Independence Impaired: An Analysis of Proposed Changes in Assurance Services and the Future Impact on the Accounting Profession

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Capstone Approval Page

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Abstract

This paper analyzes the auditor independence issues debated during the Accounting Wars, and their applicability to present and future impacts stemming from the Enron fallout. This study documents SEC proposed independence changes and the resulting conflicts between Big Five accounting firms and the SEC. Past and current proposals are examined separately. Relationships or similarities are noted. Based on the progression of past and present proposals and mandates, a determination of future changes is made.

A strong relationship exists between the past and present proposals which indicates substantial changes within financial reporting, the elimination of consulting services, and the creation of new oversight boards. The cause and effect of each proposed change is discussed. From this analysis, accounting firms with SEC registrant clients can generate a realistic picture of the future of accounting.
Independence Impaired: An Analysis of Proposed Changes in Assurance Services and the Future Impact on the Accounting Profession

The late 1990’s saw a heated debate between the Securities and Exchange Commission and Certified Public Accountants referred to as the Accounting Wars. Led by Chairman Arthur Levitt, the SEC expressed concerns over a variety of issues said to impair independence. After a highly publicized feud, each side made concessions. The result was the SEC’s adoption of revised independence rules and the contraction of several consulting services.

The Enron debacle has once again thrust accounting issues into the spotlight. The press coverage and public interest associated with the fallout has been unprecedented. Accountants are expecting sweeping changes, but unlike the Accounting Wars, the profession cannot defend itself. The Enron audit failure destroyed accountants’ credibility.

Enron has brought about a seemingly endless list of proposals and suggestions for changes to the accounting profession. Thus, speculating on every change is beyond the scope of this paper. However, by examining the proposed and enacted changes of the past, it is possible to anticipate changes in the future.

**Background**

In the early eighties, consulting practices began to grow, but the impact on the overall earnings was not substantial. Nevertheless, Congress looked at the consulting services for audit clients and found no improprieties. This was the second time audit-consulting relationships had been examined. A decade earlier, Congress performed a similar evaluation and reached the same conclusions. That was before consulting became a boom market (James).

As consulting practices grew, so too did the percent of revenues generated. Consulting fees were soaring, but growth within audit engagements had leveled off. The SEC noticed the trend, but the consulting fees were minor in relation to audit revenues. Consulting fees rose to 20% of audit fees, then 25%, and then 30%. After a string of audit failures, the SEC reexamined the relationship between audit and consulting engagements. This time the SEC concluded that these relationships impaired the auditor's objectivity and independence.

These revenues were substantial and the accounting profession was not about to let the SEC abolish management advisory services. The profession rallied together in opposition of the SEC’s changes. Led by the Big Five accounting firms and the AICPA, the profession represented a formidable force.
The argument escalated to the point where the battle became front-page headlines. Former SEC Chairman Arthur Levitt was often quoted accusing accountants of violating independence issues. These comments were met with a response from former AICPA Chairman Bob Elliot or a Big Five CEO. As the debate grew more intense and became more public, the press dubbed the fight the Accounting (or Independence) Wars. The war turned into mudslinging and both sides seemed to lose perspective over what was at stake.

SEC Viewpoint

The cause of Levitt’s crusade was a string of audit failures over a seven year period which cost investors over $88 billion. Levitt and members of the SEC attributed these failures to conflicts of interest over audit and consulting work. Consulting fees represented 51% of Big Five revenues and had grown three times faster than basic audit services (McNamee 157). Levitt believed that this growth had corrupted the accounting profession.

The SEC’s point of contention was that the fees of consulting engagements were so substantial that the auditor’s judgement would be impaired. The auditor would be unwilling to confront management over audit deficiencies in fear of losing the client. A host of related accusations followed. For example, the auditor would lose money on the audit engagement, to allow for the consulting services to get their “foot in the door”. Consulting would generate enough revenues to compensate for the losses.

Accountants argued that there was no relationship between audit failures and consulting fees. The SEC insisted that regardless of whether an audit failure resulted from consulting relationships, the appearance of independence was impaired. The reliability of the audited financial statements depends upon the perception of independence and objectivity. If the investing public does not feel the auditor is independent of management, the system fails.

Studies were done to determine public perceptions of the audit-consulting relationship. “Users perceive the benefits of these positive synergies [auditing and consulting] to exceed negative effects on independence as long as the consulting fees are not material to an individual office. ...Some evidence suggests that users believe large amounts of consulting services impair auditor independence” (Maines). Levitt argued that many of these audit-consulting relationships had substantial fees that were extremely material.

