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ARTICLE: ACCOUNTANTS' INDEPENDENCE: THE RECENT DILEMMA

Tamar Frankel*

* Professor of Law, Boston University School of Law.

SUMMARY:
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TEXT:

A fundamental issue has been raised recently in connection with the status of "independent accountants." The issue involves a new breed of a few very large accounting firms. These firms are engaged in global commerce and finance, and cater to an important segment of multinational corporations. n1

These mammoth accounting firms raise a familiar question in a new context. On the one hand, the size and diversity of the firms meet the needs of large multinational clients and offer efficiency benefits. On the other hand, these benefits expose the firms to increased possible conflicts of interest and endanger the firms' gatekeeping functions as auditors. Therefore, the applicability of the independence rules to, and the strategic structure of, these firms require rethinking and an adjustment.

I. THE GATEKEEPERS

Independent accountants are gatekeepers. The signature of an independent accountant is required for all financial statements issued by publicly held companies and companies that plan to go public. In 1933, after the 1929 crash, the Federal Trade Commission established the function of accountants as independent auditors n2 for the purpose of reducing the information costs to investors and strengthening their trust in both the information that they were receiving from issuers and in the financial system as a whole. Thus, law grants independent accountants a monopoly by requiring issuers to resort to the accountants' services. In return, law requires that accountants' relationships with the corporations that they audit be at arm's length.

Independent accountants must be autonomous from the corporations that they audit. But this autonomy is not enough. Similar to judges, who not only must be just but also seem to be just, these accountants must *seem* to be independent of their client corporations. This aura of independence is crucial to the accountants' credibility in the public's eyes. We assume that their independence will further the underlying purpose of their activity: to shore up public confidence in the information they certify, as well as the securities markets as a whole.

In connection with the rules ensuring accountants' independence from the issuers whom they audit, accountants may not own the securities of, nor serve as directors and officers for, the issuing companies that they audit. The rules apply to partners of accounting firms, but internal rules may extend the prohibition to managers and family members, even so far as to include their in-laws. n3 These independence rules have been on the books for the past seventy years.

II. THE CHANGING ENVIRONMENT OF THE LARGE ACCOUNTING FIRMS

The issue of independence arose with the recent growth of a few accounting firms, the "Big Five." These large firms have expanded their services, their personnel, and their geographical reach. Ten years ago, there were no firms of such magnitude. One reason for this growth was a legal expansion of the firms' functions. The initial requirements for audits were fairly straightforward. Auditors were tasked with determining whether the financial statements of their clients were prepared according to the accounting rules, and with verifying the statements for accuracy. In the 1970s, the functions of accountants were extended explicitly in the Foreign Corrupt Practices Act to include an evaluation of the clients' internal controls. n4 The Act represented congressional reaction to "porous" accounting in a number of large multinational corporations competing for business abroad. Competition for business in some countries involved payments to high-placed officials. To make these payments (without acknowledging their payees), American corporations began to create secret slush funds backed by false documentation. This practice threatened the legitimacy of the corporations' entire accounting system. Congress reacted by prohibiting such payments, except when a government agency authorized the payments under certain conditions, and by requiring the corporations to establish internal controls to prevent "seepage" of funds. Accountants were authorized to certify that such controls existed. Accountants are well suited to the task. After all, accounting is one form of internal control.

A second reason for the growth of these few accounting firms was their drive for efficient service to their multinational corporation customers. Efficiency requires auditing services to be accessible all over the world. These services expanded to meet the customers' needs in related areas. In short, the firms revised their business strategies and diversified their services. n5 The new strategies of these accounting firms aim at global "one-stop" services. While the large firms offer audit services, as in the past, their objective is to offer global "one-stop" full service, including: legal services, tax services, management consulting, strategic planning, information technology, and advice on mergers and acquisitions. Another important component of the service is designing new financial products. Thus, the few large accounting firms have evolved to function in an environment, and adopt business strategies that differ dramatically from those of single-service auditors. n6

Clearly, the synergies of this strategy are great. In the past years the five large accounting firms' earnings have grown by approximately twenty percent each year. n7 The auditing services help market other services. Arguably, it is easier to have access to a corporation's top management through the accounting services. Corporate management is more comfortable with a firm that is already familiar with its corporate practice and culture. Personal contacts have been established, and the accounting firm is entrenched as an outside but related part of the corporation, if not in one service area, then in another. From a business point of view, the auditing group serves the consulting side well by putting the foot in the door, even if reluctantly.

