IN THE PUBLIC INTEREST: Regulating with a Customer Focus: Certified Public Accountant
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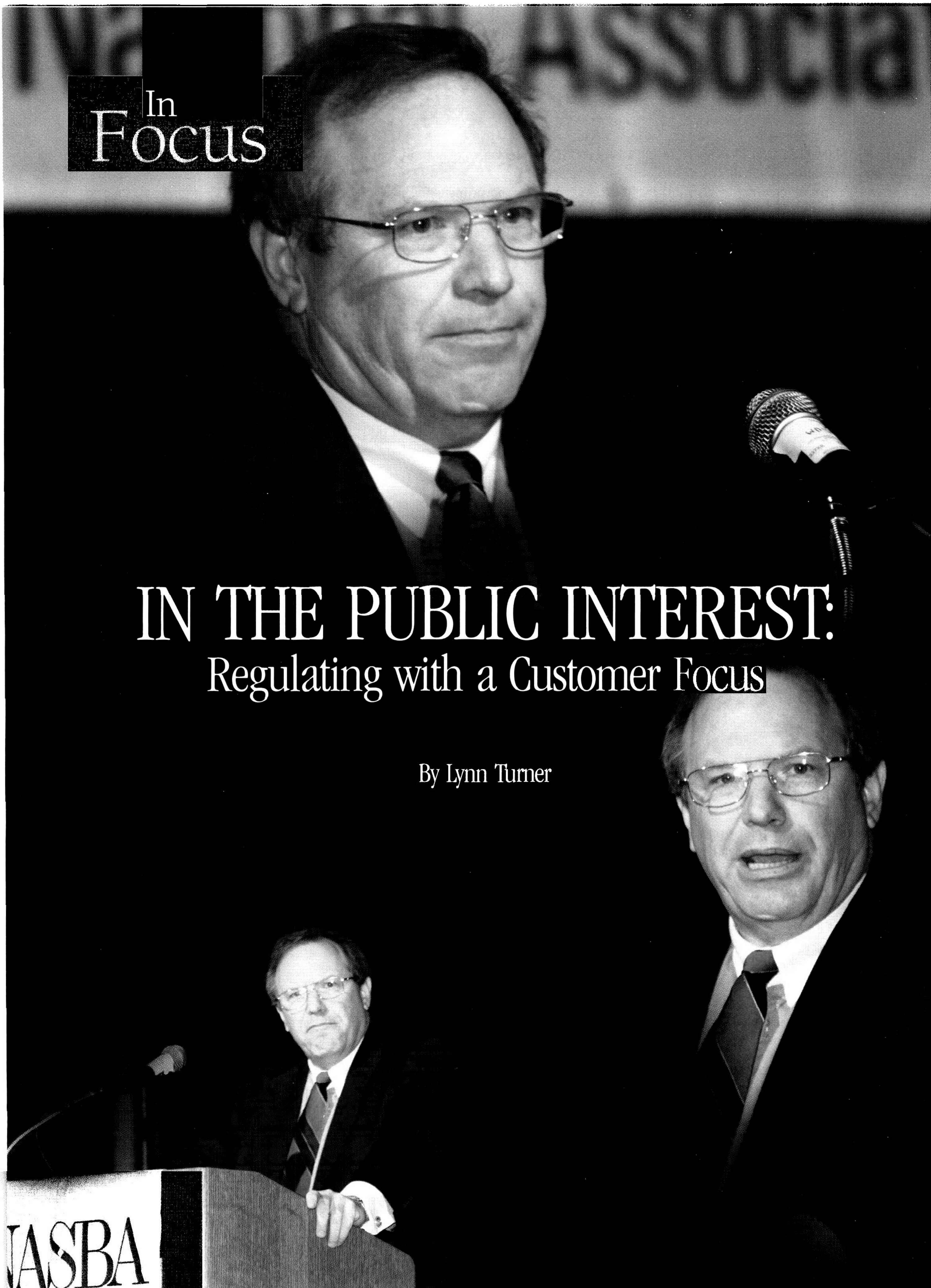

In Focus

IN THE PUBLIC INTEREST: Regulating with a Customer Focus

By Lynn Turner

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The following article is adapted from an address given by the author at the annual meeting of the National Association of State Boards of Accountancy (NASBA) on October 31, 2005, which was in turn based on one given to the board of directors of the New York State Society of CPAs (NYSSCPA) on September 21, 2005. Lynn Turner's experience, including three years as chief accountant of the SEC, makes him uniquely qualified as an observer on the accounting profession. Here, he talks about the evolution of regulation, legislation, and education in public accounting, and he outlines fundamental principles to help state licensing boards meet the expectations of the public. He challenges regulators to embrace change by "thinking outside the box."