“We'll do 57 percent growth year over year in the consulting business unit,” says Rick Romar, CFO of KPMG’s consulting practice. “And we're now at about 40 percent of the firm’s entire revenue.” Figures like these emphasize the importance of the consulting business to the accounting firms. The SEC continued its argument by alleging that the Big Five was dependent upon these revenues and auditing had taken a back seat to other services. In some firms,
consulting represented over half of the total revenues, whereas audits accounted for 30% (Hughes). Put another way, the accounting firms no longer appeared to be an objective third party.

Accountants Viewpoint

The reason Levitt sought to eliminate consulting work was the same reason the Big Five insisted on keeping it. Consulting revenues were so substantial that the profession would fight until the last breath to ensure its survival. Accountants argued that eliminating these services would not only reduce revenues, but also inhibit the growth of the industry.

Three of the Big Five firms teamed up with the AICPA to combat the SEC demand for changes within the profession. The remaining two of the Big Five -- Pricewaterhousecoopers and Ernst & Young -- sold their consulting arms. Although their actions supported the SEC proposal to eliminate consulting, they had an alternative motive. The idea was that contracting the current consulting divisions would curb the SEC's desire to eliminate all consulting services, and allow the firms to rebuild those practices. It was also supposed to have the effect of easing SEC concerns over the growth of these services.

Accountants believed that not only was the elimination of consulting services unfair, but that the profession had become the SEC's scapegoat. "... (The SEC) is using a sledgehammer when it ought to use a scalpel" (McNamee). Accountants pointed to the shifting positions the SEC took over consulting issues. The focus changed from all consulting services, to specific aspects like IT or actuarial services.

Key figures like former AICPA Chairman Bob Elliot adamantly denied the SEC allegations of consulting fees impairing the auditors' objectivity. According to Elliot, "the SEC cannot point to one case where an auditor's independence has been compromised by consulting work, which has led to fraud." Despite all the speeches, studies, and committees, the SEC could not prove consulting had compromised an audit. This fact, more than any other, swayed enough public opinion to save certain aspects of consulting.
Elements of the Accounting Wars

The SEC-proposed changes brought a firestorm of accusations and criticism from the accounting profession. These are the elements that fueled the debate.

Principles of Independence

One way the SEC decided to address independence conflicts was to redefine the principles. Although these changes had implications to the ongoing accounting debate, many of the principles had become outdated. The SEC designed the principles to address independence issues, as well as, mitigate future problems.

“...four governing principles state that independence is impaired when an auditor: (1) has a mutual or conflicting interest with the audit client; (2) audits the auditor’s own work; (3) functions as management or an employee of the audit client; or (4) acts as an advocate for the audit client” (Maines).

The debate over ‘independence in-fact’ versus ‘independence in-appearance’ dealt directly with these issues. Auditors insisted that consulting activities never brought about violations of these principles. The SEC asserted that there was an appearance that the rules were not followed. Each of these four principles became an element of the Accounting Wars, but the second and third principles were the core of the debate.

“...Proposed Rule sets forth a general standard for the test of auditor independence, specifically that the SEC ‘will not recognize as independent an accountant who, with respect to an audit client, is not, or would not be perceived by reasonable investors to be, capable of exercising objective and impartial judgment on all issues encompassed within the auditor’s engagement’” (www.sec.gov).

The SEC’s proposed rule attempts to end the debate whether or not the auditors are independent based solely on their actions. The rule indicates that if the perception of independence has been obscured, the auditor cannot be considered independent.

Financial Relationships with Audit Clients

The SEC expressed concern over auditor independence for those firms in which the audit team had a financial stake in the client it was auditing. However, unlike many of the other proposed changes, the Committee expands this practice. Audit firm personnel that are not involved with a particular engagement, are permitted to have various investments. The types of investments include loans, checking and savings accounts, and insurance products.
All staff or management with the ability to influence the audit cannot have any direct or material indirect financial interest in that client or subsidiary. This limits the investment opportunities for auditors, especially for partners with numerous SEC clients. In 1999, PricewaterhouseCoopers (PwC) admitted to widespread independence violations stemming from financial relationships. “Almost half of the reported violations involved direct investments by the professional in securities, mutual funds, bank accounts, or insurance products associated with a client” (CPA Journal).

The 8,000 independence violations became a media spectacle and diminished the firm’s reputation. The PwC disaster demonstrated the effects of noncompliance with SEC independence rules. As a result, firms actively eliminated these conflicts.

