



Restoring Trust in America's Business Institutions

SLOAN PROJECT ON BUSINESS INSTITUTIONS AT THE
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CONFERENCE PROCEEDINGS

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Editors

PANEL II

ACCOUNTING REFORM: PROGRESS AND UNRESOLVED PROBLEMS

PROFESSOR WILLIAM BRATTON: We proceed to consider the crisis in financial reporting, the evolution of Generally Accepted Accounting Principles, the role of the auditor, and regulatory initiatives respecting the auditing profession. We are very pleased to have with us, first, G. Michael Crooch, a Member of the Financial Accounting Standards Board (FASB); second, George Diacont, the Director of Registration and Inspection at the Public Company Accounting Oversight Board (PCAOB); third, Dennis Nally, the Chairman and Senior Partner of Pricewaterhouse Coopers, LLP; and, finally, Shyam Sunder, the James L. Frank Professor of Accounting, Economics, and Finance at the Yale School of Management.

MR. G. MICHAEL CROOCH: It's a pleasure to be here. I need to give you my standard disclaimer that the decisions of the FASB are made when we're all together and we can all agree and vote. So most anything that I say, although I promise to make it as truthful as I can, must be considered mine and mine alone.

I think it's important for this group to know who we are and how we work. The FASB is not attached or governed by the U.S. government. It's a private organization; a foundation. We have about 16 trustees. Their job is to provide funding and to appoint the members of the FASB. Under Sarbanes-Oxley, our funding has been changed. In Sarbanes-Oxley the legislators decided that we should not be beholden to the people for whom we make our rules. Previous to this, there was an appearance of impropriety because nice firms like Pricewaterhouse would give us money so that we could formulate the rules that they would have to follow—grudgingly at times. But Sarbanes-Oxley provided a funding mechanism for both the PCAOB and the

FASB. It's an interesting formula. If you are a public company you take your 12-month trailing weighted average market capitalization and divide that by the 12-month average market capitalization for all public entities. That fraction multiplied by the total of the PCAOB and FASB budget is the check that the company has to write in order to be sure that its shares continue to be tradable. Thus, the FASB is independent in the sense that it operates based on a charge that companies must pay in order to remain public.

There are seven board members. If you are a board member you have to be independent. In effect, you have to retire, breaking all ties with the companies or organizations from which you came. Our personal investments are limited and we have to make filings with regard to our investments. We have a separate staff that's full-time. So we are truly an independent organization.

Our job is to create accounting standards, which offer guidance to companies when drafting their financial statements. We do that in a deliberative process. We create our documents and exposure drafts. We then issue them for exposure, get input, and re-deliberate. It takes four out of the seven members in order to pass one of our standards.

Now, what happened and how much of what happened is an accounting problem? If you look really carefully into many of the scandals, you will see that the scandals happened because of fraud. Often the accounting rules in existence at the time were not being followed. For example, when HealthSouth has a meeting of 16 or 17 people to decide how the firm is going to calculate its earnings, it does not appear to be following the accounting standards that we issued. In some of these cases, investment bankers, attorneys, company officers, and sometimes accountants colluded in an effort to get around the rules. To take another example, Enron allowed a non-paper trail in one instance. According to the published reports, one of the investment bankers actually traveled from New York to Houston so that

an oral promise to repay a certain amount could be performed directly by the company's people. I would assert that that's not an accounting failure; that's a fraud.

Were there things that we should have done and have we done anything about them? Certainly. Special Purpose Entities (SPEs) were a mechanism used by many companies. Some investment houses have as many as 4,000 SPEs they use to do their business. SPEs are not evil in and of themselves. In fact, they satisfy many legitimate business needs, such as isolating assets. The vast majority of SPEs are for legal isolation purposes. But these SPEs are consolidated in the companies' financial reports. The ones that you've heard about and that you have concerns about were those that were not consolidated. What have we done? I don't want to get into a lot of technical accounting jargon, but the real issue was "should the SPE be consolidated with the company and thus the assets and the liabilities show up on the financial statements that Enron or whomever else puts out?" The answer is that under the rules at the time they didn't have to, although there should have been some more disclosure. We have tried to develop some literature that will give guidance for special cases. Entities that didn't have to consolidate under the normal rules, based on equity ownership, will now have to be consolidated. In a normal consolidation, if, say, General Electric owns all of a subsidiary's stock it then combines those financial statements when it reports, based on its ownership of shares. In contrast, a lot of these unconsolidated SPEs didn't have enough equity held by an outside owner to support the conclusion that the equity participant was, in fact, the one that was in control. I saw one SPE that had a \$15,000 investment by the Red Cross, which held all of the voting shares, even though there were well over a few hundred million dollars worth of assets in the thing. Under our new approach, if you have an interest in an SPE and you're either going to receive the majority of the benefits or you're going to absorb the majority of the losses, then you're probably going to be in control of that entity and its activities. Either that or you're dumber than a rock. So we

now decide who is involved by looking at the entity's variability, its operations, and its participants.

