CHOOSE TO BE AN AUDITOR OR A CONSULTANT!

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Abstract

The paper looks at the evolving role of a Certified Public Accountant (CPA) as a result of the new guidelines and legislation being drawn out due to the recent litany of financial mismanagement cases in the corporate world. After Enron, WorldCom and Parmalat, the practice of employing an audit firm to perform auditing services as well as other consulting services for the same year has come under immense criticism, close scrutiny and review. This came about as it emerged that most of the accounting misdeeds were due to poor, lenient and condescending auditing practices by the firms that gained lucrative consulting work. This has been substantiated by an analysis done on the companies listed under the first board of BURSA MALAYSIA (KUALA LUMPUR STOCK EXCHANGE). The analysis contains a comparison of the fees paid by the companies towards audit as well as non audit services to the same audit firm. This paper, thus, looks at the resultant effect and how an individual or corporation may proceed under the new accounting environment. It has been concluded that, while the law is a bit flexible towards the auditors accepting non audit work along side audit work, it is the duty of the professional bodies to implement compelling codes of conduct. One of the ways identified is by ensuring that the accounting or management consultant of a company shall not accept to act as a statutory auditor for the same company in the immediate five years following the year in which the firm had acted as a consultant. A similar clause was imposed and is being implemented only by two countries around the world; Hong Kong and Singapore.

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Introduction

The role of a Certified Public Accountant (CPA) has been under an evolution process since the early nineties. However, this study had come under the spotlight soon after the revelation of Enron’s and WorldCom’s collapse, leading to the ‘big 5’ becoming ‘big 4’, followed closely by Adelphi and Parmalat. In all these cases, the root cause for their remarkable pace of fall seemed to point at questionable codes of conduct adopted by these firms.

Due to the manner in which business functions in the US are structured, many employees of the collapsed companies lost their life long savings. Along with many independent investors, these folks led by the misleading financial reports filed to the Securities and Exchange Commission (SEC), invested heavily in the firms’ stocks and bonds, as it declared hefty profit and projected a healthy growth of the organizations. These stocks, after the diabolical revelations, became worthless when the firms were declared bankrupt and insolvent. WorldCom for example had its stock value plunge from a high of $60 per share to a mere $0.08 per share. The SEC estimates that financial fraud has cost investors as a whole over $100 billion in the last 6 years alone.

Investor confidence at Wall Street took a massive hit which could not be reversed until the onset of the Iraq War. Funds were withdrawn from major businesses across the country, thus cutting off funds from an already depleted American economy, which in turn had an adverse impact on the global economy. This led to the general public, major corporate players and many government agencies going up in arms crying for justice and a review of the audit certificate given by the auditors, prior to filing the financial statements at the SEC.

Initial investigations revealed one questionable practice that stood out like a sore thumb and was found to be consistent across all these collapsed firms which is, the roles played by accountants as the firm’s supposedly independent auditor as well as its consultant on various business aspects. Further probing into this particular practice, revealed that these accounting firms received higher revenues for consulting work than traditional audit work. This practice cast a dark shadow over the authenticity of financial reports declared and certified. The false feeling of audit independence and conflict of interest were paramount and found to the wanton.

Major industry players were making more money by selling clients add-on services in the form of consulting in various business aspects than they do...
from auditing work. Over a 5 month study period, carried out by 3 Universities across the US, it was revealed that the 5 largest accounting firms earning revenues to the tune of 67 to 74 percent were based solely on non-auditing services. The “add on” services provided include areas such as human resource management, technology services like software and deciding on which computer systems to purchase, tax evasion methods and at times, even sit in on merger & acquisitions evaluations. It also became common for auditors to leave their auditing firms to take up positions within the company they had previously provided consulting cum audit services.

Accountability when things do go wrong is surprisingly missing. Accounting firms tend to decline answering questions on their actions, invoking the need to protect client confidentiality. It has been oft-quoted that, auditors are hired, fired and paid by the companies they are responsible for auditing. As Warren Buffet put it, the common theme amongst accountants is “Whose bread I eat, his song I sing”. With career path and the sheer amount of money involved, improper compromises and temptation to go easy on the audits often abound, thus creating a heady “conflict of interest” environment.

This led to the US Government and its President, George W Bush, to come out strongly condemning the corporate business world and demanding changes and increased accountability. Legislation was passed state-wise and at Federal levels to curb the possibility of fraud by making the upper management and the Chief Executive officer (CEO) of the firm legally accountable for the false reporting practice on the firm’s financial positions.

The most sweeping legislation, the Sarbanes-Oxley Act of 2002 (Act), made it a crime for anyone within an organization or acting on behalf of it to influence or mislead an auditor for the purpose of rendering the financial statements misleading. The core aspect of the Act, Section 303(a), reads as follows:

“It shall be unlawful, in contravention of such rules or regulations as the SEC shall prescribe as necessary or appropriate in the public interest and for the protection of investors, for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the performance of an audit of the financial statements of that issuer for the purpose of rendering such financial statements misleading.”

The Act does not only address the actions of the firms’ management but also lists certain practices required to be followed by accountants and failure to do so would result in them being adjudged falling on the foul side of law in terms of coercion. This includes, but is not limited to, the following:

- Issuing/re-issuing a report on a financial statement that is not warranted in the circumstances;
- Not performing audit, review or other procedures required by Generally Accepted Accounting Principles (GAAP) or other professional standards;
- Not withdrawing an issued report; or
- Not communicating matters to an issuers’ audit committee.

It is important to note that the new Act does not limit itself to the firms’ annual financial statement alone. An auditor could render firms’ financial statements materially misleading by improper influence during the interim financial statements. The Act, spearheaded by the SEC, also attempts to adopt a negligence standard. By using the term “knew or should have known” in Rules 13b2-2(b) (1), 13b2-2(b) (2) and 13b2-2(c), the SEC declares proving a particular purpose or intent is not required.

The prohibition introduced by the SEC, although covered under some existing security laws, provides an additional safeguard on codes of conduct, coercion, manipulation, mislead, or fraudulent influence on an auditor during his/her review on the financial statements. It is hoped the new legislations would help ensure management makes open and full disclosure to, and has honest communications with, the auditor of the financial statements.