**Employment Relationship Conflicts**

Like investment conflicts, family relationships with employees of the auditee can affect independence and integrity. An auditor reviewing the work of immediate family members may not be as diligent as they would be to an unrelated party. Whether or not the auditor's performance is exemplary, the appearance is that the auditor’s judgement has been impaired. The SEC imposed new rules to combat these issues.

These new rules ban relationships\(^1\) with family members who have significant influence on the audit. While the standard does not specify the extent to which the influence becomes significant, the rule generally applies to management or highly sensitive positions. Examples of sensitive positions would include internal auditors, purchasing agents, cashiers, etc.

**Non-Audit Services for Audit Clients**

**Disclosure of Non-Audit Fees**

The SEC believed so strongly that non-audit activities impaired independence that firms providing audit and non-audit services should be forced to disclose non-audit fees. The idea was that as non-audit fees increase, independence decreases. Having this information would allow the SEC to determine the extent of the non-audit work.

The SEC wanted disclosure to examine both types of fees and determine the rate at which non-audit fees were increasing in relation to audit fees. The percentage of non-audit fees to audit and

\(^{1}\) The SEC refers to relationships as any immediate family member, such as spouse, dependents, and others. ‘Others’ refers to non-dependent close relatives who have a material interest, significant influence, or position involving sensitive activities.
total fees could indicate which relationships present the greatest independence risks. Additionally, the SEC could determine the relationship between audit and consulting in subsequent audit failures. This information would be useful in addressing unexamined independence concerns.

Implementing this proposal would require companies to disclose non-audit fees paid to their auditors. The SEC advocated that the board of directors and the audit committee detail the controls that ensure audit quality. These controls needed to include measures to segregate audit and consulting activities. The profession felt that the audit committee should be the determinant as to auditor independence, and not the SEC.

Information Technology Consulting

Perhaps the most hotly debated of the proposals was the elimination of information technology consulting. This can be attributed to the characteristics of IT services. First, IT consulting was one of the most lucrative consulting engagements. Second, IT directly impacted audited systems by designing systems controls. Finally, IT consultants were responsible for training the company’s employees and acted as management until employees had sufficient skills to maintain the systems.

Today’s economy requires companies to immerse themselves in electronic data interchange (EDI), management information systems, and Internet sites. Accountants insisted that it would be impossible to adequately conduct an audit without experienced computer professionals (McNamee 158). The best way to obtain an understanding of an information system was to work on it. The Big Five asserted that IT employees were auditing tools, as much as they were consultants.

The SEC was not about to waiver on this issue. First, the SEC pointed to the principle prohibiting auditors from reviewing their own work. Auditors trace documents and information through the systems created by the firm’s IT employees. The SEC once again utilized the “appearance” argument. With engagements as large and costly as IT projects, it appeared that the audit firm was functioning as management. IT engagements could last several years and, during this time, the consultants would be responsible for running the company’s systems.

Internal Audit Outsourcing

“The practice of outsourcing the internal audit function to the external audit firm has raised fears by many parties, such as the SEC, of possible independence impairment. The fear stems from the increased economic bond that exists when additional services are provided to an audit client,
as well as, the long-held view that internal auditing is a management function and, as such, is incompatible with the external audit function" (Swanger, et al.).

Internal audit outsourcing was of concern for the SEC during the Accounting Wars. IA outsourcing mirrors the independence conflicts of Information Technology Consulting. Auditors rely on the work of the internal audit department. Should internal audit be outsourced, the external auditor would be reviewing its own work.

Like IT consulting, internal auditing services violate much of the auditor's independence criteria. The internal audit department acts as an agent for management by examining risks and internal controls of the business. While internal auditors strive to be objective, they are employed by management to complete audits and special projects. At the end of their work, internal auditors make recommendations designed to add value to that business.

Internal audit departments are an internal oversight control of the company. By outsourcing this function, no separation exists between the internal and external auditor. The unification of these services eliminates the company's ability to assess risk and internal controls and places these tasks entirely with the audit firm.

Accountants countered SEC arguments with their standard rhetoric -- no audit failure ever resulted from a relationship with consulting. The profession utilized another approach by saying that performing internal audit work would give the external auditors a more in-depth view of the company. This would result in more effective and efficient audits through better allocation of time and resources.

**Legal Services**

Acting as both auditor and advocate has never been an accepted practice in the US. Many European countries allow multidisciplinary practices (MDPs), and the Big Five has pushed for the US to sanction these practices. With SEC concerns over independence and strong opposition from the American Bar Association (ABA), MDPs never stood a chance.