It's turned out to be a very complicated process because many of these entities are very complicated in and of themselves. One of the things we often hear is, "Why can't you just write some really simple rules?" Well, my first response is that the transactions we're trying to write rules about are, in fact, very complicated. It's hard to write very simple rules about very complicated transactions.

A second major area that we've had to examine concerns guarantees. Although there was some guidance in there about reporting on guarantees, it wasn't well-followed. We have therefore put out a statement that addresses the various types of guarantees. Enron is reported to have guaranteed the equity of an SPE with its own shares. Enron would guarantee to pay for something that would otherwise be a liability by obligating itself to transfer its shares, but not obligating itself to assume another liability or transfer assets. This transaction led to a problem in the literature regarding the definition of assets and liabilities, because Enron didn't record the shares that it would have to pay in the future as a liability. The way we work is that we have a conceptual framework and we put our rules out and make them consistent with that conceptual framework. Every conceptual framework relating to accounting has definitions of assets and liabilities. Our definition of liabilities was that if you had a liability, you had an obligation that you would satisfy by either transferring assets or assuming another liability. There was no mention of equity. To solve this problem, we've put out a document that changes the definition of assets and liabilities such that if, in fact, you are using your stock as a currency, you must show that obligation that you're going to pay with your stock as a liability on your financial statements.

The last thing that we're working on is employee stock options. On this I happen to be what we call the Board

collaborator, which means that I'm the Board person who is trying to marshal stock options through our organization. We hope to issue an exposure draft in the first week or two of February that gives an idea of what we think the accounting standard ought to be. We get an awful lot of comments about stock options. CEOs tell us, "This has been the driver of our business. It's the reason people work so hard. It's the reason why we've been so successful in this business. But if you guys say I have to expense them, I'll have to take them away." I have trouble with that. Under our view of the economics, stock options are valuable in that if you receive them you get something of value. We believe that because they are things of value when given to employees, they ought to be expensed and this document is going to try to do that.

MR. GEORGE DIACONT: It's a pleasure to be here. I'm obligated to tell you that anything I say today reflects my opinion and not necessarily the opinion of the PCAOB or anybody at the PCAOB.

I became the Director of the Division of Registration and Inspections on March 17th, 2003. The Division is unquestionably the heart of the PCAOB; it will be the largest division of the PCAOB once we finish hiring in late 2004. When I came to work at the PCAOB in March, our first priority was hiring competent staff. It's very difficult to hire the kind of people we need; people who can go into a corporation or a large accounting firm and to be able to determine whether audits were conducted properly. We need people with current audit experience. My senior people have to be partners from the audit firms and those are the people that I've been hiring. But it's been very difficult. That was our first priority in March and it's still our first priority now.

Before I came aboard, the Board made a fateful decision as far as inspections are concerned. In our first year we only would conduct what they characterize as limited inspection procedures. What they meant by "limited" is that we were just going to look at the Big 4 accounting firms. In

the press this "limited" procedure has been criticized. But let's put this in context. There are approximately 15,000 issuers. The Big 4 firms account for about 11,000 of those issuers. So these "limited procedures" are directed at the auditing firms that cover 11,000 public companies. They will in fact encompass about 9,000 staff hours. Maybe you think that's not much, but bear in mind that when we fielded our first team to start the limited inspections in June, it consisted of 23 permanent staff and 5 consultants.

We've been hiring since then and we now have a larger staff, but not nearly large enough to carry us into 2004. In September 2003 we opened our New York office, which will accommodate about 50 professionals. In October we announced the intent to open offices in San Francisco, Dallas, and Atlanta and we expect to have these offices operating by January. We've hired and appointed a deputy director of the Dallas office and that individual is right now trying to staff that office.

In November we expect to wrap up the limited inspection procedures that we started in June. By December we will be writing our reports on the four accounting firms. These limited procedures have two objectives. First, we're looking at the business practices of the major firms; in a few moments I'll talk about business practices and how they affect audit quality. Second, we're looking at engagements. We're selecting a certain number of engagements and reviewing them, asking "do they comply with the professional auditing standards?" But we're not stopping there. We're also looking at whether or not the information contained in the work papers and the documentation and the discussions we had with the audit team suggest that the financial statements may be misstated. During this whole process we're also sensitive to the possibility that there may be evidence or an indication of fraud.

