

# Corporate Governance Center

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Mr. Donald T. Nicolaisen, Co-Chair  
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U.S. Department of the Treasury  
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Dear Chairmen Levitt and Nicolaisen, and members of the Advisory Committee:

Dana R. Hermanson  
Research Fellow

We are members of a task force established by the American Accounting Association (AAA) to monitor the activities of the Treasury Advisory Committee on the Auditing Profession (Advisory Committee or ACAP) and to comment on the Committee's proposed recommendations. Our comments in this letter are based on our own opinions and do not represent an official position of the AAA. These comments are based on the recommendations made in the Draft Report dated May 5, 2008. In this Report, the Advisory Committee lists as the principle guiding its activity: "... to promote and encourage prosperity and stability by both improving the quality of the audit process and audits and ensuring the viability and resilience of the public company auditing profession." We evaluate each recommendation of the Advisory Committee as to its likely efficacy in accomplishing these objectives.<sup>1</sup>

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Paul D. Lapidus  
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## Human Capital Issues

Terry L. Neal  
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***Human Capital 1 – Implement market-driven, dynamic curricula and content for accounting students that continuously evolve to meet the needs of the auditing profession and help prepare new entrants to the profession to perform high quality audits.***

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We agree with the spirit of this recommendation, and believe that advances in online materials are helping to reduce the time lag in updating the curriculum. The Advisory Committee advocates frequent updating of the Uniform CPA Examination content to serve as a catalyst for faculty to update course content. Our concern is that this strategy will only be effective if the CPA Exam is written assuming that the typical candidate has completed 150 hours of collegiate education. To the extent that collegiate accounting programs cover recent developments (e.g., IFRS, fair value,

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<sup>1</sup> We thank Michael Bamber, Linda McDaniel, and Arnie Wright, former presidents of the Auditing Section of the American Accounting Association, for their suggestions.

XBRL, etc.), this coverage will most likely (at least in the near future) occur during the fifth year of schooling, when students have acquired basic knowledge of accounting on which to build. If the CPA Exam is written based on a 120-hour education (as is arguably the case now), the impetus for covering some of the recent professional developments will be reduced. Recent developments at the state level suggest a trend away from requiring 150 hours of education to sit for the CPA Exam, likely constraining the ability of the AICPA to incorporate more advanced topics into the Exam.<sup>2</sup>

***Human Capital 2 – Improve the representation and retention of minorities in the auditing profession so as to enrich the pool of human capital in the profession.***

We appreciate the goal of attracting and retaining highly qualified minority students into the auditing profession and auditing academia. To promote audit quality and investor protection, it is critical that auditing firms target the best and brightest students of all ethnic backgrounds. The answer to this problem is to recommend systemic reforms to the public accounting profession that will enable the profession to truly recruit the best and brightest, including a sizable number of the best and brightest among African American and Hispanic students, as well as other ethnic minorities. In addition, interested, qualified doctoral candidates of all backgrounds should have access to appropriate levels of funding for doctoral study.

As long-time observers of recruiting practices by auditing firms, we offer two issues for consideration that relate to recruitment of students in general. First, to achieve efficiencies in recruiting, some of the largest firms focus their recruiting efforts on relatively few “target” schools, which offer many high-quality graduates. This strategy, however, may lead to missing equally (or perhaps better) qualified individuals at smaller schools, who are fewer in number. Second, because demand for accounting graduates in the past ten years has outstripped supply, we have observed the firms trying to “lock in” students with job offers earlier in their college years. Early job offers reduce the motivation for students to work hard in their senior (and even junior) level courses. We urge the Committee and the firms themselves to consider these recruiting practices as perhaps deleterious to audit quality in the long run.

***Human Capital 3 – Ensure a sufficiently robust supply of qualified accounting faculty to meet demand for the future and help prepare new entrants to the profession to perform high quality audits.***

We offer several observations related to this recommendation:

- Funding for doctoral study is absolutely critical. In our discussions with people considering a career in academic accounting, the main hurdle (by far) to pursuing a Ph.D. is the time and cost of the program. Many prospective students simply cannot get past the notion of experiencing four to six years of \$20,000 annual compensation. Thus, increased funding is crucial, as is a continuing dialogue about

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<sup>2</sup> For instance, the Commonwealth of Massachusetts recently reduced the number of hours required to sit for the CPA Exam from 150 to 120, requiring only that candidates obtain the additional 30 hours within three years of passing the Exam.

the appropriate length of a Ph.D. program, which might vary widely across institutions or types of programs. Increased funding could also encourage universities not currently granting Ph.D.s in accounting to begin programs.