The consulting side reciprocates, some consultants say, with abundance. Auditing practice is not as lucrative as consulting. n8 Auditing may not always be very interesting and therefore, attracts either less talented persons or novices, who leave as soon as they can. n9 The promise of the profits from the consulting side maintains the high quality of the auditing side. From a business point of view, consulting and auditing sides match. Both sides offer diversification to the firms' partners, business synergies, and serve clients well. The sum value of each practice separately is smaller than the value of their combined practices. Without the audit work the consulting practices may not be as competitive.

The business expansion of the large accounting firms brought additional conflicts of interest. If a firm offers "one-stop" shopping, it is likely that the auditing and consulting services to clients would overlap. If an audit examines the services provided to a client by the consulting practice of the same accounting firm, the firm will audit its own advice and its own performance. If advice concerns the well-being of a corporate client, this advice results in a conflict of interest that dampens the critical view of the auditors and pressures the auditors into relaxing their judgments, especially if the audited corporation is expected to reciprocate by favoring the firm's consulting side with lucrative work.

III. THE INDEPENDENCE RULES AND ONE-STOP GLOBAL SERVICE

For a number of reasons, the independence rules limit the ability of the large accounting firms to continue the move towards one-stop global service. First, as the number of partners and managers grows, the cost of verifying their independence increases. Second, partners in the consulting side are prohibited from holding securities in any client of the auditing side. Therefore, as the number of clients grows, partners and others who are prohibited from investing in clients' securities are increasingly limited in their investment choices. Arguably, auditors may not invest even in mutual funds because most large firms audit mutual funds and advisers.

Third, the prohibition on investments can overflow to other financial assets. Thus, when KPMG (a Big Five firm) obtained a contract to audit Prudential, Britain's largest life insurance company, partners and family members were required by the Securities and Exchange Commission (SEC) to divest any insurance policies that they held as insureds of this insurance company. n10 The SEC considered applying this rule to partners worldwide. n11 Fourth, to avoid auditing the performance of their own firms, the consulting side of the firms is often forced to transfer jobs to others, even though the firms believe they can, or are even more qualified to, provide the service. An audit job for $ 5,000.00 may block the opportunity to obtain a consulting job of two million dollars. One service or the other service must be chosen. Such situations not only result in losses of potential income but also do not promote a harmonious relationship between the audit and consulting arms of the firm.

IV. PRESSURES TO CIRCUMVENT AND VIOLATE THE INDEPENDENCE RULES

The continued move towards one-stop service creates pressure to circumvent and violate the independence rules. In January 1999, the SEC censured PricewaterhouseCoopers because its auditing partners in a particular office were investing in a client's securities while performing the audit. n12 PwC was ordered to retain an independent consultant at its expense to review PwC's compliance with certain measures, and report such findings to the SEC. n13 The review found that this incident was merely a symptom of a much deeper problem. The law firm's report, which the SEC adopted as its own, concluded that there were many partners that invested in clients' securities. n14 The report emphasized the faulty culture and controls at the firm. n15 A recent study found warning signs concerning investors' perceptions of weak independence. n16 These reports suggest that this problem could develop over time, and may be related to the development of accounting firms' multidisciplinary business services.

