

Auditing and consulting in accounting firms

[Finance](#)



MORAL HAZARD: CONFLICT OF INTERESTS (Auditing and consulting in accounting firms) of MORAL HAZARD: CONFLICT OF INTERESTS

Moral hazard can be present in any number of situations, but more commonly found in a contractual obligation between two parties to an agreement. In this instance, one party may have no incentive to honor his obligations and responsibilities in the said contract, contrary to a usual expectation to do so, by behaving differently. Another instance is when banks take excessive risk in their investment portfolios on the expectation the government will bail them out in case of any trouble through the Federal Deposit Insurance Corporation (FDIC) in which case, the burden has now been effectively shifted to the taxpayers through the use of tax monies for a bailout.

The concept of moral hazard originated in the insurance business when the insured party exhibits immoral behavior by giving out wrong information, implying an outright fraud, but this definition has since been used in economics, in a situation where there is asymmetry in the information available. One party has more relevant information or data than the other party and is therefore in a better position to take action that will insulate itself from risks, while the other party unknowingly bears the negative consequences if things go wrong or not as expected.

Previously, external auditing firms were hired for their accounting and auditing skills for expertise in these matters. However, the past few decades saw the rise of many independent smaller accounting firms, causing an intense rivalry or competition for new accounting clients. A response by the big global accounting and auditing firms was to branch out into a new service, in which they profess to have management expertise, and this is in <https://assignbuster.com/auditing-and-consulting-in-accounting-firms/>

the consultancy business. In the auditing market, there was saturation and maturity, hence accounting and auditing firms started to offer integrated auditing, consultancy, and advisory services (The Economist, 2012, p. 1). This situation has an inherent moral hazard in it, because accounting and auditing firms should not provide consultancy services to the same firms that they are auditing. There is a good tendency to manipulate the books (window dressing) to enhance assets, profits, or credit rating to justify the huge consultancy fees, which is a very lucrative revenue stream for these firms. Some regulators and policymakers have doubts whether it is possible to maintain accounting integrity or professional independence in these kind of situations. This is clearly an anomaly, similar to the fox guarding the chicken coop; it has been demonstrated by the corporate financial scandal of Enron with the collapse of its auditing firm, Arthur Andersen (Knapp, 2012, p. 16) because of its loss of credibility among accounting clients, pulling in huge fees of \$27 million from Enron.

Although the big firms claim to maintain professional responsibility with regards to the strict separation of its auditing and consultancy services, it is virtually impossible to do so and a perception persists that doing both services to the same client jeopardizes its independence. This inherent conflict of interest results in audited financial statements losing their value or usefulness to stakeholders, investors and other interested third-parties, such as lenders and regulators. In the case at Enron, auditing controls as arms-length reviews no longer existed to prevent fraud and other wrongdoing (Free, MacIntosh & Stein, 2007, p. 1); the malfeasance got institutionalized.

An alternative to enhance the integrity of audited financial statements is <https://assignbuster.com/auditing-and-consulting-in-accounting-firms/>

through the exercise of ethical executive leadership in an organization that emphasizes good corporate social responsibility by hiring two separate firms, one for auditing purposes only and another firm for a consultancy service. Another option is strictly implement the provisions of the Sarbanes-Oxley Act by limiting the non-audit professional services that firms can offer (Mills, 2003, p. 88).

References

Free, C., MacIntosh, N. & Stein, M. (2007, July-August). " Management controls: The organizational fraud triangle of leadership, culture, and control in Enron." Ivey Business Journal Online. Retrieved December 19, 2012 from http://wwwold.iveybusinessjournal.com/article.asp?intArticle_ID=701

Knapp, M. C. (2012). Contemporary auditing: Real issues and cases. Mason, OH, USA: South-Western Cengage Learning.

Mills, D. Q. (2003). Wheel, deal, and steal: Deceptive accounting, deceitful CEOs, and ineffective reforms. Upper Saddle River, NJ, USA: FT Press.

The Economist (2012, September 29). " With the audit market maturing, accounting firms become consultancies." Retrieved December 19, 2012 from <http://www.economist.com/node/21563726>