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How the U.S. Accounting Profession Got Where It Is Today: Part II

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A Gradual Degeneration of Professional Values

By 1980, a deterioration in professional values appears to have set in. At the Institute's annual meeting in October, outgoing Board Chairman Wm. R. Gregory, a practitioner from Tacoma, Washington, vividly warned members of the increasingly fractious climate in the profession:

It seems that the effects of the phenomenal growth in the profession and competitive pressures have created in some CPAs 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.¹

In 1982, Max Block, a CPA and the former longtime editor of *The New York Certified Public Accountant*, lamented that "accounting profession" was "a term that has lost some of its relevance" (Block 1982, 165). Among other things, he remarked that "Some of the major firms do not refer to themselves as Certified Public Accountants or Accountants and Auditors," not even on their letterheads (Block 1982, 176). However, this was not news. Six years earlier, only two of the Big Eight firms, all of which wrote letters to the Metcalf subcommittee that were photocopied in *The Accounting Establishment* (1976), used stationery identifying the sender as accountants or auditors.² The other firms provided no identification of the sender at all, just the name and address of the firm. Block (1982, 176) added, "This [practice] undoubtedly eliminated the service limitation implicit in such titles."

This professional climate evidently worsened in the following years. In May 1985, the Institute's Special Committee on Standards of Professional Conduct for Certified Public Accountants, headed

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Professor Zeff expresses his appreciation to several accounting academics and to more than a dozen active and retired senior partners of major accounting firms for their comments on earlier drafts. He also appreciates the suggestions of the anonymous reviewers.

Editor's note: This concluding part of Professor Zeff's sobering account of how the U.S. accounting profession fared in the 20th century addresses how the forces encountered in earlier times affected the professional nature of accounting firms for some 20 years beginning in the early 1980s. Sadly, accounting "industry" replaced accounting "profession" in many circles. Part I appears in *Accounting Horizons*, September 2003.

¹ Gregory's speech was given at the annual business meeting on October 6, 1980. The transcript of his speech was kindly supplied by the Institute.

² The stationery of both Haskins & Sells and Peat, Marwick, Mitchell & Co. identified them as Certified Public Accountants.

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by George D. Anderson, the Institute's 1980–81 board chairman, all but pressed the panic button in its interim report to Council:

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. (Special Committee 1985, 3–4)

The Special Committee was appointed in October 1983; in May 1986, when submitting its final report, the Committee reiterated its somber assessment: "The competitive environment has placed pressure on the traditional commitment to professionalism in the practice of public accounting" (*Restructuring Professional Standards* 1986, 6). The Committee added that "Many observers are concerned ... that the long-term consequence for the profession of uncontrolled expansion of [non-attest] services will be a diminished faith in the auditor's independence. This issue cannot be left to the marketplace alone for resolution" (*Restructuring Professional Standards* 1986, 43). In a carefully crafted sentence, the Committee proposed standards of conduct to "impose a measure of self-restraint and self-regulation by calling upon AICPA members to use their judgment in applying broad standards to determine what is consistent with professional conduct in the provision of nonattest services" (*Restructuring Professional Standards* 1986, 43). Like the Public Oversight Board in 1979, the Special Committee did not undertake to proscribe any specific non-attest services. It is noteworthy that only three of the Special Committee's 15 members were partners in Big Eight firms, none of them in their firm's executive office. George Anderson, the Committee's chairman, was the managing partner of a local accounting firm in Helena, Montana.

Bernard Z. Lee, a member of the Special Committee, the Institute's 1983–84 board chairman and CEO of the major accounting firm of Seidman & Seidman, in Houston, a self-described "hawk" on the subject, was quoted as saying (prophetically):

The profession is changing and change is necessary, but we need to approach it with caution and there needs to be reasonable limitation on what services we should be providing as a profession. There's a perception by our critics, Congress for one, that we may be sacrificing our objectivity if not our independence. If we do not limit the scope of services, then someone will do it for us. (Weinstein 1987, 50)

Other changes in the big firms signaled their further removal from the mainstream professional dialogue. By the mid-1980s, all of the Big Eight firms' house organs that occasionally contained technical articles on accounting and auditing either closed down or became entirely nontechnical. Following the decision by Lybrand, Ross Bros. & Montgomery to do so in 1973, four Big Eight firms discontinued their house organs between 1981 and 1984, and the remaining two firms' house organs soon became nondescript magazines with no affinity to the accounting profession. Ernst & Ernst's house organ never contained technical articles. Between 1971 and 1973, four Big Eight firms began to publish a series of widely distributed booklets expressing their views on controversial accounting issues, but all of these series terminated, as if on cue, in 1979. Beginning in the 1970s, most of the firms began issuing newsletters that mainly described and reported current developments, yet some still contained the firm's views on technical issues. But by the mid-1980s all of the firms' newsletters had become entirely factual (Zeff 1986, 133–138), evidently steering clear of the espousal of controversial views on matters of accounting principle. Even the state societies of CPAs began discontinuing their journals or replacing them with bland magazines having little, if any, professional content.³

³ The leading exception has been *The CPA Journal*, published by the New York State Society of Certified Public Accountants. *The Ohio CPA Journal* finally succumbed in 2002.

