Big Picture

By Allan Koltin and Jeffrey S. Pawlow

Separating Auditing from Consulting for Privately Held Businesses Would Devastate Accounting Firms*

Recently, we had an opportunity to talk with Allan D. Koltin, CPA, President and CEO of Practice Development Institute, Inc. (PDI), and a nationally recognized expert on the accounting industry. PDI is a Chicago-based consulting firm that helps CPA firms with strategic planning, mergers, practice management, marketing and profitability issues. Since the beginning of the year, Allan has been quoted almost daily in the media about the Andersen/Enron debacle, the future of the accounting profession and industry reform. He has appeared on CNN (Lou Dobb's show), Fox TV and WGN TV, and has been featured in BUSINESS WEEK, FORBES, NEW YORK TIMES, THE WALL STREET JOURNAL, THE WASHINGTON POST, LOS ANGELES TIMES and CHICAGO TRIBUNE. Here's what he had to say about these and other issues confronting the industry.

Jeff: It's hard to believe how much has happened since the beginning of the year. Let's start with the Andersen/Enron fiasco and ask how this ever happened in the first place?

Allan: Jeff, it's really a combination of things, but the biggest issue would be the looseness of how Andersen was governed and the excessive latitude local office partners had. Clearly, Enron was a high-risk account and, when push came to shove, the rainmaker partner (David Duncan) was able to overrule the professional standards/quality control partner (Carl Bass) and others. Specifically, when Carl Bass suggested to David Duncan that there was a problem with the financial reporting on Enron, David ultimately told Andersen leadership that the problem wasn't the financial reporting, it was Carl Bass and his continued negativity, and that the executives at Enron wanted him off the account. My guess is this probably would not have happened at the other "Final Four" accounting firms, because their governance is much tighter and quality control would always govern any decision of this magnitude.

Jeff: It's becoming more apparent that Andersen's lackluster audits were not confined to Enron, as other clients such as WorldCom, Qwest, Global Crossing and numerous others have recently restated their financial results. All of us know that Andersen was once a great firm. What changed at Andersen?

Allan: My guess is that much of this started in the early 1990s when the consulting group of Andersen spoke up at a now-famous partner retreat and said they were sick and tired of sharing their profits disproportionately with the audit partners. The outcome of this retreat was a division within the firm, whereby they essentially created two companies and set up what would ultimately be the sale of Andersen Consulting (now Accenture) 10 years later. When Andersen Consulting was sold, Andersen audit partners expected to receive $15 billion in the settlement. Unfortunately, they received only $1 billion. What made this even a bigger negative was that most of the $1 billion was kept in the firm as working capital, which we now know has virtually disappeared.

Simply stated, many believe that when the audit partners were no longer able to rely on the lucrative consulting practice profits, they went out and accepted audits, primarily in the telecommunications and energy industries, that other firms might have rejected. Perhaps another way to put this is that they were much more lax and accepting in terms of financial reporting disclosures (or lack of disclosures) than most other firms. For many years, accounting firms simply accepted that lawsuits and liability were a cost of doing business. But I

Allan Koltin, CPA, is President and CEO of Practice Development Institute, Inc. (PDI) in Chicago, Illinois. Jeffrey S. Pawlow is managing partner of The Growth Partnership, L.C., in St. Louis, Missouri. He is also Editor-in-Chief of the JOURNAL OF TAX PRACTICE MANAGEMENT.

don't think anyone could ever have imagined the magnitude of the financial reporting problems that went on at Enron, WorldCom and others.

Jeff: Since that time, a majority of the Andersen partners have been displaced to the Final Four and a couple of the middle-market national accounting firms. What do you hear about how well the integration is going at these firms?

Allan: I don't think the integration will be easy, but I do believe the vast majority of Andersen partners will learn to adapt to a new culture. I would guess, however, that within the next year, 15 percent to 20 percent of the Andersen partners/staff who went into these deals will find a way to exit from them. They'll either start their own firms or join others created during the Andersen demise. For some partners who were with Andersen for a long time, it will be extremely hard to fit into a different culture, especially since the Andersen culture that was engrained into them led them to consider it the most successful accounting firm in the world. Another reason why you'll see some of them leave is that they will not be able to bring with them as many clients as they and their new firms had hoped. Right now, we're seeing some big surprises as Andersen partners who thought certain clients would follow them find these clients are going to other firms instead.

Jeff: At the time of this interview, we have seen a dozen or so Fortune 1,000 companies restate their earnings. Have we reached the bottom of the barrel or are we yet to hear about quite a few more restatements and financial problems?

Allan: Jeff, I'd love to tell you that we're at the end of the cycle. But between now and the end of the year, I believe we're going to see many more companies come out of the woodwork to talk about substantial restatements of earnings. It doesn't mean these companies are bad; it simply means that you have a situation today in which audit committees and Boards of Directors are taking a much tougher stance in terms of financial reporting. Also, auditing firms are now much more demanding in terms of better disclosure of financial reporting practices at public companies. Given the climate and the recent passage of the Sarbanes-Oxley Bill, my guess is that you'll see more restatements in 2002 than the last three years combined. Having said that, I think you'll see the economy and confidence in financial reporting begin to get much healthier in early 2003.

