



[Home](#)  
[Current Issue](#)  
[Back Issues](#)  
[The Archive](#)  
[Forum](#)  
[Site Guide](#)  
[Feedback](#)  
[Search](#)

[Subscribe](#)  
[Renew](#)  
[Gift Subscription](#)  
[Subscriber Help](#)

Browse >>

[Books & Critics](#)

[Fiction](#)

[Food](#)

[Foreign Affairs](#)

[Language](#)

[Poetry Pages](#)

[Politics & Society](#)

[Science & Technology](#)

[Travel & Pursuits](#)

[Subscribe to our free  
e-mail newsletters](#)



[See an index of This Month in  
The Atlantic's History.](#)

[More on politics & society  
from The Atlantic Monthly.](#)

[More on economics from The  
Atlantic Monthly.](#)

#### From the archives:

##### "The Roaring Nineties"

(October 2002)

A Nobel laureate and former Clinton adviser offers a revised economic history of the 1990s. By Joseph Stiglitz

##### "The Myth of Oppressive

Corporate Taxes" (June

1982)

Congress has found an expensive solution to what wasn't wrong with the economy. By Gregg Easterbrook

[E-MAIL  
ARTICLE](#)

[PRINTER  
FORMAT](#)

[SUBSCRIBE TO  
THE ATLANTIC](#)

The Atlantic Monthly | January 1992

## Cooked Books

*Shoddy and in some cases sharp practices by the Big Six accounting firms are the hidden element linking the financial scandals of the 1980s and 1990s*

by William Sternberg

.....

There's an old joke in the accounting profession about a businessman who wanted to hire an auditor. He set up interviews with representatives of several leading CPA firms. "How much is two plus two?" the businessman asked each applicant. The first three applicants gave the correct answer and were promptly dismissed. The fourth applicant, who got the engagement, pondered the question and then replied, "How much do you want it to be?"

No one is laughing anymore about accounting practices intended to satisfy clients. Investors, regulators, politicians, and accountants themselves are asking how so many insolvent and fraud-riddled banks, savings-and-loan associations, insurance companies, and industrial corporations could have received clean audits from major firms shortly before they collapsed.

As the accountants hasten to point out, not all business failures are audit failures. Less than one percent of audits produce allegations of malpractice. Sometimes conditions deteriorate rapidly after the audit is completed. Sometimes management is extremely clever in disguising illicit conduct. Markets can change in unpredictable ways, and the public can have unrealistic expectations about what auditors are supposed to do. But still: you have to wonder how twenty-eight of thirty savings-and-loans that failed in California in 1985 and 1986 could have received clean audits the year before they went belly up. How could Arthur Young have certified Vernon Savings & Loans when more than 90 percent of its loans were bad, or allowed Charles Keating to siphon money from Lincoln Savings & Loan? How could Deloitte, Haskins & Sells have okayed the books at CenTrust Savings Bank of Miami when its chairman was spending millions of dollars in insured deposits on Old Masters and other luxuries? How could Main Hurdman and then Touche Ross have signed off on the cooked books of the Wedtech Corporation, whose chief executive was mercurial and semi-literate? How could Ernst & Whinney have given a clean review report to ZZZZ Best, a California carpet-cleaning outfit run by a twenty-year-old whiz kid whose major contracts turned out to be nonexistent? How could Coopers & Lybrand have missed fraudulent activities and reckless management at the Los Angeles-based Mission Insurance Company? And how could Price Waterhouse have taken so long to blow the whistle on the Bank of Credit and Commerce

"Are Big Businessmen Crooks?" (November 1961)

The author takes a searching look at the Sherman Antitrust Act and at the penalties which it has been recently imposing upon big business. By Leland Hazard

Justice to the Corporations (January 1908)

"Let us begin anew, knowing that the corporations are today obeying the laws, and knowing also that the standards of honesty, honor, and fair dealing have been carefully studied and are higher than in the last century." In 1908 an *Atlantic* contributor assured readers that in the future corporations could be trusted.

**From *Atlantic Unbound*:**

Flashbacks: "Cooked Books" (March 5, 2003)

How should we crack down on corporate corruption? Articles from the early twentieth century to the 1990s have considered the question from a variety of viewpoints.

Politics & Prose: "Who Owns Capitalism?" (June 15, 2000)  
Has democracy at last caught up with the corporation? By Jack Beatty

International, known worldwide as the bank of crooks and criminals?

