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COMMENTARY

Responses of the American Accounting Association's Tracking Team to the Recommendations of the Advisory Committee on the Auditing Profession

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INTRODUCTION

In fall 2007, the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession (ACAP; hereafter Advisory Committee or Committee) began its deliberations. Co-chaired by former Securities and Exchange Commission (SEC) Chairman Arthur Levitt and former SEC Chief Accountant Donald Nicolaisen, the Committee was composed of distinguished members from a variety of groups, including accounting practice, law, industry, and academia (see U.S. Department of the Treasury 2008). The Committee was charged as follows:

The objective of the Committee shall be to provide informed advice and recommendations to the Secretary of the Treasury and the U.S. Department of the Treasury on the sustainability of a strong and vibrant public company auditing profession. The Committee should consider, among other things: (1) the auditing profession's ability to attract and retain the human capital necessary to meet developments in the business and financial reporting environment; (2) audit market competition and concentration; and (3) the financial resources of the auditing profession, including the effect of existing limitations on auditing firms' structure (<http://www.treas.gov/offices/domestic-finance/acap/charter.pdf>).

The Committee held a number of public meetings in late 2007 and 2008 and issued its draft recommendations in a May 2008 *Draft Report* (ACAP 2008a). The *Draft Report* was followed by an addendum in June 2008 (ACAP 2008b), a *Second Draft Report* in July 2008 (ACAP 2008c), and the *Final Report* (ACAP 2008d), which was approved on September 26, 2008, by a vote of 14 to one.

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The three authors of this commentary served on the American Accounting Association's (AAA) Treasury Tracking Team, charged with monitoring the Committee's activities and responding to calls for comments on proposed recommendations. The first two authors testified before the Committee (December 3, 2007, and June 3, 2008, respectively), and the third author provided individual written comments (October 4, 2007). In addition, the Tracking Team submitted a comment letter on May 15, 2008, and provided responses to subsequent Committee questions on June 20, 2008. This commentary is based on, but not limited to, our May 15, 2008, comment letter, as well as our other comments provided to the Committee.¹ In this paper we expand on our original letter, and where appropriate, include further references to relevant research to support our views.

The following sections present the Committee's recommendations, followed by our responses.² The views expressed in this commentary are the authors' and do not necessarily reflect the views of the AAA or its Auditing Section. The recommendations are divided into three sections, consistent with the organization of the Committee's charge and with its reports:

- Human Capital;
- Firm Structure and Finances; and
- Concentration and Competition.

HUMAN CAPITAL

Human Capital Recommendation 1: Implement Market-Driven, Dynamic Curricula and Content for Accounting Students that Continuously Evolve to Meet the Needs of the Auditing Profession and Help Prepare New Entrants to the Profession to Perform High-Quality Audits.

We agree with the spirit of this recommendation, and believe that advances in online materials are helping to reduce the time lag in updating the curriculum. The primary challenge may be in keeping textbooks current.

In our view, however, a more serious issue relates to the CPA exam and the 150-hour requirement. The Committee recommends that recent capital market developments (e.g., IFRS, fair value, risk management, etc.) be tested on the CPA exam no later than 2011. Moreover, at least one Big 4 firm argued for an even greater expansion of topics covered in the accounting curriculum, suggesting that the curriculum should include ethics, fraud examination and forensic auditing, negotiation and communication skills, global business, and valuation (Deloitte 2008). Given the call for expanding the scope of the accounting curriculum, the Committee suggests that testing these topics on the CPA exam would spur universities to include this material in the curriculum. However, the typical accounting undergraduate program has only six to seven courses above Accounting Principles (the introductory accounting course). Given the complex nature of the topics involved, many of the recent developments in the capital markets would likely be covered in the fifth year, if they are covered at all. However, if students can take the exam after 120 hours, as is the case in eighteen states, the exam has to be written assuming this limited level of

¹ Also see Carcello (2008) for an adaptation of the first author's December 3, 2007, testimony.

² In this commentary we use the final Committee recommendations, from the *Final Report* (ACAP 2008d). The changes from May 15 to the *Final Report* are not extensive and primarily relate to firm structure and finances. In addition, in some cases our May 15, 2008, comment letter suggestions are cited/reflected in the final recommendations. In such cases, we have retained our original May 15 suggestions in this commentary and have noted that they have been considered by the Committee in its *Final Report*.

education.³ Therefore, the presumed effect of CPA exam content on university curricula will be lost. Therefore, if the content of the CPA exam is to be substantially expanded, allowing students to take the exam before completing 150 hours of education is setting students up for failure.

If states continue to allow students to sit for the CPA exam with only 120 hours of education, an alternate way of testing student proficiency in expanded competency areas is to add a second "layer" of the exam for public company auditors. This second layer of the CPA exam could be taken after the master's degree and several years of experience are completed. Thus, the current four parts could then continue to test the base level (undergraduate) education content.

