

CONFLICTS OF INTEREST IN THE ACCOUNTING AND AUDITING PROFESSION

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Abstract: *The corporate failures of Enron, Parmalat, WorldCom, HIH and the global accounting firm Arthur Andersen have shaken the foundations of investor confidence in the transparency, integrity and accountability of corporations and capital markets. The damage, both economic and social, has been incalculable, and the implications are far-reaching for corporate management, company directors, audit firms and the investing public. An array of factors contributed to these events, but one thing is for certain – the billions of dollars in corporate value lost were due in significant part to unscrupulous management and boards of directors that failed to meet their responsibilities. The accounting profession, including auditors, also played a major role in these events.*

Key words: *accounting, auditing, financial statements, conflicts of interest, confidence, transparency.*

Introduction

Accountancy and auditing are complex and technical processes. Its key characteristic is that it provides some level of assurance to users of conventional, externally-issued accounting reports that the representations made in those reports are consistent with the underlying economic realities. The demand for this service is, in many instances, involuntary because of legislative or other regulatory requirement.

It must be remembered that the financial reports of a company are the representations of the management and directors of that company. It is the board of directors that is ultimately responsible for the content disclosed in those reports. An audit is an attestation of these representations by management by the auditor and assesses the truth and fairness (or in the minds of some, validity or integrity) of those financial reports. These highlights two factors; (1) that the financial reports are indeed simply representations of management and are not primarily the responsibility of the auditor, and (2) that it is the auditor's responsibility to attest to the validity and reliability of those reports. [7]

For the attestation to be of value in the market for financial information, it must meet two necessary conditions. First, the attestation needs to be competently undertaken and executed. It needs to be undertaken by those with relevant expertise in the practice of auditing. This will include expertise on the planning and execution of the audit itself and may include specific specialist expertise in the industry of the auditee company. To be competent, the audit will need to include relevant and applicable audit processes and methodologies and, where relevant, technologies. Secondly, for an audit to be of value it must be undertaken with judgments made and views held that are independent of the management and board of the auditee company. The auditors' judgments need to test the assertions and representations made by auditee managements.

The crisis of public confidence in the accounting profession arising from auditing failures revealed in the disastrous collapses of major corporations, is perceived as a threat not only to the business of auditors but to business itself. The response of governments worldwide to corporate scandals has been greater regulation. This response is often taken in the name of supporting the need for protecting the public's interest. Attention has been focused on flaws in the capital market and reforms to corporate reporting and accounting/auditing that may rectify them. Stock exchanges, global and local accounting and auditing standard-setters, institutional investors and other stakeholders have called for transparency and accountability in corporate governance, business ethics and corporate reporting. New laws and best practice guidance require strict monitoring of auditor independence, codes of ethical conduct, more disclosures, and CEO/CFO certification of various key statements in corporate reports. The aim of these requirements is to ensure effective checks and balances are in place so that good corporate governance and business ethics are observed.

Regulation alone will not regain public trust. Confidence in the capital markets depends on confidence that the reporting and regulatory process will deliver accountability and transparency. This in turn depends on integrity – and integrity depends on one's core ethical beliefs and behaviours. Accountants and auditors face ethical questions on a daily basis. Arguably the underlying principle of both professions' ethics is independence. They must balance their duty to their clients, their profession, society and numerous other stakeholders. An actual or perceived conflict of interest may arise as a result of these competing interests and lead to public distrust – a familiar sight in recent years. Confidence is quickly lost and slowly regained in these instances. A strong code of professional and personal ethical guidelines is a critical starting point to embedding ethical behaviour. The codes set out general guidelines on concepts such as independence, competence and honesty, as well as statements addressing specific issues of professional behaviour. These guidelines are backed with the power to monitor and penalise non-conforming members.

The nature of conflicts of interest

Conflicts of interest may involve a conflict between one's self-interest and the requirements of the role one occupies, or a conflict between two different roles one occupies, or further, they may involve a role confusion which serves to mask a conflict of interest. Further, we will examine the different types of conflicts of interest that may and do arise in the accounting and auditing profession.

The chief financial officer (CFO) traditionally is the executive officer within an organisation entrusted with ensuring that the company operates with financial discipline and propriety and not excess and impropriety. However, in a business environment where investors are expecting and demanding ever-increasing earnings every financial quarter, CFOs come under constant pressure to 'cook the books' and make them look better than they are.[6] This places CFOs in two potentially conflicting roles; the traditional role of policing the integrity and accuracy of the accounts and financial statements of a company, and the contemporary 'role' of making sure that the quarterly earnings of the company look the best that they can, even at times assisting this outcome by recourse to some 'creative' accounting. This conflict of roles creates, in turn, a conflict of interest that has the tendency, at least potentially, of interfering with the proper exercise of the CFO's fiduciary duty of ensuring the integrity and accuracy of the company's financial statements – a duty entrusted to them by the board of directors and the shareholders of the company, as well as prospective investors who require true and fair financial statements on which to base their informed investment decisions.

