for the review of President and Board as is the case in Sweden. Perhaps a requirement and more precise rules to follow would make it easier for the American auditor?

⁵⁰ FAR INFO no. 8 (2002)

⁵¹ Ibid.

⁵² AICPA Homepage (23/4/ 2003)

⁵³ Bratton (2003)

⁵⁴ Andersen, Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers.

⁵⁵ Bratton (2003)



Another difference between the two countries is that no discharge is granted Presidents and Board Members of American companies. If this was to be done in the US as well, stockholders might make higher demands upon the auditors regarding the review of Management. Auditors would have to perform closer and more elaborate audits to make certain not to miss anything before recommending discharge.

American authorities do not recognize the analytical model that is seen, in Sweden, as a mean for ensuring the auditor's independence and objectivity. Perhaps the model can, in some senses, be compared to the Sarbanes-Oxley Act, which states that the American auditor is no longer allowed to perform any consulting services for her clients. The objective of this prohibition is also to assure independence.

There are also several similarities between the Swedish Management Audit and the Sarbanes-Oxley Act. Nevertheless, while the former has a long history and tradition, the latter one was recently established in haste. It is also noticeable how they treat similar issues in different ways. Both are mainly designed to protect the stockholders, but while the objective of the Swedish Management Audit is to find any problems or irregularities early in order to prevent them from escalating, the Sarbanes-Oxley rather tries to act as a deterrent by advocating more severe punishments. Therefore they rather seem to be complementing each other than being two separate alternatives.



4. Enron Corporation

We look into Enron Corporation and what the scandal was about. First, we examine the Management's financial strategies and what they tried to achieve with them. Then we examine the Board of Directors to see what they did, or did not, do.

4.1 Historical Background

In 1985 Enron Corporation was created from the merger between the energy companies Houston Natural Gas and InterNorth. At the time it was considered a pioneer in trading natural gas and electricity.⁵⁶ As the years passed, Enron's Management developed its business from an old-style energy company to a company highly involved in trading and speculations. At the end of the 1990s Enron's revenues had tripled to more than 100 billion US dollars and it was seen as one of the most successful corporations in America, dominating the energy market.

Enron's human resource policy was to hire only the top talent, young go-getters from Ivy League schools eager to get ahead and climb to the top. It is said that ruthlessness, greed and arrogance soon characterized the corporate culture at Enron.⁵⁷ The high performers got high bonuses and the low performers were fired.⁵⁸ Some say the compensation plans and stock option programs were created to enrich the executives rather than being in the stockholders' best interest, creating a moral hazard problem.⁵⁹

In 1992 the SEC approved a change of accounting method. This change made it possible for Enron to become the first non-financial public company in the US to use so-called mark-to-market accounting. The method has been criticized for creating "non-cash revenues". As Enron sold long-term gas contracts, they were able to enter the revenues from these contracts right away, even though no cash had actually been collected. This way Enron was able to turn up a huge profit without actually having anything to back it up with.⁶⁰ But it was the creation and treatment of off-balance sheet entities, so-called Special Purpose Entities (SPEs) that were at the core of the Enron affair. These transactions were also a way to hide losses and generate profits.⁶¹

The result of these aggressive treatments enhanced the company's reported earnings and made it possible for President Jeffrey Skilling, Chairman Kenneth Lay and other Enron executives to earn big bonuses.⁶² *Fortune Magazine* published an article in March 2001 that criticized the company's accounting practices. The article did, however, not get much attention and most analysts kept recommending the stock to their clients. Executive Sherron Watkins also attracted attention to this in her now famous letter to Mr. Lay, who had become President after Mr. Skilling's resignation in August of 2001. She wrote: "*I am incredibly nervous that we will implode in a wave of accounting scandals.*"⁶³

⁵⁶ Fortune (12/9/2001)

⁵⁷ Ibid.

⁵⁸ Newsweek Vol. 139, Iss. 5 (2002)

⁵⁹ Gordon (2003)

⁶⁰ Bryce (2002)

⁶¹ Bratton (2003)

⁶² Ibid.

⁶³ Fortune (12/9/2001)



The letter was discovered the following January by congressional investigators. By then Enron had filed for bankruptcy⁶⁴ and accounting firm Arthur Andersen's legal counsel had instructed its auditors to destroy all documents associated with Enron except the most basic ones.⁶⁵

4.2 Enron's Financial Strategies

Enron's accounting measures and financial statements were so complex that we will only give a brief summary of it. The following chapter is based on the master's thesis *Rebuilding Public Trust* by Redin⁶⁶.

During the 1990s, Enron made heavy investments that were expected to provide positive returns over time but did initially cause Enron's balance sheet to show huge debts, which in turn would negatively affect the company's credit ratings and stock price. To prevent this from happening, Enron set up separate entities that could borrow money from outside investors. As these entities were presented as investments instead of being consolidated with the company, Enron executives were able to do this without it showing on the company's balance sheet. Many of these entities were so-called Special Purpose Entities (SPEs).

Enron had three major SPEs: Chewco, the LJM's and the Raptors.

Chewco was a limited partnership formed in 1987. There are certain rules for an SPE to follow in order for it to be considered an investment, thereby avoiding its consolidation with the company. Andersen concluded in November 2001 that Chewco did not follow these rules, and shortly thereafter Enron announced that it would restate its financial statements from 1997 through 2001. This caused the Enron's debt to increase enormously.