Apart from Government steps, even professional bodies have begun reviewing their own practices and adopting changes that were deemed beneficial to all concerned. The American Institute of Certified Professional Accountants, the Institute of Internal Auditors, The Canadian Public Accountability Board, The Institute of Chartered Accountants of India, The Malaysian Institute of Accountants and many more have initiated steps in that direction and are in the process of streamlining and developing a common standard and/or practice that could be adopted as a whole or in parts to ensure uniform understanding and clarity in financial reporting across nations.

With the corporate world spotlight shining brightly down on the accounting industry, changing rules and regulations and a murky job definition, one can imagine the dilemma of a CPA today. What can he/she go on to be? An auditor, confined to the rigid, strenuous and intense working requirements (“real accounting work”) or should he/she branch out into consulting services (where the demand is huge and the money excellent comparatively)? It goes without saying that it is “time to Choose”! Auditors or Consultants

**Research problem**

The role of accountants has been identified as a key contributor to the demise of a number of major industry players in the corporate world due to accounting misrepresentation and fraud. Many professional accounting boards and governments have
introduced new guidelines and laws to protect the stakeholders and ensure a more transparent and reliable accounting system. This, however, leaves many accountants and accounting firms in the limbo - to take the role of an auditor or a consultant? Basically, the research problems are summarized as follows:

- The impracticality and consequences of playing the dual role of auditor and consultant.
- The lack of proper pointers for accounting firms in deciding which role best suites its own business interest.
- Inadequate information on how the separation of these roles, in firms that are already deeply ingrained in current practices to meet new laws and accounting guidelines that were passed rather quickly.
- Challenges faced by auditors in earning their fortune if they had to choose between audit and consultation.

**Objectives of the Research**

The objectives of the research are:

- To explore the impact of separating the audit and consulting roles on the industry as a whole.
- To evaluate probable steps large firms could undertake to ensure a smooth transition while implementing the changes required by the new guidelines and law.
- To explore the possibilities and options that are open to firms or individual CPA to consider when deciding on role playing.

**Scope of the Study**

The practice of utilizing consultants as auditors by public listed and other large organizations is common and rampant. After the financial scandals involving large multi-national organizations, many steps have been taken to address the role of auditors as a whole and its influence on management and function of the organization. This study focuses on the impact the current practice, developed through legislation and consultation.

While this approach sounds good, it is still open to abuse in terms of SBT board members selection. It merely adds another layer of bureaucracy which is akin to hiring extra policemen to watch over current ones.

Berger and Nicholas (2000) analyzed the corporate auditors and their role as they come under more and more scrutiny by the Securities and Exchange Commission (SEC). They revealed that, in recent times, corporate auditors have been guilty of more than just violating fundamental conflict of interest rules, but also have been at the centre of nearly every financial scandal. In a SEC report, PriceWaterhouseCooper (PWC) was cited for more than 8,000 violations for violating simple basic rules of ethics. The report estimated that of PWCs 2,700 audit partners, 86 percent had at least one ethical violation. Arthur Anderson was fined $70 million for its role in Waste Management Securities litigation; Ernst & Young paid $355 million and $32 million for its part in Cendant and Informix, respectively. Trust and integrity being the cornerstones for an efficient financial marketplace, it is crucial that auditors maintain total independence from the client at all times, Berger and Nicholas asserts. This is to ensure objective and complete fidelity to the public trust. As many corporate auditing firms do not consider...
auditing as lucrative as non-audit services, they tend to offer discounted audit fees in order to leverage themselves into the company to cross-sell the firm’s more profitable non-audit services. This has led the SEC to raise tough questions on conflicts of interest. Berger and Nicholas called on the SEC to keep pressuring audit firms to either divest or reorganize to protect shareholders from being subjected to phony financial data. This article, thus, called for separation of audit and consulting services but did not offer much in terms of steps firms could adopt to separate these functions.

SmartPros Institute (2004) analyzed the effort by the SEC Chairman William H. Donaldson to push through reforms that has upset America’s large companies. The main point of contention was the selection process of board members. Comparing the current system to that similar to the election process in the former Soviet Union, where there’s only one nomination on the ballot, that too elected by the incumbent member, as “not really an election”. Other reforms being pushed include a review of corporate top management salary structure that continues to soar, the right of an institutional investor to nominate one or more director candidates if majority of the votes were withheld for the incumbent candidate in the previous election and a new requirement mandating brokerage firms holding shares for investors to acquire permission from the actual owners prior to casting their vote for an incumbent candidate. SmartPros noted the willingness of Donaldson to see through these changes and reforms even if it required him to vote against his fellow Republicans but a common ground is being sorted to avoid such drastic action. It also stated the chances of the reforms going through under Donaldson is rather high as he had, back in 1969, done just that, i.e. forcing large corporate change in the way brokerage firms sold stocks. On that score, Donaldson may very well end his career as how he started it, by forcing another round of change on the reluctant corporate elite.

If Donaldson succeeds, it would put in place a more mechanized structure that would not permit auditors to influence much of management operations. Wharton Institute (2004) analysed a key allegation in the accounting scandals involving WorldCom, Tyco and Enron that points to accounting irregularities in these organizations as one of the principal reasons for the major debacles. The Institute based their article on the paper Fees Paid to Audit Firms, Accrual Choices and Corporate Governance by David Larcker and Scott Richardson. While acknowledging major audit failures, the paper questioned how “systematic” is the notion that if a firm does a lot of consulting it will pay more attention to the consulting income rather than to the audit. They felt that the Congress and the SEC have passed new regulations and laws that compelled many firms to separate their accounting and consulting businesses, as being rushed through to pacify public outcry and should have been thought through more carefully. They said that the abuses arising from the recent cases, were not elaborate schemes to manipulate earnings but were simple, clear-cut fraud. In the case of Adelphi, business and personal expenses were not maintained separately. At Parmalat, the central issue was a forged bank account document indicating the firm had $4.98 billion in a non-existing account. At Enron, the wrongdoing was more complicated and hidden. The new SEC rules limits auditors from providing many consulting services, including the design of financial systems, appraisal and valuation services, actuarial and legal advice and other services related to audits. Thus, all major accounting firms have either sold off or spun off their consulting services. Please note that some of these audit firms have cunningly repositioned themselves as “corporate arbiters” with the connivance of retired judges, retired bankers and senior corporate lawyers. They have repackaged their consulting services and are offering the same to companies undergoing corporate restructuring, mergers and acquisitions. Cases in point are Salomon, Smith and Barney, ECM Libra, etc. They often operate from an outside jurisdiction to avoid litigation. The paper illustrated the concerns which many accounting firms argue that their clients benefit from using consultants who also act as auditors because these consultants/auditors have better insights into the company. It points out that only 8.5% of the cases studied showed a positive association between non-audit fees and unusual accounting behavior. The laws, they felt, seemed to punish the majority of accounting firms who were never guilty of any auditing malpractice.

