**BIG 4 AUDITS: A THING OF THE PAST?**

***Anthony H. Catanach Jr. and J. Edward Ketz***

***Grumpy Old Accountants, October 2011***

As the Public Company Accounting Oversight Board considers [changes to the audit reporting model](http://pcaobus.org/News/Releases/Pages/03222011_AuditorsReportingModel.aspx), we must ask: *is the report really the problem, or is it the audit behind that report.*

The accountant’s job is not easy, and it’s even tougher in the largest accounting firms. The “up or out” promotion policy in these firms creates huge pressures for client development and retention, not to mention stresses to generate and maintain bonuses for managers and partners. The result: major incentives for accountants to “bend” the rules for clients.

Recently, we learned that [KPMG let Motorola record revenue](http://www.bloomberg.com/news/2011-06-09/dirty-secrets-fester-in-50-year-relationships-jonathan-weil.html) in the third quarter of 2006 even though the contract that originated the sale was not signed until the early hours of the 4th quarter. Without the deal, Motorola would have missed its third-quarter earnings target.

As we learn more about the large accounting firms’ role in the financial crisis of 2008, the news is not good:

* A [KPMG audit partner](http://www.bloomberg.com/news/2011-02-24/what-vikram-pandit-knew-and-when-he-knew-it-commentary-by-jonathan-weil.html) apparently ignored bank regulatory reports in order to give Citigroup clean internal control opinions. KPMG issued a “clean” internal control report on Citicorp on February 22, 2008, despite the engagement partner’s knowledge on February 14, 2008 of material weaknesses found by bank examiners. We are anxious to see how KPMG explains this “oversight.”
* Or how about the case of [Ernst & Young approving “Repo 105”](http://goingconcern.com/2010/03/ernst-young-was-comfortable-with-lehmans-shady-accounting/) transactions to keep debt of the books of Lehman Brothers right before the financial crisis started.

And even more recently, we have Ernst & Young blessing Groupon’s aggressive “gross revenue” recognition policy despite its complete violation of generally accepted accounting principles. Apparently, the Securities and Exchange Commission agreed with us (see [Groupon Finally Restates Its Numbers](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/327)), as they required Groupon to restate their financial statements for this “accounting error,” and amend their S-1 yet again.

All of these are clear cases of “rule bending” to help the client! Apparently, the new regulations put in place after Enron that were supposed to make it easier for accountants to do the right thing are not working. Evidently, those laws just aren't tough enough to deter large accounting firms from siding with their “paying” client, rather than their “real” client, the investing public.

Could inadequate governmental funding and political influence be exacerbating the problem? Consider the following:

* Often, it takes two to three years for the SEC to review in detail the most recently filed financial statements of publicly traded companies. With limited resources, the regulators simply cannot keep pace with the volumes of corporate securities filings. In short, timely oversight of financial reporting irregularities isn’t happening, unless perhaps a whistleblower steps forward.
* Since inception the [PCAOB has issued fewer than 40 actions](http://pcaobus.org/Enforcement/Decisions/Pages/default.aspx) against auditors for violating generally accepting auditing standards despite numerous post Sarbanes-Oxley accounting failures. Particularly noteworthy is the fact that of the Big Four accounting firms that audit the vast majority of exchange listed firms, only a handful have been cited despite the numerous cases of malpractice that the marketplace has witnessed. Could political influence be contributing to this “preferential treatment?” How else can you explain the application of “too few to fail” treatment to the large accounting firms? They don’t really audit anymore, so who really cares if they fail?

So how much of this “rule bending” is related to lobbying clout? According to the Center for Responsible Politics ([www.opensecrets.org](http://www.opensecrets.org)) in an article entitled “Wall Street’s Campaign Contributions and Lobbyist Expenditures,” accounting firms spent $81 million on campaign contributions and $122 million on lobbying between 1998 and 2008. Accounting giants Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers spent, respectively, $32 million, $37 million, $27 million, and $55 million. In 2007 alone, accounting firms employed 178 lobbyists.

And the Big Four continue to poison the regulatory waters. Just as Goldman has been criticized for sprinkling their people into key positions at Treasury during the financial crisis of 2008, the Big Four have done exactly the same at the SEC and PCAOB, the very institutions that regulate them. A simple review of staff biographies for each of these organizations is confirmation enough. Additionally, we all can cite examples of former regulators join the Big Four as consultants when they retire.

