Dear Sir Donald Brydon - I wrote this White Paper on the failure of the auditing profession [adapted from my articles in the Financial Fraud Law Report] -- have also been in roundtables at the ICAEW on this topic. Will speak on this topic as well with folks at the ICAEW in August in California.......

My five point plan suggest how to restore the reputational capital of the profession, our raison d'etre - to detect, prevent and uncover fraud in order to protect the public interest. I offer this paper as a suggestion....

This paper is my own work and does not reflect the official position of the NYSSCPA, the CPA Journal or the Board.

thank you for listening.
rick
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Auditors at the Gate: Restoring the Reputational Capital of the Profession

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Acknowledgment

The author is especially thankful to distinguished law professor, John Coffee, A.A. Berle Professor of Law at Columbia University Law School and director of the Center on Corporate Governance, author of Gatekeepers: The Professions and Corporate Governance, Oxford University Press, 2006, for his suggestions in a discussion on May 25, 2013, and his inspiration for this article.

Introduction

This paper explores the following:

- Importance of the public accountant's role in society;
- Unprecedented level of audit failure;
- Recent causes of financial fraud (materially misleading financials) in publicly traded companies; and
- Practical solutions to improve audit results and help restore trust in our financial institutions and capital markets.

Understanding these issues is essential for financial advisers and Certified Financial Planner certificants who build equity portfolios for their clients.

Finally, based on personal interviews with thought leaders in the U.K., this article explores the more inclusive regulatory approach taken by their Financial Regulatory Authority: supervision over all financial advisers and all enterprises that sell products or offer services to the public (including the suitability of their offerings for their clients).

Side Bar 2 (later in this paper) identifies the top three areas of financial statement manipulation that all financial advisers and Certified Financial Planner certificants need to be aware of.

Unique Role of CPAs as Gatekeeping Professionals

In financial markets, there are three professions referred to as "gatekeeping professions": the auditor, the attorney, and the securities analyst.[1] "Gatekeepers" are the outside, or independent, watchdogs or monitors who screen out flaws and defects and who verify compliance with standards or procedures.[2] Gatekeepers are licensed professionals who owe their credibility and reputation to their independence, impartiality, and fairness, or what legal scholars call "reputational capital."

Loss of reputation can mean abandonment by most clients and bankruptcy of the firm, as finally occurred at Arthur Andersen. In fact, Arthur Andersen's billing of Enron at $100 million was insignificant compared to the $9 billion of revenue lost from the clients who finally abandoned the firm after the scandal, leading to its demise.

As John Coffee, director of the Center on Corporate Governance and luminary Columbia University legal scholar argues:

> The premise should be made explicit; corporate governance does not work, nor can management be held accountable in the absence of a system that makes gatekeepers reasonably faithful to the interests of investors.[3]

The fact is that public accountants hold the most critical and unique role in protecting the integrity of our capital markets.[4] There is no other independent force in the capital markets as powerful. If the system were to falter, there would be no government, institution, or regulatory entity that could replace it. Public accountants are the institutional power whose responsibility is to ensure the accuracy of financial statements, the bedrock of investor confidence.[5]

In early years, the reputational capital of the public accountant was essential to the survival of the firm. George May, an early managing partner at Price Waterhouse in 1912, advocated using accounting as a social force [and] zeal to protect the public trust." May also believed that "the high minded accountant, who undertakes this practice, assumes high ethical obligations…none in which the practitioner is under a greater ethical obligation than to persons who are not his immediate clients."[6]

Similarly, over 100 years ago, Robert Montgomery, one of the founders of modern auditing in America, declared:

> It is true that contingent liabilities are at best difficult to locate and almost impossible of discovery when an attempt is made to conceal their existence. But a professional auditor is supposed to undertake difficult tasks and if he cannot report on anything except the entries which he finds in the books, he had better retire from the profession. [7]

If we accept John Coffee's argument of the primacy of the role of the auditor as gatekeeper (see *Financial Fraud Law Report*, "Why Audits Fail to Uncover Fraud," April 2011), then accountants must become responsible for detecting fraud and restoring the social contract between the industry's promise to society and the public's grant of exclusivity to CPAs as sole auditors of public companies. Auditors have the unquestioned responsibility to protect the public against fraud (material misstatements, omissions, and materially misleading financial reports).[8]

Public Expectation and Reluctant Avoidance

Unfortunately, in recent years auditors have become reluctant guardians at the gate, adopting "avoidance techniques" in order to hide their traditional responsibility to the public. The fundamental issue, therefore, is as reluctant guardians of the public interest, how do we make the next generation of professional accountants/auditors become true stewards of the public interest, passionately discharge their fiduciary obligations, reclaim this honorable profession's prestige and bring back its lost luster?[9]

Regardless, the gap between public expectation and auditor self-interest is the most significant issue facing the accounting profession in the U.S. today. It is no more clearly articulated than by Leslie LaManna, president of the California Board of Accountancy, who stated:

> The biggest misconception is regarding our mission … I discovered early on I had to focus not on what is necessarily best for our profession, but what serves the public best ... . We're there primarily to protect the public …. If the industry were to adopt "serving the public" as their highest priority, the expectation gap would diminish and CPAs would again become the most trusted profession.[10]

Legal Precedent for Uncovering Fraud

While public accountants have viewed their responsibility to the public narrowly, the courts, historically, have weighed in on the public's side. For example, in a unanimous decision by the Supreme Court, in *United States v. Arthur Young*,[11] the Supreme Court affirmed the "duties owed directly by the 'gatekeepers' to investors."[12] The court wrote:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.[13]

Unprecedented Failure of the Accounting Profession and its Regulators

Recent quotes underscore the current plight of the industry:

> If any other businesses, such as manufacturing or software companies had such high failure rates in their products, they would go out of business.[14]
>
> No major fraud has ever been discovered by auditors … in as much of the auditors work is based on the faulty assumption that separation of duties within the corporation prevents fraud, a core albeit unsupportable foundational auditing standard… . The many disclosures of cooked books … proves [this to be] correct.[15]

During the last five years of unprecedented wealth destruction, it is undeniable that public accounting firms rendered clean opinions on entities that were later determined to be Ponzi schemes; on global financial institutions whose ongoing business activities forced them into insolvency, bankruptcy, bailout, or forced merger only months later. Clean audits were reported on many of the largest financial intermediaries who required backstopping by an emergency act not used since the Great Recession.[16]

In 2011, Congress released the Financial Crisis Inquiry Commission Report as a highly emotionally charged response to the economic downturn.17 The report vilified the banking and financial services industry. Our "captains of finance and public stewards of our financial system ignored warnings ... [there were] egregious and predatory lending practices ... pervasive permissiveness ... institutions acted recklessly ... stunning instances of governance breakdowns and irresponsibility ... chief executives whose failures drove us to crisis ... cheap money ... intense competition ... the quick deal ... short-term gain ... ."[18]

But absent from this 600-page report was any reference to the auditors, who for almost 100 years audited banks and financial service companies; whose responsibility was to protect the public and to ensure that financial statements of the companies they audited were accurate, truthful, and fairly presented their operating results.

The fact is that audit failures (materially misleading financial reporting, material omissions, financial misstatements, and misappropriation of assets) during this recent period exceeded in magnitude the "wave of corporate scandals between late 2001 and the end of 2002 when hundreds of public corporations restated their financial statements and scores were sued by the Securities and Exchange Commission."[19]

As John Coffee remarked, "financial restatements serve as a good proxy for fraud."[20]

In 2009, the Public Company Accounting Oversight Board (PCAOB) publicly reported that, at the Big Four accounting firms, it had found something wrong in nearly "one in six audits it reviewed that year. A year later, the proportion had doubled to one in three." The next-tier firms scored even worse, according to the report.[21]

In the sensitive area of financial services where the crisis first began, the results by the PCAOB inspectors were even more unsettling. They "zeroed in on the willingness of auditors to accept valuations of complex securities without determining whether the valuation methods used were reasonable."[22]

In the financial services sector, PCAOB reported that out of 23 brokerage firm inspections, 15 of the 23 audits cited "did not perform sufficient procedures to test the occurrence, accuracy, and completeness of revenue." In six of the remaining audits "where the auditor had to deal with how much securities were worth, the firms did not perform sufficient procedures to test the valuation."[23]

Against this background is the fact that financial fraud continues to grow in the United States, according to the FBI statistics. Statistically, by 2007, there were "more than 1,700 pending corporate, securities, commodities and investment fraud cases, which is an increase of 37 percent since 2001."[24]

But financial fraud continues unchecked. In November 2012 a 60-year-old bookkeeper for the city of Dixon, Illinois pleaded guilty to one count of wire fraud in the largest municipal embezzlement in U.S. history.[25] A Midwest public accounting firm had failed to uncover this decade-long fraud and had rendered clean or unqualified audit opinions of the city of Dixon during this period. Then, not more than four months later, the PCAOB disclosed in their February 25, 2013, report that 44% of the audit firms inspected had at least one "significant audit performance deficiency" and that there was "no evidence of any correlation between the size of a firm and its ability to perform an audit that complies with PCAOB standards."[26]

Forbes contributor Francine McKenna summarized the SEC enforcement director's argument: "the number and severity of earnings restatements (a flag for possible accounting fraud) has declined dramatically since mid-2000."[27] This author suggests, however, that it is more a result of the SEC having reorganized its enforcement division—eliminating an accounting fraud task force—than in a true reduction in accounting fraud. Further, less than a year after the SEC enforcement director's remarks, the SEC announced creation of the Financial Reporting Task Force, whose principal goal "will be fraud detection and increased prosecution of violations involving false or misleading financial statements and disclosures … focus[ing] on identifying and exploring areas susceptible to fraudulent financial reporting, including on-going review of financial statement restatements and revisions."[28] On September 26, 2013, Mary Jo White, "Wall Street's main cop," announced "plans to ramp up its policing of financial fraud…and insist on admissions of guilt as a condition in settlements."[29]

Sarbanes Oxley (SOX)[30]

Ironically, the greatest audit failures and corporate frauds occurred after enactment of Sarbanes Oxley, arguably the most wide-reaching U.S. financial regulation in 70 years. Similarly, fraudulent financial reporting shows no signs of abatement even after later enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and creation of the PCAOB (and its legal existence under the SEC upheld by the Supreme Court, *Free Enterprise Fund v. PCAOB, 561 U.S., 2010*).

The unintended consequence of Sarbanes Oxley was that SOX actually reduced the number of businesses under the existing regulatory system and created new opportunities to "go dark." In 2004, the Emory School of Law's Law and Economics Research Report concluded that SOX was forcing a number of issuers out of the regulatory system (a term called "going dark"), which adds a completely new layer of unregulated firms into the marketplace.

A LEXIS search for companies filing Schedule 13E-3 to go private in 2004 revealed that close to 40% cited cost of compliance with federal securities laws, complete with cost estimates. Companies ranged from Cox Communications to First Commerce Bancshares.

William Carney, co-author of the study, further reported that one interesting phenomenon of Sarbanes Oxley has been the extent to which large foreign issuers considering listing in the United States have decided to forgo U.S. listing. Issuers include Porsche in Germany and Daiwa Securities in Japan. The U.K. London Exchange has marketed its regulatory regime as less onerous and has obtained listings ranging from Gucci, Rogers Wireless, and others. In 2005, four U.K. companies announced that they were considering terminating U.S. registration.