A good overview of the malice that took down many large corporations and the result of new legislation passed to arrest the problems in the financial corporate world. SmartPros Institute (2004) in their analysis on the effect of Sarbanes-Oxley Act (SOX) noted that many firms are in some form of a compliance conundrum. The institute notes that SOX is meant to make publicly traded firms more transparent in their operations and business to investors. However, this measure has added extra regulatory expenses, not necessarily guaranteeing better management and diverts staff away from duties required for actual business activities. It quotes a recent survey finding amongst 321 firms in which, it found on average each firm expects to expand up to 15,000 working hours and up to US$1.9 million in first year SOX compliance cost. Another survey of 450 publicly traded companies revealed an increase, on average, of 90.4 percent or US$2.3 million in cost to remain a public entity compared prior to SOX implementation. These extra costs have caused privately-held firms to defer or put-off completely the plans to go public. Firms that elect to sell off their business are also caught as their marketability would be hit as prospective buyers would need to fork out additional costs to make it SOX compliant. The need for
independent board members raises the possibility of well-qualified managers leading to the company not knowing anything about the business the company engages in. Small family run business that plan to expand would need to get someone not related to the industry to sit in its board merely to meet SOX requirements and not contribute directly towards the companies’ productivity but merely serve as a watchdog. The continuous problems creeping up highlights how impractical SOX can be to many firms. Some have come to question the wisdom behind SOX, and claims it was implemented in an ad hoc manner as a knee-jerk reaction to the Enron, WorldCom and similar financial debacles. In fact, many in the industry point that the market was already on a steady downward movement and if there was any correlation between these debacles and investor sentiment, there should have been a sharp decline. Instead there was a choppy trend that took an upward surge, not because of the implementation of SOX but more due to the Iraq armed conflict.

The article looks at the added costs and implications to the firms’ management and owners. Shareholders and investors have a right to know and hence the increased costs to comply with SOX should not in any way concern Wall Street.

Legislation
White & Case (2003) gave a interpretation on the final rules released by the SEC in the implementation of Section 303 of the Sarbanes-Oxley Act. The rules cover any firm that files reports with the SEC under section 13(a) or 15(d) of the Securities Exchange Act of 1934, including foreign private issuers. The new rules were designed to compel senior management or anyone acting on behalf of an organization to be open and forthcoming to the auditors of the issuers’ financial statements. SOX was meant to restore investor confidence, thus any acts that incapacitates the auditors to perform his/her work diligently in order to provide accurate reports for the benefit of the issuers shareholders, are deemed unlawful. The SEC also defines the period of “engaged in the performance of an audit” between the auditor and issuer, before the professional engagement period has begun and after it has completed. The article then lists out some conduct and actions that would fall on the foul side of the law. This includes coercion, manipulation, misleading or fraudulent influence. To the SEC, the mere act, not success of these actions, would render the financial statements materially misleading. A list of actions that could cause action to be taken against accountants is also listed.

A good definition of section 303 of SOX, which would affect literally all public listed organizations, but falls short of defining the actual sanction that the SEC would take on those found guilty of violating SOX.

Schneider (2003) commented on the rush by the accounting industry’s Big Four firms, technology companies and as well as consultants to design and develop software to help finance managers to comply with Section 404 of the Sarbanes-Oxley Act (SOX). This has raised concerns with regards to the possibility of the firms being in breach of auditor independence rules, especially if accounting firms are helping in the design and setting up of the actual system, that they will later evaluate and attest. In light of this development Schneider asserted that, the SEC was right in reminding accountants by issuing a caveat emptor warning them of the consequences of blurring the lines between audit roles and consultancy. The fact that the SEC came straight out and warned accountants that such action is illegal illustrates the determination by the Exchange to enforce the new rules, Section 404 in particular. Independent estimates expect the Fortune 1000 firms to spend somewhere to the tune of US$2.5 billion in 2003 alone on work and technology related to SOX compliance. While many call it an implementation “over kill” as it merely performs as an automated tool to gather documents that would later have to be analyzed anyway, the accounting industry see it as a means to assist and expedite their attestation tasks. However, with so much money at stake, the temptation and thus the possibility of accounting firms touting more leverage by cross selling their own software is high and very real.

The article while seemed straight forward, did point to the ambiguity of auditors as consultants and the reluctance on the accounting fraternity to let go the more lucrative consultation services.

Alexander (2003) gives a straight and point form explanation of Sarbanes-Oxley Act of 2002 on the effects of improper influence by organizations on auditors. It talks about the amendments to the law that makes it unlawful for any officer or director of a public listed organization or anyone acting on behalf of the organization, to take any action to coerce, manipulate, mislead or fraudulently influence any independent public or certified public accountant engaged in auditing or reviewing the organizations financial statements that are required to be filed with the SEC. These actions would render the filed financial statements materially misleading, thus null and void. It is important to note, that the SEC took pains to define that third parties, like employees of accounting firms, attorneys, securities professionals, acting under the direction of an officer or director, who knew or should have known that their actions would cause misleading information to the auditors can and should be sanctioned. Alexander then proceeds to list out actions the SEC recommends accountants to undertake and avoid. He gives a clear picture of the ground rules the SEC wishes to lay down for both management and auditors to play by.