Some of the answers will no doubt emerge from a tidal wave of litigation that has engulfed the big accounting firms amid the wreckage of these and other failed enterprises. As of last May 1, federal banking regulators alone had thirty-two lawsuits pending against accounting firms, seeking \$2.5 billion for damages to government insurance funds from accounting malpractice. This litigation could well be followed by billions of dollars more of derivative claims from piggybacking plaintiffs.

Some of the lawsuits may be frivolous, a search for deep pockets by investors and creditors desperately seeking scapegoats for their bum investments. Other cases will be settled, or covered by insurance. But the sheer volume of alleged audit failures has already traumatized the once staid and gentlemanly accounting profession. Legal-liability exposure has become the industry's top concern. Accounting journals are filled with articles about sheltering personal assets, damage control, and the fine print of liability-insurance policies. Partners at big firms, once seen as having the job security of tenured professors, are being laid off by the hundreds. The traditional structure of the accounting partnership itself, according to which partners can be held personally liable for the actions of their firms, may be doomed. Accounting groups have begun the tedious process of trying to persuade states to allow CPAs to form limited-liability corporations. It's already too late for Laventhol & Horwath, which was the nation's seventh-largest accounting firm when it collapsed, in 1990, largely because of costly malpractice lawsuits. One or more of the six biggest firms could follow if major litigation goes against them. And, as in so many other industries, America's post-Second World War leadership in accounting may be usurped from abroad.

**U**nderstanding how big-time accounting got into this mess requires understanding how the auditing system developed in the United States and how the go-go years of the 1980s exposed the system's flaws. The audit function, along with the prototype of the modern corporation with multiple shareholders, was brought to the United States by British accountants in the late nineteenth century. The American Institute of Certified Public Accountants (AICPA), a voluntary association to which about three quarters of the CPAs in the United States belong, traces its roots to 1887; its creation marked the emergence of accountancy as a profession. When the unfettered capitalism of the turn of the century led to demands for truthful financial reporting, state boards of accountancy were formed to confer standards on the fledgling profession. In 1933 and 1934, as a result of the stock-market scams, the first federal securities acts were passed. The new laws required that public companies have their financial statements audited by independent accountants. But although the federal government mandated audits, it refrained from providing auditors and even from establishing audit standards, leaving both to the profession itself. Nor did the new securities laws provide the money to pay the auditors, so companies hired and paid their own watchdogs—a situation that has been likened to authors' being able to pick their own book reviewers.

To use another analogy, imagine if the meat you buy at the supermarket were inspected not by the U.S. Department of Agriculture but by private inspection firms hired by the meatpackers. Suppose these private inspectors defined their task as determining whether the cows were being slaughtered in accordance with generally accepted meatpacking principles

(GAMP). Suppose further that if an inspector happened upon a blatant violation of GAMP, he would be obliged to report it not to the grocery or consumers but to the management of the meatpacking company that hired him to do the inspections. If management disagreed with the assessment, the inspector would have to decide whether to see things management's way or to walk off the job, allowing another inspection firm to pick up the business.

That may sound like a complicated recipe for allowing a lot of rotten meat to make its way to market, but it is approximately the system that has evolved for inspecting the financial statements of this nation's major corporations. Like any system premised on biting the hand that feeds it, this one hasn't worked very well. Many corporations have come to view audits as little more than bothersome compliance exercises mandated by the Securities and Exchange Commission, to be accomplished at the lowest possible cost. Sophisticated investors have learned not to take audited financial statement at face value; unsophisticated investors have been burned time after time. Abraham J. Briloff, a professor emeritus of accounting at Baruch College, in New York, who is regarded as the prickly conscience of the profession and its most acerbic critic, has suggested that auditors' certificates be accompanied by a skull-and-crossbones logo, to show that swallowing or inhaling the reported data could be injurious to the reader's financial health.

Throughout the years, the public's perception of the auditors' role has varied considerably from the auditors' own definition of it. This chasm between what the auditors do and what the public thinks they do is delicately referred to as the expectations gap. Many people believe that auditors play detective, digging out aberrations and blowing the whistle at the slightest hint of wrongdoing. A clean audit is seen as akin to the Good Housekeeping Seal of Approval, stamped by wizened veterans who have painstakingly combed through the records and carefully tracked down every lead.

