FIXING CPA ETHICS CAN BE AN INSIDE JOB

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It's been quite a year for certified public accountants: Enron, WorldCom, Qwest, Global Crossing, Tyco -- to name just a few of the profession's black marks. Shareholders have lost $460 billion in those five companies, and CPA jokes have replaced lawyer jokes. Once among the most-trusted professionals, some CPAs could exchange their pinstripes for prison stripes.

Fortunately, Congress has passed the most sweeping business reform legislation in nearly 70 years. We now have a law to ensure that embarrassing and costly audit failures will be a thing of the past. We can return to business and focus on rebuilding the economy with restored faith in the audit process. Right?

I don't think so.

The Sarbanes-Oxley Act can make some difference, despite the accounting industry's lobbying efforts to hobble it. But even a vigorously enforced Sarbanes-Oxley Act will not address the core problem with the audit process: conflicts of interest. Auditors cannot be truly independent as long as they depend on fees they receive from the entities they audit. Furthermore, Sarbanes-Oxley applies to only 17,000 or so publicly traded companies. It will not regulate the several hundred thousand annual audits of private companies, not-for-profit organizations, and state and local governments.

The spin by the American Institute of CPAs is that now things will be different, that auditors can be tough enough to "just say no" when companies try to cook the books or bend the rules. To illustrate this point, the AICPA's CEO recently gave a speech in which he described an accountant, Al Bows, from the 1930s, who had the fortitude to stand up to a client.

"One day he discovered that the CEO of one of his client companies was secretly running a competing business on the side to siphon off profits. The client controlled a major account for Bows. But Bows told him to cut the con game out -- or he'd turn him in. The client was angry, but he stopped cheating his shareholders. Al Bows possessed a characteristic crucial to the profession. He had the guts to say no, even when he had a lot to lose."

Two things are remarkable about this story. First, the AICPA chief had to reach back 70 years to find an example of an honest, tough, ethical accountant. Even more remarkable is that no one is asking the obvious question: Why should an accountant or auditor be put into a clearly conflicted relationship? The reason it takes "guts" to say "no" is that auditors have "a lot to lose" when they decide to tell their clients they can't cook the books. That isn't right.

There are about 350,000 CPAs in the United States. If every one of us were just like Al Bows, we would not need any ethics rules for auditors. We would "do the right thing," regardless of the cost. But we have ample evidence that not all CPAs make the right choice when their livelihoods and lifestyles depend on keeping the people who pay their fees happy.

There is a better way: Make auditors independent. It would be incredibly easy to do. All it would require is a one-word change to one of the ethics rules that CPAs must follow.

Let me explain. The current rule on independence takes up 24 pages of fine print in the AICPA Code of Professional Conduct. The rule gives detailed guidance on how to determine when stock ownership and investor relationships impair independence. The rule does not, however, provide any guidance whatsoever about whether independence is impaired when an auditing firm receives $1 million a week from the company it is auditing, as Arthur Andersen's Houston office did from Enron. Thus, the rule says that an auditor is not allowed to own a single share of stock in the company he or she audits, but it ignores situations in which the livelihoods of several audit partners and several hundred audit firm employees depend on keeping a client happy.

Let's turn for a moment from the 24 pages covering independence to the key paragraph in another rule, Rule 102-2, on conflicts of interest. Someone unfamiliar with Rule 102-2 might think that getting $1 million a week in fees from a client one is auditing might fall under this clause. After all, here's the Merriam-Webster definition of a conflict of interest: "A conflict between the private interests and the official responsibilities of a person in a position of trust."
Here's the more complex AICPA definition:

"A conflict of interest may occur if a member performs a professional service for a client or employer and the member or his or her firm has a relationship with ***another*** [my emphasis] *person, entity, product, or service that could, in the member's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the member's objectivity."*
The AICPA definition is a lot of mumbo jumbo that ends up allowing conflicts rather than banning them. A smell test tells us that an accounting firm has a conflict of interest when it receives fat consulting fees from an entity that it is also auditing. But under the AICPA definition, the auditor's relationship with that entity cannot create a conflict or impair objectivity. Only a relationship with another person or entity can do that. Which is hogwash.

Perhaps it was an accident that the AICPA definition was written that way. Or perhaps it was written that way so that the high-profit, low-risk business of providing consulting services to audit clients could thrive. It doesn't matter why. What matters is that it is easy to fix. It will not require another law or more federal regulations.

Simply change the word "another" to "any": "A conflict of interest may occur if a member performs a professional service and the member has a relationship with any person, entity, product, or service that could be viewed as impairing the member's objectivity."

Then we can shift the focus to the second part of Rule 102-2, which says that even if the auditor has a conflict of interest, she or he can still provide services, as long as those who will use the services are informed of the nature and magnitude of the conflict. This should include shareholders as well as managers and should require the addition of an "information paragraph" to the auditor's report. The paragraph might read as follows:

"We receive consulting and audit fees directly from XYZ Corporation. This is a conflict of interest as defined by the AICPA Code of Professional Conduct. During the year ended 31 December 2002, we received consulting fees from XYZ Corporation that were 0.05 percent of our practice office's total revenue for the year, and our audit fee from XYZ Corporation is 0.04 percent of our practice office's total revenue for that year."

The disclosure that an audit firm gets less than a tenth of a percent of its annual income from a client it is auditing probably won't bother the users of financial statements. But what if that percentage reaches 5, or 10, or 25 percent? Some readers may decide that the auditor might not be tough enough to say "no." Investors might invest elsewhere. Stock analysts might rate a company's stock marginally lower if the audit report contains this conflict-of-interest disclosure. Lenders might charge such an entity a slightly higher interest rate. Some not-for-profit organization donors might decide to donate elsewhere.

These market forces will induce both publicly traded and private companies, and even not-for-profit organizations, to look for ways to avoid the stigma of this disclosure in their audit reports. Each firm or company could establish a completely independent officer or committee to procure and manage the audit. Banks might take on the audit management role when they need an independent audit of a major borrower. For government entities, a citizens committee could perform this function. Stock exchanges might decide that it increases investor confidence when the exchanges perform this audit management service.

Audit fees would still come from the entity being audited, via the audit management group. But the auditor would be beholden to a client -- the independent audit management group -- who only wants to know the truth about the financial statements. It would no longer require "guts" to say "no." Instead, overlooking cooked books would have dire consequences for the auditor. Isn't that what we want?

Change that one word in the ethics rules, tweak auditing standards to require the informative disclosure in the audit report and define what it requires for the audit management group to be considered fully independent. That's all it will take. Adam Smith's invisible hand will do the rest.

I predict that within a couple of years, we would not see many conflict of interest disclosures in audit reports. Audits arranged and managed by independent third parties would become the norm. Auditors would no longer face the unsavory choice of keeping clients happy or losing their livelihoods. Auditors could then focus all of their time, talent and energy on telling financial statement users exactly what they need to know: the truth.

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