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> "I believe the administration of an effective quality-review process will help state boards meet the expectation of the public."
>
> — *Lynn Turner*

I have enormous respect for the work of the state boards of accountancy, which is often carried out with scarce resources but very dedicated staff. Early in my career, I had the good fortune to work for and be mentored by Dick Goode, a partner in my former firm who was active in the Utah state board and who would later hold a key leadership role in NASBA. He provided me with an important lesson as to the critical public interest role that state boards have in overseeing the accounting profession.

The first CPA legislation in the country became law in New York on April 17, 1896. The bill provided for issuance of a certificate conferring the title of "certified public accountant" upon qualified persons, and for prohibiting the use of the title by others. It also provided for examination of applicants, but did not include education or experience requirements.

I'm also reminded of one of the first CPA firms in America: Barrow, Wade, Guthrie & Co., of New York. The managing partner in the firm, whose clients included Ontario and Western Railway, candidly noted, after the first six months of 1886, that operations had resulted in "gross service credit" of $4,842.08 and a net profit of $21,33.50, after charging the principal's salary.

I mention these tidbits of history because some things in our profession seem not to have changed in the past 100 years, such as state boards providing for examinations and conferring the title of CPA on successful candidates. Yet other things, such as the partner salaries, firm profits, or the complexity of the business world we operate in, have changed quite dramatically.

I recently read: "It has been said that those who ignore history are bound to repeat it." With this in mind, I have tried to relate the development of the profession to the changing environment, and to record the mistakes and the missed opportunities, as well as the victories and achievements.

"There are striking parallels between the problems confronting accountants many years ago and those facing them today. Lessons can be learned from the failures as well as the successes of the past."

Those words, of John L. Carey, the respected former vice president of the AICPA, were penned in 1969, more than 35 years ago. Yet they resonate as much today as when they were first set to paper.

Indeed, as a profession, we have had many successes that we often overlook. Our financial reporting is much more transparent today than it was when the accounting profession first formally began setting accounting principles in the 1930s. I hope we do not undo that progress with the shortsighted proposal some have made for two sets of standards: "Big GAAP" for one company with a certain type of transaction and

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"Little GAAP" for another company with the exact same transaction. And I do believe audits today are of a much higher quality than they were when the stock market crash of 1929 occurred or the bear market of the 1970s went bust.

Value Proposition

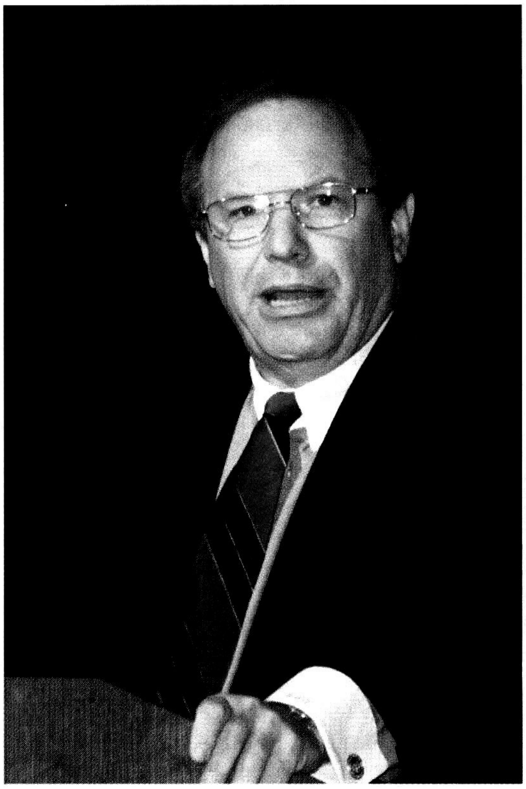
I want to challenge you to think outside the box and not so much of the past, but of the future. State boards are at a point in time when they have a marvelous opportunity to advance the profession and to serve the public interest.