Recently, the SEC has delegated its functions concerning accountants' independence to a new Independence Standards Board ("the Board"). The Board was tasked with closely monitoring dangers ranging from the lack of accountants' independence to the integrity of the financial markets. In January 1999, the Board issued its first standard, requiring auditors subject to the independence rules to disclose in writing, at least annually, all relationships between the auditors and the clients that may reasonably be viewed to bear on independence. n17 This standard thus requires an annual meeting between the auditors and the clients' audit committee. n18 An auditing system may be weak if it targeted auditors are vested with the decision power regarding their own potential violations, especially if there is no monitoring system in place. To this end, at least one large accounting firm has been employing an electronic system that is updated for accuracy. n19 Further, violations should be documented and resolved formally. The SEC is planning to extend its investigation to other accounting firms. n20

While PwC posted one of its compliance tools for new partners and employees on its website, n21 the SEC is preparing additional probes, and Congress is pressing the SEC to do more in this area. n22 An apparent dissatisfaction with the auditing services provided by the Big Five has emerged in recent years. n23 The increased number of lawsuits filed against these firms may manifest this dissatisfaction. n24 Perhaps the corporate auditing system, both external and internal, resulted in a tendency to cut corners, bend rules, and massage numbers that can distort issuers' performances and inflate share prices. n25 Consequently, the incidence of fraud linked to auditors' poor performance is rising. n26 This trend is dangerous to our market economy because direct verification of the issuers' financial statements is very costly for investors. If the issuers' financial statements are unreliable, investors will either demand a higher premium for their money, thereby raising the cost of capital for issuers, or deny issuers capital altogether.

Arguably, these suits have arisen not on the merits but because the firms represent a "deep pocket." Perhaps auditors' certifications raise unrealistic expectations. The public believes that an audit provides the final (and only) number; however, auditing is a more subjective discipline than it seems. Auditing represents an opinion, not a certainty. n27 Thus, people's expectations cannot be the basis of the standard for auditors' liabilities. Auditors should not be held to a simple, clear-cut liability rule, but given protection if they act in good faith.

Globalization and changed objectives bring their own issues. The Big Five accounting firms sign off on accounts in foreign countries, based on local standards, and these are far less rigid than those standards in the United States are. n28 Auditors must certify financial statements under different standards or impose United States standards that are unacceptable in other countries. Certification of such global audits under different standards may mislead readers, but this communication defect could be remedied by appropriate disclosure. The attitude of the auditors themselves is a more serious concern. Adherence to more relaxed local standards (whether or not certification is accompanied by comments about the differences with United States standards) creates undesirable tendencies in the auditors themselves. People are creatures of habit, auditors included. Lax approaches may percolate into the United States' practices to the detriment of our system.

V. THE INDEPENDENCE RULES DEBATE

The independence rules applicable to accountants are also the subject of controversy. On one side of the debate are arguments for tightening these rules. The proponents of this view put an increasingly high value on contribution of accountants to the integrity of the securities markets, and believe that accountants' independence and legitimacy are crucial to investors' trust. Further, in their opinion, even if the cost of audits will rise upon barring accountants from consulting, the cost of protection per share may be negligible, and investors would gladly pay the difference for the reduced risk. Some speculate that the accountants themselves would welcome relief from the pressure to sell the services of colleagues.

Others argue for the separation of audit from consulting as an assurance of independence. They argue that the consulting practice, not the ownership of a small number of the client issuer's shares, is the real threat to the accountants' independence. Pressures and incentives to market the consulting services can subvert the auditor's independence. Ownership of a few thousand dollars' worth of the issuer's shares is less likely to have this corruptive effect.

Critics of independence rules argue that the rules are too strict and should be reviewed. They argue that the independence rules are arcane, rigid, detailed, fixed, and too numerous. n29 The rules apply to specific independence decisions and afford little opportunity to consider new situations through reasoning by analogy. Independence rules have become detached from the business realities and the evolution of society in the twenty-first century. The rules ignore the development of the Big Five, and do not take into consideration the changes in the industry and in the environment. Therefore, it has been suggested that the rules not only should be simplified, but also that the itemized rule-based model should be changed.