The Big Five has a great deal to gain had those laws been enacted. It was said that Arthur Andersen was the largest law firm in the United States. Accountants argued that direct access to the sensitive data they were privy to, put them in the best position to address legal issues. Advocates made sure to include that barring MDPs constrained the profession to solely auditing.

The SEC and ABA had a relatively easy time of refuting legal service advocates. First, acting as an advocate of a client eliminates independence. The client would pay the audit firm for
enhancing its legal position and acting in the best interests of the client. This does not meet the objectivity criteria.

The other contention is that auditors have no confidentiality relationships with the clients. Auditors do not have the freedom to divulge information at will; yet, there are situations where disclosure is required. In these instances, a conflict of interest is created. On one hand the auditor must disclose information, and on the other, the lawyer is prohibited from doing so.

*Other Management Advisory Functions*

The SEC had trouble convincing the profession, Congress, and the American public that eliminating certain management advisory services was essential. Simply defining consulting proved difficult enough. While debate continued over which services were considered consulting activities, the SEC was positive which services impaired independence -- IT, internal audit, and legal.

The public questioned why one consulting activity was targeted, while others were not. Realizing the flaw within the argument, the SEC took several steps to address these other consulting services. More conservative SEC proponents encouraged complete elimination of all audit-consulting relationships. The SEC took the approach that contraction of the consulting services (mentioned above) presented the greatest opportunity to eliminate independence impairments.

SEC concerned itself with the issues of financial and relationship conflicts and consulting issues. Special project consulting and various other financial services never reached the forefront of the debate, thus never became an issue.

*Creation of the Independent Standards Board (ISB)*

The Public Oversight Board was created in the late 1970s, when Congress held hearings on a number of audit failures that had shaken confidence in the major auditing firms. The primary responsibility of the POB was to investigate alleged audit failures and oversee peer reviews. ²

While the POB addressed many of the concerns of the time, it was crippled by severe limitations. First, the Board had no enforcement power. The Board was seen only as an intermediary to the SEC and not a force that could directly impact the profession. Next, the Board received a great

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² Peer reviews are a triennial review process in which the major accounting firms examine one another's quality control procedures.
deal of its funding from the Big Eight (now Big Five). As these firms contributed substantial amounts, many wondered who was controlling the POB.

With mounting independence concerns over the POB, the SEC was forced to search for alternative oversight processes. New ideas about regulatory committees were examined, such as government or outside funding and changes to membership criteria. Although these concerns existed, the government remained confident in the profession's ability to regulate itself and decided to defer POB issues to another time.

**Results of Accounting Wars**

The Accounting Wars were a draw. The press reported that the accounting profession had weathered the storm and saved many consulting activities. Pressures from accountants, lobbyists, and government officials, as well as, changing political tides forced the SEC to withdraw some of its demands. From the SEC's point of view, it accomplished most of what it set out to do and let the profession and public know independence violations would not be tolerated.

The SEC eliminated the family relation conflicts of interest and was surprisingly liberal on changes to financial relationships. The commission required disclosure of non-audit fees and dismissed any future for multidisciplinary practices in the United States. Although these issues are substantial, they were not the Big Five's greatest concern.

The biggest blow came from the SEC's demands for the elimination of IT consulting to audit clients. Deloitte & Touche has recently initiated similar actions of PwC and E&Y by eliminating its consulting practice. KPMG took its consulting division public. Although unrelated to the SEC demands, Andersen was already in the process of losing its consulting services. However, Andersen felt the impact of the ban, as it had promised to rebuild its consulting practice.

The SEC successfully eliminated a number of other consulting activities including the following:

- Bookkeeping services
- Appraisal services
- Actuarial services
- Management functions
- Legal services

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3 Consolidation within the accounting profession has decreased the number of large firms to five, known as the Big Five.

4 The Andersen Worldwide consulting group was known as Andersen Consulting, which was renamed to Accenture.
Somehow several other outsourcing functions and consulting activities were reprieved. Although the similarities between IT consulting and internal audit outsourcing were apparent, the SEC elected to retain internal audit outsourcing on a restricted basis. "Under the final rule, an auditor's independence is impaired by performing more than forty percent of the audit client's internal audit work related to the internal accounting controls, financial systems, or financial statements..." (www.sec.gov).

"Accounting firms must demonstrate to the profession's overseers that their supervision and pay systems don't give auditors incentives to cut corners to win consulting jobs and that they discipline auditors who stray" (McNamee). This was the common view of how the profession could right the ship, but only a year later Enron collapsed. Enron's downfall redistributed the power, and every change debated during the Accounting Wars will have a new sounding board.