Auditors, however, define their role as merely testing whether management has fairly presented the financial statements in accordance with generally accepted accounting principles, or GAAP—the admittedly permissive rules for financial reporting. Beyond that, auditors say, the best they can do is provide reasonable assurance—not a guarantee—that the financial statements are free of material misstatements. The auditor's final opinion, which carries the accounting firm's signature, falls into one of three categories: clean, or "unqualified," if the records amount to a fair representation of the company's underlying economic health; "qualified," if there are exceptions to an otherwise fair representation; and a "disclaimer," meaning the client's record-keeping is so inadequate that the auditor cannot even render an opinion. For companies experiencing serious financial difficulties, the auditor is also supposed to state whether there is "substantial doubt" that the entity can continue as a "going concern" for a reasonable period of time.

The most prestigious audits, the ones that carry the most weight, are those performed by the six largest firms—Arthur Andersen, Ernst & Young, Deloitte & Touche, Peat Marwick, Coopers & Lybrand, and Price Waterhouse. (The Big Six were known as the Big Eight until the merger of Ernst & Whinney with Arthur Young to form Ernst & Young, and the merger of Deloitte, Haskins & Sells with Touche Ross to form Deloitte & Touche.) In 1990 each of these firms took in more than \$1 billion in U.S.

revenue and had more than 900 partners. Contrary to popular perception, however, much of the on-site audit work for these firms' clients is delegated by partners to young associates with four-year degrees, working on tight budgets and even tighter deadlines.

Exacerbating the expectations gap is continuing confusion over some very basic questions. For instance: Who is the auditor working for? Many accountants will say that their clients are the managers of the company that hired them. They talk in terms of an auditor-client relationship similar to the privilege afforded attorneys and doctors. But the U.S. Supreme Court, in the case of *U.S. v. Arthur Young*, has ruled otherwise. The Court held in 1984 that by certifying the public reports that depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client and owes ultimate allegiance to the corporation's creditors and stockholders and to the investing public. "This 'public watchdog' function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust," Chief Justice Warren Burger wrote.

The accounting profession, however, has been slow to grasp the full meaning of this. As recently as last June the 300,000-member AICPA opposed proposals to give regulators the power to review auditors' work papers, saying that such steps "could undermine the confidentiality of the auditor-client relationship." Some critics of the profession see a misperception of who the client is as the essence of the problem. "The accountants think in their heart of hearts that they have what would amount to an attorney-client relationship, where in effect they could keep everything private," says Ron Wyden, an Oregon representative who has been trying to change auditors' responsibilities. "The Arthur Young case basically destroyed that possibility."

Another area of continuing confusion has been the degree to which auditors are responsible for searching for fraud. Early texts set forth three objectives for the audit: detection of fraud, technical errors, and errors of principle. As auditors increasingly experienced difficulty in finding carefully concealed frauds, they began to regard fraud detection as beyond their responsibility. Management was simply presumed to have integrity. More recently the profession has acknowledged a responsibility to attempt to detect "material fraud." But even if the auditor does discover undisclosed illegalities, these are reported to the company's management and directors, not to regulators or investors. If they refuse to act, the most the auditor is supposed to do is resign from the audit and make sure the client informs regulators of the reason for the "disengagement."

The defects in the system have been evident for decades, but they became intolerable during the deregulated 1980s, when hundreds of billions of dollars of federally insured deposits fell into the hands of high-flying financial institutions run by roguish managers. Few would argue that auditors could have prevented the savings-and-loan crisis, although it might not have been as costly if the profession had fulfilled its responsibilities. Certainly federal regulators bear a large part of the blame for promulgating feeble regulatory accounting principles, or RAP, in a desperate attempt to disguise the problems until, it was hoped, the industry could grow out of them. Federal bank examiners, underpaid and stretched too thin, had little recourse when savings-and-loans used RAP to hide their insolvency. To its credit, the accounting profession

resisted RAP, but the regulatory climate did communicate a mood of laxity that filtered through to the big firms' audits. Tough audits could have provided an early warning signal, waving red flags before million-dollar problems became billion-dollar problems. But rarely were the alarms sounded before it was too late. The profession, known for moving with what one accountant calls "geological speed" in the face of change, was unable to keep pace with the rapid changes in the economy. At a time when savings-and-loans were plunging headlong into complex financial dealings like real-estate development and mortgage-backed securities, the AICPA accounting guidelines, issued in 1979, were more applicable to the savings-and-loan industry's "3-6-3" days (pay three percent to depositors, lend the money at six percent, and be on the golf course by three in the afternoon). Although some interim guidance was issued, not until September of 1990 was a draft of a revised audit guide for savings institutions released.