Also related to attracting new Ph.D.s in auditing is the issue of access to data. Researchers in financial accounting have publicly available data sources (CRSP, COMPUSTAT, etc.), while much of auditing research requires proprietary data. It is critical to get all of the major audit firms and regulators to assist researchers with access to data. In addition, smaller firms are under-represented in research. They could also be encouraged to participate, for example through a consortium organized by the Center for Audit Quality. Further, the data derived from PCAOB inspections could be a valuable source of insight, assuming those data could be adequately protected in terms of confidentiality.

- Professionally qualified (PQ) faculty members are important to the delivery of accounting education at many institutions; however, we believe that it is critical to maintain an appropriate balance of tenured/tenure-track and PQ faculty. The creation of knowledge through research is an essential mission of universities. Research is especially important in the current environment of accounting and auditing, in which we need to understand the impact of the many changes recently made in standards, regulation, and policy. If accounting departments are heavily staffed with PQ faculty whose primary responsibility is not academic research, accounting departments will struggle to advance accounting knowledge and to maintain academic credibility on campus when other departments are primarily made up of active scholars. Finally, we believe that it is important for students to consider broader issues in their accounting education, such as how auditors make decisions or how accounting incentives shape managers' behavior. While PQ faculty may provide valuable contributions in such inquiries, research-oriented faculty are in most cases best suited to lead them.
- The Committee calls for mandatory practice sabbaticals for one person per department per year. While the concept of practice sabbaticals is appealing, a rigid, mandatory model would create significant practical problems. First, this would create a serious teaching capacity issue on many campuses, especially those with small accounting departments. For example, a department with five accounting faculty would lose 20% of its teaching capacity if one faculty member were off campus each year. Second, for people at schools in remote geographic locations (i.e., small college towns), this plan would require participating faculty to relocate for a year. Third, it is unclear whether such a program would involve only auditing faculty, or all accounting faculty. There is an acute shortage of auditing, tax, and systems faculty,<sup>3</sup> and individuals in those specialty areas may be most likely to be involved in such sabbaticals. Fourth, for untenured faculty and those tenured faculty seeking promotion to full professor, a practice sabbatical would essentially mean a

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<sup>3</sup> See R. D. Plumlee, S. J. Kachelmeier, S. A. Madeo, J. H. Pratt, and G. Krull, "Assessing the Shortage of Accounting Faculty," *Issues in Accounting Education* 21(2) (May 2006): 113-125 for a discussion of the faculty shortage by area.

year of little time to advance research projects under way, with corresponding costs to co-authors as well as to the individual taking the sabbatical. Finally, it is unclear how the costs of such a program would be covered. The cost of paying and relocating hundreds of accounting faculty on practice sabbaticals each year could run well into the tens of millions of dollars. We question whether the large accounting firms are willing to absorb such costs. The fundamental issue from an economic perspective is that faculty working at auditing firms would be underutilized (e.g., a \$200,000 per year faculty member working as an audit senior), as would audit firm personnel teaching at educational institutions (e.g., a \$200,000 senior manager teaching as a lecturer, which is a \$50,000 - \$70,000 per year position).

Notwithstanding the concerns above, we believe that greater faculty-professional exchanges are a good idea. We suggest that the Committee recommend that accreditation standards be revised to:

1. Place equal emphasis on completing a sabbatical with a private sector institution or government entity as with publishing one “tier A” paper. This may seem minor to nonacademics, but this would be a significant incentive. We are pleased that the Committee recommends that university administrators increase the reward for completing a professional sabbatical.
2. Require all accredited institutions to offer faculty sabbaticals no less frequently than once every seven years and to encourage faculty to take their sabbaticals in practice. (Please note that a typical faculty sabbatical only covers 50% of a professor’s salary.)

