

# Auditors and other services: “Phlogiston logic” the order of the day

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*“Phlogiston”* is a substance which scientists once believed played an important part in the process of combustion. It later turned out that there is no such thing as “phlogiston”. But until this happened, scientists seriously pronounced the values of phlogiston. Today, phlogiston also means the “fallacy of misplaced concreteness” – when a hypothetical notion is treated as if it is real. Dr Frederik Van Zyl Slabbert explained the phenomenon of *phlogiston logic* as it related to the former apartheid regime. He refers to the manner in which Hendrik Verwoerd invented and then used the concept of “one white nation” and “many black nations”. “From it flowed policies totally unrelated to reality, but with devastating consequences”.

Whenever the debate over auditors providing other services to the companies they audit rears its head, auditors, supported by their professional bodies, raise numerous arguments to indicate how unreasonable the prohibition of this practice would be.

The industry’s advertising and promotional muscle works mercilessly to publicize only supportive arguments and to suppress any views to the contrary. In academic circles their journals (funded and supported by a well established “old-boys” network), which publish only views that are in line with the strategy of these bodies, are known as “captured” journals. Research grants are channeled to those known to support their

strategies, thereby effectively eliminating any critical voices. Where these critical voices do surface, the tactic is predictable: *ignore*, *isolate* and *discredit* them.

The arguments presented to support the continuation of the practice whereby auditors provide other services to their auditees, are cloned from a mixture of phlogiston logic and crooked thinking.

In presenting their arguments, those arguing *for* the continued practice, escort the listener/reader through seemingly logical statements which end up with the inescapable conclusion: audit and other services are in perfect harmony, supporting and complimenting each other. A bit like this: "We all agree that the roof gets wet when it rains, so if the roof is wet, we surely all agree it must be raining". This incorrect assumption is then used to justify other seemingly logical conclusions.

Or for example: "All cats are four-legged animals. Fido (the dog) is a four-legged animal, therefore, Fido is a cat." Since Fido now has nine lives, as all cats have, we can safely assume that he won't mind us taking one of them! Add to this a fair measure of "predigested thinking" and the argument becomes even more convincing (and misleading). The advocates of the argument that auditors should be allowed to provide other services to their auditees, also only allow the argument to be carried along predetermined postulates for popular discussion.

This article presents a few of the most common arguments raised by those in favour of auditors providing other services to the companies they audit. It also exposes the flaws in those arguments. It is trusted that the reader will identify the phlogiston logic.

### Argument A

*There is enormous pressure on auditors to "add value". Due to high costs associated with an audit, managements want auditors to provide more than just an audit report. If the audit profession does not respond to this call for added value, it may find itself without any demand for its product.*

Because the nature and extent of audit work is not generally known, the argument that “audit has to add value” is commonly accepted. This is a good example of a logical fallacy. The term *value* has a dual meaning. Audit does indeed have to add value. The value is, however, related to the creditworthiness of the reported figures, the assurances that management has properly discharged its responsibilities. Not the value of improving internal control systems or saving income tax through clever tax avoidance schemes. The audit does indeed *lose all value* if it is not conducted by an *independent* auditor. Quite right then, that management, realizing that the audit itself has no more value (auditor not independent), requests the auditor to provide some other valuable service instead.

That is why the psychologist Thouless (1956) reminds us: “The first step necessary to enable the detection of fallacies in the arguments presented, is to get out of the habit of judging the soundness of an argument by considering whether we agree with its conclusions, and to concentrate instead on examining its form.”

### Argument B

Some years ago, the Office of the Auditor-General convened a meeting to discuss its rule that audit firms contracted to assist the Office with the audit of entities were not allowed to provide any other services to that entity. *A partner of a big audit firm argued that this prohibition was unnecessary if the other services did not relate to financial figures. If his firm was the auditor of a waste disposal company and the company asked them to assist with the development of a new sewage system, how on earth, he argued, does the sewer and the work done there have any effect on the financial figures. At the same meeting other auditors pointed out that providing assistance with interviewing and appointing senior staff, had no effect on the figures in the financial statements. According to them it was therefore unreasonable to prohibit such involvement.*

In the above examples, a major part of the argument has been omitted. If you agree with the arguments by the auditors, you have fallen into the trap, you have concentrated on their conclusions, but forgotten to examine the argument’s form.

Independence refers to the relationship between auditor and management. Only a person *independent* from management can effectively judge management and express the necessary opinion with regard to the assertions and statements they have made in the financial statements. So, no matter in which financial or non-financial aspect of the business the “other services” are provided, such work introduces a new relationship between auditor and management. It is a relationship whereby management engages the auditor; whereby the auditor is responsible to management; whereby the auditor is willing to receive instructions from management; whereby management approves the remuneration of the auditor; whereby the auditor is paid by management; whereby the auditor’s work is judged by management; whereby the auditor’s work can be terminated by management.