What are some of the areas that we've been concentrating on in the last few months? One thing that we

would like to understand is the tone at the top. What message is being communicated by the top leadership of the accounting firms? What are the firm's priorities? How does the quality of the audit practice fit in with the firm's priorities? How effective are their communications? In other words, what's the character of the firm that we're looking at?

Partner compensation is another key area and probably one of the most controversial. I've been told at least four times that, "We don't even tell our partners what our other partners make and you want to come in and look at our most sensitive information?" Well, we had to look at this information because what we were trying to do is to determine what the incentives are in the firm. How are the monetary funds of the firm allocated among its partners and what is the basis for that allocation? One argument that has been made is that some firms in the last few years have been favoring the partners that are really good at selling services over the partners who are super-technical people but who may not be so good at selling services. That is something that we're cognizant of while looking into partner compensation. We're also looking at compensation and comparing it with what the firm is saying verbally about its policies and procedures and looking to see whether there are any inconsistencies in connection with what's being said and what's being compensated.

One other very important area that we're evaluating is how these accounting firms determine risks. How do they determine the risks of the issuers that they hire? How do they determine risks for the issuers that they decide to fire? How are those risk assessments intertwined with the audit process? How do they determine risk in connection with their internal inspection program? How about the risk of a partner who's not doing his job? How about the risk that in a given engagement the financials may be improperly stated in connection with an audit? How about the risk that there may be fraud that was not detected in the audit?

One question I had when we started the inspections process, and still have to a degree, is "How is it that these accounting firms have put so much money and so much of their resources into their internal inspection processes?" They have some of their best people involved with these internal processes. So how is it that this sophisticated process for assessing risk and for evaluating partners has failed over the last few years to detect some of the major audit busts that have occurred? How have these sophisticated processes failed to detect some of the large frauds that have occurred over so many years? I don't yet have the answer to that question, but that's certainly a question that we're trying to resolve through the inspections process.

Foreign affiliated firms are also important. The board has decided that foreign firms have to be registered if, in fact, they are the issuers that trade on U.S. markets. The board is trying to decide to what extent we will inspect these foreign firms and how we can come up with a scheme for inspecting them that would be acceptable to the countries with which we're dealing. We're currently trying to gather an information base to understand how U.S. firms interrelate with their foreign affiliates. How do they test the audit quality of the foreign affiliates? Is that testing of the quality of the foreign affiliates reasonable? Is it adequate? Does it meet the auditing standards? I don't know how far we're going to be able to go down this path in 2003 because of the limited amount of time left. But we intend to continue the process of gathering information to understand the relationships and the quality control implications for those relationships.

The year 2004 will be a year of full-blown inspections. Beginning in 2004, we'll be examining every year those accounting firms that have over 100 audit engagements as defined by Sarbanes-Oxley. That's eight firms right now: the Big 4, Crowe Chizek, McGladrey, BDO,

and Grant Thornton. We will examine all other firms once every three years. As of today my registration department has received about 700 applications—at the present time we've listed about 600. In addition to the 700, I have 300 firms who have requested passwords and IDs. That means that they've started the process of registration. I don't know how many of those are going to register but we have 700 in-house now. So I'm guessing that starting in 2004 our inspections will look at no less than 200 accounting firms; and it could possibly be 300 firms, depending on how many actually end up registering.

Throughout 2004 we're going to continue to look at firm practices, the tone at the top, and the other matters that I've mentioned that relate to the accounting firms' business practices. But what we're going to do that's going to be a lot different is that we're going to be reviewing a large number of engagements. We're going to examine at least 5 percent of the practice of the major firms and for some of the smaller firms the percentage will be a lot higher.

MR. DENNIS NALLY: I've been Chairman and Senior Partner of Pricewaterhouse Coopers for about 15 months and I have been in the profession for over 29 years. From my perspective these have been some of the most interesting times I have ever spent in the profession. The kinds of changes and the challenges that we've all been through have been nothing short of remarkable. So what I would like to do is to give you a sense of what we see as life after Sarbanes, of what the last 12 months have been like, and of what the trends are that we're seeing develop. Then I want to give you a sense of some of the open issues that I think still need to be addressed and I'd like to look down the road at some of the critical issues that we're trying to deal with as a profession.