We further suggest that the Committee recommend that firms registered with the PCAOB and that audit more than 100 public companies per year be required to offer multiple temporary employment opportunities for professors seeking these opportunities and that these opportunities include the following characteristics:

- a. The firm would reimburse any portion of the faculty salary not covered by the university’s sabbatical policy.
- b. The firm would provide assistance with locating suitable temporary living accommodations and financial reimbursement for these costs.
- c. The opportunities at the firm would be available in both the national office and in (large) field offices throughout the country.
- d. The sabbatical with the firm would include involvement in at least one research project – jointly determined by the professor and the employing firm – and the firm would provide the professor with access to either data or the time of their professionals for participation in experiments or surveys.

The above recommendations, if adopted, would: (1) create a faculty incentive to pursue these opportunities in practice, (2) not pose an insurmountable burden on universities, and (3) enable firms to limit the number of these opportunities to manage their cost and administrative burden associated with running such a program.

***Human Capital 4 – Develop and maintain consistent demographic and higher education program profile data.***

We support this recommendation.

***Human Capital 5 – Encourage the AICPA and AAA to jointly form a commission to provide a timely study of the possible future of the higher education structure for the accounting profession.***

We strongly support the formation of professional schools of auditing / accounting to prepare future generations of public company auditors for long-term career success. We refer the Committee to Professor Joe Carcello's oral and written testimony to the Committee on December 3, 2007, in this regard. Such professional schools would focus heavily on auditors' public responsibility and would include significant education in emerging audit practice areas including internal control frameworks, fair value, IFRS, and XBRL, among many others. We believe that professional schools and changes in licensure and accreditation could both enhance future auditors' education and help to reduce the shortage of doctorally-qualified auditing faculty. However, in order for professional schools to be successful, they need to be well funded and to have a degree of independence from business schools that enables substantial control over the tenure and promotion process (subject to overall university standards).

***Human Capital – Other Issue***

There is an additional, unaddressed issue that we believe merits consideration by the Committee. Many CEOs and CFOs have MBA degrees (rather than graduate degrees in accounting), and research indicates that these two parties are the most likely perpetrators of fraudulent financial reporting (see the COSO-sponsored study, *Fraudulent Financial Reporting: 1987-1997*). We believe that MBA programs need to expand their coverage of the importance of reliable and transparent financial reporting, the role of sound corporate governance and effective internal controls, and the provisions of the Sarbanes-Oxley Act, among other topics. Accordingly, we believe the Advisory Committee should call on business schools to better ensure that MBA students fully appreciate the importance of reliable, transparent financial reporting, and the Committee should call for the AACSB to put in place incentives for this objective to be achieved.

**Firm Structure and Finances**

***Firm Structure and Finances 1 – Strengthen auditing firms' fraud detection and prevention skills and clarify communications with investors regarding auditing firms' fraud detection responsibilities.***

We agree that cooperation among the firms and other market participants in fraud detection and prevention, and sharing of best practices by the firms, could result in a significant improvement in audit quality that would benefit society.

As part of this recommendation, the Committee also urges the PCAOB to clarify the auditor's role in fraud detection as part of the standard auditor's opinion. We agree that expanding the information contained in the auditor's report might be helpful to users. For instance, prior research on the expectations gap suggests that users would benefit from disclosure in the auditor's report of findings regarding fraud or illegal acts, as well as other information pertinent to the client's risk of misstatements from error or fraud, and business failure. (For a full review of research on the content of the auditor's report, see: B. Church, S. M. Davis, and S. A. McCracken, "The Auditor's Reporting Model: A Literature Overview and Research Synthesis," *Accounting Horizons* 22(1) (March 2008): 69–90.)

In addition to these responses on the Committee's recommendations, we urge the PCAOB to carefully evaluate the efficacy of SAS No. 99 (including the auditor's level of responsibility for detecting material financial statement fraud), in light of what has been learned from the inspection process. Information gleaned from analysis of engagement workpapers can clarify whether there remain any weak points in auditing standards, or whether the difficulty lies in failure to follow existing standards.