**Changes from Enron**

It has been said that Enron's downfall was unthinkable. The reality is that the misdeeds of one firm stunned the strongest financial economy in the world. Enron cost investors over $80 billion and employees thousands of jobs. The government is frantically defusing an already exploded bomb in hopes that this never occurs again. What is certain, is that Andersen's audit failure will bring about more proposals and changes to the profession than the all past accounting conflicts.

While only little more than a year has passed since the height of the 'Accounting Wars', the environment in both the SEC and the accounting profession has changed. The SEC has a new chairman, Harvey Pitt, and new demands in overseeing accountants. But even the SEC has taken a backseat to the politicians. For the mean time, Congress is the real oversight committee.

The SEC has taken some criticism for its regulatory processes and its alleged compromise of the Accounting Wars. It is not alone. The POB, FASB, and AICPA have received their share of criticism as well. Government officials have begun proposing changes that address the inefficiencies, poor oversight, and lack of independence of the current regulatory process.

The government's goal is to rebuild investor perceptions of the US economy and of the accounting profession. Like Levitt, the government is focusing much of its attention on non-audit services and the independence of auditors. However, this is not the Accounting Wars revisited. Accountants' objections will not headline the Wall Street Journal. Public opinion and political influence will not affect the government's decisions.
Financial Reporting Alterations

A great deal of attention has been placed on the complexity and nature of financial reporting. Both the government and press have stated their desire for simplification of financial information. The methods of simplification have been vague, but suggestions ranging from increasing the speed of new standards to pro forma financial statements have been presented. The recent trend has been citing the need for cooperation among financial and accounting services.

Changes to Accounting Standards

"The reforms under consideration include: a system of ‘current’ disclosure, more disclosures of ‘trend’ and ‘evaluative’ data, an updated and improved system of periodic disclosure, clearer and more understandable financial statements, disclosures about critical accounting policies, faster and more responsive setting of accounting standards, a more rigorous system of oversight of the accounting profession, a system safer from conflicts of interest among auditors, more meaningful protection by audit committees, and a system of more transparent analyst recommendations" (Schlank).

The profession has been charged with creating accounting standards that are too obscure and complex for the average investor. Congress has raised the issue as to whether the complexity of these standards is beneficial to the public. In order for the public to better understand the information, government officials have addressed two changes -- (1) the creation of a new governance board to supervise the profession (discussed below), and (2) the adoption of less complex standards.

It has been said in the past that accountants are the only people who can understand the issues involved in financial reporting. The Enron scandal has only further broadened this issue. Public outcry has suggested financial statements cannot be easily deciphered, and investors cannot base decisions on certain information. "More information and timely disclosures in plain English are required" (Castellano).

The problem is that many business issues are too unique and intricate to fit nicely into one easy-to-understand set of rules. Accountants argue that complex issues necessitate complex rules. One response has been requiring further disclosures within the notes of the statements. Financial information that is unclear would require further elaboration as to allow the average investor to base decisions on it.
Pro Forma Financial Statements

The Enron disaster brought about the search for alternate means of financial reporting, and as a result, the SEC has cautioned that pro forma financial statements loom on the horizon. Pro forma financial information is a controversial topic within the profession. Accountants argue that this alternative reporting method presents a host of new dilemmas. Pro forma information does not coincide with GAAP. Without a set of standards, pro forma reporting is unstructured and easily manipulated.

Pro forma figures differ from GAAP by excluding certain expenses and losses from earnings. Although unprofitable companies are strong supporters of pro forma reporting, statistics have shown that pro forma differs greatly from GAAP reporting. For example, in the fourth quarter of 2001, Amazon reported a pro forma loss of $58 million. When measured with GAAP, Amazon's net loss nearly tripled to $170 million.

Even the SEC agrees that pro forma information can create problems. The SEC said the method "may not convey a true and accurate picture of a company's financial well-being." Pro forma eliminates one-time events, tax effects, and other information that would be included within GAAP reports. Nevertheless, the SEC believes that accurate pro forma reports offer insights into businesses that GAAP reporting cannot.

Prospective Financial Information

Pressure from the investing public and government officials for forward-looking financial information has caused regulators to search for alternative measures of business performance. Prospective information would address the concern of more timely information. This forward-looking information would allow for more up-to-date information than the current historical reporting model. With the assistance of the Internet, prospective reports could be accessed at anytime from anywhere. Advocates believe that this information will mitigate the risk of convoluted financial information, such as Enron's special purpose entity issues.