The critics of the rule question the fundamental assumptions on which independence of accountants is required. They seek to reexamine, and take a fresh look at, the conceptual framework for auditors' independence, and consider new factors. For example, they ask: What role should cost-benefit analysis play in accountants' independence? They argue that perhaps we should consider the benefits from the large accounting firms to themselves and to the issuers and weigh these benefits against the added risk of public distrust in the markets. Perhaps, they say, the benefits may far outweigh the risks.

The critics also question the assumptions concerning investor confidence, and whether the risk and safeguard analysis is appropriate in evaluating the risk from weaker independence of accountants. These critics seek to determine the role of users' perceptions in setting the standards for accountants' independence.

These questions are loaded and go to the heart of the problem. We have always made the assumption that independence and public confidence should not be subject to a cost-benefit analysis. Experience in "runs" and "bubbles" suggests that investors (maybe others as well) are not always entirely rational. Investors who cease to trust the informational integrity of particular issuers may cease to trust the integrity of the entire markets. The available literature on public mania suggests as much. n30 Further, the tendency of investors not to make a cost-benefit analysis is tied to the degree of risk that they are willing to take. At some point, investors are not willing to make the cost-benefit analysis and will just pull out. If their risk level is lower (*e.g.*, with respect to bank deposits) they will pull out sooner, and do so from all banks, whether the banks are in a weak or strong financial situation. Although investors might not be so risk-averse with respect to equities, if they suspect unfair treatment or untrue financial statements, they might pull out as well. In the best case, they will discount the price either of the particular issuer whose financial statements are not verifiable, or the issuers similar to that issuer, or the securities in general.

The question is whether we can play the game of risk-benefit with investors' confidence. If the trial is unsuccessful, the damage may be horrendous and may take years to remedy. If the trial is successful, then the few large firms, and perhaps the large issuers, who would take advantage of "one-stop" shopping, will continue to benefit. However, investor confidence is not an area in which we can experiment at low cost. The uncertainty of the outcome and the impossibility of reversing a catastrophic result in a short-time period require rejection of the risk-benefit analysis, or at least warrant a long and hard evaluation of this approach.

Critics of the independence rule also focus on the rule's details. One question is: To whom should independence restrictions on audit firms apply? Should these restrictions apply to the firm, the engagement team, or all partners in the firm? Should applications of the restrictions vary based on facts and circumstances? These questions may bring about more flexibility and more reasoned results. While auditors directly involved in an issuer's audit should not own any of the issuer's securities (including derivative securities), perhaps those not participating in the audit on the consulting side of the firm may hold certain amounts of stocks or bonds of the issuer (limited by dollar amount or as a percentage of salary). Indeed, perhaps all partners may hold mutual fund securities or participate in blind trusts. Partners in such firms usually hold shares of a fund that manages their pensions or investments, and may also be insulated from these funds. Hence, total insulation of the parties from the most acceptable and prevalent form of investment today is unnecessary.

In addition, the large accounting firms are global and must remain so because their clients operate worldwide. The only reason for precluding this practice is to ensure that the firms do not follow the more lax foreign accounting rules outside the United States. Effective internal control, not blanket prohibition, is required to prevent such a race to the bottom and maintain high accounting standards.

One proposal, which may have followers, suggests that accounting firms disclose whether they have a consulting practice, or whether they are "pure" auditors. Presumably, the issuers will examine investors' preferences to find out whether the difference between pure and diversified auditing firms affects investors' trust, and hence the price of their securities. That approach allows the markets--the investors and their advisers--to determine how accounting firms will be structured and what is the necessary degree of independence that accountants should demonstrate. The concern that a negative investor opinion would threaten the integrity of the markets, may be ameliorated by market surveys and focus groups. If the danger is negligible, disclosure may be worth trying. In the last analysis, consulting practices lower professional standards for auditing, while self-regulation may not be effective to combat the great temptations posed. One academic has warned the industry that violations of the independence rules may lead to SEC intervention and threaten auditors' autonomy. n31 This threat may serve as a wake-up call for the entire accounting profession.

