

**Statement of Stephen A. Zeff, Rice University, submitted to the PCAOB
prior to its Public Meeting on October 18, 2012**

A possible reason for the lack of professional skepticism – possible longer term and shorter term solutions

I would like to suggest a reason why professional skepticism has apparently surfaced as a problem on the part of independent auditors. It emerges out of the way in which the subject of financial accounting is taught in accounting degree programs in U.S. universities. I have complained for over thirty years about the deficient approach to teaching accounting, and in an article published in 1989, drawn from remarks I made at the annual meeting of the American Accounting Association the previous year, I questioned whether accounting properly belongs in the university curriculum.¹

I have not personally inspected the way accounting is taught in U.S. universities, but I can judge how it is taught by examining the textbooks that are used in the financial accounting courses. In the textbooks for financial accounting/accounting principles, intermediate accounting, and advanced accounting – which are used in the three years of core financial accounting courses in every university offering an accounting major – the principal problem areas (for example, accounting for revenue, merchandise inventories, fixed assets, liabilities, shareholders' equity, financial instruments, leases, income taxes, pensions, and intercorporate investments and consolidations) are treated in a manner that places emphasis on memorizing rules and minimizes any discussion and analysis of the historical evolution of the practices sanctioned by GAAP, the "political" lobbying that may have led to compromised standards, and the deficiencies in the standards and their application. Better alternatives to the existing standards are rarely, if ever, presented – until they actually become inscribed in GAAP. In sum, the core material in financial accounting is presented as a settled body of myriad rules which must be absorbed in order to pass the Uniform CPA Examination, which students usually take within a year or two of the completion of their college or university degree program.

By contrast, the authors of accounting textbooks prior to the 1970s typically took positions on financial accounting controversies, and they recommended sound practice and criticized unsound practice. In particular, the textbooks written between the 1910s and the 1950s by Professor William A. Paton, at the University of Michigan, regularly challenged accounting doctrine and encouraged students

¹ "Does Accounting Belong in the University Curriculum?" *Issues in Accounting Education*, Spring 1989.

to think analytically through the issues about what constitutes proper financial reporting.² In Statement No. 4 issued in 1970 by the Accounting Principles Board, “Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises,” the Board implied that the authors of financial accounting textbooks made a practice of conveying their opinions in accounting areas not covered by APB Opinions and Accounting Research Bulletins. But today the textbooks are, with few exceptions, retailers of GAAP.

There was a time, prior to the 1990s, when a required “accounting theory” course was a staple in accounting curricula around the country. In these courses, the students would read articles and treatises on the theory and historical development of the field. They would write papers and engage in discourse on contemporary topics of controversy. But the accounting theory course has almost entirely disappeared as a requirement, and, from what I can determine, it is not available even as an elective course in many accounting departments today.

I appreciate that the core body of knowledge of financial accounting standards must be learned by aspiring accountants and auditors. But if one can judge by most of the textbooks, this knowledge is acquired with little, if any, analysis of (1) why the transactions, types of securities, actions of regulatory bodies, or economic or legal circumstances gave rise to the need for an accounting standard³; (2) what optional treatments the standard setter seriously considered when deciding upon the standard, including the reasons for its decision; (3) what “political” forces, if any, influenced the shape of the resulting standard, including the objections that fed this use of muscle; (4) the problems experienced so far in the application of the standard; and (5) the deficiencies, if any, in the existing standard which need to be remedied. When students are informed of the areas in which International Financial Accounting Standards (IFRS) differ from U.S. GAAP, the reasons for these different treatments are seldom brought out, and the textbook authors do not adjudge whether the U.S. GAAP or IFRS solution is the better of the two, and why. In sum, the textbooks do virtually nothing to stimulate students’ critical and intellectual faculties.

Why would one expect that students thus educated in accounting, who will one day become accountants or auditors, will have developed an independence of mind and a healthy skepticism of the

² See my essay, “Paton on the Effects of Changing Prices on Accounting, 1916-55,” in Stephen A. Zeff, Nicholas Dopuch and Joel S. Demski (editors), *Essays in Honor of William A. Paton: Pioneer Accounting Theorist* (Ann Arbor, MI: Division of Research, Graduate School of Business Administration, The University of Michigan, 1979).