All these elements conflict with the relationship the auditor has on grounds of his/her audit appointment. The need for an audit originates from the premise that the interests of shareholders and those of management may easily be in conflict. No auditor can therefore serve two masters and satisfy both in circumstances where their interests are different. In this regard, the advocates in favour of the “other services” debate have in fact disregarded one of the basic auditing postulates (refer Mautz & Sharaf) stating that the auditor acts exclusively as auditor when examining the financial statements. This again illustrates how phlogiston logic has diverted the argument away from the most basic assumptions underlying the audit function.

The nature of the audit assignment requires the auditor not to accept instructions from management, but to be responsible and accountable to the shareholders and to subject the work of management to *independent* assessment.

In addition to the above, the professional pronouncements (Code of Conduct) remind the provider of other services that he/she (in our case the auditor engaged to perform the other services) *owes a duty of loyalty to their employer* (in our case the management). The word “loyalty” implies a form of faithfulness or subordination. Any dictionary of synonyms lists the word “dependability” as a synonym for “loyalty”, highlighting the loss of independence where other services are provided.

### Argument C

*The provision of other services is an integral part of the audit. It is a way in which auditors can add value, since the client wants more than just the auditor's opinion. As the Chief Executive of one of the big five audit firms put it: "The reality is that audit firms are finding that their clients are increasingly looking for auditors that are in essence business advisors, and that the audit has become a by-product of their interaction with the client".*

In this regard the audit industry has (incorrectly) assumed that management is the actual client and not the shareholders. Of course, management wants auditors to assist them with their business problems, especially if it means that the otherwise distant and formal relationship between auditor and management is broken down to a *business partner* level. Shareholders send auditors into their companies to check on management and to demand accountability. Wouldn't we all love the Receiver of Revenue or other regulators to be our "business partners"!

An examination of the relationships relevant to the audit function substantiates the position that auditors are appointed by the shareholders and also report to shareholders. Even the audit remuneration is approved by shareholders at the annual general meeting. The shareholders are the auditors "clients", not management.

### Argument D

*During the audit, the auditor obtains a thorough knowledge and understanding of the "client's" business. This knowledge enables the auditor to provide other services at a much cheaper rate than outsiders would be able to. If other accounting firms were to be engaged, the company would also have to pay them to obtain the knowledge the audit firm has already acquired.*

The argument contains many fallacies. Firstly, whilst the statement could be partially true, it misses the actual argument. The argument is about auditor independence. If providing other services prevents the auditor from issuing an independent opinion and has the effect that the auditor is seen as a business partner, the audit fails to achieve its objectives. Therefore the total audit fee can be classified as fruitless and wasteful expenditure.

Secondly, there is no assurance that these “other services” are indeed provided at a cheaper rate. Research in non-captured scholarly journals indicates that the exact opposite may well be true. If the audit is performed by a management lapdog that exposes none of management’s errors and oversights, who will contest an expensive consulting fee? A case of “One hand washes the other and the shareholder bites the dust”.

The Public Accountants’ and Auditors’ Board (PAAB) *Code of Professional Conduct* states “One key concept in auditing involves examination of the system of internal control which necessarily involves suggestions for improvement. For these reasons it is impracticable to define the limitations on the advice which a member or associate in public practice may give.” In short, since auditors have to examine the internal control system of the companies they audit, making recommendations to improve these systems is a natural product of the audit.

Again there is partial truth in the statement, but again, the real argument is about independence. What happens if the auditor’s recommendations are later found to have overlooked an important aspect and that this was the reason for a substantial theft or loss? How independent are auditors to report such matters, if their work (other services) has actually contributed to or caused the loss? In addition, identifying weaknesses is one thing, making recommendations to improve the system involves much more work. Various options have to be evaluated, the effect of the recommendations investigated and many other factors have to be considered. Making recommendations on how to improve systems is certainly not described in the auditing standards.

This self-imposed, but mistaken “duty” may in fact account for higher than necessary audit fees. Auditors will tell you that in business, risk dictates remuneration. The higher the risk, the higher the expected reward. They also say that the more work they do, the higher the fee. Making recommendations certainly adds an additional risk in that the recommendations may be challenged and possibly found to be wrong. There is only one motivation for auditors to voluntarily do more work *and* incur a higher risk – they earn a higher fee!

Again the examination of the argument exposes its fallacies.

