Accounting Quality, Auditing, and Corporate Governance

Eugene A. Imhoff, Jr.

SYNOPSIS: To achieve orderly capital markets around the world, corporations must provide investors and creditors with relevant, reliable, and timely information. Accounting, auditing, and the structure of corporate governance that they operate within are essential components in the flow of information to capital market participants. However, recent accounting failures have pointed out the need for substantive improvements in these components. The academic accounting community can play a role in stimulating change aimed at enhancing market efficiency through commentary and scientific-based research that provide direction for change.

The purpose of this commentary is threefold. First I review the historical development of accounting, auditing, and corporate governance in an effort to identify and understand salient features of the past that have led to the current state of affairs. I then propose changes in accounting, auditing, and governance that I believe will address the current problems with the underlying quality and integrity of the financial reporting process. The third purpose of these comments is to stimulate further debate and empirical research aimed at enhancing the future quality and integrity of the financial reporting process.

THE PAST

Demand for Auditors

The 18th century industrial revolution stimulated the formation of capital markets and the separation of owners and managers.¹ With this separation came the potential for opportunistic management behavior. This, in turn, created a market for independent auditors, voluntarily hired by some to provide a way to check on managements’ performance with the owners’ resources. However, the publicly owned corporation survived for well over a century without any requirements regarding auditing, guided only by the financial reporting rules of the stock exchanges. But when the market crashed in 1929 Congress became convinced that it was due, in part, to the lack of meaningful reporting requirements to protect investors and creditors.² They believed economic conditions would not improve until the public regained confidence in the financial markets and the Securities Act of 1933 and the Securities Exchange Act of 1934 were passed to address these concerns.

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¹ The New York Stock Exchange was established in 1792 for the trade of ownership shares.
² For a discussion, see Willet (1968, 208–214).
The SEC was given the responsibility for establishing financial reporting standards and began issuing standards in 1937. They also required all publicly traded corporations to have an independent audit each year. The independent auditors would attest to the fairness of management’s financial reports to the shareholders, would note any deviations from the acceptable accounting rules (Generally Accepted Accounting Principles, or GAAP), and would perform their audits in accordance with established auditing practices and procedures (Generally Accepted Auditing Standards, or GAAS). In essence, the SEC handed the public accounting industry a franchise to serve every single public corporation on behalf of the investing public.

The Role of Corporate Boards

Shareholders understood the limitations of the corporate structure from its inception, and often appointed representatives to serve their interests. These shareholder advocates took the form of the “Corporate Board of Directors” whose responsibilities were to meet with and oversee the managers of the entity and look out for the interests of the owners. Boards eventually added refinements such as subcommittees to address some of the more sensitive governance issues. During the 20th century the “audit committee” was established to provide an interface between the independent auditor and management. Normally made up of outside directors, the audit committee was designed to add to the quality and integrity of management’s financial reports, serving as a liaison with the independent CPAs and eventually the internal auditors in most corporations. The board of directors also made sure managers received appropriate compensation for their efforts. Many boards established special “Compensation Committees” to see to it that incentive plans properly rewarded managers for their efforts to maximize shareholder wealth.

Auditing Standards and Accounting Rules

As the 20th century unfolded the audit industry prospered and gained respect. But their development was not without setbacks. From time to time weaknesses in auditing standards were highlighted by widely publicized cases of management fraud and corruption. Professional auditing standards improved in response to these problems, and the image of the professional accountant remained one of respect in the business community during most of the 20th century.

Accounting standard setting also experienced a series of growing pains and changes in authoritative bodies. With the blessing of the SEC, the AICPA formed the Committee on Accounting Procedures (CAP) in 1939 to lead the establishment of accounting rules. The CAP was replaced by the AICPA’s Accounting Principles Board (APB) in 1959. Then, due to mounting criticism over the dual responsibility of the AICPA for both accounting rules and auditing standards and practices, the APB was replaced. In 1973, an independently funded full-time, standard-setting organization called the Financial Accounting Standards Board (FASB) was established. The mission of the FASB was to develop standards that would best serve the decision-making needs of investors and creditors. The reporting requirements under U.S. GAAP and the capital markets they served both grew significantly in the last quarter of the 20th century.

