Auditing and Consulting: Is it a time to choose?

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Comments (Optional):
Auditing or Consulting:  
Is It Time To Choose?

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Honors Research Project
Questions and concerns regarding WorldCom Inc.'s restated financial reports surfaced due to the honesty, or lack there of, of the company's latest auditor, KPMG. The concerns stem from a controversial series of disputes between state taxing authorities and WorldCom, now doing business under the name MCI, over an aggressive KPMG tax-avoidance strategy that the company used to reduce its state-tax bills by hundreds of millions of dollars from 1998 to 2001. The strategy involved moving sales from high-tax states to low-tax states. WorldCom used the strategy and was later charged with tax evasion. Now a coalition of 14 states asked a U.S. judge on Wednesday to force KPMG to surrender $146 million in fees it received or applied for from bankrupt phone company MCI and to bar the accounting firm from continuing to audit the company's books, according to a court filing (NYSSCPA.org). This case, along with others, prompted concern as to whether or not auditors can be consultants without neglecting their independence. Before drawing a conclusion, one must understand the purpose and importance of an audit, the users of the audit, and the Generally Accepted Auditing Standards that auditors must follow in order to perform an appropriate audit.

As businesses increase in complexity, the need for reliable information and assurance services also increases. Accountants and auditors therefore play a vital role in providing financial statement information, assurance for such information, and consulting. Businesses and investors depend on them to provide reliable and accurate information in order to make sound decisions. Auditors specifically are often the driving force behind recommendations that improve profitability and operational controls.
Assurance services are independent professional services that improve the quality of information for decision makers (Arens). These services are valued because of the independence and lack of bias with respect to the information examined. One type of assurance service is an attestation service. Attestation involves a CPA firm issuing a report about the reliability of an assertion that is the responsibility of another party. An audit is a type of attestation service. An audit report expresses an opinion about whether the financial statements are in "material conformity" with Generally Accepted Accounting Principles (GAAP). When a client presents financial statement information, it make assertions about its financial condition and results of operations. An auditor's report on financial statements is used by external users to make business decisions because of the auditor's independence from the client and knowledge of financial statement reporting matters. The primary users of audit reports are investors; however managers in evaluating company's performance also use them. Other external users include suppliers of capital through debt and equity agreements. Debt and equity investors rely not only on the disclosures within the financial statements, but also on the actions of the audit committee and board of directors, which represent their interests (Gleim).

Due to the importance of audits and their relation to other attestation and assurance services, the process of auditing is closely examined. To conduct an audit, information must be in a verifiable form and standards must be followed. Auditing defined is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established
criteria (Arens). Therefore, once again, auditing should be done by a competent and independent person.

The first part of the definition is the accumulation of evidence. Evidence is any information used by the auditor to determine whether the information being audited is stated in accordance with the established criteria (Arens). This can be oral testimony from the person being audited, written communication with outsiders, observations by the auditor, and electronic data about transactions. The quality and volume of evidence is important in satisfying the purpose of the audit. Unlike accounting where the concern is recording, classifying, and summarizing financial information for decision making, the concern for auditors in determining whether recorded information properly reflects the economic events that occurred during the accounting period. Some financial statement users and members of society confuse the two mainly because most auditors are concerned with accounting information. However auditors must also know how to accumulate and interpret audit evidence. This involves determining the proper audit procedures, deciding the number and types of items to test, and evaluating the results.

The organization that promulgates generally accepted auditing standards (GAAS) is the American Institute of Certified Public Accountants (AICPA). The AICPA Conduct Rule 202, Compliance with Standards, requires adherence to standards circulated by bodies designated by the AICPA Council (AICPA.org). Therefore the Auditing Standards Board is the body designated to issue auditing pronouncements. They issue Statements on Auditing Standards (SAS), which are deemed to be GAAS. According to AU 150, Generally Accepted Auditing Standards, GAAS are concerned with the quality of the auditor's performance, including his/her professional qualities and exercise of
judgment in connection with audit engagements (Gleim). The ten standards include three general standards, three standards of field work, and four standards of reporting. These ten standards are binding for AICPA members and are considered standards by state boards of accountancy and courts. The standards are the following:

General Standards

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the planning and performance of the audit and the preparation of the report.

