CALIFORNIA STATE UNIVERSITY, NORTHRIDGE

SELF-REGULATION AND THE ACCOUNTING PROFESSION

A graduate project submitted in partial fulfillment of the requirements for the degree of Master of Public Administration

by

Renate E. Wigfall

January 2007
The graduate project of Renate E. Wigfall is approved:

Warren M. Campbell, Ph.D.  

Christopher A. Leu, Ph.D.  

Henrik P. Minassians, Ph.D., Chair  

California State University, Northridge
DEDICATION

This graduate project is dedicated to my husband Elmore with whom I started and finished this journey. He is my partner and my best friend and has always been the "wind beneath my wings", especially for the completion of this paper. It was his support and encouragement along the way that helped me stay on course and finally succeed. I also dedicate this project to my son Jonathan and my daughter Stefanie, both talented writers who I know will accomplish great things in life.

I would also like to express my gratitude to the staff and faculty at the California State University, Northridge, Roland Tseng College of Extended Learning for their support and expertise in guiding me through this process. A special thank you to Dr. Warren M. Campbell and Dr. Christopher A. Leu for their support and patience along the way and especially to Dr. Henrik P. Minassians, the chair of my committee, for giving me guidance and sharing his knowledge and expertise.
TABLE OF CONTENTS

SIGNATURE PAGE ii
DEDICATION iii
LIST OF FIGURES v
LIST OF TABLES vi
ABSTRACT vii

CHAPTER I - Introduction 1
CHAPTER II - History of Accounting Self-Regulation 11
CHAPTER III - Industry Self-Regulation: A Public Policy 18
CHAPTER IV - Advantages and Disadvantages of Accounting Self-Regulation 24
CHAPTER V - Case Study - The Rise and Fall of Enron 28
CHAPTER VI - Opinion Survey and Results 37
CHAPTER VII - Recommendation and Conclusion 54
REFERENCES 58
APPENDIX 60
LIST OF FIGURES

Figure 1: SOURCE- GAO-02-742R ACCOUNTING PROFESSION ISSUES 4

Figure 2: ENRON Stock Price Daily Close 2001 - 2002 34
LIST OF TABLES

Table 1: Regulations Governing Publicly Held Companies 6
Table 2: Punishment for Poor Corporate Governance 7
Table 3: Effect on Holdings Due to Poor Corporate Governance 7
Table 4: Punishment for Poor Corporate Governance 17
ABSTRACT

SELF-REGULATION AND THE ACCOUNTING PROFESSION

by

Renate E. Wigfall

Master of Public Administration

Several large publicly traded companies recently admitted to misstating critical elements of their audited financial statements and subsequently filed for bankruptcy. The accounting profession has been deemed culpable for the $7 trillion investment losses that resulted after the stock markets reacted to the reported accounting frauds and bankruptcies. The large losses were mostly attributed to a failure of the self-regulating standards of the accounting profession.

On July 30, 2002 the Sarbanes-Oxley Act (also called the Accounting Industry Reform Act) was signed into law in response to this public policy issue. The Act is intended to improve the quality of financial reporting, independent audits and accounting services and to strengthen the independence of accounting firms. Restoring public confidence in the financial markets and the accounting profession, however, will require more than the passing of more new regulation. The Accounting Industry Reform Act increased the regulatory and oversight responsibilities of the Securities and Exchange Commission (SEC) which now faces various problems regarding the successful implementation of the government’s mandate. The Securities and Exchange Commission’s long history of inadequate funding coupled with tremendous regulatory
responsibility but very little final authority to sanction violators of SEC regulations has observers wondering if the new legislation will bring about the changes policy makers intended.

After researching the literature relative to the public policy issue of self-regulation and how it applies to the accounting profession, accounting and business students as well as accounting professionals from the private and public sector were interviewed to determine if the current system of self-regulation will be effective in accomplishing this goal. This research project determined that a change from the previously existing system of total self-regulation within the accounting profession was necessary, however, a change to direct government control is not recommended. The analysis further supports a model of self-regulation which takes into account the conditions under which different configurations of regulatory institutions, standards and enforcements practices can be applied to address the inefficiencies of the current system.
CHAPTER I
INTRODUCTION

A significant number of recent financial corporate scandals have led to public pressure to reform corporate business practices and increase industry regulation. Several large publicly traded companies misstated critical elements of their audited financial statements and subsequently filed for bankruptcy. As a result, the accounting profession has been deemed culpable for the $7 trillion investment losses that occurred after the stock markets reacted when the accounting frauds became public and many corporations filed for bankruptcy. The large financial losses were mostly attributed to a failure of the self-regulating system of the accounting profession. This graduate project will focus on the following questions: Is the current system of self-regulation within the accounting profession effective in preventing future fraudulent behavior and restoring public trust in American financial markets? Can the implementation of more regulation encourage socially responsible corporate behavior? And lastly, what are the advantages and disadvantages of self-regulation versus governmental regulation? In order to examine and research these issues, available public policy literature published by experts in the field was reviewed. In addition, opinion survey data relative to various aspects of accounting self-regulation was collected and analyzed. The research of the various aspects of this public policy issue and the analysis of the collected data has helped identify a model of self-regulation with adequate governmental oversight to ensure socially responsible corporate conduct, protection and support of the public interest and to foster a higher level of ethics in both public and private sectors.
In December of 2001, shortly after admitting to accounting errors that inflated earnings by almost $600 million, the Texas energy trading company, Enron Corporation, filed for bankruptcy protection. The company held $62.8 billion in assets and thus became the biggest bankruptcy case in U.S. history, even dwarfing the Texaco filing in 1987 with $35.9 billion in assets. On the day Enron filed for bankruptcy, the company's stock fell from $75 a year earlier to 26 cents per share. Many Enron employees lost their life savings and their jobs, and tens of thousands of investors lost billions of dollars.

The collapse of Enron Corporation however, was not the only large accounting fraud in the United States during this time period. WorldCom, a telecommunications company, admitted that $3.8 billion in expenses was improperly represented as capital investments, and joined companies like Dynegy, Computer Associates, Global Crossing, Quest, ImClone, Tyco and Adelphia who all admitted to misstating cash flows, debt burdens, losses, revenues, and earnings. Similarly to the Enron collapse, thousands of employees lost their jobs and their entire life savings which were tied up in company stock options while company executives received severance packages worth millions of dollars. Public confidence in capital markets declined to an all time low and the international financial community became very cautious as stock markets continued to suffer large losses.

In the attempt to identify the major drivers that caused the collapse of Enron and so many other publicly traded companies, Congressional Committees, the Security and Exchange Commission (SEC), the U.S. Justice Department and Enron's own audit firm, Arthur Andersen LLP, started the investigative process which ultimately concluded in
May 2006 with the conviction of top level Enron executives. The all too obvious conclusion was that Enron's top management and audit committee, the company's outside law firm, the auditors from Arthur Anderson as well as investment advisors all appeared to have a certain level of responsibility for the financial losses incurred by millions of investors. In a letter to Senator Paul S. Sarbanes, Chairman of the Committee on Banking, Housing, and Urban Affairs, David M. Walker, Comptroller General of the United States, expressed the extent of the problem:

"The issues surrounding the accounting profession's current self-regulatory system for auditors involves many players in a fragmented system that is not well-coordinated, involves certain conflicts of interest, lacks effective communication, has a funding mechanism that is dependent upon voluntary contributions from the accounting profession, and has a discipline system that is largely perceived as ineffective. Simply stated, the current self-regulatory system is broken and oversight of the self-regulatory system by the Securities and Exchange Commission (SEC) has not been effective in addressing these issues to adequately protect the public interest" (Walker, 2002).

The following diagram in Figure 1 illustrates the complexity of the system of regulation and oversight and the stakeholders who relied on the system and the information it provides.
In his letter, Walker further stresses the important role of independent auditors and various inherent problems in the self-regulatory system. Walker’s recommendations for direct government intervention along with the increasing political pressure from the investing public and other stakeholders resulted in new legislation. In July 2002, in response to this public policy issue, the Sarbanes-Oxley Act (also called the Accounting Industry Reform Act) was signed into law. The implementation of the new legislative act is intended to improve the quality of financial reporting, independent audit and accounting services, and to strengthen the independence of accounting firms. The Securities and Exchange Commission (SEC) and the self-regulatory organizations it oversees – both the New York Stock Exchange (NYSE) and the National Association for
Securities Dealers (NASD) have adopted new standards for public companies and securities dealers. In addition, the newly established Public Company Accounting Oversight Board (PCOAB) is working on reforming public oversight for auditors. Finally, state and federal enforcement agencies have aggressively pursued the prosecution against corporate executives and others accused of violating well established rules of the financial markets.

The act was hastily passed because of public pressure on the administration to increase regulation. Without the benefits of a thorough public policy analysis, many provisions are ambiguous and open to different interpretations. At this point it would be premature to assess if the Sarbanes-Oxley Act is the best solution for restoring public confidence and reliance on auditors’ statements regarding the financial health of publicly traded companies. The public reaction to the recent corporate scandals illustrated the need for reformed business practices and increased regulation. Restoring public confidence in the financial markets and the accounting profession, however, may require more than the passing of new legislation, improved auditing standards and effective law enforcement. A severe lack of ethical professional conduct by the accounting industry, within the corporations to which they provides services and in the public agencies responsible for regulating the industry appears to be the main reasons for the pervasive accounting practices which caused the large financial losses for millions of investors.

In a 2004, Cary Coglianese, Thomas J. Healey, Elizabeth K. Keating and Michael L. Michael co-authored a report titled, *The Role of Government in Corporate Governance*. The report was later issued by the Center for Business and Government, John F. Kennedy School of Government, Harvard University. In the report authors point
to another measure of public attention to this public policy issue: "In 1998, *The Economist* published no editorials devoted to corporate governance issues. By 2002, it published twenty of them, followed by 20 more in 2003 and still more in 2004" (Coglianese et al., p.1). The report further states, "These responses make clear that the governance of corporations has become a central item on the public policy agenda. The recent scandals demonstrate that lax regulatory institutions, standards, and enforcement can have huge implications for the economy and the public" (Coglianese et al., p. 2).

A Wall Street Journal Online/Harris Interactive Personal Finance Poll conducted in October 2005, found that despite the passing of the Sarbanes-Oxley Act three years earlier, more than half (55%) of U.S. investors think that the financial and accounting regulations governing publicly held companies are too lenient. The percentage increases to 77% among males between the ages of 45 to 54 (New Poll Shows, 2005). The following tables from the poll illustrates the survey results by age and gender in more detail.

**Table 1: Regulations Governing Publicly Held Companies - by Age and Gender:**

*Do you think that the financial and accounting regulations governing publicly held companies are too lenient, too strict, or about right?*

<table>
<thead>
<tr>
<th>Base: Investors</th>
<th>Male Age %</th>
<th>Female Age %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total (n=1,248)</td>
<td>18-34 (n=173)</td>
<td>35-44 (n=154)</td>
</tr>
<tr>
<td><strong>Too Lenient</strong></td>
<td>55</td>
<td>44</td>
</tr>
<tr>
<td><strong>Too Strict</strong></td>
<td>6</td>
<td>14</td>
</tr>
<tr>
<td><strong>About Right</strong></td>
<td>39</td>
<td>41</td>
</tr>
</tbody>
</table>

Note: Percentages may not add up to 100% due to rounding

The survey further found that regardless of government regulation, investors are more likely to believe that punishment for poor corporate governance should be directed
toward certain individuals rather than the corporation as a whole.