First, I'd like to discuss the last 12 months. I will tell you that the changes we have seen in terms of corporate governance and the kinds of things that our clients are

dealing with are nothing short of remarkable. Probably more change has occurred in the last year in terms of governance than anything that we've seen in the previous 25 years. Today, committee meetings are much more frequent. The days of having audit committees meet three times a year for an hour a session with a programmed agenda are long gone. Today, you're seeing audit committees meet anywhere between 10 and 20 times a year and the length of those meetings has increased significantly as well. For example, last week I was in an audit committee session that lasted over two-and-half-hours. Equally important, we spent about 30 minutes just with the audit committee, without executive management present. Two years ago that would not have happened. There may have been private sessions with the external auditor but they were often very quick. "Any issues we need to talk about? Move on." Today, audit committees are very engaged in this process and very focused on the right issues. We can debate what was done in the past, but audit committees today are taking their jobs very seriously. They're focused on the company's risk. They're focused on the right issues from an accounting standpoint, such as where judgments are being made and where significant estimates inherent in preparing financial statements are being considered. They're involved up-front in discussions around transactions that affect a company's financial statements, prior to any release of earnings or information to the public. I've seen a sea change in the corporate governance function, in terms of how audit committees are carrying out their responsibilities.

You've seen some of the highly publicized stories about how companies are really addressing some of the changes from a governance standpoint, with the addition of independent directors on critical committees, such as compensation committees, audit committees, and nominating committees; that's real. You see some trends beginning to emerge in terms of the separation of the role of CEO from that of chairman. Lead director concepts also are getting a lot of discussion in corporate boardrooms today. A year ago,

I don't think there would have been such discussions. So, I think there's been a lot of progress in the last 12 months.

But many organizations are still struggling with what all of this means. For example, you see a lot of audit committees that are actually struggling to understand what their role should be. How far should they go to deal with the whole question of governance versus management? What's the right balance? How much detail do they need to get into? I think organizations are really struggling with that and I suspect it's going to take some time to work out the right balance as people get more comfortable with their new responsibilities and the new requirements.

From an executive management standpoint, the CEOs today understand that their responsibilities include internal controls and the tone at the top. Two years ago, the conversations that external auditors were having with executive management were all about the business, the direction of the business, investments, strategy, and how all of that affected our responsibilities as the external auditor. Today, the conversations are much more focused on the control structure of an organization. How do they stack up with other organizations? What are the best practices? What's our independent assessment of the control environment? Do they have the right people doing the right things? The conversations that we're having with executive management are very different today than they were 12 to 18 months ago, which is very encouraging.

I still think that there is a huge expectation gap between what the public expects independent auditors to do and what our responsibilities are. Mike Crooch alluded earlier to the whole issue of fraud. That is an area where I think the profession and the standard-setters are not necessarily on the same page in terms of our responsibility to uncover fraud. There is no question that the general public has an expectation that an independent auditor and independent accountant should have that as a primary

responsibility. It is a complex issue, in terms of the ability to really detect fraud. It's not even known whether or not you can, in fact, detect fraud, even with the very best procedures and the very best people involved in the engagement. That is an issue that I believe we've got to wrestle to the ground once and for all and get some clarity on. I have a view that if we don't address that issue and clarify for the public what our responsibility is for the actual detection of fraud, there will continue to be a significant expectation gap between what we do as a profession and what the public expects us to do.

I think we still have some significant issues to deal with regarding the complexity of the accounting framework that we use today to prepare and audit financial statements. The environment today is incredibly complex, if you consider SPEs, consolidation, and some of the other unique aspects of accounting that we're all trying to deal with. In many respects we have gone from a standard-setting process to a process that is very much rules-based. This process is very specific and has created more issues than it has solved. I think we ultimately have to get back to an environment where our accounting standards are really based on principles, so that preparers of financial statements and auditors of financial statements can look at the substance of transactions and make sure that the accounting and reporting transparency of those transactions is consistent with the substance. I don't think you can continue to just promulgate and issue rules in the volumes that we're currently dealing with. I think it's very difficult to expect any practitioner to stay current with all of the rules that are out there—which are so specific and so narrow—while actually producing quality reporting.

I think the issue of convergence of accounting standards is one that really requires more debate and discussion. In the U.S. we have the standards being set by not only the FASB but also the SEC and other regulators. We have the international accounting standards organizations that are also out there promoting standards. We need to see

how all of this ultimately comes together, how much convergence there is between the various groups that are really setting standards. That's a key challenge for the profession, the preparers and users of financial statements.