Regarding LBOs, according to the authors of this study, the going private movement increased 500% in 2004. In 2001 there were only 115 LBOs in the United States, in 2002 only 109. By 2004 there were 521 leveraged buyouts, and a significant reason was the cost of compliance with SOX.

Corporate securities expert Larry Ribstein (author's note: my former author), in his book, *The Sarbanes Oxley Debacle: What We've Learned and How to Fix It*, argues that while the direct costs are substantial, the indirect costs of SOX include diverting executive attention from the hard work of maximizing shareholder value, distorting executive's and director's incentives and investment decisions, and reducing access to capital markets by entrepreneurs, all of which create opportunities for excessive litigation.

Further, Ribstein suggests that there is striking evidence of the market's evaluation of SOX. One study of SOX's financial costs estimates that firms' total market value declines by $1.4 trillion around legislative events leading to the passage of SOX. The present value of the $6 billion annual implementation cost would be about $300 billion.

But the most striking indictment of its ineffectiveness is the comment by Hank Greenberg, former head of AIG, who reported that the world's largest insurer was "spending $300 million a year fulfilling the new requirements."[31] As the reader may recall, AIG holds the record to date as the largest global corporate failure in history.

It should also be noted that under SOX, "public auditors were required to flag any 'material weaknesses' in a company's internal controls, presumably providing an early warning to companies, investors and the SEC."32 The fact is that in a study by two accounting professors, auditors waived the flag just 25% of the time before a restatement in 2008, and only 14% in 2009, the last year studied. There was no warning before the 2008 Lehman Brothers' collapse or before Citigroup "lowballed its subprime mortgage exposure" in 2007.33

Inclusive Regulatory Response in the U.K.

The response to the global financial meltdown in the U.K. was very different than in the United States. As a result of the global financial meltdown in the U.K. there was significant regulatory activity aimed at combating financial crime and increasing consumer protection.

But the pathway in the U.K. versus the United States was considerably different. Building on the regulatory acts of 2000, the "Twin Peaks" of regulation, effective on April 1, 2013, effectively created two independent bodies that were accountable to the Treasury, Parliament, or both; these two bodies are the Prudent Regulatory Authority (PRA) and the Financial Conduct Authority (FCA). Among their objectives is "… [to make] it clear that there are real and meaningful consequences for those firms or individuals who don't play by the rules."[34]

Unlike Dodd-Frank and more recently the JOBS Act, which enabled an even larger segment of institutions to "go dark" (out of the regulatory system or to avoid or postpone some audit requirements), the two U.K. entities now supervise all "banks, building societies, credit unions, insurers, and major investment firms" as well as oversee "financial services firms…asset managers and independent financial advisers."

Their purpose is clearly "… to reduce financial crime … [and take action] … when a firm acts unethically or disregards consumer interests."35

These two institutions, as a result of expansion of the Financial Services Act of 2012, were also given broad powers found in Section 166 of the Financial Services and Markets Act of 2000 (FSMA) (known as the "Skilled Persons Report").[36]

Recent Causes of Financial Fraud in the U.S. and Its Economic and Social Cost[37]

One reason put forward on why fraud has increased is the change in how executives are compensated. "Only in America" did compensation for senior executives undergo such a fundamental change.

Until the 1980s or 1990s, the incentive mechanism for senior executives was in the form of cash-based compensation. However, during the 1980s and 1990s and through today, executive compensation in large part is pegged to increases in stock price through grants of stock options (equity compensation). This fundamental change in compensation created "incentives for short-term financial manipulation and accounting gamesmanship."[38]

Studies, in fact, found a strong statistical correlation between higher levels of equity compensation and both earnings management and financial restatements (an indicator of financial fraud or misstatement of financials).[39] The leading factor for restatements (and agreed to by auditors) was the presence of a substantial amount of "in the money stock options in the hands of the firm's CEO."[40]

What is even more dramatic is that "if a CEO held options equaling or exceeding 20 times his or her annual salary (a substantial number of CEOs did), the likelihood of a restatement (an indicator of financial fraud) increased by 55%."[41]

Coffee put it this way: when one pays the CEO with stock options, "one is using a high octane fuel that creates incentives for short-term financial manipulation and accounting gamesmanship."[42]

This was confirmed in a more recent survey by the Association of Certified Fraud Examiners (ACFE), which reported that "high-level perpetrators caused the greatest fraud-related financial losses to their organizations (based on a local U.S. study ended April 15, 2013)."[43] According to the study, "fraud committed by owners or executives was more costly than fraud committed by managers and employees. This is consistent with the findings of the ACFE global study."[44]

Studies by academics also show the distortive effect of equity-based incentives in America. In a 2012 survey of public company CFOs by Duke and Emory business professors, it was "estimated that 18% of companies manipulate their earnings by an average of 10% in any given year—to influence stock prices, hit earnings benchmarks and secure executive bonuses." The report concluded that "most of this finagling goes undetected."[45]

Other studies report similar findings. A staggering 63% of CFOs today believe they can intentionally misstate financial statements,[46] and 82% of CFOs believe that auditors will not catch them (a 10% increase since the last study).[47]

According to the SEC, in 72% of the cases over a 10-year period where fraud was committed the CEO was implicated, and in 29% of the cases the outside auditors were implicated.[48]

A 25-year study by the Conference Board of Accounting and Auditing Enforcement Actions revealed that CFOs who were implicated in the action had an even bigger risk of litigation in accounting manipulation cases than the CEO (who jawboned them for the most part), yet did not have the immediate personal financial benefits of cooking the books.[49] CPAs had the most to lose and the least to gain.

