Auditor Independence Forum
New York University Stern School of Business
Sponsored by the Audit Committee Consulting Team LLC
May 10, 2004

On May 10, 2004, NYU's Stern School of Business, Vincent C. Ross Institute of Accounting Research and The Audit Committee Consulting Team, LLC (ACCT) hosted a forum on auditor independence. The topic was timely because of the major audit failures and the loss of the public confidence in auditors and accounting firms. The Sarbanes-Oxley Act of 2002 ("Sarbanes") changed the way corporate America approaches auditor independence and governance. The panelists were from many different parts of the financial world and included Melvyn Weiss from Milberg, Weiss, Bershad, Hynes & Lerach, John O'Connor from PricewaterhouseCoopers, LLP, John H. Biggs former CEO of TIAA-CREF, Thomas J. Ray from the Public Company Accounting Oversight Board (PCAOB) and Art Siegel formerly of the previously functioning Independence Standards Board. Mark Lilling of ACCT, Professor Seymour Jones, Professor Teresa John and Professor Joshua Livnat of New York University were the moderators.

ACCT was represented by Mark Lilling, an auditor, peer reviewer and advisor to boards of directors. He initiated and sponsored the program because of his interest in challenging the current performance of auditors and restoring their role as trusted professionals. ACCT is a private, independent firm comprised of independent Certified Public Accountants who provide accounting and auditing consulting services to boards of directors. Sarbanes gave boards of directors and audit committees greater authority and ACCT professionals help these members meet their fiduciary responsibility to the public and regulatory agencies.

The Vincent C. Ross Institute of Accounting Research was established to advance accounting research and the exchange of ideas about accounting and related disciplines where financial executives, professional accountants, regulators and academicians work together to advance accounting principles and practices.

Thomas Cooley, Dean of the Stern School of Business, opened the conference by expressing the importance of the investing public having confidence in audited financial statements. He also discussed the role of the academic community in challenging the auditing profession and regulators to develop a system that will restore faith in financial reporting. Dean Cooley spoke of the increased responsibility of business schools to integrate courses on ethics in their curriculums.

Melvyn Weiss, a renowned class-action litigator, who has recovered billions of dollars for his clients, challenged the auditing profession. Mr. Weiss stated that "looking for fraud" should be the responsibility of auditors, and thus included in the scope of the audit function. He further proposed that courses in fraud detection become mandatory for CPAs. He stated that Generally Accepted Accounting Principles "GAAP" and Generally Accepted Auditing Standards "GAAS" should be regulated outside of the accounting profession. Mr. Weiss demanded auditors to be economically responsible for their errors and be required to reimburse the shareholders for their losses.

The next speaker was John H. Biggs, the former Chairman and Chief Executive Officer of Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF) who is also an audit committee member of two Fortune 500 companies. Mr. Biggs spoke about his experience as a CEO and his relationship with auditors.

During his term as CEO he insisted auditors be rotated on a regular basis and believed that a new firm brought a different perspective to his company. Sarbanes shortened the period of partner rotation on engagements, but stopped short of making audit firm rotation mandatory. Mr. Biggs also spoke about Sarbanes requiring the auditors to report directly to the audit committee.

Mark Lilling addressed the recent history of audit failures and highlighted the fees received by auditors for both audit and non-audit services. He spoke about the importance of the role of auditors in capital markets and how public and investor confidence in the fairness of financial reporting is critical to the effective function of these markets. The importance was highlighted by the fact that the New York Stock Exchanges global market capitalization is approximately 18 trillion dollars. Confidence in these markets is based largely on the expectation that auditors are fair, impartial and independent. Audits of public companies became mandatory when Congress passed the Securities Act of 1933 while trying to improve the public's confidence after the stock market crash. Mr. Lilling stated that Congress considered creating a government agency to perform the audits, but instead gave an "exclusive franchise" to certified public accountants and that today the vast majority of the 17,000 public companies are audited by a dozen auditing firms. With this franchise came a responsibility to the investing public. Mr. Lilling discussed the inherent problem that payment for services is made by the client directly to the auditor raising the issue that the amount of direct fees for audit work could influence the formation of opinions. A 1999 study by the Independence Standards Board concluded that some level of impairment exists, but it is acceptable. The current negative perception of audit firms is due to the major audit failures, the collapse of Arthur Andersen and the recent prohibition of Ernst & Young LLP from accepting new audit clients for six months because of a business relationship with a client.

Art Siegel, the former director of the Independence Standards Board, discussed why the Securities and Exchange "SEC" rules failed to provide effective guidelines for auditors to use in deciding what constitutes independence. He acknowledged that we currently have a system in place that has done a "pretty good job" in maintaining auditor independence, particularly with the improvements made by the SEC in 2000 and again in 2003 to implement Sarbanes. The improvements have prevented many potential abuses, and in a number of areas have provided auditors with "clear guide lines". However, although this system has worked well, it can be improved.