**Table 2: Punishment for Poor Corporate Governance:**

"In your opinion, should punishment for poor corporate governance be directed at....?"

<table>
<thead>
<tr>
<th>Base: Investors</th>
<th>Total %</th>
</tr>
</thead>
<tbody>
<tr>
<td>(n=1,248)</td>
<td></td>
</tr>
<tr>
<td>The Executives</td>
<td>48</td>
</tr>
<tr>
<td>The Board of Directors</td>
<td>42</td>
</tr>
<tr>
<td>The Company</td>
<td>10</td>
</tr>
</tbody>
</table>

Note: Percentages may not add up to 100% due to rounding

In addition, almost one third (30%) of investors say they have reduced or divested their holdings in a company as a result of poor corporate governance.

**Table 3: Effect on Holdings Due to Poor Corporate Governance - by Education:**

Has poor corporate governance ever caused you to reduce or divest your holdings in a company?

<table>
<thead>
<tr>
<th>Education (in percentage)</th>
<th>Base: Investors (n=1,248)</th>
<th>Total</th>
<th>High School or Less (n=145)</th>
<th>Some College (n=490)</th>
<th>College Graduates (n=613)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>30</td>
<td>23</td>
<td>33</td>
<td>35</td>
<td>65</td>
</tr>
<tr>
<td>No</td>
<td>70</td>
<td>77</td>
<td>67</td>
<td>65</td>
<td></td>
</tr>
</tbody>
</table>

Note: Percentages may not add up to 100% due to rounding

This graduate project will examine if effective government action, in the form of reformed regulatory systems, improved auditing measures, and the enforcement of existing laws will be sufficient to change business practices in order to prevent future corporate fraudulent behavior. In order to examine, research and discuss these issues, scholarly literature relevant to the public policy issue of industry self-regulation was reviewed. Extensive review of professional and academic journals relative to Public Accounting, Public Administration, and Corporate Governance further helped to analyze and answer the question of whether or not the implementation of stronger regulation
alone would be sufficient to effectively address the public policy issue of restoring integrity and public confidence to the American financial markets. In addition, survey results obtained through a questionnaire given to business students as well as accounting professionals will be utilized to provide additional information to assess the effectiveness of the current regulatory system of the accounting industry.

Chapter II of the graduate project will examine the history of self-regulation of the U.S. financial markets and government’s past role in corporate governance. This chapter will present a historical view of the Securities Exchange Commission (SEC) and the beginning of its regulatory authority. It will present the inherent limits and weaknesses of the SEC that had the responsibility but not the authority to effectively regulate the American financial markets. Chapter III examines the concept of industry self-regulation in general and explores the literature relative to this public policy issue.

Chapter IV will examine the advantages and disadvantages of self-regulation. The Regulatory Policy Program Report RPP-08, published in 2004, identified a series of potential advantages and disadvantages presented in the following list:

*Arguments in favor of self-regulation:*

- Proximity to the industry
- Greater flexibility,
- Increased compliance
- Collective interests of the industry
- Greater resources
Arguments against self regulation:

- Conflicts of interest
- Not enough enforcement
- Inadequate sanctions
- Global competition
- Insufficient resources

It is necessary to identify the environment in which self-regulation would be the most efficient form of regulation that would protect the public interest without stifling the industry’s activities and growth. The authors of the Regulatory Policy Program Report RPP-08 commented, “To some observers, the term self-regulation is an oxymoron, or something akin to the fox guarding the chicken coop” (Coglianese et al., p.5). However, self-regulation has its place in corporate governance when adequate and effective oversight is provided by governmental agencies.

Chapter V of this graduate project presents a case study of Enron Corporation; it describes the company’s innovative ideas in becoming America’s largest energy trading company and how it ultimately collapsed due to various reasons of mismanagement and dishonesty.

Chapter VI summarizes the results of an opinion survey that was given to accounting and business students as well as practicing accounting professionals. The survey addresses various important issues that may have led to ENRON’s collapse and relative to past and future accounting regulations and its actual and perceived effects on all constituents.

Chapter VII will provide a summary of the research conducted and how it relates
to the field of public administration. The self-regulation of the accounting industry and the need for adequate oversight is an example of where public administration and private industry meet and must find a viable model that will ensure the stability of the American financial markets to prevent future fraudulent corporate behavior.
CHAPTER II

HISTORY OF ACCOUNTING SELF-REGULATION

The self-regulation of the accounting profession began right after the Securities and Exchange Commission (SEC) was established by the Securities Act of 1933 and the Securities Exchange Act of 1934. Both laws were passed by Congress in response to the large sums lost by investors in the stock market crash of 1929. Both laws gave the SEC the statutory authority to set accounting standards and oversight over the activities of auditors. The SEC is responsible for regulating the issuance and trading of stocks, bonds, and other securities in order to protect the investing public and promote integrity of the capital market in the United States. As Anne M. Khademian states in a special report published by the Public Administration Review, Sept/Oct 2002, Vol. 62, No. 5: “Central to this effort are the agency’s enforcement of full and fair disclosure of financial information by companies with publicly traded securities and its authority to regulate the accounting industry as essential professionals in the disclosure process” (Khademian, p. 515). Khademian further points out that “certified public accountants must audit financial information that is filed with the Securities and Exchange Commission to ensure that public companies report robust, clear, and timely financial information” (Khademian, p.515). Since the SEC’s inception, the responsibility of establishing auditing standards was left with to the accounting profession, which is represented by the American Institute of Certified Public Accountants (AICPA).

In 1973, the primary responsibility for setting accounting standards was moved from the AICPA to the Financial Accounting Standards Board (FASB) which set the
ground rules for measuring, reporting, and disclosing information in financial statements of non-governmental entities. The AICPA worked with the FASB, through a collaborative process, based on common principles and objectives, to issue guidance to supplement the work of the FASB. In 1978, the Auditing Standards Board (ASB) was formed as the entity within the AICPA to set the ground rules for how an auditor determines whether the information reported in a financial statement is reasonable and whether it conforms to generally accepted accounting principles (GAAP). In addition to these authoritative boards, the accounting profession also established certain requirements such as peer review and quality control inquiry.

These self-regulating programs were overseen by the Public Oversight Board, which was created in 1977. Its purpose was to assure regulators, investors and the public at large that audited financial statements of public companies could be relied upon. The body was purely advisory and had no powers of intervention. It dissolved after the collapse of Enron Corporation and after the government announced its intent to reform oversight and regulation of the accounting profession.

One major factor contributing to the failure of self-regulation in the accounting industry was the government-mandated elimination of proscriptions against advertising and competition in the 1980s. Robert J. Bricker, professor of accountancy at Case Western Reserve University’s Weatherhead School of Management states in the January 2003 issue of The CPA Journal that this action “had the unintended consequence of moving accounting away from its “professional” model of service (Bricker, 2003).” It allowed accounting firms to offer consulting services as well as auditing services to the same client without concern for auditor’s independence or potential conflict of interest.
Coupled with the growth in information technologies, firms expanded and enjoyed incredible growth in consulting revenues. By the late 1990s, consulting became the main source of profit for most big accounting firms. In the case of ENRON Corporation, the accounting firm Arthur Andersen LLP had been paid $52 million during the year prior to the company's bankruptcy proceedings of which $25 million was for audit work and $27 million for consulting services. Arthur Levitt, then chairman of the SEC, saw this practice as a conflict of interest, undermining tough audits since, accountants feared losing lucrative consulting contracts if the audit results did not please their client. Levitt identified this issue as a matter of national economic interest.

In April 2000, Arthur Levitt proposed solution to stop consulting services for audit clients was met with strong opposition from the accounting industry. Ernst & Young and Price Waterhouse agreed to work with the SEC to change the rules, but the remaining three of the “Big Five” firms, namely KPMG, Deloitte & Touche, and Arthur Anderson perceived Levitt’s proposal as a threat to their business model of enhancing profits. In their opposition to the SEC’s proposal, the accounting firms supported a lobbying campaign, spending nearly $23 million in campaign contributions to the Republican as well as the Democratic party. This intense lobbying effort resulted in sufficient congressional pressure on the Commission to influence a change to its ruling. Accounting firms could keep their consulting business if they disclosed potential conflicts of interest to corporate audit clients.

Another major factor contributing to the industry's failed self-regulation was the SEC's history of inadequate funding. Although state boards and the SEC have the authority to investigate and discipline acts of accounting fraud, these bodies are often to
under-funded and under-staffed to vigorously pursue many investigations.

In 2002, the SEC had approximately 3,000 employees who staffed its Washington, D.C. headquarters, five regional and six district offices. This staff was charged with the oversight of 17,000 publicly traded companies, 8,000 brokerage firms, 700,000 brokers, 7,500 investment advisors and 34,000 investment company portfolios. The staff also oversaw the activities of the nation’s securities markets and professional associations, clearing agencies, and the work of the Municipal Securities Rulemaking Board. Khademian notes the “the legislation passed in 1999 concerning the deregulation of the banking and insurance industry has added even more to the agency’s workload. The Accounting Industry Reform Act of 2002, added additional oversight responsibilities of the new Public Company Accounting Oversight Board to the SEC’s responsibilities.” (Khademian, 2002, p.521)

The General Accounting Office report in 2001, GAO-01-947, identified as the main reasons for staff turnover within the SEC as low pay and compensation. The report indicated that the SEC experiences difficulties in hiring and retaining qualified attorneys, accountants, examiners, and other professional staff mainly because it does not have the authority or the financial resources to pay salaries that are comparable to other federal financial regulatory agencies. During the period of 1998 to 2000, the SEC lost approximately thirty-three percent of its staff, including 500 attorneys. In 2000, the staff turnover rate among attorneys, accountants, and examiners had increased to 15% (GAO 2001). Khademian observed in her article in the September/October 2002 issue of Public Administration Review (PAR) that according to the SEC, “it takes at least two years on-the-job training to prepare new
staff for the legal, accounting, and examination work of the commission” (Khademian, p. 520). Khademian also states that “the rapid turnover of staff means the agency invests a great deal of time in training new hires, but rarely reaps the benefits of the new expertise if the employee leaves after two or three years (Khademian, p. 521)”. According to the GOA 2001 report, in 1992, attorneys stayed with the SEC on average for 3.4 years. By 1999, the average tenure was 2.5 years. According to Khademian, historically, attorneys have viewed their time spent working for the SEC as preparation for a career in securities law in the private sector (p.521). As salaries became less and less competitive with other regulatory agencies and private companies, staff turnover and recruitment became a serious problem for the agency charged with the responsibilities as described earlier. The lack of financial resources and inadequate staffing has been identified as another contributing cause to the failure of self-regulation of the accounting industry.

In addition, the very concept of self-regulation encouraged a laissez-faire attitude among industry members. There was an analysis done by the Washington Post of the disciplinary actions against accountants during the 1990s. Their analysis found that the profession and individual members faced little public accountability. The analysis also showed that even when the AICPA’s Professional Ethics Division determined that accountants sanctioned by the SEC had committed violations. The Washington Post found that "Even when the AICPA determined that accountants sanctioned by the SEC had committed violations, it closed the vast majority of ethics cases without disciplinary action or public disclosure." (PBS Online, 2006)

One of the cornerstones of the 2002 Sarbanes-Oxley Act is the establishment of
the Public Company Accounting Oversight Board (PCAOB) under the jurisdiction of the Securities and Exchange Commission. The SEC appoints a five member board and oversees the board’s efforts to register accounting firms that audit public companies. The board sets rules for auditing, and procedures for overseeing and maintaining quality assurance of auditing practices. The board has the authority to investigate accounting firms and impose sanctions for noncompliance with the rules of the board and securities laws.