***Firm Structure and Finances 2 – Encourage greater regulatory cooperation and oversight of the public company auditing profession to improve the quality of the audit process and enhance confidence in the auditing profession and financial reporting.***

We agree with the spirit of this Committee recommendation, which has several specific parts. First, the Committee recommends that Congress pass a law requiring that states substantially adopt the mobility provisions of the Uniform Accountancy Act by 2010. We agree that there should be enhanced mobility of CPAs across state lines. An action of the U.S. Congress in this regard may be indicated for public company engagements, due to the national interest in financial markets efficiency. For instance, a separate national license for public company audits could be layered on top of the current state-based licensing system. However, we are less convinced that Congress should step into what has been the purview of the states regarding audits of non-public entities, or other services such as compilation, review, and tax.

In the second specific point under this recommendation, the Committee urges that the agencies regulating the auditing profession meet regularly to improve effectiveness and reduce overlap. We agree.

The third specific point is that the states should improve the financial and operational independence of state boards of accountancy. We agree.

***Firm Structure and Finances 3 – Urge the PCAOB and the SEC, in consultation with other federal and state regulators, auditing firms, investors, other financial statement users, and public companies, to analyze, explore, and enable, as appropriate, the***

***possibility and feasibility of firms appointing independent members with full voting power to firm boards and/or advisory boards with meaningful governance responsibilities to improve governance and transparency at auditing firms.***

We agree wholeheartedly with this Committee recommendation. There is ample research supporting the importance of independence within the governing structure of corporations. In the long run, inclusion of independent board members in the auditing firms' governance structures should yield higher quality audits and better firm performance. Further, the Sarbanes-Oxley Act recognizes the importance of independence in the governance structure of corporations by mandating that all audit committee members be independent of the corporation. Independent members of firm boards could have functions similar to the audit committees of public companies, for instance being responsible for maintaining whistleblower programs and supervising the "audits" of key performance indicators suggested in the Committee's third recommendation under Concentration and Competition.

***Firm Structure and Finances 4 – Urge the SEC to amend Form 8-K disclosure requirements to characterize appropriately and report every public company auditor change and to require auditing firms to notify the PCAOB of any premature engagement partner changes on public company audit clients.***

We agree that improved disclosure would provide better information to the financial markets on audit quality, and would shift power to the auditor when there is a disagreement with management. However, improving disclosure is only one of the possible means of addressing the issues around auditor changes. For instance, in Australia, notification to the securities market regulator is required prior to the auditor change. This gives the regulator a chance to contact the parties involved and understand the reasons for the switch. While permission to switch auditors is routinely granted around the regular annual meeting, mid-year switches are looked on with great scrutiny. We urge the Committee to consider this alternative in its effort to improve audit quality.

#### ***Firm Structure and Finances – Other Issue***

The Committee's deliberations have involved issues regarding transparency and liability, on which it has not yet issued recommendations. These are among the most difficult questions faced by the Committee, auditing profession, regulators, and the firms themselves, as both transparency and liability relate to the fundamental issue of balancing the privacy of the firms against their ability to stay in business in the long term. On the issue of transparency, the Committee discussed a PCAOB proposal, not yet finalized, to require reporting under Sarbanes-Oxley Section 102(d), and an upcoming requirement that public company auditors in the European Union post annual reports on their web sites containing information on their business practices. We support the disclosure of such information by auditing firms, both to provide information to the financial markets relevant to the quality of audits performed by the firms, as well as to serve as an incentive for firms to adopt good governance practices.

The Committee has also considered various proposals for relief from liability exposure, which some argue has reached untenable proportions. When major firms cannot get

adequate insurance to protect their partners, the entire structure of the auditing profession in the United States is threatened. However, as educators, researchers, and observers of the profession over the past twenty-plus years, we see a risk in providing litigation relief without a corresponding increase in transparency and regulatory control as discussed by the Committee. We base this concern on evidence following the Private Securities Litigation Reform Act of 1995 (PSLRA), which provided relief to auditing firms by making it more difficult for plaintiffs to pursue class-action lawsuits, and providing proportionate liability in damage awards. Research shows that following the PSLRA, earnings of Big 6 clients were more aggressive (H. Y. Lee and V. Mande, “The Effect of the Private Securities Litigation Reform Act of 1995 on Accounting Discretion of Client Managers of Big 6 and Non-Big 6 Auditors,” *Auditing: A Journal of Practice & Theory* 22(1) (March 2003): 93–108). Also, following the PSLRA, auditors were less likely to issue going-concern modified audit opinions to financially-troubled companies (M. A. Geiger and K. Raghunandan, “Going-Concern Opinions in the ‘New’ Legal Environment,” *Accounting Horizons* 16(1) (March 2002): 17–26). Thus, audit quality arguably dipped following the PSLRA. Accordingly, we believe that there should be a *quid pro quo* – in exchange for some form of liability relief, the auditing firms must give up some element of operational control to ensure that audit quality does not suffer. We fear that in the absence of additional control mechanisms within the auditing firms, some firms may respond to reduced liability risk by doing less audit work (see written comments to the Committee from Andrew Bailey on this issue). Such a response would not serve the interests of the investing public.