The LJM's were three private equity funds formed 1999-2000 with the purpose of establishing and operating off-balance sheet entities designed to transact with Enron. The activities with the LJM's were concentrated in the final weeks of each fiscal quarter and many of the deals were reversed once Enron had handed in its financial reports to the SEC. These entities allowed Enron to be able to make up their own value of assets within the company. Enron's CFO, Andrew Fastow, controlled the general partner of each of the LJM's, which caused him to be able to sit on both sides of a negotiation - both representing the LJM's and Enron - thereby lining his own pocket.

The Raptors were set up to handle the transactions between Enron and LJM2. Through this entity, Enron set up a very complicated hedging system where Enron still bore all economic risk. In other words, Enron hedged risk with itself. This worked fine as long as Enron's stocks were highly rated as the Raptors allowed Enron to gain from increases in the value of their own stock. But as soon as Enron's stock price decreased, the system broke down.

⁶⁴ Business Week Online (28/1/2002)

⁶⁵ Time South Pacific, Vol. 159, Iss. 3 (2002)

⁶⁶ Redin (2002)



4.3 Failures of the Board and the President

Enron's Board consisted of very renowned people, several of whom served on the boards of other companies. A US Senate Report⁶⁷ concluded:

“The directors [...] have a wealth of sophisticated business and investment experience and considerable expertise in accounting, derivatives and structured finance”.

Typical board duties include among other responsibilities the following: to select and compensate executives, evaluate auditors, monitor overall company performance, oversee financial statements and, maybe most importantly of all, safeguard the interests of the company's owners. According to the report mentioned above and to many observers, it appears the Enron Board of Directors fell short of safeguarding the stockholders by allowing the company to engage in the five failures described below.

1. Excessive Compensation

The Board approved a compensation plan based on stock options that made a major part of the management compensation dependent on the stock price. In 2000, 66 percent of Mr. Lay's compensation was stock-based; the same number for Mr. Skilling was 75 percent. The plan may have been a temptation for the Management to manipulate Enron's result in order to make the short-term stock price higher.

2. Undisclosed off-the-books Activity

The resulting effects of the possible manipulation of the financial results became easier to cover up and hide when the Board approved a new disclosure policy. It is said that this new policy was the principal failure of the Enron Board. It made the firm's financial results opaque to the market as a big part of Enron's business was performed through the SPEs. According to Gordon⁶⁸, the Board should have reacted when the Management began creating these off-balance sheet entities by intensifying their internal monitoring. Instead, by approving the new strategy, the Board made it impossible for analysts and external participants to correctly analyze the company's and its managers' performance. Although consolidation of the SPEs might not have been mandatory according to the US GAAP, it would have been possible for the Board to require the information to be put in footnotes making it available to the public.

3. Lack of Independence

There is said to have been some financial ties between certain Board Members and Enron. The Board also failed to ensure independence between Enron and its auditor Andersen.

4. Conflicts of Interest

The Board allegedly approved a deal making Enron's CEO Mr. Fastow in charge of the LJMs, thereby allowing him to profit on Enron's expense.

⁶⁷ US Senate, Report 107-70 (08/7/2002)

⁶⁸ Gordon (2003)



5. High Risk Accounting

The above mentioned transactions created a much higher risk and although it was individual officers' transactions and affairs that mislead the market, in some people's opinions, the Board should have been aware of the need for a more intense monitoring of results and finances.⁶⁹

Enron also engaged in business deals with very high risk, from buying plants in politically unsafe areas, to going into the business of selling weather derivatives.

On February 1, 2002, the *Report of Investigation*, also called the Powers Report, concluded that:

*"The Board cannot be faulted for failing to act on information that was withheld but it can be faulted for the limited scrutiny it gave to the transactions between Enron and the LJM partnerships."*⁷⁰

Ms. Sherron Watkins claimed in a senate hearing that Mr. Fastow and Mr. Skilling deliberately had deceived the rest of the Management. The conclusion of her testimony was that Mr. Lay neither knew what was going on nor understood it and was tricked by his closest co-workers.⁷¹ On the other hand, Mr. Skilling himself claimed in another Senate hearing that he did not know of any irregularities in the company and that he thought the company was in good shape when he left his appointment in August 2001. It has not yet been completely clarified who knew what and when, but even if Mr. Skilling's statement is true, it does not lessen his responsibility. It is the President's job to know what is going on in his company, especially if the stockowners and employees are being misled. Allegedly, Enron's corporate lawyer warned the Management at the end of 2000 that their accounting methods could have dire consequences and suggested measures to be taken to lessen the damage, but the warning was evidently ignored.⁷²

The Management of a company has the primary responsibility for implementing the Board's resolutions and controls. According to the *Powers Report*⁷³ the Management of Enron failed to do so on several respects, with the main faults being that no one accepted the primary responsibility for oversight and that the controls were not executed properly. The most fundamental management control flaw was, however, the lack of separation between the LJM's and Enron personnel as described above. According to the same report, the most basic reason why the controls failed was structural. Most of the controls were based on an old model, in which Enron's business units were in full command of transactions and had the time and motivation to find the highest price for the assets they were selling. However, during the last few years before the collapse, this was no longer the case.

⁶⁹ Gordon (2003)

⁷⁰ Ibid.