#### Argument E

*Specialised knowledge on accounting matters is a scarce resource and South Africa does not have an unlimited supply. If certain firms are prohibited from offering other services, a valuable resource is wasted.*

By now the reader should be able to identify the misleading notion. No-one proposes that audit firms are prohibited from providing other services to companies. They should, however, not be allowed to provide these services to companies *where they also act as auditors*. In this way the full capacity of the audit industry is left intact. The consulting work will only be redistributed amongst the various firms in the cartel. Having one accounting firm improve the system and another one auditing these changes will in fact improve the quality of both the audit and the other services.

For example, firm B (the consultants) will work very meticulously, knowing that their competitor (firm A) is auditing their work. And the most obvious advantage also needs stating: Firm A can now make a truly independent assessment of the system. After all its not their own work they are now asked to audit.

#### Argument F

*The last case presented argues that South Africa values a free-market approach to business and that companies have the right to choose their business advisers. If management decides that they want to engage their auditors for other services, any prohibition to that effect would compromise their “free market” choice. The PAAB’s Code of Professional Conduct joins the chorus: “Many companies (particularly the smaller ones) would be adversely affected if they were denied the right to obtain other services from their auditors.”*

Predigested thinking: The audit function is simply *not* based on free-market principles. Management has no choice but to appoint an auditor, since an Act of Parliament requires them to do so. To worsen matters; they may not appoint the person or firm of their choice, but have to choose from a closed, elitist group which is registered in terms of another Act. Ironically, auditors do not complain about this curtailment of free market forces. Applying phlogiston logic, we could formulate the following sentence for inclusion in the PAAB’s Code: “Many companies (particularly the smaller ones) would be adversely affected if they were denied the right to *not* appoint an auditor.”

The next time you are confronted with an argument that advocates one audit firm being allowed to provide both audit and other services to the same organisation, beware the clones of phlogiston logic and ask yourself: is this yet another policy “totally unrelated to reality, but with devastating consequences”?

### Argument G

*“Research has not proven that the provision of other services negatively influences the auditor’s independence”*

This last argument is the most misleading and malicious of them all. Not only does it exploit the fact that the public does not have a detail knowledge of the auditing industry’s standards as formulated by the self-regulating bodies, it also distorts the truth and betrays science and those practicing it.



The simple truth is that research has proven the detrimental effects that the provision of other services have on auditor independence. It has been proven many times over, as will be shown later.

### ***The first flaw***

The first flaw in the above argument is that the professional bodies do not define what they mean by “independence”. Therefore anything goes (or doesn’t). This manipulative approach has been experienced before: When the laws of the apartheid government defined certain human rights infringements as being within normal policies, they were perfectly legal. No rule or law forbade these practices, in spite of the majority of people rejecting them. Now because professional auditing bodies allow the provision of other services to auditees such practice is deemed “legal”.

- Why did the apartheid government never define what they understood by “human rights”?
- Why have the auditing self-regulators not defined what they understand by “independence”?

If they did, the public would be able to evaluate their standards objectively.

### ***The second flaw - the big secret!***

Those who point out so cynically that *“Research has not proven that the provision of other services negatively influences the auditor’s independence* warily guard a big industry secret. The public is not told that the industry’s own standards state that an auditor does not only have to be independent, but must *also be seen to be independent*.

And here, at last, we also find our definition of independence. Like beauty, it lies in the eyes of the beholder or, in the case of other services, in the judgment of the *users* of auditing services. Should the *users* of auditing services state that an auditor is not independent (even if, for argument’s sake, the auditor may actually be independent in a particular case), then the end result is that this particular auditor is not meeting the

industry's own standard of independence. This auditor is not *seen* to be independent and therefore does not adhere to the auditing standards: end of matter.

*The argument's third flaw*

So, according to the auditing industry at least, research has not proven that provision of other services impedes auditor independence. For a moment, let us put aside the fact that it has actually been proven many times. The question is: why should the *users* of auditing services prove anything? Taking into account the statutory monopoly the auditing industry enjoys, its self-generated and self-regulated standards and their claims that they adhere to these standards as well as the fact that the auditor receives remuneration for services provided that the work actually meets these standards, surely *auditors* have to prove that their "other services" do not compromise independence. The onus to provide proof is on the auditors not the public. *Auditors* have to prove that they are still independent even whilst providing other services – and I strongly doubt that they would be able to. I have, over the last decade, studied hundreds of articles on the topic and have not read a single article that actually *proves* auditor independence where other services were also provided.