More broadly, this issue raises questions regarding the efficacy of the 150-hour requirement. Some evidence indicates that students with 150 hours of education are better prepared for success in the profession than are those with 120 hours. Raghunandan et al. (2003), after controlling for SAT scores, accounting credit hours, and enrollment in CPA exam preparation courses, find that students completing a 150-hour program have higher CPA exam pass rates. Allen and Woodland (2006) find that students with 150 hours of education are modestly more likely to pass the CPA exam. Cumming and Rankin (1999) study student preparedness for the CPA exam in Florida, among the first states to adopt a 150-hour requirement. Pass rates on the CPA exam approximately doubled from before to after the 150-hour requirement. Finally, Wier et al. (2005) find that the performance evaluations of those with an M.B.A. or M.Acc. degree are higher than those holding only a baccalaureate degree, although they measured performance of management accountants, not of external auditors. Thus, research suggests that the 150-hour requirement has value.

Clearly, the efficacy of 150-hour programs depends heavily on the content of the extra 30 hours. Although students can complete an additional 30 hours of education without obtaining a master's degree, we believe that a master's degree should be the qualification for entry into the public accounting profession. We recognize that a student completing an additional 30 hours of coursework could be equally as well prepared for the CPA exam as a student completing a master's degree. However, we advocate a master's degree for entrance into the public company auditing profession for three reasons. First, a master's degree curriculum is relevant to the accounting and auditing profession. Conversely, because some states allow great discretion as to the extra 30 hours of coursework to be completed, it is possible for students to meet the 150-hour requirement by taking additional courses that do not address the expanded educational competencies identified by the Committee. Second, graduate programs in accounting increasingly include value-added activities outside the curriculum; students obtaining 150 hours of coursework outside of a master's program are deprived of the learning that occurs in these activities.⁴ Third, a graduate degree is likely to offer more of a credentialing benefit to students than simply completing an extra 30 hours of coursework, and, in the authors' view, a graduate degree is the appropriate credential for a professional in the 21st century (i.e., as is the case with law and medicine).

Human Capital Recommendation 2: Improve the Representation and Retention of Minorities in the Auditing Profession So As to Enrich the Pool of Human Capital in the Profession.

We appreciate the goal of attracting and retaining highly qualified minority students into the auditing profession and auditing academia. To promote audit quality and investor protection, it is

³ The trend toward taking the CPA exam at 120 hours may be growing. For example, the Commonwealth of Massachusetts recently reduced the number of hours required to sit for the CPA exam from 150 to 120, requiring only that candidates obtain the additional 30 hours within three years of passing the exam.

⁴ For example, the graduate program at one of the authors' institutions sponsors trips to Washington, D.C., to visit Capitol Hill, the Securities and Exchange Commission (SEC), PCAOB, AICPA, and the U.S. Department of the Treasury, as well as sponsoring an international trip to Hong Kong. These activities, among others, are available only to master's students.

critical that auditing firms target the best and brightest students of all ethnic backgrounds. The answer to this problem is to recommend systemic reforms to the public accounting profession that will enable the profession to truly recruit and retain the best and brightest, including a sizable number of the best and brightest among ethnic minorities. In addition, interested, qualified doctoral candidates of all backgrounds should have access to appropriate levels of funding for doctoral study. Finally, although not included in the Committee's recommendations, the Committee received testimony on the under-representation of women at the partner level (Gillan 2008). Given that approximately half of accounting graduates are female, accounting firms need to do more to help women progress to the partnership level within these organizations.

As Dennis Nally, the chairman of PricewaterhouseCoopers (PwC), stated in his testimony before the Committee, "no issue is more important than our ability to attract and retain talented professionals from diverse backgrounds who can be deployed efficiently in an increasingly global marketplace" (PwC 2008). We agree, but we question whether the Committee's recommendations are sufficiently responsive to this mandate. Carcello (2008) documents the low starting salaries in accounting *vis-à-vis* law and investment banking and, more ominously, how the discrepancy in starting salaries in accounting as compared with these other fields has grown over time. He also suggests a reform of the accounting educational model that may serve to substantially increase starting salaries for those students choosing to pursue a career in public company auditing. Notwithstanding our concern about starting salaries in accounting, the major public accounting firms have proven success in recruiting large numbers of undergraduate and graduate students (e.g., see Gerdes 2008). However, public accounting continues to be an extremely demanding profession. In our view, unless firms continue their efforts to develop more flexibility in responding to concerns about work-life balance and/or raise compensation sufficiently to overcome these concerns, the exodus of talent from the profession is likely to be a continuing challenge (see Carcello et al. 1991 on the divergence between student expectations and accounting staff experiences).