In that regard, as with any business or organization, it is important to ask: What is the objective or mission of a state board of accountancy, and what value does it add? What benefit does the public get from the dollars spent by a state board?

I tried to list a few, from a public-interest perspective. These include:

- You ensure new entrants into the profession have met basic levels of knowledge, and that those in practice have maintained their education.
- You oversee the examination process and granting of licenses to those who hold themselves out to the public as CPAs, a special and not easily obtained title.
- You set professional and ethical standards by which CPAs are expected to conduct their work when serving the public.
- As a regulator, you establish programs, principally through peer review programs, to inspect the quality of the work of practitioners.

All of these roles are important. But in the end, what the public expects first and foremost from you is that subpar performance is prevented whenever possible. And that state boards will take appropriate action when an individual does not live up to his public obligations.



Too often, people minimize the role of a state board, especially in light of the PCAOB [Public Company Accounting Oversight Board]. But I think that is shortsighted. I strongly disagree with those who have advocated that state boards be eliminated rather than strengthened. The audits of Enron, Tyco, WorldCom, and Adelphia were all performed by auditors licensed and subject to the jurisdiction and regulation of state boards of accountancy. In recent years, just as there were scandals among public companies, other scandals across the country have caught the public's eye, involving audits of school districts, municipal pension funds, and health funds. These audits are not under the jurisdiction of the PCAOB or the SEC; rather, they are the sole responsibility of the respective state regulators.

To counter those who would eliminate state boards' role in today's regulatory scheme, I believe you need to be able to demonstrate that you add value and can meet the expectations of the public. That means it is important that you be able to address the challenges you face with respect to the evolving role of quality-control programs, education, and licensure.

Quality-Control Programs

With the establishment of the inspection program of the PCAOB, the previous system of peer reviews as it relates to auditors of public companies has disappeared. However, I believe that ensuring the quality of audits remains a primary and very important function of state boards of accountancy.

Here is a topic on which one can learn much from the lessons of the past, including the failures in the system of firm-on-firm peer reviews. One lesson to keep in mind is that, from 1977 through peer review's demise in January 2002, the former Public Oversight Board (POB) did not oversee a single inspection report that was modified or that called into question the quality of audits performed by the major international accounting firms. During this time, the investing public suffered through the savings-and-loan failures in the 1980s and, later, through reports in the press about companies such as Cendant, Sunbeam, Livent, Waste Management, and W.R. Grace.

Yet in just the first two years that the PCAOB has existed, we have seen inspection reports that highlight significant issues with the quality of audits performed by both large and small firms. We have seen a number of unqualified reports as well, but reports of questionable audit quality are what catch the public's attention and make headlines.

With this change, there is now a serious and real risk that a firm will receive an unqualified "peer review" report covering audits for the same period of time as a report issued by the PCAOB critical of the quality of the work of the firm. Such reports will call into question yet again firm-on-firm peer reviews, and whether such reports benefit the public or mislead them. I cannot imagine why a state board would want to accept that risk.

At the end of the day, what the public wants to know is whether they can place their trust in the credibility of the profession's work, including audits performed by CPAs. They want to know if substandard performance is being identified and dealt with in a timely and effective manner. When it is, they will see the value proposition in their state accounting regulator. When it is not, they will ask, Why?

To that end, I believe some fundamental principles, including the administration of an effective quality-review process, will help state boards meet the expectation of the public. These principles include the following:

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First, the quality-review program should be based in legislation that provides due process and maintains confidentiality. A statutory approach is also required to provide disciplinary powers and to permit the board to work closely with other regulators. Without an appropriate statutory-based program, a state board can quickly be turned into a toothless lapdog, as opposed to an effective watchdog.

Second, the quality-review process should be independent of those subject to its inspections. This requires public representation in and oversight of both the process and regulation. It also means that a firm should not be able to choose or recommend who will review the firm. After Enron and the final unqualified Arthur Andersen peer review report, the public will never accept a process as being independent if a firm can pick who will perform its review.

Third, the inspection process must have an adequate scope and be staffed with independent, competent inspectors. When issues arise in the profession, as they have in the past with the savings-and-loan crisis, the regulator must be able to perform "special inspections." This was one of the sound recommendations of the Panel on Audit Effectiveness, often referred to as the O'Malley Panel report, issued in 2000.

