CPA Auditors Should be Heroes to the Public,

But They Currently are Listening to a Different Drummer

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In a $13 trillion dollar economy, the public depends upon its CPA auditors to be heroes. The investing public depends upon the integrity of financial statements for entrusting their hard-earned funds, perhaps a life's savings. The cases of Enron, WorldCom, Rite Aid, Tyco, Lincoln Savings, Cedant, Waste Management and others keep ringing in our collective ears. Not just from the harm to direct and mutual fund investors, but also to employees, retirees, customers, lenders, labor unions, financial analysts, fund managers, and vendors.

CPA auditors serve a tremendous social function. They are presumed expert in applying the well-respected Generally Accepted Accounting Principles. They rightfully enjoy sizeable incomes. The enjoy monopolies for audit services. They enjoy the guaranteed legislated market for their audit services with publicly-traded corporations, nonprofit corporations, and many other organizations. In return for those advantages, the public expects sterling performance. In a real sense, the failings of auditors can be more dangerous than failings of doctors. When a doctor errs, one patient suffers. When an auditor gives an erroneous opinion, millions of investors may suffer potentially in the billions of dollars. In a real sense, an ounce of prevention may be worth a ton of cure.

The importance of watchmen watching the financial watchmen cannot be overstated. Investors can't personally comb the books and records of companies, and so must rely upon their CPA auditor watchmen. Indeed, the opinions of CPA auditors are directed not just to a corporation's directors, but to the stockowners. For publicly-traded companies, these opinions are ultimately directed to the entire public.

This basic philosophy is embodied in the law: "Protection of the public shall be the highest priority for the California Board of Accountancy in exercising its licensing, regulatory, and disciplinary functions. Whenever the protection of the public is inconsistent with other interests sought to be promoted, the protection of the public shall be paramount." (Business and Professions Code section 5000.1.)

Unfortunately, the CPA profession has been backpedaling for the past 30 years from accepting this social responsibility. During the bank and saving and loan meltdown of the 1980s, why did the auditing profession not find the $500 billion of losses in the hundreds of scams first? For this latest year, why were the billions of dollars of subprime lending losses not first found first by whistleblowing auditors? This downhill slide among CPA auditors can be seen in their malpractice insurance rates, their unwillingness to accept financial responsibility for their opinions, their attempts to eliminate much of the

Generally Accepted Accounting Principles, and their dominance over state boards of accountancy and other regulatory bodies.

Regulatory agencies have had a dismal recent record to encourage CPA auditors to perform ethically. The Securities and Exchange Commission, the U. S. Department of Justice, and state boards of accountancy have put white collar crimes and ethics on a low priority for enforcement budgets and actions. Fortunately, the recently-established Public Company Accounting Oversight Board is getting into high gear regarding the auditing profession, following certain reforms under the Sarbanes-Oxley Act of 2002.

Malpractice Insurance

Probably the most cogent measure of professional performance is its malpractice insurance rate. An industry with a 15% failure rate would be considered a poor example to all. Major CPA audit firms generally pay around 15% of their revenues as insurance premiums for malpractice, negligence, and fraud. Insurance companies are trying to tell the public something important.

Lack of Financial Responsibility

In my accounting class, I start out by asking, "What is the first thing you should say when you see a financial statement?" The correct answer should be, "I don't believe it. I never saw any of the underlying transactions or events." I then ask, "But what if the financial statements are printed in four-color ink on slick paper? Aren't they more credible?" The answer should be, "No. They are bigger numbers and present a bigger caution."

The only reason to believe a financial statement—especially from a large company—is that someone is willing to guarantee the accuracy. That is, to put their money where their mouths are. It's a type of insurance. That's the social function of CPA auditors. They are given complete access to all the accounting books and records to be evaluated under the Generally Accepted Accounting Principles using appropriate auditing standards. Auditors are paid well for their opinion that financial statements are reliable, that is they present fairly, in all material respects, the particular financial position and results under consideration.

But how do auditors put their money where their mouth is? It's and matter of dollars and cents: they are subject to loss if they render a faulty opinion. This fear of loss must always be present to motivate auditors to stay on the straight and narrow. For a corporation with a net worth of, say, $1 billion, just how much security should the stockowners require from an auditor to ensure that the $1 billion is a reliable figure?