³ Examples would be the circumstances that led to FASB Statement No. 34 (1979) on capitalized interest and to FASB Statement No. 130 (1997) on comprehensive income, as well as the accounting practice, stemming from Accounting Research Bulletin No. 11 issued in 1941, of requiring stock dividends to be recorded at market value, which has not been adopted anywhere else in the world.

deficiencies they see in practice? This is the style of teaching that tends to be comfortable to students who crave an orderly body of doctrine, one which is not being constantly challenged by the views of preparers and regulators, and is not buffeted by the “political” lobbying of powerful interest groups. Students are taught to commit the accounting rules to memory, and not to think critically of GAAP. We do not create the conditions in our courses for the preparation of “accounting thinkers.” Hence, students looking for an intellectually exciting profession to enter may well go elsewhere after completing their accounting major.

What, if anything, could the PCAOB do about this sad state of affairs in accounting education in this country? Under Section 109(c)(2) of the Sarbanes-Oxley Act of 2002, it is stated, “...all funds collected by the Board as a result of the assessment of monetary penalties shall be used to fund a merit scholarship program for undergraduate and graduate students enrolled in accredited accounting degree programs, which program is to be administered by the Board or by an entity or agent identified by the Board.” Conceivably, the Board could decide to bestow scholarships on students only in those accounting programs which teach financial accounting as an intellectually challenging subject, one which is calculated to excite the critical faculty of students and therefore enhance the likelihood that they will eventually become practitioners of professional skepticism. A committee of the American Accounting Association could advise the Board on which university programs qualify. One hopes, and this reflects my naïveté, that the reputational effect of improving the instruction in accounting would be an incentive for accounting faculty to make their subject a more lively intellectual experience for students. This would be a longer term solution, but one cannot be sanguine that it will succeed in influencing how accounting is taught.

A shorter term solution is to require the audit firms falling under the PCAOB’s purview to certify that they have required their audit partners and managers to take a specified minimum number of hours of continuing education each year on the economic and financial dimensions of the accounting for complex and novel financial transactions.⁴ Such instruction should ideally be offered by the executive education offices of university business schools, and possibly be accredited by state societies of CPAs. At a minimum, audit firms must consider sending their partners and managers to such programs when they reach important milestones in their professional advancement (e.g., promotion to manager, senior manager, or partner). These short courses would serve as a catalyst for auditors to extricate themselves from the day-to-day crunch of managing client engagements and help focus their attention and energy on “big picture” issues. The partners and managers will have been educated in technical GAAP in their

⁴ I thank my Rice colleague K. Ramesh for this idea.

university studies, and their firms surely give them further instruction in new standards and recommended applications. But do the firms give instruction that provides them with a broad understanding of the “big picture” issues about whether, and to what extent, the indicated applications of GAAP indeed reflect economic reality? Are partners and managers aware of the criticisms that have been made in the professional literature and the financial press, and by analyst-users, of extant standards and applications? Are they aware of the information and insights that investors seek in financial reports? They need to know both about conformity with “fair presentation” as well as with GAAP.⁵ *U.S. v. Simon* (1969), the Continental Vending case, is still valid law: the court said that conformity with GAAP does not *ipso facto* constitute fair presentation in all instances. It has long been my belief that audit partners and managers do not have meaningful contact with users *qua* users. Their contacts are always with the personnel of the client company.

This is not a matter to be left just to the technical specialists in the firm’s executive office. Partners and managers need to know when to spot issues and problems and to be able to communicate their concerns about a client’s proposed practice knowledgeably to their firm’s specialists. Some thirty years ago, a major audit firm in Canada held an annual three-week partners’ retreat, and it was the firm’s practice to invite a senior accounting academic to lead the session for one day. The academic was told that he, or she, would have the entire day with the partners to discuss an important, contemporary accounting issue, one about which the academic believed that partners in a major firm should be knowledgeable. Readings would be assigned, and an active discussion would ensue. Neither that firm (now merged into a larger firm) nor any other firm of which I am aware does anything like that today.