To sum up, I have seen some major changes take place in a very short period of time as a result of Sarbanes-Oxley. These changes have brought the right spotlight, the right focus on some critical issues that, I think, were necessary. But we still have challenges that we need to address. I'm confident that by at least putting those issues out on the table and talking about them we can come to grips with what it is we all need to do collectively to move this forward.

PROFESSOR SHYAM SUNDER: I would like to talk about the use of accounting to inform and discipline markets. Also, I would like to think outside of the box and explore different paradigms and perhaps think about how markets might be able to discipline and inform the creation and operation of accounting institutions. I'll use examples of where market discipline may usefully inform and help accounting institutions.

So let me start with how we might be able to use market discipline to write better standards. First, let's talk about the writing of accounting standards, the problem that Michael Crooch talked about a few minutes ago. In the United States, over the past 50 to 70 years the securities laws have formally given the SEC a monopoly in accounting standards and informally given a monopoly to the FASB for publicly-held firms. If things keep going the way they are we might also soon see a worldwide monopoly in the hands of the International Accounting Standards Board. The problem that accounting standard-setters face is to determine which of the alternative sets of accounting standards or rules proposed to them is better and to pick the correct criteria for making this determination. One of the better-defended criteria is a preference for standards that reduce the organization's cost of

capital. But the standard-setters have no way of knowing which of the alternatives on the table will reduce the cost of capital. We can, however, use market signals to help inform that decision.

It's possible for us to develop a competitive regime of accounting standards where regulatory authorities in various jurisdictions permit two or more alternative sets of accounting standards to be used by the reporting entities and allow them to choose one of the permitted sets and publish the annual report saying, "This report has been prepared using Standard X. " Thus, we might be able to say "this bank is regulated by a federal reserve bank or a state charter or this corporation's charter is from Delaware or California or New York" and so on. That method will have substantial advantages in getting better information into the accounting rules. The reporting entities could pay a royalty to the standard-setters whose standards they use and they could provide incentives for the standard-setters to refrain from just writing more rules. We talk about "publish or perish" in academia; if your sole charge is to write rules, what are you going to do? What happens after 30 years? It's not a personal issue or a matter of intelligence. It's a structural problem that we have created and we can use competition to get better standards. Of course, proposing to let ISB or FASB or Canadian Standards or Pricewaterhouse standards compete for the reporting entities' loyalty doesn't get you anywhere with the authorities. After all, nobody likes competition for themselves.

Let's move on to the next possibility. Much has been said about who will watch the watchmen. The way we address these infinite regression problems in mathematics is that we look for the fixed point and use algebra and calculus to solve them. In the case of auditing, how many layers of watchmen are we going to have? Well, we can think about alternative ways of solving that problem. Suppose we consider the possibility that we integrate the audit function with the insurance function and remove the audit

requirement, the mandatory audit of public corporations. So the board of directors of a public corporation can vote to decide that they're going to publish their report with a financial fraud insurance of \$100 million and go to an insurance company and ask for an insurance policy on that. The insurance company will send in their own auditors to verify and will charge a premium. Both the amount of the insurance as well as the premium will be written on the cover of the report. "This report comes with \$100 million of insurance and we paid a \$5 million premium for it." Or, "This report comes with no insurance and we still had to pay some premium." I think the shareholders can judge that. It will actually provide better signals, better information to the investors than is possible under the current regime. Because I think Sarbanes-Oxley has burdened the board, which has been given an impossible task, and I think that we can use market discipline to help us address that problem.

Third, much has been said about accounting for stock options. The issue was debated in the early 1990s and now we are debating it again. It's on the agenda of the FASB, the SEC, and the ISB. Everybody who is anybody is debating the issue. But suppose we consider using market discipline to address the problem. Consider a very simple rule, perhaps one such as follows: any entity which gives equity based compensation—stock options—to their employees has to declare in their financial statements what it believes the value of those options to be and there are no restrictions on how it places a value on them. It can use the Black-Scholes formula or any other formula. It can dream a number out of thin air and put it down and we are not going to raise any questions about it. The amount that you say the options are worth will be expensed in the income statement and deducted from the tax return. But part of the rule is that whatever you say those stock options are worth, the shareholders will then be entitled to buy unlimited numbers of those options at that price. The investors will make sure that whatever number you come up with is right; it will become right. If Muhammad cannot come to the mountain, the mountain will come to

Muhammad. So, what's the problem? Is it that every stock option is different; there are different vesting provisions and so on? It's very easy for Congress or the SEC to pass legislation that compensation options can only take this particular standard form, which is tradable, and that will take care of that.