The Sarbanes-Oxley Act also requires that the SEC implement the many provisions of the new legislation. These provisions are:

- Improved and more timely disclosure requirements
- Rules to prevent conflicts of interests for securities analysts
- Rules to increase the responsibility of corporate boards (CEOs and CFOs) for their companies’ audits
- The validity of information filed with the SEC.
- The legislation also calls for enhanced criminal penalties for any wrongdoing by the corporation or the accountants preparing audited financial statements.

The effectiveness of the Sarbanes-Oxley Act was the focus of an online survey conducted in October 2005 for the Wall Street Journal Online’s Personal Journal Edition (see Table 4). Only 25% of investors surveyed feel that the new legislation has made the communication of financial information by companies much more or somewhat more transparent, and 11% of investors believe the legislation has had the opposite intended effect, having made communication much less or somewhat less transparent. The most
interesting finding is that 41% of investors are not sure about the effect the Sarbanes-Oxley Act has had on communication transparency. This would indicate that surveyed investors may not have an understanding of this legislation and its impact on business today (HarrisInteractive, 2005).

**Table 4: Punishment for Poor Corporate Governance:**
"Given what you know or may have heard about the provisions of Sarbanes-Oxley, including its restrictions and penalties or misinterpretation or misuse of company financial information, what effect do you feel this legislation has had on the transparency of communication of financial information by companies?"

<table>
<thead>
<tr>
<th>Base: Investors</th>
<th>Total (n=1,248)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Much/Somewhat More Transparent (Net)</strong></td>
<td>25%</td>
</tr>
<tr>
<td>Much more transparent</td>
<td>4%</td>
</tr>
<tr>
<td>Somewhat more transparent</td>
<td>22%</td>
</tr>
<tr>
<td>Neither more or less transparent</td>
<td>23%</td>
</tr>
<tr>
<td><strong>Much/Somewhat Less Transparent (Net)</strong></td>
<td>11%</td>
</tr>
<tr>
<td>Somewhat less transparent</td>
<td>9%</td>
</tr>
<tr>
<td>Much less transparent</td>
<td>2%</td>
</tr>
<tr>
<td>Not sure</td>
<td>41%</td>
</tr>
</tbody>
</table>

Note: Percentages may not add up to 100% due to rounding

CHAPTER III

INDUSTRY SELF-REGULATION: A PUBLIC POLICY ISSUE

The government’s practice of regulating business in order to protect the public has a long and turbulent history in this country. The degree of regulation of different types of industries as a matter of public policy often changes from one administration to another, depending on the political and economic environment at the time. An increase in industry abuses that causes material losses to the public at large usually moves to the top of any administration’s political agenda in order to stop any further abusive behavior.

More often than not, an administration’s reaction in the form of newly enacted legislation, does not bring about the desired results but rather creates new problems. In the foreword of Going by the Book, The Problem of Regulatory Unreasonableness by Eugene Bardach and Robert A. Kagan, M. J. Rossant notes that the authors provide many examples of increased regulation when the architects failed to realize the unintended consequences – in terms of increased costs and complexity, frequently harmful to productivity – of their best laid plans (Bardach & Kagan, p. x).

This realization is a strong argument in favor of self-regulation. It has been defined in the 1999 Better Regulation Task Force report as follows:

“Self-regulation is the means by which members of a profession, trade or commercial activity are bound by a mutually agreed set of rules which govern their relationship with the citizen, client or customer. Such rules may be accepted voluntarily or may be compulsory. They will normally include a procedure for resolving complaints and for the application of sanctions against those who infringe upon the rules”. (Better Regulation Task Force, 1999)
Self-regulation comes in many different forms. Systems of self-regulation range from voluntarily observed simple requirements to complex and intricate sets of rules that apply to an entire commercial activity and/or the profession engaging in that activity. Some systems of self-regulation also include authorized bodies to enforce rules and sanction violators. Systems of self-regulation are used in a variety of commercial activities and can also be found in the legal, accounting and medical professions.

As stated in Chapter I of this graduate project, recent corporate financial scandals have led to public pressure to reform business practices and to increase regulation in the accounting industry that has long operated under a system of self-regulation. Public demands for accountability, responsible corporate behavior and leadership perhaps represent the beginning of a new era for the accounting profession. But according to the 2004 Regulatory Policy Program Report RPP-08, *The Role of Government in Corporate Governance*, published by the Center for Business and Government, John F. Kennedy School of Government, Harvard University, “it is widely believed that it will take more than just leadership by the corporate sector to restore public confidence in our capital markets and ensure ongoing vitality. It will also take government action in the form of reformed regulatory systems, improved auditing and stepped up law enforcement” (Coglianese, et al., p.1).

The passage of the Sarbanes-Oxley Act in 2002 in response to public demand and political pressure, enacted new financial controls and stricter reporting requirements for publicly traded companies. The Securities and Exchange Commission and the self-regulatory organizations it oversees – the New York Stock Exchange (NYSE) and the
National Association of Securities Dealers (NASD) – have all adopted new standards for public companies and securities dealer. In addition, the newly created Public Company Accounting Oversight Board (PCAOB) is setting new rules for auditors, auditing companies that are publicly traded and state and federal enforcement officials are aggressively prosecuting cases in which corporations and their leaders are accused of violating financial rules that have damaged the investing public.

All of these recent developments indicate clearly that a change to the current system is necessary and that the governance of corporations has become an important public policy agenda item. The many corporate scandals referred to earlier in the text have shown that lenient regulatory organizations, weak standards and enforcements can have immense negative effects on the economy and the public at large. When government decides to respond due to political pressure in order to protect the public, it is important that any response is thoroughly analyzed in order to be effective. A comprehensive public policy analysis before any changes are enacted is of the utmost importance at this stage. “Regulatory reforms that over-react or that address symptoms while ignoring underlying causes can be costly and counterproductive (Coglianese et al., p.3).” It then becomes the government’s responsibility to help restore public confidence in the financial markets and in the integrity of corporations that are publicly traded without inhibiting any free market forces.

In 1982, Eugene Bardach and Robert A. Kagan of the University of California at Berkeley, published their book *Going by the Book; The Problem of Regulatory Unreasonableness*. In concurrence with the statement by M.J. Rossant in his foreword to the book, Bardach and Kagan believe that architects of increased regulation often do fail
to realize the unintended consequences, in terms of increased costs, complexity or even their negative effect on productivity. Their study demonstrated that often efforts to assure health and safety for American workers and protection for consumers were not necessarily helped by more rules and regulations (or even penalties). Some actually discouraged rather than encouraged responsible behavior.

The same challenge is apparent relative to the demand for increased regulation in response to the many corporate financial scandals. To address this challenge, the Center for Business and Government and its Regulatory Policy Program organized a conference in May 2004 on the role of government in corporate governance. The conference brought together government officials, business leaders, and academic researchers to discuss three fundamental public policy challenges raised by the recent corporate abuses. The perspectives and themes that emerged at this conference have been published under the title, *The Role of Government in Corporate Governance* and has been integrated into this research project, as they provide a framework for improved systems of corporate governance and government oversight.

The public policy discussion focuses on the advantages and disadvantages of self-regulation in the corporate environment and specifically addressing the following questions:

1. Who should regulate?
2. How to regulate?
3. How to enforce new regulation?

Under the current system, the government shares regulatory authority and oversight with several non-governmental, self-regulatory bodies. The system of self-
regulation has long been accepted as the preferred option for the securities markets, the accounting professions and legal professions. But are the existing self-regulatory systems sufficient to prevent further corporate scandals? Has it become necessary for the government to change from its oversight role of self-regulatory institutions to strictly controlling and enforcing corporate behavior?

In addition to deciding who should regulate it is also important to consider how to regulate. Self-regulating standards could be expressed as general guiding principles which would require the adherence to the spirit of the law, or regulation could take the form of specific rules which clearly states what is allowed and what is not. The authors of the report, *The Role of Corporate Governance*, believe “that rules have their virtues, and they have been widely used, but they also may allow corporate actors to find ways to comply with the letter of the law while circumventing its spirit (Coglianese, et al p.3).”

Another big challenge then would be how to enforce any newly adopted rules or principles. Some critics feel that a move towards more aggressive enforcement is necessary in order to deter future corporate fraud. It would also have to be decided if enforcement should be targeted at individual violators or at the corporation in which the misconduct occurred. In addition, the question of jurisdiction comes into play as both state and federal governments have the authority to sanction violators.

Self-regulation can work and there is not enough evidence to show that it has failed. The collapse of Enron along with the many other corporate scandals were serious problems with devastating consequences. But as William A. Niskanen, the chairman of the Cato Institute, points out it is also “important to recognize that the more serious corporate malfeasance was apparently limited to a few dozen of the 12,000 U.S. public
corporations and that the general performance of the stock market and the U.S. economy has been better than most other industrial nations, both in the last several years and in the last two decades” (Niskanen, p.432).

**Summary:**

The system of self-regulation has long been accepted as the preferred option for the securities markets, the accounting, legal and medical professions. The current system in the accounting profession was identified as an attributing factor to the large financial losses suffered by many publicly traded companies and will probably undergo changes in an effort to prevent future fraudulent corporate behavior. Any potential changes being considered have to be thoroughly analyzed relative to these three important questions:

- Who should regulate?
- How to regulate?
- How to enforce new regulation?
CHAPTER IV
ADVANTAGES AND DISADVANTAGES OF SELF-REGULATION

A thorough analysis of the self-regulatory institutions that have been important to the effective functioning of our financial markets has to also address the advantages and disadvantages of self-regulation. Since the stock market collapse in the late 1920s and the emergence of the Securities and Exchange Commission, legislation has given the primary responsibility of rulemaking and the enforcement of sanctions against violators to self-regulatory organizations. This public policy of self-regulation also extends to the accounting and legal professions.

The recent corporate scandals have lead regulators to questions whether the current system of self-regulation is still adequate or if changes are necessary. If changes are warranted, what needs to change? Can or should a system of self-regulation be maintained or abolished? In order to answer these questions, it would be useful to analyze the various advantages and disadvantages of self-regulation.

*The Role of Government in Corporate Governance* report identified five distinct advantages a system of self-regulation has to offer (Coglianese, p.7):

1. **Proximity**
2. **Flexibility**
3. **Compliance**
4. **Collective Interests of Industry**
5. **Resources**

The advantage of proximity refers to the fact that self-regulatory organizations are much closer to or even part of the ever changing environment and are therefore in a better position to respond to those changes. Government agencies are often too far removed
from the industry changes and therefore do not have the expertise to recognize the need for change.

The advantage of flexibility refers to the fact that the self-regulatory organizations have the ability to adapt to changes and adopt new rules more easily and probably faster than an government agency could. The organizations are generally not subject to prescribed procedures (red tape) in order to bring about change. In addition, governmental agencies would prefer not to get involved in politically unpopular decision and rule making.