In practice what surety from a CPA auditor backs up an audit opinion? It's the total of four things: the assets of the firm, the individual assets of the partners who work on the audit, the individual assets of all the other partners, and the malpractice insurance coverage.

Up through the 1980s CPA auditors had to be general partnerships. That is, all the personal assets of all the partners backed up the opinions of the firm. This method ensured that all partners kept a strict eye on all the others, because their personal fortunes could be imperiled by misdeeds of others. This form of quality control is the best, since it is the first line of defense against issuing faulty opinions.

However, when CPA auditors started losing malpractice lawsuits in the bank and savings and loan debacle of the 1980s, they started having to pay out hundreds of millions of dollars of judgments, penalties, and fines out of their own personal pockets. In a backwards move in the early 1990s, CPA auditors were allowed to become limited liability partnerships (those three letters LLP right after their names). This means that the only personal assets that are at stake are those of the individual one or two partners actually involved in an audit, rather than all the other partners. The Big Four CPA audit firms, KPMG LLP, Ernst & Young LLP, PricewaterhouseCoopers LLP, and Deloitte & Touche LLP, have thousands of partners, each of which is conservatively a millionaire. For a 4000-partner firm, this means that $4 billion of financial backup to opinions has been whisked away from aggrieved parties and investors. It has cheapened the value of opinions, and has removed an important self-regulating internal mechanism. (As a contrast, the legal profession still operates as general partnerships.)

Without the personal assets of al the partners, this leaves the investing public with only the net assets of the CPA auditing firm, the personal assets of the couple participating partners, and the malpractice insurance.

It would certainly be useful for the investing public to know just what does back up the CPA auditor's opinion for each company, so that an intelligent tradeoff can be computed. But in current practice, this information is secret. A stockowner resolution was proposed to LTV Corporation in 1998 to require a reporting of these figures to the stockowners. Unfortunately the stockowners were not even allowed to vote on the proposal because the Securities and Exchange Commission allowed LTV to omit the agenda item, saying the wherewithal of CPA auditors is a matter "relating to the conduct of the Company's ordinary business operations" and could not even be considered. ("No Action" letter of November 25, 1998, from SEC Office of Chief Counsel, Division of Corporation Finance)

<u>Low Priority at Federal Enforcement Agencies</u>

The "Ten Most Wanted" list of the Federal Bureau of Investigation is revealing. It currently has seven murderers, one bank robber, one sexual assailant, and one terrorist. It does not include any white collar criminals who have been causing vast damages in our economy. (<u>www.fbi.gov/wanted/topten/fugitives/fugitives.htm</u>)

The Sarbanes-Oxley Act of 2002 promised to impose criminal fines up to $5 million and sentences of up to 20 years in jail for corporate executives who issue false and misleading financial statements. (HR 3763, Sections 302 and 906) To date, the U. S. Department of Justice has prosecuted a total of zero. To put this in perspective, in 2005 there were 1599 restatements from publicly-traded corporations, and there were 1876 in 2006. Restatements, by definition, involve a previous statement that was materially false

and/or misleading. For every restatement, there was a CPA auditor involved. (The Wall Street Journal, February 12, 2007, "Restatements Still Bedevil Firms")

The Securities and Exchange Commission can investigate errant auditors. But its enforcement budget has remained static since 2002 rather than being dramatically increased since the Enron-inspired reforms. It should be doing more in such a target-rich environment. The Enron fiasco happened in 2001 with the complicity of Arthur Andersen LLP. The SEC—seven years later—has just gotten around to punishing the Arthur Andersen partners involved, David B. Duncan, Thomas H. Bauer, Michael M. Lowther, and Michael C. Odom, by barring them from appearing before the SEC as accountants, but no fines. "From 1998 to 2000, the accountant, David B. Duncan, was reckless in not knowing that the unqualified audit reports he signed on behalf of Arthur Andersen were materially false and misleading, the S.E.C. said." (The New York Times, January 29, 2008, "Accountant and S.E.C. Reach Deal in Enron Case")

<u>State Boards of Accountancy</u>

CPA auditors hold their licenses from state boards of accountancy, not from a federal agency. These boards have the power to revoke or suspend licenses under probation and impose fines and cost restitution. Anyone can lodge a complaint about CPA auditors based on news reports of wrongdoing unearthed by lawsuits and regulatory actions of the SEC and others. Unfortunately for the public, most boards of accountancy are dominated by license holders, and most meetings of boards of accountancy are not governed by open meeting laws.