Europe

In contrast to the United States, in Europe over the same time period very few public companies announced restatements.[50] "The reality is that … managements in Europe … had less motivation to cheat … [and] the inference thus arises that European managers did not feel the same pressure to 'cook the books' as did American managers over this same period."[51] Coffee also offers an explanation for this phenomenon:

> One critical explanation that distinguishes from Europe most … [is that] executive compensation abruptly shifted from a cash-based system to an equity-based system … [and] created powerful pressures to overstate income in order to inflate the firm's stock price … this happened only in the case of U.S. companies and a relatively few European firms.[52]

According to a major survey conducted in 2012 by the International Institute of Auditors (IIA), in the United States, in contrast to European markets, "fraud risk" was identified as the fourth highest audit coverage area. "Fraud risk" was not even listed as a top-five risk area for European stakeholders (boards, audit committees, senior management, and internal auditors).[53] A similar study by the Association of Certified Fraud Examiners in their 2012 Report to the Nations on Occupational Fraud concluded that of the 1,388 frauds reported by 94 countries, survey participants reported over 57% of the cases in the United States.[54]

The important factor playing into this difference, again, may be the level of compensation between United States and EU CEOs as a ratio to employees. CEO compensation in the United States as a multiple of average employee compensation was around 53:1. However, it was only 16:1 in France, 11:1 in Germany, 10:1 in Japan, and even only 25:1 in the United Kingdom.[55]

Financial Cost of Fraud

The Association of Certified Fraud Examiners (ACFE), in their most recent survey estimated that in 2009, fraud was in the range of $2.9 trillion and that it continues to escalate.[56]

Financial Restatements as Indicators of Fraud

In a five-year study completed by the General Accounting Office (GAO) for the Senate Banking Committee, GAO reported that restating firms lost over $100 billion in market capitalization in just over a three-trading-day period surrounding a restatement announcement. On average, they suffered a 10% drop in market cap following restatement and an 18% drop within 60 days.[57]

Social Cost of Fraud

However, what is even more unsettling about the magnitude and extent of audit failure, principally in the banking, insurance, and financial industry sector, is the social cost to the global society as a result of this Great Recession.[58] Increased unemployment in the United States forced record numbers of Americans on food stamps and government assistance. Other than Congress, the median net worth of the average American (between the period of 2004 and 2010) had declined 8%.[59] In Third World countries, the Great Recession forced people into starvation. This was not a victimless crime.

Loss of Trust in Our Institutions

Equally important is the fact that financial fraud has resulted in a "growing loss of trust, faith and confidence in our financial institutions ..."[60] with "the general public … [having] an increasing presumption of mistrust in authority…and skepticism about their motives … ."[61] Only "… two-thirds of individual investors … have at least some confidence in U.S. capital markets ... ."[62] Over 35% of investors have no confidence in the U.S. capital markets, and the remaining 65% do not have full confidence in U.S. capital markets. Is it any wonder why individual participation in capital markets is at near-historical lows?

Cost of Auditing for Fraud

Would the cost of auditing for fraud be as excessive as has been argued or would the benefits outweigh the cost? In order to answer this question, the reader is guided to the billions of dollars of losses by shareholders when financial reports are restated (strong indicators of financial fraud and fraudulent financial reporting), the trillions of dollars of loss when financial manipulation goes undiscovered for years, and the societal cost of the loss of trust in our financial institutions.

Fraud audits would be more costly, but nowhere near the losses as a result of fraud. In fact, the losses from financial restatement alone exceed the combined audit fees of all of the audits of the publicly traded corporations audited by the major accounting firms.

Recommended Solutions Including Improved Education of the Profession

This author argues that auditors must regain the reputational capital (integrity, high perceived value by society, trust, and leadership) to remain relevant. The public demands it. Conclusions are based on interviews, informal discussions, and roundtables by some of the greatest thought leaders on this issue in the profession today.63 The following recommendations include:

- Auditing for fraud,
- Tightening of the Private Securities Litigation Reform Act of 1995,[64]
- CPA with dual responsibility—Introducing the Certified SEC Auditor,
- Implementing Section 166 of the U.K.'s Skilled Persons Review in the U.S.,[65]
- Clarifying AICPA's "public interest" responsibility, based on a model regulatory framework enacted in the U.K. on April 1, 2013,[66]
- Educating and training accounting professors in order to restore our role in American business as a "learned profession," and

- Reducing leadership gaps in CPA firms.

Auditing for Fraud

The absence of an auditing standard that requires auditors to detect or uncover fraud is actually a relatively new phenomenon in the United States. The auditing profession began as a result of market manipulation and the need for an independent professional to search for fraud. According to a report by the ICAEW (Institute of Chartered Accountants in England and Wales), auditing for fraud had four distinct phases in recent history:[67]

> Pre-1920–"The detection of fraud was recognised as a primary audit objective."
>
> 1920s-1960–"The importance of fraud detection declined until it became a 'responsibility not assumed.' The increased scale of business transactions was such that the cost of searching out fraud and error by the external audit was acknowledged as having become uneconomic. Some critics argue, however, that the audit profession played a more active role here in bringing about the change."
>
> 1960s-1980s–"Auditors' duties to detect fraud were partially reinstated."
>
> Post-1980s–"Auditors' duties to detect and report fraud have become more firmly established. During this period there has been a high level of public concern about the extent of corporate fraud."