Often self-regulated industries achieve a higher rate of compliance than direct government regulation can harness. The greater involvement in the creation of rules and standards usually make it easier to understand and follow them. Self-regulation also has the advantage of a common interest in their respective industry. Common interests in maintaining certain standards and a good reputation support the concept of industry participants policing each other. The last advantage refers to the availability of resources. If the self-regulatory organization is self-funded, it is not subject to any politically motivated change in government funding due to changes in the administration’s agenda.

In contrast to these very important advantages, the report also identifies five distinct disadvantages of a self-regulated system (Cogliano, p.7):

1. Conflicts of Interest
2. Inadequate Sanctions
3. Underenforcement
4. Global Competition
5. Insufficient Resources
Self-regulation can be viewed as presenting constant conflicts of interests because the industry is trying to compete in a free market and also police itself at the same time. Self interests of the industry can become more important than those of the public self-regulation it is supposed to protect. Another concern is that “self-regulation will be used by older, more established entities simply to keep out market entrants” (Coglianese, p.7) Self-regulation can lead to anti-competitive behavior when market entry becomes too restricted.

Inadequate sanctions present another disadvantage of self-regulation. As noted in the report, “the greater flexibility afforded self-regulatory organizations also means they may have the discretion to mete out only modest sanctions against serious violators” (Coglianese, p.7) When this occurs, the public loses confidence in the organization to provide adequate consumer protection and to punish those who violate the rules.

Underenforcement is listed as the third important disadvantage of self-regulation. The potential for conflicts of interests coupled with the discretion and flexibility many self-regulatory organization enjoy, can lead to a lack of oversight and enforcement of rules and regulations.

Self-regulation can present a significant disadvantage for any industry trying to compete in a global market. There is always the possibility that other foreign companies do not have to adhere to the same rules and regulation as domestic companies which puts the “competition” at an advantage. This can lead domestic companies to behave in less than socially responsible ways and have negative affects for the consumer.

In addition, available resources which are listed as advantages of self-regulation earlier, can become a disadvantage when they are not available. Even when the funding
for a self-regulatory organization is not controlled by any legislative body, and susceptible to changes in the administration, there is still the possibility that self-regulatory organizations do not have adequate financial resources needed to be effective.

**Summary:**

As discussed in detail, self-regulation has both advantages and disadvantages. *The Role of Government in Corporate Governance* states that "It is neither an inherently good nor inherently bad way to regulate corporate conduct. The challenge, then, is to find the most appropriate model. After that, the challenge is to find optimal ways of designing self-regulatory institutions" (Coglianese, et al p.9)
CHAPTER V

CASE STUDY - THE RISE AND FALL OF ENRON

Houston Natural Gas, a Texas based utility company and InterNorth, a Nebraska pipeline company, merged in 1985 and became ENRON Corporation. The deregulation of natural gas pipelines paved the way for the merger of these two independent companies. As a result of the merger, the newly formed ENRON Corporation incurred large amounts of debt which created the need for a new business strategy to generate profits and positive cash flows. Kenneth Lay, ENRON’s CEO hired consultants McKinsey & Co. to help develop ENRON’s new business plan. The consulting firm assigned Jeffery Skilling to the engagement who had extensive experience in banking and asset and liability management. Skilling proposed the following solution to ENRON’s credit, cash and profit problems: the creation of a “gas bank” in which ENRON would buy gas from a network of suppliers and sell gas to a network of consumers. At the same time ENRON contractually guaranteed both the supply and the price, charged fees for the transactions and assumed all associated risks. ENRON successfully adopted this business strategy and such created a new product and a new paradigm for the energy industry: the energy derivative.

Five years after the emergence of the energy derivative product, ENRON’s success lead to the creation of a new division called ENRON Finance Corp. Jeffery Skilling was hired to provide leadership for the new division. Soon after 1990, ENRON Finance Corp. dominated the market of natural gas contracts and with its large market share came the power to predict future prices with great accuracy, which ensured large profits.
In the April 2002 issue of the Journal of Accountancy, C. William Thomas states that “Skilling wanted to change the corporate culture of ENRON to match the company’s transformed image as a trading business”. (www.aicpa.org, 2002) He succeeded by hiring the best securities traders, and recruited new hires from the nation’s top MBA schools and from the most prestigious investment banks. Although company employees had to work long hours, ENRON generously rewarded its associates with a variety of fringe benefits. In addition, Skilling rewarded productive employees with merit-based bonuses which had no limit.

According to Thomas, ENRON’s corporate culture began to change when Skilling implemented the “performance review committee”, which became known as the harshest employee-ranking system in the country. It was known as the “360-degree review” based on ENRON’s values: respect, integrity, communication and excellence (RICE). However, ENRON’s employees realized that the only performance measure was the amount of profits that could be produced. (www.aicpa.org, 2002) Under the RICE system of employee evaluation, the personnel review committee (PRC) regularly rated its staff members on a scale of 1 to 5. In order to achieve top ratings, corporation employees were very motivated to do whatever it took to post earnings. The lower the PRC score, the faster an employee could advance in the company. The higher the PRC score, the quicker an employee would face the possibility of losing his or her job, and employees with a rating of 5 could expect to be dismissed within 6 months. The promotion, retention and dismissal policy resulted in a 15% annual employee turnover rate. As a result, the culture at ENRON had changed to one of fierce internal competition in which immediate
results and profits were rewarded in favor of prudent and fiscally responsible contracts with long term potential.

In 1996 Skilling became ENRON’s chief operating officer. His plan to apply the same business model used for the natural gas markets to the electric energy markets succeeded when the company’s lobbying efforts for deregulation paid off. In 1997 ENRON acquired electric utility company Portland General Electric Corp. for about $2 billion and by the end of that year, the division by then known as ENRON Capital and Trade Resources had become the nation’s largest wholesale buyer and seller of natural gas and electricity.

In 1999 ENRON created an electronic commodities trading web site called ENRON Online (EOL) which was significant to the financial world for two reasons: First, ENRON acted as counterparty to every transaction conducted through the website. Commodities traders received valuable information regarding the long and short term partners in each transaction as well as the products’ prices in real time. Second, because ENRON was either the buyer or seller in every transaction, the company’s credit risk management was crucial to ensure traders’ confidence in ENRON’s financial stability to provide a safe transaction environment. EOL was considered an overnight success with online commodities trades of $335 billion in 2000. In August 2000, ENRON stock traded at its highest value ($90.56) and Fortune magazine along with many other business publications called ENRON one of the most admired and innovative companies in the world.

In the mid-1990s ENRON began to incorporate “mark-to-market” accounting to record its transactions for the energy trading business. Under mark-to-market rules, any
outstanding energy related contracts or derivatives at the end of a company’s financial reporting period, has to be reported on the balance sheet at fair market value. The adjustment to fair market value will result in unrealized gains or losses which have to be reported in the income statement for the period ending. The application of this accounting rule is often very difficult due to the fact that there are usually no price quotes available for long-term energy contracts upon which to base a fair market valuation. In addition, ENRON’s profit oriented culture would dictate that valuation estimates result in unrealized gains rather than unrealized losses which then add income to the bottom line. In 1999, about one-third of ENRON’s reported pre-tax profit came from unrealized gains, in 2000 unrealized gains accounted for more than 50% of the company’s $1.41 billion reported pre-tax profit.

As ENRON’s business ventures and their associated accounting became more complicated, it was necessary to employ mathematicians, physicists and economists to help manage its risk exposure. The company also employed the CPA firm Arthur Andersen, LLP year-round as consultants as well as their auditors to prepare the audited financial statements which were used by investors to make informed investment decisions. But even with the help of highly educated and qualified staff, ENRON was not able to avoid the consequences of reporting inflated earnings in its financial statements.

Under the leadership of Andrew Fastow, who became ENRON’s chief financial officer in 1998, the corporation’s business practices and financial recordings became more sophisticated and more complex in order to continue showing profits and to keep debt and contingent liabilities off the balance sheet. Audited financial statements usually
contain explanatory notes (footnotes) that address the recording of certain transactions as they pertain to a company’s income, loss, assets and liabilities. Footnotes represent additional information to help investors understand the financial status of the corporation. In ENRON’s case, the footnotes became as confusing as the elaborate business dealings and off-balance sheet financing practices the company had developed under Andrew Fastow. Referring to a footnote from the 2000 audited financial statements, Douglas Carmichael, the Woolman Distinguished Professor of Accounting at Baruch College in New York City, told the Wall Street Journal in November 2001 that most people would be hard pressed to understand the effects of these disclosures on the financial statements. (AICPA, 2002). This statement from a Distinguished Professor of Accounting casted doubt on both the quality of the company’s earnings as well as the business purpose of the transaction. Other analysts expressed similar concerns, but all negative comments were quickly dismissed by ENRON’s executive management team. However, the negative publicity began to have its effect on ENRON’s reputation and the energy market began to perceive the company with skepticism and not trustworthy.

In subsequent months a number of events contributed to the ultimate implosion of ENRON. In February 2001, Kenneth lay announced his retirement and named Skilling president and CEO of ENRON. At ENRON’s annual conference Skilling announced that ENRON’s stock should be trading at $126 per share, although valued at only $80, thereby expressing confidence to the energy markets that ENRON was financially stable and was worth investing in. At the same time investment brokers caught up in the “bull market” environment continued to advise investors to buy ENRON stock. Shortly after ENRON suffered large cash shortfalls due to underperforming investments. Senior management
personnel started leaving the company and selling their ENRON stock which caused ENRON’s stock value to fall. In August, only six months after being named CEO, Skilling also resigned for “personal reasons”. The markets reacted to the chain of events and ENRON stock continued to slide below $30 per share. During the same month, a memo addressed to Kenneth Lay by Sherron Watkins, one of ENRON’s vice-presidents warned that the lack of disclosure of the substance of certain related party transactions could have a negative impact on the company. She concluded the memo by stating her fear that the company might “implode under a series of accounting scandals.” (AICPA, 2002) Kenneth Lay notified the company’s attorneys, Vinson & Elkins as well as the company’s auditors, Arthur Andersen, LLP to investigate this matter further.

In October of 2001, ENRON announced quarterly losses and disclosed the reversal of a $1.2 billion entry to assets and liabilities. It also announced the change of plan administrators for its employees’ 401(k) pension plan which by law locks all investments for 30 days. This prevented all ENRON employees from selling their ENRON stock which was loosing value every day. In addition, the SEC had started to investigate ENRON’s related party business transactions which had not been recorded in compliance with generally accepted accounting procedures. Amidst the revelation of the accounting irregularities, ENRON dismissed its chief financial officer, Andrew Fastow.

In November 2001, ENRON announced a restatement of its financial statements back to 1997 to reflect omitted transactions and to book adjustments recommended by its auditors. The restatement resulted in the recording of $591 million in losses and an additional $628 million in liabilities. The equity market’s reaction drove the value of the stock to below $10 per share. By the end of the month, after the announcement that a
planned merger with Dynegy, a smaller competitor, was rescinded by Dynegy because of ENRON's failure to fully disclose its off-balance sheet debt, ENRON's stock was downgraded by analysts to junk status, at 26 cents per share (see figure 2). On December 2, 2001 ENRON filed for bankruptcy protection.