Even the most accurate forecasts will be wrong despite the best intentions of management. Unpredictable occurrences like economic downturns or natural disasters cannot be incorporated into this information. "It all comes down to demand. The limitations of any system are always going to be tied to the fact that you're waiting on inputs from somebody or something" (Meyers 44). Reliance on these forecasts could cause financial catastrophes. Finally, should another Enron-type disaster occur, there would be even less opportunity to assess the degree of the parties at fault.
The inclusion of non-financial information in prospective financial statements could be another pitfall. For years, the issue of including non-financial information has been suggested, but it is apparent that this is the time for its implementation. Several benefits can be derived from the use of this information, such as technical know-how, unique training characteristics, or brand name valuation.

Government officials are calling for auditors and analysts to work together in compiling this information. This cooperation should enhance the reliability of the prospective information. Furthermore, the relationship provides the auditors with another point of view. The analysts may offer new risks, overlooked issues, or sensitive information that may be of use during the audit.

**Elimination of Non-Audit Services**

**Internal Audit Outsourcing**

While internal audit outsourcing was raised and debated during the Accounting Wars, the SEC decided that restricting the service to 40% was sufficient to mitigate independence violations. After Enron, pundits like television correspondent Lou Dobbs, saw the decision to allow internal audit outsourcing to continue as an SEC failure.

Steps have already been taken to eliminate this conflict. The Big Five firms decided to take a pro-active approach and eliminate these services for all external audit clients. The hope is that pro-active steps will lessen the government's desire for drastic changes. Meanwhile, the profession is waiting for the SEC to permanently eliminate internal audit outsourcing from external audit clients.

During the Accounting Wars, the Big Five and AICPA officials pointed to the fact that the SEC did not have proof that consulting fees ever resulted in an audit failure. As the internal and external auditor, Andersen potentially gave definitive proof to the SEC. The fees resulting from management advisory services were in excess of $27 million, while audit fees only resulted in $25 million.

Enron has breathed new life into internal audit departments. An often-overlooked aspect of businesses, much more attention is being focused on internal audit. Internal auditors are being asked to evaluate those controls that deal specifically with financial reporting, and recommend corrections of any inadequacies.
Other Non-Audit Services

Like internal audit outsourcing, areas that slipped by during the Accounting Wars, will be banned in the near future. Some of these services include human resource outsourcing, corporate finance, and special projects. Whereas accountants were able to mount a substantial defense to the proposed changes during the Accounting Wars, the profession has little option but to agree with any and all new proposals.

The future elimination of consulting services has led firms to split off many consulting areas. During the Wars, the Big Five sold off their IT consulting divisions, but Enron has forced firms to take more drastic measures. The recent trend has been to eliminate a wide range of services and institute independence risk assessment committees within the firms.

About the only other service accountants can offer is tax consulting. There are even questions concerning the independence of this core service. Tax consultants advocate strategies minimizing taxes. This planning could create independence conflicts. Financial reporting requires the auditor to examine tax issues. Once again the firm is potentially auditing its work. Another conflict is earnings management. Tax consultants advocate reducing earnings or increasing expenses in order to minimize taxes. This impacts the fairness and reliability of reporting. Government officials have not indicated that this service would be eliminated.

Changes to Governing Bodies

Independent Accountability/Oversight Board

An independent regulatory board should ensure that the accounting profession is held to the highest ethical standards. Under this proposal, an independent regulatory board would be established, under the supervision of the SEC, to develop standards of professional conduct and competence. This board would have the ability to monitor, investigate, and where needed, enforce its ethics principles by punishing individual offenders.

-President Bush

This March marked the end of the Public Oversight Board’s tenure. The five-member board voted unanimously to "terminate its existence" (Williams 19). The termination of the POB was in response to SEC Chairman Harvey Pitt’s proposal for a new regulatory body. Citing this proposal, the POB believed it had no place in the future of accounting.

Pitt’s proposal stated his desire for the creation of two new oversight boards. One would act as a disciplinary board that dealt with audit failures. Its primary purpose would be to examine any
alleged audit failures. The other board would be responsible for monitoring audit quality. This board would be responsible for reviews and referrals to the disciplinary board.

The proposed boards differ from past and current regulatory boards in two distinct ways. First, the proposed boards are to be entirely independent – from its members to funding. The existing regulatory boards often include members from practice with a background within public accounting. The funding of these boards is also suspect. The Big Five firms contribute significant portions to these boards. The other difference is the disciplinary enforcement previous boards lacked. Other boards could not directly punish, and therefore, do not have the authority of government agencies.