Day (2003) comments on the SEC’s sudden backtrack to permit auditors to continue providing tax consultation services. While the accounting industry was rightly delighted by the move as tax consultation contributes nearly a quarter of its total revenue, many in the investors group were disappointed in what they
termed as “watered down” legislation. The new legislation, however, did prohibit accountants from performing several non-audit services such as consulting on technology issues and human resource policies. The ruling has in effect placed the burden of decisions on tax consultations by auditors on the shoulders of a company’s board of directors, specifically its audit committee. Other changes adopted by the SEC that raised an eyebrow, makes only the top auditor in a team to be rotated every 5 to 7 years, allowing some members not requiring any rotation. The only “feel good” ruling that came about was the need for auditors to maintain a better paper trail. Day pointed out the disappointment by the majority of shareholders and investor groups who were very disappointed with the SEC’s apparent failure to address key areas. She also stated that it was rather perplexing that the SEC has actually permitted an accounting firm to provide consultation work on taxation and then have the same folks auditing and attesting the results. At this rate, Day expects the SEC to also back down from its earlier proposal to mandate lawyers report suspected violations by their corporate clients as this would no doubt run in contravention of existing laws protecting lawyer-client privilege and right to a confidential relationship. To this, Day wonders if the “Client” in this case is the shareholders and stakeholders or the firm’s management.

A good example of how the SEC had to backtrack on some proposals, possibly due to a combination of pressure from the accounting industry and impracticality of some proposed measure.

Industry Analyses
Foley (2004) highlights the measures many companies and accounting firms are undertaking in the wake of Enron’s debacle. Household name companies like Walt Disney, Apple and Freddie Mac have already initiated steps to ensure that the same company is not hired to act as auditors and consultants in the same instance. Shareholders in many other firms, like Motorola and PG&E, have also proposed similar action in their respective companies. The article points out that big accounting firms tend to provide “a buffet of services” due to the hefty payments one gets as a consultant as opposed to being a mere auditor. An example cited indicated Disney paid PricewaterhouseCoopers US$8.7 million for audit services as opposed to nearly US$32 million for consultation services for the year 2001. Skepticism of having the same firm providing both auditing and consulting services was rife since the early 1990s but this became more pronounced only after the Enron implosion. As such, most of the “Big 5” firms have announced that they would voluntarily separate these functions. Finally, the article gives some pointers as to how a company could separate their consulting and auditing practices if it is already under the same company. These range from allowing current consulting projects to end at their natural endpoint to moving project responsibilities in-house and outsourcing for technological related portions of the project.

While the article talks about the move made by most large corporations, it does not address why many of these firms, chose their consultants to act as auditors (and vice versa) to begin with.

Imhoff (2004) asserts that America’s capital markets are afflicted by problems in accounting, auditing and corporate governance that have undermined the quality and integrity of financial reporting. Only by making serious and substantive changes at all organizational levels across the board can the business community move forward into an orderly marketplace. Despite Congress passing and President George W. Bush signing into law new legislation to address issues in accounting and auditing and corporate governance, the legislation is sorely insufficient in tackling the real underlying problems that plagued the marketplace. In essence, as many large CPA firms try hard to reduce audit costs (lowering entry level hiring, cutting number of audit hours, reducing “test of details”, etc.) in order to be price competitive, the quality and integrity of the financial reporting system have been hit hard. As most auditors assume there is no specific “bright line” rule from prohibiting management’s activities, a mere conformance to acceptable accounting rules or Generally Accepted Accounting Principles (GAAP) would result in financial statements being passed as “fairly presented”. Often, managers try to mask their wealth enhancing activities by hiring consultants who are financial wizards that seek to develop new, untested schemes designed to showcase excellent results by manipulating the accrual-based financial reporting process. Imhoff suggests the best to address these problems in a two-pronged manner. Firstly, mandate all major publicly traded companies to rotate their CPA firms every 3 years. This would encourage auditors to exercise their professional judgment in voicing out any detrimental activities, creates a comprehensive oversight of procedures and judgement employed by predecessor audit firms and finally it also addresses the low-balling practices by requiring each audit to be priced to make a profit on its own. Secondly, weaknesses in corporate governance need to be addressed. This can be achieved by barring former CEOs or top executives from acting as chairman of board of directors in publicly traded firms, outside directors should not be allowed to hold stock options, new board members are nominated by a subcommittee that is independent of management and finally, continued education requirement on a yearly basis made mandatory for all board members.

The approach, in theory, sounds noble and just, however, the steps prescribed here involve high cost that may or may not be in the best interest of the firm.

Raymer (2004) in her article points out steps being undertaken by the Canadian government and private accounting firms in lieu of the corporate scandals in the U.S. It is pointed out, that in Canada,
Unlike many other countries, auditors act in the interest of the firms that hire them and not the interest of shareholders. Also, accountants, rather than independent sources, set the accounting rules. Even interpretation of the Generally Accepted Auditing Standards (GAAS) and the Generally Accepted Accounting Principles (GAAP) are not in synchrony with that in neighboring U.S. This has permitted improper company finance reporting, leaving it open for manipulation and failure to detect fraud and accounting deficiencies. A recent study has illustrated that, where when U.S. accounting rules were employed, more than two thirds of companies reported lower profits as opposed to using Canadian rules. The Canadian Public Accountability Board was set up in the light of these circumstances. Its mission is to ensure public confidence in financial reporting and promote high quality independent auditing. Rules governing auditors should be changed to reflect some form of responsibility towards shareholders. Also, new rules and guidelines should not be set by accountants anymore. The Canadian Institute of Chartered Accountants (CICA) released a guide, “Integrity in the Spotlight: Opportunities for Audit Committees”, in January. The book highlights that the audit firm no longer reports to the management but to the audit committee and it further describes the role of the audit committee. In addition, CICA’s public interest and integrity committee proposed a more rigorous and “principle based” code of conduct. This was done in co-operation with the U.S. Financial Accounting Standards Board. A new independent board, the Auditing and Assurance Standards Oversight Council, was formed to oversee activities in the Assurance Standard Board. In November, the Certified Management Accountants of Canada issued guidelines for company boards and CEOs in the form of a “scorecard”. The measuring and improving performance of corporate boards addresses enterprise governance, a combination of corporate governance and performance management. It would seem likely that the Canadi ans are busy setting up one Board after another, to cover up for the lack of proper audit and accountability controls that came to light only after Enron.

They seem to be addressing the issues on one hand, but with so many Boards one wonders if there will be a uniform set of guidelines to follow.