Fourth, as the Commission on Auditors' Responsibilities, known as the Cohen Commission, recommended in 1978, state boards, their quality-control process, and discipline must all be transparent. Inspection reports should be made available to the public upon completion of the inspection process. These reports should be in sufficient detail to provide the reader useful information about the quality of the firm's work. This includes both deficiencies and positive comments. As someone who has read and used these reports, I am just as interested in learning about the CPA firm that has a high-quality practice as I am in avoiding one at the other end of the scale. Also, the principle of transparency is maximized and at its best when it results in best practices being reported on and shared with all participants in the profession.

A fifth principle of a successful quality-control program is that it must be educational. It should identify what professional practice should be, not just what it is. And as I just mentioned, it should identify best practices. If we are to continuously improve the profession, inspections should benchmark against best practices, not existing practices.

The sixth principle is that there should be discipline and accountability for those situations where substandard performance is identified. The disciplinary process should be embedded in each firm as part of the quality-control process. Disciplinary actions should be taken by an appropriate body and should match the level of behavior with the appropriate discipline. Remedial actions may be appropriate in certain situations involving simple negligence, but they are insufficient when there are repeated instances of negligence, reckless, or fraudulent practices. And ultimately, when the disciplinary process is complete, and all involved have been afforded appropriate due process, the results of the process should be publicly reported.

Likewise, there needs to be accountability for those who are responsible for inspections and discipline. Unfortunately, this is one issue for which the performance of many, but not all, state boards has fallen way short. At the SEC, I saw example after example of seriously substandard performance by a practitioner go unpunished by state regulators. While some of this shortfall is the result of a lack of funding, it is nonetheless cause for the public to wonder if state boards are in fact capable of oversight and regulation of the profession.

Therefore, number seven on my list is that state boards and the work they undertake to perform, including quality-control processes, must have adequate funding. The O'Malley Panel recommended greater funding to ensure the credibility of the process. Yet today we continue to see a lack of adequate funding, which serves only to undermine the credibility of your work.

Number eight is the ability to affect standards when deficiencies in practice are identified. For example, as issues with contingent fees and commissions have arisen, it is important that changes be made to standards to avoid these abuses.

Ultimately, most of these principles are common sense, not rocket science. That is why they are easily understood by the public, and why the public challenges attempts to avoid them. It is also why, if they are ignored, the public will eventually cause them to be adopted when a crisis develops and we in the profession once again lose control of our destiny.

Let me digress here to discuss the governance of the large international accounting firms. I believe, as the Cohen Commission recommended, that these firms should be required to have independent external boards of directors. I also believe they should be required to produce annual financial reports, similar to what public companies file with the SEC. Given the immensely important role these firms have in today's capital markets, and the limited competition in that market, it is only appropriate these firms enhance their transparency and governance. Had better governance and transparency existed in the past decade, I believe we would still have an Arthur Andersen today, and KPMG LLP would not have become involved in the tax-shelter business that seriously threatened its existence.

Education

In 1894, members of the accounting profession first approached the New York Board of Regents asking that it establish schools of accountancy. And while that experiment ended just two years later, the role of education in our profession and the positive impact state boards of accountancy can have on education have increased exponentially. To that end, I greatly applaud the efforts of the vast majority of state boards to adopt the 150-hour requirement.

However, the profession needs to think "outside the box" with respect to its education system, curriculum, and teaching methods. Having recently spent time as a professor in academia, I believe the current system is falling short of what it can be, and is failing to provide businesses and accounting firms with adequately trained new hires. In doing so, it is shortchanging the very students it seeks to educate.

Let me share another quote from the Cohen Commission report:

> The desirability of establishing separate schools of accounting in universities has received increasing attention in recent years. … Whether the argued improvement in the recognition and prestige of accounting and control over curriculum will be realized and whether the problems of appropriate balancing of courses and faculty can be overcome cannot be determined with certainty in advance. However, the gradual and successful development of separate graduate professional schools in law, medicine, and other fields

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suggest that such problems are capable of solution. … The importance of instilling in students an appropriate professional attitude and the need to expose them to the pressures and problems of public accounting practice during the formal education process support the need for graduate professional schools of accounting similar to law schools. … Our review of major audit failures that have caused public accounting firms difficulty indicates that problems have resulted largely from the exercise of poor judgment under conditions of stress and pressure."