As long-time observers of recruiting practices by auditing firms, we offer two issues for consideration that relate to recruitment of students in general. First, to achieve efficiencies in recruiting, some of the largest firms focus their recruiting efforts on relatively few "target" schools, which offer many high-quality graduates. This strategy, however, may lead to missing equally (or perhaps better) qualified individuals who are at smaller schools and who are fewer in number.⁵ Second, because demand for accounting graduates in the past ten years has outstripped supply, we have observed the firms trying to "lock in" students with job offers earlier in their college years. In some instances we have observed a decline in student motivation once the student has accepted a job offer. We urge the Committee and the firms themselves to consider these recruiting practices as perhaps deleterious to audit quality in the long run.

Human Capital Recommendation 3: Ensure a Sufficiently Robust Supply of Qualified Accounting Faculty to Meet Demand for the Future and Help Prepare New Entrants to the Profession to Perform High-Quality Audits.

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

⁵ Solomon (2008) notes that at the time of his writing, the current chief executives of the Big 4 firms attended the following universities: University of St. Thomas, Utah State University, Western Michigan University, and Rice University. Clearly, top accounting talent can be found at a variety of universities, not just the major schools.

appropriate length of a Ph.D. program, which might vary widely across institutions or types of programs. Increased funding could also encourage universities not currently granting Ph.D.s in accounting to begin programs. Since the time of filing our response with the Committee, the leaders from over 70 large CPA firms and other organizations have announced the Accounting Doctoral Scholars (ADS) program (see <http://www.adsphd.org/>). Thus far, the program's sponsors have pledged financial support of \$15 million for the program, which will provide support for up to 120 accounting Ph.D. students in the fields of auditing and tax.

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

Third, professionally qualified (PQ) faculty members are important to the delivery of accounting education at many institutions; however, we believe that it is critical to maintain an appropriate balance of tenured/tenure-track and PQ faculty. The creation of knowledge through research is an essential mission of universities. Research is especially important in the current environment of accounting and auditing, in which we need to understand the impact of the many changes recently made in standards, regulation, and policy. If accounting departments are heavily staffed with PQ faculty whose primary responsibility is not academic research, accounting departments will struggle to advance accounting knowledge and to maintain academic credibility on campus when other departments are primarily made up of active scholars (see Bailey 2008b). In addition, we believe that it is important for students to consider broader issues in their accounting education, such as how auditors make decisions or how accounting incentives shape managers' behavior. While PQ faculty may provide valuable contributions in such inquiries, research-oriented faculty are in most cases best suited to lead them.

Fourth, the Committee calls for essentially mandatory practice sabbaticals for at least one faculty member per department per year. While the concept of practice sabbaticals is appealing, a rigid, mandatory model would create significant practical problems. First, this would create a serious teaching capacity problem on many campuses, especially those with small accounting departments. For example, a department with five accounting faculty would lose 20 percent of its teaching capacity if one faculty member were off campus each year. Second, for people at schools in remote geographic locations (i.e., small college towns), this plan would require participating faculty to relocate for a year. Third, it is unclear whether such a program would involve only auditing faculty, or all accounting faculty. There is an acute shortage of auditing, tax, and systems faculty (Plumlee et al. 2006), and individuals in those specialty areas may be most likely to be involved in such sabbaticals. Fourth, for untenured faculty and tenured faculty seeking promotion to full professor, a practice sabbatical would essentially mean a year of little time to advance research projects underway, with corresponding costs to coauthors as well as to the individual taking the sabbatical. Finally, it is unclear how the costs of such a program would be covered. The cost of paying and relocating hundreds of accounting faculty on practice sabbaticals each year could run well into the tens of millions of dollars. We question whether the large accounting firms would be willing to absorb such costs. The fundamental issue from an economic perspective is that faculty working at auditing firms would be underutilized (e.g., a \$200,000 per year faculty member working as an audit senior), as would audit firm personnel teaching at educational institutions (e.g., a \$200,000 practitioner teaching as a lecturer, which is a \$50,000 to \$70,000 per year position).

Notwithstanding the concerns above, we believe that greater opportunities for faculty-professional exchanges are needed. We suggest that the Committee recommend that accreditation standards be revised as follows:

- (1) Place equal emphasis on completing a sabbatical with a private sector institution or government entity as with publishing one “tier A” paper, a notion that the Committee cites in its *Final Report*. However, the Committee recommends that university administrators “place as high a value on professional sabbaticals for purposes of promotion and tenure as they do for research and scholarly publication” (VI: 22). This recommendation goes far beyond our suggestion of counting a sabbatical as one tier-A publication, perhaps too far as it may actually *overweight* sabbaticals in the faculty performance evaluation process.
- (2) Require all accredited institutions to offer faculty sabbaticals no less frequently than once every seven years and to encourage faculty to take their sabbaticals in practice. (We note that a typical faculty sabbatical covers only 50 percent of a professor’s salary.)

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

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

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

Human Capital Recommendation 4: Develop and Maintain Consistent Demographic and Higher Education Program Profile Data.

We support this recommendation. Consistent data are critical to assessing human capital issues facing the profession.