⁷¹ DN (15/2/2002)

⁷² DN (08/2/2002)

⁷³ Powers et al. (2002)



The last months before the collapse, Enron managers and Board Members knew about the financial situation of the company. President Kenneth Lay was only one of many who allegedly used this information to sell off most of their stocks before the news broke. At the same time he tried to reassure Enron employees and stockowners that “[Enron’s] financial liquidity has never been stronger”.⁷⁴ After the bankruptcy, Enron employees had not only lost their jobs but also a huge portion of their pensions that had been kept in the form of Enron stock.

4.4 Summary and Interpretations

This has been a short summary of the complex affairs surrounding Enron before its collapse into bankruptcy in December 2001. For an outsider it is very difficult to know what really happened and to know who knew what in the Enron affair. There are many different opinions and testimonies and the investigation and trials will be complicated. However, to many it seems clear that the Enron Board and Management fell short of their duties; it is just difficult to prove that it was done deliberately.

The Board consisted of very competent, experienced and highly regarded people. How could they not have a clue of what was going on? Why did they not react? An independent auditor should have been able to question the Board’s lack of involvement. Perhaps the fact that the Board was very renowned could mislead the auditor into assuming that they were doing their duty protecting the stockholders when she in fact should have dug a bit deeper?

By conducting very complicated accounting strategies, the management tried to hide the company’s true financial status. This created the impression that their figures, which after years of high-risk business actually were quite tarnished, were excellent. The Management and the Board were praised in the media and by the market for leading such a financial wonder. The fact that they also were able to become wealthy from the deals just enhanced their risk taking and the complexity of the financial statements. Perhaps greed was the driving force? The corporate culture and compensation plan created by Skilling certainly encouraged risk taking and selfishness.

We will in the following chapter go through the thoughts and opinions of some Swedish and American auditors regarding among others their view of the Enron affair. In chapter 6, *Analysis and Conclusion* we will then apply the Swedish Management Audit on the scandal to see if it could have changed the outcome.

⁷⁴ Time South Pacific, Vol. 159, Iss. 3 (2002)



5. Interviews

This chapter includes the interviewees' opinions and thoughts on the matter. How important do they think the Management Audit is? In their opinion, could it have changed the outcome of the Enron scandal? What do they think of the Sarbanes-Oxley Act?

5.1 Sweden

5.1.1 Interview - Helena Adrian, Authorized Public Accountant

Conducted at the office of Adrian & Partners, Gothenburg, on April 14th 2003.

It was Ms. Adrian who first gave us the idea to study the Swedish Management Audit after an interesting guest lecture at the Gothenburg School of Economics and Commercial Law. She is a partner and authorized public accountant at accounting firm Adrian & Partners where she has been working for the past 20 years. Specializing in corporate and tax law, she is also a member of the Swedish Association of Auditors' Tax Committee.

Ms. Adrian says that the Management Audit often is the most challenging part of an auditor's work, especially if there are disagreements within the company. When conducting a Management Audit one has to look at the written sources such as contracts, but one must also talk to the people within the company. This is also related to the Financial Audit, as the assessment of the company's risk, which is done at the beginning of the Financial Audit, is a part of the Management Audit as well. Ms. Adrian also points out that it is not possible for an auditor to discover everything.

"We can only look at the decisions and the basic data for the decision-making. In Sweden we do have a good basis for this kind of control, for example registration for corporate taxation and corporate registration number. You can easily find out if the Board of Directors previously has served 17 companies later declared bankrupt."

When it comes to auditing a small company, the procedure is slightly different. The small company often lacks minutes of the Board of Directors' meetings et cetera. Therefore the auditor has to start looking at the balance sheet to see if something major has happened during the year and then return to the files and search for the required documents and contracts. The next step includes looking at these contracts and making sure the deal has been done the right way. Big companies often have special departments for finance and accounting, but this is not the case in the small company. Perhaps a consultant has done all the accounting and if so the auditor has to audit his work as well. And for small companies that often lack the legal expertise, one single business risk might put the entire company's future in jeopardy. In that case, it is important to keep close contact with the client. Sometimes the auditor might look at contracts before they are signed to assure they are fair or alert the Management if the risk is too big.

But it is important to point out that the auditor should not tell the client what to do, but only give recommendations. If the auditor comes across a mistake or something that is wrong she will let management know, but she cannot put herself in the consultant's



position. However, her role might include an exchange of opinions and experiences with the Management, but as long as she applies the analytical model there will not be any problems or conflicts handling this situation according to Ms. Adrian.

She also says that the importance of the Management Audit has increased during recent years. During the times of the industrial companies, the auditor's focal point was the balance sheet. As the economy changed and companies became more and more customer and service oriented, the focus shifted to the income statement. How about the future?

“Maybe the increasing commitment to the employees and their competence will make the Management Audit the next focal point. When it comes to today's auditors, their biggest flaw is that they do not put enough energy into the Management Audit; they believe the income statement and balance sheet are more important. In my opinion, the Management Audit is one of the most important parts of an auditor's work.”

The reason the Management Audit is so important is that it is within this area that the risk of becoming liable for damages is the biggest. One single mistake might lead to very serious consequences. Ms. Adrian believes that more focus on the Management Audit would prevent many lawsuits and she hopes that the importance of it will increase.