I think what we're talking about is a mind set, thinking out of the box. Are there any situations in which we can usefully and beneficially use the forces of markets to inform our decisions and improve our institutions? I believe the answer is yes. The three proposals I just listed may or may not be right. Maybe there are weaknesses in them. But let's discuss them, let's examine these and other such proposals to see if institutions can be strengthened.

Just in case you think I'm a market ideologue, let me give you an example on the other side. Take the accounting failures and the auditing failures of the recent years. It's fun for TV cameras to show these guys in trouble or even sometimes in handcuffs and being led off to the appropriate place. But while it might make good TV, I suspect that it is not a bad people problem. Why not? I'm not saying there are no bad people. But we can't design our laws or rules or standards for a world of angels. There are people who are going to have all kinds of motives. I think the problem is that there are bad policies; it's a bad policy problem.

My summary on this is that market criterion was applied in this case incorrectly and we have paid a very heavy price for it. In these two difficult years many of my friends have asked me in all sincerity, "Why can't accountants tell the simple truth?" The fact is that what's true is not simple. We can and should use the guidance, feedback, and information from markets to restore trust in our business institutions. Indeed, we can and should create new types of institutions that can take advantage of market signals but that do not succumb to the failures of markets. With discretionary care I believe we can do that and market

discipline can go a long way to find sustainable designs to match society's expectations to individuals' self-interest. But we can't depend on regulation and enforcement to implement all of this. As Thomas Paine said, "That government is best which governs least." I still believe that if we apply market discipline carefully, we will have better regulation than that which government on its own could provide.

PROFESSOR BRATTON: We'll now go to the audience for questions.

AUDIENCE MEMBER: Dennis Nally, how much change did you see before Sarbanes-Oxley but after Enron, and how much change did you see after Sarbanes-Oxley?

MR. NALLY: Most of the change I have observed is post Sarbanes-Oxley. Many organizations were trying in the post-Enron environment to assess how best to deal with a lot of the issues that we're talking about, but I think Sarbanes was the galvanizing event. It forced organizations to step back and address their whole internal control structures and to look at their corporate governance activities. Sarbanes clearly was the catalyst.

PROFESSOR CONSTANCE BAGLEY (Harvard Business School): There has been mention of the question of rules-based systems versus just having general principles, a question which has certainly been bandied about a lot. Why does that tend to be discussed as an either/or choice? Could we, on top of the rules base, overlay something akin to the "true and fair" that you see in Britain, so that an accounting firm and the audit committee would have to determine not just whether they followed the specific rules, but would have to step back and see if the transaction in reality is something that is being accounted for the proper way?

MR. CROOCH: My position on this is that the rules-based standards that we have in the United States have been demand-driven as opposed to us providing them as a part of

the supply. When we put out documents that we propose for our exposure drafts, we increasingly try to make sure that we know what the objective of the standard is and we increasingly try to have enough guidance in the standard so that people will be able to apply it. We frequently get long lists of questions from all kinds of constituencies and they ask us to answer in the standards. Auditors, preparers, and others get great comfort from the fact that they can point to something that says "this is the way that you have to do this particular transaction in this particular set of circumstances."

Prior to Sarbanes-Oxley there was a problem. You had CEOs and CFOs that would say to their auditor, either "Show me where it says that I have to do it that way" or, "Show me where it says I can't do that." If you're the auditor you certainly will try to convince your client to do something a certain way but it's a lot easier if you're able to show him or her by saying, "Well, can you understand English? Read this right here." There was a tremendous amount of demand for that kind of language.

In addition, for a long time the SEC went through what I've described as their rule-making stage. It was something along the lines of, "My way or the highway." There was not a great deal of sympathy for preparers and auditors working through an accounting issue who came to a reasoned professional judgment that they felt reflected the economics in accordance with the accounting literature. They would for whatever reason find themselves in front of the SEC and the SEC would say, "Nope, that's not the right answer. And, by the way, you have to restate." Now, you don't have to do that many times before you want to be sure that you have enough rules in front of you that you could point to something that can convince them that you were right.

As you might suspect, I've talked about this a lot. We are to blame because we have succumbed to giving answers when we probably should not have done so. But we do not

sit around trying to think up new questions to send, saying "You know, I think it would be fun today if we screw over the public accounting profession. Let's put out something that's different from the way they think it is and see what happens." We don't do that. I'm sure they think we screw them over sometimes but it's not because we're trying to. We're honestly trying to react to what the market asks us for.