Human Capital Recommendation 5: Encourage the AICPA and the AAA Jointly to Form a Commission to Provide a Timely Study of the Possible Future Structure of Higher Education for the Accounting Profession.

We strongly support consideration of professional schools of auditing/accounting to prepare future generations of public company auditors for long-term career success. We refer the interested reader to Professor Carcello’s oral and written testimony to the Committee on December 3, 2007 (also see Carcello 2008). Such professional schools would focus heavily on auditors’ public

responsibility and would include significant education in emerging audit practice areas, including internal control frameworks, fair value, IFRS, and XBRL, among many others.

We believe that professional schools and changes in licensure and accreditation could both enhance future auditors' education and help to reduce the shortage of doctoral-level qualified auditing faculty. However, for professional schools to be successful, they need to be well funded and to have a degree of independence from business schools (just as law and medical schools are independent from other units of the university) that enables substantial control over the tenure and promotion process, subject to overall university standards. Such independence, however, would not preclude a professional school of accounting from working with the business school where such collaboration is jointly beneficial. The professional school would be funded just as any other unit of the university is funded, through tuition, state support, and private giving (assuming a public university). Consistent with other professional schools, many states would allow the university to charge premium tuition. In addition, if a separate license for auditing public companies were simultaneously adopted, and this license required graduation from a professional school (on a prospective basis), the professional school would be favorably positioned to secure adequate resources from the central university administration. We also believe that requiring a separate license for auditing public companies, including graduation from an accredited professional school, would likely lead to an increase in starting salaries and thereby help the profession to attract the best and the brightest.

Human Capital: Other Issue (M.B.A. Education).

We believe that an additional, unaddressed issue merits consideration by the Committee. Many CEOs and CFOs have M.B.A. degrees (rather than graduate degrees in accounting), and research indicates that these parties are most likely to perpetrate fraudulent financial reporting (Beasley et al. 1999). We believe that M.B.A. programs need to expand their coverage of the importance of reliable and transparent financial reporting, the role of sound corporate governance and effective internal controls, and the provisions of the Sarbanes-Oxley Act of 2002 (SOX), among other topics. Accordingly, we believe the Advisory Committee should call on business schools to better ensure that M.B.A. students fully appreciate the importance of reliable, transparent financial reporting, and the Committee should call for the AACSB to put in place incentives for this objective to be achieved.

FIRM STRUCTURE AND FINANCES

Firm Structure and Finances Recommendation 1: Urge the Securities and Exchange Commission (SEC), and Congress as Appropriate, to Provide for the Creation of a National Center to Facilitate Auditing Firms' and Other Market Participants' Sharing of Fraud Prevention and Detection Experiences, Practices, and Data and Innovation in Fraud Prevention and Detection Methodologies and Technologies, and Commission Research and Other Fact-Finding Regarding Fraud Prevention and Detection, and Further, the Development of Best Practices Regarding Fraud Prevention and Detection.

We agree that cooperation among the firms and other market participants in fraud detection and prevention, and sharing of best practices by the firms, could result in a significant improvement in audit quality that would benefit society. Fraud remains a significant threat to investor confidence and audit firm viability, and we see no downside to devoting additional resources to fraud research and best practices, especially in cooperative arrangements involving both academics and practitioners.

This recommendation also includes a call for commissioning of research on fraud prevention and detection. Investment in research on fraud in the form of remuneration, data, and/or the time

of professionals would be very valuable in expanding our knowledge in this area. While auditing firms have in the past supported research on their fraud detection and prevention activities,⁶ relatively less research considers the roles and activities of other financial professionals (e.g., financial analysts and audit committee members) with respect to fraud prevention or detection. For example, there is a paucity of research on board and audit committee behaviors that are effective in reducing the incidence of fraud. In addition, we know relatively little about the role that internal audit plays in reducing fraud, including characteristics of those internal audit groups particularly adept at preventing or detecting financial statement fraud (e.g., authority, budget, size, and scope).

Firm Structure and Finances Recommendation 2: Encourage Greater Regulatory Cooperation and Oversight of the Public Company Auditing Profession to Improve the Quality of the Audit Process and Enhance Confidence in the Auditing Profession and Financial Reporting.

We agree with the spirit of this Committee recommendation, which has several specific parts. First, the Committee recommends that Congress pass a law requiring that states substantially adopt the mobility provisions of the Uniform Accountancy Act by 2010. We agree that there should be enhanced mobility of CPAs across state lines.⁷ An action of the U.S. Congress in this regard may be indicated for public company engagements because of the national interest in financial markets efficiency. For instance, a separate national license for public company audits could be layered on top of (or ultimately replace) the current state-based licensing system. However, we are less convinced that Congress should step into what has been the purview of the states regarding audits of nonpublic entities, or other services such as compilation, review, and tax.