These large accounting firms also are not shy at promoting their agendas. What are they interested in? They favor accounting rules that promote more judgment in the application of GAAP that reduce the likelihood of litigation, e.g., fair value and [International Financial Reporting Standards](http://profalbrecht.wordpress.com/2008/12/23/accounting-firms-lobbied-obama-for-ifrs/). They also support caps on litigation costs for their malpractice, as well as continued protection from disclosure of their governmental inspection reports and disciplinary actions.

* Are investor interests really served by the [PCAOB’s refusal](http://www.businessweek.com/news/2011-03-30/dirty-little-secret-unravels-in-bermuda-blunder-jonathan-weil.html) to disclose the names of companies whose auditors failed to conduct proper audits? Even though fewer investors today actually rely on the current audit report for assurance on financial statement quality, all would appreciate knowing that a specific company’s auditors “did not obtain sufficient competent evidential matter to support its opinion on the issuer’s financial statements,” as occurred in Alterra’s case.
* Today, according to [Francine McKenna](http://retheauditors.com/2011/03/13/forbes-auditors-abandon-investors-on-liability-limits/) at *re: The Auditors*, the Big Four are devoting significant attention to the Dodd-Frank Act since this legislation gave the SEC the authority under existing antifraud rules to take action in cases involving transnational securities fraud. This prompted seven major accounting firms, including all of the Big Four, to pool their legal resources and plead for protection. In a joint comment letter to the SEC, the audit firms reminded the SEC that they already face claims in the United States that are big enough to threaten their existence. Now they’re worried that allowing private actions related to transnational securities fraud will enable that threat to seep into their international audit networks as well.

So, how can we solve this Big Four audit problem? [Mark O’Connor,](http://retheauditors.com/2011/03/30/an-honest-services-crisis-professional-poison-and-a-chicago-connection/) CEO and Cofounder of Monadnock Research provides some clues. We report his suggestions in bold below, and our thoughts on how to implement them in italics:

* **We need to take the right steps by sponsoring organizations, individuals, and legislation that will do the right thing.***Traditional academic and professional accounting organizations have aided and abetted the “audit problem” by their silence. Therefore, we must encourage and support parties (e.g., bloggers, concerned citizens, journalists, etc.) that are willing to promote meaningful change to the audit model and related enforcement.*
* **Trade secrecy for transparency.***Encourage the PCAOB to fully report their inspection findings. A good start would be naming the companies subjected to faulty audits, as well as the individual engagement partners who signed off on the bad audits.*
* **Turn them in.***Experienced professionals (academics, concerned citizens, etc.) must proactively report auditing and reporting violations they find. All too often, many stay on the sideline unwilling to put their professional beliefs on the line. Use “*[*whistleblower hotlines*](http://www.sec.gov/complaint/tipscomplaint.shtml)*”…that is what they are there for.*
* **Shun them. Stop working for the bad guys and stop associating with them. Just being connected with them is poison.***This takes intestinal fortitude, particularly for parties that benefit from the “support” provided by the large auditing firms (e.g., academics, business schools, etc.). In the case of B-schools that conveniently and mindlessly send their students to the Big Four, are they really acting in the best interest of their students by sending them to work for firms that routinely commit accounting and auditing malpractice? Is this ethical?*
* **Stop doing business with them.**

*The PCAOB needs to dismiss the “the too few to fail” argument promoted by the large accounting firms. What is to be gained by perpetuating the illusion that public company audits are being done, when they are not? The PCAOB needs to actively ban firms for their shoddy work. Others will gradually fill the void filled by the offending firms.*

* **Trust, but verify.***Consider use of a “joint audit” approach where two firms are engaged to audit a company. This might actually promote competence and independence.*

We have one other rather obvious suggestion: ***meaningful enforcement of existing regulations***. No rule changes required…just make sure that auditors and accountants actually do their jobs. We need to demand meaningful consequences to accounting and audit malpractice.

The evidence suggests that accountants and auditors today can shirk their audit responsibilities to the public with little or no lasting harm to themselves, and surely, not as much hurt as they have caused the investing public (see [Paper Tigers: The U.S Accounting Oversight Regime](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/208) and [Accountants Behaving Badly](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/332)). The public should be outraged that few, if any, Big Four accountants actually lose their licenses permanently, and are free to prey on the trust of the unsuspecting investor.

So what can we do to wake people up to this lack of regulatory enforcement? We have an idea that likely will scare quite a few people: a Megan’s list for accountants that details all regulatory actions against accountants and auditors. Let’s let the public know that these fake auditors are still out there practicing. A bit too extreme you say? Okay, let’s just continue writing about all these cases and posting commentary on the information superhighway.

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*