The more the savings-and-loan crisis is dissected, however, the worse the accountants look. A General Accounting Office study of eleven Texas S&L failures found inadequate and unprofessional audits in six cases. Then there's the role accountants played in the nation's biggest thrift failure, the collapse of Lincoln Savings & Loan, which will cost taxpayers approximately \$2.6 billion and reportedly prompted an elderly investor to commit suicide. Most of the scrutiny in the Lincoln Savings & Loan case has focused on the five U.S. senators who went to bat for Charles Keating, the chairman of Lincoln's parent company, American Continental, of Phoenix. Yet when the Keating Five went into their now-famous meeting with federal regulators, on April 9, 1987, the senators thought they were on solid ground because they had a letter from Jack D. Atchison, a managing partner at Arthur Young's Phoenix office, stating that Lincoln was solvent and profitable.

According to notes taken by one of the participants at the meeting, Senator Dennis DeConcini, of Arizona, said, "Why would Arthur Young say these things? They have to guard their credibility too. They put the firm's neck out with this letter."

"They have a client ...," replied Michael Patriarca, a regulator.

DeConcini: "You believe they'd prostitute themselves for a client?"

Patriarca: "Absolutely. It happens all the time."

Another frequent occurrence is that the auditor switches sides and takes a job with the client. A little more than a year after the Keating Five's meeting with regulators, Atchison left Arthur Young to begin working for American Continental, at an annual salary of \$930,000. Asked by the House Banking Committee to testify about the affair, Atchison invoked his Fifth Amendment privilege. Arthur Young, which is now part of Ernst & Young, has agreed to pay the federal government more than \$40 million to settle charges that its Lincoln work was faulty.

Keating, meanwhile, had the gall to sue the Office of Thrift Supervision in an effort to regain control of Lincoln after it was seized by federal regulators, in 1989. Unfortunately for him, the case was assigned to U.S. District Court Judge Stanley Sporkin, a former chief of enforcement at the Securities and Exchange Commission. After listening to testimony about all of Keating's financial shenanigans, Sporkin, himself a certified public

accountant, ruled that Lincoln had been operating in an unsafe and unsound manner and that regulators were fully justified in seizing it. Sporkin went on to note that Keating had surrounded himself with cadres of lawyers and accountants even as American Continental siphoned money out of Lincoln. "Where were these professionals ... when these clearly improper transactions were being consummated?" Sporkin wrote in his widely quoted opinion. "Why didn't any of them speak up or disassociate themselves from the transactions?" As it turned out, Atchison's successor at Arthur Young, Janice Vincent, did refuse to certify some of Keating's further dealings. Naturally, Keating tried to have her replaced. Failing that, he hired a competing firm.

Accountants also played a prominent role in another publicized thrift failure, that of Silverado Banking, Savings and Loan, a Denver concern of which the President's son, Neil Bush, was a board member. In 1985 Silverado's auditors, Ernst & Whitney, forced the thrift to report \$ 20 million in losses because of problem loans. Silverado's managers weren't pleased with that result, so they got rid of Ernst & Whitney and hired Coopers & Lybrand, which took a more flexible view of the books. In 1986 Silverado reported \$15 million in profits and the managers got \$2.7 million in bonuses. A year and a half later the enterprise collapsed, at a cost to the government of some \$1 billion. Bank examiners later called the case "a clear example ... of opinion shopping" and said that the auditors in Coopers & Lybrand's Denver office had lacked expertise for the complex assignment. Last July, Coopers & Lybrand agreed to pay \$20 million to the Federal Deposit Insurance Corporation to settle potential claims relating to its Silverado audits.

Turn the spotlight on the auditors' role in the nation's most spectacular bank failures and, again, the picture isn't pretty. Consider the 1988 collapse of First RepublicBank Corporation, of Dallas, which had been formed a year earlier through the merger of RepublicBank with InterFirst Corporation. According to a complaint filed by the Securities and Exchange Commission, Arthur Young filed misleading audits of RepublicBank at a time when partners in the accounting firm held \$21.8 million in loans from the Dallas bank. Of the partners who received loans from the bank, at least ten were on the client-service team for RepublicBank, including three senior members of the audit team. (Ernst & Young is contesting the complaint and says that the Arthur Young auditors met the standards at the time.) One would think it would be obvious that such loans from a bank to its "independent" auditors should be prohibited, but it took the AICPA until September of last year to approve a rule banning its members from taking most loans from audit clients.