In the second specific point under this recommendation, the Committee urges that the agencies regulating the auditing profession meet regularly to improve effectiveness and reduce overlap. We agree, as regulatory overlap can create inefficiency, and is not necessarily more effective.⁸ The third specific point is that the states should improve the financial and operational independence of state boards of accountancy. We agree with the Committee's concern that some state boards lack the resources for effective monitoring of professionals within their borders, and we support the recommendation.

Firm Structure and Finances Recommendation 3: Urge the PCAOB and the SEC, in Consultation with Other Federal and State Regulators, Auditing Firms, Investors, Other Financial Statement Users, and Public Companies, to Analyze, Explore, and Enable, as Appropriate, the Possibility and Feasibility of Firms Appointing Independent Members with Full Voting Power to Firm Boards and/or Advisory Boards with Meaningful Governance Responsibilities to Improve Governance and Transparency at Auditing Firms.

We agree wholeheartedly with this Committee recommendation. Ample research supports the positive relation between independent corporate governance and favorable financial reporting and

⁶ There are a number of examples of such research. In a recent behavioral study, Wilks and Zimbleman (2004) compare auditors' risk assessments using alternative approaches. An example of an archival study is Johnstone and Bedard (2003), who examine the association of fraud risk factors with client acceptance decisions using data from a large professional services firm.

⁷ Given the increasing globalization of business, it may also be appropriate to begin exploring cross-border licensure. To protect investors, any such license would need to expose the holder to oversight by the SEC and by the PCAOB. Since the CPA license is currently state-based, a cross-border license for auditing public companies is consistent with Carcello's (2008) recommendation for the development of a separate license for public company auditors.

⁸ In the previous paragraph, we discuss creating a layer of "federalized" CPA licensure for audits of public companies, which may seem at odds with the notion of reducing regulatory overlap. While a national-level public company auditor certification mechanism would add complexity in one way (i.e., there would be two layers of certification where now there is one), it would simplify in another (all auditors of public companies would be subject to the same set of rules regarding certification, and would be free to move across state lines for those engagements).

auditing outcomes (e.g., Abbott et al. 2004; Beasley 1996; Carcello et al. 2002; Dechow et al. 1996; Klein 2002; see Cohen et al. 2004 and DeZoort et al. 2002 for reviews of this literature). In the long run, inclusion of independent board members in the auditing firms' governance structures should yield higher quality audits. Furthermore, SOX recognizes the importance of independence in the governance structure of corporations by mandating that all audit committee members be independent of the corporation. Independent members of firm boards could have functions similar to the audit committees of public companies, for instance being responsible for maintaining whistle-blower programs and supervising the "audits" of key performance indicators suggested in the Committee's third recommendation under Concentration and Competition. However, we recognize that adding independent members to firm governing bodies is not without cost, both to the firm and the individual. For example, the firm would have to incur the costs of identifying and compensating the individuals serving on its governing body and may incur the opportunity cost associated with slower and consensus-based decision making. In addition, the individuals would be exposed to liability risks that may not be adequately insurable (BDO 2008; Ernst & Young LLP 2008; PwC 2008).

During the Committee's process, the Committee asked us to respond to the following related question, "Would there be any value in revising CPA firm structures to provide for a separate subsidiary that would only provide audit services and that would include separate governance (i.e., include outside directors)? Would this structure provide adequate protection to the capital in the collective organization outside of the audit subsidiary?" We believe there is merit in considering audit-only firms or audit-only subsidiaries (see Hermanson 2007; Wyatt 2004 for concerns about the incompatibility of auditing and consulting). We view it as unfortunate that this audit-only model, which we understand Arthur Andersen offered to the U.S. Justice Department with Paul Volcker as overseer, was not given a chance to demonstrate its efficacy. We do believe that there are great challenges to ensuring that the governance of such audit-only subsidiaries would be truly "separate" and not subject to the strong influence of those providing nonaudit services. In addition, anecdotal evidence suggests that margins on audit services are lower than those on nonaudit services. Thus, it is a potential issue whether, in today's competitive environment, an audit-only firm could obtain sufficient revenues to perform the work needed to reduce misstatement risk to target levels and pay the salaries sufficient to attract and retain the best professional talent.

Firm Structure and Finances Recommendation 4: Urge the SEC to Amend Form 8-K Disclosure Requirements to Characterize Appropriately and Report Every Public Company Auditor Change and to Require Auditing Firms to Notify the PCAOB of Any Premature Engagement Partner Changes on Public Company Audit Clients.

We agree that improved disclosure would provide better information to the financial markets on audit quality and would shift power to the auditor when there is a disagreement with management. However, some firms argue that disclosing the reason for every auditor change is overly broad, and requiring the auditor to respond as to the accuracy of the reason given by management for the auditor change may not be possible as the auditor may not know management's motivation (BDO 2008). Moreover, improving disclosure is only one of the possible means of addressing the issues around auditor changes. For instance, in Australia, notification to the securities market regulator is required *prior to* the auditor change. This gives the regulator a chance to contact the parties involved and understand the reasons for the switch. We understand that in Australia, permission to switch auditors is routinely granted around the regular annual meeting, but midyear switches are looked on with great scrutiny. This manner of involvement by the U.S. SEC staff would reduce the cost of administering the program and would focus attention on the more

potentially difficult situations. We urge the Committee to consider this alternative in its effort to improve audit quality.

