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Auditors To Focus On Exclusive Franchise

By Mark S. Lilling CPA

Every financial era produces its share of criminals that steal from investors, manipulate financial records and fraudulently operate businesses. We have seen McKesson Robbins create a Ponzi scheme in 1937, Allied Crude Vegetable Oil Company overstate its inventory of salad oil in the late 1950s and the current cast of well-known players like Enron and, World Com, Sunbeam and Parmalat.

This era, however has produced audit firms that support unethical business practices and that must change. Auditors cannot continue to engage in activities that are not in the public's interest to create huge profits. A firm promoting tax shelters, even to non-audit clients on one floor in a building cannot be the conservative auditors that the public demands on a different floor. Corporate culture will always reward the highest profit center and this fact will push auditors towards profits, rather than conservative auditing.

Profits, even high profits, are necessary to reward the long hours, education and personal liability that auditors incur. Congress has established an "exclusive franchise" for auditors that should generate sufficient profits for the limited number of firms providing these services.

Public and investor confidence in the fairness of financial reporting is critical to the effective functioning of capital markets. Confidence is based largely on financial statements being audited by fair, impartial and independent firms. Eighteen trillion dollars in New York Stock Exchange global market capitalization relies on these audited financial statements.

Audits of publicly traded companies have not always been required. After the stock market crash of the late 1920s, Congress wanted to improve the public's confidence in the stock market and made audited financial statements mandatory in the Securities Act of 1933. Congress first considered creating a government agency to perform audits, but instead gave an "exclusive franchise" to certified public accountants. Today, the vast majority of the 17,000 public companies are audited by a dozen firms. With this franchise comes a responsibility to the investing public, which is currently unfulfilled.

The Sarbanes-Oxley Act of 2002 severely limited the services that auditors can provide for their audit clients and mandated that non-audit services beare approved in advance by audit committees. These prohibited activities include bookkeeping, financial system design, appraisals, actuarial services, internal auditing and other management functions. This is designed to separate the auditors from the management of the company. The only non-audit services still allowed are limited tax services and comfort letters to underwriters.

Most of the "final four" accounting firms have separated themselves from their management consulting divisions but are providing non-audit services to the audit clients of the other large firms. At a recent conference, a tax partner in a large firm stated that he is actively looking to provide tax consulting services to audit clients of other firms since he is limited with his own firm's clients. What kind of tax consulting will be offered? In May 2004, the Justice Department announced that it was launching a criminal probe into tax shelters that

Ernst & Young LLP had promoted in order to save U.S. corporations billions of dollars in taxes. KPMG LLP disclosed that federal prosecutors were investigating “certain tax strategies” that were sold to wealthy individuals. Deloitte & Touche LLP, PricewaterhouseCoopers LLP as well as second tier firms, BDO Seidman LLP and Grant Thornton LLP have also been implicated in selling aggressive shelters.

A client of my firm recently used “final four” tax professionals to settle a tax audit for a 15% contingency fee based on a relationship by a former IRS employee now working for the firm. The distressed business unit of a large firm helped a non-audit client obtain a net operating loss carry back significantly faster than through normal channels. These relationships led to huge fees that appeared to be dramatically higher than hourly rates.

Such behavior by audit firms is not limited to tax matters. Ernst & Young was sanctioned by the SEC in April 2004 for an independence violation for auditing Peoplesoft Inc. a client at the same time it was developing and marketing a joint business venture with them. The sanctions ban Ernst & Young from accepting new audit engagements from public companies for six months, levy a fine of $1.7 million and dictate that an independent consultant assesses its policies and ties to other audit clients. The SEC censured KPMG in 2002 for engaging in improper professional conduct because it was purported to serve as auditors for a client, “Short Term Investment Trust”, a money market fund of AIM Management Group Inc., at the same time it had made a substantial financial investment in the client. KPMG did not admit or deny the charges and agreed to undertake remedies to prevent and detect future misconduct. The SEC issued a report in 2000 stating that almost half of PricewaterhouseCoopers LLP partners had at least one independence violation. According to a press release from the SEC, the report “found excusable mistakes, but also attributed the violations to laxity and insensitivity to the importance of independence compliance”. PricewaterhouseCoopers acknowledged that the “review disclosed widespread independence noncompliance that reflected serious structural and cultural problems in the firm”.

It is my belief that public company auditing firms should severely limit the type and the nature of the services that they perform, even to non-audit clients. It is contradictory for auditing firms to have divisions selling “tax shelters”, performing engagements for contingency fees, and other “value added services” while attempting to earn the public’s trust through auditing. The services provided by auditing firms should be restricted to assurance services, tax compliance, and limited consulting. This would focus the firm’s energy on their core franchise, auditing. If auditors focus on this franchise, the public and the auditors will both win.

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