A weak link in the audit firm-audit committee chain: the selection of the audit committee

I believe that John C. Bogle, in his written testimony for the PCAOB Public Meeting on March 21, 2012, put his finger on what may still be a serious problem: the power granted to the audit committee to hire the audit firm and oversee its engagement “is limited by the fact that it is the management that appoints the Audit Committee.” This could be a particular problem when the chief executive officer (CEO) doubles as the chairman of the board of directors, a practice which continues to be prevalent in Corporate America, while it is now frowned upon in Great Britain and has virtually disappeared there.

⁵ It is of interest that Section 302(a)(3) of the Sarbanes-Oxley Act requires the principal executive officer and the principal financial officer to certify compliance with “present fairly,” without a link to conformity with GAAP. For a further discussion of the significance of “present fairly,” see my article, “The Primacy of ‘Present Fairly’ in the Auditor’s Report,” *Accounting Perspectives*, vol. 6, no. 1 (2007).

The board chairman chooses the membership of the audit committee, and it should not be the CEO who makes that selection.⁶

To be sure, the New York Stock Exchange recommends that every listed corporation have a nominating or governance committee composed solely of independent directors which is to select new board members or, alternatively, to recommend their candidacy to the full board. Yet the CEO can participate in the committee meetings and play a role in the appointments process. NASDAQ's corporate governance requirements authorize a majority of independent directors or a nominating committee composed solely of independent directors to select new board members or, alternatively, to recommend them to the full board.⁷ Yet top management in some or many American corporations may still have influence, perhaps even considerable sway, over the selection and retention of members of the board of directors, including the audit committee. Much depends on how seriously top management and the board regard good corporate governance. By 2001, Enron's Chairman/CEO Kenneth Lay had composed an audit committee with half of its members living abroad (in London, Rio de Janeiro, and Hong Kong), thus knowing little about U.S. business practices and U.S. GAAP, and its chairman had been entrenched in that capacity since 1985.⁸ Something must be done to free the selection of members of the audit committee from *any* top management influence.

One possible remedy would be that one or two "financial expert" members of the audit committee of each corporation could be selected ("co-opted") from a pool of competent, independent candidates by a committee of the stock exchange or stock market on which its shares are traded, and be remunerated by the corporation in accordance with an announced schedule of fees set by the appointing committee. The one or two co-opted members would not be entitled to vote but would otherwise participate in all meetings of the audit committee. They would be entitled to bring matters to the full board of directors. This suggestion recognizes that the historical model of the corporate board of directors in the United States is no longer suited, in all respects, to the needs of the twenty-first century.

Appointment of retired audit firm partners to audit committees

⁶ See Mr. Bogle's testimony on page 268 of the PCAOB Public Meeting on March 21, 2012.

⁷ The Securities and Exchange Commission has signed off on both the New York Stock Exchange's and NASDAQ's corporate governance strictures. For the SEC's action, see Release No. 34-48745, issued on November 4, 2003 (<http://www.sec.gov/rules/sro/34-48745.htm>).

⁸ In an article published in April 2002 by *Vanity Fair*, the audit committee chairman was reported to have said in 1989, about the nature of his duties, that "I'm here to support management. I'm here to support Ken Lay." (See <http://www.maryellenmark.com/text/magazines/vanity%20fair/925E-000-024.html>.)

I believe that the appointment of retired audit firm partners to audit committees is a very desirable practice so long as they can appreciate the “big picture” and are not solely GAAP technicians. It is interesting to note that it was not until the middle of the 1970s that the retired partners in audit firms began to be invited to serve on the boards of directors of U.S. corporations. The first, as far as I have been able to determine, was Thomas D. Flynn, a senior partner of Arthur Young & Company (AY), who served as a member of the board of Household Finance Corporation (HFC) beginning in 1973 and as chairman of HFC’s audit committee beginning in 1974, which coincided with his final two years as an active partner in AY.⁹ By 1975, he had retired from AY and continued his service on the HFC board and as chairman of its audit committee. Prior to then, this practice of appointing retired partners in audit firms to corporate boards was unknown in the United States. I believe that retired audit firm partners, who usually are required to retire from their firms by age 60, bring excellent technical credentials and experience to the work of the audit committee. My only concern about this practice is expressed in the next section.