In 1985, Ralph E. Walters, a senior audit partner Touche Ross & Co. and a former FASB member, wrote, "The dual concerns of Congressional oversight and the litigious environment have made CPAs nervous about criticizing the status quo. Some even consider it dangerous. So, controversial articles on accounting/professional matters are not in style."⁴ Dale L. Gerboth, an audit partner in Arthur Young, observed in 1985:

Written articles don't even do much any more to enhance a firm's professional reputation. The business community already perceives all of the large firms as highly competent in accounting and auditing. Even the most brilliant article will not add significantly to that perception. Firms now try to differentiate themselves in other ways, primarily by stressing their commitment to client service ("We take business *personally*").⁵

Even the Big Eight firms' written submissions to the FASB were perceived to be of a lower standard in the 1980s than in the 1970s. In 1985, FASB Vice Chairman Robert T. Sprouse wrote that the quality of letters of comment from the Big Eight firms had, in recent years, deteriorated in terms of their "comprehensiveness, thoughtfulness, and clarity of the constructive recommendations they contained." The most likely explanation for this drop in quality, he said, was "that past experience has made the accounting firms reluctant to take clear positions that may prove to be offensive to some of their current and prospective clients."⁶

Others also sounded foreboding notes. Donald J. Kirk, the FASB chairman and a former audit partner of Price Waterhouse, wrote as follows in 1984:

My major concern is whether the profession will continue to operate in a way that protects its [auditing] franchise and ensures credible financial statements. ... It is essential ... that the additional services offered by accounting firms don't detract from the firms' major responsibility of auditing financial statements or impinge on their independence. (Kirk 1984, 29)

In its 1985–86 annual report, the Public Oversight Board warned that the appearance of independence could be endangered:

the Board is of the opinion that the continuous expansion of consulting services may be perceived as impairing auditor independence and thus adversely affect the value of the audit function in the long run. (*Annual Report 1985-1986* 1986, 16)

Implications of Firms' Big Move into Consulting Services

The growth of consulting services in the Big Eight firms from the mid-1970s onward was palpable: "consulting fees as a percentage of total gross firm fees had increased from a range of 5 percent to 19 percent in 1977, to a range of 11 percent to 28 percent in 1984" (Previts 1985, 134). Even by 1978, six of the Big Eight firms placed in the top 10 U.S. consulting firms in terms of gross billings for consulting services (Hayes 1979, D1). By 1983, Arthur Andersen & Co. was number one in the list of the top U.S. consulting firms (Previts 1985, 154). By 1990, fees from consulting vaulted to 44 percent of total gross fees for Arthur Andersen/Andersen Consulting and ranged from 20 to 25 percent of total gross fees for the other Big Six firms. (See Exhibit 1.) The relative contribution of fees for tax services to total gross fees rose by about five percentage points from 1975 to 1990 (Zeff 1992, 265).

The experience in Price Waterhouse (PW), one of the Big Eight firms that was, with Haskins & Sells, previously among the least aggressive in expanding into consulting services, epitomizes the drive toward consulting in the second half of the 1970s and even more so in the 1980s:

Long a secondary focus within PW, consulting became an important line of business during the 1980s. The MAS Department posted significant gains during the late 1970s and early 1980s: partners increased from 33 in 1975 to 71 in 1980, and to 108 by 1985; staff increased in even

⁴ Letter to the author dated February 1, 1985.

⁵ Letter to the author dated February 8, 1985.

⁶ Letter to the author dated May 9, 1985.

greater proportions, from 337 to 1,300 (8.2 percent to 18 percent of the total firm personnel) in the same period. In addition, the consulting practice's contribution to profit doubled, from 6.8 percent to 13.3 percent. Its dependency on work from audit clients declined at the same time, from 64 percent in 1975 to 26 percent by 1985, largely as a result of a rising volume of work from government organizations. The composition of MAS also changed. By 1988, only one out of four consultants were CPAs, compared with one out of two in 1974. In 1980, a milestone for the MAS Department was reached when one of its non-CPA partners, Paul Goodstat, began to serve on the [firm's] Policy Board. Symbolic of all of these developments was the 1984 decision to rename this practice area Management Consulting Services. (Allen and McDermott 1993, 235)

In sum: "By 1986, PW had evolved to the point where its mission was to become nothing less than a 'full-service business advisory firm'" (Allen and McDermott 1993, 233).

These developments were likely duplicated in the other Big Eight firms, where, through hiring or the takeover of boutique consulting firms, non-CPAs increasingly were brought into the firm's consulting practice (see, e.g., Berton 1985d, 12), and senior consulting partners began to play active roles at the top levels of the firm's overall management hierarchy. By the 1990s, non-CPAs were well represented in the top management of the Big Six firms.

What forces drove the accounting profession in the 1970s and 1980s? Following their aggressive expansion overseas in the 1950s and 1960s, in order to serve their globally expanding clients, the major audit firms apparently concluded in the early 1970s that the audit market was becoming largely saturated. To compensate, the firms aggressively broadened the scale and scope of their

EXHIBIT 1
Breakdown of Gross Fees According to
Accounting and Auditing, Tax, and Management Consulting

	Percentage of Gross Fees			
	Accounting and Auditing	Tax/Management Consulting	Tax/Management Consulting	
	1975	1990	2000	
Arthur Andersen & Co.	66/18/16	35/21/44		Arthur Andersen & Co./Andersen Consulting Arthur Andersen & Co.
		48/38/14	43/31/26	
Price Waterhouse & Co.	76/16/8	51/26/23		PricewaterhouseCoopers
Coopers & Lybrand	69/19/12	56/19/25	33/18/49	
Peat Marwick Mitchell	68/21/11	53/27/20	45/38/17	KPMG
Ernst & Ernst	73/17/10	53/25/22	44/30/26	Ernst & Young
Arthur Young & Company	69/17/14			
Haskins & Sells	74/15/11	57/23/20	31/20/49	Deloitte & Touche
Touche Ross & Co.	62/24/14			

Sources: 1975: *The Accounting Establishment* (1976, 30).

1990: *International Accounting Bulletin*, Issue No. 84 (March 1991, 13) and the firms' annual reports for 1990 to the SEC Practice Section of the AICPA's Division for CPA Firms.

2000: The firms' annual reports for 2000 to the SEC Practice Section of the AICPA's Division for CPA Firms.

consulting practices. In addition to tax-compliance services, tax consulting also expanded. The distribution of the major firms' gross fees shifted markedly from accounting and auditing to tax and consulting services, a portent of further developments to occur in the 1990s and after.

