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Topic 6 Essay

Non-Audit Consulting Services Give Rise to Decline in Auditor Independence

"The accounting profession is coming under another round of scrutiny in Washington. This time, the concern is over consulting, which has become big business for the nation's largest public accounting firms" (Hayes, 1979). One might believe that this was a lead paragraph line from a current news clipping given the recent events that have taken place in the accounting industry. However, this statement was actually released over twenty years ago. On several occasions during the past decades, congressional legislators have raised questions about whether public accountants can remain independent when they perform consulting services for attestation clients. The Metcalf and Moss subcommittees in the late 1970's and the Dingell subcommittee in the mid-1980's conducted hearings on the issue. The accounting profession also initiated several inquiries into the impact of non-audit services on auditor independence. The matter was investigated by the Cohen Commission in 1978; Public Oversight Board in 1978, 1979, and 1986; Special Committee on Standards of Professional Conduct for CPA's (Anderson Committee) in 1986; National Commission on Fraudulent Financial Reporting (Treadway Commission) in 1987; and Public Oversight Board's Advisory Panel on Auditor Independence (Kirk Panel) in 1994 (SEC, 2000). None of these historical studies found any significant instances where performing non-audit consulting services had diminished independence.

Given all of these seemingly intense historical studies, one might infer that the debate over auditors performing consulting work for audit clients was over. However, in light of many companies making massive restatements and prominent giants, like Enron and WorldCom, falling, the issue has once again made its way back into the public eye. U.S. companies paid 72 percent of their total public accounting fees for non-audit services in 2002 (Whitman, 2002). Many believe there is a correlation between the restatements and bankruptcies caused by improper accounting and the increase in non-audit consulting services being performed by public accounting firms. The non-audit services are believed to cause an independence issue for the firms. Providing non-audit consulting services to attestation clients has contributed to a decline in independence and professional skepticism for public accounting firms.

Independence, whether true or perceived, is the hallmark of the public accounting profession. True independence maintains freedom from bias and personal interest in an auditor's conduct on an audit. Perceived independence is the financial statement users' belief that the auditors have actually achieved true independence. A lack of either type of independence may result in diminished audit credibility.

Independence is one of the primary reasons why users of financial statements value public accountants' opinions concerning the proper application of GAAP to client financial statements. Quite simply, if investors cannot trust auditors to keep watch over corporate management, they cannot have confidence in the financial data on which they base millions of investment decisions daily. As Senator Howard Metzenbaum said in a SEC hearing, "When auditors' independence is called into question, the reliability of the financial statements of public companies is also called into question" (SEC, 2002).

Fierce competition among firms for revenue has helped instigate the explosion in growth and demand for non-audit services. Generally, strict audit services generate only a small margin of profit for the firms. Thus, in an attempt to increase revenue, many accounting firms have diversified by providing non-audit services, which are mainly future-oriented or address implementation activities and generally yield a greater profit margin. These services have resulted in firms "lowballing" auditing fees in order to cross-sell the firm's more profitable non-auditing services.

Proponents of the audit profession's expansion into consultancy services, like Zoe-Vonna Palmrose, PwC Auditing Professor at the University of Southern California, argue that providing consulting services is a matter of efficiency and actually improves audit quality. Auditors, in the nature of their engagement, gain vast knowledge of a client's internal controls and systems. Hence, the auditors have insight to provide management with a valuable external perspective based on the latest industry expertise. The audit quality may be further increased by the additional understanding of the client's business. In order to provide the consulting service, auditors must examine the company and industry even more closely.

In contrast to proponents' beliefs about firms providing consulting services to attestation clients, the SEC and others believe that auditors should not be performing non-audit consulting services. Critics are primarily concerned about two effects of non-audit services on auditor independence. First is the fear that non-audit service fees make auditors financially dependent on their clients. Thus, auditors have financial incentive to retain clients and are less likely to disagree with management for fear of losing the engagement. The second is that the consulting nature of many non-audit services places auditors in a managerial-type role. This role threatens auditors' independence to the transactions they attest.

Non-audit fees have skyrocketed for many companies, potentially causing auditors to become less independent. For example in 2002, J.P. Morgan Chase & Co. paid PricewaterhouseCoopers $18.4 million for auditing services and $85.9 million for other services; General Motors Corp. paid Deloitte & Touche $16.1 million for its financial audit and more than six times that for consulting services (Whitman, 2002). In public accounting, fee compositions of this imbalanced nature are typical. In the above examples, engagement partners on these clients may be pressured to give unqualified audit opinions rather than risk losing total fees of $104.3 million and $102 million, respectively. Pressure may be even greater when partner compensation is derived primarily on engagement fee revenue.

Auditors may also have difficulty attesting to transactions that they consulted on or premeditated, thus weakening their independence. This hitch is apparent in two recent restatements by Pinnacle and Avon for transactions in 1999 and 2000, respectively. In both instances, PricewaterhouseCoopers (PwC) served as the auditing firm and advised on and approved of the improper accounting of its own non-audit fees. For Pinnacle, PwC permitted improper capitalization of $6.8 million in consulting fees that should have been expensed. In the case of Avon, PwC auditors allowed improper accounting methods for an impaired asset, which was comprised primarily of $26 million in accounting system consulting fees. PwC further assisted in drafting misleading disclosures for the transaction. Both PwC clients had to issue restatements, and in July of 2002, PwC was fined $5 million. The SEC found in both cases that PwC failed to audit with independent, professional skepticism. Stephen Cutler, the SEC's Director of the Division of Enforcement, said, “This case demonstrates the heightened risk of an audit failure when an accounting firm assists in and approves the accounting treatment of its own consulting fees. Faced with that situation here, PwC lacked the objectivity and impartiality required of an independent auditor” (SEC, 2002).

The recent corporate collapses that occurred have raised many questions over public accounting and auditor independence. While auditors cannot be assigned full responsibility for the collapses, lack of auditor independence due to firms providing non-audit consulting services may be at least partially to blame. Providing non-audit consulting services to audit clients may indeed give auditors a better understanding of a company. However, despite this advantage, it can become extremely difficult for a firm doing consulting work to remain independent and objective in its attestation on financial statements. Auditors may not be willing to jeopardize a combined audit-consulting engagement by raising criticisms and acting professionally skeptical during an audit. Nonetheless, should auditors even succeed in true independence during an audit, there is still the issue of perceived independence for financial statement users. Overall, in order to inspire investor confidence in the integrity of the capital market, auditor independence is critical, and thus auditors should not engage in non-audit consulting services for their attestation clients. The bedrocks of the auditing profession, independence and professional skepticism, must be protected.

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