A possibly conflicted appointment: A retired audit firm partner named to the audit committee of a client company of the partner’s former firm

I do not know how widespread this practice is in the United States, but it has been followed for decades in Australia, apparently without much criticism until the HIH Insurance scandal broke in 2001. At HIH, which was audited by Arthur Andersen, the retired country managing partner of Andersen was serving as chairman of the HIH board and as chairman of its audit committee, and a retired senior technical partner of Andersen was also serving on the audit committee. To me, even when retired partners are no longer financially dependent on their former audit firm (for retirement and other benefits), such an appointment can be problematic. When a respected senior partner in an audit firm, now retired, becomes chairman of the audit committee of a company which is a client of the retired partner’s former firm, the partner in charge of the audit engagement, out of respect for the retired partner, may submit more readily to the will of the audit committee on some sensitive and contentious matters. At the very least, the personal relationship between the retired partner serving as chairman of the audit committee and the partner in charge of the engagement may be less than arm’s length. Non-accountants, and especially judges, may find this to be a conflicted relationship. One wants the audit committee members

⁹ This practice was so unusual at the time that HFC, prior to appointing Flynn, asked its own audit firm, Haskins & Sells, whether it would object to Flynn being so appointed. H&S said it had no objection. Flynn was a previous president of the American Institute of Certified Public Accountants. I learned of this episode in the 1970s from Paul C. Nagel, Jr., the vice chairman of HFC’s board of directors.

who possess the required financial expertise to be independent in fact and in appearance from the engagement and technical partners of the company's audit firm.¹⁰

Mandating audit firm rotation

I have never served on a corporate board of directors, and my only experience of service in audit firms was three summers in 1954/1955 and 1975 in Chicago and Toronto, in a small firm and in Clarkson, Gordon & Co., respectively. I am hardly in a position to argue for or against mandatory audit firm rotation based on personal experience on either side of the table. Among the writers of comment letters to the PCAOB and panelists who submitted statements at the PCAOB's two previous Public Meetings (and those who were quoted in the PCAOB's concept release of August 19, 2011), there are a number who favor such rotation and others who oppose it. In major world capital markets, as far as I am aware, there has been little experience with mandatory audit firm rotation.¹¹ There has been, however, considerable experience with audit firm rotation initiated by companies or by audit firms, and the knowledge acquired about the cost and risks of transition, especially for multinational enterprises with hundreds or thousands of subsidiaries around the world, may be instructive.¹² The challenge to the PCAOB, if it were to consider proposing mandatory rotation, is to demonstrate persuasively that the benefits of rotation exceed the costs.

One of the practical problems of audit firm rotation, as suggested by former SEC Chairman David S. Ruder (in comment letter 630), is that one or more of the other Big Four audit firms may be rendering non-audit services to a company being audited by a given firm, and the other firms may not wish to surrender their lucrative non-audit services for an audit engagement which promises, in all likelihood, a much more slender profit margin coupled with greater legal exposure.

¹⁰ I have written about this matter with Dan Guy, in "Retired Audit Firm Partners on Boards: Independence Considerations," *Director's Monthly*, February 2002.

¹¹ In comment letter number 634, Kathleen Harris and Scott Whisenant reported the following: "Italy adopted a nine-year rotation rule in 1974; Spain adopted a nine-year rule in 1989; South Korea adopted a six-year rule in 2003; Brazil enacted a five-year rule in 1999; Singapore and Canada adopted rotation rules for domestic banks; Austria adopted a six-year rule in 2004" (page 7). Before the Spanish law would have precipitated the first rotations, it was modified to allow the auditor to serve for an indefinite period. I am informed that the audit firms mobilized themselves in the 1990s to oppose this time limit on audit engagements.