**Increased Review Procedures**

Peer reviews were designed to act as a system of checks on auditors. The Big Five firms were the only accounting firms large and experienced enough to review one another. These firms would periodically rotate the peer review process. The string of high profile audit failures had caused SEC officials to search for alternate review processes, but Enron has necessitated that one is found immediately.

With new boards come new review procedures. Should Pitt successfully enact his proposal for a new oversight board, peer reviews will become a thing of the past. The new boards will eliminate the peer review process by creating new review procedures. A function of one of these boards will be to conduct audit reviews. Compared to past oversight boards, the new board will be much larger. In order to review Big Five firms, the board would need a talented audit staff and disciplinary and governing members.

These new review procedures will provide the system of checks and balances the public is seeking. Although this may not appear to be a major departure from peer review, having an independent body perform the review eliminates several independence conflicts. First, accusations of cooperation or collusion cannot be made. Second, reviewers can directly discipline auditors for deficient findings. Finally, these reviews would also enhance the board’s image as an overseer.

The new review process does raise some new problems. Where will this new army of auditor regulators come from? What credentials will they have? With so much variation within accounting, these overseers may not have the adequate skillset to determine the accuracy of the reporting. For SEC registrant companies, the most experienced auditors would already be employed by one of the Big Five firms. It does not seem feasible to suggest that the government would be willing to match the salary of these firms in order to lure away the best people. This
begs the question, "How will the new review process be more effective than peer review without the best people?"

**Financial Accounting Standards Board (FASB)**

"Part of the problem is that the SEC has in the past allowed the Financial Accounting Standards Board (FASB) to fail to set timely accounting standards. The FASB must act more quickly in the future."

— SEC Chairman Harvey Pitt

Like so many other accounting issues, the FASB’s future has come under scrutiny. Issues concerning funding, governance, and effectiveness have been raised. The resulting speculation has ranged from incremental changes to a complete elimination and federalization of the standard setting. At a minimum, the new regulatory bodies will carefully scrutinize the development of new standards.

The FASB in fighting to stay alive. It has taken proactive steps in altering its standard-setting process. The board’s biggest criticism has been the inefficiency in developing of new standards. FASB has begun proposing changes in an attempt to convince government officials and the American public that the standard-setting process will be efficient. These proposed changes include the following: (1) changing the voting requirement for approval from a supermajority to a simple majority and (2) shorter comment periods for proposed standards.

FASB has another significant speed bump to overcome. Independence concerns have been raised about the funding and relationships of the Board. Fears of Big Five dominating FASB have led many to speculate that the Board is not independent. First, the current seven-member board is composed of three public practice members - usually Big Five advocates. The second contention is that significant contributions by Big Five firms represent a substantial portion of the Board’s overall funds. It remains unclear as to how FASB will address the status of members and funding concerns.

**Self-Regulation & Self-Governance**

Will the government intervene as a regulatory body? Just a year ago, the question would be easily answered, "No." But in the wake of Enron, accountants are not so confident. While complete governmental regulation is unlikely, the profession can expect new oversight and regulatory boards and changes to the existing agencies. Nonetheless, the AICPA will continue certifying accountants and disciplining violators and CPAs will remain as the only government sanctioned auditors.
Where self-regulation is the monitoring and enforcement of codes of conduct, quality control, and promulgation of GAAP and GAAS, self-governance refers to the accountants’ role in guiding the profession and determining its future. CPAs can expect the government to dictate the profession’s immediate future. Topics like expansion of consulting services and the need for an alternative credential have taken a back seat to the upcoming changes.

The days of the FASB’s inefficient standard setting have passed. So many initiatives have been undertaken that the role of private sector governance is vanishing. While the SEC always had the final word, the profession could rally together and present a formidable defense. Enron has eliminated much of that ability given control to the Congress and the SEC. The new model of accounting includes increased awareness at the congressional level and tighter controls by SEC officials. The government will spend much more time and money overseeing accounting issues. For the meantime, the profession is unable to defend itself or expect any public support. It can only outlast the storm.

**Future of Accounting**

Where does the profession go from here?

The profession’s private regulatory process is on the way out. While few proposals have been ratified, past changes and present actions have predetermined the short-term future of accounting. New supervisory boards, independence standards, and government involvement will limit the power of the AICPA’s ability to self-regulate. The charge for the SEC to advance its oversight procedures has also reduced the hope for continued private control.