Questions of Accounting Quality Arise

Despite the continuous development and refinements in GAAP and GAAS during the 30 years following WWII, a new wave of high-profile business scandals ensued. Accounting and auditing

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3 For a classic source of the development of corporate governance, see Berle and Means (1932).
4 See, for example, the cases of Ultramares v. Touche (1931) and McKesson & Robbins, Inc. (SEC 1940) that impacted the auditing standards for inventory and accounts receivable verification.
5 See, for example, Escott et al. v. Bar Chris Construction Corp. et al. (1968), United States v. Simon (1969) (the Continental Vending Corp. case), and Equity Funding in 1973 (see Seidler et al. 1977).
were often cited for failing to prevent these problems. By the end of the 1970s both accounting and auditing were under attack for failing to satisfy the needs of investors and creditors. Congressional investigations led by U.S. congressmen in both the House and Senate (Moss and Metcalf, respectively) criticized the public accounting profession for their lack of independence from corporate managers (U.S. Senate Subcommittee on Reports 1976; U.S. House of Representatives Subcommittee on Oversight and Investigations 1976). One area identified as troublesome was the dual role that CPA firms played as both independent auditors and management consultants to some of their client firms. This, in turn, created concern about the underlying integrity and quality of the financial reporting process. It is noteworthy that the academic accounting community responded to these developments with research to document the extent of the problem and to suggest solutions. However, the CPA firms stayed the course, weathered the criticisms of Congress, and came out the other side realizing the strategic advantage they had to further develop their high-margin consulting practices.

GAAP was also criticized during this period for its inability to provide relevant and reliable information in periods of significant price change. Double-digit inflation rates led the SEC and later the FASB to issue reporting requirements to address the limitations of the historical cost principle. However, during the 1980s when inflation waned, corporate lobbying succeeded in eliminating these disclosure requirements.

The 1970s also ushered in new initiatives by the major CPA firms to maintain their client base as waves of corporate mergers and acquisitions took place. As client firms merged with companies in other countries or developed operations abroad, the big CPA firms needed to grow internationally in order to retain their market share. Mergers with foreign auditing firms followed. Ernst & Ernst became Ernst & Whinney; Peat, Marwick, & Mitchell became KPMG Peat Marwick; and Haskins & Sells became Deloitte Haskins & Sells.

CPA firm combinations were not confined to international firms. Within the U.S. a good deal of CPA firm consolidation and attempted consolidation also occurred. Firms sought to provide a full menu of consulting services to clients in every industry to demonstrate their market strength and expertise. Major CPA firms developed reward systems that focused on the growth in their client base and the ability of partners to obtain new business. To this end the Big 8 not only acquired smaller firms, but also began to acquire one another. In the process Ernst & Whinney merged with Arthur Young; Deloitte, Haskins & Sells merged with Touche Ross & Co; and Price Waterhouse merged with Coopers & Lybrand—and the Big 8 became the Big 5. Like any firm that grows significantly and rapidly through merger(s), the big CPA firms struggled with the merging of company cultures and their ability to maintain high-quality services during a period of time when they faced increasing pressure to reduce costs.

The Audit as a Commodity

As the CPA firms grew and merged, they became more strategic and more cost-conscious in their efforts to obtain new clients. In the mid-1970s, in response to pressures from the Federal Trade Commission, the rules of the AICPA changed to permit CPA firms to advertise. Aggressive open

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6 For a good review of the literature regarding audit independence, see American Accounting Association Financial Accounting Standards Committee (2001).

