Consulting Practices Draw Regulatory Scrutiny as Their Growth Accelerates

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by Rob Lenihan

Summary: Auditing firms maintain they can provide consulting services in a variety of areas and still perform quality audits. But some watchdogs fear that the growing financial reliance upon consulting fees may undermine the auditors' legal charge to protect investors. So far, the firms are able to say that they’ve balanced the needs of both business lines without hurting their audit work.

PCAOB Chairman James Doty stood before an audience at Baruch College in November 2012 and made his feelings clear.

"In the United States," Doty said, "large audit firms' revenues from consulting are growing rapidly, at some firms more than 15% a year. Audit fees have stagnated at, basically, the inflation rate. Thus audit practices have shrunk in comparison to audit firms' other client service lines."

“This,” Doty added, “threatens to weaken the strength of the audit practice in the firm overall.”

Criticism of audit firms and their consulting businesses has persisted for years, and the conflicts of interest inherent in the consulting work are often scrutinized in the aftermath of financial scandals.

Section 201 of the Sarbanes-Oxley Act of 2002 bans audit firms from providing public company clients most non-audit services without the approval of the client's audit committee. The restrictions were intended to end conflicts of interest that were seen as undermining the auditor's role as a protector of investor interests.

Regardless of the potential for conflict, there is little doubt that consulting has become an important business for the major audit firms.

KPMG LLP reported in December that advisory revenue grew 8.3% in the latest year to $7.86 billion, a significant portion of the $23.03 billion the company report for the fiscal year ending September 30.

Auditing, by comparison, grew by only 0.9%, to $10.31 billion.
Ernst & Young LLP announced combined global revenues of $24.4 billion for the year ended June 30, with advisory services increasing 16.2% to about $5 billion. Assurance increased 3.4%.

PricewaterhouseCoopers LLP said advisory revenues increased by 17% to $8.7 billion in 2012, driven largely by growth in consulting services. Assurance increased by 3% to $14.9 billion.

Deloitte LLP said its consulting revenue grew by 13.5% to $9.7 billion in 2012. Its audit and enterprise risk services revenue grew by 6%.

“In the last five years,” says Joseph Carcello, an accounting professor at the University of Tennessee, “auditing revenues seem to be growing, if at all, at no more than the rate of inflation, and consulting has been growing 8% to 15% a year.”

Carcello says Sarbanes-Oxley cut down on potential conflicts of interest with audit firms and that he sees no compelling reason to ban consulting completely at this point. However, he notes, that if consulting revenue growth continues to outstrip auditing fees for an extended time, there could be a shift in the way audit firms approach their business, as consultants take over the firms’ senior leadership.

“The mind-set of a consulting firm is ‘I’m here to help clients solve problems,’” Carcello says. “That’s completely opposite of the mind-set of an auditor. The mind-set of an auditor is ‘I’m here for the benefit of a third party.’ That’s a gatekeeper mind-set; that’s a public watchdog mind-set. If the consulting mind-set comes to dominate accounting firms, it makes me concerned that the auditing function could suffer as a result of that.”

Auditing firms maintain they can provide consulting services in a variety of areas and still perform quality audits.

Charles Elson, the director of Weinberg Center for Corporate Governance at the University of Delaware, acknowledges that while there is a great deal of unease about the potential hazards of consulting, there is little evidence to support those concerns.

“The empirical evidence out there has never been able to demonstrate a connection between a busted audit and a consulting engagement,” he says. “At some point, someone will either empirically prove there is a connection or there isn’t, and we can make policy based on that.”

“Until then,” Elson says, “it’s a sort of gray area and it will make for good stories.”
W. Robert Knechel, an accounting professor at the University of Florida, says that “to date, this is not a significant problem as far as influencing audit quality.”

“The argument’s been going on for 25 years,” he says. “When you hear people talk about non-audit services being bad, they usually tend to use anecdotes. Anecdotes are nice, they give meaning to a story, but they aren’t necessarily systemic evidence because you can always find a scenario that supports your position.”

While there is “a strong synergy” between tax services and audits, Knechel says some of the other services that audit firms offer “do get kind of far afield of what an audit or accounting firm should be thinking about or doing.”

Consulting can indeed cover a large territory, taking in such areas as computer systems design and implementation; mergers and acquisitions, cash management, strategy, forensics, and industry specific fields, such as healthcare.

For their part, auditors maintain that they can keep both businesses separate and successful.

Greg Garrison, PwC’s vice chairman for clients and markets, says “the audit practice is the foundation of our firm.”

“It’s one we continue to invest in because we believe it’s a good business for us,” he explains. “It provides a foundation for the rest of our practice in terms of the brand we have and have had for well over a 100 years, and in fact, if you look that investments we continue to make it that practice, it’s clearly something we will stay with because it’s who we are.”

Dana McIlwain, who heads PwC’s advisory practice, says 90% of the firm’s advisory work is for non-audit clients.

“Where we do work for audit clients, we’re obviously very focused to insure that it’s permissible services,” he says. “I think the double digit growth in the advisory practice is indicative of a large market, and I think clients are looking for a wide range of skills and capabilities and industry expertise to solve their most complex business issues.”

Cindy Fornelli, executive director for the Center for Audit Quality, says auditing firms need to develop an expertise in a wide range of areas.

“You do want to build up expertise within your firm so that you have experts on hand and you make it attractive for people to enter the profession,” she says. “I would fear if you had
audit-only firms, you wouldn’t be able to attract young talent as easily as you might when they’re coming into a firm where they have an array of areas to focus on.”