![ENRON Stock Price, Daily Close 2001 - 2002](image)

**Figure 2: ENRON Stock Price Daily Close 2001 - 2002**

As described earlier, the circumstances related to ENRON's failure were described by Harvey Pitt, the then Chairman of the SEC, as the "perfect storm" (AICPA, 2002). According to Pitt, the outdated reporting and mandated financial disclosure system, was arcane and impenetrable. Coupled with the extreme profit driven organizational culture at ENRON, it seemed to be only a matter of time before ENRON's complex and sophisticated accounting system of recording business transactions, collapsed like a house of cards.
ENRON's collapse has caused many losses: Approximately 4,500 employees have lost their jobs and their entire retirement savings which were tied up in ENRON stock. A former vice-chairman of the company committed suicide in connection with involvement in the financial scandals. Investors around the globe are now skeptical of the American equity markets and the public perception is that the accounting profession in its self-regulatory role, did not intervene to prevent fraudulent behavior.

As investigations of ENRON’s accounting practices revealed more details, senior executives were charged with criminal acts and ultimately convicted. In 2002, the accounting firm of Arthur Andersen LLP was convicted of obstruction of justice for shredding documents related to the ENRON audits as a result of prosecution by the U.S. Department of Justice. Since the U.S. Securities and Exchange Commission does not allow convicted felons to audit public companies, the firm voluntarily surrendered its licenses to practice as Certified Public Accountants in the United States. In 2005, The Supreme Court of the United States unanimously overturned Andersen’s conviction due to flaws in the jury instructions. In the court's view, the instructions allowed the jury to convict Andersen without proving that the firm knew it broke the law or that there was a link to any official proceedings that prohibited the destruction of documents. Despite the new ruling, experts believe that it highly unlikely that Andersen will ever return as a viable business. The accounting firm lost nearly all of its client after the indictment, and there are still over 100 civil suits pending against the firm related to its audits of ENRON and other companies. Arthur Andersen LLP once employed 85,000 employees worldwide and 28,000 in the United States. Today the firm employs approximately 200 staff
members who are based primarily in Chicago where most of the work is focused on the pending lawsuits.

**Conclusion:**

The collapse of ENRON illustrates the shortcomings and disadvantages of self-regulation in a very complex, innovative and ever-changing business environment. This case along with many other similar corporate financial failures started the public debate over self-regulation in the accounting industry. It also became the basis for a "Post-Enron" survey which will be discussed in the next chapter.
CHAPTER VI

OPINION SURVEY AND SUMMARIZED RESULTS

The methodology used to further analyze the public policy issue of accounting self-regulation includes the analysis of a questionnaire created by Ph.D. student William H. Belski, and is presented in his work, *A Post-Enron Examination of Student Perceptions to Potential Accounting Reforms* (2003). Belski surveyed 158 business and accounting students based on the assumption that current business and accounting students represent future business leaders and therefore a survey of upper-level students would be warranted. Belski also felt “that students tend to give us a generalized understanding of how the general public may view such reforms”.

As part of this graduate project, the same questionnaire was presented to four accounting professionals from various backgrounds such as public accounting firms, not-for-profit organizations and higher education faculty in order to survey the opinions of professionals working in the field and to compare and contrast their answers to those of the students. The questionnaire was given to accountants based on the premise that accounting professionals’ opinion are built on empirical knowledge and practice rather than merely theory as is probably the case with most students.

Belski states that his questionnaire was initially developed and adapted from a January 28, 2002 article from Business Week titled “Accounting in Crisis”, which addressed a number of each of the topics addressed in the questionnaire. The surveys were given to evaluate the response to various questions regarding reforms to the accounting profession and financial reporting procedures. The results of the questionnaires provide valuable information relative to the opinion of an informed
section of the public which is familiar with the accounting and financial reporting issues discussed in this graduate project.

In other words, the opinions of the business and accounting students provide valuable insight into what future accounting and financial reporting rules and regulations might evolve to, along with how the overall landscape of the accounting profession will change. Whereas, the opinions of the professionals in the field provide valuable insight into how the reforms might change the accounting professions in the near future. An analysis of the answers to the questionnaire shows the similarities and differences among the two groups questioned. The final recommendations based on the collective research are presented in Chapter VII.

Belski’s questionnaire addresses multiple topics relevant to the past self-regulation and future regulation of the accounting profession. The complete questionnaire is presented in the Appendix section of this paper. The following section presents the individual topics addressed in the questionnaire as well as the survey results. Belski also included a short commentary relative to the survey topic to ensure that survey participants were better able to understand the context of each question.

**Topic 1: Enact Stronger Self-Regulation:**

“Currently, the accounting profession is self-regulated. The AICPA, made up of a series of industry trade groups, is charged with the responsibility of monitoring auditor independence and audit quality. The Public Oversight Board (POB), a separate group of the AICPA, is charged with ensuring that the public interest is considered in the oversight of auditors. The POB relies entirely on the CPA firms for its funding and has no authority to investigate, no subpoena power, and no power to punish infractions. Separately, the AICPA runs a system of peer review. Peer review refers to accounting firms ‘auditing’ other accounting firms to ensure professional standards are being upheld. Although smaller firms have occasionally been censured by their peers, no Big Five firm has ever failed a review.
One alternative is to transfer the Regulation and discipline to a new self-regulatory organization (SRO), similar to the National Transportation Board, staffed and overseen largely by public outsiders who would take over the review process. Another includes setting up a governmental agency to regulate auditing and auditors.

But while it sounds good, creating such regulatory bodies such as a SRO or other governmental agency will be far from easy. First of all, to have real power it requires action by Congress, which in a shortened election year already has plenty of other things to do. How it will be funded is sure to be a topic of long and hot debate. Also, the history of regulation has been far from pristine” [Italics added] (Belski, 2003).

<table>
<thead>
<tr>
<th>Questions</th>
<th>Student % agree</th>
<th>Professional % agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Self-Regulation of Accounting Profession</td>
<td></td>
<td></td>
</tr>
<tr>
<td>A problem currently exists in the way the accounting profession is self-regulated.</td>
<td>52 acctg 72</td>
<td>75</td>
</tr>
<tr>
<td></td>
<td>48 other 48</td>
<td></td>
</tr>
<tr>
<td>No changes are necessary with respect to the way the accounting profession is self-regulated.</td>
<td>23 acctg 17</td>
<td>25</td>
</tr>
<tr>
<td></td>
<td>77 other 77</td>
<td></td>
</tr>
<tr>
<td>Regulation and discipline should be transferred to a new self-regulatory organization (SRO), similar to the National Transportation Board, staffed and overseen largely by public outsiders who would take over the review process.</td>
<td>50 acctg 38</td>
<td>50</td>
</tr>
<tr>
<td></td>
<td>50 other 50</td>
<td></td>
</tr>
<tr>
<td>A governmental agency should be set up to oversee and regulate auditing and auditors.</td>
<td>50 acctg 45</td>
<td>50</td>
</tr>
<tr>
<td></td>
<td>50 other 50</td>
<td></td>
</tr>
</tbody>
</table>

The results of these survey questions indicate certain similarities between the student and the professional group: the majority of both groups agree that there is a problem with the way the accounting profession is currently self-regulated and believe that changes are necessary in order to restore and maintain confidence in the financial
markets. It is interesting to note that the percentage of accounting students compared to the percentage of accounting professionals endorsing a change of the current system is almost identical which indicates that accounting students compared to business students appear to be better informed about the weaknesses of the current system.

In addition, half of all professionals and half of the accounting students surveyed both support the formation of a new SRO and a system under which a governmental agency would oversee and regulate the audit process. This further underscores the believe that the current system is largely perceived to be ineffective.

**Topic 2: Bar Non-Audit Services Offered to Audit Clients:**

Prior to the Sarbanes-Oxley Act, public accounting firms had become increasingly dependent on revenue generated through consulting services provided to their audit clients. In 1993, 31% of the industry’s fees was generated through consulting activities, by 1999, the percentage of revenue from consulting services had increased to 51%. Belski noted in his survey, the results of a University of Illinois’ study of the first 563 companies that filed financial statements after February 5, 2001, “…for every dollar of audit fees clients paid their independent accountants $2.69 for non-audit consulting.”(Belski, 2003)
## Questions

<table>
<thead>
<tr>
<th>2. Non-Audit Services Offered to Audit Clients</th>
<th>Comparison of Student vs. Professional Answers:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>Student % agree</strong></td>
</tr>
<tr>
<td></td>
<td>(acctg &amp; other majors)</td>
</tr>
<tr>
<td>To ensure an independent audit, accounting firms should be required to split off their (non-audit) management consulting groups.</td>
<td>53 acctg</td>
</tr>
<tr>
<td></td>
<td>47 other</td>
</tr>
<tr>
<td>To ensure an independent audit, accounting firms should be required to split off their (non-audit) tax and corporate finance work groups</td>
<td>25 acctg</td>
</tr>
<tr>
<td></td>
<td>75 other</td>
</tr>
<tr>
<td>No changes need to be made with respect to non-audit services being made available to audit clients</td>
<td>30 acctg</td>
</tr>
<tr>
<td></td>
<td>70 other</td>
</tr>
<tr>
<td>The independence of the auditor would not be jeopardized if the auditing firms bar all non-audit services to its audit clients but are permitted to keep their management consulting and tax work groups.</td>
<td>50 acctg</td>
</tr>
<tr>
<td></td>
<td>50 other</td>
</tr>
</tbody>
</table>

The answers to the above questions clearly show a significant difference of opinion between the student and professional groups surveyed: none of the accounting professionals find it is necessary to separate consulting services in order to retain independence and only 25% agree that corporate finance and tax services should be split off. In addition, the majority of professionals do not see an independence problem if audit firms continue to consult and prepare tax returns for their audit clients as long as any other finance services are not permitted. These results show that accounting professionals perceive any major changes in this area as a potential threat to their revenue generating capabilities and therefore a threat to their industry at large.

Students, on the other hand, who do not have the benefit of practical experience and are probably still more idealistic than practicing professionals, endorse the separation
of management consulting and auditing services. The group of accounting students again appear to have a better understanding of the practical applications of the proposed changes and tend to be closer in their answers to the professionals than the business students at large.

**Topic 3. Rotation of Independent Auditors:**

The changing or rotation of auditors further addresses the topic of audit independence as well as the possibilities and limitations of previous auditors familiar with the company compared to a new set of auditors.

<table>
<thead>
<tr>
<th>Questions</th>
<th>Student % agree</th>
<th>Professional % agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>3. Rotation of Independent Auditors</td>
<td>% (acctg &amp; other majors)</td>
<td>%</td>
</tr>
<tr>
<td>Requiring mandatory rotation of independent auditors would help the accounting profession to maintain its independence.</td>
<td>25 acctg</td>
<td>67</td>
</tr>
<tr>
<td></td>
<td>75 others</td>
<td></td>
</tr>
<tr>
<td>Instead of requiring mandatory rotation of independent auditors, firms should maintain current system of changing audit partners periodically but keeping the same firm in place.</td>
<td>60 acctg</td>
<td>33</td>
</tr>
<tr>
<td></td>
<td>40 other</td>
<td></td>
</tr>
</tbody>
</table>

The survey results in this section which also addresses the independence issue and an auditor’s objectivity reveals again the difference between students and professionals: whereas the majority of students support mandatory rotation of audit firms, only 25% of professionals agree with this statement. It is interesting to note that the percentage is the same for accounting students who probably understand the issues involved in engaging a different audit firm every year. When a corporation engages the same audit firm every
year, the auditors will be familiar with the business of their client. Audit and working papers from the prior year can be used as a guide for the current audit thus saving time and money.