In the Bank of Credit and Commerce International case, possibly the biggest bank fraud in history, Price Waterhouse attested to the bank's financial statements as "fair and true" as late as April of 1990, despite having evidence of fraudulent transactions. Price Waterhouse officials in London were apparently concerned that qualifying their opinion of BCCI's books would trigger a depositor run and the bank's collapse.

**A** common theme in audit failures is a lack of true independence on the part of the auditors. This is rarely the result of outright corruption. The vast majority of accountants are honest and dedicated, and bribery has been a factor in only a few major audit failures, such as the collapse of ESM Government Securities, of Fort Lauderdale, Florida, which touched off a savings-and-loan crisis in Ohio.

The coercion is more subtle, a series of short-term economic incentives built into the system that make it more tempting for the auditor to be a shill for management than a public watchdog. As the audit firms became more competitive and bottom-line-oriented, the pressure to retain fee-paying clients and perform quick audits overwhelmed concerns about the firms' long-term reputations. Another factor is that traditional audit work is increasingly taking a back seat to a variety of other services being offered by the major accounting firms. In 1990 the Big Six firms received just 49.6 percent of their revenues from auditing and accounting, down from 62.4 percent in 1982, with the majority of billings now being for tax work gement consulting. Some firms are offering audits—their exclusive franchise—at big discounts to attract clients for their more lucrative consulting services: the profession's traditional function has been downgraded to a loss leader.

Compounding the independence problem is the failure of the audited financial statements to reflect economic reality. Auditors have frequently allowed transactions that can somehow be shoehorned into GAAP but bear little or no resemblance to the real world. As a result, institutions that appear to have substantial assets turn out to be insolvent. The General Accounting Office study of eleven failed thrifts found a startling gap: accountants had certified the S&Ls as having a total positive net worth of \$44 million, yet at the time they failed, five to seventeen months after the date of the last audit reports, they were \$1.5 billion in the hole. In case after case, U.S. Comptroller General Charles Bowsher notes, "the value melts right off the balance sheet." For example, thrifts were allowed to value junk bonds and real-estate investments at the amount they paid for them, even if the market for these assets had collapsed and they were virtually worthless. As a result, many regulators are urging that holdings be accounted for at current market values instead of their original cost.

Embarrassing discrepancies between audited financial statements and reality aren't confined to S&Ls. Professor Briloff, who has been sermonizing about the shortcomings of the accounting profession for a quarter century, warns that banks could be headed down the same path as the savings-and-loans; other fear that insurance companies could soon follow, and note that several carriers received clean audits shortly before they were declared insolvent by the regulators.

**G**iven the costs of a system that fails to detect financial debacles in the making, why has so little been done in the way of reform? It hasn't been for a lack of trying by a few members of Congress.

During the past six years Ron Wyden has sat through two dozen hearings on the subject, causing colleagues to question his sanity. Wyden has been pushing modest legislation that would require auditors to assess a company's internal financial controls and report uncorrected fraud directly to regulators. The bill would also provide legal protection to auditors who blow the whistle in good faith. But his efforts have been stymied by accounting trade groups and by corporate interests unwilling to bear the increased costs of audit reform.

Part of the reason for congressional inaction is the lack of public outrage. Because all but the biggest depositors are shielded from losses, and the cost of the thrift bailout is being shunted to future generations through deficit financing, there's no great pressure to act. Another factor is the sheer complexity of the issues. "Let's face it," Wyden says. "Members of Congress don't get up in the morning and say, 'Let's talk about GAAP and

RAP.' This is complicated material, even to those who are very sophisticated."

Not to be overlooked is the power of the AICPA, which helped block Wyden's legislation for several years before acquiescing in the fall of 1990 to a modified version, which died in a conference committee. "The AICPA has fought this tooth and nail for years," a frustrated congressional aide says. "They are powerful in a negative way. They tell members of Congress, 'This is a technical area. You do not know what you are doing.'" Bernard Z. Lee, the AICPA's deputy chairman for federal affairs and the head of its fifty-person Washington office, says he wishes the institute had the clout ascribed to it. Wyden's original bills didn't go anywhere, he says, because they had serious technical flaws.