Jeff: Help our readers to understand, if you could, the one or two major challenges facing accounting firms by virtue of the passage of the Sarbanes-Oxley Bill.

Allan: My guess is that having the accounting profession regulated and, to some degree, governed by an independent board is something that the profession clearly is not in favor of. Having said that, we really didn't have a leg to stand on in Washington, as the Senate, House and SEC debated the issue of accounting industry reform. I think the biggest change right now is the separation of audit and consulting on any public company and soon, on any governmental or regulated entity.

One thing to keep in mind is that this doesn't mean accounting firms can do only audits or only consulting. Rather, how to provide these services is a decision that needs to be made on an individual basis in servicing existing clients. My guess is that some firms will find audits profitable and will set up an alliance whereby they can potentially feed consulting business to some other entity in the hope of getting referrals in return. Alternatively, a firm may look at the potential profit margin on the consulting work and find a friendly competitor to refer the audit to, or at least suggest to the audit committee that they consider a particular firm. The referring firm would then simply serve the client in a consulting, value-added capacity. I'm seeing much more discussion among firms about establishing alliances and collaborative relationships in anticipation of the separation between audit and consulting services.

Jeff: Allan, with approximately 47,000 practice units (CPA firms) in the country, are most of them affected by these changes today? And if not today, could they someday be affected by these changes?

Allan: Jeff, you bring up a great point. Most of these changes really involve SEC (public) companies, governmental agencies and regulated industries. We as a profession are extremely concerned about what we refer to as the "cascade" effect or "trickle-down" theory, whereby state legislatures and state accounting boards will want uniformity with national legislation and potentially will pass a similar audit or consulting standard that privately held companies will need to follow. The impact of this would simply be devastating to the accounting profession and I doubt most firms could recover from it.

Fortunately, I do believe that if the profession again takes a grassroots approach and has 47,000 firms write their senators, congressmen and other political lobbying groups, I do believe we have the strength to win the war. Owners of closely held businesses clearly have a different relationship with their CPA firms. They want and need a CPA to be not just an accountant but, more importantly, to also be a strategic business advisor. There clearly is a difference between Fortune 1,000 companies, mid-cap public corporations and closely held businesses. The government and the investment public need to understand these differences and not overreact in a devastating manner.

Jeff: Quite recently, we have seen the IRS in conjunction with the Justice Department begin filing lawsuits against national accounting firms for their involvement in "tax solutions." Can you tell us what tax solutions are and whether or not this will be the next big negative to hit the accounting profession?

Allan: My guess is that tax solutions have been going on ever since the first tax shelter was created and its important to keep in mind that the words *tax shelter* and *tax solution* are not necessarily negative. Many accounting and law firms have provided value-added services to clients by figuring out legal tax strategies to minimize their tax burden. I can't help but think that to some degree the IRS and the Justice Department are going after accounting firms in these areas simply because of the public outcry against the accounting profession.

A tricky issue now being debated by national accounting firms and the IRS is how much, if any, of the tax strategies (and the names of clients) need to be shared with the government. The accounting firms are making some valid arguments about the need to protect their clients' confidential information, as law firms do, and I think you'll see those arguments tested over the next several months.

Jeff: Allan, is it possible that the national accounting firms involved will have to give back the fees they received from these tax solutions deals? And could the clients involved face substantial penalties and interest?

Allan: My guess, Jeff, and this is only a guess, is that what has happened will probably be grandfathered. But there will also probably be an agreement between the national accounting firms and the IRS to essentially curtail or forever retire some of the more creative tax strategies that now exist. Some firms currently offer as many as 50 different tax solutions strategies to clients. This doesn't mean that all 50 are bad or are in violation of IRS standards. It just means that there might be a handful that need to be permanently relinquished with an agreement to not introduce similar tax planning strategies in the future.

Jeff: One last question in terms of public perception. We've talked about the outrage and negativity that exists toward the accounting profession in the federal government and the investment public. How will this affect recruiting of talent into the accounting profession?

Allan: Interestingly, if there is a silver lining to all of this, we're finding that kids today, whether in high school or college, actually think accounting is cool. I think they were able to look at the Andersen/Enron issue, isolate a few bad apples and realize that things like this can happen in any business or industry. What I think they really came to understand, though, is that accountants aren't simply public servants paid similarly to workers within the federal government. Instead, they are quite entrepreneurial, have the potential to make a lot of money and really advise clients on a wide array of not just accounting, but also business, financial and strategic issues. I think you'll see a turnaround in terms of kids who choose to pursue accounting as a degree in college as well as an increase in those accounting students who choose to move into public accounting as a profession.

Jeff: Allan, I want to thank you for taking the time from your busy schedule to talk with us today and we look forward to catching up with you some time in the future.

Allan: Thanks, Jeff. I'd be glad to talk with you again about these important issues.

For more of Allan Koltin's thoughts on these and other issues confronting the accounting and consulting industry, contact him at (312)245-1930 or akoltin@pdiglobal.com.

ENDNOTES

* From an interview with Jeffrey S. Pawlow, Founder and President of The Growth Partnership, Swansea, Illinois.