## **Concentration and Competition**

***Concentration and Competition 1 – Reduce barriers to the growth of smaller auditing firms consistent an overall policy goal of promoting audit quality. Because smaller auditing firms are likely to become significant competitors in the market for larger company audits only in the long term, the Committee recognizes that Recommendation 2 will be a higher priority in the near term.***

We agree that greater competition in the audit market would benefit corporations, employees, and investors, as long as firms compete based on audit quality rather than on low fees. The Committee recommends that the SEC require disclosure of any agreement that limits an issuer’s choice of audit firm (e.g., an underwriter may limit the issuer to using a Big 4 auditor in its contract). We agree.

The Committee also recommends that representatives of smaller auditing firms be included in committees, public forums, etc., established by regulators as a means of enhancing the name recognition and reputation of these firms. We agree. Moreover, such recognition would provide further incentives for these firms to build the personnel quality of their organizations. For example, one of the non-Big 4 firms has recently hired a former SEC Deputy Chief Accountant and a former PCAOB Director. This type of investment in improving professional quality should be encouraged.

***Concentration and Competition 2 – Monitor potential sources of catastrophic risk faced by public company auditing firms and create a mechanism for the preservation and rehabilitation of troubled larger public company auditing firms.***



We agree that preserving a large audit firm from failure due to either a criminal indictment or a catastrophic liability judgment is appropriate and in the public interest. The Committee recommends a two-step mechanism triggered by a severe threat to a firm's viability: an internal governance mechanism and an external preservation mechanism.

Our concern with the current version of the Committee's recommendation is that the internal governance mechanism is invoked voluntarily, and it appears that the external preservation mechanism can only be invoked if the internal governance mechanism was not effective. We are concerned that the failure by a firm to invoke the internal governance mechanism could lead to firm failure. We suggest that the Committee recommend that the SEC and/or PCAOB be granted the power to require a firm to invoke its internal governance mechanism or to directly invoke the external preservation mechanism when particularly severe threats arise.

The Committee recognizes that the PCAOB, as part of its inspection process, considers various firm policies and procedures that reflect the firm's culture and governance (e.g., partner evaluation and compensation, internal disciplinary actions, etc.). We strongly support the importance of firm culture and governance as mechanisms for improving audit quality. Research shows that social influence by superiors affects the willingness of subordinate auditors to engage in quality-threatening behaviors. (For example, A. Lord and T. DeZoort, "The Impact of Commitment and Moral Reasoning on Auditors' Responses to Social Influence Pressure," *Accounting, Organizations and Society* 26(3) (April 2001): 215-235). Also, studies of professional auditing find that governance structures and partner compensation mechanisms are important in aligning the behavior of individuals with the long-term interest of the firm in promoting audit quality. (For example, J. Carcello, D. Hermanson, and F. Huss. "Going Concern Opinions: The Effects of Partner Compensation Plans and Client Size," *Auditing: A Journal of Practice & Theory* 19(1) (Spring 2000): 67-77.) These studies and others imply that firms can do much to incentivize their personnel to do the right thing, by rewarding audit quality instead of revenue generation, and by creating mentoring systems to promote appropriate guidance of junior-level staff by senior firm personnel.

***Concentration and Competition 3 – Recommend the PCAOB, in conjunction with auditors, investors, public companies, audit committees, boards of directors, academics, and others, determine the feasibility of developing key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose these indicators. Assuming development and disclosure of indicators of audit quality are feasible, require the PCAOB to monitor these indicators.***

While we believe that this is among the best recommendations of the ACAP, our related concern is that many of the indicators suggested – e.g., average experience level of staff, annual staff retention, etc. – are input-based. Although there should be a correlation between better inputs and good outputs, the public policy imperative is on the output side.<sup>4</sup>

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<sup>4</sup> The PCAOB's inspection process could be used to generate indicators of audit quality, at a minimum compliance with accounting and auditing standards. The Committee might call for more transparency and public reporting of the results of the PCAOB inspection process.

