

## NEWS & VIEWS

### BROADLY SPEAKING

#### FEBRUARY IS CPA IN INDUSTRY MONTH

CPAs in industry comprise approximately 30% of our readers. Last year *The CPA Journal* began a campaign to pay particular attention to the special needs of that group. The monthly CPA in Industry column premiered in May of 1992. All feature articles are being edited from the perspective of CPAs in all vocations. The culmination of this year-long effort is this special CPA in industry issue.

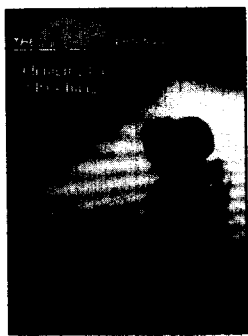
The lead article is a panel discussion with eight CPAs in industry coming from a variety of circumstances—large conglomerate to small apparel manufacturer and financial broker, chief financial officer to internal auditor and tax manager.

The panelists express their candid views on why they decided to leave public accounting and whether the grass is actually greener. CPAs in industry and those who would like to know how the other half lives will find their views interesting and challenging.

Other articles for CPAs in industry have to do with effective bonus plans, health insurance, and small business wellness programs.

CPAs in public practice have not been overlooked—we have our usual two tax articles for starters. And the two health related articles—health insurance and wellness programs—are for everyone. □

#### MORE ON "CHANGING THE IMAGE OF THE CPA"



In the January News & Views, John C. Burton and Rholan Larson commented upon Donald Chapin's speech on "Changing the Image of the CPA," which was presented as a feature article in the December

issue. Chapin commented on the image of the CPA in the eyes of regulators and proposed solutions to lift the level and

scope of services to meet the expectations of the public and other third parties.

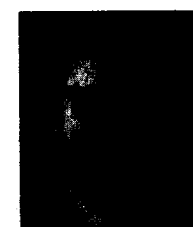
In his speech Chapin said, "The wrong solution would be for the profession to continue trying to close the expectation gap by reducing expectations." In his view, "It will be necessary in its interaction with the government for the profession to take a proactive role and propose both expanding its service to the public and some form of government regulation."

Both Burton and Larson agreed with Chapin that it was time for the profession to be more responsive and expand its role to do more in the public interest.

As part of *The CPA Journal's* objective of presenting a balanced view of issues facing the profession, this month we present excerpts from a speech, "Auditors are Part of the Solution, Not Part of the Problem," given by Shaun F. O'Malley, Chairman and Senior Partner of Price Waterhouse, before the Business School Alumni Association in November 1992. O'Malley began his speech by describing the impact of litigation on the profession and the need for liability reform. He then proceeded to discuss the "expectation gap" and the need for a better understanding on how to close it. □

#### Toward a Better Understanding of the Expectation Gap

By Shaun F. O'Malley



The effort to reform the liability system is only a partial solution to the accounting profession's problem. In tandem with this effort, I believe we must address the public's unrealistic expectations regarding the independent auditor's role in preventing business fraud, mismanagement, error, and failure. These expectations stem partly from the characterization of the profession as the public's "watchdog." They are also a product of the demand for absolute assurance against risk. The public's expectations and the liability system have fed on each other to create an impossible situation in which auditors are seen as absolute guarantors against fraud, failure, and financial ruin. Therefore, shareholders and third parties feel fully justified in

demanding that we compensate them for losses and unmet expectations—even if they themselves were responsible for the losses, or even if their expectations were unrealistic to begin with.

My own firm has been a victim of this syndrome, notably in the Standard Chartered litigation recently tried in Arizona—a case in which a jury handed down a \$338 million verdict against us, despite the fact that losses incurred by the bank were in no way related to any services rendered or advice provided by Price Waterhouse. Indeed, acknowledging that there was no explicit consulting relationship between the bank and my firm, an official testified that he had, "hired Price Waterhouse in his mind" which, unfortunately, seemed to be enough of a relationship for the jury. We have moved for a new trial and are confident that we will be vindicated. [Note: Arizona Superior Court Judge John Sticht subsequently rejected the jury's verdicts, calling them "irreconcilably inconsistent" as to be "blatantly erroneous" on both liability and damages.]

Now, don't get me wrong. If auditors are culpable, they should be accountable. But the unprecedented volume of litigation against CPAs does not signal an epidemic of bad audits. Instead, auditors are being made scapegoats for faulty public policy, bad legislation, bad regulation, congressional interference, and bad management. And it's no overstatement to suggest that the Federal government is doing everything it can to shift the cost of the S&L bailout to the partners and employees of CPA firms.

Now, I am not suggesting that the concept of the auditor as public watchdog be rejected out of hand. Indeed, I favor exploring ways to improve our ability to help prevent fraud and to meet reasonable public expectations. However, I object strenuously to a public watchdog role being imposed by legislative fiat without a thorough examination of the consequences—particularly the enormous liability consequences. And I object even more strenuously to that role being imposed retroactively by judicial fiat.

