Public Accounting: Profession or Business?

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Debates are the order of the day in the United States this month, and we've already witnessed two debates between our presidential candidates and one between our vice-presidential candidates. After what I've observed, I want to assure you that in my remarks today, I'll stay "on message," as the not-entirely-felicitous saying goes, that I will answer directly and forthrightly all questions that may be asked, that I have been given no clever one-liners by my staff, and that I will neither smirk nor sigh when my worthy opponent, if an opponent he be, has the floor. I hope this sounds like progress!

In this debate on the future of the accounting profession, I'm going to focus largely on the issue of auditor independence. While I have no business degree nor attest certificate, I've pored over more than my share of corporate and mutual fund financial statements. And while I have never worked in a controllership or treasury function nor have I been trained as a security analyst, I have been both an eye-witness to, and active participant in, the sweep of financial history over the past fifty years and have accordingly garnered a considerable amount of study and experience in virtually all phases of American finance. Through this experience, I have developed a passionate concern about the well-being of our financial markets, and this evening I'd like to discuss my views with you. (I am, of course, speaking for myself and not for any of the organizations with which I am associated.)

The integrity of financial markets—markets that are active, liquid, and honest, with participants who are fully and fairly informed—is *absolutely central* to the sound functioning of any system of democratic capitalism worth its salt. It is only through such markets that literally trillions upon trillions of dollars—the well-spring of today's powerful American economy—could have been raised in the past decade that became capital for the plant and equipment of our Old Economy and the capital for the technology and innovation of our New Economy. Only the complete confidence of investors in the integrity of the financial information they received allowed these investment needs to be met at the lowest possible cost of capital.

Sound securities markets require sound financial information. It is as simple as that. Investors require—and have a right to require—complete information about each and every security, information that fairly and honestly represents every significant fact and figure that might be needed to evaluate the worth of a corporation. Not only is accuracy required but, more than that, a broad sweep of information that provides every appropriate figure that a prudent, probing, sophisticated professional investor might require in the effort to decide whether a security should be purchased, held, or sold. *Full disclosure*. *Fair disclosure*. *Complete disclosure*. Those are the watchwords of the financial system that has contributed so much to our nation's growth, progress, and prosperity.

Independence

It is unarguable, I think, that the independent oversight of financial figures is central to that disclosure system. Indeed independence is at integrity's very core. And, for more than a century, the responsibility for the independent oversight of corporate financial statements has fallen to America's public accounting profession. It is the auditor's stamp on a financial statement that gives it its validity, its respect, and its acceptability by investors. And only if the auditor's work is comprehensive, skeptical, inquisitive, and rigorous, can we have confidence that financial statements speak the truth.

Our government, our regulators, our corporations, and our accountants have, over this long span, properly placed the auditor's independence from his client at the keystone of our financial reporting system. And auditor independence has come to mean an absence of any and all relationships that could seriously jeopardize—either in fact or in appearance—the validity of the audit, and, therefore, of the client's financial statements. The auditor, in short, is the guardian of financial integrity. On the need to maintain, above all, this principle of independence, I hear not a single voice of dissent—not from the corporations, not from the profession, not from the regulators, not from the bar, not from the brokers and bankers—the financial market intermediaries—and not from the institutional investors who, as trustees, hold and manage the securities portfolios of their clients. So far, so good.

But being for independence is a bit like being for God, for motherhood, and for the American way. For the relationship between auditor and client is complex—beginning with the fact that it is the client who *pays* the auditor for its services, creating an interdependency that is anything *but* independence. Long ago, we made a societal decision to accept that conflict because, simply put, we couldn't figure out any arrangement that was better. A system of mandatory audits by a Federal agency, for example, would probably have been intolerable even to those most disposed toward using government as the first line of attack in dealing with any other national issue.

So over the years we've developed a whole series of structures and safeguards to minimize the susceptibility of the audit firm to the dominion of the client, and put in place requirements designed to assure that the auditor remains free of entanglements that threaten his objectivity and independence. But as times have changed, these issues have become increasingly complex, and the entanglements have become more numerous. In 1997, in part as a response to these developments, Securities and Exchange Commission Chairman Arthur Levitt, in concert with the American Institute of Certified Public Accountants, established the Independence Standards Board (ISB), giving it the responsibility of establishing independence standards applicable to the audits of public entities, in order to serve the public interest and to protect and promote investors' confidence in the securities markets.

