Auditory discomfort

Recent rulings in America have highlighted the conflicts of interest inherent in modern accountancy

WHO could refrain from sniggering at the delightful sight of PricewaterhouseCoopers (PwC), the world’s biggest and most cumbersomely named accounting practice, being knocked about by America’s Securities & Exchange Commission (SEC)? On January 6th the firm was found guilty of no fewer than 8,000 violations of SEC rules on the independence of auditors from their clients. In fact, in some respects, PwC may be justified in feeling hard done by. Some of the SEC’s recent sniping at accountants is rather unfair, and amounts to an unwelcome attempt to extend the SEC’s mandate beyond America. But there is no doubt the accountancy profession warrants a close look and—in some cases—a firm hand.

After all, auditors have missed some remarkable scams over the past few years. The bankruptcy of Bank of Credit and Commerce International springs to mind. So does the plundering by Britain’s Maxwell group of its employees’ pensions. One reason for blunders is that, for some firms, auditing seems to have been reduced to mindless box-ticking. As a business, it has become a loss-leader for selling much more lucrative advice, ranging from business-restructuring to legal services.

The PwC investigation, which was triggered by a censure of the firm’s Florida practice a year ago, found that almost 2,000 individuals, including around half of the firm’s 2,700 American partners, held shares in companies that it audited. With masterful understatement, a letter from “Nick and Jim”, the firm’s chairman and chief executive, told fellow partners that the findings “would be embarrassing”.

Few quibble with the SEC’s insistence that there should be strict rules safeguarding the independence of auditors. After all, the law requires almost all companies to be audited, and the accounting profession has a monopoly on the business. But the rules have to address two issues: individuals’ financial incentives, and those of the firm as a whole, of which the most important may be the non-audit services offered by auditors to their clients. The SEC has concentrated on enforcing arcane rules concerning individuals’ finances while failing, so far, to address the far more pressing “scope of service” issue.

In this, the SEC is, by no means for the first time, expanding its jurisdiction to little benefit. Its remit does not include the regulation of auditors. It has assumed that role through its oversight of listed companies and the accounting requirements that it imposes upon them. Moreover,
because so many non-American firms want to list their shares in the United States, and because their auditors are likely to be one of the global Big Five, foreign auditors find themselves under the SEC’s aegis too.

Its rules are wide-ranging, embracing not only shares but also pension plans, mutual funds and credit-card balances. That these restrict considerably the investments auditors in big practices can make is fair enough. It is less fair that the rules also preclude partners and managers from putting their money in “blind” trusts, where they would not know which companies they had invested in. It is not just staff, but spouses, dependants and even, on occasion, in-laws who might find their financial dealings under scrutiny. At KPMG, which won the audit of Prudential, Britain’s biggest life-insurer, from PwC last year, auditors have been forced by the SEC to dispose of Pru policies now that the insurer is seeking an American stockmarket listing. There is talk that this restriction might be extended to partners worldwide.

The two-year-old Independence Standards Board (ISB), which is supervised by the SEC, has been examining the whole body of regulations that has accrued since the 1933 Securities Act. It now fills a quarter-inch-thick rulebook and countless “letters”. The ISB is sensibly trying to establish a conceptual framework to define auditors’ independence as laid out in the 1933 act. It is not just accountants who hope it will resist the temptation to put too much flesh on the old law’s bones. The last thing America needs is more rules.

Of more importance is the work that the ISB is to do in examining the independence of auditors in “multi-disciplinary practices”. The independence of an audit is much more likely to be compromised in a firm hoping to sell high-price consulting or tax work than by an individual who holds a few thousand dollars’ worth of shares. Of course, if accountants are barred from selling other services to their audit clients, then the cost of audits may well go up. But companies should be happy that they are not having their arms twisted into buying other sorts of advice from their auditor’s colleagues. Auditors too would be freed from the insidious pressure of selling or reviewing colleagues’ work. And for shareholders, surely the price of truly independent audits is one worth paying?

LINKS

Click here to download in PDF format the full text of independent consultant’s report to the Securities and Exchange Commission on PricewaterhouseCoopers. The Independence Standards Board’s website is here.

Top of page