7 An exception to the general response to the congressional pressure, interestingly enough, came from Arthur Andersen. In the 1970s Harvey Kapnick was the managing partner of that firm and he helped to build it into the largest CPA firm in the world. Mr. Kapnick was influenced by the congressional inquiry of the mid-1970s in a different way than most, and began proposing to his partners that Andersen spin off the consulting operations from the audit operations of the firm. Mr. Kapnick was voted out of the managing partner position in 1979 and retired from the firm.

8 See ASR No. 190 and FASB No. 33 reporting requirements.
competition for audit clients soon became a new attribute of the accounting profession.\textsuperscript{9} Like any competitive industry, cost would be a key ingredient in determining the winners and losers. So firms set out to be the low-cost provider of audit services, commonly viewed as the entry to the more lucrative consulting engagements with client firms.\textsuperscript{10}

CPA firms worked to cut costs of their audits in many ways. One obvious change was the nature of their entry-level hiring. By the late 1970s entry-level auditors with graduate degrees became relatively uncommon compared to prior decades. By the 1990s, several firms began hiring students without accounting training and putting them through educational programs affiliated with several major universities.\textsuperscript{11} CPA firms worked to streamline the number of hours required to conduct an audit in order to be as competitive as possible in bidding for new audit business. Independent CPA firms also went after the internal audit business. By bundling all audit-related services, “independent” CPA firms were able to reduce the client firm’s overall costs of auditing.

By the late 1980s the major CPA firms had taken the franchise handed to them by the Securities Acts of the 1930s, and turned the audit into a commodity. The downward pressure on auditing costs led to relative reductions in salary and quality of audit staff, less substantive tests of details and more reliance on analytical review techniques, and factors that generally led to a lower-quality audit.\textsuperscript{12} In hindsight, the impact of these changes on the quality of the financial reporting process seems obvious. In the boom markets, the negative consequences of declines in audit quality had few opportunities to surface. But in the aftermath of an economic boom, problems stemming from poor quality auditing and permissive accounting tend to surface with great regularity.

\textbf{THE PRESENT}

\textbf{Governance, Financial Reporting, and Management Incentives}

Let’s reconsider the reporting setting. Today corporate boards, managers, auditors, and accounting standard setters are presumably all working together to create a financial reporting process of unparalleled integrity. Over the years, U.S. GAAP has become the benchmark for all other nations. Greater “transparency” for U.S. financial statements stems from greater recognition and disclosure requirements of GAAP as well as more frequent and timely reporting requirements.\textsuperscript{13} The Chairman of the U.S. Securities and Exchange Commission has implored his counterparts in other countries (IOSCO members) to converge to U.S. GAAP to ensure orderly capital markets and a lower cost of capital for market entrants and participants.\textsuperscript{14}

Within the U.S. financial reporting environment, we have increasingly provided managers with incentives to manage earnings and to delay and/or conceal bad news. For better or worse, most cash

\textsuperscript{9} To illustrate the extent to which firms would go to obtain new clients, consider the Penn Square Bank example where Arthur Young & Co. lost the audit to Peat Marwick in 1981 after giving a qualified report on loan loss reserves in 1980. Peat Marwick gave Penn Square a clean opinion in March 1982 on both the 1980 and 1981 reports and related loan loss reserves less than four months before Penn Square failed.

\textsuperscript{10} See Burton (1985) and Stevens (1985).

\textsuperscript{11} Coopers & Lybrand had a program with Northeastern University and others for many years dating back to the 1980s. More recently, Ernst & Young has developed programs at University of Virginia, Notre Dame, and elsewhere to train recruits to become auditors through special accelerated programs.

\textsuperscript{12} These accusations are based largely on discussions with audit staff, former audit staff, and former students. However, in my 25 years at the University of Michigan Business School our accounting B.B.A.s went from the highest paid to the second to lowest paid job category. Our current Master’s of Accounting students specifically trained for careers in auditing are routinely bid away by significantly higher-paying nonaudit employers. Discussions with colleagues elsewhere add support to these accusations.