“Many auditors today do not have enough knowledge of the companies they are auditing. I myself have clients who have gotten into trouble due to the fact that their previous auditor did not review the things that are included in a Management Audit correctly.”

But if it is so useful, why does the Swedish Management Audit not exist in other countries as well? Ms. Adrian's opinion is that Sweden is not very good at promoting its methods. Especially accountants are very careful and not at all good at marketing.

“We do accept directives from the European Union, but do not try to sell our own ideas. For example, after the Enron collapse nobody stepped forward to say how good it was that we actually do have management auditing in Sweden and that something like that scandal never could have happened here.”

If the United States had practiced the Swedish-type Management Audit, Ms. Adrian believes that Andersen would have had to take more action to conceal the irregularities and maybe it would have made it more difficult to circumvent the problems. Errors in the financial data are easier to get around or hide than shortcomings in the management of the company.

“Every step taken to prevent this from happening again is good. I am not saying the Management Audit provides a one hundred percent foolproof protection against economic fraud, but if the auditor finds something suspicious she should inform the Board and give them three weeks to correct it; if not she must report it.”



Follow-up question answered via email May 20th 2003

In the hypothetical case where it is the CFO, and not the President or Board of Directors, who breaks the law or acts in a way that causes damages to the company, would that also be discovered during the Management Audit?

“The Board is responsible for the accuracy of accounting, management of assets and the company’s finances and if a manager is acting improperly, perhaps the Board’s control is not sufficient.”

The Management Audit also includes an examination of the written instructions and authorities given to the Chief Accounting Officer, Chief Financial Officer, controllers et cetera by the Board and the auditor has to look at how these instructions are followed. An auditor could find a manager that exceeds his or her authority if the Board does not react or take measures. In this case the Board has not lived up to its controlling role or chapter 8 in the Swedish Companies Act that regulates the role of the Board.

5.1.2 Interview - Helena Herlogsson, Authorized Public Accountant

Conducted at the offices of Ernst & Young, Gothenburg, on April 25th 2003.

As a former employee of accounting firm Andersen, Ms. Herlogsson has some knowledge of the affairs between Enron and its auditor. She started her career at Andersen 13 years ago, but began working for Ernst & Young in fall of 2002 as a consequence of the accounting scandal in the United States that made Andersen disappear from the accounting scene. At Ernst & Young she is handling international companies.

The Management Audit is one of the most important parts of the audit, as it is the basis of the decision whether to grant discharge or not. But Ms. Herlogsson also points out that it is much easier to know exactly what to do when it comes to the Financial Audit and that the Management Audit can be viewed as less clearly structured especially by relatively new accountants. But with the implementation of the new auditing standard⁷⁵ a more specified and detailed audit program will be implemented. The provision to examine whether or not the company is following the law is more clearly stated in this new standard.

The Management Audit performed by Ernst & Young consists of several activities. The auditor looks at how the company is run, its accounting systems, its bookkeeping practices and essential contracts. She asks for copies of the minutes from the Board of Director’s meetings and key contracts to make sure everything is in order; if contracts have been signed by a person with the authority to do so and naturally if the decisions made are economically justified. She also verifies that the accounting of taxes has been done properly and if the value-added tax and the general payroll tax have been paid in time. Naturally, she cannot look at everything but have to consider risk and usefulness.

⁷⁵ Revisionsstandard i Sverige, RS 209 goes into effect January 1, 2004



“The auditor is not supposed to discover everything. We have an obligation to discover major faults, but not to search for intentional wrongdoings. If the client wants to deceive the auditor there are possibilities to do so.”

In a small company there is usually a lack of information, perhaps there are no documented minutes from the Board meetings. But the auditor still looks at if the organization is well structured and if the Board is treating the right things at their meetings. This is done continuously during the year and not only in connection with the year-end closing of the books.

Ms. Herlogsson says she cannot answer the question what would have happened in the Enron case if the United States had practiced the Swedish-type Management Audit; but she says that it is interesting to see how there is much more focus on internal control in the US after Enron. The companies are now required to make an additional statement in the annual report saying that everything has been conducted in the right way; if it is discovered that this is not the case, they will be liable. The Sarbanes-Oxley Act creates a much higher pressure on the CFO and other executives.

Enron was a very complicated case of accounting fraud. Ms. Herlogsson points out that it is not even clear yet if a crime was committed. An example is the creation of special entities that were not consolidated and Ms. Herlogsson believes that if the principle of true and fair view had been practiced auditors might have been able to see through this.

“The US has more laws and recommendations and does not use the principle of true and fair view. I do not think this is about the Management Audit, rather about accounting technique. Of course it is difficult to say, but I doubt the use of the Swedish Management Audit would have made a difference. I believe in the application of true and fair view as well as legislation.”



5.2 USA

5.2.1 Interview - Marcia Halvorsen, CPA

Conducted at Ms. Halvorsen's office May 9th 2003.

Ms. Halvorsen is a certified public accountant in the US and worked at small and mid-sized accounting firms for 20 years while teaching part-time at the University of Cincinnati. As a guest lecturer at the Gothenburg School of Economics and Commercial Law, she teaches financial accounting, US GAAP, international accounting and accounting control systems.