The media has inundated the public with future accounting changes, but there are three areas that can expect the most substantial changes -- financial reporting, oversight committees, and non-audit services.

**Changes within Financial Reporting**

As all of the changes directly or indirectly impact financial reporting, it is the core of accounting disputes. The issues concerning consulting and independence relate to reliability of financial reporting. The issues concerning standards and governing bodies address the relevance of the financial information.

Direct changes to financial reporting are currently the responsibility of FASB. The FASB and new oversight committee will be at the forefront of future changes. Each proposed standard will be measured using a new set of criteria. The new criteria will include clarity, timeliness, and
necessity. The new oversight committee will be focused on the causes of recent misstatements--especially Enron. Revenue and debt recognition and special purpose entities will be two of the issues promptly addressed.

The proposed changes to financial reporting standards are contradictory. Congress and the SEC demand more timely standards, but the press and investing public seek clarity in financial reporting. Quickly ratifying additional standards will increase the complexity of financial reporting, which will lead to further confusion.

FASB, along with the SEC and other regulatory bodies can expect a wide array of problems stemming from pro forma information. First, pro forma information will be unaudited and could mislead investors. These misled investors will accuse accountants of providing unreliable information, which would further degrade the profession’s reputation. Reliance on this information would cause more problems than the present historical reporting model. Pro forma reports do not address the public concerns over the reliability of financial information.

Despite the setbacks, the government will pursue a new financial reporting model. This model will be designed to include pro forma information, risks and uncertainties, non-financial data, and be accessed through a variety of channels (Castellano 39).

Changes to Governing Bodies

New governing bodies will reshape the face of accounting. Boards and committees have come and gone during the profession’s history, but there has never been an accounting issue as predominant as Enron. The new boards resulting from the Enron scandal will have authority and responsibilities its predecessors did not. Success or failure will be determined by how well the new board uses its power.

These new standard-setting and oversight boards are widening the divergence between the self-regulation and government regulation. This unfortunate result of Enron has a side effect that further decreases the power of the profession. As more and more of the ability to govern itself is taken away, the less power the profession had to resist government changes and take active measures in expanding services.

It is unlikely that the accounting profession will deteriorate to providing only the traditional services, but should misstatements continue, complete government intervention is foreseeable. The AICPA has lost much of the public’s confidence, and therefore, CPAs are not the trusted professionals they once were. The government will take any steps necessary to rebuild the public’s confidence in financial statements. The bottom line is the profession can expect heavy government intervention until that confidence is restored.
Elimination of Non-Audit Services

Consulting was the crux of the Accounting Wars. The once heated debate has fizzled into voluntary contraction. Arguments over impaired independence, whether in appearance or in fact, have been settled once and for all.

When it came to light that Andersen preformed the internal and external audit functions, the future of IA outsourcing was sealed. Human resources and financial service consulting will be completely done away with. Even certain special project consulting engagements will cease for audit clients. Any engagement in which management is anything other than a third party is susceptible to elimination.

The consulting activities that continue will be restricted. Research has shown that a small percentage of consulting work for audit clients does not affect public perceptions of independence. Those accepted services would be confined to an established percent of audit fees.

As mentioned above, speculation over the continuation of one of the longest running accounting functions, tax work, was considered. The SEC would be hard pressed to convince businesses and even its own members to ban tax consulting to audit clients.

Conclusion

The accounting profession longs for days of the Accounting Wars. The heated exchanges between the SEC and the profession would seem comical. The SEC’s independence proposals would be seen as worthwhile changes that will benefit the profession’s image. Arthur Levitt would be revered as the man who solved the independence question with fair and impartial changes.

Okay, maybe not…but maybe the profession needs to rethink its views on the Accounting Wars. Perhaps the public argument was advantageous to the profession. Since the profession is in no position to defend itself, at least the Accounting Wars give the government guidelines in its attempt to correct the Enron mistakes. Imagine hundreds of lawyers planning the future of accounting without any criteria to base their decisions.

By following the independence debates, the government is allowing firms to take proactive steps. Firms have already begun restricting consulting services, and the Big Five is preparing for the new oversight board(s). The open issues of the Accounting Wars will not be the entirety of the results from Enron, but it may cushion the blow.
Four decades of controversy over independence has culminated in the downfall of one company. Enron will bring about more changes to the accounting profession than all the independence, oversight, and financial reporting debates put together. Hopefully, under the right leadership, continued ethical practices, and quality work, the profession will regain its status as trusted professional service providers.
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