In California, the largest state in the country, laws for open meetings and open records do apply. (www.dca.ca.gov/cba) The Board of Accountancy underwent considerable legislated restructuring in 2002 following the national debacles. The board now has a board of 15 composed of seven licensees and eight public members, instead of previous majority of licensees. Thirteen members are appointed by Governor Arnold Schwarzenegger, and one each is appointed by the leaders of the State Assembly and State Senate. (Bills AB270 and AB2873 <u>www.leginfo.ca.gov</u>)

The board has acted decisively on occasion. In 1994 it investigated Arthur Andersen's role in the Lincoln Savings fiasco that lost hundreds of millions of dollars under the direction of Charles Keating. (The "Keating Five" phrase refers to five U. S. Senators who tried to keep federal regulatory agencies from investigating Keating—Sen. John McCain of Arizona, Sen. Alan Cranston of California, Sen. Dennis DeConcini of Arizona, Sen. John Glenn of Ohio, and Sen. Donald Riegle of Michigan.) The board imposed fines and cost on Arthur Andersen of $1.4 million plus thousands of hours of training and pro bono work. (Board of Accountancy "Stipulation for Settlement AC-94-8, July 29, 1994)

KPMG helped to precipitate the largest bankruptcy of any county in the country, Orange County in California 1993. The board eventually punished KPMG with fines and costs of $1.8 million in 2002. (Board of Accountancy "Decision After Nonadoption" AC-98-17, July 25, 2002)

The board is limited, however, by personnel rules from Governor Schwarzenegger such that the enforcement staff does not even have an office in the southern part of the state, which accounts for 60 percent of the cases, and cannot offer competitive salaries for investigative CPAs.

These recent complaints about major CPA auditors have been deferred or turned down for investigation:

PricewaterhouseCoopers LLP: "The suit alleges, among other claims, that Tyco International Ltd. committed securities fraud by improperly accounting for acquisitions and manipulating quarterly results. Earlier this year, Tyco agreed to pay about $3 billion to settle the case, which would be the largest payout in a securities litigation by one company. Tyco's auditor at the time—PricewaterhouseCoopers LLP, which was also a defendant—has agreed to pay $225 million." (The Wall Street Journal, November 1, 2007)
Board of Accountancy position: "We will review your complaint and advise you as to the California Board of Accountancy's jurisdictional authority in this matter." (December 10, 2007, BOA letter to complainant)

Ernst & Young LLP: "In its report on Ernst & Young LLP for 2006 the [Public Company Accounting Oversight] Board said the firm appeared to have signed off on some public company audits without having sufficient evidence to support its opinions. The board cited problems related to eight Ernst & Young audits. The board had cited 10 audits for 2005." (The Wall Street Journal, May 3, 2007) Board of Accountancy position: "In conclusion, we believe the 2005 and 2006 PCAOB inspection reports referenced in your recent complaint are not clear and convincing evidence of violation of California's Accountancy Act and our review of your complaint is now complete." (December 18, 2007, BOA letter to complainant)

Deloitte & Touche LLP: "Deloitte & Touche, one of the Big Four accounting firms, agreed yesterday to pay $1 million to settle accusations that it had botched an audit of a pharmaceutical company by entrusting it to a partner it knew to be a poor auditor. The penalty was issued by the Public Company Accounting Oversight Board and was the first use of its disciplinary powers against a large accounting firm." (The New York Times, December 11, 2007) Board of Accountancy position: "We will review your complaint and advise you as to the California Board of Accountancy's jurisdictional authority in this matter." (December 27, 2007, BOA letter to complainant)

CPAs Oppose GAAP

The Generally Accepted Accounting Principles form the bulwark of clear and reliable financial reports. In approximately 20,000 pages it examines every nook and cranny of business operations, transactions, and events and specifies exact ways to record and present them under the direction of the Financial Accounting Standards Board. CPAs have enjoyed the cachet of having mastered GAAP for the benefit of their clients. GAAP provides a clear understanding for both the issuer and reader to rely upon.

However, under the leadership of the Chairman Christopher Cox, the SEC is actively working to eliminate GAAP in financial statements for publicly-traded securities.