In the event auditors were to return to their historic duty to uncover and deter fraud, the largest firms need only to align some of their actuarial, forensic, and fraud teams within the firm to areas of high corporate and financial risk. As this author has learned from studying forensic accounting and performing expert witness work, not only is fraud discoverable, but there are a finite number of fraud scenarios, schemes, and permutations as follows:

> Each business system has a finite and predictable list of inherent fraud schemes. Each inherent fraud scheme has a finite and predictable list of fraud permutations ... . Each fraud scheme permutation creates a finite and predicable list of fraud scenarios.[68]

It also turns out that fraudsters are not all that clever. Regardless, out of more than 2,000 pages of PCAOB's accounting rules as of January 13, 2013 (transferred to the PCAOB from prior rulemaking bodies as a result of Sarbanes Oxley), there is still no requirement for U.S. auditors to detect or uncover fraud.

As guardians at the gate, auditors ought to evolve back 100 years to their principal historical pre-1920s role; change Auditing Standard No. 1 and Generally Accepted Accounting Principle No. 1 as follows:

> Auditors are responsible for detecting and uncovering financial fraud including material misstatement, materially false and misleading financials, material omissions or material off balance sheet transactions and or fraudulent reporting.

Tightening the Private Securities Litigation Reform Act of 1995 (PSLRA)

When self-regulation fails, regulatory intervention is required. In *Acting in the Public Interest*, *a Framework for Analysis*, the thought leadership at the ICAEW concluded that "Incentives can be used to promote behavior through self-interest, but law or regulation is likely to be more effective where the desire is to change behaviour in a manner that would otherwise be resisted."[69]

When the Private Securities Litigation Reform Act of 1995 (PSLRA) was passed, it accomplished a number of legal changes, all of which "were in the direction of reducing legal threats to the auditing profession."[70] According to Coffee, the act raised the pleading standards to a level well above that applicable to fraud actions in general.

PSLRA also substituted "proportional liability for joint and several liability,"[71] effectively eliminating class action lawsuits against auditors (as secondary defendants). The PSLRA also resulted in a special pleading rule that required the plaintiff at the outset of the case and before discovery, to plead with particularities giving rise to a strong inference of fraud.[72]

The upshot, according to Coffee, was a catch-22. "One cannot plead a strong inference of fraud against the auditor until one has obtained discovery, and one cannot obtain discovery until one has pleaded a strong inference of fraud."[73] The result was that the threat of litigation against accounting firms was significantly reduced post-1995. In 1992, there were over 190 audit-related suits filed against the then-Big Six firms. By 1996, accounting firms were named in only six cases.[74]

Tightening up of PSLRA and restoring direct liability may shift the balance of power slightly more in favor of the gatekeeper:

> Gatekeepers need to be subjected to the 'real threat of litigation' [in order to] generate [a level of] deterrence.[75]

The change would benefit auditors by providing an additional weapon in their defense against corporate managers. "Named" audit partners, or audit managers, faced with a real threat of litigation over materially misleading financials, might not be as accommodating to the client. Individual accountants and audit partners (not their firms), as PCAOB recommends, would face the same exposure to the public as the executives of Enron and WorldCom and others, perhaps creating an enhanced deterrent.

Supporting the Gatekeeper—the Independent Attorney

The attorney is one of the three principal gatekeepers. As Coffee suggests, in addition to restoration of the PSLRA, there may be a second level of legal support for the auditor that would increase audit success. The "independent attorney" would be hired to perform financial due diligence on the audit report and the "management discussion and analysis" portion of the financial statement.

As an example, had the Repo 105 agreement been physically examined by an attorney in any one of the 10 years that the fraud was perpetrated, and had the restrictions and limited requirements been detected, financial fraud at Lehman Brothers and its subsequent bankruptcy might have been avoided; or at least uncovered early and as a consequence, the financial markets, potentially, may not have seized.

The independent attorney would also examine compensation arrangements of the senior executives and, along with the outside auditor, identify the areas of financial risk, financial exposure, and potential for financial statement manipulation.

Clearly, if revenue recognition, lease capitalization, or off-balance-sheet financial instruments were at issue, documents reviewed by the attorneys would increase the chance for detection of financial misstatements.

The process would be as follows: the independent attorney would "certify" the results and report also to the audit committee. This dual level of oversight might potentially improve the gatekeeping process and provide a greater level of assurance to the process than auditing alone. Again, this additional level of gatekeeping might move the auditor closer to his or her potential to detect and uncover fraud.

CPA as Certified SEC Auditor

Drawing on rules established in the legal marketplace, in Comment to Rule 3.3 of the American Bar Association's (ABA's) Model Rules of Professional Conduct, the "… lawyer must not allow the tribunal to be misled by false statements of law or fact or evidence that the lawyer knows to be false … ." In layman's terms, attorneys have a dual responsibility: "to be first and foremost a zealous advocate for his/her client, but must act truthfully to the tribunal (duty of candor) and cannot mislead it in favor of the client's case."[76]

CPAs do not (with the exception, perhaps, of client representation before the IRS) have a similar advocacy obligation. Instead, their obligation is to the public, and by extension, to the regulatory authorities that serve the public interest. As auditors are granted a monopoly, franchise, and self-regulation by the public to audit publicly traded enterprises, would not a dual responsibility to the SEC or PCAOB (auditor as officer of the SEC) strengthen the auditor's obligation to increase assurance that financials are true, accurate, honest, and fairly presented?

Implementing Section 166 of the Skilled Persons Review

Skilled Persons Review

The Skilled Persons Review is a powerful weapon in the war on financial fraud. In the U.K., the Financial Services Authority has increasingly used a unique power found in the Financial Services and Markets Act of 2000.

Audits can be initiated by regulators, and their increasing use of this power is found in Section 166: the Skilled Persons Review. Given the level of audit failure and inadequate audits previously mentioned, the Skilled Persons Review may be prescriptive of what the PCAOB could add to their regulatory tool kit.

