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Comment: The Multi-Disciplinary Practice of Certified Public Accountants and Lawyers

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COMMENT: THE MULTI-DISCIPLINARY PRACTICE OF CERTIFIED PUBLIC ACCOUNTANTS AND LAWYERS

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INTRODUCTION

I want to thank the organizers of the Ault Symposium on Professional Responsibility and Multi-Disciplinary Practice ("MDP") for this opportunity to express my opinion on the matter of the multi-disciplinary practice of certified public accounting and law. I am aware that most of the conference participants and subsequent readers will be lawyers; however, I write from the perspective of an accountant. My views have developed over the last twenty years as an academic researcher and accounting administrator at several large state universities. During that period, I held several named professorship positions supported by large public accounting firms. More recently, I spent a year as the Academic Accounting Fellow in the Office of the Chief Accountant at the United States Securities and Exchange Commission ("SEC"). The views expressed here are mine alone. I am confident that many of my academic and professional colleagues will not agree with my reasoning or conclusions and, of course, the SEC takes no responsibility for the statements of current staff or past academic accounting fellows. The following is not an academic research paper; rather, it is a statement of opinion.

My recent experience at the SEC provided new perspectives on the critical issues raised by multi-service/multi-disciplinary practices in public accounting. While my activities at the SEC were diverse, two are of particular importance to my perspective on this issue. First, I developed a series of reports based on extant academic accounting research, including such topics as public accounting service fees and the distribution of fees across the services; corporate governance practices, particularly the authority and responsibility of audit committees of the board of directors; and the nature of decision-maker bias and its potential impact on auditor decisions. Second, over half of

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my time was spent on the development of the recently adopted revised independence rules applicable to independent accountants practices before the SEC.[1] The SEC independent accountant rules apply only to those accountants who provide independent opinions on annual audited financial statements and quarterly reviews of companies filing with the SEC and trading on U.S. financial markets. The issue of multi-disciplinary practices was not a specific focus of my work at the SEC. Nevertheless, the issue clearly bears directly on the auditor independence.

I. THE "BUSINESS" OF PUBLIC ACCOUNTING

The certified public accounting profession occupies a unique place in the financial markets. We, as a profession, hold a franchise, a monopoly, on the annual audit and quarterly review of financial statements filed with the SEC. It has been noted by others that the auditor is the person that a company must hire if the company is to file financial statements with the SEC and trade on U.S. financial markets. The franchise was created by the 1933 and 1934 Securities Acts when Congress decided not to create a federal audit agency for the purpose of auditing private company annual financial reports. It is not too much of an oversimplification to say that these acts and their subsequent revisions form the basis of what can be called the professional services of the public accounting profession.

When Congress decided that the audit function would remain in the private sector, they also decided that the audited company would pay for the cost of the audit, resulting in a unique contracting arrangement. The auditor contracts with management to perform an independent audit, i.e., an audit independent of management. According to Congress and the courts the auditor's client is not management, but rather the shareholders, the investing public, and certain other users of the resulting audited financial statements. This contract fee payment arrangement continues as both a theoretic and practical stress point for auditors in maintaining their independence of management and satisfying the public trust. This fact favors exercising great care when considering other services that might add to the stress already placed on auditor independence.

Over time, the public accounting firms developed a limited number of other services offered to management. Prior to the 1970s and 1980s, most of these services were generally accepted as closely re-

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[1] Revision of the Commission's Auditor Independence Requirements, Securities Act, Release No. 33-7919, 65 Fed. Reg. 76,008 (Dec. 5, 2000) (to be codified at 17 C.F.R. pt. 210, 240), *available at* http://www.sec.gov.

lated to accounting functions and the independent accountants' unique expertise. Yet, even as these services developed, concerns were raised about the threat to auditor independence when rendering an opinion on annual and quarterly financial statements. By the early 1980s, the breadth of non-audit client/management services had increased to the point that I began to refer to the "business" of public accounting rather than the "profession." My intent was to create a broader definition of public accounting that allowed for distinguishing the rapidly expanding non-audit activities from the auditing franchise. Initially, public accountants did not appreciate the distinction and it was not well received. However, not too long thereafter, the large public accounting firms began to refer to themselves using similar terminology. The most extreme version characterized the large firms as "client service entities that happen to include an independent audit product line." Whatever the characterization, everyone agreed that the business model was changing in significant ways.

We need to keep in mind that the independent public accounting franchise includes only the audit of annual financial statements and the review of quarterly financial statements for those companies filing with the SEC and trading on U.S. financial markets. The SEC's mandate runs only to the generally accepted accounting practices and principles required for financial statement filings and the generally accepted auditing standards for the independent audit and review services. No similar monopoly power exists for the independent accounting firm with respect to the myriad of other services offered to management by these same firms.