\textsuperscript{13} The number of accounting “standards” in U.S. GAAP provides support for this position. Also, see recent evidence by Leuz et al. (2003) suggesting the U.S. reporting environment is the least permissive of 31 nations studied with respect to earnings management.

\textsuperscript{14} For example, see the speech by Arthur Levitt (1998) and empirical research concerning the impact of disclosure on cost of capital by Botosan (1997).
bonus plans as well as most stock option plans or stock award plans are based on accounting results (Bloedorn and Chingos 1991; Ittner et al. 1997). This has made the financial statements the focal point of management’s wealth maximization strategy. So while the financial reporting process is providing investors and creditors with GAAP- and GAAS-based reports on the entity’s performance, it is also impacting the current and future wealth position of its managers (and board members).

Incentives for a strategic game can easily develop in this environment. The game: managers try to mask their wealth-enhancing activities and/or their managerial failures by manipulating financial reports, often to conceal or delay bad news. If the managers are unable to perpetuate these window-dressing activities, then they can always hire the creative talents of financial consultants. The role of many of these financial wizards (often from the client’s CPA firm’s consulting group) is to develop financial schemes to help managers look like they are performing beyond the expectations of the shareholders.

**Identifying the Problems**

Reading the popular press since the turn of the century leaves one wondering how the corporate disasters of today could have happened given our system of governance, the transparency from our financial reporting requirements, and the development of audit technology in response to the hard lessons of the past. What is it that is not working in practice?

Start with the fact that corporate boards are not really nominated by the shareholders. They may be voted in by the shareholders but no choices are offered on the ballots. How do the proposed slates of corporate directors get their names on the ballots? Let’s face it: the CEO significantly influences the membership of corporate boards. It is not unusual for the Chairman of the Board to be either the current or former CEO of the firm, to be the most influential person in nominating new board members, and to control the agenda of all that goes on at board meetings. Top management’s influence over the board composition seems contrary to effective corporate governance. If the corporate board oversees management on behalf of the shareholders, then why does management sit in such a position of importance on the board of directors? Why does the CEO nominate people to serve on their own oversight board?

**Options and Incentives to Conceal Bad News**

Adding to the problems of board independence is the fact that board members are frequently compensated with stock options. Options provide incentives not to face up to setbacks in a firm’s performance. If management can find ways to conceal and/or defer them to the future when things might improve, then currently exercisable options that might otherwise become worthless can be realized. What kind of incentives do options create for corporate boards? How can holding stock options that could become worthless when bad news is revealed make the corporate board advocate for transparency and full disclosure in financial reporting? This is the reality of corporate governance in the U.S. today, and it provides the opportunity for major problems with our system of checks and balances.

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15 While the ultimate value of stock option and award plans are based on future market prices, the quantity (pool) of options made available to managers (and directors) in any given year is frequently based on current accounting performance measures.

16 This is a problem for growth firms that try to perpetuate their growth. Enron is among the many growth companies that resorted to bad accounting in order to maintain rapid growth in sales and earnings. Andersen was there to help Fastow create the vehicles (Raptors 1-4) for dressing up the financials.

17 Evidence by Davis (1996) on interlocking directorships suggests that there is more of a “club” atmosphere among U.S. corporate directors than those in other countries. More troublesome still, evidence by Dechow et al. (1996) shows that when the CEO is the Chairman of the Board and there are more insiders on the board, the public entity is more likely to violate GAAP.

18 For example, the 2000 Korn/Ferry International’s Annual Board of Directors Study (Korn/Ferry International 2000) documented that 55 percent of the firms surveyed reported the current CEO/chairman played the dominant role in appointing members of the board and committee chairs.
Fraud, Errors, and Restated Financial Results

What investors and creditors do observe all too often lately are instances where it appears the auditors and/or the audit committees were not effective. These are the cases of fraud, material errors or misstatements, material omissions, restatement of multiple prior years’ earnings because of accounting oversights or improprieties, or maybe just aggressive accounting called to the attention of the corporation by the SEC or shareholder advocates. Recent examples abound and include such icons as AOL Time Warner, WorldCom, Boeing, Computer Associates, Xerox, Enron, Tyco, IBM, and on and on. Auditing failures have taken down one of the largest CPA firms in the world, and it may not be over yet. What path should we follow to improve the governance process in general and accounting and auditing in particular? Groups that might initiate changes to improve these weaknesses in corporate governance, accounting, and auditing include the SEC, the public stock exchanges, and the AICPA.