In the 1970s and increasingly into the 1980s, consulting in the Big Eight firms commanded a much larger share of their gross fees. Moreover, in most firms the margins from consulting were believed to exceed those from the audit engagements, especially when competitive bidding often drove down the gross audit fees. While the firms, as profit-seeking enterprises, had always been run as businesses, professional values were nonetheless paramount. But the incessant drive in the 1970s and especially in the 1980s to widen the scope and scale of lucrative consulting services, coupled with the development of the firms' strategic plans, as businesses, to promote growth, greater profitability and global reach, launched them as emerging international behemoths.⁷ They formed integrated international firms and became truly worldwide enterprises, ready to serve their multinational clients in services across the board and around the globe. Examples were Touche Ross International in 1972, Peat Marwick International and Deloitte Haskins & Sells International in 1978, Ernst & Whinney International in 1979, and the Price Waterhouse World Firm in 1982.⁸

In the midst of the corporate merger wave of the 1980s, the firms themselves focused on forming combinations. In 1984, an attempt by Price Waterhouse and Deloitte Haskins & Sells to unite failed to materialize (see Allen and McDermott 1993, 228–229). In 1986, Peat Marwick and the European-dominated firm KMG merged to form KPMG (Cypert 1991). In mega-mergers during 1989, Ernst & Whinney and Arthur Young combined to become Ernst & Young, and Deloitte Haskins & Sells joined with Touche Ross to create Deloitte & Touche (Stevens 1991, Chapter 5). Also in 1989, Price Waterhouse and Arthur Andersen held merger talks that failed to unite the firms (Allen and McDermott 1993, 246–248). In 1997–98, Ernst & Young entered into merger talks with KPMG that ended without result. Finally, in 1998, Price Waterhouse merged with Coopers & Lybrand to form PricewaterhouseCoopers, creating the Big Five.⁹

An important element in the firms' drive toward profitability and growth—business aims, not professional aims—involved placing pressure on partners to generate more revenue by securing new audit clients and retaining existing ones, and, for audit and tax partners in particular, to cross-sell consulting and other attest services. The consequences of not meeting “income targets,” where such existed, were various, including, at the extreme, dismissal from the firm. This is hardly a climate compatible with audit partners believing they should (or could) stand up to clients on questionable accounting and disclosure treatments. Indeed, in 1984, Ralph Walters, the senior partner at Touche Ross, said that the big firms, in their push toward growth and profitability, were reluctant to lose a client over a matter of principle (Walters 1984, S/9).

Evidence of the effects of this pressure has been reported in the press and elsewhere. Mark Stevens writes that, beginning in 1984–85, the newly elected CEOs of Deloitte Haskins & Sells and Touche Ross abruptly challenged the maxim, “Once a partner, always a partner.” Deloitte CEO J. Michael Cook's “ultimate goal was to change Deloitte's self-image from that of a professional firm that happened to be in business (the traditional view among the giant CPA firms) to a business that happened to market professional services” (Stevens 1991, 170). “Cook knew all too well,” Stevens wrote, “that if he was going to create a leaner, meaner, more businesslike firm, he would have to take the painful step of pruning back the partnership, in part by pressuring those who couldn't cut the mustard to take early retirement. . . . Until that time partnership had been more of a coronation than a job” (Stevens 1991, 172). Underperforming partners were dismissed. Stevens added, “[Cook] awarded the biggest bonuses and highest salaries to those who proved themselves capable of graduating from

⁷ For a financial journalist's view in 1978 of the increasing competitiveness of the Big Eight firms, see Bernstein (1978).

⁸ Arthur Andersen was always run as a worldwide firm, based in Chicago, but in 1978, it set up Arthur Andersen & Co., Société Coopérative in Geneva, Switzerland to coordinate its worldwide organization.

⁹ For a historical review of the merger activity of major U.S. accounting firms, see Wootton et al. (2003).

being 'auditors' auditor' to being business advisers" (Stevens 1991, 174–175). Edward A. Kangas, the CEO at Touche Ross, adopted a similar strategy, "handing out pink slips to mediocre performers" (Stevens 1991, 208) and to those who did not generate minimum fee levels.

To be sure, firms dismissed underperforming client partners or reassigned them to nonclient tasks in earlier years, but typically because they failed to adhere to professional and technical standards, not because of a failure to bring in sufficient business. But now, because of the heightened pressure placed on them in their firms, including enhanced legal exposure and the need to keep current with increasingly complex and intricate accounting and auditing standards, as well as the growing disparity between their salaries and those in industry, more audit partners left their firms and headed for financial positions in enterprise.

The arrival of a profoundly altered competitive climate in the practice of public accounting was underscored in a remark attributed to Michael Cook in 1985: "Five years ago if a client of another firm came to me and complained about the service, I'd immediately warn the other firm's chief executive. ... Today I try to take away his client" (Berton 1985d, 1). The press quoted a close observer of the accounting profession as saying at the time, "Today almost anything that makes money goes" (Berton 1985d, 1).

Peat Marwick evidently followed this route as well (Stevens 1991, 173). It was reported in 1985 that Peat Marwick and Grant Thornton & Co. dismissed partners for failing to meet marketing targets (Berton 1985d, 1). In 1985, Ralph Walters of Touche Ross wrote:

The major firms are on a growth treadmill that inevitably will stop, but each manager is determined to keep it moving ever faster during his regime. This has required diversification into many "information-based" services. The aggregate effect of these diversifications is to change the balance of the professional mindset—moving farther from an audit mentality and toward a consulting mentality. The diversified service draws the firms increasingly into competition with other disciplines that have few or no professional/competitive constraints, and our traditional professional standards of conduct are a competitive handicap.¹⁰