Here is how it works: Under the regulatory structure under the Financial Services Act of 2012, both U.K. regulatory authorities, the Prudential Regulatory Authority (banks, investment firms, credit unions, building societies, insurers, etc.) and the Financial Conduct Authority (financial advisers, asset managers, regulated financial services providers), will be able to contract directly with "skilled persons and charge the cost of the report (from about $4,000 to as much as $4.5 million) back to the firm (166(3)(b))." PRA's principal objective is to "reduce financial crime when a firm acts unethically or disregards the consequences of its actions."

"A power that was arguably conceived as something to be invoked only when the regulator did not have the expertise in-house has morphed into one of the most widely-used instruments in the regulatory tool kit."77 What is particularly interesting is that regulators hire an "outside skilled person" from a public list of professionals (attorneys, consultants, economists, accountants, actuaries, financial analysts, and other experts) to look into whatever matters the regulators are interested in, and require the firm to pay for it.

This power has been used sparingly, but for a wide variety of examinations. These include "effectiveness of control functions, adequacy of systems and controls [compliance, risk management and data security], corporate governance and senior management arrangements, treating customers fairly [sales practices and suitability of advice], client money, market abuse, prudential controls [accuracy of regulatory reporting] and others."[78] While not specifically identified, the Skilled Persons Review is also prescribed in urgent and sensitive cases, in complex cases, or where more than one firm is the subject of the same report or information required.[79]

In 2007 there were 29 skilled persons reports that were commissioned by the Financial Services Authority. By 2011/12 it had grown into 111 cases, and for the fiscal period 2012/2013 it looks like that number will be exceeded.[80]

Clarifying AICPA's "Public Interest Responsibility"

An Honorable Profession

CPAs have the highest reputation in the Western World among all professions. They also have the highest industry (audit) failure rate among all professions. The contrast between their outcomes and core values is disquieting (see Financial Fraud Law Report, "Why Audits Fail to Uncover Fraud, April 2011). The core values of the profession are to serve as the "moral and ethical compass within our democratic society; to ensure that financial disclosure and reporting of government and private enterprises are truthful, honest, fair, accurate and responsible,"[81] and honor the AICPA's "…commitment to objectivity, integrity and competence; excellent performance on behalf of clients."[82]

Institutional Resistance

In late November 2012, AICPA released the results of "CPA Horizons 2025," a strategic look into the next 15 years of the CPA profession. The study consisted of over 5,600 CPAs participating, over 75,000 comments by CPAs, in-person forums, focus groups, interactive surveys, online forums, thousands of hours of debate, and discussions led by a luminary 22-member advisory body. The objective of this monumental study was to examine "the current and future relevance of our core purpose" over the next 15 years.[83]

Core Values[84]	Core Competencies[85]
Integrity	Communications skills
Competence	Leadership skills
Lifelong learning	Critical thinking/problem-solving skills
Objectivity	Anticipating and serving evolving needs
Commitment to excellence	Synthesizing intelligence to insight
Relevance in the global marketplace	Integration and collaboration

"CPA Horizons 2025" was issued against the backdrop of prolonged recession and unprecedented wealth destruction.

Noticeably absent, of course, was mention that the AICPA act in the public interest, protect the public against fraud, and safeguard the public trust. "When it comes to assigning blame, when do we stop looking elsewhere and start looking in the mirror," asked NYSSCPA former executive director Louis Grumet ("Losing Our Moral and Ethical Compass," *The CPA Journal*, May 2009).

The Expectations Gap—Is it Widening?

Throughout the 20th century, government, investors, and the accounting industry debated the role of the accounting firm in American society. Popularly termed the "expectation gap," the gap between what the public perceives as our role in society versus the expectation of the public accounting firm in its service to the client continues to burden the profession. Study after study defines and reaffirms this obligation:

> Research over a decade after the release of the expectation gap SASs and also after the issuance of SAS No. 82 (AICPA 1997) … indicate that … investors have higher expectations for various facets and/or assurances of the audit than do auditors in the following areas: disclosure, internal control, fraud, and illegal operations.
>
> Investors expect auditors to act as "public watchdogs."[84]

In its simplest form, the public wants outside auditors and internal auditors to uncover fraud and the chief financial officers not to bow under the pressure of CEOs to commit fraud.

Instead, the "accounting profession [sought] to close the expectation gap by downsizing investor expectation, perpetuating a toothless system of professional discipline, and avoiding [management's] 'preferability' decisions as to the choice of accounting principles … "[85]

The "AICPA fought adamantly to resist 'uniform' accounting principles (which would improve comparability of financial statements),"[86] and instead expanded its "rules and alternative accounting treatments" since "narrowing the issuer's ability to pick and choose accounting principles suggests … an inability to resist pressure from clients."[87]

A study reported by the ICAEW looked at accounting standards development in the U.S. and similarly concluded:[88]

> The accounting theories used to justify the standards as being in the public interest usually follow the decision on the accounting, rather than the other way around. In other words the theory does not drive the standards but is the result of political intervention to provide a public interest excuse.[89]

Since all major accounting firms have a relatively similar level of client restatements of public companies, in effect, there was no reason for them to reign in the inventory of accounting principles. As a result, they did not have to compete for quality or reputation (reputational capital). Instead, firms were "competing for accommodation, rather than for quality or excellence," and for this reason "no accounting professional in private practice called for reform of the profession."[90] Neil Barofsky, the inspector general, who was appointed by the President of the United States under the Inspector General Act of 1978 by Congress to focus on the "bailout," echoed that "auditors have proven themselves to me, over and over again, to be more concerned about the steady stream of fees than in doing their job."[91]

Francine McKenna suggests, in addition, that auditors no longer trade on trust and integrity and as a result have lost the fear of loss of reputation. Instead, they trade on anonymity.92 As proposed by the PCAOB, audit reports should identify the auditor in charge of the audit, his or her experience and education, companies under his or her audit management, and any regulatory or enforcement issues relating to the auditor.

