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A warm welcome to today's Business Links Seminar

Accounting Crises, Auditing and Politically Motivated Regulation: A Review of the Last Decade

Presented by

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Overview of presentation:

- A brief review of accounting crises
- What was the "alleged" role of auditors?
- Some examples of high profile failures – why?
- What were the consequences for auditors?
- An Australian case study (1): The Ramsay Report
- The role of evidence in formulating policy – some general principles
- A simple model of audit quality and some lessons from history
- Evidence on auditor independence – does it support the actions of regulators and politicians?
- Where is the "next crisis" (and what is being done about it)?
- An Australian case study (2): Changing educational requirements
- Some concluding comments

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A brief review of accounting crises

- Last decade has seen a number of high profile corporate collapses as well as many significant examples of "accounting fraud"
  - Parmalat (Europe)
  - Enron (US)
  - Sunbeam (US)
  - Worldcom MCI (US)
  - HIH (Australia)
  - OneTel
  - Harris Scarfe

- A common thread is the failure to reveal deterioration in financial/business performance on a timely basis – keep this in mind!

- Put simply, "bad news" failed to arrive as quickly as it might

- In some cases evidence/allegation of private benefit (e.g., large bonuses based on "flawed' accounting numbers)

- High profile/size of organization has meant considerable public "reaction" and calls for regulatory action.

What was the alleged role of the auditors?

- Some confusion between whether auditors are blamed for accounting failure or business failure
- Auditors are sometimes portrayed as “gatekeepers”
- Perhaps most commonly, auditors are blamed for “turning a blind eye” to accounting deficiencies, in particular aggressive accounting practices?
- Why would auditors fail to act – the allegation is a lack of independence, rather than a lack of ability to “see through” aggressive accounting?
- Is this necessarily true?
- How important is “independence” anyway?

Some examples of high profile failures – answering the "why" question

•Knowing "why" is important in identifying the (incremental) role of the accounting profession.

•Some Australian examples:

- HIH
- OneTel
- Harris Scarfe
- They all sold product for less then its cost!

•Enron

- Greed/ego – "The smartest guys in the room"
- Failure to grasp economics of ever-expanding business
- Impossibility of reliably reporting performance (what is the value of a 20 year energy supply contract with a series of put and call options attached?)
- Did Andersen ignore the problems or not see them?

Some examples of high profile failures – answering the "why" question

- MCI WorldCom
  - Straight accounting fraud – expenses treated as capex. Did the auditor miss it or ignore it?
- Bottom line:
  - Aggressive/fraudulent accounting doesn't "kill" firms. It actually keeps them alive for too long.
  - Auditors don't "cause" business failure
  - Is "accounting fraud" a reflection of auditor incompetence or lack of independence?
  - Who killed Andersen – the market or the regulator?

What were the consequences for auditors?

- A host of new regulations:
  - Auditor tenure restrictions (but was this happening anyway?)
  - Auditors restricted on selling other services (differs internationally, but US restrictions impact global accounting firms and their clients)
- Auditors also face more statutory responsibilities and extensions of the audit process (internal control reporting)
- Not all bad news – audit fees have increased!
- Curious logic – auditors “blamed” for failure but then given further statutory responsibility! Does this make sense?

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An Australian case study (1): The Ramsay Report

- A report on the "Independence of Australian Company Auditors"
  - Chaired by prominent corporate law expert
  - Commissioned mid-2001 prior to an election
  - Had to report before findings of HIH Royal Commission

- Report uses overseas requirements as a benchmark, without ever justifying why they are good/appropriate benchmarks

- No explicit identification of independence problem, but a raft of suggested changes to "improve" independence of auditors

- Suggested an Australian PCAOB

- Failed to identify sources of reduced auditor independence other than anecdotally – complete failure to carefully consider robust empirical evidence (but also a lack of evidence)

- No cost/benefit analysis

- No critique of existing regulations.

- A political exercise?

