

## The future of the accounting profession

### Introduction

The Audit Committee Leadership Network (ACLN) held its eighth meeting in New York on March 10, 2005. During discussions that day, network members met with the leaders of the Big Four accounting firms to discuss the future of the accounting profession. The discussion covered:

- **Sarbanes-Oxley:** a positive impact on the accounting profession in the long term
- **Section 404:** widening the expectations gap in the short term
- **Restoring balance:** putting judgment back into the system

In May 2004 members first discussed the role of external auditors in light of Section 404 and the creation of the Public Company Accounting Oversight Board (PCAOB). *ViewPoints* reported, “Many of the network members are seeking to understand the challenges confronting the leadership of the Big Four accounting firms. As one member commented, ‘It matters how accounting firms are run.’”<sup>1</sup> That discussion led to an invitation to the leaders of the Big Four accounting firms to participate in an interactive dialogue with network members on the current and future state of the accounting profession.

The representatives of the Big Four accounting firms participating in the session were:

- Gene O’Kelly, Chairman and Chief Executive Officer, KPMG LLP
- Dennis Nally, Chairman and Senior Partner, PricewaterhouseCoopers LLP
- Jim Quigley, Chief Executive Officer, Deloitte & Touche USA LLP
- Jim Turley, Global Chairman and Chief Executive Officer, Ernst & Young

The members of the network participating in the session, who sit on the boards of about 30 large-, mid-, and small-cap public companies between them, were:

- Jim Adams, Audit Committee Chair, Texas Instruments
- Bob Burt, Audit Committee Chair, Pfizer
- John Clendenin, Audit Committee Chair, The Home Depot
- Scott Cowen, Audit Committee Chair, Newell Rubbermaid
- John Ferraro, Vice Chairman, Ernst & Young
- Tom Flannery, Americas Director, AABS Quality, Ernst & Young
- Roland Hernandez, Audit Committee Chair, Wal-Mart
- Judith Richards Hope, Audit Committee Chair, Union Pacific
- Peter Ueberroth, Audit Committee Chair, The Coca-Cola Company
- Sandy Warner, Audit Committee Chair, General Electric Company

*ViewPoints* reflects the network’s use of a modified version of the Chatham House Rule whereby names of members and guests and their company or firm affiliations are a matter of public record, but comments made during the meetings are not attributed to individuals, corporations, or firms.

<sup>1</sup> Audit Committee Leadership Network, “Section 404: Lessons learned and value earned?” *ViewPoints*, June 4, 2004, 6.

## Executive summary

The accounting profession is in a state of transition: it is moving from self-regulation to oversight by an independent regulator and from reporting to senior management to reporting to the independent audit committee of the board of directors. There are few precedents for such a change within a professional service firm environment, and there are many tensions involved. The issues arising from this transition affect not just the accounting firms, but their clients and the wider investing public. For that reason, members of the Audit Committee Leadership Network and the leaders of the Big Four accounting firms took the opportunity to meet and begin a candid dialogue on the future of the accounting profession.

The specific issues that participants in the dialogue found to be most important are highlighted below, with more detailed discussion on the following pages.

- **Sarbanes-Oxley: a positive impact on the accounting profession in the long term** *(Page 3)*

Network members and leaders of the Big Four agree that Sarbanes-Oxley will have a beneficial long-term impact on the accounting profession. The benefits are likely to include: decreasing the risk that fraud will remain undetected for long periods (thus reducing the size and perhaps even the number of fraud cases); a rebalancing of the auditor's relationship with senior management and the audit committee; and, for the accounting firms, a return to their core offerings with a renewed emphasis on the quality of their services. In the short term, however, there is a fair degree of tension in the relationships among audit committees, management, auditors, and regulators.

- **Section 404: widening the expectations gap in the short term** *(Pages 4-5)*

Members are concerned that the emphasis on Section 404 and its cost to business has given rise to the perception among the investing public that corporate fraud is being stopped in its tracks. Network members fear that eventually there will be another headline-grabbing case of large-scale corporate fraud, which may lead to calls for further legislation and regulation, potentially resulting in a greater burden for public companies.