Firm Structure and Finances Recommendation 5: Urge the PCAOB to Undertake a Standard-Setting Initiative to Consider Changes to the Auditor's Standard Reporting Model, and Urge that the PCAOB and SEC Clarify in the Auditor's Report the Auditor's Role in Detecting Fraud Under Current Auditing Standards and Further that the PCAOB Periodically Review and Update These Standards.

The Committee recognizes that the current auditor reporting model in the United States is a "pass/fail" model. Committee members note that this binary reporting form results in little deviation from standardized wording and "does not adequately reflect the amount of auditor work and judgment" that goes into preparation of the auditor's report. We agree that expanding the information contained in the auditor's report may be helpful to users. For instance, prior research on the expectations gap (see Church et al. 2008 for a review of this literature) suggests that users would benefit from disclosure in the auditor's report of findings regarding fraud or illegal acts, as well as other information pertinent to the client's risk of misstatements from error or fraud, and business failure. Auditors gather a great deal of information in the course of the audit, and the current pass/fail opinion with boilerplate language does not provide very much unique information to financial statement users. However, there also are costs associated with expanding the nature of the audit report. For example, an expansion of the audit report may expose auditors to increased legal liability (BDO 2008).

This recommendation also contains a discussion of the relative responsibilities of auditors versus other parties in preventing and detecting fraud, noting that the standard form audit report does not mention the word *fraud*. Presenting a brief history of attention to the "expectations gap" between auditors and the investing public regarding responsibility for fraud detection, the Committee urges the PCAOB to review auditing standards relevant to fraud. We agree and particularly urge the PCAOB to carefully evaluate the efficacy of SAS No. 99, including the auditor's level of responsibility for detecting material financial statement fraud, in light of what has been learned from the PCAOB inspection process. Information gleaned from analysis of engagement workpapers can clarify whether there remain any weak points in auditing standards, or whether the difficulty in fraud detection lies in failure to follow existing standards or other factors.

Firm Structure and Finances Recommendation 6: Urge the PCAOB to Undertake a Standard-Setting Initiative Mandating the Engagement Partner's Signature on the Auditor's Report.

In its first *Draft Report*, the Committee originally recommended (as part of Concentration and Competition Recommendation 5) that the name of the senior auditing partner on the engagement be disclosed in the proxy. In our response, we noted agreement with this recommendation, but we suggested that the Committee go further. We suggested that as in other countries (e.g., Australia, France, Germany, Luxembourg, Malaysia, Taiwan, and soon the United Kingdom; see Church et al. 2008), the Committee recommend that engagement partners sign their names, as well as the firm's name, to the audit report. We believe this policy would be more effective than only proxy disclosure, as placing the partner's name on the audit opinion is a more direct public statement of responsibility. Requiring partners to sign their names also increases transparency, and may change behavior because the partners' reputation is now publicly at stake (Institute of Chartered Accountants in England and Wales [ICAEW] 2005). However, the accounting profession clearly opposes requiring engagement partners to sign their names. The profession argues that this change fails to appreciate that engagement teams perform audits and that the opinion is the joint responsibility of

the partner, other engagement team members, and the firm itself (BDO 2008; Ernst & Young LLP 2008; PwC 2008). Although the audit is clearly a product of the contribution of multiple individuals in a firm, this policy is analogous to the requirement that CEOs and CFOs personally certify the financial statements under SOX Section 302, even though such statements are prepared by large teams.⁹ A further concern is that the impact on professional liability of this policy in the U.S. context is unknown. Notwithstanding the concerns of the profession, we are encouraged to see that the final recommendation calls for the PCAOB to consider requiring the engagement partner's signature on the audit report.

Firm Structure and Finances Recommendation 7: Urge the PCAOB to Require that, Beginning in 2010, Larger Auditing Firms Produce a Public Annual Report Incorporating (a) Information Required by the EU's Eighth Directive, Article 40 Transparency Report Deemed Appropriate by the PCAOB, and (b) Such Key Indicators of Audit Quality and Effectiveness as Determined by the PCAOB in Accordance with Recommendation 3 in Chapter VIII of this Report; and Further, Encourage the PCAOB to Require that, Beginning in 2011, the Larger Auditing Firms File with the PCAOB on a Confidential Basis Audited Financial Statements.

We advocate greater transparency and governance improvements by the auditing profession, especially if the profession is granted liability relief. We support the disclosure of EU-type information and audit quality indicators by auditing firms, both to provide information to the financial markets relevant to the quality of audits performed by the firms, as well as to serve as an incentive for firms to adopt sound governance practices. In terms of requiring the major audit firms to confidentially file audited financial statements with the PCAOB, we believe that this is a very healthy recommendation and one that will allow the PCAOB to more effectively assess risk in the market for audit services.

