Money & Investing

SEC's Auditor Rules Could Pose A Dilemma for Big Client Firms

By MICHAEL SCHROEDER and JONATHAN WEIL
Staff Reporters of THE WALL STREET JOURNAL

WASHINGTON -- Many big companies that use their accounting firms for both auditing and consulting soon could face a tough choice: Either switch one of the jobs to a different firm, or keep the status quo by jumping through new regulatory hoops and disclosing fees for all the world to see.

Some industry executives and analysts predict that many public companies will opt to end existing consulting relationships with their auditors, rather than bother with the procedures established under new auditor-independence rules approved Wednesday, as expected, by the Securities and Exchange Commission. A major feature: stiff new public-disclosure provisions of consulting arrangements that pose potential conflicts of interest.

"For many companies, if not most companies, the conclusion has been reached that they are not going to buy consulting services from the same firm that performs their audits," said Michael Cook, retired chairman of Deloitte & Touche LLP. "The risks are so high if something goes wrong."

And the auditing firms themselves also may be reluctant to pursue consulting arrangements whose financial details would become publicly available, other analysts said. "When you shine the light on some of these relationships, it forces the consulting divisions to think long and hard about the price of disclosure," said Tom Rodenhauser, president of Consulting Information Services LLC, Keene, N.H.: "It's painful for these guys ... to disclose the amount of money that's spent on these systems. Normally that kind of information is never available unless there's a lawsuit."

The new measures are aimed at modernizing conflict-of-interest rules that have grown increasingly outdated amid a surge in consulting revenues at the Big Five accounting firms over the past few years. Specifically, the SEC issued a comprehensive list of nine nonaudit services that either can't be cross-sold to audit clients or, if sold, are subject to certain restrictions. Rather than ban information-technology consulting outright, for instance, the SEC said such consulting would have to be reviewed by each company's board committee for possible conflicts of interest. Fees would then have to be made public.

The rules, approved by a 4-to-0 vote, followed a fierce battle between the SEC and much of the accounting industry over the past five months. And if many companies eventually do end dual relationships with their auditing firms, it will mark a significant victory for the SEC. Earlier this year, the agency had sought an outright ban on information-technology and certain other consulting services by auditors, but backed off in order to win widespread industry support.

The new proposals do have at least the qualified support of big accounting firms, including Arthur
Andersen LLP, Deloitte & Touche, Ernst & Young LLP and PricewaterhouseCoopers LLP. But the
firms, which had threatened to challenge the SEC in court if they perceived the regulations went too far,
said they won't sign off until the final language is published.

An SEC spokesman said the agency is expected to complete fine-tuning of the rules within a week.
While some of the new rules will apply within a matter of a few months, the toughest restrictions on
accounting firms' providing consulting services to auditing clients won't kick in for 18 months,
according to Lynn Turner, the SEC's chief accountant.

Industry executives and analysts are split on the degree to which accounting firms will be financially
pinched by the changes, and, of course, any firm that loses business could well pick up other business
that has been lost by a rival.

An SEC official earlier this week said regulators estimate that about 10% of the Big Five firms' total
annual revenue comes from consulting work for audit clients. The accounting firms, all private
partnerships that don't publicly release detailed financial statements, don't confirm the SEC estimate and
decline to release their own tallies.

PricewaterhouseCoopers Chief Executive James Schiro said in an interview that it is too early to tell
what the new rules' impact will be. But he doesn't believe the new regulations will send clients rushing
for the exits or that public disclosures of potentially conflicting relationships alone likely will prompt
clients to cut back the business they give to firms that play dual audit-and-consulting roles.

"I don't think you drop a relationship just based on appearances," said Mr. Schiro, whose firm is
attempting to sell its consulting unit or take it public, among other options that would separate it from
the parent firm. On Monday, Hewlett-Packard Co. announced it had ended talks to buy the consulting
unit.

Lou Salvatore, interim global managing partner at Arthur Andersen, also isn't willing to concede that
audit clients will cancel consulting arrangements in large numbers. "We have had dialogue with
corporate clients, and I don't have any sense business will be lost," he said. "I don't think it will have a
dramatic effect on our clients."

Restrictions will apply also to work on financial statements prepared internally for management and
board use. For instance, an accounting firm's consulting affiliates won't be able to provide more than
40% of an audit client's internal-auditing services. Companies with assets of less than $200 million will
be exempt from this restriction. Meanwhile, the new rules reinforce existing prohibitions against
auditors' providing such things as broker-dealer and legal services.

Under the new rules, accounting firms can offer information-technology consulting services to auditing
clients provided that the new disclosure requirements, as well as some other provisions, are met. For
instance, public companies would have to disclose in annual financial filings with the SEC the total fees
for auditing, consulting and other services provided by their outside auditors. Company audit committees
also would have to state that they have considered whether any conflicts of interest exist with their
auditors.

The audit clients themselves are taking a wait-and-see approach. "We have not seen the final wording, so
it's just not prudent to speculate," said Christine Castro, a spokeswoman for Walt Disney Co. In its
proxy this year, Disney disclosed that it has tapped its independent auditor, PricewaterhouseCoopers, to
provide a variety of consulting services on various tax, information-services and business-process matters. "But obviously if the SEC requires changes, we will comply." Ms. Castro declined to disclose the fees paid by Disney to PricewaterhouseCoopers.

Some audit-committee members reacted warily to at least some of the new rules. Vincent O'Reilly, a senior lecturer at Boston College's Carroll Graduate School of Management who serves on the board of several companies listed on the New York Stock Exchange, said: "To have absolute rules doesn't make any sense. I think the SEC has championed two very important initiatives. One, in the establishment of the independence standard, and second, the strengthening of audit committees."

But, he added, "I am not in favor of disclosure" of fees paid to the accounting firms, because it could prompt some companies to ditch top-notch consultants just to avoid appearances of potential conflicts that truly may not exist. And that, he said, could hurt companies, if they end up going with an inferior choice. Companies could go with a less-qualified vendor "just to avoid the disclosure," he fretted.

Another concern of audit-committee members, in weighing whether an auditor has a conflict, is that they could face heightened legal liability if an audit ultimately fails to detect accounting problems.

-- Cassell Bryan-Low contributed to this article.

Write to Michael Schroeder at michael.schroeder@wsj.com and Jonathan Weil at jonathan.weil@wsj.com

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