For an American, the term "Management Audit", is associated with the control of government entities in order to see if they are fulfilling their mission since, in the US, there is no required Management Audit for corporations as is the case in Sweden. Instead, the control of Management is included in the Financial Audit. For example, an internal control assessment is done to determine how much one can rely on the company's internal control. Their attorney also has to send the auditor information about any on-going lawsuits and there is an audit segment addressing the question of going-concern. Finally, the auditor writes a Management Letter to hand in to the Management, but this document is not published.

When it comes to the Enron collapse, Ms. Halvorsen points out that none of us really knows what happened and no one has yet gone to jail. Andersen is out of business, but for destroying business papers, not because it has been proven they conducted faulty audits. But there was probably collusion in Enron. Ms. Halvorsen mentions the SPEs and the fact that people from Enron knew about the improper connections and relationships. She says the auditor should have been able to find this out. It is also probable that the Board was not doing their job. They did not ask the right questions or investigate further.

"The Board is very sheltered. They are often friends with executives and often own stock in the company as well. If the auditor had rigorously been looking at the Board's minutes, had spent some time with them and questioned connections et cetera they should have seen it coming."

Regarding the Sarbanes-Oxley Act, Ms. Halvorsen's opinion is that it is still not a good enough protection for the stockholders. However, it is a step in right direction with more stringent financial penalties and jail time. This might shake the auditing community and as a result produce better audits for a while, but in the end she believes that it will not be better after all as the risk of penalty is not great enough for a dishonest person.



Follow-up questions answered via email on May 15th 2003.

During the Swedish Management Audit the auditor must assess whether the Management has exposed the company to any unjustified large risks without bringing any correspondingly large advantages, is this the case in the United States as well?

Ms. Halvorsen underlines that to her knowledge the evaluation of risky business practices such as operations in certain foreign countries, use of financial derivatives or spending large sums on research and development, are not required.

“I am not aware of any requirement [in the US] that the auditor must assess the business risk of management actions. The auditor does evaluate the internal control policies and procedures of a company, and based on that evaluation indirectly assesses the risk of not finding errors or omissions in the company’s accounting.”

The auditor must also assess whether or not the company is a “going concern,” so indirectly the auditor is assessing business risk when she evaluates whether the company will stay in business for the next year and will be able to pay its debts. However, Ms. Halvorsen is not aware of any American requirement to evaluate various business practices that might seem risky, for example operations in certain foreign countries, use of financial derivatives or spending large sums on research and development.

“I do not think auditors would want this responsibility, particularly given the litigious climate that exists in the United States. Furthermore, US GAAP, I believe, is intended to show the financial statement readers enough information so that the readers can make their own evaluation of the company’s business risk.”

Are the Board and Management scrutinized enough by American auditors? Ms. Halvorsen’s opinion is that, at least in some highly publicized situations such as Enron, Health South and WorldCom, the auditors could have looked more closely at the Boards, and certainly at the Management. But this is hindsight, and no U.S. Board Members have yet been charged with any misconduct.

“In my experience, not very much time is spent on an examination of the Board. The auditor reads the Board minutes (perhaps 1% of the audit time), looking for decisions and actions in order to see if subsequent procedures took place. However, no time is spent on determining whether Board Members attend meetings, are knowledgeable about the company, or are knowledgeable about finance and accounting.”

Ms. Halvorsen continues to say that many Board Members are current or former executives of the company, well-known business and political leaders or acquaintances of the Management. Until recently, there was no open challenge to the legitimacy of this “old boys” system. But it seems, in the US, that there will now be more attention paid to the Board Members: who they are, what their relationship is to the company, how they are compensated and what they know about the company. However, it is the SEC and the new Public Company Accounting Oversight Board (PCAOB) who are making various



decisions, which hopefully will improve the role of the Boards and Management as far as protecting the various outside stakeholders. For example, the SEC is requiring more non-executive Board Members and is requiring CEOs and CFOs to confirm the validity of the financial statements. Ms. Halvorsen also points to the so-called "court of public opinion", where many people feel both the Management and Boards should be more attentive to stakeholders' interests. As a result she thinks we may to some extent, at least in the short-term, see a higher degree of responsibility from both Boards and Managements.

"I do not know if the Swedish model of a "Management Audit" is a useful tool or not. I personally do not feel it is the role of the auditor to comment, either positively or negatively, on the business success, failure or ability of the Management of a company. I believe it is the role of the auditor to determine if the financial position and results, as presented by Management, are fair and in accordance with GAAP. Beyond that, I don't think auditors should comment on Management's actions."

However, Ms. Halvorsen feels that following Sarbanes-Oxley, with the separation of the audit function from the consulting function, we may see auditors returning to their first and foremost responsibility. She thinks we will see fewer instances of conflicts of interest and less willingness, on the part of auditors, to look the other way when the Management abuses GAAP.

5.2.2 Interview - Jan Marton, CPA

Conducted at Mr. Marton's office May 9th 2003.

Mr. Marton earned his MBA at Columbia University, is a US certified public accountant and worked for Deloitte & Touche in the United States. He is now a senior lecturer at the Department of Accounting, Gothenburg School of Economics and Commercial Law.

Mr. Marton does not believe that the Swedish Management Audit could have made a difference in the case of Enron. He says that the measures taken in the Swedish Management Audit are also done in the US; they just do not call it the same thing. Enron were stretching the rules and a lot has to do with the auditor's independence. But even if the auditor's had done their job properly he does not think it would have helped.