PROFESSOR BRATTON: George Diacont, is it really "my way or the highway" over at the SEC accounting office?

MR. DIACONT: Well, the SEC has statutory authority to establish accounting principles. So it's absolutely the case that if the SEC decides that a particular matter is Generally Accepted Accounting Principles, they have the legislative authority to enforce it. But how that legislative authority is administered and practiced varies from commission to commission. I spent 25 years at the SEC dealing with investigative and prosecutory matters and I can say that over the years the SEC has largely deferred to the accounting profession in the establishment of accounting standards. I only know of two instances where the SEC said, "There are no accounting standards in this particular area. We don't like what's there and we're going to establish our own GAAP standards." The SEC does interpret a lot. When there is a question, the major accounting firms will come to the chief accountant and ask for his determination based on certain facts and circumstances. But most of the chief accountants, and most of the commissions that I'm familiar with, have operated within the framework of the accounting profession that establishes those standards.

But the question that I really want to answer is whether there should be an overlay, an overlay that presents fairly not just whether something complies with Generally Accepted Accounting Principles. I would argue that we already have such an overlay, at least as far as the auditing profession is concerned. The profession has an obligation

under the auditing standards to determine whether the financial statements are fairly in accordance with Generally Accepted Accounting Principles. The problem when you're trying to figure out whether or not a company complies with Generally Accepted Accounting Principles is that the accounting principles are not very precise in a lot of instances. Very few of them are binary, telling you that if you do this you comply with GAAP. The determination of whether the accounting complies with GAAP is done within the context of particular facts and particular circumstances. I heard this debate of whether we should have principle-based accounting or whether we should have rules-based accounting. I always thought that we had a combination of both. Up until now it depended on which GAAP standard you looked at. I don't think it's going to matter one way or the other, at least as far as what the investing public cares about and that's fraud. Regardless of whether you're dealing with principles-based accounting or rules-based accounting, someone who wants to make the financial statements look better than they are can manipulate those statements in a way that makes them fraudulent. The folks that say that there is going to be some panacea--that if we go to principles-based accounting it's all of a sudden going to be a euphoric situation--they're kidding themselves because it's not going to be a solution to it.

PROFESSOR JAMES COX: My question is for Michael Crooch: what changes have you witnessed inside the FASB since the passage of Sarbanes-Oxley in terms of your deliberations, energy levels, and agendas?

MR. CROOCH: What has happened recently is that we have shortened some of our time lines with regard to issuing standards. Only time will tell if that is a good thing. Before I was there, the FASB would get letters from several organizations saying that we were too slow. "How could it possibly take you so long to put out such and such a rule?" Now, we're getting comments that, "You're doing this too fast. Don't you have to look at it more and study it some

more before you put this out?" But the system is under a tremendous amount of pressure. In addition to trying to solve the accounting problems that we're working on and in addition to Dennis Nally trying to work on the audit side, corporate managers have been terribly stressed. They're trying to be sure that they get all of the things in place that have to be in place. As a result, I sense that the entire system is under a lot of stress. Everybody believes that they need to get it right, and that's what everybody wants to do. It creates stress to make sure that the audits are done correctly, that the accounting standards have been interpreted correctly, that you get them out on a timely basis, and that they work the first time. There's also stress because people are having a hard time applying them. There is also stress to make sure that you've pushed all of these approvals through the organization so that when the CEO and the CFO have to sign this thing and say, "Everything is all right," they have the assurance of their people. There's a lot in Sarbanes-Oxley that has stressed the system.

AUDIENCE MEMBER: Whenever there are allegations of a failure to disclose a material fact in a disclosure the immediate thought of many lawyers, especially on the plaintiff side, is to bring in the accounting firms because they should have had something to do with that failure to disclose; and these lawsuits seem to be proliferating. Now we have this idea of additional regulations and oversight, which in turn would create further rules that could create more exposure. How would that impact on liability? You've talked about fraud as one of the areas where you don't get involved and the companies don't get involved and they shouldn't get involved, because you can't uncover everything. Would accountants ever propose going one step further, doing investigative forensic accounting—because accountants are going to be sued in many cases anyway for these disclosures? That's the thinking of a lot of law firms. What are the solutions? What are the alternatives for accounting firms concerning these increasingly difficult problems regarding liability in the

future?