Mr. Siegel stated that in his view our rule-based system gives little attention to rationale, thus creating a lack of incentive to consider the implications of situations not covered by the rules. It is, unfortunately, an environment in which people think, "if it is not prohibited, it must be permitted." This would be regretful under any circumstances, but it is particularly dysfunctional today. Mr. Siegel suggested that we need agreed-upon objectives and standards. An important by-product of such articulated objectives and standards would be to assist audit committees in discharging their responsibilities by giving them the right tools to do their job.

Mr. Thomas Ray, the Deputy Chief Auditor of the newly created PCABO, who formerly was a standard setter at the American Institute of Certified Public Accountants (AICPA) and a former partner at KPMG LLP was the next speaker. He discussed the difficulties encountered in creating the PCAOB. Mr. Ray addressed the role of the PCABO as the new creator of auditing standards for public companies, and outlined the recently issued standard on reporting internal control. The requirements of independence are predicated on four basic principles: (1) an auditor must not act as management or as an employee of the audit client, (2) an auditor must not audit his or her own work, (3) an auditor must not serve in a position of being an advocate for his or her client, and (4) an auditor must not have mutual or conflicting interests with his or her audit client. The standard also states that an auditor must not accept an engagement to provide internal-control-related services to an issuer for which the auditor also audits the financial statements, unless that engagement has been specifically pre-approved by the audit committee. Maintaining independence, in fact and appearance, requires careful attention, unless the auditor and the audit committee are diligent in evaluating the nature and extent of services provided, the services might violate basic principles of independence and cause an impairment of independence in fact or appearance.

John O'Connor, Vice Chairman-Services Leader, PricewaterhouseCoopers LLP had the interesting role of defending the public accounting profession. Mr. O'Connor spoke about his firm's changing role and that they now report directly to audit committees. He gave examples of how audit committees are approaching their relationships with auditors and are spending more time listening to the auditor's opinions. He also acknowledged that his firm and other large auditing firms are standing up to management and currently meeting their responsibilities to the public. He argued that mandatory auditor rotation was not acceptable because of the start-up costs associated with changing auditors. Mr. O'Connor also disagreed with Mr. Weiss in regard to auditing for fraud and the source of accounting standards.

The audience of over 130 enthusiastic people had challenging questions for the panel with PricewaterhouseCoopers bearing the brunt of hostile questions about auditor's recent performance. John O'Connor had to respond to why the auditing profession had failed the public. Questions included "what is the diagnosis of the problem?, and is risk- based auditing just a reason for large firms to do less work?". An audience member accused the auditors of "intellectual dishonesty".

After a short break and continuing conversation between the audience and panelists, Shyam Sunder, of Yale University and Joshua Ronen of NYU's Stern School of Business presented their academic approach to auditor independence.

Professor Sunder suggested that the decline in auditing performance related to a lack of growth in the profession in the 1970's and the concurrent lifting of the advertising ban by the profession at the insistence of the government. Increased competition resulted in decreased profits, creating incentives for shortcuts to achieving growth and profitability.

Increased competition resulted in decreased profits for audit firms, creating incentives for shortcuts to achieving growth and profitability.

Professor Sunder also proposed a move towards a closer alignment of tax reporting with reporting under GAAP. Professor Sunder suggested that congruence between tax and accounting audits would result in improved compliance, and provide reduced opportunities for fraud. Under the current system, managers are motivated to inflate earnings and minimize current tax expense. If tax and GAAP are consistent, inflated earnings will bring real costs to the company, causing managers to be more conservative in reporting earnings that are soft and not likely to be realized.

NYU's Professor Ronen's idea for failed audits is insurance. He has proposed "financial statement insurance", a proposal he claims is rooted in sound economic theory.

In a principal/agency setting, incentive contracts are designed to maximize the objective function of the principal. In publicly traded corporations, the Principal's (Management) objectives are not aligned with those of the shareholders. Thus the contractual agreement with the agent (auditor), fails to incorporate the objectives of the shareholders. Ideally, the Principal would be the shareholder. However, diffuse ownership makes this impossible. If the Principal is an insuring body for financial statement fairness, contracts can be designed such that the agent's (auditor's) performance will maximize the objectives of the insurer. The objectives of the insuring body can be closely aligned with those of the shareholder. This is an intriguing and revolutionary concept.

The audience had numerous questions about the practicality of the two academic solutions stating that the insurance industry will never take the risks associated with guaranteeing the fairness of financial statements and that the cost of such insurance would make it prohibitive. The audience challenged Professor's Sunder's conclusion that increased competition in the auditing profession caused the standards to fall. Mark Lilling noted that the accountant's exclusive franchise was so valuable that the auditors could not help but be profitable, all they had to do was do their job and there would be adequate profits and growth.

The conference was an opportunity for a divergent panel and audience to debate and discuss the issues. It was clear that the audience was disappointed in the auditors recent performance and that they felt that auditors must be held to a higher standard in the future. Mark Lilling ended the conference questioning the audience about their view of the future of auditing. The audience responded with some pessimism, but in general, there was confidence in the future role of auditors.