These words were timely in 1978, and they are certainly most relevant today. As a result, one must again ask why it takes our profession decades to adopt such wise recommendations.

Looking back at the history of the medical and legal professions, their schools were not always what they are today. And certainly, the complexities of the medical profession and practice have increased, just as they have in our own profession. The difference is that medicine and the law have changed their schools from undergraduate programs to advanced degrees with specializations. If we are to gain equal stature through better-prepared and -educated entrants into the marketplace, then we too need to rethink our education system and the need for professional schools. The 150-hour education requirement is a very positive step forward, but it should be only the profession's next step, not its last step.

I have had the good fortune to visit many universities over the past half dozen years. My interactions with students at numerous schools have led me to believe that the students in professional schools of accountancy, such as the University of Texas or Brigham Young University, are better equipped to enter the job market and to serve the public than those who are not.

I believe the universities also need to rethink their curriculums and to ensure that they provide the following:

- The fundamentals, including accounting principles and concepts. A student who does not understand the principles of revenue recognition, accounting for leases, or asset securitizations is not ready for a public accounting firm. Likewise, someone who does not understand risk management and related topics, such as the use of derivatives, is not ready for corporate America.
- There needs to be more instruction on "accounting theory" that teaches students not just the how-to, but also the why. This will also teach students to exercise their judgment and to develop an ability to apply principles, not just rules.
- Ethics education needs to be built into the coursework to provide students with real-life, pressure-packed situations in which they must make stressful decisions. It is unfortunate that we as a profession have failed to heed the recommendations made by the Cohen Commission. If we had, maybe some auditors would have made some different decisions in recent years, thereby avoiding career-ending mistakes.
- Accounting students should receive broader and more in-depth knowledge of finance, including financial instruments; a greater understanding of marketing and its critical relationship with accounting; as well as more management, including strategic decision making and risk management. And that is on top of understanding technology and its role in these areas of business.
- Colleges need to require internships and bring more practical experience into the classroom. Both the medical and legal professions in Britain require this practical education. My belief that this will improve and enhance the education of those entering the accounting profession is founded partly on academia today being too much of an ivory tower. For better or worse, a much higher percentage of college professors today have a PhD than 30 to 40 years ago, but they often have little or no experience as a practitioner. Consequently, although they can do an excellent job of teaching accounting theory—what is between the covers of a book—they have great difficulty in going further. Therefore, practitioners need to find a way to provide more of their time to assist and provide resources to business schools. At the same time, the accounting firms need to find a way to provide academia with greater, unfettered access necessary for research projects.

Indeed, technology, business, finance, marketing, and management have undergone titanic changes since I enrolled in college 35 years ago. But based on my recent experiences on campuses, education has not kept up with these changes. For the most part, we still try to teach too much in too little time, and we fail to teach students how to think and make judgments. I urge you to spend some time in classrooms, and while you will see the positive benefits of new technology, I think you will also find curriculums and textbooks are still too similar to those of earlier years.

State-by-State Licensure

This present age is digital, mobile, and global. Borders exist for only two purposes: maps and politics. Although having to obtain a CPA license in each state where one practices has been properly questioned, so long as state boards are effective overseers and regulators, protecting the public, they have a reason to continue this practice. But when they fail in this role, the value proposition for their existence quickly disappears.

I applaud the states for their efforts to make it easier for CPAs to obtain licenses by reciprocity. But every state can and should do more to facilitate this process. There is no reason that, with the technology available today, state boards working in coordination with NASBA cannot create a national database of CPAs, including examination and licensing data, that would also permit those with current licenses to request and receive reciprocity online within hours, rather than weeks or months. That goal can and should be achieved in the foreseeable future, not in decades.

Aspiring to Greatness

I hope I have challenged you to get outside the box, throw off the chains that have often hobbled our profession and prevented us from leaving the comfort of the status quo. It takes that type of thinking to reclaim control of our destiny, to create a really exciting profession that will entice the best young minds to join us, and to be not just good, but to be better than that. I hope that you, individually and as an organization, will provide our profession with the leadership that will enable it to become not just good, but great. ❑

***Lynn Turner** is a managing director of the investment research and proxy advisory firm Glass Lewis & Co. LLC and a member of the* CPA Journal *Editorial Board. He was chief accountant of the SEC from July 1998 to August 2001.*

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