Ridley and Burnham (2004), pointed out the unique role internal auditors play in an organization. Traditionally, audit committees rely heavily on internal auditors to insulate them from “surprises” and ensure compliance to audit standards and approaches. However, with the impending change in the audit world, the nature and results of audit work have changed as well. The article examines the trends, “best practices” and some tools available to audit committees to use in exercising their oversight role. Some recent trends include restructuring (right-sizing/defining) organizations and strategies, redefining “internal control” and reassigning responsibility for it, outsourcing and co-sourcing business activities, empowering employees, suppliers and customers with changes in the mechanisms of accountability and finally using self assessment tools and partnering with management, in place of traditional audit techniques. It is important to ensure that the appearance of internal auditors’ independence is maintained and the reliance of senior management and audit committee is kept well balanced. One good way audit committees can review internal audit departments performance, is by benchmarking with similar departments in other organizations. This can be done by reference to auditing surveys conducted by trade/industry associations or by membership in the Global Audit Information Network (GAIN). External reviews of internal auditing department, according to the Institute of Internal Auditors (IIA) standards, should be carried out by qualified individuals who are independent of the organization at least once in 3 years. Ridley and Burnham conclude that with the changes in the way internal audit functions have resulted in better audit coverage with limited resources. Also, internal auditors being more management-oriented are helping improve the quality of organizations’ asset management and ensure a high confidence level amongst audit committee members.

While the article touched on the changes in Internal Audits, it did not address in detail how management can make best use of this special department to ensure better governance and insulation from shocks that an external auditor might find.

Roper (2002) looked at the Enron affair from a consumer’s point of view. She listed out the common practices adopted by Enron’s senior management that led to the collapse and the failure by the SEC to see it coming. She calls on Congress to place the following safeguards that would help:

- Restore independence to the outside audit
- Improve oversight of the auditing industry
- Restore liability for auditors who abuse public trust
- Enhance independence and expertise of corporate boards
- Provide adequate funding to the SEC
- Spur improvement to the accounting rules

In Enron’s case, the highlights were that, audits were not really independent due to prevalent conflicts of interest, auditors were virtually under no regulatory oversight, reduced liability threat to auditors, the audit committee failed to oversee the auditors’ activities and accounting rules were found to be inadequate. To top it all, it was revealed the last time Enron’s financial statements were reviewed by the SEC was in the year 1997.

An interesting summary of what had occurred at Enron and gaping holes in the financial industry had lead to the sudden implosion of the company.
Surmacz (2002), based on his Q&A session with Terry Jost, vice president for business development for the Americas, Cap Gemini Ernst & Young, indicates that it is normal practice amongst the Big 5 firms to provide a host of other services in addition to traditional audit and tax services. However, this has led to winding up of business by several audit firms. In the example of Ernst & Young, it sold its consulting arm to Cap Gemini in May 2000. Independent consultants would better serve the company as they can better focus on their strengths of providing business solutions rather than be bogged down with audit and tax concerns. He goes on to say that any organization that has either a real or perceived conflict of interest should take steps to identify conclusively if an issue exists so as to avoid any negative effect. Once an issue is identified a “game plan” should be formulated and acted out. There seems to be indication that corporations would rather pick a larger consulting firm over smaller consultancies as they provide a faster transition period and are relatively more secure to do business with. On the impact of Enron-Arthur Andersen, he feels the industry has not really been hurt badly as the actions by these firms were isolated and not wantonly practiced by other CSA firms. Finally, he mentioned that it would take a lot for the management in Andersen to get itself out of the mess as it needs to work on building employee morale and reinvigorating and establishing confidence in its marketplace. Without mentioning much detail, Surmacz has made some recommendations that management could take to separate its consulting and auditing practices.

The statements would be better if explained with some examples to offer more clarity.

Waldmeir (2002) reflects on the role lawyers play in influencing and their association with decision making in today’s’ corporate world. The main point being the call for lawyers to be more open to auditors and change the ethics code which stops lawyers from reporting wrongdoings to regulators or law enforcement officials even if fraud in the scale of billions of dollars are being committed. This call is led by the SEC which feels lawyers can be one of the firsts to get a whiff of any wrongdoings and could arrest the problem before it develops into something akin to the gigantic proportions of Enron. However, the American Bar Association (ABA) is expected to balk at this request as it goes against one of the most fundamental institutions of American justice. The ABA reasserts that the job of the lawyer is to advocate for his client. The role of protecting public interests is the responsibility of others. One point that has been contentious is the partnerships which lawyers and accountants form to provide joint services for the same firm. The role of an accountant is to protect the investor by public disclosure while the role of a lawyer is to protect his client, even if it means hiding information. Thus it would be a mistake to combine these two fundamentally different professions. Waldmeir at the end feels lawyers are not too concerned at this moment, as steps being taken by the SEC mainly concern the accounting profession.

An insight at how other professions could have influenced consultation work provided by auditing firms on its own bread and butter is revealed

Hilzenrath (2001) analyzed the roles played by auditing in fraud cases plaguing the corporate financial world. Commenting just after the collapse of Enron, he questions the authenticity of these so called independent auditors, especially when more and more forensic accounting findings in troubled and fraudulent organizations revealed that the very organizations that are supposed to be protecting investors by strict audits were actually earning 7-8 times more revenue by advising these organizations on various business aspects. Hilzenrath further points out the stated role of a Certified Public Accountant (CPA) as defined by the Supreme Court back in 1984 was to protect public interest, most of these folks were busy expanding their own revenue reach by extending other non-audit work for their clients. The list of scandals arising from these dubious and more often than not “conflict of interest” cases were growing and were not limited to small players. PricewaterhouseCoopers (PwC), KPMG, Ernst & Young and Deloitte & Touche have all had their share of scandals involving billions of dollars. The main theme in all these cases was the fact most of these firms were more interested and concerned about growing and maintaining their consultation role over mere audit work. Although some institutions and boards like the American Institute of Certified Public Accountants (AICPA) attempted to ensure some form of standard and practice across the board, this never really took off as commitment and the justification for the need of it was never apparent to many CPAs and even their bosses who were busy raking in additional profits by the truckloads. Hilzenrath’s is a very interesting article on the problems faced by corporate America as a result of Enron and stuck its finger right on the fault lines.