The ISB

By agreement, the initial membership of the ISB consisted of four members from the accounting profession and four public members, one of whom would serve as Chairman. The same eight individuals who joined the Board in 1997 continue to serve today, and I have been privileged to serve as one of the public members. After nearly three years of meetings with my public colleagues, let me assure you that there can be no question of their staunch and complete independence, to say nothing of their integrity, their intelligence, and the dedication that they have brought to their task. *Business Week* recently stated that most of the Board members were "tied to" the profession, implying that one or more of the public members was less than independent. When I challenged its editors to specify the party or parties involved and describe any inappropriate bias, the inane allegation was promptly withdrawn. The independent members *are* independent.

While the four non-public members are of course members of the profession, I can tell you that in three years of working with them I have developed a high respect for the integrity, intelligence, and dedication they too have demonstrated. Of course their point of view is hardly independent of their professional interests, but it is a serious, respectable, thoughtful, informed viewpoint, one that has helped the public members better understand, not, I think, the principles involved, but the complex issues involved in implementation—in taking sound and fair actions that give force to the principles.

I came to the Board with but a single preconception: A growing concern that the many of the great professions that have served our society so well are moving rapidly toward becoming businesses, a trend that, if taken to the extreme, would undermine the sound and durable principles on which they were founded. In the dog-eat-dog, money-driven, competitive world in which we live today, I suppose it would be surprising were it not so. And surely many benefits have resulted: A greater appetite for enterprise growth, likely greater efficiency and organizational certainty, perhaps even greater creativity and innovation. Such benefits are not to be disdained. But those benefits can carry a societal cost—a diminution of traditional standards, a reduction in focus on clients, and, at least in some fields, an increase in costs. But the heart of the matter is that there is a difference, however difficult to measure, between a business and a profession. When that line is crossed, we as a society are the losers.

Business vs. Profession

My concerns, as you might imagine, are not mere abstractions. As I observe the mutual fund industry, in which I've spent 50 years, I see it moving from a profession—investment management—to a business—product marketing. I see fewer mutual funds that focus on sound investment principles, and more funds—often higher-risk, aggressive funds—created to meet the demands of the marketplace for the transitory fads and fashions of the day—"hot new products," if you will. I see portfolio strategies based on short-term speculation rather than long-term investment, with an attendant quantum leap in portfolio turnover. And I see costs of management soaring primarily to fund massive advertising campaigns and only partly to enhance investment research and analysis. Fund expenses have risen almost in lock-step with assets, meaning that the lion's share of the truly staggering economies of scale inherent in managing money are being arrogated by the managers rather than flowed through to the shareholders. This diversion of investment returns means that the financial interests of the clients are being subordinated to the financial interests of their trustees, whose primary concern was once acting as good stewards for those who have entrusted them with their assets. It is not a big stretch to recognize a similar pattern—albeit in a very different way—in the medical profession, where the interests of the patient seem clearly to have been superseded by the interests of the care-givers—the insurance-industry/drug-producer/private-HMO complex.

I note the pervasiveness of the societal trend of professions to become businesses because it may help explain the similar trend in public accounting, though I would argue that the high standards of the attestation profession may, fortunately, have mitigated its full fruition. Nonetheless, over the years, attestation has come to account for only about one-third of the $26 billion of revenues of today's "Big Five" accounting firms, with tax services accounting for one-quarter. The remainder, not far from one-half of revenues, is derived from consulting, management, and advisory services. The potential problem that arises from this trend, obviously, is that the desire to garner or retain a highly-lucrative consulting contract from an audit client could jeopardize the auditor's independence. Admittedly, I have seen no independent studies which have directly associated audit failures with related consulting contracts. On the other hand, those relationships, if they exist, would be difficult to discover, and in any event causality would be impossible to establish. But as I testified at the SEC's hearings on Auditor Independence Requirements in July: "Studies cannot always confirm what common sense makes clear."

The SEC's Independence Proposal

The SEC's proposed Independence rule would, among other things, provide new—and often more appropriate—principles for determining whether an auditor is independent, largely tracking earlier standards established or being established by the ISB relating to investments in audit clients, family and employment relationships, and appraisal and valuation services. These enhanced and modernized standards seem to have generated little controversy, and I hold the view that the establishment and maintenance of such independence standards should remain the province of the ISB, and that the proposed rule-making in these areas is unnecessary.

The other principal rule amendment, however, has generated a firestorm of controversy. It identifies certain management and consulting services that, if provided to an audit client, would impair the auditor's independence. The services that the public accountant would be effectively barred from providing include those which involve either a mutual or conflicting interest with the client; the auditing of one's own work; functioning as management or an employee of the client; or acting as the client's advocate. Expressed as general principles, honestly, it is unimaginable to me that any reasonable person could disagree *in the abstract* that such roles would threaten—or, at the very least, be perceived to threaten—the auditor's independence.

