Is the Current Structure of the Auditing Profession Adequate for

The Needs of our Economy?

Leonard N. Stern School of Business

Vincent C. Ross Institute of Accounting Research Roundtable

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The best kinds of research and practice brought together in one place….exemplifies what Stern is all about. Lee Sproull, Vice Dean, NYU Stern

To set the stage for a discussion of the current structure of the auditing profession and its implications for the economy, a comparative analysis of the percentage of firms audited by the "Big-N " was presented by Joshua Livnat, NYU. "N" in recognition that ***"The Big"*** has changed over the years. The percentage of firms audited by the Big-N decreased over the past two decades from approximately 80 to 65 percent. For firms below $100 million cap, the decline for big N has been close to 50%, with an equivalent increase for the small and mid-size accounting firms. However, for firms above $100 million cap, the percentage has remained relatively stable.

Will the Big-N increase, and is there sufficient competition in the auditing profession?

Cono Fusco of Grant Thornton, remarked that the time and resource consumption related to changes in the Post-Sox period have created a need for firms of all sizes to re-assess, realign, and allocate their resources more efficiently. The reduction by large firms of their client base is for the most part, unrelated to risk. Capacity constraints have been the driving force. Firms of all sizes are competing for segments of the market for which they are best suited, and it is believed that ultimately market pressures will determine the size and number of auditing firms.

"How big is too big?" and what are the consequences thereof?

In defense of "Big", Carmine DiSiblio of Ernst & Young noted that the growth of multi nationals and global regulations require a global footprint that only large size firms can support. It is also a fact that the client base of the Big-4 include many domestic firms. There was a consensus of opinion that one of the main factors hindering the ability of mid to smaller size firms to compete for these clients are the onerous rules regarding "independence". The "independence" rules have created barriers to entry. The auditing profession is not, by design, anti competitive. Competition is fierce for the top 100.

Does being "Big" translate into getting away with it because of the economic consequences of the "fallout" of another "Big Failure"?

Fear has been a motivating factor in getting the audit profession to do their job. Representatives of both the PCAOB (Charles Neimeier) and the SEC (Walter Ricciardi) assured participants that large firms do not receive preferential treatment. The SEC has the "ammunition", will use it if necessary, but much prefers to hold their fire. They currently have 160 investigations pending.

John H. Biggs[1]of NYU noted that there has been a tremendous change in leadership attitudes. An indication of which, in his recent experience, has been that Joint Ventures must now "settle" for a smaller size audit firm.

Is there a sufficient number of trained auditors in the economy?

Dan Noll of the AICPA presented the results of a recent AICPA research project[2] the highlights of which were:

- Both enrollments in and graduation from accounting programs continue to rise
- Racial minorities accounted for 23% of Bachelor's degree graduates, 21% of Master's graduates and 38% of PhDs.
- Firms hired 17% more new accounting graduates in 2004 than they did in 2003, of which 23% were minorities.
- The demand for accounting PhDs is almost twice the supply.

Although the statistics look promising, it does not answer the question of here and now. Representatives of the auditing firms said the individuals they are currently hiring are intelligent, well trained, and more sophisticated than in the past. Participants commented that the early retirement of mature, experienced auditors at a relatively young age, creates a loss of human capital with serious consequences. It was suggested that audit firms reassess their hiring and retirement policies to avoid the brain drain of the "*snow on the roof, fire in the belly*" generation.

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> *Structure is the manner in which parts are arranged or combined to form a whole; something made of a number of parts held or put together in a specific way.*

When applied to the auditing profession, the "*parts*" are not confined to the number or size of CPA firms. If we are to determine the adequacy of a "*structure*", the first step in the process must be to identify the *parts*, review the *arrangement*, and analyze the *links* that hold them together.

The addition of the PCAOB has been the only structural change in recent history. In general, participants agreed that the PCAOB has been successful in improving the pre-Enron culture by reviewing things that were not looked at before, including, but limited to, tone at the top, reward systems, assignment of responsibility and governance issues.

Charles Niemeier (PCAOB) believes that fear of liability has been the motivating factor in getting auditors to do a good job. PCAOB inspections have found considerable improvement in compliance with the standards, auditing and better risk assessment.

The independence rules, which can be defined as *part* of the structure, prohibit auditors from expanding the scope of their measurement process, oft times resulting in bad measurement. Miklos Vasarhelyi of Rutgers, suggested that permitting auditors to expand the scope of the measurement process, including wider sets of measurement, codification of non-financial

[1] Former chairman TIAA-CREF

[2] *The Supply of Accounting Graduates and the Demand for Public Accounting Recruits*, AICPA 2005

measures[3], and provide some assurance service will improve and stabilize the current structure. Auditing bad numbers serves no useful purpose.

The application of innovative technology, e.g. real-time auditing would be an innovative step toward restructuring the flow of information by strengthening the *links* between the parts. In reviewing the current arrangements and the links that connect them, a question was raised as to the efficacy of the long-established separation of the Standard Setting body, the FASB, and the Auditors of the Standards. A topic worthy of research.

> "…other industries…strive to distinguish themselves by quality of product or service, the accounting profession seems strangely insulated from a "race for the best". Their only way to distinguish themselves… is by size…There are economies of scale, but the Big Five firms are bogged down by a complex and unruly web of hierarchies and alliances.
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> The first step would be to scrap the uniform …audit report….such audit reports would be differentiated by scope, by depth, and the capabilities of personnel." Baruch Lev, WSJ January 22, 2002

Litigation has long been an impediment to innovation, and the foregoing suggestions could conceivably open the flood gates of legal action. Joshua Ronen calls for putting a cap on auditor liability His innovative proposal would reform the auditor-client relationship and the structure of the auditing profession. Professor Ronen's proposal[4] would have the audit firm incorporate as an audit risk insurer [ARI] for the purpose of assuming the liability for GAAP deficiency damages resulting from restatements. The premium, which would be a function of internal controls, will signal the quality of the company as well as increase competition. If auditors could compete on the dimension of quality we have better quality and better assessment of risk.

An interesting question was raised during the discussion: "If we have International Accounting Standards should we also have International Auditing Standards?" Seymour Jones of NYU, commented that existing cultural differences do not lend themselves to uniform auditing standards. What may appear in *principle* to be a good idea may not be appropriate in *practice*.

Brendan Dougher, representing PricewaterhouseCoopers, LLP, concluded the discussion by noting the progress the auditing profession is making under the Sarbanes-Oxley legislation. There was a consensus among Roundtable participants that the audit profession has "stepped up to the plate", and are taking their responsibilities very seriously. There was also deep concern relating to the barriers to entry created by the independence rules, and the dark shadow of litigation that has clouded innovation and progress.

The Roundtable was made possible through the generous support of PricewaterhouseCoopers, LLP and Grant Thornton LLP.

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[3] The Enhanced Business Reporting (EBR) Consortium is leading the effort to improve the quality, integrity and transparency of non-financial information. The new model's focus won't be on historical information, but on information that delivers a broader view of a company's current and future performance

[4] "The Public Auditor as an Insurer of Client Restatements: A Radical Proposal for Reform", Joshua Ronen and Kenneth A. Sagat, Journal of Accounting, Auditing and Finance, forthcoming Summer 2007.