VI. A POSSIBLE ANSWER

Current events, occurring while this Article was being prepared, seem to provide an answer. The accounting firms are separating their consulting practices. Notwithstanding the business reasons for allowing (or even encouraging) large accounting firms to engage in consulting services, multidisciplinary practices should be prohibited. n32 One large firm, Andersen Worldwide, has separated its consulting and auditing practices. However, the separation was caused by internal disagreements rather than because of the independence issue. n33 History repeats itself as Andersen Consulting is attempting to separate from its parent, Andersen Worldwide. n34 Again, the rift is caused by an internal disagreement. n35 However, two other members of the Big Five firms are planning to separate their practices. Ernst & Young recently sold its consulting business. n36 PwC has already decided to separate its auditing and lawyering practices from its consulting business. n37 Paradoxically, even a sale of the auditing part does not necessarily solve all problems. If the auditing practice sells its stake in the consulting practice, what will the auditing part do with the proceeds, which may amount to millions of dollars? It cannot distribute the equity stakes to the partners. In addition, with a sale of a firm's consulting practice, profitability will decrease. How will auditors attract talent? Presumably they will have to raise the fees to offer better pay. How much will the market bear? The future of these firms may bring us the answers.

FOOTNOTES:

n1 The five largest accounting firms serve most major public companies in the United States. *See Auditing Rules for Accountants*, N.Y. TIMES, Feb. 2, 2000, at C14. The Big Five accounting firms include PricewaterhouseCoopers (PwC), Andersen Worldwide, KPMG Peat Marwick, Deloitte & Touche, and Ernst & Young.

n2 *See* Floyd Norris, *Rules That Only an Accountant Could Fail to Understand?*, N.Y. TIMES, Jan. 8, 2000, at C1.

n3 *See* Adrian Michaels & Michael Peel, *SEC Accuses Accountancy Firm of Jeopardizing Audit Independence,* FIN. TIMES, Jan. 8, 2000, at 2; AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, CODE OF PROFESSIONAL CONDUCT § 101-9 (Jan. 12, 1988) (as amended Jan. 14,

1992) (noting family relationships' effect on independence and defining "close relatives" to include non-dependent children, stepchildren, brothers, sisters, grandparents, parents, parents-in-law, and their spouses). *See also* Audit Committee Disclosure, Exchange Act Release No. 42,266 (Dec. 22, 1999), *64 Fed. Reg. 73,389* (Dec. 30, 1999) (requiring certain processes for corporate audit committees and defining independence).

n4 *See* Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, § 102, 91 Stat. 1494 (codified as amended at *15 U.S.C. § 78m* (b) (2) (B) (1994)).

n5 *See* Seth Sutel, *Stock-Owning by Accountants Tightened*, RECORD (Bergen County, N.J.), Feb. 2, 2000, at B1.

n6 The business scene for accounting services has changed as well. Accounting firms are not only the acquirers and auditors of other firms; they are also acquired by other businesses. For example, American Express and H&R Block are buying up accounting firms, or at least the non-audit part of the accounting firms. *See* Steve Tuckey, *37-Year Audit Vet Is Independence Maven*, INS. ACCT., Jan. 31, 2000, at 1. IBM has considered buying or allying with PriceWaterhouseCoopers. *See* Beth Piskora, *IBM Mulls Buying PWC Consulting Biz*, N.Y. POST, Jan. 28, 2000, at 28.

n7 *See PwC Rap Renews Debate over Big Five Structures*, MGMT. CONSULTANT INT'L, Jan. 20, 2000, at 1.

n8 *See* George M. Kraw, *At PriceWaterhouseCoopers, Rules Made to Be Broken*, RECORDER, Jan. 26, 2000, at 4.

n9 *See id.*

n10 *See Auditory Discomfort: Auditors Under Fire: Recent Rulings in America Have Highlighted the Conflicts of Interest Inherent in Modern Accountancy*, ECONOMIST, Jan. 15, 2000 (noting that the SEC considered worldwide partnership divestiture because Prudential was "seeking an American stockmarket listing"); Robert Bruce, *Old-Fashioned Concept You Cannot Ignore*, TIMES (London), Jan. 13, 2000, at 34.