II. CROSS-SELLING

How is it that the independent accounting firms have become the largest client-service businesses in the world? The answer is perhaps obvious, but, because of our unique monopoly position, worth making explicit. The independent accountant is invited in by management as a matter of law to provide audit and review services. The resulting special relationship and knowledge garnered by this work gives the independent accountant another unique opportunity, the opportunity to cross-sell services. Any other service provider must break into the special relationship before they can obtain the firm specific knowledge that comes to the independent accountant almost as a matter of course. This has proven to be a substantial advantage for both the independent accountant and management, leading to the one-stop-shopping concept of client service and a phenomenal expansion of the types of services offered management by independent public accounting firms. Where the more traditional auditing and accounting services previously accounted for fifty to seventy-five percent of the fees earned by independent accounting firms, today the fee relationship is nearly reversed and for some clients non-audit fees exceed audit fees by multiples of three to thirty times. Why is this important?

III. COMPETENCE, OBJECTIVITY, AND INDEPENDENCE

The 1933 and 1934 Securities Acts, as interpreted by the SEC and courts, require that the auditor be competent and independent, in fact and appearance, of company management. Competence and independence are the two essential ingredients in capturing and retaining the public trust. Lacking independence and the appearance of independence essentially destroys the economic utility of the auditor's opinion. Professional and regulatory independence rules are intended only to protect auditor objectivity by allowing them to maintain their independence in fact and appearance. Some have tried to focus on objectivity as the key value factor and suggest that independence is a lesser condition. The difference in terminology is not one of practical significance, and can be misleading. The ongoing debate about how and who will decide whether the auditor can reasonably be assumed to be independent in fact and also appear to be independent is the key issue. This was fundamentally the debate between the profession and the SEC during the recent revised independence rule debate. The SEC was not satisfied that the new business model, as it relates to the firms' audit clients, protected auditor independence, and thus they were not convinced that the new business model served the investing public.

Are the attributes of competence and independence needed when offering one-stop-shopping client services beyond the audit and review services? Unlike the audit, consulting services come with no legal third party responsibility. The contract is clearly between the consulting firm and management. Management may expect an objective assessment, but not one independent of management's needs and preferences. The firm is there to do a job for management. Issues of competence, objectivity, and independence are subjects of reputation and negotiation, not SEC rulings.

However, the SEC must step in when the non-audit services threaten the public trust by undermining the real or perceived reliability of the audit opinion on the financial statements. Even when the SEC does intervene, the resulting independence rules apply only to the independent public accountant's relationships with audit clients. With respect to non-audit clients, independent public accounting firms have the freedom to offer whatever services the market will buy.

IV. SEC INDEPENDENCE GUIDELINES FOR AUDITORS

The SEC considers four basic issues when judging whether the certified public accountant qualifies as an independent accountant for audit and review purposes. The Commission considers "whether a relationship or the provision of a service: (a) creates a mutual or conflicting interest between the accountant and the audit client; (b) places the accountant in the position of auditing his or her own work; (c) results in the accountant acting as management or an employee of the audit client; or (d) places the accountant in a position of being an advocate for the audit client."[2] Each concept describes a type of threat to auditor independence. The existence of any threat heightens the risk that an auditor may lose his independence in fact or appearance and suffer the loss of public trust and the value of his services.

The SEC considered banning management outsourcing of internal auditing and information technology consulting services related to the financial accounting systems for SEC audit clients. There was and is concern that the subsequent audit of financial statements places the auditor in the position of auditing their own internal audit and systems work. Both the profession and the SEC recognized that threats exist as the number and type of services expand for audit clients. The debate was and is one about how to protect against particular threats and whether some threats reach the level where objectivity in fact or appearance is so threatened as to warrant outright prohibitions of certain services and/or relationships between audit clients and public accounting firms. Some combination of threats, safeguards, and prohibitions form the basis of the ongoing professional debate.

The SEC's mandate gives them the responsibility and power to decide on the mix of safeguards and prohibitions necessary to assure continuing auditor independence. The SEC is also empowered to enforce its will. However, the SEC does not have the resources necessary to exercise effective direct enforcement. Historically, the profession has worked with the SEC and its professional associations to create a largely self-regulatory regime. The SEC recognizes that it must rely on the profession to implement any standard whether set by the SEC, a professional organization, an individual firm, or an independent, possibly even statutory, oversight group.

Both the practicing professionals and the SEC staff seek to protect the credibility of the financial reports and financial markets. The SEC has the more easily specified objective: protect investor interests. The SEC's concern with a public accounting firm or audited company's profitability is secondary to the reliability of its financial

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[2] *Id.*

reports. The independent accounting firm is concerned with protecting the public interest while expanding its services and profitability. The need to balance a focus on growth and profits with the unusual nature of the fee payment arrangement contributes to a concern about the increased risk of lost independence.