The role of an auditor is potentially in conflict with the role of a financial adviser, when one accountant performs both roles for the same client there is a conflict of interest. Thus we have potential conflicts of interest in accounting firms that perform audits for the companies for which they also provide lucrative financial consultancy and other financial management services. Here the latter role has a tendency to curtail the auditor's independence, and can thus potentially interfere with the proper exercise of an auditor's fiduciary duty of ensuring that a company's financial accounts present a true and fair view of the company's operations. The role of Arthur Andersen in Enron's collapse is a case in point, and crucially highlights this conflict as potentially conducive to corporate corruption.

The ethically problematic nature of the practice of providing both consultancy and auditing services for clients by accountancy firms, also illustrates an important conceptual distinction between external instrumentalism on the one hand, and internal instrumentalism on the other.[5] In an external instrumentalism, the means or instrument is external to the end, in that it need not have any of the distinctive characteristics of the end. In internal instrumentalism, on the other hand, the means or instrument is internal to the end: it is instrumental to the end not only causally but also conceptually in that its features are also constitutive of the end. It serves as an instrument to the end by enforcing, reinstating, or in some other way bringing about a certain result, while at the same time it embodies distinctive characteristics of the result.

In the case of the practice of providing both consultancy and auditing services (so called 'conauditing'), there is a conflict between the dictates of internal instrumentalism and those of external instrumentalism.[2] In the case of auditing, the purpose is to provide independent public assurance, by way of the certification offered in the auditors' report, that the financial statements of a corporate entity, whether private or public, present a true and fair view – one that can be relied upon with regard to accuracy and completeness by all relevant stakeholders. As such, both the means and the end of providing that type of independent public assurance must conform to the same conceptual and professional criteria of providing reliable certification as to the true and fair view of a corporate entity's financial statements. By contrast, the primary purpose of offering accounting and consultancy services to a corporation is to provide the corporation with the best financial planning, so as to facilitate the successful application and implementation of financial accounting practices and policies for maximising the corporation's profits and assets and minimising its losses and liabilities. Moreover, such financial consultancy is designed to enable the corporation to present its financial statements in the best light possible within the law so as to enhance its market profile, thus rendering it attractive to prospective investors. As such, the strategies of financial consultancy are external to the concern of ensuring that the corporation's financial statements are true and fair – not merely from the corporation's internal subjective perspective, but equally from the independent external and objective perspective of all relevant stakeholders. As the case of Enron illustrates, creative accounting policies employed to make the accounts look good, even when conforming to corporate law, need not reflect a true and fair view, especially as regards the interests of the shareholders – prospective investors as well as other relevant stakeholders that have an interest that the information provided in a corporation's financial statements is actually, and not merely cosmetically, true and fair. Conauditing practices seek to have it both ways: with regard to auditing they conform to a principle of internal instrumentalism, but with regard to consultancy they conform to a principle of external instrumentalism that seems to be inherently incompatible with the internal instrumental auditing function of providing public assurance that a corporation's accounts are true and fair.

Although a conflict of interest might not in the first instance necessarily involve, or result in, corruption, it can nevertheless provide the conditions, and perhaps one of the

necessary conditions, which might facilitate corruption. Thus, it is better for all concerned if the conflict of interest is avoided or if that is not possible the conflict is disclosed and managed in an apparent and accountable way. In the case of Enron, for example, the potentially conflicting roles and interests of Arthur Andersen, in their dual capacity as both financial consultants and auditors of the company, may have created the conditions that facilitated the corrupt activities. That is, the conflict between Arthur Andersen's dual role as auditors and financial consultants may have been a major contributing factor in their failure to exercise proper diligence and care in auditing Enron's financial statements. This was a care which Arthur Andersen owed to Enron's shareholders, which included a large number of the company's employees, a stakeholding group to whom Arthur Andersen owed a fiduciary duty in their capacity as auditors. That fiduciary duty was, however, undermined by their role as financial consultants of Enron. By virtue of that role, Arthur Andersen owed a fiduciary duty to Enron's management, which undermined their role as independent auditors and made them complicit, by association if not by direct involvement, in dubious accounting practices that had the effect of concealing debt and inflating earnings. If the Arthur Andersen auditors knew of those accounting practices (or should have known about them) and did not inform those to whom they owed a fiduciary duty – that is, all the Enron shareholders, and not just the company directors who held large numbers of Enron shares – then they were responsible for deception, by omission if not commission, and thus responsible for the corrupt activities.