THE FUTURE

Recommended Changes for Corporate Boards

The U.S. capital markets are considered the largest, most liquid, and most sophisticated in the world. Perhaps the SEC deserves some credit for this reputation and for historical improvements in the governance process. However, recent pre-Enron changes to improve the independence and financial awareness of audit committees of corporations were initiated by the stock exchanges themselves. Has the SEC done all it could have to prevent the problems that have surfaced? The SEC has the potential to be the most influential party in the process of improving the current problems with the quality and integrity of the financial reporting system and related governance issues.

In their defense, a case can be made for the SEC’s enforcement division being underfunded and understaffed. However, it is not clear that the SEC has achieved all that it could have given its role as the primary party responsible for the enforcement of securities regulations and financial reporting oversight. The SEC is obviously aware of the market’s current lack of confidence in financial reporting oversight. Yet they failed miserably by demonstrating their inability to appoint the new Public Accounting Oversight Board members within the allotted time period. In the process, SEC Chairman Harvey Pitt has resigned, and several candidates for the Board were found to have shady pasts even after they were announced as nominees. Other aspects of the Sarbanes-Oxley Act of 2002 designed to build confidence in the marketplace are expected to be equally ineffective. This kind of government response fails to address the fundamental problems with accounting, auditing, and corporate governance.

Proposed Initiatives

The SEC should take the lead at improving the governance system immediately. What can they do? I suggest that the SEC consider initiating several important changes:

- Prohibit the CEO or any other past or current top manager of the corporation from acting as chairman of the board of directors, from being involved in any way in the nomination of directors, or from being responsible for setting the board’s agenda and meeting requirements;
- Prohibit all outside directors from holding stock options in any entity whose board of directors they are a member;

20 The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees was created in 1998 by New York Stock Exchange and the National Association of Securities Dealers. When the report of the Committee came out in 1999, it received the support of the SEC and was essentially adapted by the NYSE and the NASD/AMEX in their corporate governance rules.
21 It was reported that one nominee, former FBI Director William Webster, led the audit committee for U.S. Technologies when it fired BDO Seidman as their independent auditor in August 2001 following a report a month earlier by BDO Seidman concerning serious defects in U.S. Technologies’ accounting reporting and internal controls (Wall Street Journal 2002b, 2002c).
• With one exception (CEO or other), make the board members consist of outside directors who have not been employed or had significant business relationships with the corporation or its top executives;
• Establish a continuing education requirement for all outside board members, calling for 30 hours per year of corporate-funded continuing education coursework from accredited programs of study.

If the SEC fails to take the lead with these proposals, the stock exchanges should initiate them on their own. These suggestions could go a long way toward enhancing the independence and competence of corporate boards of directors, and to more effectively represent shareholders’ interests. Corporate managers should be called on to report to the board whenever necessary. But corporate managers do not need to chair the board, control the agenda of board meetings, or guide the nomination of new board members. These are all activities that independent outside directors should manage.

Mandating a continuing education requirement would also help directors keep abreast of the rapidly changing nature of business. We are in a knowledge revolution where the best practices in business are in a continuous state of change. Too few senior business leaders make the time to keep abreast of current developments in finance, financial reporting, governance, and changing demographic trends in business and industry. For example, how many corporate board members do you suppose are up to speed on recent requirements concerning derivative securities? Evidence on how poorly businesses have complied with new recognition or disclosure requirements is sufficient to justify questioning the understanding of those with oversight responsibilities.