Only one third of all students support the current system with a periodic change of individual audit partners, whereas the majority of professionals endorse this option which again, is echoed by the group of accounting students surveyed.

**Topic 4. Forensic Audits:**

"Forensics is associated with the art and science of legal evidence and argument. In forensic accounting, auditors introduce forensic auditing techniques into the average financial statement audit. That is, hotspots such as revenue-recognition issues and the establishment of reserves, two of the most common reasons for earnings restatements, are subject of forensic reviews. Opponents argue that forensic audits will end up with little more than an excuse for auditors to raise their prices. In addition, opponents claim there is no evidence proving the use of forensic auditing increases the effectiveness of the audit".(Belski, 2003)

Auditors attest to the fact that a company’s audited financial statements accurately and in all materiality reflect the true financial status and strength of the corporation. At current audit firms are not required to employ forensic methods in order to detect fraud.
<table>
<thead>
<tr>
<th>Questions</th>
<th>Comparison of Student vs. Professional Answers:</th>
</tr>
</thead>
<tbody>
<tr>
<td>4. Forensic Audits</td>
<td>Student % agree (acctg % &amp; other major %)</td>
</tr>
<tr>
<td>Auditors should be required to introduce some forensic auditing techniques into the average financial statement audit.</td>
<td>Professional 1 % agree</td>
</tr>
<tr>
<td></td>
<td>28 acctg</td>
</tr>
<tr>
<td></td>
<td>72 other</td>
</tr>
<tr>
<td></td>
<td>35</td>
</tr>
<tr>
<td></td>
<td>0</td>
</tr>
</tbody>
</table>

All of the practicing accounting professionals surveyed agree that auditors should not be required to use forensic techniques as part of their financial statement audits. Only 35% of students and only 28% of accounting students believe that forensic techniques could add value to an audit as those techniques would be employed to discover fraud and other illegal activities. Professionals are not favor of this added audit feature because currently most accountants and auditor are not trained to apply these techniques.

In addition, applying forensic techniques could mean that auditors could be held liable if fraud was committed but not detected in the course of an audit.

**Topic 5. Limit Auditors’ Employment with Prior Audit Client:**

"Proponents claim that accountants must be barred from later taking jobs with the companies they are hired to audit, until now a common practice. The claim is an auditor hoping to land a lucrative job with his client will not be aggressive in his/her work. The concern is that the numbers might not be scrutinized with the necessary rigor when the company’s old audit partners are adding them up. Many claim this idea goes to the perception of independence and state that it might not have anything to do with reality, but often perception becomes reality. Opponents, on the other hand, claim that many companies exhibit similar rotation between their accounting staff and audit firms and never run into independence problems. Moreover, they state that there are legal obstacles to limiting people's freedom to work where they like." [Italics added] (Belski, 2003)
## Questions

<table>
<thead>
<tr>
<th>5. Auditor Working for Prior Audit Client</th>
<th>Student % agree (acctg % &amp; other major %)</th>
<th>Professional % agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent auditors should be precluded or limited from accepting employment from an audit client they have previously audited. That is, the rotation between the audit firm and the client's accounting staff should be limited.</td>
<td>30 acctg</td>
<td>51</td>
</tr>
<tr>
<td></td>
<td>70 other</td>
<td>75</td>
</tr>
<tr>
<td>Movement should be allowed, but any movement between the audit firm staff and the client being audited should be disclosed in the financial statements.</td>
<td>n/a</td>
<td>53</td>
</tr>
<tr>
<td></td>
<td>n/a</td>
<td>25</td>
</tr>
<tr>
<td>As an investor, you would be concerned that the accounting numbers might not be scrutinized or evaluated with the necessary vigor and/or honesty when the company employees are made up of previous audit firm employees.</td>
<td>40 acctg</td>
<td>63</td>
</tr>
<tr>
<td></td>
<td>60 other</td>
<td>50</td>
</tr>
<tr>
<td>No changes or limitations should be made with respect to auditors' moving on to work for their clients.</td>
<td>40 acctg</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>60 other</td>
<td>25</td>
</tr>
</tbody>
</table>

The results of these survey questions are somewhat similar when comparing the student answers to those of the professionals. However, a mandate of financial statement disclosure regarding the movement of accountants between audit firm and client staff is supported by the students but not by the accounting professionals. Both groups agree that the movement should be allowed, but limited.

**Topic 6. Composition of Audit Committee:**

"In 1999, the SEC Blue Ribbon Commission recommended that audit committees be made up solely of independent (of management) directors, each of whom should be financially literate, with at least one having accounting or financial management expertise. The SEC recommendation, however, was not adopted as intended. When the U.S. stock exchanges moved on the SEC's recommendations, altogether different rules were adopted for listed companies: the new rules allowed for directors of the board to be on the company's payroll, former
employees and their families were allowed to be directors after three years, and audit committee members with a “significant business relationship” with the company could also be directors if the board determined that their ties would not interfere with their independent judgment” [Italics added] (Belski, 2003).

<table>
<thead>
<tr>
<th>Questions</th>
<th>Comparison of Student vs. Professional Answers:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>6. Composition of Audit Committee</strong></td>
<td></td>
</tr>
<tr>
<td>Companies should be required to follow the 1999 SEC blue-ribbon commission recommendation.</td>
<td>Student % agree (acctg % &amp; other major %)</td>
</tr>
<tr>
<td></td>
<td>Professional % agree</td>
</tr>
<tr>
<td></td>
<td>85 agree</td>
</tr>
<tr>
<td></td>
<td>75 agree</td>
</tr>
<tr>
<td>As an investor, you would be concerned that the audit committees would be biased if directors on the company payroll are permitted to be on the audit committee.</td>
<td>95 agree</td>
</tr>
<tr>
<td></td>
<td>50 agree</td>
</tr>
<tr>
<td>No changes are necessary to the formation and consistency of audit committee members.</td>
<td>10 agree</td>
</tr>
<tr>
<td></td>
<td>25 agree</td>
</tr>
</tbody>
</table>

It is very interesting to note that the majority of students and the majority of accounting professionals agree that public companies should follow the SEC 1999 blue-ribbon commission report which requires that audit committees be made up solely of independent (of management) directors. The opinions of both groups, however, differ regarding the issue of audit committee bias when a member is on the payroll of the company being audited. An overwhelming majority see a conflict of interest and bias, whereas only 50% of practicing accounting professionals perceive a problem in this area. It appears to be a black and white issue for idealistic students, but an issue of practicality and reality for professionals. Both groups agree, however, that some kind of change is necessary relative to the formation of audit committees.

**Topic 7. Reformed Accounting Rules:**

In the past, the Financial Accounting Standards Board (FASB) set the standards for the accounting profession. Through the publicity of the recent accounting scandals, the practices and procedures of this standard setting body have come into question.
### Questions vs. Professional Answers:

<table>
<thead>
<tr>
<th>Questions</th>
<th>Student % agree</th>
<th>Professional % agree</th>
</tr>
</thead>
<tbody>
<tr>
<td>The financial accounting standard setting should be federalized. That is,</td>
<td>25</td>
<td>0</td>
</tr>
<tr>
<td>the government should take over the setting of accounting standards.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Accounting has become increasingly complex just as business has.</td>
<td>97</td>
<td>50</td>
</tr>
<tr>
<td>The Financial Accounting Standards Board (FASB), the standard setting</td>
<td>33</td>
<td>25</td>
</tr>
<tr>
<td>body of the accounting profession, is more proactive than reactive in</td>
<td></td>
<td></td>
</tr>
<tr>
<td>their response to changes in accounting rules.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No discretion in the selection of accounting methods should be available</td>
<td>20</td>
<td>0</td>
</tr>
<tr>
<td>to companies. That is, all companies should be required to use the exact</td>
<td></td>
<td></td>
</tr>
<tr>
<td>same accounting method. For example, all firms should use FIFO,</td>
<td></td>
<td></td>
</tr>
<tr>
<td>accelerated depreciation, etc.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>No changes are necessary with respect to cleaning up how the accounting</td>
<td>18</td>
<td>50</td>
</tr>
<tr>
<td>rules are set.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The answers to this set of questions again shows some similarities and some differences. The biggest, but clearly predictable difference observed relates to the increasing complexity of business and the associated accounting. Almost 100% of all students agree with this statement, whereas only half of the accountants feel this way. For a business student and/or accounting major, the field of accounting must appears very complex and difficult to master; accounting professionals, on the other hand, are more comfortable in their chosen career although constant changes in industry and business practices forces the profession to adjust and learn new skills.

None of the accounting professionals agree that financial accounting standards should be federalized and only a small percentage of students agree. Also, none of the accountants support the idea that there should be no discretion available to companies in
applying various accounting methods. Having a certain amount of flexibility allows companies to apply a method most advantageous to their financial statement disclosure. Only a small percentage of students agree with that accounting standards should be federalized and that companies should not have discretion over the application of certain accounting methods. This indicates resistance and disapproval to the idea that one solution would fit all situations.

Both students and accountants believe that the Financial Accounting Standards Board is more reactive than proactive. Due to the structure and function of FASB, it appears that this body has little ability to be proactive as it can only react to changing industry practices after the fact.

Relative to the issue of how accounting rules are set, accounting professionals are split 50/50 on the issue of necessary change, whereas the majority of students believe that changes need to be made. The difference in percentage stems from the difference in perspective of both groups: practicing accountants realize that changes will translate into changes to be implanted in the business practices of their own firms which can be very costly. Students on the other hand are still operating in the theoretical fields of accounting and therefore are more idealistic in their approach.

**Topic 8. Payment of Audit Fees:**

At present, public (and private) companies select and engage an audit firm of their choice. Based on the scope of the engagement, a fee is set and will be paid for by the company being audited. Some critics have pointed out that this constitutes a clear conflict of interest: since the goal of any company is to receive an unqualified opinion,
or clean audit, and it is the goal of the audit firm to deliver “good service” in order to be retained again, the concept of “auditor independence” is called into question.