Beginning in the 1970s, there was an increasing tendency to specialize by type of expertise or class of industry (Allen and McDermott 1993, 192–194), yet an attempt by the Institute to recognize the former through a formal accreditation process met with stiff resistance (Chenok 2000, 13–16). Arthur R. Wyatt, an FASB member at the time and a former Arthur Andersen partner and a former chairman of the Institute's Accounting Standards Executive Committee, wrote in 1985: "[m]y experience has been that as one becomes more of an industry specialist he tends to become somewhat of an apologist for the industry."¹¹

Impact of S&L and Bank Failures: The Dingell Hearings

The failure of many banks and savings and loan institutions during the 1980s raised troubling questions about the propriety of accounting and auditing. In addition, three notorious cases of alleged auditor fraud—E.S.M. Government Securities (Sack and Tangreti 1987), Wedtech Corp. (Traub 1990), and ZZZZ Best—embarrassed the accounting profession. A major source of pressure on the FASB and on audit firms surfaced when regulators in the banking and thrift industries advocated the use of deceptive accounting practices in order to "rescue" failing institutions in the name of the "public interest."¹² Donald J. Kirk, the FASB chairman from 1978 to 1986, was quoted in a 1990 article as saying that "[The regulators] created equity out of thin air, with incredible rationalizations" (Gerth 1990, D5). The same article reported that the AICPA joined with the regulators in lobbying the FASB to be responsive to the industry's problems. In a paraphrase, Kirk said that "the incident showed that the accountants' institute was too sympathetic to the industry,

¹⁰ Letter to the author dated February 1, 1985.

¹¹ Letter to the author dated March 4, 1985.

¹² See Berton (1985b), Simonetti and Andrews (1987), Arnold (1988), and Revsine (1991).

which was a big client for many accounting firms” (Gerth 1990, D5). The commercial banking sector also played with “regulatory accounting practices” (RAP), which departed from GAAP. Set by bank regulatory agencies, RAP allowed banks to ignore losses on bad loans or, at the most, amortize the losses over five- to ten-year periods.

In February 1985, Rep. John D. Dingell, Democrat from Michigan and chairman of the Subcommittee on Oversight and Investigations of the House Committee on Energy and Commerce, reacting to the accounting issues attending numerous bank, thrift, and corporate failures, launched three years of hearings into the adequacy of the accounting profession’s self-regulatory system. His first two witnesses were Professors Robert Chatov and Abraham J. Briloff, who had been relied upon heavily by the Metcalf subcommittee’s staff in 1976. They stated their opposition to the practice by audit firms of rendering any consulting services to their audit clients (*SEC and Corporate Audits (Part I)* 1985, 31, 143; Briloff 1987). The year 1985 also saw the formation of the National Commission on Fraudulent Financial Reporting, known as the Treadway Commission. Jointly sponsored by the Institute and four other accounting bodies, the Commission was charged “to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence” (*Report of the National Commission...* 1987, 1). The Commission issued 49 sweeping recommendations in its final report published in 1987. Philip B. Chenok, the Institute’s full-time president at the time, later observed that most of the recommendations “were subsequently implemented either through congressional legislation, regulatory action, or by the profession itself” (Chenok 2000, 29). Yet in 1992, Donald H. Chapin, a former audit partner of Arthur Young and then a senior executive in the General Accounting Office, pronounced that, “All in all the Treadway inspired work is turning out to be disappointing, and, I think counterproductive” (Chapin 1992, 18).¹³

Industry Raises the Ante

During the 1980s, financial reporting norms came under stress as (1) industry regulators increasingly viewed them as a means of achieving “public interest” goals like those mentioned above for banks and thrifts, and (2) companies and trade associations ratcheted up their lobbying of the FASB for preparer-friendly standards. A reinvigorated merger movement, coupled with the onset of pervasive restructurings, placed increased revenue and earnings pressure on CEOs, whether as engineers of attempted takeovers or as defenders against such takeovers. To the audit firms, the merger movement also portended a loss of clients, as only one of the audit firms of two merger partners would be appointed the auditor of the merged entity.¹⁴ It was also a decade marked by an increased emphasis on analysts’ earnings forecasts, adding to the pressure on CEOs to achieve earnings targets. Stevens (1985, 224) found evidence of this latter strain of earnings pressure on management as early as the mid-1980s, with the consequent insistence that the company’s accountants manage the earnings to meet the forecast: “Do whatever the hell you have to do and do it quickly and discreetly” (paraphrased by Stevens).

One consequence of these pressures was a drive by companies to secure their auditor’s approval for creative accounting techniques, especially in the recognition of revenue. Another involved a series of attempts by bodies representing preparers to diminish the FASB’s ability to issue rigorous standards. In 1985, the Financial Executives Institute issued a white paper, demanding that the

¹³ In a memo to the author dated January 23, 2003, Chapin clarified what he meant by “counterproductive,” as follows: “The Treadway Commission made a number of good recommendations in 1987, but the implementation steps for the most important of them did not go far enough and left the door open to continuing fraudulent reporting. I expressed the view in 1992 that implementation was counterproductive because many people were satisfied with the minimal implementation that had been done and that stopped the momentum for needed improvements.”

¹⁴ For discussion of this issue in the context of Price Waterhouse, see Allen and McDermott (1993, 227). The restructurings did, however, spawn new business, as “some firms, like Deloitte, Haskins & Sells and Touche Ross, began to emphasize consulting for investment bankers in mergers, reorganizations, and bankruptcies” (Allen and McDermott 1993, 227).

trustees of the Financial Accounting Foundation (FAF) reconstitute the FASB with a larger representation of ex-financial executives, as a result of which the FAF's trustees appointed a second preparer to the Board (Miller et al. 1998, 179–180). Three years later, after Arthur R. Wyatt resigned from the Board because, he said, preparers were interfering in the Board's work (*Users and Abusers* 1987, 13; Berton 1987), a task force of The Business Roundtable, a body composed of CEOs of some 200 of the largest U.S. corporations and banks, proposed the creation of a new oversight body. It "would be given the power to add or delete projects from the FASB's agenda or to reject any of the Board's standards after they had been passed" (Miller et al. 1998, 182).¹⁵ A representative from the preparer community was to be included on the body. SEC Chairman David S. Ruder summarily rejected the proposal, which put an end to the episode (Ruder 1989, 11–14; Van Riper 1994, 135–140).

