

Are audit firm consulting services detracting from their core business?

Auditing firms have always inspired trust and integrity, but is their expansion into providing consulting services to clients posing a potential risk to audit quality and investor protection?

King IV, and an even more rigorous call for adherence to corporate governance principles, puts these diversified services at odds with auditor independence, which are so core to the integrity of SA's economy.



Independent audits crucial to economy

"Take for example the catastrophic investor losses in the US that were a result of Enron and WorldCom among others. Major accounting firms were implicated in a host of accounting irregularities during these scandals," says Richard Firth, CEO of MIP Holdings.

These events saw the introduction of the Sarbanes-Oxley Act (SOX) of 2002, which was passed by the US Congress in order to protect investors from the possibility of fraudulent accounting activities by corporations. SOX was passed by huge majorities in the senate and the house, and the legislation founded the Public Company Accounting Oversight Board (PCAOB), a private-sector, non-profit corporation to oversee the audits of public companies and other issuers to protect investors' interests.

"The scandals of the early 2000s and the subsequent Act can only lead us to the conclusion that independent audits are crucial to the integrity of our capital markets. Without an independent audit, the markets cannot hope to be open and free. However, if the companies responsible for the audits are themselves providing consulting services, at which point is there a conflict of interest?" Firth asks.

Additional services affect audit objectivity

He adds that many of the large name firms have increasingly been providing IT consulting services to their clients over the past few years, creating divisions dedicated to delivering the specialist expertise required to manage and maintain their technology infrastructure, and utilise it for innovation and growth.

“Many investors are worried that the auditor’s interest in developing or maintaining a non-audit services relationship with their customers could overtake their interest in the primary audit relationship. In addition, investors are concerned that various non-audit services, when given to an audit client, create core conflicts that go totally against auditor objectivity.”

According to him, this is why the rise of the advisory and consulting services within accounting firms is raising red flags. “The growth in these services could definitely pose a threat to auditor independence and quality. Investors have a right to be concerned that the firms may not maintain the utter independence that ensures integrity.”

Legislation tightening up loopholes

As a result of these concerns, many countries have put legislation in place to minimise the potential for conflicts of interest. In America, accounting firms are not allowed to provide non-audit services to companies for which they perform audits; in Britain, the rules are not as strict, allowing auditors to perform “internal audits” and provide advice to companies they audit.

Audit firm rotation

Until recently, South African law was quite relaxed about the relationship. That may change – pending a new legislation that has been tabled, which makes provision for mandatory audit firm rotation, forcing companies to change auditors every few years. According to Firth, this system has long been used in Europe, where auditors have to be changed every 10 years. However, he says, these “Chinese walls” are very unlikely to provide true protection.

“Five years is a long time in which audit firms can establish consulting-type relationships with their clients, even if they don’t strictly provide audit services. Professor Mervyn King recently said that there are more than enough safeguards in SA’s existing rules to ensure auditors are independent, including the requirement that the partner in charge of auditing a company’s financials is changed every five years, and the fact that the Companies Act stipulates that shareholders must appoint the audit committee, which then has to ensure that auditors are independent,” Firth says.

Detracting from core business

“Yet we still see audit firms going outside of their traditional mandate and there is enough of a grey area to allow these companies to continue providing consulting services without breaking any laws. The only system we have in SA to provide red flags within the auditing sphere is based on tips, making it hard to delineate what is or isn’t ethical or allowed.”

He adds that there is also the concern that an increased focus on growing the advisory services business may detract the leaders of the firm from the core audit business. “This could result in lesser investments being made in the audit practice. This could include smaller spend on training, technology, innovation, and of course the hiring of skilled professionals.”

It is his view that accounting firm heads need to address the possible threats that arise from a growing advisory and consulting practice. “In addition, they should make sure that they continue to invest in the audit business, including hiring top staff, implementing best-in-class technology, and ensuring adequate training is given. Most importantly, as firms boost their advisory practices and turn into multidisciplinary service providers, firm heads must never forget the principle of total

independence.”

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