Moreover, although many of the suggested input-based measures seem intuitively likely to improve audit quality, we are aware of no empirical evidence to suggest that these metrics lead to better audit quality (probably because audit firms typically do not provide such data to academics; see our other comments regarding the issue of data accessibility under Human Capital). We encourage the Committee to consider other input-based measures where extant research finds a positive relation between the measure and audit quality (i.e., the relevant output measure). For example, there is an extensive literature that finds that greater auditor industry specialization leads to better audit quality. Moreover, we encourage the Committee to consider output-based measures of audit quality – e.g., fewer client frauds, fewer client restatements, less earnings management, more accurate auditor reporting before a bankruptcy filing, etc., after appropriate risk adjustment given the nature of the audit firms’ client portfolios. The academic literature contains a number of such metrics.

As with any measurement system, a move to reporting quality metrics could be “gamed” by some firms. The Committee recommends that the PCAOB would monitor these indicators through its inspection process, but we would go further. For firms that audit more than 100 companies per year, we suggest that the Committee require that these data be audited by the GAO, PCAOB, or another independent entity and publicly disclosed on an annual basis.

***Concentration and Competition 4 – Promote the understanding of and compliance with auditor independence requirements among auditors, investors, public companies, audit committees, and boards of directors, in order to enhance investor confidence in the quality of audit processes and audits.***

The Committee recommends that SEC and PCAOB independence requirements be combined into a single document and that this document be made publicly available via the web. The Committee also recommends that the AICPA and state boards should clarify differences in their independence standards from those of the SEC / PCAOB. The Committee further recommends that firms develop additional independence training materials geared to partners and mid-career professionals. Although we support these recommendations, we would go further. We suggest that the Committee recommend the SEC develop an aspirational, principles-based approach to independence rather than continuing to develop ever more minute rules. In particular, we believe that the *raison d’être* of auditor independence rules is to foster objectivity, leading to greater professional skepticism. We recommend that the PCAOB focus heavily on indicators of professional skepticism (or lack thereof) during its inspection process. (In this regard, we encourage the Committee to consult: M. H. Taylor, F. T. DeZoort, E. Munn, and M. W. Thomas, “A Proposed Framework Emphasizing Auditor Reliability over Auditor Independence,” *Accounting Horizons* 17(3) (September 2003): 257–266.)

***Concentration and Competition 5 – Adopt annual shareholder ratification of public company auditors by all public companies.***

The Committee recommends an advisory shareholder vote on the selection of the audit firm, and that exchange self-regulatory organizations should adopt this recommendation as a listing standard. We agree, but again we would go further. We suggest that the Committee

recommend an advisory shareholder vote on each member of the audit committee for companies that have not adopted a majority vote provision for all board members.

The Committee also recommends that the name(s) of the senior auditing partner(s) on the engagement be disclosed in the proxy. This is a superb suggestion, but we encourage the Committee to go further. We suggest that as in other countries (e.g., Australia) the Committee recommend that the engagement partner sign both his or her name, as well as the firm's name, to the audit report. We believe this policy would be more effective than proxy disclosure, as placing the partner's name on the audit opinion is a more direct public statement of responsibility.

***Concentration and Competition 6 – Enhance regulatory collaboration and coordination between the PCAOB and its foreign counterparts, consistent with the PCAOB mission of promoting quality audits of public companies in the United States.***

We support this recommendation, and agree that the PCAOB should communicate with foreign regulators and participate in global regulatory bodies. We caution, however, that communication and participation should not be precursors to PCAOB abdication to foreign regulators or to some future trans-national regulatory body. In particular, the Board's proposal (PCAOB Proposed Rule 4012) to fully rely on inspections performed by certain foreign regulators – even regulators whose structure differs in important respects from the PCAOB's structure as articulated in the Sarbanes-Oxley Act – is potentially problematic and one that demands more debate and scrutiny than it has received to date.

We appreciate the opportunity to comment on the Committee's draft recommendations. We will be pleased to elaborate on any of the comments above.

Sincerely,

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