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The Role of Evidence in Formulating Policy

- As a researcher, a topic of some interest (and belief)
- What makes for "good" regulatory policy:
  - ➢Sound economic reasoning
  - ➢Intelligent data analysis

- Contrast this with how much of the recent regulatory change impacting the accounting profession has occurred:
  - ➢Hayek (1954) "Historical myths have played perhaps nearly as great a role in shaping opinions as historical facts"
  - ➢Might "historical" also be "hysterical"?
  - ➢One "myth" – did the market collapse of 1929 trigger pressure for regulation of financial reporting and audit – no! (but it did give the calls massive impetus)

- Accounting has evolved over a very long time (record keeping tracks development of civilization)

- Accounting in its present form (with audited financial statements) is a product of the last few centuries, as are professional accounting firms and professional associations, but auditing per se has a much longer existence (Watts and Zimmerman 1983 JLE).

A Model of Audit Quality

- An application of "good" economic reasoning (Benston's first requirement). After all, auditing evolved as a response to economic demand, not regulation (merchant guilds in UK in 15th-17th centuries)

- Audit quality has two components (deAngelo 1981 JAE):
  - Competence (probability of identifying an issue)
  - Independence (probability of dealing with the issue/resisting client pressure)

- This model is consistent with auditing arising in response to powerful economic forces, not as the result of regulation (in contrast, what do most students think?)
- The model also implies that audit firms will care about their reputation (and history supports this, as well as more recent empirical evidence)

- This model also highlights a major flaw in regulatory and political focus on the accounting profession, particularly auditors – the allegation is that audit quality was low because of reduced independence. But how important is independence relative to competence?

- Suggested and actual regulatory intervention has focussed on terms of the auditor-client engagement (NAS and tenure). Both are (possible) determinants of independence.

The Evidence

- Intelligent data analysis (Benston's second requirement) needs suitable empirical measures that capture the key constructs.

- Basic question: is auditor quality impaired when independence is threatened?

- Hard to measure effect of reduced independence "in appearance", so focus is on independence "in fact"

- We need to measure:
  - Variation in audit quality
  - Variation in threat to independence

- Audit quality not directly observable

- Audit report (predicting qualifications)

- Litigation against the auditor

- Capital market effects

- Properties of audited financial statements such as "earnings quality" (joint product of management representations and audit quality)

- Threat to independence – the extent of an economic bond between the auditor and the client
  - Tenure (audit firm/team/partner)
  - NAS (at what level of analysis?)

- I will focus on NAS effects as an example.

The Evidence: NAS and its effect on auditor independence "in fact"

- A selective (but representative) summary
- Demonstrates how research is refined over time (careful analysis)
- Focus on "earnings quality" as a proxy for audit quality variation
  - Earnings management (unexpected accruals)
  - Benchmark beating
  - Cash flow prediction
  - Conservatism
- Interesting to see how an initial and "attractive" result is questioned by subsequent analysis
- High profile results are naturally subject to further testing
- Top academic journals publish very few studies that fail to reject the null hypothesis (suspicion about lack of power)
- But top journals also always interested in papers that question a documented "result"

The Evidence: NAS and its effect on auditor independence "in fact" (cont)

- Frankel/Johnson/Nelson (2002 TAR)
  - Very high profile – special AAA conference, fast-track into TAR, front page of Wall Street Journal
  - High RNAS (NAS relative to audit fees) is associated with higher (absolute unexpected accruals and greater probability of beating analysts' forecasts of earnings)
  - Results don't extend to other benchmarks (such as earnings increases or avoiding a loss)
  - One year of US data (2001) following fee disclosure regulation
  - No evidence of market reaction to fee disclosures
- So a "result" supporting calls for NAS restrictions
- But how robust are the results?
- Problems in defining the relationship between managerial incentives to manipulate accounting numbers and the incentives of the auditor.
- Issues with how key constructs are operationalized
- Other reasons behind accounting manipulation
- Data/statistical issues

The Evidence: NAS and its effect on auditor independence "in fact" (cont)

- Ashbaugh/LaFond/Mayhew (2003 TAR):
  - Frankel et al. result driven by method of estimating unexpected accruals (i.e., the proxy for earnings management)