V. INDEPENDENCE RULE-MAKING

All parties to the independence rule-making effort were hard pressed to find definitive research results to support their positions. Those supporting the profession's objections to the new rules attribute this to the fact that "there is no independence problem." They claim that there is no evidence that independence has ever been lost because of the non-audit service relationships described in the proposed independence rule. There is a certain convenience to the "lack of evidence" argument. The data is generally not available, in part due to confidentiality issues and also because only the firms have much of the data and they would not produce it even upon direct request. Those supporting regulatory action point out that accepting the "no evidence" argument effectively blocks regulatory action whenever those regulated are the necessary source of evidence. Waiting until definitive evidence of failure is made evident to the public does not satisfy the SEC's mandate to protect the public.

In the end, the revised rules resolved none of the issues to anyone's satisfaction. The changes did little to limit non-audit services while relaxing the rules related to firm and firm personnel financial and investment relationships with audit clients. A potentially significant disclosure requirement was imposed on SEC filing companies. The audited companies must now separately disclose fees paid to their external auditor for audit and review services, information technology services related to financial reporting systems, and all other fees.[3] The disclosures were required annually beginning with first proxy filings after February 5, 2001. The proxy filings beginning after February 5, 2001 did disclose that audit and review fees were, on average, a smaller contributor to the total fees earned by the firms than previously had been thought and that some non-audit fee relationships are significant multiples of the audit fee.

The audit fee recurs annually over reasonably long periods of time, while the consulting fees are periodic in nature; thus, the mere size of a consulting fee is not in itself a threat to independence. Assuming the continued fee transparency required under the revised SEC rules is retained, we will see whether non-audit fees are actually

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[3] *Id.*

as periodic for audit clients as has been suggested. As evidence builds, we may also find a relationship between audit longevity and the size of non-audit fees. In any case, the issue remains open, but data is now forthcoming only because of the SEC's revised independence rules.

Some assert that the investing public is better off due to the synergies produced by non-audit services, synergies that result in better management performance and the auditor's ability to perform a better "independent" audit. The synergies argument is neither supported nor definitively contradicted by hard evidence. However, the argument appears to be internally inconsistent when the profession defends its ability to maintain auditor independence by building "walls" between the competing functions. If the walls effectively protect auditor independence, they would seem likely to destroy the potential for meaningful synergies.

VI. INDEPENDENT ACCOUNTANTS, LAWYERS, AND MULTI-DISCIPLINARY PRACTICES

Now, to the matter at hand: "Should independent accountants and lawyers be allowed to offer their services to audit clients in a single practice organization?" Individuals with law degrees currently work in a public accounting firm, but do not practice as lawyers and as a result, are neither subject to the rules of the legal profession nor able to claim the attorney/client privilege on behalf of their clients. Similarly, individuals with CPA certificates who work in a law firm cannot offer audit and review services for SEC clients. Also, note that strictly speaking, the SEC has nothing to say about offering legal services to non-audit clients. It has been pointed out that there is no existing rule that explicitly prohibits the joint practice of accounting and law for SEC audit clients. The very fact that this was pointed out suggests that practitioners take the view that "if there is no rule, we can do it." This mentality is not encouraging if we are to rely on these same practitioners to regulate themselves. Nevertheless, the observation is technically correct. However, there are numerous letters and memos from the SEC making it clear that offering legal services to audit clients will be considered a conflict of interest of sufficient magnitude as to preclude the appearance of independence in performing a financial statement audit or review. In sum, the SEC currently prohibits offering legal services in an MDP when it comes to SEC audit clients.

Others at this conference have done an excellent job of pointing out the unique character and differences in the codes of conduct of lawyers and accountants. First, and most obvious, lawyers are not expected to be independent of their client. They are, in fact, expected to be their client's best advocate. Second, the legally recognized client confidentiality in a lawyer/client relationship simply does not exist between the accounting and client management. Third, the lawyers' regulatory oversight is court-based and thus has legal "teeth," a distinct difference from the accounting profession with its heavy emphasis on self-regulation and minimal enforcement capacity.

It has been argued that SEC audit clients receiving legal advice from their public accountant could waive their client/lawyer privilege and that the lawyer would be required to accept this arrangement. This sounds easy, but runs against a long history of professional commitment in the legal profession. Alternatively, can a firm build a wall sufficiently high to "protect" the auditor from the lawyer services? But then what happens to synergies? And what will happen when a lawyer becomes aware of a problem that could have a material impact on the financial statements? Coupled with the already strong client/management service orientation of the existing public accounting firms and the perceived threat to independence these relationships already create, do we want to add lawyers to the mix?

I believe we should not permit multi-disciplinary practices that result in an accounting firm or a law firm offering audit and legal services to the same clients. I do not have confidence in either the ability or desirability of the walls as a threat reduction mechanism in this case. Nor do I believe that without walls the threat to independence can be overcome by a simple agreement to have the client forgo that traditionally important benefit of client/lawyer confidentiality. I believe this position to be consistent with the limited evidence available with respect to auditor independence and recommend that we err on the side of caution and ban legal/accounting MDPs.