Nonetheless, in 1990 the FAF trustees approved a stiffening of the FASB's required voting majority from 4-3 to 5-2, a move driven by corporate interests to slow down the Board (Van Riper 1994, 160–165; Miller et al. 1998, 182). These thrusts by Corporate America in the 1980s served notice that it was monitoring the work of the FASB closely and would intervene if necessary. Another assault on the FASB occurred in 1996, this time by the Financial Executives Institute, which sought to bring the Board under the control of the preparer community. It was repulsed by SEC Chairman Arthur Levitt, who countered by securing the appointment of four representatives of the public interest to the FAF board of trustees (Miller et al. 1998, 186–192; Zeff 1998b, 535–537; Levitt 2002, 111–115).

Impact of Heightened Client Pressure on Auditors

As preparers became more assertive and aggressive, audit firm partners seemed to recede into the shadows, evidently reflecting the growing pressure from their clients. In two major articles published in 1988 and 1991, Arthur Wyatt provided his own perspective as a former FASB member and as a principal in the Accounting Principles Group of Arthur Andersen, a Big Six firm that continued to express its own views forthrightly. In 1988, he wrote, "Too often the Emerging Issues Task Force (EITF) is used [by audit firm partners] more as a forum to argue a specific client's fact situation than as a forum to achieve a professionally oriented solution ..." and "Unfortunately, the auditor today is often a participant in aggressively seeking loopholes [on behalf of corporate clients]" (Wyatt 1988, 24). Wyatt wrote in 1991:

Attesters [i.e., audit firm partners] ... no longer really bring their own views to the Board, but rather too frequently present a synthesized version of their client's views. It has become commonplace for the Board to receive a response letter from an accounting firm at or near the end of the exposure period indicating its response will be delayed because the firm has not yet completed a survey of its clients. ... Many attesters seem to have lost their ability and/or willingness to present their own views, leaving cynics to speculate that attesters are unwilling to incur potential disfavor with one or more of their clients by taking a position on controversial issues. (Wyatt 1991, 113)¹⁶

The Public Oversight Board agreed. In its 1993 special report, *In the Public Interest*, it expressed concern over the following scenario:

allowing the views of major clients to bias a firm's ostensibly independent response to FASB discussion memoranda, invitations to comment, and exposure drafts, or to influence a firm to not take a contentious and complex issue to the Emerging Issues Task Force because of concern about getting the "wrong" answer. (Public Oversight Board 1993, 45)

¹⁵ Some of the flavor of CEOs' criticisms of the standards that the FASB proposed to issue during the 1980s and 1990s may be appreciated by a reading of the stream of letters from Thomas A. Murphy, the retired CEO of General Motors, to Donald J. Kirk and Dennis R. Beresford, the successive chairmen of the FASB (see Bricker and Previts 2002).

¹⁶ This author observed the same behavior during his four years of service on the Financial Accounting Standards Advisory Council (1988–1991).

The dialogue by leading practitioners over accounting standards, so vibrant in the 1960s, had largely died out by the end of the 1980s, in part a victim of the growing commercialism of the profession.¹⁷ When the FASB came under attack in 1990, including continued pressure from The Business Roundtable, John C. Burton and Robert J. Sack, both former chief accountants at the SEC,¹⁸ wrote, “The public accounting firms, the traditional base of support for the Board, are strangely silent” (Burton and Sack 1990, 117). In a reference to the increasingly competitive environment in which the big accounting firms found themselves at the end of the 1980s, Van Riper (1994, 162) wrote, “the need to please clients and hold on to audit engagements was greater than it had been in more than a half a century.” By the outset of the 1990s, evidently, any ostensible leadership among the Big Six firms for supporting the public interest in sound standard setting had largely disappeared.

In the latter 1980s, some of the big firms began distancing themselves from the term “accounting,” as they expanded the horizons of the information services that CPAs might render. Writing with Gary John Previts in 1987, Arthur Andersen partner Robert Mednick argued that the emergence of new information technology “has placed a significant premium on the information-gathering, analyzing and evaluating skills of the CPA and has led us to conclude that there will be a gradual recognition of today’s CPA as tomorrow’s ‘independent information professional’” (Mednick and Previts 1987, 232).

One leader of the profession went so far as to recommend that CPAs give up their exclusive franchise to conduct audits. A. Marvin Strait, a former Institute board chairman and the managing partner in a small accounting firm in Colorado Springs, Colorado, argued that, as “information professionals,” CPAs need to free themselves from the constraints that state boards of accountancy place on their non-attest services. He recommended that CPAs give up the licensed monopoly accorded them under state law, that the AICPA replace the state boards as the body that examines and certifies candidates for the CPA designation, and that the state boards confine their regulation to “the CPA’s work in services with a third-party interest and attest engagement, and compilations where there has been third-party reliance” (Strait 1993, 186).

The SEC and Others Voice Concerns about Auditor Conduct

During the Reagan and senior Bush administrations, the SEC seemed to adopt a less outwardly confrontational posture toward the accounting profession about the possible conflict of consulting services with auditor independence. Nonetheless, during the 1980s and apparently continuing into the 1990s, the SEC balked at allowing audit firms to engage in “business relationships” with their audit clients even if they were not material to either party (Mednick 1990, 92–93). The SEC also declined to adopt the view of the Big Six firms that the appearance of independence should be judged “from the perspective of a *reasonable and prudent person* who possesses both *knowledge and experience*” (*The Public Accounting Profession: Meeting the Needs of a Changing World* 1991, 22). Citing the U.S. Supreme Court’s unanimous decision in *United States v. Arthur Young*, 465 U.S. 805 (1984), the SEC’s staff instead placed emphasis on the perspective of the “investing public” (*Staff Report on Auditor Independence* 1994, 16) or of a “reasonable investor” (SEC Staff Analysis [of the AICPA White Paper], 1997, 1; Zeff 1998b, 537–539).¹⁹ Adding to many voices, the SEC’s accounting staff quoted the following passage from Chief Justice Warren Burger’s opinion in the Arthur Young case, in which he said that the independent public accountant performs a “‘public watchdog’ function [that] demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust” (p. 818 of the court opinion). This debate between the big firms and the SEC’s staff may continue, but the Supreme Court has spoken clearly and definitively.