CONCENTRATION AND COMPETITION

Concentration and Competition Recommendation 1: Reduce Barriers to the Growth of Smaller Auditing Firms Consistent with an Overall Policy Goal of Promoting Audit Quality. Because Smaller Auditing Firms are Likely to Become Significant Competitors in the Market for Larger Company Audits Only in the Long Term, the Committee Recognizes that Recommendation 2 Will Be a Higher Priority in the Near Term.

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

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

⁹ As with CEO/CFO Section 302 attestation, the argument in favor of engagement partner signature is basically that such disclosures increase accountability, and are thus likely to improve decisions. Prior research studies in the auditing context (e.g., Johnson and Kaplan 1991; Kennedy 1993) show that accountability reduces auditors' information processing biases, and increases consensus and self-insight.

Concentration and Competition Recommendation 2: Monitor Potential Sources of Catastrophic Risk Faced by Public Company Auditing Firms and Create a Mechanism for the Preservation and Rehabilitation of Troubled Larger Public Company Auditing Firms.

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

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

The Committee recognizes that the PCAOB, as part of its inspection process, considers various firm policies and procedures that reflect the firm's culture and governance (e.g., partner evaluation and compensation, and internal disciplinary actions). We strongly support the importance of firm culture and governance as mechanisms for improving audit quality. Research shows that social influence by superiors affects the willingness of subordinate auditors to engage in quality-threatening behaviors (e.g., Lord and DeZoort 2001). Also, studies of professional auditing find that partner compensation mechanisms may influence auditor behavior (e.g., Carcello et al. 2000; Trompeter 1994). These studies and others imply that firms can do much to incentivize their personnel to do the right thing by rewarding audit quality instead of revenue generation and by creating mentoring systems to promote appropriate guidance of junior-level staff by senior firm personnel.

Concentration and Competition Recommendation 3: Recommend the PCAOB, in Conjunction with Auditors, Investors, Public Companies, Audit Committees, Boards of Directors, Academics, and Others, Determine the Feasibility of Developing Key Indicators of Audit Quality and Effectiveness and Requiring Auditing Firms to Publicly Disclose These Indicators; and Assuming Development and Disclosure of Indicators of Audit Quality are Feasible, Require the PCAOB to Monitor These Indicators.

Although we believe that this is among the best recommendations of the Committee, our original concern was that many of the indicators suggested—for example, average experience level of staff and annual staff retention—are input-based. Although better inputs and good audit outputs should show a correlation, the public policy imperative is on the output side.¹⁰ We encourage the Committee to consider other input-based measures where extant research finds a positive relation between the measure and audit quality (i.e., the relevant output measure). For example, an extensive literature finds that greater auditor industry specialization is associated with better audit quality (e.g., Low 2004; Owghoso et al. 2002; see Gramling and Stone 2001 for a review of this literature).

In addition, we previously encouraged the Committee to consider output-based measures of audit quality—for example, fewer client frauds, fewer client restatements, less earnings

¹⁰ The PCAOB's inspection process could be used to generate indicators of audit quality, at a minimum compliance with accounting and auditing standards. The Committee might call for more transparency and public reporting of the results of the PCAOB inspection process.

management, and more accurate auditor reporting before a bankruptcy filing—after appropriate risk adjustment given the nature of the audit firms' client portfolios. The Committee has adopted this suggestion stating, "The Committee believes that the PCAOB should consider both output-based and input-based indicators" (ACAP 2008d). Moreover, the Committee now discusses some output-based measures in its report.

As with any measurement system, a move to reporting quality metrics could be "gamed" by some firms. The Committee recommends that the PCAOB would monitor these indicators through its inspection process, but we would go further. For firms that audit more than one hundred companies per year, we suggest that the Committee require that these data be audited by the GAO, PCAOB, or another independent entity and publicly disclosed on an annual basis. In addition, we suggest that measures of audit quality include some qualitative measures, as these measures are more difficult to manipulate.

Concentration and Competition Recommendation 4: Promote the Understanding of and Compliance with Auditor Independence Requirements Among Auditors, Investors, Public Companies, Audit Committees, and Boards of Directors, in Order to Enhance Investor Confidence in the Quality of Audit Processes and Audits.

The Committee recommends that SEC and PCAOB independence requirements be combined into a single document and that this document be made publicly available via the web. The Committee also recommends that the AICPA and state boards clarify differences in their independence standards from those of the SEC/PCAOB. The Committee further recommends that firms develop additional independence training materials geared to partners and mid-career professionals.