This is quite significant, since the auditing industry has assembled a host of so-called "captured" academics, who enjoy considerable benefits whilst publishing statements which support the industry. These benefits include research grants, prestigious positions on committees, a superficially high profile in professional journals as well as numerous awards and titles.

I have on record, a letter from the Chief Executive of the South African Institute of Chartered Accountants (SAIOCA) which states that the Institute will support research as long as it *is in line with the Institute's strategies*. Researchers publishing results which may contradict the regulators' own construct of what constitutes the reality of auditing, do so at the risk of having the regulators' vast influence and infrastructure used against them to attempt to discredit not only published material, but also personal integrity.

And yet, in spite of all the efforts by the auditing industry to silence critical voices, many scholarly works prove the detrimental effect that providing other services has on auditor independence.

***Biased research – the fourth flaw***

Although professional accounting bodies are not known for their research initiatives and outputs, they do occasionally use this word to give credibility to their viewpoints. In fact, their research reputation is highly suspect.

Some time ago the Office of the Auditor-General approached the Department of Auditing at the University of Pretoria and asked for advice regarding certain research findings of the SAIOCA on the topic of other services. The SAIOCA together with private sector audit firms were putting pressure on the Office to relax its rule that private sector auditors helping the Office on a contract work basis, were not allowed to also provide “other services”. In support of their arguments the SAIOCA attached a list of references. An examination of the SAIOCA list, however, revealed that it was a selective collection of articles that only included authors who supported the unrestricted provision of other services. They were mainly published in *captured* journals or research sponsored by audit firms or professional societies. When the Department of Auditing approached the SAIOCA to enquire why none of the scholarly works published in international journals of high research status had been included in the list, we were told that the list was not to be seen as a comprehensive source on the subject...

Another professional body, the Public Accountants’ and Auditors’ Board (PAAAB), administers a system whereby research assistance is given, provided the researchers meet certain conditions and criteria. One such condition is that a “supervisor” is appointed by the PAAAB and that the researcher has to report to this “guardian” before publishing any material. The perfect system of censorship.

Another professional body, the Public Accountants’ and Auditors’ Board (PAAAB), runs a research unit for which selected outside researchers are contracted, provided they meet certain conditions and criteria. One such condition is that the PAAAB appoints a

“supervisor” for each project and that the researcher has to report to this “guardian” before publishing any material. The perfect system of censorship.

With a new Act for the accountancy and auditing industry in the pipeline, we have recently read a lot about the “research” which has been conducted by the professional bodies. Such research, the SAIOCA in particular, claims, forms the basis of their inputs towards shaping the new legislation. As member of SAIOCA, and an accounting academic, I approached the Institute and asked to be given access to the available information and the research outputs. This could not be done. After numerous enquiries I was eventually told that there was no research report or information that could be made available to me. I also asked for the names of those who served on the research team that supposedly undertook the research, and what methodology the team followed. To date the Institute has not been able to answer these simple questions.

***And finally: the proof***

A few years ago, the Department of Auditing at the University of Pretoria undertook a research project of enormous scale, involving more than 16,000 financially knowledgeable persons in South Africa. 43% of the 4,470 respondents indicated that the provision of other services had a detrimental effect on auditor independence. 43% did not see the auditors as independent in such circumstances. The research questionnaires were also sent to auditors. 19% of the 1,374 auditors that responded indicated that they believed that they were less objective when also providing other services. This is significant, as it meant that the auditors were actually admitting to not adhering to their auditing standards.

The above research was undertaken before the Commission of Inquiry into the Affairs of the Masterbond Group and Investor Protection in South Africa published its findings and drew attention to the negative impact that other services have on auditor independence. The questionnaires were also sent out prior to subsequent scandals such as Regal Treasury, Leisurenet (in South Africa) and Enron and Worldcom, all of which highlighted the “other services” aspect.

It is therefore safe to assume that at present an even higher percentage of auditors and financially knowledgeable persons would indicate that “other services” negatively affect auditor independence. Providing more convincing proof that auditors are not *seen* to be independent.

Similar research findings have been published in other countries – what more proof do you need?

### *Conclusion*

The provision of both audit and other services to companies allowed the auditing industry to earn huge fees. In this regard the audit provided the perfect springboard to identify and offer lucrative other services to the companies which are compelled by law to appoint an auditor. The auditors’ statutory right to obtain information and speak to management, has thus given the auditors a tremendous advantage over other consultants. The auditing industry has profited immensely from these conditions. It is naïve to believe that they will voluntarily relinquish this advantage. It will have to be taken from them. Given the financial benefits involved, no-one should underestimate their determination to keep it.

Fortunately, history has taught us that sectional interests may *delay, but never stops* the achievement of a public interest equilibrium.