- **Sustaining the profession: new challenges for the accounting firms** *(Pages 5-6)*

Participants are concerned that the current stresses on the accounting profession will have a negative effect on recruitment and retention. Audit committee chairs are also worried about the potential for another Enron-type event to bring down one of the Big Four, which would lead to the collapse of the current system for auditing global public companies.

- **Restoring balance: putting judgment back into the system** *(Page 6)*

Audit chairs and their auditors are concerned about a perceived loss of balance in the regulatory environment that is crowding out professional and business judgment. Participants described second-guessing in every part of the system – the regulators with registrants and accounting firms, the accounting firms with their clients, and, within the accounting firms, national offices with engagement partners. This second-guessing seems to create an environment where reasonable good-faith judgments on gray areas are considered by some as blatant disregard for the rules. Audit chairs feel they lack the

public voice that would make it possible to influence this situation. As one network member said, *“The impact is on us, our investors, and our global competitiveness.”*

### **Sarbanes-Oxley: a positive impact on the accounting profession in the long term**

On July 30, 2002, President George W. Bush signed into law the Sarbanes-Oxley Act, which mandated a number of reforms to enhance corporate responsibility and restore investor confidence. After network members’ first review of the impact of Sarbanes-Oxley, *ViewPoints* reported, “The discussion among network members suggests the tone among leading audit committees has shifted since Sarbanes-Oxley. Some directors see Sarbanes-Oxley as the catalyst to reform; others see it as a reaction to changes that were already taking place in the wake of the Enron scandal.”<sup>2</sup>

This generally positive view of the legislation was echoed by leaders of the Big Four accounting firms when they met with network members in March 2005. One Big Four leader said he had told his firm’s employees, *“In five years’ time, we’ll look back and say [Sarbanes-Oxley] was the greatest thing that happened to the [profession]. I say that from a professional, not a commercial, point of view.”*

In the ensuing discussion, the representatives of the Big Four accounting firms outlined what they see as the long-term benefits from implementing Sarbanes-Oxley:

- Although financial statement fraud cannot be entirely eliminated, the risk of fraud in financial reporting has been reduced. In addition, it is less likely that fraud will remain undetected for long periods (thus reducing the size and perhaps even the number of fraud cases).
- The auditor’s relationship with senior management and the independent audit committee will be rebalanced.
- Accounting firms will return to their core offerings of audit and audit-related services, tax and tax-related services, and transaction-related services.
- Accounting firms will put renewed emphasis on the quality of their services.
- The PCAOB’s inspection process will spread best practices throughout the profession, despite any short-term stress involved.

However, network members and the auditors both agree that the lack of clarity from regulators is interfering with the accounting firms’ ability to provide service to their clients. The problem was outlined by one accounting firm leader: *“There is a lot of second-guessing in the system. The level of stress is at its highest in over 30 years. The National Office people become very conservative, and they second-guess the engagement team, so they [in turn] second-guess the client beyond the natural skepticism we are trained in, and the whole system becomes dysfunctional.”* One network member responded, *“We don’t like to be second-guessed either. We are not [even] at the table when auditors and regulators agree on a restatement that comes out of [the] inspection [process].”*

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<sup>2</sup> Audit Committee Leadership Network, “Audit committee emerging roles and responsibilities,” *ViewPoints*, October 15, 2003, 3.

## Section 404: widening the expectations gap in the short term

Section 404 of the Sarbanes–Oxley Act states, “each [company] annual report required by section 13(a) or 15(d) of the Securities and Exchange Act of 1934 ... [shall] contain an internal control report, which shall – (1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.”<sup>3</sup>

Audit chairs and the Big Four leaders are broadly supportive of Sarbanes–Oxley as a whole, yet they agree that implementing Section 404 has been particularly challenging. One of the Big Four leaders said, “[This] is about finding our way through the ‘Death Valley’ between the vision [of Section 404] and [its] execution.” Network members are looking to reduce costs in the future and build a sustainable process. They want to understand the lessons learned from year one, both internally and from the accounting firms.

Network members are skeptical about whether Section 404 would have stopped the Enron fraud, but in response to that question, one of the Big Four leaders stated, “The risk would have been reduced. There are larger disincentives now. There is whistleblower protection and a direct link to the audit committee. It is difficult for auditors to detect collusive fraud, particularly when third parties participate in the fraud designed to deceive the auditor.”