Standards of Field Work

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of internal control is to be obtained through to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting

1. The report shall state whether the financial statements are presented in accordance with generally accepted accounting principles.
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

3. Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking. The general standards will be the primary focus because the issue of whether or not to provide both consulting and auditing services, deals with whether or not these standards are being satisfied.

In deciding to undertake an audit engagement, the auditor will most likely consider the general standards. An auditor who cannot meet any one of these requirements should not accept the engagement (Gleim). Adequate technical training and proficiency is the first general standard. This requires the auditor to have formal education in auditing and accounting, adequate practical experience for the work being performed, and continuing professional education. AU 210, *Training and Proficiency of the Independent Auditor*, states that an individual just beginning an auditing career (junior assistant) must obtain professional experience with proper supervision and review by a more experienced auditor (Gleim). If the CPA or CPA's assistant are not qualified
to perform the work, he or she have a professional obligation to suggest someone else who is qualified to perform the work, or decline the engagement. Another general standard, which will be discussed in greater detail, is an independent mental attitude. The Code of Professional Conduct and SAS stress the need for independence. CPA firms are required to follow many practices to increase the likelihood of independence of all personnel. The final general standard is due professional care. This involves due care in the performance of all aspects of auditing. Auditors are professionals responsible for fulfilling their duties with great care. This includes quality of working papers, sufficient audit evidence, and the appropriateness of the audit report (Arens).

Although the company pays an auditor, they should continue to be sufficiently independent to conduct audits that can be relied upon by users. According to the AICPA in the Section 100 of the Code of Conduct, “independence is considered to be impaired if:

1. This needs a subject--Had or was committed to acquire any direct or material indirect financial interest in the client audited,

2. The auditor was a trustee of any trust or executor or administrator of any estate if such trust or estate had or was committed to acquire any direct or material indirect financial interest in the client,

3. The client had a joint closely held investment that was material to the auditor.

4. The CPA firm had any loan to or from the client, any officer or director of the client or any individual owning 10 percent or more of he client’s outstanding equity securities or other ownership interests.
5. A partner or professional employee of the firm or his or her immediate family, or any group of such persons acting together owned more than five percent of a client’s outstanding equity securities or other ownership interests.

During the period of the professional engagement, a firm, or partner or professional employee of the firm was simultaneously associated with the client as a(n):

1. Director, officer, or employee, or in any capacity equivalent to that of a member of management.
2. Promoter, underwriter, or voting trustee; or
3. Trustee for any pension or profit-sharing trust of the client (aicpa.org)

In a nutshell, independence implies that the auditor be impartial with respect to the client. Anything that might have an affect on the findings of an auditor who is not impartial for any of the above reasons will lack the credibility that makes them valuable to financial statement users.

The AICPA places tight details on the boundaries of independence in an effort to limit partiality; however they also concluded that providing consulting and attesting services for clients did not impair an ‘independent mental attitude.’ This has created lots of controversy within the profession. Critics argue that excessive involvement in consulting engagements with attest clients can impair auditor independence, which is a distinctive characteristic of the profession and a basic element of the accountant-client relationship. On several occasions during the past two decades, congressional legislators have raised questions about whether CPAs can remain independent when they perform auditing services for consulted clients. The Metcalf and Moss subcommittees in the late
1970s and the Dingell subcommittee in the mid-1980s conducted hearings on the issue, but found no instances where auditor independence had been impaired following the rendition of consulting services (dartmouth.edu). The accounting profession also initiated several inquiries into the impact of CPA consulting services on auditor independence. The Cohen Commission investigated the matter in 1978, by the Public Oversight Board (POB) of the AICPA’s SEC Practice Section (SECPs) in 1978, 1979 and 1986, by the Special Committee on Standards of Professional Conduct for CPAs (Anderson Committee) in 1986, and by the National Commission on Fraudulent Financial Reporting (Treadway Commission) in 1987. None of these studies found any instances where independence had been diminished as a result of performing consulting services. However, CPAs were urged to be aware that consulting for attest clients may be perceived by some as an impairment of auditor independence.

