Conflict of Interest within Public Accounting Firms Caused by Horizontal Integration

Over the past few decades public accounting firms have been expanding their services to include more than strictly external audit services. This horizontal integration, however, has caused a great deal of controversy among public accounting firms, the SEC, politicians, and the general public. Many people, particularly the SEC, feel that by providing non-audit services public accounting firms are creating a conflict of interest. The issue of conflict of interest has become apparent in recent years due to many highly publicized corporate scandals. One well-known example is the case of Enron and its auditing firm, Arthur Andersen. Although the Enron scandal was one of the most publicized cases, it was by no means the only case or even the largest. Other cases include WorldCom, Parmalat, Tyco, HealthSouth, Qwest, and Global Crossing (Flegm, 2005).

Auditor independence has been, and continues to be, a greatly debated issue largely due to the fact that public accounting services are in constant demand. The U.S. law requires that all publicly traded firms submit to audits of their financial reports, performed by independent outside auditors hired at the firm’s expense (Moore, Tetlock, Tanlu, Bazerman, 2004). Independent outside auditors are crucial to ensuring reliable financial information regarding publicly traded firms.

In a recent attempt to enforce the independence of auditors and to prevent conflict of interest, the 2002 Sarbanes-Oxley Act (SOX) was created. The Act mandated a number of reforms to enhance corporate responsibility, enhance financial disclosures and combat corporate and accounting fraud. SOX also mandated the creation of the Public Company Accounting Oversight Board (PCAOB) to oversee the activities of the auditing profession (U.S. Securities and Exchange Commission). The reforms mandated in SOX, however, have many loopholes and seem to be an insufficient response to the issue of horizontal integration, or the provision of non-audit services by public accounting firms. The result is that public accounting firms remain responsible for a great deal of ethical decision making and therefore, have a high degree of liability. The opinions of public accounting firms, the SEC, politicians, and the general public on this issue greatly differ. The conflict of interest created by horizontal integration is perceived differently by different parties.

Public Accounting Firms. From the perspective of public accounting firms, horizontal integration is a positive and necessary development in the industry. Public accounting is an incredibly competitive industry. Therefore, firms feel constant pressure to expand their services in order to gain a leg-up on their competitors. The expansion of public accounting services to include non-audit services has proven to be very profitable. In addition, auditors argue that with their specialized skills they are the most equipped to provide valuable
consulting services to their clients. In response to accusations that the provision of non-audit services creates a conflict of interest, the public accounting industry argues that the two services are capable of remaining independent of one another. Firms believe that their audit groups and consulting groups are shielded enough from one another that they can prevent a conflict of interest from occurring.

The SEC. The mission of the U.S. Securities and Exchange Commission (SEC) is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation (U.S. Securities and Exchange Commission). Auditor independence is a top priority for the SEC and in order to ensure auditor independence the SEC believes that strict regulations are crucial. It is their belief that investor confidence is strongly rooted in the accuracy of financial information, which cannot be achieved without complete auditor independence. Over the past few decades, in opposition to the public accounting industry, the SEC has pushed for stern legislation in order to prevent ethical issues, such as the corporate scandal involving Enron and Arthur Andersen. The SEC feels that the expansion of the public accounting industry into non-audit services is motivated by the wrong reasons. It wants to ensure that auditors act in the interest of the public rather than their clients (corporate managers) or their own financial interests.

Politicians. Politicians tend to take a more responsive approach to the issue of horizontal integration within the public accounting industry. While some politicians do feel strongly one way or another regarding this issue, most are greatly influenced by the opinions of their campaign investors. One example of this occurred in 2002 when then-SEC Chairman Arthur Levitt was pushing for strict legislation regarding auditor independence, or the elimination of conflict of interest. The SEC went into rulemaking, and the rules they proposed to separate consulting from auditing were met by resistance on the part of the public accounting firms, who lobbied Congress, and Congress put pressure on the SEC to compromise significantly (Reutter, 2002). In this case, public accounting firms were making very large campaign contributions in an effort to sway the support of Congress. They were ultimately successful and the rules proposed by the SEC were greatly slackened. Rather than standing firmly behind the actions that they believe will be most beneficial to investors and the corporate economy, their biggest concern is their reelection campaigns.