MR. NALLY: You're absolutely right that it's a critical issue facing all of the firms in this profession. Whenever there is a material fraud, the audit firm is normally going to be there, the last one in line with the checkbook open dealing with the litigation that stems from that. So whether we like it or not, we are, in fact, being held accountable for that detection—or lack thereof. So I think in order to effectively deal with this as an issue there has to be a clear understanding of what it is an auditor does to detect fraud under the existing standards and we need to have a clear understanding as to what the auditor could do in situations where it may make sense to do more from an audit standpoint. For example, there are certain organizations that when you look at the company's business model, its internal control structure, its tone at the top, and the focus of their business, you may find that they create opportunities to let fraud take place in that organization. If that's the case, what procedures should the auditor deploy? Does it make sense to have forensic auditors as a part of that team? How about special procedures? I think that's the next step, the next evolution of this discussion, which is: what should the standard be in those situations? We also must try to get agreement with the standard-setters regarding the standards that the audit firm would deploy to actually deal with the whole question of litigation in those situations. The issue of liability is one of the top issues facing this profession going forward. Today, cost of litigation is my firm's second largest cost component, right after people. Five years ago it never even made the radar screen. So, the future viability of these firms is really in jeopardy if we don't deal with this issue.

MR. CROOCH: Also, if you really want firms like Pricewaterhouse Coopers to look for fraud, the price tag would be enormous. On top of that, if you get a circumstance where five or six people agree to collude to fool the auditors, they won't find it; it just can't be done.

MR. ROGER CONNER: To what degree did the rising emphasis on short-term share price over the last 10-15 years act as one of the driving forces that has led to what are now seen as shady accounting practices? Especially, Professor Sunder, I'd like to ask about the extent to which that and the change in the market for accounting services has contributed to this, because it seems there may have been a feedback loop. That is, if the accounting firm cooperated with those attempting—intentionally or unintentionally—to manipulate short-term share price there was a feedback loop, but it wasn't a good one.

PROFESSOR SUNDER: I think your question relates to the rules versus standards issue. There are institutional consequences from the belief that people have come to have in the efficacy of written accounting standards. The usefulness and value of written standards or the belief in such usefulness that is widely held today was not held 50 or 70 years ago. When the term "Generally Accepted Accounting Principles" came in to vogue more than half a century ago there were very few written standards. "Generally accepted" literally meant generally accepted. Today the same term, "generally accepted," has come to mean something which is quite different from the plain English meaning. "Generally accepted" suggests a socially acceptable norm, rather than a fortified body of rules. Yet we don't think twice when we describe the collection of rules written by FASB or ISB as Generally Accepted Accounting Principles. But they are written, enforced accounting principles; these are not necessarily generally accepted and that's part of the problem, in that we have come to rely on this. The other part is the demand from auditor and client relationships. We have a false belief today in the value of reducing alternatives. There is a very broad consensus that if somehow you have a set of accounting rules for general acceptance, with fewer alternative ways of treating a given transaction, it's a better system.

PROFESSOR BRATTON: I would like to redirect

the question to Dennis Nally: Was there a client-based demand that you experienced in the late 1990s that was driven by short-term stock price considerations? Was there a change between 2000 and 2003 in the impact of that demand?

MR. NALLY: If we all think back to 1995 through 2000, there was much reference to the new economy, new age companies, dot com this, and dot com that. The pressure on organizations to meet analysts' expectations of short-term earnings and quarterly earnings was absolutely remarkable. We were going through a period of tremendous growth. We would have a company that was expected to report earnings of \$1.20 a share. They would roll up their numbers and they would come out to \$1.18, and the company would have some analyst ready to downgrade their stock because they missed their earnings by two cents. That downgrade could mean a 25 to 40 percent decline in market capitalization. Does that create pressure on an organization? It absolutely does. But I'll tell you what's really ironic to me as an independent auditor. When a company reports \$1.20 a share, there are a lot of judgments that go into reporting that figure--estimates, accounting policies, principles, practices, and so on. For shareholders to discount a company's stock by 25 percent because it reported \$1.18 versus \$1.20, suggests to me that they really don't understand what's going on in that company. I think that's what really created a lot of problems.

But to sit there and say that this influenced how auditors thought about their role and responsibility is absolutely not the case. The real issue is determining the quality of a company's earnings. Whether the company reports \$1.18 or \$1.20, it's incumbent upon the auditor to evaluate the quality of those earnings. If they're making adjustments to reserves or other judgments, how does that impact the company's earnings? How do they report that information externally? Are they being transparent with that communication to the public? I think it's the job of the independent auditor to do that and if they're doing their job

well those issues get flushed out the right way.