Resistance to change within the profession continues as of this writing. It is no more clearly demonstrated than by a recently passed congressional bill, which prohibits the PCAOB from imposing mandatory auditor rotation. This bill is expected to be passed by the Senate and signed by the president.

United Kingdom's Approach—ICAEW

The contrast at the ICAEW is remarkable. Rather than avoiding an open debate with its members, at the ICAEW the tone from the top is, "What can we learn from our failures," as opposed to, "How can we hide from them?"[93]

"Self-regulation" is the ICAEW model in the U.K. A "consultative relationship" exists between the ICAEW and the financial services regulatory authorities. In the U.K., the model as described to this author by the executive director of ICAEW is "supervised self-regulation." The accountancy profession in the U.K. undertakes much of its own regulations, but is subject to independent oversight of that regulation by the Financial Reporting Council (FRC). The composition of the FRC and the funding of the operation are set to ensure that there is good input from the profession, but that it does not have a majority decision-making ability.[94]

Supervised self-regulation also provides the ability to focus on the contributions that ICAEW can make to society and on the "development of practical policy proposals and professional guidance …how we can make a valued contribution…[to] members; clients and employers; investors; and regulators… [and]…the whole of the public where, for example, the smooth running of capital markets is concerned."[95]

> ICAEW's Code of Responsibility also includes public interest entities (PIEs), companies listed on recognized stock exchanges and other entities that have a wide range of stakeholders.[96] Their mission is to fight business crime and financial fraud. In their 2013 white paper titled, "Business Crime and Misconduct," the ICAEW states: "Chartered accountants are responsible for many functions in the fight against crime and misconduct as part of their professional work." Areas where ICAEW provides guidance and representation include "business crime and misconduct … business and economic crime … bribery and corruption … fraud … money laundering …"[97]

The author is not aware of a similar set of principles or statements by the AICPA.

Educating and Training Accounting Professors

Accounting Professors and the American Accounting Association

The American Accounting Association, the association of global accounting professors, recently completed a multiyear, multimember research study entitled "Charting a National Strategy for the Next Generation of Accountants" (The Pathways Commission on Accounting Higher Education).

In the author's opinion, the commission report is a status quo denial of a fundamental fact: The accounting profession is suffering today from a credibility gap and public mistrust is greater than any time in its history.

The commission report highlights the importance of our profession's work: "absent the confidence and trust engendered in market participants by the ready availability of reliable accounting information, domestic and global markets would cease to function efficiently, businesses would fail to thrive and flourish, and global prosperity would become something less than an attainable goal."[98]

The Credibility Gap

This critical issue, the credibility gap, omitted from the Pathways report, however, demands that accounting professors and industry practitioners examine the fundamental accounting curriculum and assess the foundational elements, standards, principles, and practices that are currently taught by professors to determine whether the profession is providing the added value that society requires for their protection, and to determine whether their teachings are relevant, and whether and when they will need to begin to reeducate the next generation of CPAs.

The Learned Profession Gap

Accounting professors today do not share a "societal" understanding or social sensitivity with the public. They do not connect with their liberal arts colleagues; neither do their students. As reported in the South African Accounting Journal a few years ago, when accounting students were asked about social responsibility, one student remarked that "if we were interested in society we would become sociologists." To become a "learned profession," accountants need to understand how important their contribution is to society and the public trust.

Given the high level of financial restatements, inadequate audits uncovered by the PCAOB, and escalating level of financial fraud, the Pathways report, totally ignored this "elephant in the room": the expectation of the auditor to protect the public against fraud with responsibility to protect society and the public interest.[99]

Education Gap

The differences in education, curriculum, and professor training between accounting and other "learned professions" are significant. Four immediate differences between accounting training and legal training come to mind.

First, about half of U.S. law professors have advanced degrees outside of law in political science, the social sciences, behavioral sciences, and natural sciences. This is not the career path for accounting professors, whose education is mostly limited to business, accounting, and research.

Second, in law schools, courses are taught on ethics, ethical practice, and the law and society. It connects law with social issues and law students with society at large. This author is not aware of any social science type courses, such as "accounting in society" or "socially responsible accounting" or any comparable subject, at any of the best accounting schools in America.[100]

Adding required courses in the area of "socially responsible accounting," "accountants in the public interest," and others would raise the cultural consciousness of the profession and the professors who teach the next generation of accountants and auditors.

Third, there are about 22 legal specialties including securities law, intellectual property law, administrative law, corporate law, distribution law, antitrust law, criminal law, and tax law taught in law schools. Most law schools offer electives in a number of these fields, but other than taxation, technology courses, and management accounting courses, most accounting departments within business schools do not offer electives in industry-focused specialties or offer opportunities to study or excel in, for example, audits of broker dealers, distributors, leases, financial instruments, or others.

In California, additional knowledge is required for auditors. There is an audit "A" license as well as a "B" license for CPAs. Would not the educational value of an auditing degree improve outcomes by better preparing the auditor before entering practice?

Fourth, the better business schools all use business cases to train their students on management success. But this author is not aware of any accounting school that uses a "case book" (law schools) to shape the student's accounting mind. Case books, as the reader may know, identify pivotal cases in a particular legal area that shape student learning.

This author has not identified a single audit case book similar to the way law school courses are taught or even a curriculum that teaches auditing using a pure case-based approach to include cases involving fraudulent financial reporting, revenue recognition, leasing, and financial instrument fraud based on enterprises that have had financial restatements as a result of SEC, FBI, or other regulatory enforcement actions over the past 40 years.