"Sometimes there are very strong incentives to lie. You lie and get 10 million dollars, or you tell the truth and get nothing."

Regarding the Sarbanes-Oxley Act, Mr. Marton says that it was drafted very quickly as a way for senators and congressmen to show that they have the power to act. Because of this, the Act is not very good. Until 2003 the courts of law were controlling auditor's work, but the fact that the SEC now must review the auditor's work can be a positive change. The addition that it is now criminal for the Management to lie to the auditor is also good.



He does not agree that the implementation of “true and fair view” would be a good idea. The general view of the United States as rules-based versus Europe as mainly principles-based can be questioned. There are many judgments made in the US as well, also in the Enron case. And a fully principles-based system would make it more difficult for the auditor to argue before the company Management, as there would be no specific rules to rely on. And in the United States it is the legal experts that drive the development of the rules through court cases. If the country were to adopt a principles-based view the system would collapse according to Mr. Marton.

“It is not the rules that are the problem. It is how people chose to apply them. The question is why the rules look like they do? How should they be designed to make people behave in a certain way?”

So why is the Management Audit so important in Sweden? Mr. Marton says that it might be the long historical tradition and the fact that Swedes have a different view on responsibility than the Americans. In Sweden the review of the Board is done to see if they have fulfilled their responsibility so that they can be granted discharge. People want a definitive end to the responsibility of Management, a limit after which they cannot be prosecuted for failures made. In other countries, including the United States, this is not the case.

5.3 Summary and Interpretations

The interviewees all have quite different backgrounds, which also is reflected in their attitudes and opinions regarding the Swedish Management Audit and its usefulness in the Enron case. All three Swedish interviewees think that the Management Audit is a useful tool for an auditor and both Swedish authorized accountants agree that the Management Audit is one of the most important parts of an auditor’s assignment.

As to the fact why the Swedish-type of Management Audit does not exist in other countries, Ms. Adrian believes that Swedes are just not good at promoting their ideas and methods abroad. Mr. Marton, however, rather leans towards the long tradition and the Swedish view on responsibility.

Regarding the Sarbanes-Oxley Act, the interviewees agree that it is a step in the right direction, but not nearly enough to protect the stockholders.

We did, however, get different opinions whether or not the Management Audit could have changed the course or outcome of the Enron collapse. Ms. Adrian believes a properly conducted Management Audit could have helped the auditors to find the problems sooner as it would have made it more difficult for them to avoid looking into the Board’s and the Management’s control.

Ms. Herlogsson does not share this opinion and rather sees the problem as being of a more principles-based nature. She believes that applying the right principles to the American system, such as *true and fair view*, would have helped the auditors to pinpoint



the faults in the accounting to the Management, which in the rules-based system was not possible.

Being an American, Ms. Halvorsen's expertise does not lie in the field of the Swedish Management Audit, but she is of the opinion that it should not be the role of the auditor to comment on the ability of the Management of a company. Instead of blaming the Management, she sees the Board's lack of control to be the main reason for why the collapse could take place.

Mr. Marton argues that since basically the same tasks as the ones performed in the Swedish Management Audit are carried out in the US, although not under the name "Management Audit", this cannot be the problem. He is more of the opinion that the auditor's lack of independence was the problem. But even if Andersen should have found the faults, the main issue according to Mr. Marton is rather the high incentives for the Management to lie.

The fact that none of the four auditors questioned agrees on what really happened in the Enron affair and whether the Swedish Management Audit could have had influence or not is yet another sign of the complexity of the scandal. By applying the Swedish-type Management Audit to these circumstances, we will try to conclude if it actually could have made a difference.

It is important to remember that these interviewees not were selected because of their extensive knowledge of the Enron affair, but because of their background as accountants/auditors in Sweden and the US. This means that their opinions are not necessarily the truth, but well-educated estimations and predictions that help us to form an opinion on the matter.



6. Analysis and Conclusion

This final chapter includes the analysis of the main question, stated in the purpose. The analysis is based on the theoretical chapters as well as on the interviewees' opinions. The chapter ends with suggestions for further research.

6.1 Analysis

To determine whether the Swedish Management Audit could have influenced the course or outcome of the Enron scandal by either preventing it or mitigating the effects, we will apply each of the eight steps a Swedish auditor carries out when performing a Management Audit to the Enron case. These steps were first presented in chapter 3.1.4. We base the discussion on what an independent auditor could have found in the years leading up to the scandal, with emphasis on the summer and fall of 2001, after the first questions had been raised in the media about Enron's accounting, but before the company filed for bankruptcy.

1. The first step is to establish whether there was essential financial damage to the company that can lead to liability for damages for the President and the Board of Directors. This question is fairly easy to answer considering Enron's present situation. The effects the scandal has had on its profitability, liquidity, financing et cetera cannot be overrated, and although the company had done its best to hide its losses in complicated transactions, their true financial situation was probably visible to a trained eye long before the collapse. The threats to the company's going concern are also easy to see in retrospect. But as the debts, although hidden, were so massive, any auditor looking in to the SPEs would realize that they truly were a threat to the whole company's existence.
2. It is a bit harder to know if the damages to the company were caused deliberately or by negligence. The Board and Management probably did not intend for the company to go bankrupt, but it seems like they did not do much to prevent it either. Kenneth Lay claimed not to have known about the operations, but even after Sherron Watkins made him aware of the problems in mid-August of 2001, he kept arguing that the company was in great financial condition.