The role of the Arthur Andersen auditors with regard to Enron highlights one of the core problems concerning conflicts of interest: role conflicts that involve a conflict of interest relating to outcomes concerning stakeholder groups, to whom one has conflicting fiduciary duties, can potentially facilitate or result in corruption. In sum, in their role as auditors Arthur Andersen may have participated in, or at least tolerated, the concealment and later destruction of evidence that revealed deceptive and misleading accounting practices and policies in the financial reporting of Enron's accounts which no doubt contributed to the corruption within the company, and thus are indirectly if not directly partly responsible for the corrupt accounting practices within Enron.

Resolution of conflicts of interest

The most obvious way to deal with conflicts of interest that actually or potentially facilitate or result in corruption is to avoid them whenever possible. Potential role conflicts can best be avoided through a strict division of duties and responsibilities that does not allow one of the opposing roles to exert undue influence over the other. For example, the division of accounting responsibilities between the cashing and banking functions on the one hand, and the accounts payable and receivable functions on the other hand, reduces the risk of a conflict of interest between those two functions that may otherwise facilitate potential corruption.[3]

A further way of reducing conflicts of interest arising from conflicting role obligations is to institute a strict division and separation of roles between members of professions or other institutions that owe fiduciary duties to different groups of stakeholders with potentially conflicting interests. For example, in the case of accountants, conflicts of interest can best be avoided through the strict division and separation of the auditing and financial consultancy functions within an accounting firm. However, this control may not be adequate to avoid conflicts of interest in situations, as the ones at present, where fees from financial consultancy services far exceed auditing fees. One possible solution to this problem is to increase audit fees substantially to at least match those from financial consultancy services, or, if that is not possible, require accounting firms to choose to undertake one but

not both of the two potentially conflicting roles. Under this envisaged scheme, accounting firms that specialise in auditing would be precluded from acting as financial consultants to their clients, or alternatively, from auditing the accounts of their financial consultancy clients. The problem, of course, with either suggestion is that they might not prove to be feasible or practical for implementation.

It may not, however, always be possible to avoid conflicts of interest, so the next best solution is to disclose them. One of the main conditions conducive to corruption is concealment or secrecy, which enables the agency of the corrupt person or group to remain undetected, thus allowing the corrupt person or group to engage in corruption with impunity and without fear of retribution. Accordingly, disclosure of conflicts of interest, if exercised stringently and properly, can be an effective control measure against corruption by eliminating or at least reducing one of its contributing factors, namely concealment or secrecy.

Apparent conflicts of interest can be as ethically problematic as actual conflicts of interest, because of their tendency to mislead people and create in their minds uncertainty concerning the reliability and integrity of the judgment of those from whom they have a legitimate expectation of a fiduciary duty of trust. The best way to avoid such apparent conflicts of interest is by disclosing sufficient information to demonstrate that there are no actual or potential conflicts of interest. This is important because a suspicion of corruption regarding a person or institution created by merely apparent conflicts of interest can be as damaging to public confidence in that person or institution as actual or potential conflicts of interest. It is precisely for this reason that transparency as an anti-corruption measure is important, not only as a way of preventing corruption through eliminating or reducing one of its key contributing conditions – namely, concealment or secrecy – but also for preserving and maintaining public confidence in persons, professions, practices, processes and public institutions by eliminating or at least reducing the appearance of conflicts of interest.

Conclusion

Role of auditor is potentially in conflict with the role of financial adviser when the same person performs both roles for a client; there is a conflict of interest. Thus we have conflicts of interest in accounting firms that perform audits for the companies for which they also provide lucrative financial consultancy and other financial management services. Here the latter role has a tendency to curtail or diminish the auditor's independence, and can thus potentially interfere with the proper exercise of an auditor's fiduciary duty of ensuring that a company's financial statements present a true and fair view of the company's operations. The role of Arthur Andersen in Enron's collapse is a case, showing how conflicts of interest in auditing can contribute to and result in corruption. Conflicts of interest in auditing should thus be avoided wherever possible, as their mere disclosure does not remove the conflict of interest and hence does not remove its capacity to cause corruption, as in the Enron case.

The corporate collapses and the role of accountants and auditors in it, contribute to decreasing the credibility of profession, public trust has been badly shaken, and the profession has learned the hard way that it should not take its position in society for granted. As the capital market evolved alongside the rapid growth of technology and globalisation, there was an unhealthy shift in attitudes in the corporate world, one that has also existed in earlier times in the development of modern corporations. It is important to understand this phenomenon if any proposed reforms are to be effective in the future. Contemporary approaches to teaching accounting and auditing ethics tend to be unproductive by abstracting ethics from its practical applications. Teaching of ethics needs to be firmly grounded and

integrated into the practical and applied experience of accounting and auditing students and practitioners. The emphasis must be upon the development and practice of the applied skills of values clarification, ethical decision-making and ethical policy-setting. Although the teaching of ethics to accountants and auditors cannot eliminate all cases of professional misconduct, it can assist in minimising such occurrences by waking professionals out of their state of drowsy morality and inspiring them to develop their professional competence (or virtues) and promote excellence in accounting and auditing practice.

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