

Ross Roundtable
On
Impact of Reemergence of Consulting Practices
At Major Auditing Firms
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Paul Zarowin, the Director of the Ross Institute, welcomed the participants to a Roundtable that, by the nature of its topic, was anticipated to be among the “top ten” of controversial discussions in the long history of Ross Roundtables. The Roundtable has always strived to invite discussants that are advocates, opponents, or neutral in order to foster a well-balanced discussion. Professor Seymour Jones, moderator of the panel, provided a brief history of the events leading up to the passing of the Sarbanes Oxley Act (SOX) which included a provision that prohibited auditing firms from providing certain consulting services for their audit clients. This prohibition had a major impact on the revenues of major firms. Furthermore, condemnation of major firms by the Public Company Accounting Oversight Board (PCAOB) regarding their performance has further served to tarnish the reputation of the auditing profession.

The condemnation reports issued by the PCAOB coincided with auditing firms reporting significant revenues based on the rebuilding of their consulting practices. Auditing firms were being criticized for the significant amount of resources diverted from their auditing practice to rebuilding their consulting business. Professor Jones noted that the PCAOB reports, in general, did not find errors, misstatements, or negligence; nor were restatements required. It was the “quality” of the auditors’ work that was being criticized. In his opinion the criticism was misdirected, and sparked by the shift in focus to consulting services. During his tenure as an auditor, the auditor reigned supreme. There was no overlap between the auditor and the consultant and conflict of interest or lack of independence was not an issue. Can we go back?

Professor Jones introduced the distinguished panel of experts representing a broad range of professions, saying that the participants were looking forward to hearing their views on the existing or potential problems of auditing firms providing consulting services for their clients. Does this create a conflict of interest? Does consulting create a breach of independence? Should we be concerned with the perception of shareholders? What alternatives are there to the current structure of the profession?

Through the lens of the accounting and regulatory professions:

The efficient functioning of our capital markets, our economy, and our economic well being depend upon the quality, credibility, and trust worthiness of financial information—the ultimate responsibility of the audit function. Be it actual or perceived—market participants have to trust the information that will determine their actions. The “crown jewels” of our country, our capital markets, were threatened. SOX was the antidote. What constitutes audit quality? Two basic elements are the competence and objectivity of the auditor. However, it is equally important to analyze the influence the firm has on its staff and the effect thereof of providing consulting services.

It is at the firm level that consulting services create issues of moral hazard. One could make an argument that having the expertise of consultants serving non-audit clients “under one roof” creates readily available *expert advisors* for auditors on issues that are not an essential part of their knowledge base. However, it will be the culture of the firm that determines if the merger of the professions creates synergy or rivalry resulting in conflicts of interest. The auditor’s role within the firm must be primary. If the consulting practice is the primary target of investments, in terms of time, money, and hiring personnel—the auditor’s role in the firm will be diminished along with the quality of the audit function.

There have been both positive and “not so positive” consequences of SOX, but the discussant felt it was important to acknowledge that the creation of the PCAOB served among other things, to reinforce the importance of objectivity and strengthen the role of the audit committees. The audit partners must understand that they have to answer to the audit committee and the interest of the audit committee is to have a good audit.

Through the lens of the securities investigation, litigation, and enforcement profession:

“*Chicken little-- the sky is not falling*”. The 2002 crisis involved two separate issues: One was the quality of the services being delivered, and “Anderson” became the poster child for the tarnished image of the accounting profession. The second issue was one of independence, and the area on which to focus currently to “fix things”. Periodic reviews of major firms by the SEC have been mandatory for decades. However, pervasive non compliance with rules has continued to exist. Outdated rules created problems that resulted in unintentional errors in reporting. The Enron crisis was the catalyst that pivoted the SEC into making the long-overdue changes, and also established the PCAOB. Although there were judicious efforts to curtail consulting services that impinged upon the quality of audits, SOX, the costly *magic bullet*, has failed to live up to its expectations.

In discussion with clients he finds that managers, the users of audit services, are satisfied with their current relationship with their auditors and support the re-emergence of consulting practices. Shareholders, on the other hand, are dissatisfied with issues of transparency and the communication of information to the market. If you want to change the existing structure, amplifying the obligation of the auditor, you cannot ignore the commensurate liability. In addition to efforts by the PCAOB to increase the scope of its regulatory authority, it is debating whether the auditor has to take personal responsibility by signing his/her name to the opinion. Needless to say, there is strong opposition by both the Center for Audit Quality and the accounting profession.

