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A COMMENT ON ACCOUNTING AND AUDITING

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This is a hard time for business. But, on the stage tonight are two men who represent integrity at its finest in our financial and business community. No institutional investor spokesman has been more consistent in demanding the highest standards from auditors than John Biggs. Before and after the Enron debacle, John articulated tough positions on such issues as auditor rotation or the division of auditing from management advisory services. In taking these positions, he spoke as a business statesman.

John Bachmann is an individual who is nationally recognized as one of the great figures in the broker-dealer community. He is the managing partner of Edward Jones, which is among the most respected corporations in the country. It is a firm with an extraordinary compliance record. Those who doubt business should be in the audience tonight, because they would hear individuals who adhere to the highest ethical standards, and practice what they preach.

John Biggs, in his eloquent remarks, referred to this as a "hangover decade." We have seen the bubble burst and all of us, one way or another, are paying a price for it. There is no question that there is a degree of self-correction currently occurring. Boards will be more scrupulous, auditors will say no, the SEC is about to receive a substantial infusion of staff that may increase its staff by as much as 800 individuals.[1] The Public Company Accounting Oversight Board ("PCAOB"), which was authorized in July 2002 under the Sarbanes-Oxley Act,[2] has the potential to be a powerful augmentation to the SEC in its review process and particularly in its inspection of auditors and its enforcement efforts. We are unlikely during the first years of our current decade to see the type of systemic failures in the business community that we witnessed during the 1990s.

I want to address issues that will become significant once the pendulum starts swinging the other way. In terms of public policy, largely unaddressed

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1. Bloomberg News, *Key Senator Backs SEC's $841.5-Million Budget*, LOS ANGELES TIMES 4 (Apr. 9, 2003).

2. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002).

by the Sarbanes-Oxley Act, are three issues that will be of signal importance in the years to come.

First is the structure of the auditing profession. There are approximately 13,000 corporations that register with the SEC under the Securities Exchange Act.[3] About ninety percent of these firms currently are audited by four auditing firms.[4] To say there are four, however, overstates how few there really are. In some industries, there are only two or three that are viewed as having relevant expertise. During my professional lifetime, I have witnessed a steady decline from the Big Eight to the Big Six, the Big Five, and now the Final Four. Why are there so few? Why do new auditors not enter the top segment of the industry? What is it about auditing that has made it an industry of seemingly impenetrable entry barriers?

To some degree, the conventional wisdom today focuses on the cross-subsidy of audit services by management advisory services. That is to say the Big Four allegedly charge relatively low auditing costs and make much of their income by providing management advisory services to the clients. To some degree, there is an international dimension to this — there has been a growth in the geographic scope of leading auditing firm. Would our country be better served by more auditing firms for public companies? Would our country be better served by an industry in which competition to provide the highest quality audit services allowed new entrants? That is a question that is addressed only indirectly in the Sarbanes-Oxley Act by a section that requires a study.[5] The study will be completed later this year, an appropriate time for the SEC and the PCAOB to focus on the structure of the auditing profession. Few topics are of greater potential significance to the auditing profession than its structure. Beyond the normative question — should efforts be made to increase the number of major public auditing firms — are complex questions of mechanics. How could such a restructuring occur? Would it be financially viable? How would it relate to the Sarbanes-Oxley Act's partial separation of auditing and management advisory services?[6]

Second, we live in a domestic economy that is more involved in a transnational economy. To a much greater extent than few decades ago, when Americans owned relatively little foreign investment and foreigners owned very little international stock, securities trading now crosses borders. Paul Volcker, the current Chair of the International Accounting Standards Board (IASB), leads an effort to address the question: Will the world economy better

3. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78mm (2001).

4. Bernard Wolfman, *"Sarbanes-Oxley" Needs Fixing, available at* http://www.sec.gov/rules/proposed/s74902/bwolfman1.txt.

5. Sarbanes-Oxley Act § 701.

6. 98 U.S.C. 15 § 1701 (2003); Pub. L. 107-204, Title VII, § 701, 116 Stat. 797 (July 30, 2002).

be served by harmonization of United States accounting standards with those throughout the leading securities markets in the world? It is a question that the SEC has long viewed warily. Our disclosure requirements, including our accounting standards, long were regarded as the most rigorous in the world.[7]

The IASB, however, recently preceded the Financial Accounting Standard Board to require the expensing of stock options, and it served notice that an international body can be more rigorous than the United States in its disclosure standards.[8] This prompts the question: Are we moving toward a more global economy in which the essence of security trading will be to have a top tier of securities simultaneously capable of being issued and traded in multiple countries throughout the world under similar or identical standards? This is a question that, in a time of corporate scandal, has received relatively little attention. It was an issue that the current Chair of the SEC, William Donaldson, put on the table in the early 1990s when he was Chairman of the New York Stock Exchange and focused on listing standards applicable to international issues.[9] Inevitably, as our economy becomes more bound up in a global economy, we will face a day in which the need for the harmonization of domestic and international standards may require some compromise in domestic standards. The question we will face then is whether we can still insist upon standards sufficiently rigorous to protect United States' investors while simultaneously protecting the ability of United States corporations to effectively sell securities throughout the world.

Finally, I want to address an explicit theme that both John Biggs and John Bachmann addressed. John Biggs, in his allusion to Galbraith's *The Great Crash*,[10] depicted not merely a financial crisis, but a moral one. The deterioration of ethical standards in the 1920s was the subtext of the great crash. We have recently seen a similar deterioration in ethical standards in corporate governance and in auditing firms. Decades ago, auditors were symbols of integrity. They became far flashier during the 1980s and 1990s, as their profession gravitated from auditing financial statements to increasingly providing management advisory services. By 2000, management advisory services provided approximately fifty percent of the income of the Big Five accounting firms at a time when auditing accounted for about thirty percent.[11]

7. Douglas Flint, *A Passion for Clarity: IAS 39 Is In the Front Line of the Conflict Pitting Principles Against Rules*, THE FINANCIAL TIMES (LONDON), Feb. 6, 2003, at 2.

8. Cassell Bryan-Low & Silvia Ascarelli, *Proposal to Treat Options as Costs Will Be Laid Out*, WALL ST. J. Nov. 7, 2002, at C16.

9. Cheryl Beth Strauss, *Do U.S. Investors Need More Foreign Listings?; The SEC Says It Won't Fix What Is Already Working, But The NYSE Says It's Not Working Well Enough*, INVESTMENT DEALERS' DIG., Nov. 9, 1992, at 16, 16.

10. JOHN KENNETH GALBRAITH, THE GREAT CRASH (1929).

11. Joanne Rockness & Susan Ivancevich, et al., *Auditor Independence: A Bit More Rope*, *available at* http://www.fei.org/magaziene/articles/1-2-2001_auditing.cfm.

This was a business model that implicitly characterized auditing less as the backbone of audit firms and more as a loss leader.

The recovery of the moral posture of what was, and should be, a great profession requires us to focus again, fundamentally, on auditing. There is a hunger right now, not only in corporate boardrooms, but also in the new management, that has emerged in the leading audit firms for a profession that will be respected. This is a potential evolution that will require the auditing profession to recognize that the profession relies on the confidence and integrity that investors and business corporations have in their audits. For the audit profession to be, in fact, a profession, means it needs a new model — one less reliant on highly profitable services that are derivative of auditing and more focused on what for so long the audit profession did so well.