It wants to replace GAAP with the International Financial Reporting Standards (IFRS) and have CPA auditors render opinions using this other system.

IFRS consists of about 2000 pages of principles and guidance, which give companies and auditors wide latitude in interpreting. The loss of 18,000 pages of direction means that the meaning of terms and figures can vary considerably among firms and CPA auditors, such that comparability and consistency are considerably impaired. "Materiality" will become even hazier.

GAAP is based on American commercial law. No particular national commercial law governs IFRS. Gerrit Zalm of the Netherlands is the current chairman of the IFRS governing body International Accounting Standards Committee Foundation. Americans are not required to be on the IFRS board. IFRS is not generally taught in American business schools, nor understood by the American investing community.

An example of differing results under GAAP and a foreign-based accounting system arose when Daimler-Benz AG wanted to trade on the New York Stock Exchange in 1993. Up until this coming year, the SEC has required foreign firms to provide a GAAP presentation of its financial statements in order to trade in the U. S. The $102 million net income under German rules turned into a $579 million loss under GAAP. "[Chairman Edzard] Reuter acknowledged that his and other German companies had obscured operating losses or propped up gains in lean quarters by injecting income from the fat ones. Daimler enjoyed windfall profits in the 1980s and saved a portion of those earnings as reserves 'for difficult times, and now we have such times,' he said." (Los Angeles Daily News, September 18, 1993)

On November 15, 2007, the SEC adopted this exception to allow foreign companies to use IFRS only and not include a GAAP translation. The SEC had solicited comments from the public for this regulatory change and had received many. In a revealing set of comments, each of the Big Four CPA firms favored the replacement of GAAP with IFRS. Indeed, James S. Turley, Chairman and CEO of Ernst & Young LLP, wrote an op-ed article for The Wall Street Journal on November 9, "At Ernst & Young, we will weigh in with strong support for the SEC to set a certain date for a shift to IFRS."

Not just content with having foreign-based firms using IFRS, the SEC is proposing to eliminate GAAP entirely for all publicly-traded firms. Again, the Big Four CPA firms are supporting this quantum leap away from GAAP to IFRS. The entire campaign, including comment letters, can be seen on the SEC website: www.sec.gov/spotlight/ifrsroadmap.htm.

Public Company Accounting Oversight Board

A positive reform in the Sarbanes-Oxley Act of 2002 was to create the Public Company Accounting Oversight Board. It now specifies the auditing standards for the country. It also examines the performance of CPA auditors. Its website shows inspection reports on CPA firms large and small, listing out many deficiencies. The website has about 500 inspection reports (www.pcaobus.org/Inspections/Public_Reports/index.aspx). Many

parts of the inspection reports are not made public, but the public portions provide illuminating revelations about the quality of audit work in this country.

Standing Up CPA Auditors Again

The essential beneficial social function of CPA auditors can be restored so that their opinions provide meaningful assurance as to the reliability of financial statements. Too much backsliding has been allowed to proceed. In a realistic world, one cannot expect the CPA profession to work against its own self-interest. After all, CPA auditors are a business lobbying group, like all self-interested lobbying groups representing their financial interests against all others. The public really can't CPA auditors to bite the hands that feed them.

The investing public needs to take appropriate political action at the federal and state levels. The non-CPA accounting profession has a vested interest in making sure that GAAP and proper accounting practices are maintained.

At the federal level, the two regulatory agencies PCAOB and SEC need to be monitored, and input needs to be provided for improvement. The President needs to be urged to appoint sympathetic members. In Congress the two oversight committees are the Senate Banking, Housing and Urban Affairs Committee (Christopher Dodd, D-CT, Chair, and Richard Shelby, R-AL, Ranking Member) and House Financial Services Committee (Barney Frank, D-MA, Chair, and Spencer Bachus, R-AL, Ranking Member).

At the state level, the legislatures and boards of accountancy need to be monitored, and input is needed for improvements. The new laws in California could be a good model. Accountants would be well advised to attend state boards of accountancy meetings to see if and how the accounting profession is in fact being supervised in their states. Moreover, anyone can file complaints against CPA auditor with boards of accountancy based upon news reports of possible misdeeds.

Yes, the public can be the watchmen who watch the (government) watchmen who watch the CPA auditor watchmen who watch the company accountant watchmen. If everybody energetically and ethically fulfills his or her duty, the only way is up.