I fully concur with the statement made in the recent California Supreme Court's decision in *Bily versus Arthur Young*: "An

auditor is a watchdog, not a bloodhound."

Within the limits of their capabilities, and within the constraints of the financial statement examination, auditors may be able to assume more responsibility to search for fraud. But auditors simply cannot be bloodhounds, tracking down fraud from the faintest scent, and calling the posse down on the alleged perpetrators. I believe many who say we should be watchdogs really mean bloodhounds. That is not possible, and even our role as watchdogs raises some serious concerns. Let me share three of them with you.

**Increased Expectations Without**

**Results.** First, certain proposals for preventing or detecting fraud could further raise public expectations, without producing commensurate results. One such proposal is for management and auditor evaluations of the adequacy of internal control systems and public reporting of the results of such evaluations in annual reports. Regulators and legislators place great faith in the effectiveness of internal controls in deterring fraudulent and illegal behavior and in the effectiveness of internal control reviews in ensuring that such systems are in place and functioning properly.

Internal control systems can do much to increase chances that fraud will be prevented or detected. But they must not be oversold. Sophisticated schemes to defraud can and do escape detection. The most rigorous controls can be circumvented with widespread collusion. When this happens, those who experienced losses will likely assume that the auditors performed inadequate internal control reviews. And they will sue us. Furthermore, juries of lay persons totally unfamiliar with the complexities of the issues will continue to find for plaintiffs whom they perceived have been injured and whom they assume will be paid out of an endless supply of insurance funds. That is why the accounting profession will not support any further legislative expansion of independent auditors' responsibilities without meaningful liability reform—for it is our view that increased obligations that create unreasonable expectations will almost certainly produce increased litigation.

**On a Collision Course.** My second concern is that failing to carefully define the auditor's role as public watchdog could place the interests of shareholders and the presumed interests of the general public on a collision course, with the auditors at the point of impact. Theoretically, stockholders' interests and the public's interests should be the same. This is not necessarily true in real life. It will certainly not be true if those who want us to be bloodhounds have their way, because they want us to bark long and loud at the first sign of fraud.

Auditors do detect fraud. We do help prevent fraud, and we do much to help protect the integrity of financial information. When we discover signs of fraud or other potential problems, we report them to management, the audit committee, and the Board of Directors. Critics call this process secretive and self-serving, but it was developed for a very good reason. It protects shareholders by giving companies a chance to resolve situations which, if made public, could cause stock prices to plunge or have other serious consequences. One consequence is that the auditors will be sued. Auditors are not supposed to place their clients in financial jeopardy. That's not in keeping with our mandate under the securities laws.

There's also a Catch-22 here. Shareholders and management will sue us because we disclosed too much, too soon. Third parties will sue us because we told them too little, too late. This Catch-22 is why the profession is seeking meaningful liability protection under any proposed legislation requiring direct auditor reporting of fraud to regulators.

**Challenge of the Premise.** Finally, I challenge the premise that an independent audit function that does not become a fraud-detection mechanism lacks usefulness. Nothing could be further from the truth. We live in a global economy. The enormous complexity and geographic reach of business operations and financial transactions has increased dramatically. So has the need for reliable, relevant and useful financial information for decision making. The systems and the standards that govern the development of this financial information are becoming far more complicated. There is more

room for judgment, and more potential for error. The need for an independent and objective check on the systems and the judgments and decisions underlying reported financial results is greater than ever, simply because of their complexity and because reasonable and ethical people will disagree over the application and interpretation of accounting standards. But the independent audit does not serve that purpose alone. It's also a management tool. It helps improve the efficiency and effectiveness of business operations because it uncovers problems and areas for improvement. That makes it a competitiveness tool as well, and that is something this country clearly needs.

I could give you many more reasons why the independent financial statement audit is crucial to our capital markets and our economy. But I'm not trying to sell you an audit. Instead, I'm trying to sell you the idea that, if the liability-laden role of public watchdog drives the independent audit function, everything else about the function that is useful and relevant will be at risk. What I'm trying to sell you is fairness. Fairness in our liability system, and fairness in what is expected of the accounting profession. □

**THE SBA GOES ONLINE**

**T**he Small Business Administration (SBA) created an on-line, bulletin-board service named SBA ONLINE to meet the needs of small business owners and advisors. The system went online in October 1992 with 20 lines available to callers.

From the outset, the system received over one thousand calls per day. The SBA responded by expanding the system to handle 41 lines.

The system offers a number of useful features to small business owners. A list of SBA's 30 most frequently asked questions, with answers, can be accessed from the main menu. This helps the SBA answer on a consistent basis the questions most frequently on the minds of small businesses and frees up the operators to be available for more non-routine matters.

Since the SBA is an enormous organization with offices in all 50 states, the system also includes the feature of