Another question to answer is whether any Board Member or the President was favored in an improper manner. We know that CFO Andrew Fastow was able to earn large sums of money from his involvement in the deals between the LJM's and Enron, which regarding his double role as negotiator for both companies can be considered to be improper. However, according to the Companies Act, only the President and the Board Members can be liable for damages. On the other hand, according to Ms. Adrian, the Board might be liable if the appointed managers exceed their authorities and if they fail to check up on their work or take measures to stop it. With this in mind, this could have been another reason for why the auditor should have found a reason to do a closer audit of the company.



President Kenneth Lay was only one of the executives and Board Members who used his knowledge about the company to sell off his stocks before the news about their financial situation broke. As they still kept recommending the stocks to their employees and other stockowners, at least we think of it as being improper.

A third question is if the underlying material on which the Management and Board's decisions were founded was good enough. As we have not had access to that kind of information, we do not know if the decisions were well founded. Considering the results of the transactions, the lack of adequate internal control and the overall performance of the Board, we assume that the decisions were not based on any extensive research of what would be best for the company. An auditor would in her review look at the Board's minutes and would then together with her internal control review have had enough information to form an opinion on whether the damage to the company was caused intentionally or by negligence. To us, it seems evident that the Board and President did not do enough to prevent the devastation although it should have been clear to them long in advance what was about to happen. Therefore we interpret it as being deliberate.

3. According to the *Powers Report*⁷⁶, one of the main problems was that Enron did not have functioning control systems. The fact that no one seemed to even raise an eyebrow that the CFO could sit on both sides of the table in a negotiation caused huge problems to the company. There are many other examples how Enron executives were able to earn money by taking advantage of the company. These problems should have been fairly easy to find by reviewing the minutes from Board meetings and other documents. Whether budgets were used properly or not is a question we have chosen not to look into due to the limited scope of this study.
4. Step four concerns whether the company had an internal control good enough to accomplish complete accounting records and to dispose the resources according to the President and Board's intentions. This might not be relevant since the problem with the accounting was rather that it was more of a complicated scam, created by the Management, trying to hide debt.
5. Due to the same limitations as in question three, we have not looked into whether Enron paid their taxes the way they were supposed to. Enron did not pay any corporate taxes during four of its last five years, but as this was a part of their accounting strategy, it is probably possible to defend.
6. Question six affects whether the accounting is disposed properly in order for the Management to get a correct view of the result and financial position. If Mr. Lay's testimony that he did not understand what was really going on is true, the accounting was not sufficient. The larger problem was rather that investors and other participants were not able to get adequate information about the company's financial position. Consequently, the question might not be relevant here.
7. Same answer applies here as to question 5.

⁷⁶ Powers et al. (2002)



8. The last step is to check whether the Board and the President follow the Swedish Companies Act in all other senses e.g. about liquidation and the company's by-laws. This question is impossible for us to analyze, as we have not had access to Enron's by-laws. When doing this review the auditor checks if the interim reports have been properly submitted and if they comply with the law. This phase of the Management Audit also includes determining whether the Management or Board has exposed the company to any unjustified large risks that could cause harm to the company without the possibility of bringing correspondingly large advantages. This was, as mentioned earlier, one of the main issues where Enron's Board of Directors failed to protect the company's stockholders. It was done by high-risk accounting and risky business deals, which is something the auditor should have pointed out.

6.2 Conclusion

All in all, the Swedish Management Audit appears to be a useful tool. There were several problems in the control and management of Enron, which the auditor could have observed by conducting a Swedish Management Audit. But as Ms. Halvorsen and Mr. Marton pointed out, the auditors should also have noticed these problems under the American system if they had only done their job properly. Therefore the application of the Swedish Management Audit might not have made much difference; an independent and objective auditor might just have been enough to prevent this scandal.

On the other hand, as the Swedish Management Audit is more detailed with all the different steps in the audit thoroughly explained in FAR's *Revisionsbok*, it would have made it harder to neglect a comprehensive examination of the Board and President thereby possibly helped to ensure a better audit.

After conducting this study, we conclude that it is impossible to find a definite answer to the question asked in chapter 1.3 - could the Swedish Management Audit have influenced the lapse or outcome of the Enron scandal? In conclusion, we believe that the use of a Swedish-type Management Audit would not have prevented the scandal. If the Management and/or Board want to lie and deceive the auditor, the market and the rest of the company there are possibilities to do so. However, it might have mitigated the outcome of the scandal by making the stockholders aware of the company's financial situation earlier. By informing the Board of the improprieties found and then retiring from the assignment, the auditor could have made it public and given the stockholders and employees a chance to move their savings and pensions to other investments.



6.3 Suggestions for Further Studies

- Why has not the Swedish Management Audit been adopted in other countries? Are the same tasks performed in the Financial Audit or are they completely left out?
- A study of e.g. the new member countries of the European Union. When they changed their accounting and auditing practices after the fall of the former Soviet Union, on which countries' practices did they base their new systems? Did they use any of the Swedish methods?
- How many auditors' reports include an adverse opinion? Which are the main reasons for it? How does it affect the companies the following years regarding their financial situation, the stockholders' trust et cetera?
- How was the Enron scandal portrayed in the media? Was the picture realistic and believable? A study of the American as well as the Swedish press and broadcasting media before and after the collapse.