These changes would enhance the ability of corporate boards to govern corporations in the interests of shareholders. They address the two issues related to governance that we have failed to address thus far: management has too much influence over the composition and conduct of corporate boards; corporate board members are not competent and/or independent enough to prevent opportunistic management behavior at the expense of shareholders. Something more must be done to enable corporate boards to fulfill their responsibilities as powerful and knowledgeable shareholder advocates.

**CPA Firm Recommendations**

What can the auditing profession do to enhance the independence of CPAs? There are many factors working against auditor independence that must be identified and considered. Some of the independence issues are linked to audit quality issues as well. Some troublesome aspects of today’s audit environment include:

• Auditors auditing former auditors who are managers and/or board members of client firms;
• Concern about losing the entire portfolio of service revenue from the client firm due to a disagreement regarding management’s financial statements;
• Lack of adequate audit expertise, training, and/or supervision because of cost considerations.

Auditors find themselves working side-by-side with the managers of the corporations they audit. They must consider management to be the paying client for all nonaudit services and at the same time the focal point of their investigations and oversight responsibilities for their “independent” audit services. At times it is a blur as to who is being served. Auditors find themselves auditing client-firms whose managers are their former audit colleagues, perhaps the person from whom they took over the audit. This does not excuse auditors for failing to be independent or for referring to the client’s

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22 A recent *Economist* (2002) article discusses CEOs who claimed to have not understood the accounting problems at their companies and CFOs who are today much less competent in accounting issues than prior generations of CFOs due to their background. A profile of the educational background of CFOs for the *Fortune* 500 is provided.

23 See, for example, Roulstone (1999) on how inconsistently firms responded to the SEC’s FRR No. 48, forerunner to SFAS No. 133, relative to the mandated disclosure requirements.
management as “the client” when conducting an audit. Requiring an audit for publicly owned companies only makes sense if auditors are independent of management.

The pressure on auditors to appease managers of client firms who are at the same time clients who receive tax and/or internal audit and/or consulting services from the CPA firm is great. When ambiguous accounting treatments that might be used to manage performance and/or mask failure are identified, auditors seem pressured to accept them unless they clearly violate GAAP. This setting encourages the auditor to go along with the desires of management on accounting matters that may violate the spirit of GAAP but not the bright-line rules within GAAP. Too often the concern over the loss of a client has caused auditors not to use good professional judgment.24

Proposal to Improve Auditor Independence

What can be done to enhance auditor independence? Although the Sarbanes-Oxley Act of 2002 included a number of provisions intended to address auditor independence, their substantive impact will be modest. In addition to the new oversight board, the Act addresses both audit staff rotation and nonaudit services. However, the new five-year staff rotation rule is only a modest improvement over the old seven-year rule and will be just as ineffective. To meet the seven-year rule the lead audit partner would be rotated off in the seventh year and then rotate back onto the engagement in the eighth year. Such behavior points out how ineffective any legislation is without a spirit of cooperation. The new act also includes some modest additional restrictions on nonaudit services. Even before the Act passed, several of the big CPA firms realized large gains from the sale of their consulting units. However, this did not end their consulting activities. Recent evidence shows consulting continues to dominate audit revenues of the major CPA firms.25

One solution to problems of auditor independence is the mandatory rotation of CPA firms. Rotating CPA firms every three years could be the single most effective change for enhancing independence.26 It would reduce the likelihood that an auditor would be auditing a client’s managers who were former auditor colleagues. It would also reduce the auditor’s concern over losing the client, and would most likely result in all nonaudit services becoming more independent of the audit. Tax and consulting services would go to those firms with the most to offer and without respect to who the auditor is at present.

Auditor rotation has often been proposed in the past and is currently being re-examined by the GAO. Such a requirement could be mandated by several parties such as the SEC or the independent stock exchanges. However, it would be best for the accounting profession if the AICPA took the lead and made this requirement effective for all audits of SEC registrants.