Although we support these recommendations, we would go further. We suggest that the Committee recommend the SEC develop an aspirational, principles-based approach to independence rather than continuing to develop ever more minute rules. In particular, we believe that the *raison d'être* of auditor independence rules is to foster auditor objectivity/professional skepticism, which should enhance auditor reliability (see Taylor et al. 2003). We recommend that the PCAOB focus heavily on indicators of professional skepticism (or lack thereof) during its inspection process. In this regard, we encourage the Committee to consult Taylor et al. (2003) for a model of auditor reliability, which ultimately is much more important than technical compliance with independence rules.

Concentration and Competition Recommendation 5: Adopt Annual Shareholder Ratification of Public Company Auditors by all Public Companies.

The Committee recommends an advisory shareholder vote on the selection of the audit firm, and that exchange self-regulatory organizations should adopt this recommendation as a listing standard. We agree, but we would go further. We suggest that the Committee recommend an advisory shareholder vote on each member of the audit committee for companies that have not adopted a majority vote provision for all board members.

Concentration and Competition Recommendation 6: Enhance Regulatory Collaboration and Coordination between the PCAOB and its Foreign Counterparts, Consistent with the PCAOB Mission of Promoting Quality Audits of Public Companies in the United States.

We support this recommendation and agree that the PCAOB should communicate with foreign regulators and participate in global regulatory bodies. We caution, however, that communication and participation should not be precursors to PCAOB abdication to foreign regulators or to some future transnational regulatory body. In particular, the Board's proposal (PCAOB Proposed

Rule No. 4012) to fully rely on inspections performed by certain foreign regulators—even regulators whose structure differs in important respects from the PCAOB’s structure as articulated in SOX—is potentially problematic and demands more debate and scrutiny than it has received to date.

CONCLUSION

The Committee has addressed a number of fundamental issues in its deliberations, and we commend the Committee co-chairs and members for their diligence and willingness to contribute. We believe that many of the Committee’s recommendations will serve to promote audit quality and the long-term viability of the public company auditing profession. Although the profession faces great challenges, the events of the past eight years clearly point to the critical role that auditing plays in our financial system. As long as the major auditing firms remain firmly fixed on their *public responsibility to investors*, we are confident that the public company audit will continue to provide investors with significant benefit.

While our comments above indicate support for many of the Committee’s individual recommendations, we close this discussion with a caveat that arises from taking a step back and viewing the big picture of what the Committee did and did not recommend. The Committee’s charge, quoted in the introduction to this paper, concerns the *sustainability* of the auditing profession. Arguably the greatest threat to the profession in the United States is the litigation exposure resulting from our legal system, which differs in a number of ways from that of other countries. Regarding auditor liability, the Committee’s deliberations have involved issues on which it was unable to reach consensus (although the Committee makes no recommendations regarding liability reform, the *Final Report* does provide an analysis of the issues discussed and information gathered in its deliberations). These issues (e.g., the appropriate jurisdiction of litigation cases against audit firms and the advisability of litigation caps) are among the most difficult faced by the Committee, the auditing profession, regulators, and the firms themselves, as liability concerns relate to the fundamental issue of the firms’ ability to stay in business in the long term. When major firms cannot get adequate insurance to protect their partners, the entire structure of the auditing profession in the United States is threatened. However, as educators, researchers, and observers of the profession over the past 20-plus years, we see a significant risk in providing litigation relief without a corresponding increase in transparency and regulatory control as discussed by the Committee (see Bailey 2008a).¹¹

Accordingly, our response to the draft recommendations and our verbal testimony before the Committee indicated that we believe there should be a *quid pro quo*—in exchange for some form of liability relief, the auditing firms must give up some element of operational control to ensure that audit quality does not suffer. In the absence of additional control mechanisms within the auditing firms (such as those proposed by the Committee), some firms may respond to reduced liability risk by simply doing less audit work. Such a response would not serve the interests of the investing public. However, some of the recommendations above (such as engagement partner signature, changes in the audit reporting model, and disclosure of currently proprietary data regarding firm operations) could increase litigation risk. Other recommendations (increased salaries for professionals, funding of faculty internships) would increase the firms’ production costs, but some of these efforts should also increase audit quality. It is an empirical question as to whether

¹¹ We base our concern on evidence following the Private Securities Litigation Reform Act of 1995 (PSLRA), which provided relief to auditing firms by making it more difficult for plaintiffs to pursue class-action lawsuits, and providing proportionate liability in damage awards. Research shows that following the PSLRA, earnings of Big 6 clients were more aggressive (Lee and Mande 2003) and auditors were less likely to issue going-concern modified audit opinions to financially troubled companies (Geiger and Raghunandan 2002). Thus, audit quality arguably dipped following the PSLRA.

the Committee's suggested reforms will have a greater effect on improving audit quality, thus reducing liability risk, or will simply lead to greater liability exposure for the profession. As such, the long-term effect of the Committee's recommendations on the sustainability of the auditing profession is difficult to predict. We encourage regulators and others to continue to examine the appropriate blend of liability reform and efforts to promote audit quality.

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