An issue that is of major import, and should not be ignored, is an inspection process that is perhaps exclusive to the PCAOB—the audit either succeeds or fails. The vast majority of deficiencies are documentation of evidence, and over reliance on management representation. They are not errors in the financial statements. We should neither dismiss nor over emphasize the results of the inspections. What we must do is create a global, uniform audit methodology. We must engage in judicious and deliberate thinking about how to proceed and how to finance this endeavor. There are no easy answers.

Jurisprudence:

Looking at the law-- Common Law that has existed in the U.S. and the U.K. for 150 years. In this country the accountants’ auditing engagement is unique. The auditor has a

fiduciary obligation of trust and honesty to the shareholders, is compensated by the corporation, and is engaged and supervised by either the Board or an audit committee. Common law mandates absolute good faith, lack of conflict of interest, and loyalty—which for the auditor is to the shareholder. “*You cannot serve two masters*” who have conflicting obligations. The notion that you can mitigate this conflict with virtual divisors is unacceptable in any other profession. Until such time that it is understood and accepted that the auditors’ primary and unlimited obligation is to report fairly and honestly to shareholders, the audit function is worthless. Accounting firms hire consultants for e.g. systems design, transaction structuring, tax planning, valuation and legal advice. In all the aforementioned there is a fundamental conflict that runs so deep that it is impossible for the auditor to give a reliable opinion; to be independent. In any one of these situations, the audit becomes an audit of “self”. The concept of independence appears in all fiduciary relationships

Most people would agree that the government should not be running our business, and that the private sector is more efficient and effective in the allocation and employment of our scarce resources. What can we do to provide independent services? Consulting, like incentive compensation, has behavioral consequences. It may be worthwhile to consider the benefits of smaller firms, reduced compensation, and investment in technology to increase automation and reduce future capital requirements.

If the market demands more transparent and meaningful reports, both the firm and the market will be willing to pay. The unprecedented losses that resulted from “polluted information” **will not** be forgotten. The consequences of subsidizing audit services with consulting fees **should not** be forgotten nor permitted to continue.

Well over a century ago, an internal structure that established legal and professional rules of independence and fiduciary duty emerged creating disincentives for professional misconduct. This intricate structure embraced self regulation. It is now gone and government agencies have filled the void. The audit profession must now answer the question: “Do we want government regulation of our profession?”

Through the lens of a legendary economist and regulator:

The focus of today’s Roundtable is conflicts of interest between auditing and consulting services. Arthur Anderson, a very proud firm that had the reputation for being the most disciplined auditor, provides a perfect lesson of how these two factors can become corrosive. The anointed Czar when the Enron scandal erupted saw that all of his efforts to resolve the problems were met with failure. The esteemed economist believes that if Anderson had not been indicted, instead of becoming the poster child for scandal, it could have emerged as a smaller audit-only firm, serving as a model for rebuilding from lessons learned. The auditing profession and the entire economy would have been the beneficiaries.

What does consulting do to the central discipline of the auditing function? The culture of the entire firm changes when auditing and consulting are merged. Similar arguments can be made for banks and other entities. Speculative proprietary functions should not be permitted in institutions whose fundamental mandate is to provide a public service. Bank deposits should not be subsidizing risky investments. That said, the problems facing the auditing profession are unique. The compensation structure, by its nature, creates complex issues that have no simple resolution. Auditors are paid by the firm to attest to the firm’s compliance with ethical and legal

standards. “Don’t bite the hand that feeds you”. Existing compensation schemes have a negative impact on the disgorgement of the ethical responsibilities of auditors and lawyers. The status quo is unacceptable. It is time for “Think Tanks” to get into motion.

A “voice” from the media:

A rather unusual phenomenon within an academic setting occurred when participants were told to “hold on to their seat belts” while a series of allegations were made against audit firms, economic entities, the SEC and the PCAOB. All are allegedly involved in varying degrees of misconduct and cover ups. It was alleged that all four of the largest global audit firms are involved in scandals one way or another by virtue of their roles as auditors, consultants, or both.

Some of alleged abuses for which no evidence was provided included:

- Bribery
- Tax consulting
- Numerous violations of independence rules that *are clearly occurring* and have not been investigated.
- Reported “all other services” not explained that were *probably* for forbidden technology services.
- Foreclosure reviews
- Investigation of slave labor
- Unspecified “illegal acts”
- Insider trading by two partners (for which they were indicted) compromised the independence of the entire auditing firm with reference to the firms involved.
- Cover ups
- A *code of silence* for audit partners linked to compensation and post-retirement contracts.
- Directors belong to a *clique*, promoted by e.g. the NACD¹, and receive incentive pay and stock options that impact their independence.
- The SEC & PCAOB have stopped enforcing compliance against inappropriate financial interests and strategic alliances.
- Auditors providing advice on GAAP and SEC reporting for specific transactions.