Rotation and cost considerations. Whenever rotation is suggested, auditors often note the problems with increasing the cost of the audit due to lack of familiarity with the client’s business. It is difficult to accept this argument as sufficient justification to reject mandatory rotation. If increased costs resulted, then it is more likely to be from a voluntary increase in the amount of audit work performed and the quality of the auditors hired to do the work. These two changes would address the two most common areas of audit deficiencies noted by the SEC in enforcement actions (Beasley et al. 2001). Moreover, any increase in the cost of doing the audit would be passed on to the shareholders, and I suspect they would gladly pay for it knowing they were actually getting an independent opinion on management’s financial statements.

24 Client firm’s managers have often asked the CPA firm to replace certain auditors on an engagement, implicitly because of accounting disagreements. Amazingly, CPA firms often comply with these requests.
25 Seventy-two percent of the fees paid to auditors of U.S. companies in 2002 were for nonaudit services, unchanged from 2001 (Wall Street Journal 2002a).
26 Three years is not a magic number, and is used primarily as a basis for discussion. I believe three years is an appropriate length of time.
Rotation of auditors would also have a positive impact on the problem of competitive bidding for the audit. Over the past two decades we have seen an escalation of firms trying to low-ball one another to get new audit clients. While this had a negative impact on the quality and profitability of the audit services, the overall CPA firm profits and revenues have grown.27 Requiring the rotation of auditors every three years should mitigate this low-balling practice. CPA firms will not be able to risk pricing audits so low that they will not be profitable.

**Rotation and first-year audit problems.** A commonly cited argument against rotation is the increased probability of an audit failure during the first year of an engagement. However, all evidence on first-year audit failures has been obtained in an environment without mandatory rotation. First-year failures may have occurred because of poorly trained audit staff, or after a low-ball bid for a new engagement, or any number of other factors that could influence audit quality. These potential confounding effects make it impossible to extrapolate what would happen under mandatory rotation. The relevant question seems to be can a CPA firm plan and conduct a high-quality, low-risk audit in the first year of an engagement? Given the state of technology in the auditing and assurance services industry, the training available to people who enter the profession, and the amount of guidance provided by GAAS, any serious effort to conduct a high-quality audit can and will succeed. While audit costs are apt to increase, the relevant question is how much are shareholders willing to pay for a high-quality independent audit? When you realistically consider all the discretionary costs involved in both the management and oversight of a publicly owned company, it is hard to imagine shareholders or their independent board representatives becoming overly concerned about the costs of a high-quality independent audit.

**Rotation and oversight.** There are several important side benefits that should come from mandatory rotation. The activities of the former Public Oversight Board (POB) included a certain amount of peer-reviewed audit work.28 One CPA firm would periodically check up on the audit practices and procedures employed on audits of another CPA firm. A peer review is a review of another CPA firm’s working papers. Many auditors will admit that fear of a peer review keeps the mention of an error or adjustment out of the auditors’ working papers unless it is clear that it will be “booked” by the client firm. Concerns about possible adjustments are thoroughly discussed before written documentation is actually made in the working papers of the audit.

With mandatory rotation, every auditor will know with certainty that someone from another firm will soon be doing an audit (not a review of working papers) of the same client-firm. This should reduce the tendency of an auditor to keep things from their written work product that might suggest they have overlooked some weakness in the client firm’s books. It would be embarrassing and costly for one CPA to overlook something that another CPA might discover. The incentives for CPAs to find and report errors and omissions overlooked by another CPA firm are obvious. Rotation could and should significantly improve the overall quality of an audit, and enhance the quality of the financial reporting process.

**Rotation and professional judgment.** Rotation should also offer stronger incentives for the CPA to stand up to the managers of the client-firm in any accounting dispute. Currently auditors may be reluctant to force accounting adjustments on management of client-firms for at least two reasons: (1) fear of losing the entire engagement, and (2) lack of a bright-line accounting rule that could be used to require management to change their accounting treatment. Rotation should mitigate the first of these issues. With rotation every few years CPAs will be more inclined to act independently and

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27 See the article by Brown and Dugan (2002) for a documentary of the effects of marketing pressures on the conduct of the audit at Arthur Andersen.

