No simple solutions to conflicts by auditors
Proposals to fix system also come with problems

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How to avoid more auditing irregularities like the ones lawmakers are looking at in connection with the collapse of Enron Corp. That is the question,

and there is no shortage of suggestions.

Last week, Sen. Barbara Boxer, D-Calif., announced one possible solution in the form of legislation "to promote auditor independence." Her proposal, prompted by conflict-of-interest questions regarding Enron's relationship with the Andersen accounting firm, would prohibit accounting firms from providing management consulting services for the companies they audit.

"The American people have a right to expect that the firms that audit the companies they invest in are free from conflicts of interest," said Boxer. "These conflicts have led to the kind of hide-the-debt shell game that took place at Enron."

Two other senators, Christopher Dodd, D-Conn., and Jon Corzine, D-N.J., and Rep. Edward Markey, D-Mass., also plan to introduce legislation to regulate accountants.

Andersen is under attack for destroying documents and overlooking questionable accounting practices at the big Houston energy trading company that filed for bankruptcy protection last month. The Chicago accounting firm had a possible financial incentive to conduct what Boxer calls a "softer audit. "

Enron paid Andersen, one of the nation's Big Five accounting firms, $25 million to audit its books in 2000 and another $27 million for consulting services.

"You can't have a clean audit if you have a stake in a company -- or making a company look good -- and you get rewarded with more consulting fees," said Boxer, a former stockbroker.

Andersen officials, including Chief Executive Officer Joseph Berardino, insist the company would not risk its reputation to save $27 million, or even $100 million, in consulting fees. Many independent accountants and Andersen clients agree.

Answering a reporter's question about his company's relationship with Andersen at a recent conference in Amsterdam, Oracle Corp. Chairman Larry Ellison said, "I have actually a great deal of sympathy for Arthur Andersen; I think they're a great company."

Although he acknowledged "big-time mistakes were made by (Andersen's) audit group in

Houston," Ellison said it was an insane idea to assume that because Andersen is in the consulting business as well as the audit business, that would encourage it to give a clean audit.

"It's not the consulting business that creates the conflict of interest," said Ellison, whose firm paid Andersen $700,000 in auditing fees and $6.4 million in other fees in 2000. "It's the fact that the client is paying the auditor."

To eliminate potential conflicts and possible bribery, "you're going to have to figure out some way to get rid of all money changing hands between you and your auditor," Ellison said. "Maybe auditing should be a government service or something like that," he said facetiously.

San Francisco lawyer and accountant Ron Linder agrees with Ellison that consulting fees may magnify the potential conflict, but they don't create it.

"Frankly, auditing fees of $25 million alone are enough to create a potential conflict," he said.

Even if you cut off consulting, he said, "it would creep back in. . . . An auditor is supposed to point out weaknesses in internal controls, but that is a form of consulting, isn't it?"

Boxer's solution is also "a little on the extreme side" to Dick Avril, a partner with the Burr, Pilger & Mayer accounting and consulting firm in San Francisco.

"Auditing has an element of consulting associated with it," he said. "Historically, auditors have looked for opportunities to make recommendations to management during an audit, such as ways to improve internal controls, reduce costs such as eliminating duplicate procedures and find ways in the tax code to pay less taxes."

However, Reuven Lehavy, accounting professor at the Haas School of Business at the University of California at Berkeley, sees merit in separating consulting and auditing functions.

"Consulting fees are a significant proportion of total fees, and this puts pressure on folks at the audit unit to go along, to compromise their work.

"The problem is comparable to establishing a wall between the underwriting and research sides of an investment bank."

It is true that auditors do not simply tally figures; they ask questions and consult with clients. But Lehavy said it is possible to distinguish between issues that relate to generally accepted accounting principles, such as the tax implications of establishing an offshore subsidiary, and issues more appropriate for a consultant, such as ways to improve production lines or telecommunication systems.

However, Lehavy said it is not clear whether separating auditing and consulting functions would accomplish the goal of avoiding future Enron debacles.

"The biggest issue is to identify the core problem," he said. If enforcement of existing rules is the main problem, then lessening auditors' conflicts of interest would do some good.

However, if the accounting rules are not sufficiently tight to ensure detection of off-balance-sheet loans, and companies can hide large amounts of debt and underperforming assets, then, Lehavy said, "the core issue is disclosure, and that can be fixed with new accounting rules."

There is no shortage of suggested solutions to make audits of company financial results more objective and less objectionable. They include:

-- Require U.S. companies to hire new auditors every three to seven years to help ensure the independence of accounting firms.

-- Create a new body to replace the accounting industry's Public Oversight Board to monitor the industry. Securities and Exchange Commission Chairman Harvey Pitt proposed this, but critics argue the new board would have a large number of members from the accounting industry, making it the equivalent of the fox guarding the henhouse.

-- Get rid of the uniform audit report that is long on hedging and short on opinion and real information about unusual risks and the adequacy of internal controls.

-- Provide a scorecard of auditors based on such things as capabilities, lawsuits and Securities and Exchange Commission actions against them and the frequency of earnings restatements by clients.

-- Pass a corporate accountability act, endorsed by public-interest activist Ralph Nader, to create an independent commission to assure adequate disclosure of corporate books and records and a corporate decency act to strengthen public and investor access to corporate stock trading and other information.

-- Make boards of directors, especially audit committees of public companies, more independent. (Nine of Enron's 14 directors reportedly had business, investment or consulting ties to Enron.)

Far from a panacea, these proposals bring their own potential problems.

For example, some experts argue that aside from the high cost of replacing auditors every few years and bringing the new team up to speed, the more familiar you are with a company, the easier it is to tell if things are out of whack.

Similarly, accountant Linder argues that adding new rules and dealing with everything as a mechanical problem would provide more things for auditors to hide behind and avoid standing back and asking the simple question, "Does this make sense?"

For example, in the first quarter of last year, Enron reported $425 million of net income and negative cash flow from operations of $464 million. To some observers, such a disparity would raise a red flag.

Andersen's Web site says the firm "helps clients find new ways to create, manage and measure value."

These days, that might present more a problem than a plus to those worried about accounting chicanery.

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