It must also be clear that, whether or not the auditor has the backbone to maintain its independence under these circumstances, many management and consulting arrangements could easily be perceived as representing a new element in the relationship between auditor and corporation—a *business* relationship with a *customer* rather than a *professional* relationship with a *client.* Surely this issue goes to the very core of the central issue of philosophy that I expressed earlier: The movement of auditing from profession to business, with all the potential conflicts of interest that entails. So I come down with a firm endorsement of the *substance* of the proposed SEC rule, which would in effect bar such relationships.

Of course, I have read extensive material from the opponents of that rule making the opposite case. Some arguments seem entirely worthy of consideration, especially those relating to technical—but nonetheless real—issues that engender unnecessary constraints on an auditor's entering into *any* strategic alliances or joint ventures, or that relate to the complexity in clearly defining "material direct investment" or "affiliate of the audit client" and so on. Personally, I would hope and expect that this bevy of issues will be resolved by the profession and the Commission meeting and reasoning together.

But other opposition seemed to me to be rather knee-jerk and strident (rather like those debates I mentioned at the outset). No, I for one don't believe the SEC proposals represent "an unwarranted and intrusive regulation" of the accounting profession. And, no, I for one do *not* believe that the new rules "strait-jacket" the profession. And, yes, I do believe that the growing multiplicity of inter-relationships between auditor and client is a serious threat to the concept of independence, the rock foundation of sound financial statements and fair financial markets alike. In this context, I was stunned to see this recent statement from one of the senior officers of the investment company industry group for one of the Big Five firms. "Fund companies have increasingly looked to . . . big accounting firms to help them with operational, regulatory, strategic and international decisions." If that isn't functioning as management, I'm not sure what would be.

The Future of the Profession

While I am but a layman, I'd now like to comment on some issues that relate to the future of the profession. I begin by expressing not only my *hope,* but my expectation that public accounting will continue to operate successfully and in the public interest under the proposed SEC rules that prohibit the provision of most management and consulting services to clients. Doubtless, there are problems—serious problems—in determining the precise language and interpretation of the rules, but I'm enough of an optimist to believe that, in the environment of openness and good will on both sides, changes can be made without undermining the bedrock principle of the independence.

But there are other disturbing issues that affect the profession today, and I'd like to close by presenting just five of them. First is the question of basic accounting principles. Can the accounting principles that have served the Old Economy so well over so many years properly be applied to the New Economy? Is what is seen as a narrow accounting model applying to businesses with tangible capital equipment, hard assets, and even so-called "good will" applicable to businesses in which human capital is the principal asset, information is the stock in trade, and "first mover" status is the driving force in valuation? Clearly, many, indeed most, New Economy companies are valued at staggering—even infinite—multiples of any earnings that GAAP could possibly uncover. Interestingly, however, during the past seven months, at least the Internet business-to-consumer companies have reconciled that gap, as it were, in favor of GAAP.

So while that seemingly omnipotent master, "the stock market" may be telling the profession that the 1930s-based model of reporting doesn't work any more, please don't write off too hastily the possibility that the *model* may be right and the *market* wrong. And don't forget that no matter what "the market" may say today, its level on future tomorrows well down the road *will*—not *may*—be determined by earnings and dividends. Nonetheless, a re-examination of today's of basic accounting principles should be a high priority. And let the chips fall where they may.

Second is the question of earnings management. I noted in a speech a year ago, we live in a world of managed earnings. While it is corporate executives who do the managing, they do so with at least the tacit approval of corporate directors and auditors, and with the enthusiastic endorsement of institutional investors with short-term time horizons, even speculators and arbitrageurs—a "happy conspiracy" as I called it then. Like it or not, corporate strategy and financial accounting alike focus on meeting the earnings expectations of "the Street" quarter after quarter. The desideratum is steady earnings growth—manage it to at least the 12% level if you can—and at all costs avoid falling short of the earnings expectations at which the corporation has hinted, or whispered, or "ballparked" before the year began. If all else fails, obscure the real results by merging, taking a big one-time write-off, and relying on pooling-of-interest accounting (although that procedure will soon become unavailable). All of this creative financial engineering apparently serves to inflate stock prices, enrich corporate managers, and to deliver to institutional investors what they want.