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Appendices

Appendix A: Interview questions

Questions asked to Ms. Adrian and Ms. Herlogsson

- What is the importance of the Management Audit? Why?
- How do you conduct a Management Audit?
- Why does not the Swedish Management Audit exist in other countries as well?
- In the Enron-case: What do you think would have happened if the United States had practiced the Swedish-type Management Audit?
- Do you think the Sarbanes-Oxley Act is a good-enough protection for the stockholders?

Questions asked to Ms. Halvorsen and Mr. Marton

- How common are Compliance and Operational Auditing?
- In what kind of companies are they conducted?
- How is the Management audited in the US?
- Why does not the Swedish Management Audit exist in other countries as well?
- In the Enron-case: What do you think would have happened if the United States had practiced the Swedish-type Management Audit?
- Do you think the Sarbanes-Oxley Act is a good-enough protection for the stockholders?

Follow-up question to Ms. Adrian

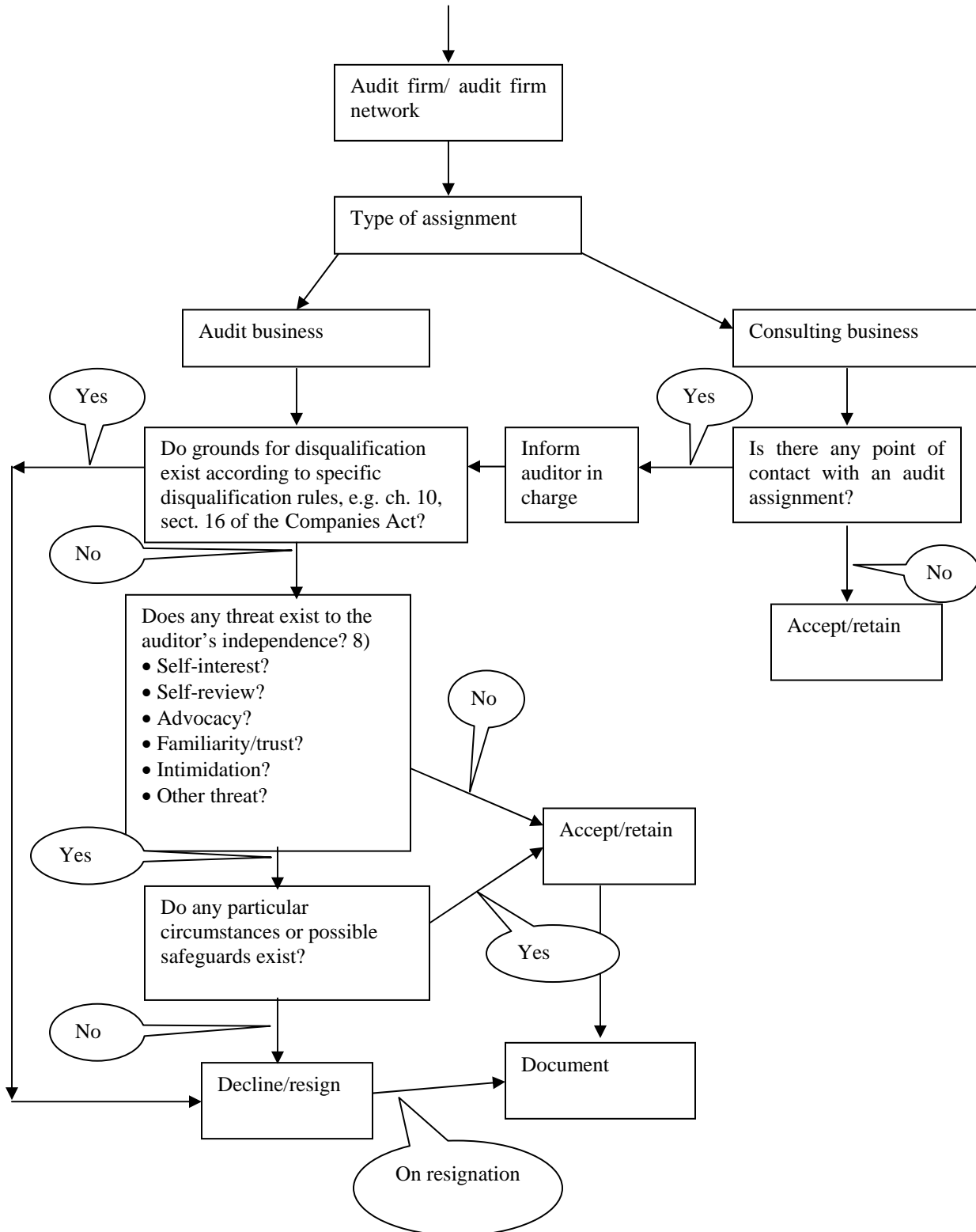
- Does the auditor have an obligation to check up on whether other managers, e.g. the Chief Financial Officer, perform their job properly, or is that left to the company itself to take care of?

Follow-up questions to Ms. Halvorsen

- How much of the audit time in the US is spent on examining the Board and President of the company?
- Is the American auditor required to assess business risk of the Management's actions?
- Do you think the Swedish-type Management Audit is useful?



Appendix B: Flow-chart – analysmodellen ⁷⁸



⁷⁸FAR homepage (14/5/2003)