It's All About Relationships

As the Interests of Accounting Firms and their Clients Become More Interconnected, Errors and Conflicts of Interest Abound

By Brenna Nelinson

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Investors rely on auditors to provide neutral, independent, and accurate assessments of the financial condition of public companies. Accounting figures are the bedrock of company valuation, and an auditor's signed statement endorsing a company's financial results is generally thought to be a high-quality, independent verification of the accuracy of reported figures.

Unfortunately, there are several reasons why investors should be skeptical of audit quality. Just a few years after a series of accounting scandals rocked US financial markets, audits of public companies contain a shockingly high rate of errors, in part due to complicated relationships between auditing firms and their public company clients.

An industry with a checkered history still struggles with conflicts of interest

US capital markets have a long history of accounting malfeasance. Perhaps most well-known today is the Enron scandal that surfaced in 2002 and took down one of the world's largest accounting firms, Arthur Andersen, as it was revealed that Enron's unprecedented success as an energy trading company was built on accounting fraud. Enron's and Arthur Andersen's relationship began as a client-auditor relationship. In the mid-1990s, however, Arthur Andersen developed a consulting business, and successfully looked to its most prominent client, Enron, as a source of consulting revenue. The year prior to its demise, Arthur Andersen generated more revenue from its consulting division than it did from its audits. Similarly, it earned more from consulting for Enron than for auditing Enron's financials. The importance of this consulting revenue to Arthur Andersen, along with the inherent conflict in providing consulting services to a company also being audited, is generally thought to have resulted in Arthur Andersen knowingly or recklessly disregarding material defects in Enron's financial statements.

Following Enron's and Arthur Andersen's downfall, Congress passed the Sarbanes-Oxley Act of 2002 (SOX), a legislative response to serial accounting frauds like

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Enron. However, SOX's passage may have lulled investors into a false sense of security. Though SOX implemented certain safeguards to promote the independence of auditors of public companies, audit quality continues to suffer and audit misconduct persists.

Indeed, audit statistics show that misrepresentations in audits are far too common. For example, the International Forum of Independent Audit Regulators found that *40 percent* of 918 audits inspected in 2017 contained serious errors, including issues pertaining to accounting estimates and internal control testing. Similarly, in 2014, the Public Company Accounting Oversight Board (PCAOB), a private-sector, nonprofit board created pursuant to SOX to oversee public company audits, found that *one third* of audits it inspected were so deficient that they should not have been issued.

There are numerous reasons for these troubling statistics. To start, while SOX considerably limits the non-audit work that an accounting firm may provide to a company to which it also provides auditing services, there is still critical gray area. For example, SOX does not list most tax services as a prohibited non-audit service. SOX allows accounting firms to provide their clients tax compliance, planning and advice if such services are preapproved by the client's audit committee. More importantly, however, the field of consulting has evolved in ways that legislators did not envision when Congress passed SOX. Since the passage of SOX, for instance, a new kind of consulting has grown out of the 2008 financial crisis known as "governance, risk, and compliance." SOX says nothing about this new field — a hybrid between consulting and auditing — and thus does not prohibit accounting firms from also providing such consulting services to their audit clients.

Today, each of the "Big Four" accounting firms (KPMG, PricewaterhouseCoopers, Deloitte, and Ernst & Young) maintains a lucrative consulting business. Like Arthur Andersen, each of these firms generated more revenue in 2017 from consulting services than it did from auditing. Revenue growth numbers tell a similar story: since 2012, these firms have experienced 44 percent growth in consulting revenue and only three percent growth from auditing. This is hardly a surprise. Accounting firms seem to understand the obvious: that auditing is a lower growth business than consulting. Despite the Arthur Andersen fallout, auditors continued to invest heavily in developing their consulting businesses. As MarketWatch reporter and former PwC auditor Francine McKenna puts it, for these accounting firms, "audit is an afterthought. It is viewed as a necessary evil."

The problems posed for the investor community

The risks to audit quality posed by this shift in focus are numerous. Given the disparity in revenue growth among the consulting and audit businesses of accounting firms, it is natural to fear that these firms, as for-profit businesses, might choose to dedicate more energy and resources to developing the consulting division at the expense of their auditing division. This could come in the form of fewer audit professionals hired, less qualified audit professionals hired, less

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training of audit professionals, and/or less investment in relevant audit technology that might improve accuracy. Each of these possibilities carries a risk of reducing audit quality.

In addition, should accounting firms' consulting businesses continue to outgrow their audit businesses, there is a risk that accounting firms may choose to place more emphasis on profitability when determining partner compensation. The PCAOB has observed instances in which an audit partner's quality ratings (which, in part, determine compensation) were "significantly affected by the profitability of their audits or their ability to generate revenue." The PCAOB also observed instances where audit quality "was not appropriately emphasized, or even appeared to be a significant factor, as compared to marketing or other activities of the firm" in compensation decisions for audit partners. Consequently, audit partners may find themselves in the unsavory position of needing to sacrifice audit quality in order to generate revenue, increase profitability, or take other similar actions purely in the interest of increasing their compensation — none of which, of course, would improve audit quality or be disclosed in the audit for investors to consider.

It is also important to understand that — contrary to popular belief — many auditors do not design their audits to ferret out fraud. A 2018 global study on occupational fraud found that only four percent of fraud is discovered by external audits. As a PwC audit partner famously testified under oath in 2016, "our audits are not designed to find fraud." Indeed, accounts from inside the "Big Four" accounting firms suggest that auditors often exploit flexibility in accounting rules to do the

opposite: paint an overly rosy picture of the client's finances. Along with such distortion of company finances can come retaliation against auditors who attempt to do the right thing. For example, a recent Financial Times article recounts how a former PwC auditor, Mauro Botta, alleged that he experienced professional retaliation for raising internal concerns about the objectivity of the PwC partners performing audits for public companies. Botta was told that "you want these guys to like you," and that he should prioritize generating revenue and nurturing client relationships and "build the relationships where the client would never want to leave PwC." Ultimately, in response to client requests, Botta was removed from audits in which he raised concerns about audit accuracy.

Overly cozy auditor-client relationships can also drive down the number of financial restatements that companies issue. A financial restatement is defined by the Financial Accounting Standards Board as a revision of a previously issued financial statement to correct an error that was material enough to render a company's previous financial reports unreliable. Restatements are meant to be a mechanism for companies to admit accounting failings. But because restatements are embarrassing and potentially costly for both auditors and company management, accounting firms may choose not to recommend necessary restatements, and, even if an accounting firm advises a client to restate its financials, the company can refuse to restate — leaving investors in the dark. Tellingly, at the same time audit firms are expanding their non-audit services for US public companies, the total number of restatements by publicly traded US companies has declined, hitting a 17-year low in 2017.

Solutions are challenging and not imminent

Given the ongoing threats to audit quality, there are numerous governance and regulatory proposals aimed at improving audit integrity. Some commentators have suggested that increasing the level of regulation of public company accounting is an appropriate way to fix the problem. Others have suggested that audit firms should adjust their bonus metrics so that auditors are rewarded for high audit quality instead of retaining or securing business. Until the ultimate solution takes shape, the prospect of unreliable auditing is a further reason for institutional investors to remain vigilant and selective with their asset allocations, and consider advocating for appropriate regulatory enhancements.

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