Another Big Four representative agreed with this analysis, saying, “The price of fully preventing fraud is more than [the system is] willing to pay: are we willing to get rid of incentive compensation for management? Our system contains risk. There will be additional frauds. [Section] 404 implementation and tone at the top should help reduce it from being Enron-scale.”

Members are not optimistic about the external auditor’s chances of finding a specific instance of fraud, nor are they willing to pay for more than “reasonable assurance” from the auditor. However, audit chairs do believe that auditors could alert the audit committee to leadership and culture conditions such as “cowboy activities and orphan units” that raise a red flag for fraud potential.<sup>4</sup>

While there have been complaints about the increases in audit fees as a consequence of implementing Section 404, one network member pointed out, “We often pay our CEO alone more than we pay our auditors to check the entire company. We don’t pay our auditors enough. With [Sarbanes–Oxley], Section 404, and the PCAOB, we are being lulled into a different sense of security. If we are not paying enough, what are we getting from our auditors?”

Members are concerned that the emphasis on Section 404 and its cost to business may have given rise to the perception among the investing public that corporate fraud is being stopped in its tracks. One member stated, “We have all been subjected to the numbing noise of 404. The public believes there is more integrity in the system, so there won’t be any more Enrons. The problem is fraud. We are all large enough

<sup>3</sup> The text of the Sarbanes–Oxley Act in its entirety is available at <http://news.findlaw.com/hdocs/docs/gwbush/sarbanesoxley072302.pdf>

<sup>4</sup> For further detail, see Audit Committee Leadership Network, “Preventing, detecting, investigating fraud: The audit committee’s role,” *ViewPoints*, March 24, 2005, 5.

*companies that someone, somewhere, will do something wrong. If there is a major hiccup – given what 404 has cost – we face a real problem. The public ... will demand extreme measures. We need to address this expectation gap now and head this off.”*

Anxiety over Section 404 implementation has often prevented recognition of the overall benefits of Sarbanes–Oxley. One Big Four leader commented, “[Section] 404 by itself does not have as much impact as all that has changed collectively, including [Section] 302 certification – which has had a huge impact in the way [that certification process] gets cascaded [through organizations] – and ethics and whistleblower programs. Together they are important cultural changes. [Section] 404 does not have the same impact on fraud because it works bottom-up, and large-scale fraud is top-down.”

### **Sustaining the profession: new challenges for the accounting firms**

The accounting profession faces new challenges, including dealing with the impact of short-term stresses on the retention of their people. As one Big Four leader put it, “*How do you cross the chasm to the future state? How do you get your people psychologically to the other side? Not everyone is going to cross that chasm [to that] better future state.*” Network members are also concerned about the long-term impact on recruitment into the profession and have welcomed the development of the talent task force, which has been set up to look at this issue by the largest accounting firms, the American Institute of Certified Public Accountants, the PCAOB, the Securities and Exchange Commission (SEC), and academic institutions.

Section 404’s unintentional widening of the expectations gap poses an additional threat to the current system of public company auditing, in which the Big Four handle almost all large global public company audits. In July 2003 the General Accounting Office (GAO, now known as the Government Accountability Office) concluded a study on consolidation and competition among public accounting firms. The GAO found that “market forces are not likely to result in the expansion of the current Big Four. Furthermore, certain factors and conditions could cause a further reduction in the number of major accounting firms.”<sup>5</sup>

In September 2003 members noted, “[The Big Four] is an oligopoly now, and we are at their mercy.”<sup>6</sup> In March 2005 members’ main concern is that the current system will be unsustainable if one of the Big Four fails. One member said it is inevitable that “... *one of the Big Four will be behind a failing registrant. We all need to influence the process so that the integrity of the Big Four is not compromised when a blowup happens.*”

The scenario members painted is of events leading to a hostile media and political environment that could drive their clients and their people to defect from the tainted accounting firm – sealing its fate and that of the profession as it stands today. Members believe that the threat of litigation is also a major factor in the vulnerability of the accounting firms. One audit chair commented, “*Next time, [an Enron-type event is]*

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<sup>5</sup> United States General Accounting Office, *Public Accounting Firms: Mandated Study on Consolidation and Competition*. GAO Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, GAO-03-864 (Washington, DC: United States General Accounting Office, 2003). Quotation is from the pdf highlights, available at <http://www.gao.gov/highlights/d03864high.pdf>.  
1. A pdf version of the entire report is available at <http://www.gao.gov/new.items/d03864.pdf>

<sup>6</sup> Audit Committee Leadership Network, “Audit committee emerging roles and responsibilities,” *ViewPoints*, October 15, 2003, 6.