Not on the official misconduct list was a suggestion that auditors should be banned from all corporate investigations involving illegal acts, senior management, or have a material impact on the financial statements. Admittedly tax consulting is permitted under SOX. However, some engagements, e.g. if they provide \$10 million a year in revenue, are in clear violation of Section 201. Although brought to the attention of the PCAOB and SEC, these alleged violations did not result in disciplinary actions or sanctions. It would appear that the concerns the firms had on giving up their consulting practices were misplaced. The SEC and PCAOB are either complacent or perhaps complicit?

The primary duty of auditors is to shareholders, and yet in the past five years consulting fees, which impair independence and professionalism, have once again been growing as a percentage of total fees. One of the major firms has some of its best advisory engagements ever

¹ National Association of Corporate Directors

with the governance risk and compliance activities related to the OCC² federal foreclosure revenues of mortgage services. Although the engagement requires auditing experience, and the auditors are the best people for the job, this has caused their business to grow dramatically in an area that in the reporter's opinion was prohibited services.

Discussion Highlights

It is important to make a distinction between “opinion”³ and “fact”⁴. It was noted by participants that the OCC engagement, which reportedly increased revenues for a major firm by \$1 billion did indeed help “bring them back”. However, the revenue from this engagement is for auditing services. The engagement to perform attest functions does **not** fall within the purview of consulting.

Highly respected and knowledgeable professionals in the legal, accounting, and regulatory professions responding to “opinions” made it clear that Section 10A of the SEC Act clearly states that auditors should look into questions of illegality. Since '95 when the law came into effect, auditors and audit committees have worked out alternative ways to do it. Until such time, if ever, that the statute is changed, auditors cannot (and perhaps should not) be removed from the process.

Furthermore, auditors providing advice on GAAP and SEC reporting for specific transactions is not only legal but encouraged by PCAOB Standard No. 16.

"The standard on communications with audit committees will improve audit quality. It emphasizes effective two-way communication on matters of great importance to the audit and the financial statements, such as significant risks, critical accounting estimates, difficult or contentious matters, significant unusual transactions, and going concern," Martin F. Baumann, PCAOB Chief Auditor and Director of Professional Standards.

Tax services are also expressly permitted by SOX, and thus not in “clear” violation of Section 201 which states that an audit firm may engage in tax services. This approach is consistent with the SEC view that tax services generally do not create the same independence risks as other non-audit services.

A question was raised: Given that it is the auditor's judgment that should determine the scope of an audit in a particular engagement, is it legitimate for the PCAOB to criticize the extent of the work performed by the auditor in particular when no errors are found?

In response it was noted that SOX dramatically increased the documentation requirements. The criticism in these cases related to “documenting sufficient evidence in support of your judgment and opinions”. The, what many consider, overly detailed documentation outlined in the original legislation, has been a very controversial issue due to the exorbitant costs associated with adherence. Suggestions were made that there should be some middle ground. Publicly traded companies with \$20 billion in revenues should not be subjected to the same costly requirements of companies with \$100 billion in revenue. “We are becoming overly regulated, and honesty is becoming cost prohibitive”. Honest, law-abiding clients are being

² Office of the Comptroller of the Currency

³ Protected by the First Amendment.

⁴ A piece of information presented as having objective reality, supported by authenticated documentation or statutes.

forced to shop around. Many participants voiced their concern that there is a direct correlation between excessive regulation of the industry and the recession.

Reporter's Commentary: The auditing profession can re-invent itself. It can regain its integrity, moral compass, and perhaps its inalienable right of self regulation. But it is not an easy task. The profession has become complacent. It is so much easier to sit back in a spacious office with a beautiful view, reclining in over-stuffed chairs, receiving obese paychecks, and accepting the status quo. "Only the doomed and the damned try to change the world". Well, according to the *naysayers*, the profession appears to be doomed. So perhaps it is time to *change the world*. Change, in my opinion, unlike the "tone at the top-- trickle down theory" begins at the individual level. It is time for introspection. What happened to good ole fashioned morality, integrity, honesty, professionalism, and above all-- genuine concern for one's fellow man?

Yes, Virginia.....there is hope.

"Yes, VIRGINIA, there is a Santa ... He exists as certainly as love and generosity and devotion exist, and you know that they abound and give to your life its highest beauty and joy... (otherwise) We should have no enjoyment, except in sense and sight. The eternal light with which childhood fills the world would be extinguished." The New York Sun, September 21, 1897