There is a wide range of opinion regarding the differentiation between auditing and consulting. Many contend that compliance reviews and risk assessment objectives are strongly associated with auditing, and that implementing policies and procedures are associated with consulting. A significant majority, however, believe that the identification of critical issues and recommendations to solve problems are a mix of auditing and consulting. The following are identified as unique traits about auditing and consulting (dartmouth.edu):

**CONSULTING ACTIVITIES** Are Future Oriented

1. Addresses Implementing Activities
2. Initiated by Line Manager
3. Primary Client is Line Manager
4. Involves Staff Outside the IA Department
5. Yields a Product Rather Than an Audit Report

**AUDITS**

1. Are Historical
2. Address Compliance Issues and Business Risks
3. Initiated by Audit Director
4. Primary Client is Audit Committee/Senior Manager
5. Conducted Exclusively by Members of IA Department
6. Leads to a Standard Audit Report

One of the concerns some critics' raise about CPA consulting services and their impact on the appearance of auditor independence relates to the magnitude of such services as measured by the fees received. If CPA consulting services are provided in extensive amounts to attest clients, critics argue that auditor independence might be jeopardized. However, in cases where CPAs supply their audit clients with minimal consulting services, such concerns are not raised.

The SECPS requires data on CPA firms' consulting services engagements. On average, consulting services contributed 17% of the firms' revenues while the proportion of fees derived from accounting and auditing and tax services was 59% and 24%, respectively, over a nine-year period. The proportion of revenues earned from rendering accounting and auditing, tax, and consulting services to SEC audit clients over this same period on the other hand was 79%, 14%, and 7%. Consequently, the percent that consulting services contributes to total
fees from public audit clients is less than half of the corresponding proportion from all clients (7% as compared to 17%). The data show that despite the public accounting profession's increased emphasis on supplying consulting services, the largest practice units are still very much auditing firms. In both the SEC audit client market and the all client market, accounting and auditing remains the core of the firms' businesses. Revenues from these services made up over twice the revenues from either of their other two service lines (tax and consulting).

However this report was done in the early 1990s before the Enron debacle. Since the Enron scandal (where there were misappropriations of income and false sales), the question government officials are asking concerns the potential for corporations to buy favorable financial reports from the auditing accounting industry they pay to consult. According to Donald Sutherland, a consultant on Environmental Management Systems, in December 1996, SEC Chairman Arthur Levitt warned the accounting industry against expanding consulting practice with the same companies they audit. Addressing the American Institute of Certified Public Accountants at a national conference in Washington, D.C., Levitt cited two private sector studies on the growing trend of conflict of interest in the accounting industry's consulting and auditing practice weakening quality of financial reporting to stakeholders (baselinemag.com).