Nielson (2002) looked at the role consultants’ play, particularly those which contribute to government decision making in the United Kingdom (UK) as a result of corporate financial scandals across America. Looking at the steps taken by the US General Service Administration, which had suspended Enron and WorldCom from conducting any new business with the federal government, Nielson calls on the UK government to be more pro-active in looking into the practices of other big consultant firms and not focus only on Anderson. As action can only be taken in the US by virtue of the limitations of legal jurisdiction, chances are Anderson in the UK and Europe would merge with one of the other Big 5 firms before any action can be taken due to European procurement laws. Nielson argued that despite these large firms regularly recommend outsourcing, public/private partnerships, private financial initiations and restructuring, they are never held
responsible if the project fails. She proposed that the Public Accounts Committee should review the consultants’ recommendations, similar to the review carried out on the IT projects, where it exposed wastage to the tune of millions of pounds as a result of failed or delayed projects. Just as we engage in continuous supplier performance review, the same should be subjected to consultants.

It is a different and refreshing focus on consultants and their role directly rather than looking at the audit implications all the time.

Non (2001) citing a recent study by Stanford University, Massachusetts Institute of Technology and Michigan State University, points out a trend wherein the more a company pays its auditors for consultancy and technology services, the more likely it is to meet or beat industry analyst projections. Interestingly, a company’s stock price tends to fall if the firm files proxy statements that reveal large non-auditing services from their accounting firms. A five-month study period revealed that the 5 largest accounting firms were earning revenues to the tune of 67 to 74 percent based solely on non-auditing services. It comes as no surprise that the accounting firms reject the notion that they are anything but objective. Major accounting players call the methods used in the study as questionable. They claim the definition of “auditor independence” while being central to the study, was not defined adequately. Many defenders of the auditor-consultant nexus argue that it gives an auditor a deeper and better understanding of the company. Yet there are many who dispute that idea as being a “thin reed” on matters at hand. The counter companies are in the position to ‘manage estimates’ through bookkeeping tricks by shifting a few dollars from accounts receivable to the revenue line, cutting research and development spending temporarily or resort to sales tactics to boost sales in the final weeks of a quarter. It indicates the willingness of auditors to turn a blind eye on accounting practices that give an artificial boost to earnings per share.

The article and study was released less than 3 months before the Enron saga came to light and shows the attitude of CPAs and lack of action by legislators despite studies revealing flaws in the system.

Kegley (2000) looks at the path most Certified Professional Accountants (CPA) were focusing on prior to the collapse of Enron, Adelphi and the likes. Many CPAs were under the impression that traditional accounting functions needed to incorporate deeper expertise and understanding in international markets, technological applications and strategic knowledge management. At a recent project organized by the American Institute of Certified Professional Accountants (AICPA), 5 core services were identified as crucial for accountants to perform. These are:

- Assurances
- Technology Development & Consulting
- Management Consulting
- Financial Planning and
- International understanding

The project concludes that the new generation of CPAs would need to provide strategic advice and direction to organizations on broad management issues, performance improvement, human resource system and other non-financial matters. In fact, CPAs were told, consulting is the “next big thing” they should focus on. Despite criticism from some sections, the expectation was that many CPAs would dip their toes into the consulting pool as most of the CPAs are sole practitioners or small business firms whose main function is to establish profitable practices. This trend is unlikely to abate in the near future as long as cost competitiveness is a key determinant, more so in the light of the new twist given to the auditor-company relationship as being akin to that of service provider-customer.

It is interesting to note that many folks from the accounting industry were gung-ho in diversifying their work into other areas which they are not professionally trained or competent, but driven solely by financial gain.

Research Methodology

It is important to note, that the bulk of the analysis and research material were based on American magazines and government policies as the American system of accounting is still the “gold standard” for the world, notwithstanding the long established and time-tested British accounting standards which have and are serving with credit as the benchmark for financial reporting systems in Commonwealth countries. The source of research material and literature for the project were gathered from various sources, mainly online databases and business journals. These included data from journal articles published in online business magazines and academic repositories of various institutions that are published online.

The figure below illustrates the research framework:
Discussion, Analysis and Findings

According to a study conducted by Stanford University, Massachusetts Institute of Technology and Michigan State University back in 2001, prior to the unveiling and subsequent spectacular collapse of Enron, the more a company pays its auditors for consultancy and technology services, the more likely it is to meet or beat industry analyst projections. This should have raised alarms amongst industry players and watchdogs, the SEC in particular. This study, substantiated with numbers to back it up, was not the first study that reveals a high potential for conflict of interest on auditors who perform other non-audit consultations for a firm. Berger and Nicholas in 2000, pointed out that corporate auditors have been guilty of more than just violating fundamental conflict of interest rules, but also have been at the centre of nearly every financial scandal. What is rather intriguing is the arguments put forth by the then Big Five Accounting firms on these studies, while the word “independent auditor” lacked a proper definition.

Thus, it really should not have surprised many when the multinationals collapsed in the manner they did. What was surprising is its timing – what took so long for financial reporting based on flawed fundamentals to fail? As the saying goes “there is only so much one can shove under the carpet”.

This practice could be the result of big Certified Public Accountant (CPA) firms focusing too much on reducing audit costs, through cost containment measures, and going easy on audits with an eye on the consultancy account. A table containing the comparison of audit fee and non audit fee received by the same auditor from the same client in a single year has been attached. This data has been taken from the Kuala Lumpur Stock Exchange(KLSE) and the focus is on the companies listed on the main board of KLSE and who have also used the services of the same audit firm for both audit and non audit services. (refer to table 1). Here it is worth noting that only few out the total companies analysed have given a qualified report and the nature of qualification in these cases is insignificant. The rest of the companies have received an unqualified report. This could be, probably due to the fact that the percentage of consultancy fee received from these clients was much higher than the statutory audit fee. The basic questions are: Was Independence affected? If so, by how much and how far does it go?

Losing the consultation services would not look good on any CPA’s resume and would stifle one’s career growth, especially when auditors are
increasingly appraised based on how much of non-audit business they win from their audit clients.

While the role of the auditor is to protect the public interest by maintaining total independence from the client at all times and fidelity to the public trust, the American Institute of Certified Public Accountants (AICPA) had other ideas. They encouraged, in a 1999 publication, CPA’s to think as a “business advisor” and promote his/her accounting firms consulting services as “intense competition has reduced the audit to a mere commodity that is distinguishable to the consumer only according to price”. Thus it has become common for firms to engage in low-balling on the audit tender with the hope of getting a bigger slice off the consultancy pie.