¹² A unique case of audit firm rotation occurred between 1911 and 1929, when Du Pont rotated its audit firm every year (with two exceptions). From 1930 to 1953, the company's policy was to rotate its audit firm every several years. Finally, in 1954 it chose an audit firm whose appointment it has renewed in every year since then. See my article, "Du Pont's Early Policy on the Rotation of Audit Firms," *Journal of Accounting and Public Policy*, January/February 2003.

The decline in professionalism since the 1970s

In my two-part article, "How the U.S. Accounting Profession Got Where It Is Today," in the September and December 2003 issues of *Accounting Horizons*, I documented the decline of professionalism in accounting since the 1970s. I do not wish to recapitulate the stages in this decline. They are all too well known. But I think it is instructive to recall the laments of leaders of the accounting profession as long ago as 1980 about this descent from professionalism into commercialism. Over three decades ago, in 1980, the AICPA Board chairman, a practitioner in a small firm, said,

It seems that the effects of the phenomenal growth in the profession and competitive pressures have created in some CPA's attitudes that are intensely commercial and nearly devoid of the high-principled conduct that we have come to expect of a true professional. It is sad that we seem to have become a breed of highly-skilled technicians and businessmen, but have subordinated courtesy, mutual respect, self-restraint, and fairness for a quest for firm growth and a preoccupation with the bottom line. (page 267)

Five years later, in 1985, the AICPA's Special Committee on Standards of Professional Conduct for Certified Public Accountants all but pushed the panic button:

There has been an erosion of self-restraint, conservatism, and adherence to basic professional values at a pace and to an extent that is unprecedented in [the] profession's history....We believe the profession is on the brink of a crisis of confidence in its ability to serve the public interest. (page 268)

In 1992, an assistant comptroller general in the U.S. General Accounting Office, a former partner in a Big Eight audit firm, said, 'Expectations [of auditors] are so unbelievably low that some are questioning whether there is a role for a private sector [accounting] profession' (page 276).

In 1994, the SEC chief accountant, a former FASB member and former senior technical partner of a Big Eight audit firm, complained of "situations in which auditors are not standing up to their clients on financial accounting and reporting issues when their clients take a position that is, at best, not supported in the accounting literature or, at worst, directly contrary to existing accounting pronouncements" (page 276).

In addition, the SEC chairman, a former chairman of the American Stock Exchange, said in 1996, "I'm deeply concerned that 'independence' and 'objectivity' are increasingly regarded by some [in the accounting profession] as quaint notions....I caution the [accounting] industry, if I may borrow a Biblical phrase, not to 'gain the whole world, and lose [its] own soul'" (page 278).

These quotations are taken from my article, and they represented alarms that were sounded but unheeded many years ago. In an earlier era, auditors were in professional firms that happened to be in business, but eventually they became businesses that happened to market professional services.

I do not know if this trend is reversible. Society and the professional world are vastly different than they were in the 1950s and 1960s, when, it seemed, professionalism was a respected value in our field. I understand that the legal profession has also suffered a comparable decline in professionalism. But lawyers are hired to represent their clients. Auditors are hired to be independent of theirs.

Another indicator of the decline of professionalism in the United States in accounting is the virtual absence of intellectual leadership shown by partners in the major audit firms or by other important figures in the profession. There was a time, prior to the 1980s, when partners in the major firms gave speeches and wrote articles and even books on controversial areas in accounting principles.¹³ They seemed to be genuinely concerned that sound accounting should prevail over unsound accounting. Yet, as I wrote in an article, "Does the CPA Belong to a Profession?" in the June 1987 issue of *Accounting Horizons*, "firms are averse to taking public positions on controversial issues in a way that might affront actual and prospective clients" (page 68). These days, when partners of audit firms are invited by accounting academics to address controversial issues on panels at academic meetings, they utter little more than platitudes. One wonders whether practitioners who decline to enter into the spirit of debate and discussion on controversial issues in financial reporting will also be inclined to give vent to professional skepticism in audit engagements over such matters as management's assumptions and the application of accounting standards.

September 20, 2012

¹³ See my article, "Big Eight Firms and the Accounting Literature: The Falloff in Advocacy Writing," *Journal of Accounting, Auditing & Finance*, Spring 1986.