Accounting for Pure Independence

Why CPAs should place public trust above personal greed

by Stephen E. Roulac

When a company retains a professional services firm, the company retains not only the substance of the firm's services but also, and in some instances even more importantly, that firm's reputation. As you are known by the company you keep, any event adverse to your advisor is adverse to your interests. The Certified Public Accounting (CPA) firm, which attests to the integrity of its financial statements, is perhaps the most visible significant supplier relationship.

Public accounting is a public trust. Trusting that its institutions—such as journalism, healthcare and transportation and accounting—will provide competent and honest performance, the public expects that neither the reality nor the appearance of their trust will be threatened or compromised. The AICPA Code of Professional Conduct states: "Members should accept the obligation to act in a way that will serve the public interest, honor the public trust and demonstrate commitment to professionalism."

Audited financial statements are mandatory not optional. Large public companies are predominantly audited by the "Big Five," which have evolved from what was the "Big Eight." These five leading accounting firms enjoy a government-sponsored favored position, because companies must provide audited financial statements to regulatory agencies, specifically the Securities and Exchange Commission and state securities regulators and to their shareholders.

The favored status of the Big Five, relative to other accounting firms, is reflected in their partners' annual
earnings averaging $500,000, compared to $120,000 for partners of other public accounting firms. Chief Financial Officers, the closest private industry equivalent to an accounting firm partner, earn about $10,000 more.

Although some would argue that the best and brightest work at the Big Five firms, and therefore deserve premium compensation for superior talent and training, greater risk and harder work, the four times difference, a premium of $380,000 above what their counterparts in public accounting and private industry earn, suggests otherwise. The extraordinary compensation premium is attributable to accountants’ favored status and the oligopoly position of Big Five firms, enabling them to charge fees and realize incomes substantially greater than what other similarly trained accountants earn.

**The Need for Independence**
Accounting firms, their partners and professional employees must be independent, in fact and appearance of the financial interests of their clients. When attesting to the reasonableness of a company’s financial statements, accountants must do so from the position of having no financial interest in the companies they audit.

In recent years, the Independence Rules have become much more complex and difficult for accountants. Concerns over accountants’ independence have been raised at the very time the complexity of the financial system has increased. Mergers amongst accounting firms, combined with an accelerating pace of acquisitions and consolidation within many sectors of the economy, mean a particular accounting firm has a much greater likelihood of an incident that might give rise to an independence problem than might have existed in prior years.

With the financial market ever more influential in the economy, the integrity of the capital markets looms large. Today, market swings in response to news, good and bad, are exacerbated. Behavioral considerations, then, are of ever-greater importance. Consequently, issues of reliability and propriety are very important to society and especially to senior executives and directors.

Given the heightened significance of behavioral finance, accounting firm misdeeds create the specter of liability for senior executives and boards, both directly and indirectly. The direct link encompasses those instances in which the auditor’s dubious behavior is tied specifically to the enterprise, such as an independence violation associated with the company’s financial interests. The indirect link embraces the relationships of all companies to an auditor, whose conduct reflects at least questionable judgment, if not an overt violation.

**A Question of Ethics**
The recent blatant violations of the Independence Rule by the world’s largest accounting firm, PricewaterhouseCoopers, followed by accounting firms’ insistence that their same Independence Rules should be relaxed, suggest there is a serious disconnect between what society expects of accountants and what accountants expect of themselves. The conclusion of a SEC investigation, that “most partners of PricewaterhouseCoopers (PwC)... violated rules requiring they not have investments in companies audited by their firm,” dismaying as it is on its surface, is by no means the whole story of dubious practices. The SEC investigator concluded that it is probable that between 82 and 90 percent of PwC partners had committed an independence violation.

The independence problems highlighted by the SEC investigation raise serious ethical questions for the accounting profession as a whole and also pose challenges to its business processes and its basic competence. Even if the PwC partners’ independence violations were not materially significant in promoting their own financial interests, the appearance of impropriety is inescapable. Beyond the appearance of impropriety, this problem raises troubling questions concerning first the competence and due care of the firms’ partners and, second their ability to implement the most fundamental of confirmation tasks that are central to the auditing function.
Accountants who traffic lightly in the public trust threaten the integrity of the national and global financial system. If the largest accounting firm is unable to or chooses not to educate its partners and staff concerning the Independence Rule—a rule that is widely known to financial professionals but apparently not honored by many accountants—then the financial system's integrity is threatened.

A New Approach

To preserve the integrity of the capital markets, we need a new approach to accountants' independence. The Independence Rule should be modified to Pure Independence, which would mean that no partner or employee of an accounting firm may invest directly in the securities of any public company.

Accountants have no business buying and selling securities, as their professional energies should be devoted exclusively to the stewardship of the national and global financial system. If accountants prefer to be active in managing their own investments, then there are many opportunities for them to apply their skills in enterprises other than public accounting.

All employees of accounting firms should invest solely in mutual funds and through professional investment managers who have discretionary authority over purchase and sale decisions. This system of Pure Independence would elevate the ethical posture of CPAs, consistent with their public trust role as stewards of the capital markets.

Business leaders concerned with the integrity of the financial system will advocate that accountants concentrate on accounting and leave stock investing to professional stock investors. In selecting an audit firm, senior executives and boards ought to consider how that firm's reputation impacts their own reputation.

From the company's perspective, the truly independent accounting firm has meaningfully reduced the potential of adverse publicity that could harm its clients. By devoting their attention to serving clients' business needs, without the distraction of managing their private portfolios and monitoring their stock market involvements, pure independent accounting firms can provide higher value services at lower costs.

Because companies are known by the company they keep, what is adverse to their accounting firm is adverse to their own interests. That which calls into question the integrity of the auditor also calls into question the integrity of the auditee. Inevitably, the public might wonder whether the company is making similar poor judgments in other aspects of its business, as it apparently did in its choice of professional advisors.

Ultimately, pure independence is good for the capital markets, companies, investors, senior executives and accountants.

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