Response to “Can Professionalism and Commercialism Coexist in CPA Firms?”

I read with interest Vincent J. Love's article “Can Professionalism and Commercialism Coexist in CPA Firms?” (The CPA Journal, February 2015), and I find the question relevant and timely. However, a flaw in Love’s framing of the question leads us down a treacherous path. Quoting the New York Times, Love asks: “Are auditors going to serve the management, or are they going to serve the best interest of the investing public?”

The question is ill formed, since it speaks in absolutes. The question should direct the reader’s attention to a threat that could become a risk if there is no response; subsequent to the question, Love enumerates the changes that have been put in place in the last 20 years in response to this very threat.

In considering the more nuanced question, “What are the threats and mitigating steps of auditors’ commitment to the investing public?”, Advisory services are a manageable threat, and have been mitigated rather well since Enron.

The independence risk to the audit profession it is not new, and it is not at all linked to advisory services by CPA firms—the threat is the nature of auditing itself. Ultimately, independence is threatened when the audited entity is also the paying customer. Moving auditing to a business model whereby the auditor is paid only indirectly by the audited entity would be a step in the right direction, both in substance and in form. Such a business model would enhance the investing public’s perception and the effectiveness of the audit themselves.

The Audit Structure Needs to Change—but to What?

The current audit process is really not about independence. In every business transaction, the payee is always beholden to the payer. In auditing, however, as much as there is a fair attempt to require auditors to be “beholden to the public,” the rules of economic reality are not that flexible: If the client pays, the client has a say. As such, auditors have often been in a position where the integrity of the audit approach, audit process, and at times audit results, have been affected by this fact.

We already have an alternative working business model that overcomes this economic reality: PCAOB filers and their audit firms pay a fee to the PCAOB. Part of these fees pays for PCAOB inspections. Accordingly, the inspectors are beholden to the PCAOB (and SEC), and not to the firm being inspected.

The solution for the threat to independence posed by the economic realities of the audit-client relationship can be resolved in a similar manner by forming an association of auditors with an independent board and management that would collect audit fees from clients. The association would assess these fees according to objective criteria (e.g., total assets and total gross revenues). Clients who wish to be audited will be assigned an auditor by the association; continuity can be ensured if the auditor assignment lasts for a number of years. Benefits are likely on several fronts:

- Most importantly, the association of auditors can promote itself as a new marketplace where only a reasonable compensation fee exists. Auditors will compete over service quality, not fees.
- Because clients would pay auditors only indirectly, any consulting fees would be free from conflict of interest, thus freeing auditors to perform consulting services without a threat to independence.
- Investors, creditors, regulators, and other stakeholders would place value in an audit opinion issued by a truly independent auditor, rather than one beholden to the client.

This model has challenges and pitfalls. For example, it will take courage from all involved to make the shift from a direct relationship to an indirect relationship. However, if executed correctly, the ultimate outcome might solve the age-old problem of independence and be a true public service to society.

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Remember Related Party Procedures in Interim Reviews

Congratulations to The CPA Journal for publishing the outstanding article, “Related Parties, Then and Now: An Analysis and Review in Light of Auditing Standard 18,” by Douglas R. Carmichael in its February 2015 issue (pp. 36-42). Unfortunately, Carmichael’s otherwise comprehensive article does not clearly communicate to its readers that the issuance of the new PCAOB related party standard was accompanied by changes in the standard that governs interim reviews, which are effective for the first quarter of 2015. Even the standard itself does not mention the changes in interim review standards. I prepared the following