¹⁷ For a historical perspective, see Wyatt (1989).

¹⁸ Sack was Chief Accountant of the SEC’s Enforcement Division, while Burton was Chief Accountant of the Commission.

¹⁹ In 1994, SEC Chief Accountant Walter P. Schuetze (1994, 70) reported that his office had rejected a similar petition in 1992 from the chairman of a special committee of the AICPA.

The growth and profitability mentality that drove the big firms in the 1980s showed no sign of abating in the 1990s. In his 1991 book, *The Big Six*, Mark Stevens wrote prophetically:

Beyond the issue of size, the firms must face a more serious question: What, exactly, do they want to be? For generations, the Big Eight were proud of their role as audit professionals. . . . The fact that they were well paid (but not wealthy) partners in collegial practices that stressed caution, prudence and a disdain for the trappings of commercial businesses was a matter of pride.

Today, just the opposite is true. Anything that smacks of this traditional attitude is dismissed as a relic of the past. . . .

As the firms become more intimately involved with their clients through their consulting practices, as they think of themselves more and more as consultants who happen to do audits just to get a foot in the door and as they continue to reward salesmanship and marketing over technical proficiency, they are clearly headed toward a day of reckoning—a day when the firms, or Congress acting for them, will force the issue and demand that they decide whether they want to retain the licensed privilege of auditing the corporate community by spinning off the MAS practices, or whether they want to join in the open competition of management consulting by ejecting the audit practices. (Stevens 1991, 250–251)

In 1994, the SEC's Office of the Chief Accountant expressed concern over this trend when it said, "the staff is mindful of the potential impact of MAS on auditors' independence, in the light of the increasing role of non-audit personnel who are not bound by the accounting profession's Code of Ethics at the top management levels of the firms . . ." (*Staff Report on Auditor Independence* 1994, 34). The Public Oversight Board in its 1993 special report, *In the Public Interest*, wrote that "Attacks on the accounting profession from a variety of sources [have] suggested a significant public concern with the profession's performance" (Public Oversight Board 1993, 1),²⁰ and it recommended several measures that the firms could take to reassure the public of their objectivity, independence and professionalism (Public Oversight Board 1993, 43–46).

Donald H. Chapin, the former Arthur Young audit partner mentioned earlier, provided a depressing outlook for the accounting profession in 1992, when he addressed an annual conference of the New York State Society of CPAs as Assistant Comptroller General, Accounting and Financial Management, of the U.S. General Accounting Office. He raised the specter of possible action by Congress to regulate the profession, and he warned the profession against continuing to close the expectation gap by reducing expectations. He said, "Expectations [of auditors] are so unbelievably low that some are questioning whether there is a role for a private sector profession" (Chapin 1992, 16). He said, "We have been told that some firms are offering audits—their exclusive franchise—at big discounts to attract clients for their more lucrative consulting services. Some say the profession's traditional function has been downgraded to a loss leader" (Chapin 1992, 18). Ominously, he added, "I believe that it is very important for the profession to come up with a plan for reform which deals with survival issues. One of these issues is facilitating recognition of the public interest. How to free the profession to take on this role involves separating auditors from management control" (Chapin 1992, 22).

In 1994, SEC Chief Accountant Walter P. Schuetze, a former FASB member and former executive office partner of KPMG Peat Marwick, 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" (Schuetze 1994, 70). He offered several recent examples in

²⁰ Much of the "attack," one supposes, arose from the audit failures and the improper financial practices relating to the "savings and loan crisis," mentioned by the Kirk Panel (Advisory Panel on Auditor Independence 1994, 4). One such "attack" may have been the author's article in a Dutch journal, "The Decline in Professionalism" (Zeff 1992), which is cited by the Board on page 45. In fact, the Board invited the author to meet with it in June 1992, while it was in the process of preparing its special report. An earlier article by the author, "Does the CPA Belong to a Profession?" (Zeff 1987), may also have given leaders of the accounting profession some pause.

dealing with registrants (“of which there are more”) and said, “in these cases, it is again clear that the auditors’ actions are not individual engagement partners acting on their own, but that the actions are undertaken with the knowledge of the national offices of the firms” (Schuetze 1994, 72–73). Schuetze’s criticism of auditor conduct, voiced at an AICPA conference, was so searing that it prompted the Public Oversight Board to appoint an Advisory Panel on Auditor Independence, headed by Donald J. Kirk, to inquire into his allegations.

The Kirk Panel on Auditor Independence

The Kirk Panel, as the Advisory Panel came to be called, referred to a “growing cynicism at the SEC about the performance of the public accounting profession” (Advisory Panel on Auditor Independence 1994, 5). It observed further that “Mergers, acquisitions and restructurings in corporate America have severely aggravated competition among the Big 6 for larger clients” (Advisory Panel on Auditor Independence 1994, 5). It then pointed out the heightened interest by the corporate community in influencing the accounting standard-setting process and its strong desire that financial managers have a larger hand, vis-à-vis the external auditor, in making the judgments about a company’s accounting policies and disclosure practices. The Panel added, “Financial managers aggressively control audit activity and costs and are in a position to orchestrate meetings of the external auditor with the audit committee and the full board of directors” (Advisory Panel on Auditor Independence 1994, 6).