Conclusion

Certified Public Accountants owe their licensing, certification, legitimacy, and monopoly (exclusive ability to audit enterprises) to the public. In order to improve the batting average of auditors, public accountants need bigger bats. It is the author's belief that by tightening the PSLRA, making auditors responsible for detecting and uncovering fraud, expanding regulatory authority over all enterprises that interface financially with the public, and adding a skilled person role under SEC/PCAOB oversight, auditor outcomes will improve, as will restoration of trust in our institutions, principally in the financial services sector.

Financial and industrial fraud will never disappear; it is inherent within human nature. However, with effective vigilance and oversight by the three gatekeepers and, in particular, the fraud-focused auditor, financial gamesmanship can be reduced, financial restatements will decline, and materially misleading financial reporting will be limited. The result is restoration of the reputational capital of the accounting profession and the increased confidence that it brings to capital markets.

> "Confidence in the accuracy of accounting statements is the bedrock of investors willing to invest, in lenders willing to lend, and for employees knowing that their firm's obligations to them can be trusted."[101]

As Roy Kester wrote almost 100 years ago in his classic 1917 work, *Principles of Accounting*, "The body of principles relating to accounting cannot have a fixed content; it is subject to the changes inherent in a changing economic society." This is truer today than it has ever been.

Side Bar 1—Fraudulent Financial Reporting

- Conclusion in a 10-year fraud study based on enforcement actions by the SEC that the company's chief executive was involved in about 70% of the time.[102]
- A similar study in the U.S. by the 2012 Certified Fraud Examiner in their white paper, "Positions of Principal Fraud Perpetrators" identified managers, owners, and executives as committing 75% of the frauds, with owners and executives committing over 45% alone based on frequency and weighted for "median dollar loss."[103]
- 67,190 suspicious activity frauds reported to the FBI[104] (projected loss in excess of $4 billion in 2010, a record).
- Earlier frauds, including Dennis Kozlowski at Tyco, Bernard Ebbers at WorldCom, and Calisto Tanzi at Parmalat, were replaced by later frauds perpetrated by Allen Stanford, Bernard Madoff, Westridge Capital, Sky Capital, Mark Drier, and others.
- The revelations of large scale fraud in Japan included the 11-year Olympus Camera (goodwill write-down) fraud[105] (exceeding the duration of Lehman Brothers' Repo 105 alleged fraud by four years).
- Disclosure that "tobashi" is the name commonly used to describe corporate fraud, a seemingly "institutionalized" term in Japan.[106]
- In the U.S. and U.K., the business press reports on KPMG's search for the $1.2 billion of segregated or safeguarded customer accounts that allegedly were used as collateral for MF Global's trades.
- Formerly healthy businesses that obtained unqualified audit reports literally months before they failed—MF Global[i], Federal National Mortgage Agency, Federal Home Loan Mortgage Corporation, Lehman Brothers, American International Group (largest corporate failure in history), Washington Mutual, hurried acquisition of Merrill Lynch by Bank of America, Countrywide Savings.

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[i] The $10,000 from MF Global was filed on the May 21, 2011, with the SEC and received an unqualified audited opinion despite some risk warning signs and certain "derecognition" items buried in footnotes in the 179-page document. Rumors that MF Global was in trouble surfaced in late summer and the company went into bankruptcy in early fall. $1.2 billion was allegedly pledged as collateral and missing from customer custodial accounts.

- Auditor participation in stress tests, required by all major financial institutions recently was minimal; further demonstration of the growing loss of auditors' reputation not only in the eyes of the public but by the new independent government regulators.

Side Bar 2—The Big Three Areas for Financial Manipulation: Revenue Recognition, Leasing, and Financial Instruments

Of note, U.S. rule-making boards are just beginning to look at the differences in accounting treatment in the U.S. and rest of world (ROW) for the "Big Three Convergence Projects: Revenue Recognition, Leases, and Financial Instruments."[107] What is remarkable is that the largest financial restatements in the U.S. during the past 40 years were the result of improper revenue recognition, improper lease reporting (implosion of companies like WorldCom, who improperly capitalized their leased line costs[108]), and off balance sheet transactions of financial instruments.

Revenue recognition leads the list. Top line revenue growth is most often included as one of the goals in maximizing executive compensation. These are the most cited examples of improper revenue recognition, which led to financial restatement:

- GE's legendary ability to deliver consistent earnings growth (GE settles claims of fraud … agrees to pay $50 million, August 2009, *Financial Times*).
- Beazer Homes earnings management scheme to meet or exceed expectations (July 2009, *AICPA Forensic and Valuation Reporter*).
- Xerox's advanced recognition of lease transactions.
- Paragon Construction's accelerated contracts.
- Sunbeam's channel-stuffing revenue upsides.
- Rite Aid's revenue-smoothing techniques.
- Crazy Eddie—he just made up the numbers.
- Adelphia, Enron, and PNC's related party sales.
- Enron and Dynegy's double-booking.
- Waste Management, Knowledge Ware, and others who manufactured their own creative recognition techniques.

- Satyam allegedly inflated revenue and falsified data.
- Citibank—$40 billion civil charges for dumping toxic mortgage assets to the public.
- GE Capital—municipal finance bid-rigging allegedly defrauded public entities.
- $390 million theft from K1 Hedge Fund representing small global investors.

About the Author

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He is founding director of the Not for Profit Center for Socially Responsible Accounting (centerforsociallyresponsibleaccounting.com) and has authored numerous articles on financial fraud in the *Financial Fraud Law Report*, the *CPA Journal* and others. He is former executive vice president of Wolters Kluwer's global legal and business publishing group, former president of Panel Publishers, and executive vice president of Aspen Publishers. At Thomson Reuters he was group magazine publisher for their accounting/tax publications and while at Deloitte Touche was a staff auditor in the financial services sector.

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