The General Public. When examining the perspective of the general public regarding horizontal integration it is important to consider that, for the most part, the general public is ignorant to the complexities of these issues. To compensate for their lack of corporate savvy, the public relies heavily upon the opinions cast by the media. It can be expected that the public’s concern regarding auditor independence and corporate scandal will increase when negative media coverage of these issues increases. It should also be taken into consideration that the media is always looking for a good story so the projections by the media can often be exaggerated.

For those members of the general public that do have experience in the financial world, auditor independence is a very important issue. They want to feel confident with the accuracy of financial information that they are given regarding publicly traded companies. Some level of assurance is important to investors and crucial to the success of the U.S. economy. If investors believe that horizontal integration is a threat to the integrity of publicly traded companies, investor confidence will deteriorate, ultimately hurting the economy as a whole. Some investors, however, believe that horizontal integration is beneficial. They believe that the skills and expertise of public accountants can improve the financial success of publicly traded companies as long as it is not at the expense of accurate and reliable audit services performed for these firms.

Legislation. Because different groups examine the issue of horizontal integration from different perspectives, it is important to understand that there is a high level of complexity when designing legislation. Public accounting firms, the SEC, and the general public all have a great deal of influence over the decisions made by politicians, therefore there is never an easy answer. With so many conflicting opinions the goal of politicians is often to come to a reasonable compromise, while focusing on the integrity of the marketplace. This method of compromise is very similar to that used by politicians when creating the Sarbanes-Oxley Act (SOX).
One goal of the SOX Act was to restrict accounting firms’ ability to provide consulting services to the companies they audit. They attempted to accomplish this through a number of specific restrictions. Auditors are prohibited from offering eight specific types of consulting or other non-audit services to their audit clients. In addition, the lead audit partner must rotate off an audit every five years. Another restriction requires that the CEO, Controller, CFO, Chief Accounting Officer or person in an equivalent position cannot have been employed by the company’s audit firm during the one-year period preceding the audit (Strier, 2006).

Final Analysis. Unfortunately, the restrictions put in place by the Sarbanes-Oxley Act have proven themselves to be insufficient in curtailing the issue of conflict of interest. The act does not require individuals other than the lead audit partner to rotate off an audit. Also, the audit committee has the power to overlook the restrictions in certain cases, thereby allowing auditors to perform non-audit services to their audit clients. As a result, many people feel that the legislation provides too many loopholes and can be too easily manipulated. Rather than taking a clear and definite stance regarding horizontal integration, SOX dances around the issue and allows for judgment on a case-by-case basis, thus destroying any true objectivity.

The evolution of public accounting services presents a difficult ethical dilemma. While the ultimate goal is to maintain a fair, competitive, and vibrant marketplace, there are many different opinions regarding the best way to achieve this. Public accounting firms believe that they have the ability to ensure the integrity of their audits and avoid a conflict of interest, while also competing in the consulting industry. The SEC, however, is reluctant to bestow such a high degree of ethical responsibility on these firms.

The debate over the ethics of horizontal integration is bound to continue for years to come, unless strict legislation is enforced. The subjective evaluation of this issue permitted by current legislation creates a conflict of interest in itself. There are motivating factors behind every group that inhibit an objective evaluation. Whether or not it is the best solution for the success of the economy, the creation of a clear-cut code of ethics for public accounting practices is the only way to relieve the ethical conflict. Therefore, strict legislation must be created to ensure that the emphasis of public accounting firms is on performing top-quality audits versus generating new business and the cross-selling of non-audit services. Ultimately, the most important goal is to ensure investor confidence in the marketplace.

about the writer

Samantha Reichow is currently a sophomore in the Marshall School of Business at USC. She plans to apply to the Leventhal School of Accounting at the end of this year. She is pursuing a degree in Accounting and a minor in Neuroscience. She is also a member of the Kappa Kappa Gamma sorority. In her free time she enjoys teaching swimming lessons to young children and spending time with family and friends. Samantha’s career goals are to make Senior Manager at a Big Four public accounting firm and then become CFO of a publicly traded company. Samantha submitted this paper in response to the “Ethics Assignment” in Professor Yolanda Kirk’s WRIT-340 class.

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