Thus acting as the main motivator and foundation behind many audit firms’ relationship with large organizations, it would not be surprising for these folks to do whatever it takes, more often than not acting in contravention to legal and ethical practices, to ensure the firms’ financial reports are in line with their paymasters’ requirements and not the actual financial status of the companies audited.

While there are numerous reasons and factors contributing to the demise of the multinationals, the roles played by the auditors, who were supposed to look after public and investor interests, were found to be rather oblique, if not blurred. They seemed more interested in looking after the profit margins than worry on the actual financial health and authenticity of reports filed with the SEC yearly. Some were found to even collude with the firms through indirect consultation and tax loophole identifications and crafting new ingenious ways to get around tax, report income and move items on the balance sheet to promote a more favorable and rosy outlook.

An analytical data schedule containing the details of fees paid by companies listed in the first board of BURSA MALAYSIA, earlier known as KUALA LUMPUR STOCK EXCHANGE, to the same audit firm for audit as well as non audit services, has been attached. The statistical data has been taken for three consecutive years, namely, 2002, 2003 and 2004. The focus has been only on those companies who had the same auditors for audit as well as non audit services. In this regard, we found that out about 125 companies out of the total listed in the main board of BURSA MALAYSIA, had made use of the same auditors for both the audit as well as non audit services. Out of 125 companies 40% of the companies had earned higher fee for non audit services than for audit services and a quick look at the audit certificate showed that almost all of these companies had an unqualified audit report. Those who had a qualification was in the nature of disclaimer of opinion. While this could be genuine at one stance, however we could interpret that independence of the auditors could have been affected in each of these cases. These statistics, though not sufficient to prove deceit, could be deemed sufficient enough to raise doubts on the genuineness of the audit report. (tables 1 and 2) It took successive collapse and revelation of financial mismanagement by Enron, Adelphi, Tyco and WorldCom-MCI to finally get government agencies, the SEC and major industry players to act, especially since many ordinary folks, were not only out of a job, but also lost their life savings as a result of these scandals. It is our intention and hope that such incidents do not recur, particularly due to a lack of independence of auditors being the primary cause.

Intense media attention and public outcry on these developments ensured that the government of the day at Capitol Hill and the White House acted swiftly to plug the gaping hole in the financial accounting world. The crux of the new legislation passed in 2002 as the Sarbanes-Oxley Act (SOX), was to make it unlawful for management to willfully withhold information from auditors and to define what additional consulting services an audit firm can offer to the organization they are auditing. Behaviors and conduct of CPAs were also outlined briefly. Though many of these new rules are already covered by existing SEC Rules, the new act was to ensure that public listed organizations conduct business in a more transparent manner and hold senior management more accountable and liable for its actions.

While SOX was hailed by investors and government agencies as necessary, much needed and useful, many in the accounting industry felt it was rushed through and done only to meet public demands for action against the industry. SOX, they felt, does not address many key contentious areas and even more worrisome, is the SEC’s move to water down some of the rules it initially set out, like permitting auditing firms to provide some consultation services as well for its audit clients. Initially, it prohibited auditors from providing tax consultation services and required all auditors to rotate off a specific company’s audit team after 5 years. Tax consultation as an added service has, since Jan 31 2003, been permitted again. This action by the SEC has actually permitted an accounting firm to provide consultation work on taxation and then have the same auditors audit and attest the financial results. Also, only the top auditors of a team are required to rotate between 5-7 years. The SEC is also expected to back out from its earlier proposal to mandate lawyers in reporting suspected violations by their corporate clients as this would be in contravention of existing laws protecting lawyer-client privilege and right to a confidential relationship.

A requirement from the Clinton Administration era was modified whereby auditing firms are no longer required to specify what portion of their auditing fees comes from work other than auditing. Compliance to these new regulations has also caused an extra cost burden to many companies. Independent studies reported Fortune 1000 firms had spent somewhere to the tune of US$2.5 billion in 2003 alone on work and technology related to SOX compliance.

Despite all the negative feedback from industry players and analysts, on the balance, SOX has...
managed to provide valuable insights into accounting practices and ensure that CPAs carried out their duties as auditors more diligently and professionally. SOX also listed out behaviors that CPAs can perform and clarified language on existing exchange rules. These steps in turn helped clear up many grey areas not covered under GAAP, GAAS or similar accounting legislations. By hiring financial wizards that seek to develop new, untested schemes designed to showcase excellent results by manipulating the accrual-based financial reporting process, managers used to hide behind these grey areas to mask their wealth enhancing activities. The days of these cunning activities have been curtailed with more stringent and revealing disclosure requirement.

Even with Congress passing and President George W. Bush signing SOX into law to address issues in accounting, auditing and corporate governance, it is grossly insufficient in tackling the real underlying problems that have plagued the market place. More actions should be taken and seen to be taken by organizations and the accounting industry to showcase a more determined approach in tackling fraud in today’s corporate world. Some large companies like Walt Disney and Apple have ensured that the same company is not hired to act as auditors and consultants in a single accounting year, with Motorola and PG&E are expected to follow suit, as requested by their shareholders. Many independent analysts have called for further steps the organizations could undertake without external intervention. Steps like rotating audit firms, transparent selection process of audit firms, board members relevance and selection, barring former CEOs from acting as in certain boardroom roles have all been voiced out and recommended. As a result, many large accounting firms, including some members of the famed “Big 4” firms, have voluntarily separated their auditing and consulting services.

With the new directions in place, whether forced or voluntary, a new set of concern arises. How to go about it? Saying it and wanting to do it is one thing, to actually perform the changes, which may incur additional cost, especially on voluntary actions, requires strong will power and determination by board members. Some steps suggested include:

- allowing current consulting projects to end at their natural endpoint
- move project responsibilities in-house and outsource technological related portions
- rotate CPA firms every 3-5 years
- removal of board of directors from the process of selecting and compensating external auditors
- audit firms to divest or reorganize to ensure no form of conflict of interest exist or can be perceived to exist
- cooling off period before an auditor could sign up for employment in an organization he/she previously provided audit work
- holding consultants responsible for their advice and actions through tougher accounting rules
- Utilizing Government audit model i.e. mandate that all audits are carried out via government agencies and/or the SEC
- Complete ban on audit firms providing non-audit work for the same organization
- Empower and strengthen internal audit committees
- Appoint independent non-executive directors to the boards of companies who have professional training in accounting and auditing
- Encourage shareholder activism, especially minority shareholder activism, as it is this group which can give valuable insights into the actual financial affairs of a company as they are not bound by the wishes of the majority shareholders
- Majority independent investors and analyst conclude that independent consultants would better serve the overall interests of the company as they can better focus on their strengths of providing business solutions rather than be bogged down with audit and tax concerns.