In February 1997, three environmental groups (Friends of the Earth, Sierra Club, and Citizen Action) sent a letter to the SEC, demanding an investigation of the entertainment giant Viacom Inc. for failing to report an alleged $300 million in superfund clean up liabilities in their annual report to shareholders. Price Waterhouse LLP, auditor for Viacom's annual financial statements, issued a clean opinion for Viacom's financial
report to shareholders. Did Price Waterhouse LLP as consultant and auditor to Viacom Inc. do anything wrong and is there a conflict of interest (baselinemag.com)? The growth of consulting contracts is ruining quality financial reporting. By the late 90s, auditing assets were down to 42% of the total revenue for the Big Four (then Six) accounting firms. "It's not only the Big Six, the situation is rampant through the whole accounting profession," said David Costello, President of the National Association of State Boards of Accountancy (NASBA). "The fact is if you are doing an audit of a firm for a $300,000 fee and you have a consulting contract with the same firm for $1 million it's hard to see how you can maintain being independent with that audit," he says. Costello also comments that state boards are helpless in their efforts to combat the accounting industry in challenging cases of conflict of interest. "It's no secret the Big [Four], financially carry AICPA and the Financial Accounting Standards Board (FASB)" says Jay J. Church, Executive Director of the New Jersey State Board of Accountancy. "These organizations are being used by the Big [Four] to maneuver in state government bodies to replace the SEC's auditing authority," he says (baselinemag.com).

In 2000 SEC Chairman Arthur Levitt proposed significant changes to the auditor independence rules, which would have limited the consulting services an auditor could provide to a client. However there was a heavy amount of resistance from the profession, and in November 2000 the SEC amended the independence rules that required disclosures indicating the amounts of fees for audit work and the fees for consulting and tax work. The Sarbanes Oxley Act, grew out of the governments attempt to protect investor confidence by improving accuracy, reliability and timeliness of financial information, currently prohibits CPA firms from doing consulting for their audit clients. Although the AICPA allows firms to consult and audit, some companies—such as Apple, Borland Software, Freddie Mac and Walt Disney Co.—have announced they will no longer use their auditor as their technology consultant. Shareholders of at least 30 other companies, including Johnson & Johnson, Motorola and PG&E, have proposed that
similar measures be taken to separate the services, according to Institutional Shareholder Services (ISS), an analyst of proxy voting and corporate governance issues. "Some clients are saying that if (nonauditing) services provided by a consultant reach a certain dollar figure," the auditor should no longer be used, says Patrick McGurn, a vice president at ISS(baselinemag.com).

The Research Foundation of the Institute of Internal Auditors recently published a report titled Business Management Auditing: Promotion of Consulting Auditing. The purpose of this article is to review and summarize those portions of the report dealing with the impact of consulting activity on the independence of internal auditors. The study identified thirty-nine non-traditional services that are performed by internal auditors. For the majority of internal auditors, performing those non-traditional services is considered consulting activity that in most instances carries a relatively high risk of jeopardizing independence (dartmouth.org).

The risk to independence was perceived as greatest when the consulting activity involved accounting system implementation or design, or business/accounting related issues such as business planning, mergers, cash management, budgeting and inventories. The risk to independence was perceived to be least when the consulting activity involved non-accounting systems consulting, total quality management, pension cost review, evaluating external audit work, contract compliance, and reviewing performance of outside vendor services. Examples of other consulting assignments with varying degrees of perceived risk to independence include contingency planning, forecasts and projections, vulnerability assessments, environmental and regulatory compliance, employee performance and benefits programs, and due diligence assignments.
To consult and audit is possible, however because there has been a decrease in ethics and fraud from auditors, stricter rules should be placed on auditors in order to ensure external users that financial statements are being reported accurately and according to correct standards. Mark R. Simmons, CIA CFE in his article “Consulting Auditing's Impact on Auditor Independence” stated it best: "The greatest risk of violating the independence principle emerges not from activities widely recognized as consulting, but rather from those that are a mixture of consulting and auditing. The fuzzy boundaries between auditing and consulting offer opportunities for at least some observers to conclude that auditors, by performing non-traditional services without implementing appropriate safeguards, have violated the independence principle. The lack of clarity about what constitutes consulting rather than auditing increases the possibility those internal auditors may not be independent. This is especially true when consulting requires involvement in internal politics or conflict."


http://www.dartmouth.edu/~msimmons/internal-auditing/consult.htm

http://www.nyssecpa.org/cpajournal/old/13808659.htm

http://enfo.com/NAEP/MailLists/Arc/02/jan/0002.html

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