n11 *See Auditory Discomfort, supra* note 10.

n12 *See* PricewaterhouseCoopers LLP, Exchange Act Release No. 40,945 (Jan. 14, 1999); *Independent Consultant Finds Widespread Independence Violations at PricewaterhouseCoopers*, SEC NEWS DIGEST, Jan. 6, 2000, at 1-2.

n13 *See id.*

n14 *See* Floyd Norris, *Accounting Firm Is Said to Violate Rules Routinely*, N.Y. TIMES, Jan. 7, 2000, at C6.

n15 *See When Financial Cops Turn Bad*, L.A. TIMES, Jan. 14, 2000, at B6.

n16 *See* Tuckey, *supra* note 6, at 1; Letter from Lynn E. Truner, Chief Accountant, Securities and Exchange Commission, to Sherwin P. Simmons, Chair, Commission on Interdisciplinary Practice American Bar Association (Jan. 22, 1999) (discussing the principles of independence) (on file with author).

n17 *See id.*

n18 *See id.*

n19 *See* Norris, *supra* note 13, at C6.

n20 *See Auditors Play with Integrity*, CRAIN'S DETROIT BUS., Jan. 10, 2000, at 8.

n21 *See* Kraw, *supra* note 8, at 4.

n22 *See* Norris, *Rules That Only An Accountant Could Fail to Understand?, supra* note 2, at C1.

n23 *See* Simon Caulkin, *Calling Our Auditors to Order*, OBSERVER, Jan. 16, 2000, at 9.

n24 *See Auditors Play with Integrity, supra* note 18, at 8.

n25 *See When Financial Cops Turn Bad, supra* note 14, at B6; Claire A. Hill, *Why Financial Appearances Might Matter: An Explanation for "Dirty Pooling" and Some Other Types of Financial Cosmetics, 22 DEL. J. CORP. L. 141 (1997)* (discussing the "beautification" of companies' financial statements).

n26 *See* Caulkin, *supra* note 21, at 9.

n27 *See id.*

n28 *See* Michaels & Peel, *supra* note 3, at 2.

n29 *See* Julie Dunn, *In Defense of Auditors*, N.Y. TIMES, Jan. 16, 2000, § 3, at 2 (quoting Deloitte & Touche CEO as saying that independence rules are "arcane, archaic, overly complex").

n30 *See* 1 TAMAR FRANKEL, SECURITIZATION 89 n.15 (1991) (citing works on public manias, bubbles and runs).

n31 *See Government May Intervene in Audits, Vanderbilt B-School Professor Warns; Recent SEC Violations Threaten Future of Independent Audit*, PR NEWSWIRE, Jan. 20, 2000.

n32 *See* Kraw, *supra* note 8, at 4 ("If the accountants don't pay attention to their own professional rules, how can they be expected to abide by anyone else's?").

n33 *See* Damian Wild, *Andersen Petitions for a Divorce*, INDEPENDENT (London), Oct. 24, 1999, at 2 (noting that 1989 restructuring was caused by clash of cultures and consultants' demand for more independence).

n34 *See* Natalie Evans, *For the Record*, CRAIN'S CHICAGO BUS., Nov. 29, 1999, at 66.

n35 *See* Melody Petersen, *Consultants at Andersen Take Action*, N.Y. TIMES, Dec. 18, 1997, at D2 (noting that Andersen Consulting contends that Arthur Andersen broke its 1989 agreement by "aggressively entering into Andersen Consulting's business").

n36 *See E & Y Sells Consulting Business to Cap Gemini*, MGMT. CONSULTANT INT'L, Mar. 13, 2000, at 1; Michael Peel, *Gravy Train's End of Line*, FIN. TIMES, Jan. 13, 2000, at 2.

n37 *See* Diana B. Henriques, *Auditing Firm Plans to Split Its Businesses*, N.Y. TIMES, Feb. 18, 2000, at C8; Piskora, *supra* note 6, at 28 (reporting that newspaper has learned that IBM is considering buying or aligning itself with PwC consulting business).