Like many special interests, the AICPA backs up its lobbying with big money. Members of Congress know that opposing arcane accounting legislation isn't going to cost them any votes back home, but voting for it just might cost them several thousand dollars in campaign contributions from the AICPA's political-action committee. With little attention, the AICPA's Effective Legislation Committee has grown into one of the more well-heeled PACs on Capitol Hill. As the threat of federal regulation has increased, so has giving by the Effective Legislation Committee—from \$20,300 in the 1981-1982 election cycle to \$912,159 in 1987-1988. In the 1989-1990 cycle the AICPA's PAC gave \$1,087,044 to 176 Democrats and 141 Republicans, mainly powerful incumbents on committees with jurisdiction over banking, taxes, and commerce. This giving put the accountants' PAC in the top twenty. "That's the way the game is played," Lee says. "If the profession was going to be a player in Washington, it had to abide by the ground rules."

In a further effort to head off government regulation and address recurring problems, the AICPA has sponsored a series of commissions and task forces to examine financial-reporting issues. And congressional pressure in the mid-1970s led it to establish a complex peer-review and self-regulatory apparatus. Industry officials describe the self-regulatory process as working well; critics describe it as purely cosmetic, designed to give Congress the illusion that action is being taken to address the problems.

**I**n view of the spate of alleged audit failures during the 1980s, far more must be done to improve audit quality. Passage of Wyden's legislation would be a helpful first step that could make investors more aware of companies with sloppy internal controls and regulators more aware of potential fraud. The measures have the strong support of the GAO's Bowsher, who spent a quarter century with Arthur Andersen. "Legislative action is clearly needed to further protect investors and our Nation's government," Bowsher wrote in a letter to Wyden last May.

Regardless of what Congress does, there is much the big accounting firms can do. During the 1980s accountants got caught up with the fast-money crowd. Greed overwhelmed caution as accounting became less of a profession and more of a business. Many auditors lost their fabled skepticism and profitably cloaked swindlers' scams in respectability. Now, for the public's best interest and their own, the firms need to look inward and rededicate themselves to professionalism and independence. To some degree this is already happening: a few billion dollars in lawsuits have a way of concentrating the mind. Firms have to select their clients more carefully, weeding out those with sloppy ethics and weak internal controls,

especially companies that have fired their old auditors after disagreements. Auditors must refuse unrealistic deadlines that make it difficult to complete all the steps in an audit to their satisfaction.

In performing audits, auditors need to put substance before rules. They must recognize that the GAAP are designed to achieve a fair presentation of the facts, not provide a safe harbor for "creative accounting." Auditors must know the business they are examining, have the backbone to take tough stands with clients, and not let themselves get lost in a myriad of forms and procedural details. In many cases auditors discover the relevant facts but fail to interpret them correctly. They need to ask themselves whether the company's financial statement really makes sense. Is the client engaging in financial gimmickry? Are the transactions the equivalent of swapping two cats, each with a claimed value of \$500,000, for a \$1 million dog? Judge Sporkin suggests that advanced computer technology be used to eliminate some of the subjectivity in audits and to monitor a corporation's financial health continuously, in much the same way that the vital signs of hospitalized patients are observed. He also suggests creating an independent federal agency that would investigate financial debacles, in the way the National Transportation Safety Board studies airplane crashes.

Ethics rules need to be tightened to promote independence. If the professional organizations won't do the tightening, the government should do it for them. In both the RepublicBank case and an earlier scandal, involving Penn Square Bank, auditors received loans under special circumstances from the institutions they were auditing. The AICPA's recent action to prohibit such loans was a welcome, if overdue, step. Moreover, the practice of changing sides—auditors' going to work for their clients—ought to be curbed with a cooling-off period, like the year during which former government employees are banned from logging their old agencies. Regulators should also have to wait a year before going to work for the firms they were regulating: an SEC study of auditors' independence got sidetracked early last year when the SEC's chief accountant, Edmund Coulson, took a job with Ernst & Young's national office, in New York.