- Chung/Kallapur (2003 TAR):
  - What is an appropriate measure of economic bond?
  - RNAS doesn't capture the economic bond at either the firm or even office level (but what should the unit of analysis be – partner?)
  - Show Frankel et al. result is concentrated among small firms (less important to the auditor)
  - Can't find a Frankel et al. result using importance of NAS within overall portfolio of clients

- Larcker and Richardson (2004 JAR):
  - "Results" are concentrated in 10% of firms with unusually weak governance
  - RNAS and "fee level' results go in opposite directions

- All 3 of these studies also show that the primary result in Frankel et al. (higher absolute unexpected accruals) is actually concentrated among firm-years with unusually negative unexpected accruals - hard to see this as evidence of "aggressive" accounting.

The Evidence: NAS and its effect on auditor independence "in fact" (cont)

- US studies post-2000 probably are contaminated by effect of some scandals.

- Ruddock/Taylor/Taylor (2006 CAR):
  - Australian data pre 2000 (pre-SOX etc)
  - Test whether NAS is associated with reduced conservatism (i.e., less timely incorporation of bad news into earnings)
  - Premised on assumption that (quality) auditing prompts timely revelation of bad news (audit procedures are skewed towards looking for an overstatement)
  - Three method of identifying conservatism
  - Results are robust to a multitude of tests
  - Still illustrates difficulty of proving an experiment is powerful enough

- Other studies also important: Ferguson et al. (CAR 2004; Ke and Francis RAST 2006).

Where is the next crisis?

- Recall a recurring theme of this presentation: a failure to understand historical precedent
- We see such a failure right now at the standard setting level – an inexorable move towards increased use of mark-to-market/fair values (Tweedie's twaddle).
- This is not new – lessons from 1920's and US reaction thereto
- "Impairment testing" open to abuse – how do we know the fair value of something without a market? Does this mean a zero value as per "theoretical models" from the 50's and 60s (Chambers etc)
- How different is the dilemma of "estimating fair value" from the issue of recognizing revenue not yet received (or earned? – see Enron for a reminder regarding recognition of gains on forward contracts as revenue – service not yet provided)
- The role of verifiability and conservatism "written out" of the framework – see current IASB draft.
- Recall examples of high profile failure – aren't these examples of a lack of conservatism in reporting (i.e., the bad news was not incorporated on a timely basis)?
- We need to pay (far) more attention to research that explains why accounting looks the way it does (i.e., the role of economic forces)
- How far out of their comfort zone does fair value take the auditors?

An Australian case study (2): Changing educational requirements

•Recall my first "lesson": audit "failures" likely have far more to do with lack of competence than lack of independence.

•So what determines competence?
- Knowledge base
- Experience
- Continuing education

•Australian environment:
- Harder to recruit best students with CA designation "training" no longer restricted to CA firms (so no longer an exclusive access point)
- Pressure on ICAA to find a "solution"
- Open up access to non-accounting grads – began via exclusive short course (distance) through Deakin Uni
- No economics, no finance, limited accounting (6 units total increased to 8, but credits available)

•Is this a sensible response to an ever-increasingly complex environment?

•Absolutely critical that accountants understand complex financial and economic concepts where fair value/impairment testing is more common

Some concluding comments

- There are five lessons I hope to have illustrated

- First, the need to subject regulatory policy to sound economic reasoning and careful empirical analysis – this applies far more broadly than regulation of accounting and auditing.

- Second, the role of history – we should not ignore the past and especially what we can learn about why accounting and auditing exist in their present form. They are economic goods, not a product of regulatory fiat.

- Third, applying the first two lessons to the regulation of auditors in the past decade, it was founded on anecdotes and prejudices that almost completely miss the underlying issues.

- Fourth, if we really believe auditors are ineffective under a regulatory mandate, why did we extend the mandate rather than take it away?

- Fifth, looking to the future, why do we persist with attempting to shift accounting on ideological grounds ("value relevance") and, in some cases, reduce the quality of education at the same time? A recipe for disaster!