<table>
<thead>
<tr>
<th>Questions</th>
<th>Comparison of Student vs. Professional Answers:</th>
</tr>
</thead>
<tbody>
<tr>
<td>8. Payment of Audit Fees</td>
<td>Student % agree (acctg % &amp; other major %)</td>
</tr>
<tr>
<td>Auditors should be paid by the stock exchanges</td>
<td>Professional % agree</td>
</tr>
<tr>
<td>rather than the management of the company being</td>
<td></td>
</tr>
<tr>
<td>audited.</td>
<td></td>
</tr>
<tr>
<td>15 acctg</td>
<td>12</td>
</tr>
<tr>
<td>85 other</td>
<td>100</td>
</tr>
<tr>
<td>Auditors should be paid by the company’s investors</td>
<td></td>
</tr>
<tr>
<td>rather than the management of the company being</td>
<td></td>
</tr>
<tr>
<td>audited.</td>
<td></td>
</tr>
<tr>
<td>15 acctg</td>
<td>20</td>
</tr>
<tr>
<td>85 other</td>
<td>0</td>
</tr>
<tr>
<td>No change is necessary to the current system of</td>
<td></td>
</tr>
<tr>
<td>Independent auditors being paid by the</td>
<td></td>
</tr>
<tr>
<td>management of the companies that audit them.</td>
<td></td>
</tr>
<tr>
<td>60 acctg</td>
<td>43</td>
</tr>
<tr>
<td>40 other</td>
<td>0</td>
</tr>
<tr>
<td>A governmental agency and fund should be set up</td>
<td></td>
</tr>
<tr>
<td>to pay all audit fees. The fund would then be paid</td>
<td></td>
</tr>
<tr>
<td>for by the companies being audited based on the</td>
<td></td>
</tr>
<tr>
<td>size of the company and the difficulty of the audit.</td>
<td></td>
</tr>
<tr>
<td>10 acctg</td>
<td>25</td>
</tr>
<tr>
<td>90 other</td>
<td>0</td>
</tr>
</tbody>
</table>

The survey results for this set of questions is rather unique. All of the accounting professionals surveyed agree that auditors should be paid by the stock exchanges rather than by the management of the company being audited. Payments to auditors by the company that engaged the audit firm, compromises the independence of every audit. Only 12% (15% accounting majors) support this model which might indicate that students are not completely aware of all potential conflicts of interest involving independent audits. As shown, accounting professionals do not support any other form of payment for audit fees, whereas the majority of accounting majors supports the current system of auditors being paid by the companies being audited.
**Topic 9. General Questions Related to ENRON Failure:**

This section of the survey includes eight questions related to the collapse of ENRON Corporation. The collapse of this large Texas energy trading company was mostly attributed to the failure of the self-regulated accounting profession.

<table>
<thead>
<tr>
<th>Questions</th>
<th>Student % agree</th>
<th>Professional % agree</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>9. General ENRON-Related Questions</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>At its core, the collapse of ENRON was a business failure, not an audit failure.</td>
<td>n/a 68</td>
<td>75</td>
</tr>
<tr>
<td>The ENRON failure was caused by ENRON's auditor, Arthur Andersen.</td>
<td>10 acctg 24</td>
<td>0</td>
</tr>
<tr>
<td>Financial analysts and investment companies were as guilty as Arthur Andersen for the huge losses incurred in the ENRON failure.</td>
<td>80 acctg 45</td>
<td>50</td>
</tr>
<tr>
<td>ENRON's auditor, Arthur Andersen, operated within the professional standards of the accounting profession.</td>
<td>10 acctg 5</td>
<td>75</td>
</tr>
<tr>
<td>Arthur Andersen could have prevented the ENRON failure.</td>
<td>15 acctg 47</td>
<td>25</td>
</tr>
<tr>
<td>The management of ENRON is responsible for the failure of ENRON.</td>
<td>100 acctg 97</td>
<td>100</td>
</tr>
</tbody>
</table>
In this last set of answers relative to the ENRON failure it is again interesting to note in what areas students and professionals agree and disagree. Both groups overwhelmingly agree that ENRON’s management was responsible for the company’s collapse. The majority of both groups also believe that ENRON represents a business failure and not a failure caused by their audit firm. One noteworthy difference is observed in the survey result relative to Arthur Andersen’s operation within professional standards of the accounting profession. The majority of professionals believe that Arthur Andersen LLP operated within those standards whereas 90% of accounting majors and 95% of all students surveyed believe that the audit firm did not. This large difference in opinion could be attributed to the difference in perspective of both groups. Business students most likely have not had enough practical accounting experience and are more likely to base their opinions on media coverage. Experienced accounting professionals are more likely to identify with the problems the audit firm faced after ENRON’s collapse.

In conclusion, the following points summarize the results from the survey given business students and accounting professionals. The results show a clear concern for the potential conflicts of interest for audit firms relative to various areas of public accounting (see summary below). Both groups agreed that changes to the system of self-regulation are necessary, but students and professionals do not all agree on the scope of changes. As expected, students’ understanding and interpretation of the underlying reason which caused so many corporate financial scandals is mostly based on theoretical knowledge. Accounting professionals, on the other hand, who have the benefit of practical
experience, have a somewhat different understanding of what changes might be necessary in order to restore the public’s confidence in their profession.

- **Self-Regulation:**
  - The majority surveyed agrees that there is a problem with the way the accounting profession is being self-regulated and that changes are necessary
  - This underscores the belief that the current system of self-regulation is largely perceived to be ineffective.

- **Non-Audit Services Offered to Audit Clients**
  - The majority of professionals do not see a problem of "accountant independence" if audit firms continue to consult and prepare tax returns for their audit clients as long as no other non-audit services are provided.
  - Business students believe that accounting firms should split off their management services
  - Accounting professionals perceive any major changes in this area as a threat to their revenue generating capabilities and therefore a threat to their industry at large.

- **Rotation of Independent Auditors**
  - Whereas the majority of students support mandatory rotation of audit firms, only 25% of professionals agree with this statement and believe that a rotation of audit partners is sufficient to maintain independence.
  - Keeping the audit with the same firm ensures a certain amount of knowledge about the financial activity of the company from prior audits.

- **Forensic Audits:**
  - Professionals as well as students are in not favor of this added audit feature because currently most accountants and auditors are not trained to apply these techniques.
  - Applying forensic techniques could mean that auditors could be held liable if fraud was committed but not detected in the course of an audit.
• Auditor Working for Prior Audit Client
  ☑ Both groups agree that the movement should be allowed, but limited to avoid the appearance of conflict of interest.

  ☑ Perceived by critics as another threat to auditor independence is when auditing personnel is later employed by clients they have audited. Auditors have an implied incentive to please the audit client in hopes of future employment opportunities.

• Composition of Audit Committee
  ☑ Both groups are concerned about potential conflicts of interest if directors who are on the company’s payroll also serve as member of the audit committee.

• Reformed Accounting Rules:
  ☑ The majority of business students believe that accounting and business has become more complex, but only half of the professionals agree.

  ☑ 100% of professionals believe that accountants should retain discretion in the application of accounting rules. This view is supported by 20% of the business students.

• Payment of Audit Fees:
  Payments to auditors by the company that engaged the audit firm, compromises the independence of every audit.

  ☑ All of the accounting professionals surveyed agree that auditors should be paid by the stock exchanges rather than by the management of the company being audited, while only 12% of students support this model.

  ☑ This might indicate that students are not completely aware of all potential conflicts of interest involving independent audits.

• General ENRON-Related Questions
  ☑ Both groups overwhelmingly agree that ENRON’s management was responsible for the company’s collapse.

  ☑ The majority of both groups also believe that ENRON represents a business failure and not a failure caused by their audit firm.
CHAPTER VII
RECOMMENDATIONS AND CONCLUSION

$7 trillion in investment losses, a large number of recent corporate accounting scandals, and the bankruptcies of ENRON, WorldCom, Tyco, Adelphia and several other large corporations have led to the passage of the Sarbanes-Oxley Act (SOA) which is by many political analysts considered to be the most important and comprehensive piece of legislation to impact the role of government in corporate governance since the 1930s. Due to tremendous political and public pressure, but without a thorough public policy analysis, Congress passed and the President signed the Sarbanes-Oxley Act into law in July of 2002. It was the government’s intent to restore public confidence in American financial markets, increase regulation and prevent future corporate fraud.

The existing system of self-regulation in the financial markets and accounting profession also moved to the forefront of public debate as it was believed to be the cause for the corporate scandals. Based on the research and the information provided in the previous chapters, self-regulation appears to be here to stay. Although survey results show that the public, business students and practicing accounting professionals all believe that some changes are necessary, no one believes that direct government control would be a better choice than self-regulation. Self-regulation can remain an effective system of “self-policing” because of the inherent self-interest aspect. Industry members as well as public consumers will benefit from a well structured system of self-control because the industry and its individual member’s reputation is on the line.

The following recommendations are presented as options to consider for the future of self-regulation in the financial markets and the accounting industry:
Auditor Independence

Auditor Independence is one of the most important features when relying on audited, published financial information. Under the current system, audit firms have a potential conflict of interest, because they are selected and paid by the public corporation that they audit. This potential conflict of interest could be alleviated if audit functions were assigned to and the responsibility of stock exchanges. The stock exchanges could enact audit and disclosure rules for the corporations listed and also take on the responsibility of selecting, overseeing and paying the independent auditor of the corporations being audited. This fundamental change regarding the way auditors are paid is also recommended by William A. Niskanen, the chairman of the CATO Institute, who has analyzed and written extensively about the impact of the Sarbanes-Oxley Act in the CATO Handbook On Policy (Niskanen, p.430).

Another very important aspect of auditor independence is the conflict of interest that arises when accounting firms provide a number of different services to their clients. When the government mandated the elimination of proscriptions against advertising and competition in the 1980s, it cleared the path for accounting firms to offer any type of service their clients needed. Accounting firms started to provide consulting services as well as auditing services, without recognizing the potential for conflicts of interest. Arthur Levitt, then chairman of the SEC, identified this issue as a matter of national economic interest and attempted to have the ruling changed in 2000. In his opinion, the practice had the potential to severely undermine tough audits since accountants faced losing lucrative consulting contracts if the audit results did not please their clients. The audit firm would have a vested interest in “keeping the client happy” in order to ensure
future consulting venues and therefore might not as diligent during the audit as should be expected. This constitutes a clear conflict of interest.

It is recommended that accounting firms be barred from providing consulting and auditing services to the same client in order to further retain and enhance their independence.

**Accounting Rules**

Generally Accepted Accounting Principles (or GAAP accounting rules) constitute the “code book” for all accountants. In an ever changing local, national and global business environment, the adherence and implementation of GAAP rules along with accounting standards set by the Financial Accounting Standards Board (FASB), accounting as a whole has become very complex for accountants preparing financial statements for public corporations. It is necessary to operate and record financial activity within the perimeter of consistent rules, but an over-reliance on rules which often can be manipulated to fit the circumstance and needed results, can also be disastrous as the many corporate scandals have proven. Allan Reynolds, a senior fellow with the Cato Institute, states that “bankruptcies are real events, not simply a matter of the way records are kept. Deceptive accounting by companies attempting to conceal their troubles was a consequence of financial crisis, rather than the cause” (Reynolds, 2005). In other words, even the correct application of accounting rules will not prevent accountants and/or their management from deceptive practices if there is intent to do so.

In addition to financial accounting information, the investing public should also be informed about non-financial conditions which usually affects a public corporation just as much as market conditions. It has been suggested by political analysts like
Reynolds that the Sarbanes-Oxley Act is too “concerned with strictly enforcing the latest “generally accepted” accounting principles (GAAP) and not with the disclosure of non-financial information. A possible solution could be the development of regulation requiring such disclosure in order to complement the financial information, as suggested by Reynolds. Transparent and honest disclosure about the non-financial conditions of a publicly traded corporation will go a long way towards restoring public confidence and repairing the tarnished images of corporations and their accountants.

As stated earlier in this paper, the recent corporate scandals gave cause to intense debates over necessary regulatory changes. Some changes have already been made and those present a definite improvement to the former system of self-regulation. It is important to understand and accept the need for change to a system that has to adjust to different conditions. This does not mean that the entire system of self-regulation should be discarded, especially since it has proven to work efficiently since the 1930s.
REFERENCES


HTTP://WWW.HARRISINTERACTIVE.COM/NEWS/NEWSLETTER/WSJFINANCE/ HI_WSJ_PERSFINPOLL_2005_VOL1_ISS05.PDF
Dear Survey Participant,

The attached questionnaire was adopted from a report by Ph.D. student William H. Belski, author of "A Post-Enron Examination of Student Perceptions to Potential Accounting Reforms" and revised to incorporate the changes to the accounting industry after the passing of the Sarbanes-Oxley Act of 2002.