With or without legislation, new guidelines and whatever actions taken by independent agencies and accounting bodies, it is really up to the individual firms and organizations on how serious they would like to tackle the scourge of financial fraud and scandals. Separating consulting functions from auditing firms, while in the right direction, requires commitment and will power to see the “right” thing done in the proper and legal manner. We see that many of the previous scandals brought to the attention of the SEC were almost always settled out of court for sums running into millions of dollars. Yet, until the saga of Enron and its band of infamous insolvent firms came to the public domain, no one really paid much thought to the malpractice that has long plagued the industry. The clear demarcation of roles thus ensures a set of auditors, plying a trade at which they are experts at, would indeed keep in check and minimize misadventures by rogue management and corporate leaders.

With all these heady changes, as a CPA it can really be a trying time. One moment the AICPA encourages all its members to promote their firms’ consulting services and are rewarded based on the revenue generated for non-audit works. Suddenly within a span of weeks, they are scorned at for not concentrating on their core expertise of auditing. Today, not only is it unethical to indulge in both activities for the same client, it has also become a crime. This, under ideal conditions, should not place the CPA in a dilemma, but should instead give him/her a golden opportunity to really decide where he/she sees his/her expertise and provides a choice as
to which role should be best played in the corporate accounting world.

A young CPA or someone new to the industry is in an ideal position, to choose between being a consultant or an auditor. As he/she has not garnered the required expertise and habit in either field other than academic qualifications, it should not be too much a catastrophe to dip their toes on either side of the divide before making a more qualified and informed decision. The main divide between the two sides of the pool is, take up audit work which they are properly trained in college for 4 years or go into a world where, despite higher career growth potential and cash rewards, they are called to come up with solutions and proposals, the implementation and eventual success of which would in turn be validated and verified by an independent third party that would have a strong bearing on their future career prospects.

Many argue that after years of indulging in multiple roles, it would be hard for these CPAs to really break with tradition and head towards a more defined environment of either audit or consulting. Confidence and capacity may be called into question. Using the same argument most major accounting firms have quoted that only a small portion in the accounting fraternity are to be blamed for the scandals and mismanagement (accounting industry claims only 8.5% of the cases studied showed a positive correlation between non-audit fees and unusual accounting behavior). Of course, the amount of mullah involved could also make an audit firm think real hard before jumping on the “goodness” bandwagon. Thus, it is believed that either the industry is just too paranoid on change for the betterment or it is again misleading the public with statistics that are at best not honest. They really cannot have it both ways.

Conclusions

While the industry has been “rocked” by a spate of irregularities unearthen over financial mismanagement and blatant disregard of the law and in some cases, crafty usage of existing guidelines and standards, it is rather worrying and disappointing that the corporate world waited for something as large and sinister as Enron to occur before it did anything. Independent studies by Universities and industry analysts, citing a dangerous precedent and growth into consultancy work by accounting firms were brushed aside as mere “studies by folks who do not know the real game” by none other than the vice-president of the AICPA. In fact, the body that all CPAs look to for guidance encouraged its members to venture out and cultivate consulting services as it is the biggest revenue earner for most established accounting players.

It is really odd, if not bordering on folly, that any large organization should actually hire a firm renowned for its accounting expertise to advise them on such issues like technological development, M&E and even human resource matters! It may hold true that these firms may have suitably qualified staff who are qualified for consulting, but then, logically would you hire a person working in a fuel depot to build an engine, or a pest control specialist to establish a seedling nursery?

Hence, the call for separation of services should be lauded and handled with due diligence to ensure it does not fall on the way side. We already hear the rush by the accounting industry’s Big Four firms, technology companies as well as consultants to design and develop software to help finance managers to comply with (SOX). The move by the SEC chairman, William Donaldson, to ensure proper, valid and meaningful reforms are pushed through despite irking many of America’s large companies, should be lauded and exemplified.

Though it is difficult to check human emotions, greed, to be more candid, seems to hold court in all these cases. In the long run the benefits of a public listed company as perceived by the majority to have been independently audited with its filed financial reports holding strong credibility, would ensure a stable and potentially strong performance of the organizations stock and subsequent national economic growth.

To this effect, the CPAs, both individuals and large or small firms, should really decide on their roles based on their expertise and comfort level in handling the task involved in either auditing or consulting work. While some larger firms could handle both roles simultaneously, keeping conflicts of interest out or to a minimal impact, it would still not, in the eyes of independent investors and shareholders, be perceived to be so. In today’s corporate world, it would thus be highly beneficial for the firms or independent CPAs to refrain from performing these joint services for the same organization until all ambiguities and concerns for SOX and the changes instituted by firms and the accounting industry settles in and takes a more pronounced and discernible form. At the end of the day, CPAs should always remember that the “P” in “CPA” stands for public – serving the public and maintaining their trust is essential and part of their duties. In this regard it would be worthwhile to note that only two countries around the world have given a serious thought i.e. Hong Kong and Singapore. The change restricts the consultants from acting as statutory auditors. The authors of this article strongly believe that the accounting profession is capable of meeting ever mounting difficulties of the business world. The education, training and enriched experience provides a solid foundation for consulting work. The authors never doubted the integrity, wisdom and devotion to duty of the accounting profession. When the profession is equipped with excellent consulting skills, a CPA who is not the auditor of the company can, very well, do the consulting work. So long as this is not legalized, without any exceptions the explosion of Enron, World Com and many more will continue to occur. It goes
without saying that the time has now come, to choose either to be an auditor or to be a consultant! While it would have been interesting to identify the views of the audit firms on this subject, it is felt that, there could be a biased opinion on the part of the auditors, if they were asked to comment, specially since this subject matter affects the audit firms’ income.

References