To improve audit quality, firms need to do a better job of recruiting talented people and paying them competitively. Gary Previts, a professor of accountancy at Case Western Reserve University, in Cleveland, says the big firms have thinned in talent below the top ranks and haven't been paying the salaries needed to attract top business students. John C. Burton, an accounting professor at Columbia University's Graduate School of Business, agrees that the profession is not competing effectively for the best people. In the 1960s and early 1970s about 16 percent of Columbia's MBA class went into public accounting, while today two or three percent go into management consulting with accounting firms and less than one percent into independent audit work, which is perceived as unglamorous and risky. In 1989, 45.8 percent of AICPA members were in public accounting, down from 54.1 percent in 1980.

American business and accounting leaders should stop mouthing platitudes about the U.S. system's being the best in the world and start taking some cues from overseas. The Bank of England, Great Britain's chief banking regulator, is authorized under a 1987 law to instruct banks to have the "reporting accountant" conduct any investigations or make any reports that the regulators consider necessary. It was at the request of the Bank of England that Price Waterhouse wrote a blistering report last June

about its client BCCI. The report prompted authorities to seize many BCCI operations—and gave Price Waterhouse an initial spate of good publicity. The 1987 law also calls for three-way consultations among the Bank of England, the client, and the outside auditors at least once a year. In Canada banking regulators may review the public accountant's working papers, and two outside auditors must share responsibility for the audit, with one of the two being rotated every two years. In Japan auditors' fees are set by agreement between the Japanese Institute of CPAs and an association of manufacturers.

Most important, public accountants must have perceived and actual independence. Audit firms should refrain from providing other services for audit clients. Let them do consulting, computer-system design, headhunting, or interior decorating—but not for those companies with which they are supposed to have an arm's-length relationship. Leaders of the Big Six firms argue that offering a broad scope of services enhances audit quality and does not impair auditor objectivity. They are fond of stating that they know of no case in which providing management-advisory services interfered with independence. Yet the AICPA's SEC Practice Section already restricts members from providing services such as executive recruitment and public-opinion polling for audit clients—an acknowledgment that there is a perceived problem if not an actual one. At a minimum the SEC ought to reinstate a rule—repealed early in the Reagan Administration—requiring companies to report what other functions they were paying their auditors for.

True independence also requires severing the direct financial tie between the auditor and the company being audited. That doesn't have to mean creating an army of government auditors. Auditors could be paid from a general industry pool administered by a trustee and funded by the audited companies. This ought to be tried first for financial institutions that want to accept federally insured deposits, because of the huge risk to taxpayers' money. If the results are satisfactory, the reform could be expanded to include all companies that want to sell securities on public exchanges. The audits for companies seeking to make initial public offerings of stock ought to be commissioned by the SEC, because the current system gives accountants a vested interest in making the deal fly and papering over any potential problems.

Audits are, of course, just one part of the overall financial-reporting system. Corporate managers, directors, and audit committees still have the front-line responsibility for preparing financial statements. Standard-setters, government regulators, and educators also have major roles to play in restoring credibility to financial statements. The accounting firms can do only so much by themselves. They need help if they are to overcome the skewed system of incentives that leads to defective observation. Firms should be given legal and financial protection if they blow the whistle on clients, and companies should be banned from shopping for favorable accounting opinions. Accounting firms should be prohibited from offering below-cost audits to lure new clients.

Accounting and business groups will no doubt denounce most of these proposals as impractical and excessively expensive. But it is hard to imagine a system more flawed that has undermined the very confidence it is supposed to engender a system that has led to a jumble of rules, regulations, guidelines, and review organizations in an effort to prop up the unsupportable. With the price for the savings-and-loan bailout running

into the hundreds of billions of dollars, and large commercial banks and insurance companies teetering, the cost of doing nothing would seem far greater. Unfortunately for some of the oldest and most prestigious names in the accounting profession, defending the status quo for so long has meant that their fates will be decided not in the marketplace but in the courtroom.

What do you think? Discuss this article in the Politics & Society conference of [Post & Riposte](#).



[E-MAIL  
ARTICLE](#)



[PRINTER  
FORMAT](#)

[SUBSCRIBE TO  
THE ATLANTIC](#)

---

Copyright © 1992 by William Sternberg. All rights reserved.  
*The Atlantic Monthly*; January 1992; Vol. 269 ; No. 1 ; Pg. 20.

---

**Subscribe to <sup>THE</sup> Atlantic**  
**Guaranteed savings, no risk. Click here.**

[Home](#) | [Current Issue](#) | [Back Issues](#) | [Forum](#) | [Site Guide](#) | [Feedback](#) | [Subscribe](#) | [Search](#)