The Kirk Panel attested to the growing magnitude of consulting fees in relation to audit fees in the Big Six firms:

Five of the top seven consulting firms in the United States and six of the top seven consulting firms worldwide are reported to be Big Six firms. Some of the firms now think of themselves not as accounting and auditing firms but as multi-line professional service firms. Marketing materials and advertising present the firms to the world as business consulting organizations, not as auditors. (Advisory Panel on Auditor Independence 1994, 6)²¹

By the second half of the 1990s, all of the big firms described themselves in this way.

The Kirk Panel strongly counseled the Big Six firms against writing joint letters to the FASB on proposed standards, especially when it is known that their senior partners have been conferring with The Business Roundtable. The example given by the Panel was the firms’ collaboration on the employee stock option issue, which, the Panel said, “cannot help but create the impression that those senior partners and the firms they represent have responded both to peer pressure and to pressure from organized business groups that include the firms’ major clients” (Advisory Panel on Auditor Independence 1994, 25). Indeed, in 1994, when former Andersen senior technical partner Arthur R. Wyatt learned that the firm’s Professional Standards Group (PSG)²² favored expensing the cost of employee stock options but was overruled by the firm’s top management, perhaps because of client pressures, he said that the PSG would never reacquire its authority in the firm (McRoberts 2002, 17). Andersen joined with the other Big Six firms in a united front to oppose expensing. In a famous line, SEC Chief Accountant Walter Schuetze said, “It also appears to me, and other outside observers, that CPAs may have become cheerleaders for their clients on the issue of accounting for stock options issued to employees” (Schuetze 1994, 74).

²¹ In 1997–98, when Ernst & Young and KPMG as well as Price Waterhouse and Coopers & Lybrand were talking merger, the press releases announcing their merger plans made not a single mention of “audit” or “auditing.” The term “assurance services,” under which audit is subsumed, was mentioned once. “The firms style themselves as ‘professional services organizations,’ and they vaunt the ‘capabilities,’ ‘synergies,’ ‘presence’ and ‘global strength’ combining to produce a ‘powerful consulting resource’—‘to provide our clients with the highest level of satisfaction’” (Zeff 1998a). Nothing was said in the press releases about the firms’ ability to deliver an audit with objectivity, independence, and professionalism.

²² The PSG was formerly known as the Accounting Principles Group.

Tensions over Compensation, Litigation, and Scope of Services

Conversations with retired partners of some of the big firms suggest that a tension in some of the firms arose from the anguish felt by audit partners that their rising salaries were subsidized by the larger margins brought in by their partners in consulting. This circumstance, a likely factor in driving Andersen Consulting apart from Arthur Andersen, may have impelled the audit partners to become even more aggressive in marketing consulting and other attest services to their clients, while doing what was necessary to retain their big clients, in order to be able to hold their heads high in the firm.

Because the big firms were greatly concerned about the continuing threat of litigation, they and the Institute launched a major offensive to gain Congressional approval, eventually over President Bill Clinton's veto, of the Private Securities Litigation Reform Act of 1995. This law made it much more difficult to secure several, as opposed to joint, liability of auditors (Cook et al. 1992; Chenok 2000, 68–70). *The Economist* has since reported, "Because auditors felt safer after these changes, says John Coffee [Columbia University law professor], companies got away with more aggressive accounting in the late 1990s." In the same article, Lynn E. Turner, the SEC Chief Accountant from 1998 to 2001, said that, following the 1995 Act, "audit firms started doing less work" (Revenge of the Nerds 2003).

Furthermore, by the 1990s, Robert K. Elliott, the chairman of the Institute's Special Committee on Assurance Services, stated that "the warning signs are clear that the marketplace for audit services is saturated" (*The CPA Journal* Symposium on the Future of Assurance Services 1996, 16). The previous year, his Special Committee said, "Over the past six years inflation-adjusted accounting and auditing revenues have been flat for the 60 largest firms," at a time at which Gross Domestic Product had risen by 28 percent in real terms (Elliott 1995, 1–2). The Special Committee was established in 1994 "to develop new opportunities for the accounting profession to provide value-added assurance services" (Elliott 1995, 1). It defined *assurance services*, a new term, as "services that improve the quality of information or its context for decision makers through the application of independent professional judgment" (Elliott 1995, 2).²³ These services went well beyond the traditional financial audit function, known as *attestation*, which implies a retrospective checking up on the client. The committee charted the future implications of assurance services: "Existing services can be expanded, additional services can be provided for current users, and new services can be provided to new groups of users" (Elliott 1995, 2).

The Inevitable Clash of Two Forces

As suggested above, during the 1990s the big firms expanded into global, multidisciplinary professional services firms that also happened to conduct audits. Whether by intention of the firms' top management or through inadvertence, the firms' audit partners began to focus much more on bringing in business and keeping clients content. In a speech in June 1996, SEC Chairman Arthur Levitt said, "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'" (Levitt 1996). Levitt later alleged that some audit partners were compensated for the selling of nonaudit services, which he regarded as antithetical to a posture of independence from the client (Levitt 2002, 116, 139).²⁴

²³ This passage is taken from Elliott's report to the October 1995 meeting of AICPA Council, page 34 of the transcript. The author is grateful to the Institute for supplying the transcript.

²⁴ In December 2002, the SEC said, "Some accounting firms offer their professionals cash bonuses and other financial incentives to sell products or services, other than audit, review, or attest services to audit clients. We view such incentive programs as inconsistent with the independence and objectivity of external auditors that is necessary for them to maintain, both in fact and in appearance" (Securities and Exchange Commission 2002, Part IIE).