But if the stock market is to be the arbiter of value, it will do its job best, in my judgment, if it sets its valuations based on accurate corporate financial reporting and a focus on the long-term prospects of the corporations it values. The market today seems to be focusing at least a bit more on those verities, but there is still much room for improvement. For while the accounting practices of America's corporations may well be the envy of the world, our nation's financial environment has become permeated with the concept of managed earnings. There is a "numbers game" going on, and *pro forma* operating profits permeate financial statements. *Pro forma* seems to mean, in an Alice-in-Wonderland-world, whatever the Corporation chooses it to mean, excluding such charges as amortization of good will, taxes on option exercises, equity losses in investees, in-process R&D, for example, as these costs vanish in the struggle to meet earnings expectations. Since this game is played in press releases, it is not clear where the solution lies. But I hope that the accounting profession will get involved before the coin of the realm—earnings statements with integrity—is further debased. That corporate clients may not be enamored of having the issue of managed earnings raised is—or ought to be—irrelevant.

Third is the stock option issue. Financial statements place options in a sort-of "no man's land" in which options are not treated as compensation. But, as Warren Buffett has long argued, if options *are* compensation, why aren't they charged to earnings? And if options *aren't* compensation, what are they? Surely the profession ought to play a more aggressive role in answering that question and taking a stand on proper stock option accounting. A recent study by a Wall Street firm listed four industry groups in which accounting for stock options would have reduced earnings by an average of 28% in 1997, 23% in 1998, and another 25% in 1999; 21 companies in which 1999 earnings would have been reduced from 50% to 700%(!); and 13 companies with 1999 *pro forma* (there's that word again) pre-tax stock option compensation ranging from $500 million to $1.1 billion. Quite important enough as an issue now, the question of accounting for stock options will rise to even greater importance as corporations whose stocks have faltered—even plummeted—in the recent market decline reprice their options. I hope that FASB interpretation 44 on repricing underwater options will help to deal with this issue.

Abusive Tax Shelters

The case of overly-aggressive and potentially illegal tax-shelters constitutes a fourth issue. Earlier this year, Treasury Secretary Lawrence Summers excoriated the proliferation of "engineered transactions that are devoid of economic substance . . . with no goal other than to reduce a corporation's tax liabilities." The Secretary is right: Such transactions strike a blow at the integrity—here, an especially well-chosen word—of the tax system. And when companies demand—and receive—"black box" features in such transactions designed to make them impenetrable to all but those who designed them, something perilously close to fraud is going on. He challenges, I assume accurately, the professional conduct of the firms involved in the creation of abusive tax shelters and suggests sanctions on firms—here, the Treasury Secretary pointedly included public accountants—that issue opinions, limits on contingent fees, and excise taxes on such fee income.

It is not my place to evaluate the role of the accounting profession in these tax abuses. But it must be clear that any firm that helps develop such schemes or opines on their purported validity wins favor with the client involved, and runs a heavy risk of compromising its independence. Faustian bargains of that nature, to the extent they may exist, could even require the addition of tax services to the list of services that public accounting firms would be barred from offering to their clients. Surely, that's a high price for public accounting firms to pay.

The fifth and final issue I raise regarding independence of the future of the profession relates to the novel forms of firm structure and organizations that are now evolving. (The ISB published a Discussion Memorandum on this subject a year ago, and has received numerous comments, but has tabled the issue at the request of the SEC staff.) The traditional simple partnership model is being supplanted by alternative business structures. In one model, a group of smaller attest firms are consolidated through the sale of their non-audit practice to a third party (in a private or public offering) with the audit practice retained by the partners. An operational link remains between the two parties. In another—the "roll up" model—firms are united under a single umbrella through combination and then sale of their non-audit businesses to a third party or the public. *Byzantine* is the word that comes to mind as one looks as the organizational charts portraying these relationships. While "Byzantine" isn't necessarily bad, such dual employment surely raises important independence issues. And when CPA firms—whose integrity and independence are their stock in trade—are in fact principally investment advisory firms offering financial products sponsored by their parents, a whole other set of questions about the meaning of *professional responsibility* come to the fore.

How attest firms respond to these independence issues—and indeed whether they do—will shape the future of the profession. Most of them are clearly framed by the over-arching issue of the proper place to draw the line between business and profession. But perhaps my comments are just the ramblings of an aging Luddite who wants to bring back a proud age of tradition that will never return. In my own mutual fund industry, I *know* that the age of professional stewardship will return. While I do not understand the field of accounting nearly as well, I am confident that if financial market participants come to understand that the independent oversight of financial figures plays a critical role in our system of disclosure, that independence is at the core of integrity, and that the integrity of our financial markets is essential to their well-being, the age of professional accounting too will shake off today's challenges and return to its roots.

Note: The opinions expressed in this speech do not necessarily represent the views of Vanguard's present management.