*going to be faster and more public. Litigation costs will outweigh any accounting costs or accounting issues.”*

The Big Four are also acutely aware of the vulnerability of the current system. One Big Four leader said, *“The expectations gap has been around for 30 years or longer. The profession always thought educating the public would make it disappear and was not looking at what we could do. We have to commit to do as much as we can.”* However, the accounting firms need support from the regulators. One accounting firm leader commented, *“The next step is to get [stakeholders in the capital markets] comfortable with the idea of an expectations gap.”*

## **Restoring balance: putting judgment back into the system**

Audit chairs and their auditors are concerned about a perceived loss of balance in the regulatory environment that is crowding out professional and business judgment. Participants described second-guessing in every part of the system – the regulators with registrants and accounting firms, the accounting firms with their clients, and, within the accounting firms, national offices with engagement partners. This second-guessing seems to treat reasonable good-faith judgments on gray areas in the same way as blatant disregard for the rules. One Big Four leader admitted, *“We don’t have a strategy to redress the balance. The challenge is to get judgment back into the system.”*

PCAOB Chairman William McDonough has been at pains to stress the importance of judgment: *“At every opportunity, we encourage auditors to exercise judgment as they implement this standard ...”*<sup>7</sup> Nevertheless, auditors’ day-to-day experience suggests that judgment is being squeezed out. One accounting firm leader remarked, *“My fear is the constant challenging of professional judgments through the inspection process. What incentive is there to make a judgment if an inspector will second-guess you in six months? This impacts the amount of risk we take, how we work, and our willingness to provide judgment.”*

However, participants in the meeting said the regulatory pressure on the accounting firms is not just coming from the PCAOB inspection process. They perceive there to be an element of regulatory one-upmanship between the PCAOB, the SEC, and state attorneys general. One accounting firm leader commented, *“We need regulators to ‘problem solve’ with accounting firms and registrants.”*

Network members say the loss of public confidence in the accounting firms has put the profession on the defensive. One audit chair commented, *“The auditors are in the penalty box ... The focus on the accounting firms means they can’t be the vehicle for restoring balance [to the system]. There are lots of constituents in this game. We all have a vested interest in this. The impact is on us, our investors, and our global competitiveness. We want this to be fixed.”*

Looking ahead, members and the Big Four leaders agreed on the need to convene a wider group of stakeholders in the capital markets. One network member said, *“Audit committee chairs are at the center of the process and never have a voice at the table.”* Another member added, *“We, as directors, need to stick our heads out of the covers or it won’t change.”*

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<sup>7</sup> Speech to the Securities Industry Association, Boca Raton, FL, November 4, 2004.

## Conclusion

Public company audit chairs and auditors agree that the corporate governance changes ushered in by Sarbanes-Oxley will have a beneficial effect on the accounting profession in the long term. However, they have also identified some very real risks to the short-term sustainability of the Big Four accounting firms that work for 97% of public companies with over \$500 million of revenue. The best hope for the accounting profession is for the various stakeholders in the capital markets to come together to discuss changes that will deal with the unintended consequences of the current regulatory and litigation environment and restore reasonable good-faith judgments to the center of business and professional life.

## About this document

The Audit Committee Leadership Network is a group of audit committee chairs drawn from leading North American companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

*ViewPoints* is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board directors, members of management, and advisers who become systematically engaged in this dialogue, the more value will be created for all.

*The views expressed in this document represent those of the Audit Committee Leadership Network and the individual accounting firm leaders. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young, Deloitte & Touche, PricewaterhouseCoopers, KPMG, or Tapestry Networks. Please consult your counselors for specific advice. Ernst & Young refers to all members of the global Ernst & Young organization, including the U.S. member firm of Ernst & Young LLP.*

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