All the while, the 1990s were a decade in which CEOs felt increasing pressures for revenue and earnings performance. With improvements in information-processing technology coupled with expanding coverage in the press, the consensus earnings forecasts of securities analysts assumed much greater prominence. During the high-tech bubble of the 1990s, earnings forecasts, including the whisper forecasts prior to the SEC's Regulation FD, began to drive the markets. They thus came to command the attention of top corporate executives who, increasingly, received earnings-based bonuses and gargantuan grants of stock options whose values were themselves believed by executives to be driven by reported earnings.²⁵ Furthermore, as Alan Greenspan has pointed out, "The sharp fall [in recent years] in dividend payout ratios and yields has dramatically shifted the focus of stock price evaluation toward earnings. Unlike cash dividends, whose value is unambiguous, there is no unambiguously 'correct' value of earnings" (Greenspan 2002, 3). This is where the convenient ambiguity of the accounting measure of earnings enters the picture. The self-interest of CEOs and other top executives was transparent. They wanted higher earnings, at least as high as the forecasts to which they found themselves held hostage by the press. If they failed to "make the forecast," then they feared that their stock price, and thus their compensation, would take a tumble. In August 2000, the Public Oversight Board's Panel on Audit Effectiveness (the O'Malley Panel) characterized this poisoned climate as follows:

The growth in equity values over the past decade has introduced extreme pressures on management to achieve earnings, revenue, or other targets. These pressures are exacerbated by the unforgiving nature of the equity markets as securities valuations are drastically adjusted downward whenever companies fail to meet "street" expectations. Pressures are further magnified because management's compensation often is based in large part on achieving earnings or other financial goals or stock-price increases. These pressures on management, in turn, translate into pressures on how auditors conduct audits and in their relationship with audit clients. (The Panel on Audit Effectiveness 2000, 2–3)

The accumulated testimony about the change in character of the big firms in the 1980s and 1990s suggests the evolution toward a climate in which audit partners felt less than secure in resisting clients' insistent arguments that marginal or even illicit accounting interpretations be applied in their financial statements. In the increasingly business-dominated climate of the big audit firms, one can raise serious questions about whether audit engagement partners, and indeed the firms themselves, were steadfastly resisting these pressures. Former SEC Chairman Levitt expresses an even stronger view: "More and more, it became clear [in the 1990s] that the auditors didn't want to do anything to rock the boat with clients, potentially jeopardizing their chief source of income" (Levitt 2002, 116). The clash of the client pressures against the internal pressures on modern-day audit partners strikes this author as a recipe for disaster.

Former SEC Chairman Levitt points out that the share of big accounting firms' revenues derived from consulting rose from one-third in 1993 to 51 percent in 1999 (Levitt 2002, 8); Exhibit 1 provides a breakdown by firms. Yet, as Philip B. Chenok, the full-time president of the Institute from 1980 to 1995, said, the rendering of consulting services in itself may not be the real issue. Nevertheless, it certainly creates large questions about auditor independence in the minds of investors, journalists, jurists, and others outside the accounting profession. Chenok recalled that, when he was a partner in a large accounting firm in the 1960s and 1970s, "I was more concerned with the ability of audit partners to stand up to tough clients than I was with large consulting fees affecting their judgment. If anything is going to make an auditor bend the rules, it is the intimidation factor—the

²⁵ It has been reported that "The top five executive officers of the 1,500 largest U.S. companies take about 30% of all options issued every year. ... From 1992 to the peak of the market in 2000, this corporate elite saw a 1,000% increase in the paper value of their unexercised options, to a collective \$80 billion. Over the same period, the Standard & Poor's 500-stock index rose 350%, which means execs gained nearly three times as much as the shareholders they serve" (Bernstein 2002).

inability of an individual auditor to withstand pressure from an aggressive client" (Chenok 2000, 85–86). In the last ten to 15 years, however, the "intimidation factor" has become vastly more menacing. At the same time, the foundational change in the climate within the big firms toward growth, profitability and global reach—business, not professional values—and the consequent pressure placed on audit partners to contribute toward achieving these goals, may well have weakened the backbone of auditors who do not want to endanger their careers. As the 21st century begins unfolding, this is where we are today.

CONCLUSION

A series of defining events and decisions have brought the accounting profession to where it is today:

- The actions taken by the Federal Trade Commission and the Department of Justice to force the profession to repeal its bans against competitive bidding and direct, uninvited solicitation of clients.
- The increasing degree of sharp competitiveness for audit clients by the big firms, accompanied by the burgeoning growth in tax and consulting services to compensate for declining profits in a saturated audit market.
- The gradual withdrawal of the big firms from active participation in the dialogue over accounting principles, partly stimulated by their exclusion from the standard-setting process when the FASB replaced the APB in 1973.
- The transformation of professional firms that happened to be businesses into businesses that happened to render professional services. The audit mentality at the top management of the firms was replaced by a consulting mentality, including a headlong drive for growth, profitability and global reach—business, not professional values.
- The consequent weakening of audit partners' will to take a stand against clients' questionable accounting practices, as their risk of doing so would fall squarely on their shoulders, and not be diversified throughout the firm, as in earlier decades.

At the same time as audit partners were given these *perverse* incentives by their firm's top management, their clients were becoming ever more driven by their own set of *perverse* incentives: bonuses based on earnings, and stock options with values linked to the price of the company's stock (and therefore, it was believed, to earnings). To maximize their mounting compensation, CEOs began to take every advantage of the subjective judgments implicit in accounting choices, thus placing immense pressure on audit engagement partners—themselves under pressure to keep clients content—to accede to accounting practices arguably beyond the realm of acceptability.

The magnitude and range of consulting services rendered by the big firms in recent times has played an important part in this drama. The dramatic growth in these services has fueled the increasingly widespread *perception* of auditors' lack of independence from their clients. In my view, however, the root cause of the questionable decisions attributable to audit firms in recent years has been the purely financial incentives given to audit partners by their firms, exacerbated by other aspects of the firms' reward system, such as promotions and other such intangible benefits conferred on a partner for maintaining good relations with clients. That reward system for audit partners can be changed only by the leadership in their firms.

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