28 The new five-member oversight board (the Public Company Accounting Oversight Board) has been appointed by the SEC and is funded by publicly traded companies. It is unclear how this Board will differ from the POB in any substantive way. Can a five-member board effectively oversee all accounting in public companies when the SEC has failed to do so?
require adjustments to management’s financial reports for inappropriate accounting treatments. This likelihood will be enhanced knowing that another CPA firm will be right behind them, forming an independent view on whether the treatment is appropriate. Furthermore, CPAs could be more inclined to use their professional judgment even without a bright-line rule to refute management’s treatment of a transaction.

**GAAP and Professional Judgment**

Some have suggested our concerns over audit quality could be solved by simply developing accounting standards that are easier for auditors to apply. The popular press here and abroad has asked why we do not see a similar number of accounting-related problems in other countries. They argue the auditing is the same but the rules are different, so it must be our accounting rules that are at fault.

To attribute U.S. accounting failures to a deficiency in U.S. GAAP is totally inappropriate. U.S. GAAP represents the most comprehensive set of financial statement requirements in the world, generating greater transparency in financial reporting than any other country. It is likely that we have uncovered so many of the financial reporting problems in the U.S. because of the greater transparency in U.S. GAAP.\(^{29}\) One might ask if Enron’s problems would have been uncovered if it were a French or German or Spanish company? While the FASB makes a convenient scapegoat, they are a small part of the problem at most. Accounting rules require implementation by managers and review by auditors seeking to disclose the economics of a transaction. Managers and auditors who are no longer acting in the interest of shareholders can always circumvent both bright-line rules and principles-based rules.

**SUMMARY**

We face serious problems today in accounting, auditing, and corporate governance that have undermined the quality and integrity of financial reporting. Accounting and auditing are only components of the broader system of corporate governance and can’t be “fixed” in any lasting way without substantive changes in the overall governance process. We cannot shirk by simply blaming corporate disasters and accounting failures on the last few big CPA firms, the FASB, or the POB. And we should not stand by and wait for the new requirements from Sarbanes-Oxley to reveal their obvious flaws.

Responsible parties need to act more responsibly. The SEC is ultimately the responsible authority for oversight of our capital markets, the financial reporting process, and the enforcement of the current standards and rules pertaining to them. They need to face up to this responsibility more than they have in the past. Reconfiguring the POB and making the lead audit team members rotate every five years is far short of the responsibility they need to demonstrate to address our problems.

The AICPA is the organization that is responsible for leadership of the public accounting profession. They have done much over the years to develop and refine Generally Accepted Auditing Standards, and to provide direction to CPAs on a variety of auditing- and assurance-related issues. But they, too, have failed to show leadership in addressing the problems with public confidence in the independence of independent auditors. It is not responsible of them to stand by as if there is no independence problem and let the profession be buffeted about in the storm of public outrage. If this organization hopes to survive long into the 21st century, then it needs to act responsibly now to shore up the public’s trust and confidence in auditor independence.

This commentary attempts to make the case that governance problems are, in fact, the weakest link in addressing the problems related with accounting quality and the integrity of today’s financial reporting system. In addressing problems that have been largely blamed on accounting quality and auditing by the popular press and government, we must first address the weaknesses of corporate governance.

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\(^{29}\) For evidence see Leuz et al. (2003).
governance. With insightful leadership from SEC or from the independent securities exchanges, these governance problems can be addressed. With some leadership from the AICPA, the heart of the audit independence problems can also be addressed.

My intention in writing this commentary was to suggest substantive changes in auditing, accounting, and corporate governance that I believe will enhance the quality of the financial reporting process. These proposals are intentionally controversial. My hope is that they will stimulate debate and lead to substantive changes that enhance the quality of accounting, auditing, and corporate governance.

REFERENCES