This questionnaire asks that you evaluate and respond to various questions regarding reforms to the accounting profession and financial reporting landscape to re-establish the public trust in financial accounting information and the independent audit function in the wake of the Enron failure.

The change-for-the-sake-of-change philosophy is often used after a large inequity such as Enron has occurred, however, change is only effective if it meets the needs of its core groups. Please keep this in mind when answering these questions. If you can think of any other "ideas" to improve the image of the profession or the process of financial reporting, please share your ideas on the lines at the end of this survey. A demographic questionnaire is also included. The responses to these questions and all demographic information will be held strictly confidential.

Thank you for your time and participation in this opinion survey.

Renate Wigfall
SELF-REGULATION WITH TEETH
Prior to the Sarbanes-Oxley Act of 2002, the accounting profession was self-regulated.

A problem existed in the way the accounting profession was self-regulated.
  a. I strongly disagree with statement
  b. I somewhat disagree with statement
  c. Undecided
  d. I somewhat agree with statement
  e. I strongly agree with statement

No changes were necessary with respect to the way the accounting profession self-regulated.
  a. I strongly disagree with statement
  b. I somewhat disagree with statement
  c. Undecided
  d. I somewhat agree with statement
  e. I strongly agree with statement

Regulation and discipline, now transferred to a new quasi-public agency, the Public Company Accounting Oversight Board (PCAOB), will be more effective.
  a. I strongly disagree with statement
  b. I somewhat disagree with statement
  c. Undecided
  d. I somewhat agree with statement
  e. I strongly agree with statement

The governmental agency’s (PCAOB) oversight and regulation of auditing practices and auditors will be more effective.
  a. I strongly disagree with statement
  b. I somewhat disagree with statement
  c. Undecided
  d. I somewhat agree with statement
  e. I strongly agree with statement

Which of the following choices do you believe will be most effective for the accounting profession in reestablishing public trust?
  a. Past self-regulation of accounting profession would have been sufficient.
  b. A new self-regulating organization (SRO) staffed & overseen by public outsiders who would take over review process.
  c. The new government agency that oversees and regulates auditing & auditors.
NON-AUDIT SERVICES TO AUDIT CLIENTS

Prior to the Sarbanes-Oxley Act, accountants had become increasingly dependent on consulting revenue. In 1993, 31% of the industry's fees came from consulting. By 1999, that had jumped to 51%. In 2001, for example, PricewaterhouseCoopers earned only 40% of its worldwide fees from auditing, 29% coming from management consulting and most of the rest from tax and corporate finance work, according to the International Accounting Bulletin. More telling, in a study of the first 563 companies to file financials after Feb. 5, 2001, the University of Illinois' Bailey found that on average, for every dollar of audit fees, clients paid their independent accountants $2.69 for non-audit consulting.

To ensure an independent audit, accounting firms should be required to split off their (non-audit) management consulting groups.

   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

To ensure an independent audit, accounting firms should be required to split off their (non-audit) tax and corporate finance work groups.

   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

No changes were necessary with respect to non-audit services being made available to audit clients.

   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

The independence of the auditor would not be jeopardized if the auditing firms bar all non-audit services to its audit clients but are permitted to keep their management consulting and tax work groups.

   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement
Which of the following choices do you believe will be most effective for the accounting profession to ensure an independent audit?

a. Accounting firms should be required to split off management consulting groups.
b. Accounting firms should be required to split off tax and corporate finance work groups.
c. Accounting firms should be allowed to have both consulting and tax groups.
d. Allow accounting firms to keep their management consulting and tax work groups, but be barred them from providing both consulting services and audit services to the same client.
ROTATION OF AUDITORS

Requiring mandatory rotation of independent auditors would help the accounting profession to maintain its independence.
  a. I strongly disagree with statement
  b. I somewhat disagree with statement
  c. Undecided
  d. I somewhat agree with statement
  e. I strongly agree with statement

The rotation of independent auditors would create more problems, since new auditors need time to learn about a company.
  a. I strongly disagree with statement
  b. I somewhat disagree with statement
  c. Undecided
  d. I somewhat agree with statement
  e. I strongly agree with statement

Instead of requiring mandatory rotation of independent auditors, firms should maintain the current system of changing audit partners periodically but keeping the same firm in place.
  a. I strongly disagree with statement
  b. I somewhat disagree with statement
  c. Undecided
  d. I somewhat agree with statement
  e. I strongly agree with statement

Which of the following choices do you believe will be most effective for the accounting profession to ensure an independent audit?
  a. Accounting firms should be required to rotate after X number of years.
  b. Accounting firms should maintain their current system of changing audit partners periodically but keeping the same firm in place.
USE OF FORENSIC AUDITING
Auditors should be required to introduce some forensic auditing techniques into the average financial statement audit.

a. I strongly disagree with statement
b. I somewhat disagree with statement
c. Undecided
d. I somewhat agree with statement
e. I strongly agree with statement

The system of independent auditing is adequate without the requirement of forensic auditing. Forensic audits will end up with little more than an excuse for auditors to raise their prices with no increase in the effectiveness of the audit.

a. I strongly disagree with statement
b. I somewhat disagree with statement
c. Undecided
d. I somewhat agree with statement
e. I strongly agree with statement

Which of the following choices do you believe will be most effective for the accounting profession at increasing the effectiveness of the audit?

a. Accounting firms should be required to use forensic auditing.
b. Accounting firms should maintain their current system of financial statement audits.
LIMIT AUDITORS’ EMPLOYMENT WITH FORMER AUDIT CLIENTS
Independent auditors should be precluded or limited from accepting employment from an audit client they have previously audited. That is, the rotation between the audit firm and the client's accounting staff should be limited.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

Movement should be allowed, but any movement between the audit firm staff and the client being audited should be disclosed in the financial statements.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

As an investor, you would be concerned that the accounting numbers might not be scrutinized or evaluated with the necessary vigor and/or honesty when the company employees are made up of previous audit firm employees.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

No changes or limitations should be made with respect to auditors’ moving on to work for their clients.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

Which of the following choices do you believe will be most effective for the accounting profession to ensure an independent audit?
   a. Auditors should be precluded or limited from accepting employment from an audit client they have previously audited.
   b. Movement should be allowed, but any movement between the audit firm staff and the client being audited should be disclosed in the financial statements.
   c. No changes or limitations should be made with respect to auditors’ moving on to work for their clients.
REFORM OF AUDIT COMMITTEES

In 1999, the SEC blue-ribbon commission recommended that audit committees be made up solely of independent (of management) directors, each of whom should be financially literate, with at least one having accounting or financial management expertise. Had the SEC recommendations been adopted verbatim, half of Enron's six-member audit committee likely would have been barred from service.

When the U.S. stock exchanges moved on the SEC recommendations, it adopted new rules for listed companies, which were something else entirely. Under the New York Stock Exchange rules, directors on the company payroll were permitted, former employees and their families could be allowed after three years, and audit committee members with a "significant business relationship" with the company were also acceptable if the board determined the ties won't interfere with their judgment.

Companies should be required to follow the 1999 SEC blue-ribbon commission recommendation.

a. I strongly disagree with statement
b. I somewhat disagree with statement
c. Undecided
d. I somewhat agree with statement
e. I strongly agree with statement

As an investor, you would be concerned that the audit committees would be biased if directors on the company payroll were permitted to be on the audit committee.

a. I strongly disagree with statement
b. I somewhat disagree with statement
c. Undecided
d. I somewhat agree with statement
e. I strongly agree with statement

Former employees and their families should be allowed to serve on the audit committee after three years severance from the company.

a. I strongly disagree with statement
b. I somewhat disagree with statement
c. Undecided
d. I somewhat agree with statement
e. I strongly agree with statement

Audit committee members with a "significant business relationship" with the company are acceptable if the board determines the ties won't interfere with their judgment.

a. I strongly disagree with statement
b. I somewhat disagree with statement
c. Undecided
d. I somewhat agree with statement
e. I strongly agree with statement
No changes are necessary to the formation and consistency of audit committee members.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

Which of the following choices do you believe will be most effective for the accounting profession with respect to the audit committees?
   a. The stock exchanges should be allowed to adopt their own qualifications for audit committees.
   b. Companies should be required to follow the 1999 SEC blue-ribbon commission recommendation.
   c. No changes or limitations should be made with respect to the formation and consistency of audit committee members.
REFORM THE ACCOUNTING RULES
The financial accounting standard setting should be federalized. That is, the government should take over the setting of accounting standards.

a. I strongly disagree with statement
b. I somewhat disagree with statement
c. Undecided
d. I somewhat agree with statement
e. I strongly agree with statement

Accounting has become increasingly complex just as business has.

a. I strongly disagree with statement
b. I somewhat disagree with statement
c. Undecided
d. I somewhat agree with statement
e. I strongly agree with statement

The Financial Accounting Standards Board (FASB), the standard setting body of the accounting profession, is more proactive than reactive in their response to changes in accounting rules.

a. I strongly disagree with statement
b. I somewhat disagree with statement
c. Undecided
d. I somewhat agree with statement
e. I strongly agree with statement

No discretion in the selection of accounting methods should be available to companies. That is, all companies should be required to use the exact same accounting method. For example, all firms should use FIFO, accelerated depreciation, etc.

a. I strongly disagree with statement
b. I somewhat disagree with statement
c. Undecided
d. I somewhat agree with statement
e. I strongly agree with statement

No changes are necessary with respect to reforming how the accounting rules are set.

a. I strongly disagree with statement
b. I somewhat disagree with statement
c. Undecided
d. I somewhat agree with statement
e. I strongly agree with statement
CONFLICTS OF INTEREST

Auditors should be paid by the stock exchanges rather than the management of the company being audited.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

Auditors should be paid by the company’s investors rather than the management of the company being audited.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

No change is necessary to the current system of Independent auditors being paid by the management of the companies that audit them.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

A governmental agency and fund should be set up to pay all audit fees. The fund would then be paid for by the companies being audited based on the size of the company and the difficulty of the audit.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

Which of the following choices do you believe will be most effective for dealing with the conflict of interest over the payment of audit services?
   a. Auditors should be paid by the stock exchanges rather than the management of the company being audited.
   b. A governmental agency and fund should be set up to pay all audit fees.
   c. Auditors should be paid by the management of the companies that audit them.
   d. Auditors should be paid by the company’s investors rather than the management of the company being audited.
GENERAL ENRON-RELATED QUESTIONS

At its core, the collapse of Enron was a business failure, not an audit failure.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

The Enron failure was caused by Enron's auditor, Arthur Andersen.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

In financial reporting, there is no substitute for personal integrity and honesty.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

Instituting all the suggestions and regulations above would surely have prevented the Enron failure.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

Financial analysts and investment companies were as guilty as Arthur Andersen for the huge losses incurred in the Enron failure.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

Enron's auditor, Arthur Andersen, operated within the professional standards of the accounting profession.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement
Arthur Andersen could have prevented the Enron failure.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement

The management of Enron is responsible for the failure of Enron.
   a. I strongly disagree with statement
   b. I somewhat disagree with statement
   c. Undecided
   d. I somewhat agree with statement
   e. I strongly agree with statement