The Auditing Debate: What's the Real Issue?

By David H. Maister

An edited version of this article appeared in USA TODAY, *March 11, 2002, page 15A.*

Any way you look at it, the audit business cannot continue much longer as it is. If years of "clean" audits are no guarantee that billions of dollars of previously reported profits are, in fact, illusory, then what value does an audit actually provide? Congress and the SEC are vigorously investigating this, but there is a grave danger that they may be focusing on the wrong problem.

Auditing is a business full of paradoxes. The providers think they're providing one thing (carefully phrased as "an attestation that financial accounts based on information provided by management are in accordance with generally accepted accounting principles.")

The investing public, the users of the service, continue to believe (despite the profession's best efforts to tell them otherwise) that the service is something else: a protection against fraud, reliably affirming the financial health of the enterprise being audited.

Many people seem to think that auditing's problems are due to the conflicts created by audit firms also providing consulting services. Legislators and regulators are today holding emergency hearings about whether auditors should be able to provide these additional services, and (in anticipation of their rulings) four of the big five either have spun off their consulting divisions or have plans to do so. *(This article was written before Andersen's collapse.)* Amid all this activity, one point goes unrecognized: how irrelevant it all is!

The problem of auditor independence is not, ultimately, about the provision of consulting services. The conflict is built into the auditing system itself. Auditors are supposed to be independent of management, providing a neutral "attestation" that financial reports are a fair reflection of the business.

Yet who hires the auditors? Who pays them? Who retains them? Who can fire them? Answer: Only the company they are supposed to be auditing and no one else. Even if they never did a dime's worth of consulting, auditors would be conflicted.

The problem is made even worse by the way the output of an auditor's work is structured. They are permitted, in reporting to the public, only to issue a standardized letter with fixed language basically saying one of two things: either "We concur," or "We have reservations" (usually with no elaboration or explanation). Since the latter option is equivalent to dropping the guillotine, it's not used too often. There's not much else auditors are allowed to do.

Imagine that management is doing something questionable or on the edge. The auditor's choice is either to go along or to resign and cause a public scandal (and a loss of their own revenues). How much ability do you think they have to influence that management team? All they've got is a threat to resign (or, close to the same thing, to issue a qualified opinion) and management knows that if they do that they'll hurt their own business (lose substantial revenue).

What happens? Honorable, well-intentioned people try, with integrity, to get management to do the right thing, but unless they have incredible guts, they are forced to accept a lot of gray areas before they have to pull the trigger. If they are to do their job, auditors need more than these options for reporting their findings.

It is readily understandable that auditing firms have historically looked for additional services to provide. The auditing "product line" is an unattractive business. It's a low (or no) growth, declining-margin, highly exposed-to-litigation business.

Why would a firm that had other options want to nurture this product line? True, it does have the virtue of providing an annuity, a good, regular, dependable cash flow, year after year. And (here's the rub) firms view it as a base from which they can cross-sell their other services.

Notice that selling additional services includes not only consulting, which is getting all the attention, but a myriad of accounting services that will remain even if Congress and the SEC succeed in banning the provision of consulting services. The key distinction to be made is not between accounting and consulting, but between "attest" services (which include such things as certain tax services), where the firm serves the public by attesting to the accuracy of data, and "advisory" services, where the firm serves management.

Complete independence can only be achieved by complete separation of attest services from advisory services (an option that does not yet seem to be part of the public debate).

Even if not legislatively mandated, this separation could be a decent business choice. Most accounting firms, until recently, thought of themselves as audit firms who happen to provide a range of other services.

Now they have become professional service firms in which audit is just one of their products (and a diminishing, ever-less-attractive one at that). Maybe they should (on good business principles) drop their least attractive line of business and let someone else take it over.

The auditing function is needed, and someone has got to provide it. But to make it truly independent and free of any conflicts, we would need to find a way to construct firms that provide only attest services paid for not by those being audited but by someone else.

I haven't heard too many options for this being discussed, but one way could be for all publicly listed companies to pay a tax into a general fund (perhaps based on their revenues) administered by a government agency, which in turn would pay (private) attest firms to perform the audit.

Could a business that provides only "attest" or "audit" services survive to be an attractive business? There would be challenges. An audit is a product, not a career. Saying you are an auditor is like saying that you know how to make (or supervise the making of) one thing and one thing only—an audit. You are effectively betting your career on a single product—a risky move at best.

That wasn't a bad bet back in the good old days when demand for that one product was high, when the market placed a high price on it and when clients didn't shop for your product predominantly on price. Alas, all that has changed. Someone who is a pure auditor (rather than an accountant) will have a serious career problem.

Every year, all of the accounting firms (including our poor auditor's own firm) are furiously working hard to train vast numbers of younger people to know how to do what our auditor knows how to do—supervise an audit. So, each year our poor auditor's existing knowledge and skill is becoming less scarce and less valuable. His (or her) asset is rapidly depreciating in value.

Of course, this sad situation is true of all professionals. They all must continue to build new skills to stay ahead of the pack. But how does our poor auditor, who wants to remain an auditor, do this? The great business virtue of auditing, that it is recurring work, year after year, is its greatest career trap for the auditor.

He or she is not going to learn new things rapidly by auditing the same companies year after year. Keeping up with the latest changes in accounting regulations helps but can hardly be called rapid skill building. The best and most obvious way to continue to build skills is to stop auditing the same clients and trade up to doing the audit of larger, more complex client organizations who have stretching, challenging audit issues.

Not a bad solution, but unfortunately one that is available only to a tiny percentage of those trying to earn a living as auditors. Not every partner can audit the Fortune 100. In fact, it's fairly safe to say that the vast majority of auditors, if they are to keep their skills and knowledge valuable, will have to start doing something besides auditing. They will either have to become accountants and (upon leaving the attest firm) provide accounting and finance-related services that clients view as worthy of high fees, or they will have to be creative and find other things in our society that need an attest service.

This actually may be the savior of the attest business. Many financial, insurance and physical exchange transactions in our economy depend on the parties trusting each other that the underlying reality matches the terms in the contract (the goods are in the warehouse, we actually do have this many subscribers and so on). There could be incredible value and a great business for a company that (for once) could credibly provide truly independent, nonconflicted, third-party attest services. Whether or not this becomes a reality is up for debate, but one thing is clear. Contrary to the current Congressional and SEC debate, the problem is not as simplistic as "auditing" versus "consulting."

Let's address the real problem!

David Maister is the author of *Managing the Professional Service Firm* (1993), *True Professionalism* (1997), *The Trusted Advisor* (2000) (coauthor), *Practice What You Preach* (2001) and *First Among Equals* (2002) (coauthor.)

Prior to launching his (solo but global) consulting practice in 1985, he served as a professor at the Harvard Business School.

TEL: **1-617-262-5968**
E-MAIL: david@davidmaister.com
WEBSITE: www.davidmaister.com

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