

We Need True Auditor Independence: Escrow the Fees!

By: Steve Erickson, National Consultant to CPA Firms

Given the significant number of audit failures in recent years and now the meltdown of the financial industry in the United States the issue of auditor independence, audit fees and audit quality needs to be addressed. The relationship between auditors and their clients is a fee-based relationship that creates an inherent conflict of interest that can have significant influence over an auditor's judgment and decisions, whether consciously or subconsciously, as a debtor-creditor relationship is created. In many of the recent audit failures I find they very often have happened due to flawed estimates and judgments. It is my belief that this inherent conflict of interest could be substantially mitigated or avoided altogether by escrowing the audit fees at the start of the audit engagement.

The Enron audit failure which involved over \$50 million in auditing and consulting fees is an excellent example of this situation. Auditors are mere mortals, and no one wants to be responsible for losing a \$50+ million account, particularly if the auditing firm stands to also lose repayment of major expenses already incurred. So in an effort to satisfy the client the auditor may explore whether they can find a reasonable compromise with the client to avoid losing the business. I can't help but wonder if there has been more of this given the current state of our economy and the fact that many unqualified opinions were given on financial institution financial statements in early 2008 only to see them out of business later in the same year.

Whether the outcome is a compromise or a fired auditing firm, the users of the financial statements are the losers. Shareholders, bankers, other creditors, employees and

the general investing public may not receive the independent financial information they require and deserve to make prudent financial decisions.

Audit fees need to be escrowed with a third party in advance of the performance of work. This would minimize any negotiation of audit and accounting standards resulting in more independent and objective audits. There could even be oversight by a third party to make sure the audit has been completed in accordance with Generally Accepted Auditing Standards (GAAS) prior to the disbursement of the final fee to weed out those auditing firms that are not performing their audits in accordance with GAAS. This step alone would have been a real deterrent in some of the recently discovered Ponzi schemes and maybe could have saved investors millions if not billions of dollars.

What the public needs from the public accounting profession is increased accountability. Separate the decisions about money from the audit results and watch the quality of audits improve dramatically. The accounting profession needs to pass a standard that requires that audit fees be placed in escrow before the start of fieldwork.

Steve Erickson
National Consultant to CPA Firms
46 Mill Rd NW
Albuquerque, NM 87120
(505) 331-9100
Steve@SteveEricksonLLC.com