

Prepared Testimony

I agree with Secretary Paulson that a strong auditing profession is essential to the health and vitality of the U.S. capital markets, and I applaud him for forming this committee. I want to thank the Committee's co-chairs, Arthur Levitt and Don Nicolaisen, for giving me the opportunity to testify before this distinguished group on human capital issues facing the auditing profession.

Let me begin by telling you a story. Susan Hope is a hypothetical economics professor at a small university in the south. Professor Hope, like most U.S. citizens today, has only a defined contribution pension plan at work (similar to a 401K plan). Susan invests a substantial portion of her income in this pension plan – Susan's a big fan of the ownership society espoused by certain politicians – and her employer matches a portion of Susan's contributions. Professor Hope, were she investing her retirement contributions herself, would direct her investments to those corporations with good corporate governance, including corporations who are willing to pay a premium for quality audit services, audit services provided by individuals who are bright, motivated, well trained and, most importantly, committed to the public's interest – in this case, her interest. To the extent that Professor Hope represents the marginal investor, auditors who can deliver higher quality services (e.g., those who are better at detecting fraud and errors), would command fee premiums, and salaries would rise to reward those who provide such valuable services better than others. This would represent a market solution and, like Secretary Paulson as quoted in The Washington Post on November 20th, would be my preference.

However, a direct market for audit services – a market between the auditor and the ultimate beneficiary of the auditor’s work product – does not exist. The question is whether our existing market mechanisms approximate the result that would be obtained in a direct market. Under existing institutional arrangements, a company’s board of directors is charged with representing shareholder interests, and, through the board’s audit committee, it contracts for the amount and quality of audit services. However, a company’s board and its audit committee, either through ignorance, somnolence, or management bias, does not always contract with the most qualified auditor and sometime seems more concerned with lowering audit fees than with maximizing audit quality. Surely a market mechanism exists for such pernicious behavior – the mutual fund that Professor Hope selected, exercising their vote as an owner of the corporation, can vote the rascals on the board out – right? Wrong. For in the U.S., shareholder democracy would make Nikita Khrushchev proud, and it appears that the SEC has buried any attempts to provide meaningful shareholder access to the proxy. And, even if meaningful shareholder elections existed, recent research findings suggest that many mutual funds typically vote as suggested by company management. Professor Hope could switch mutual funds, but her employer only offers her the choice of two mutual fund families, and both have similar voting policies.

Since a direct market solution does not currently exist, Susan must rely on the personal ethics and private virtue of corporate boards, managements, and auditors. How effective will this be? Since we know from recent experience that not all such individuals have seen the light and recognize both the short- and long-term rewards from ethical behavior and private virtue, this reliance may be misplaced.

What does all of the above have to do with accounting education? It underscores the critical importance of a sufficient number of suitably-qualified entrants to the public company auditing profession, especially those whose educational experience is inculcated with an emphasis on the *public responsibility* of auditors. Currently, accounting programs are housed within Colleges of Business (COB). A typical COB has a strong, and appropriate, focus on private interest – make as much money as possible because that is why you are in business. However, the focus of public company auditors is, or at least should be, different.

I suggest that the Advisory Committee consider a different model – an education model involving professional schools of auditing, and a licensure model where a separate certification for public company auditors would exist. Both education and licensure would be overseen, in cooperation with other parties, by the PCAOB.

SOX granted the PCAOB authority over standard setting, registration and inspection, and enforcement for public company auditors. Notably absent from this list was education and licensure. Imagine a college football coach with authority over practice and play calling, and one who will be held accountable for the team's performance, without any authority over recruiting. This is unthinkable, at least in the South, but that is the very position the PCAOB is in today.

I recommend that the SEC through its rule making authority, or the Congress, expand the PCAOB's mandate to include education and licensure. Under its education umbrella, the Board, in a cooperative partnership with the American Accounting Association, would develop standards to accredit "professional schools of auditing". A prime benefit of professional schools of auditing would be that the accreditation process could include developing a student culture of professional responsibility. As a noted academic has argued, "The CPA is supposed to be

independent of their client. When should this independence begin. I would argue that this independence should begin in college.” Another benefit of professional schools of auditing is that the curriculum can be designed to uniquely meet the needs of public company auditors (e.g., internal control frameworks, fair value, IFRS, XBRL, etc.). Moreover, accrediting standards can be established to break the stranglehold of three accounting research journals on the tenure and promotion process of auditing professors at leading universities (helping to ameliorate the faculty shortage), and to emphasize the importance of professional interaction between terminally qualified professors and the practicing profession. In addition, as part of any action by the SEC or the Congress to expand the PCAOB’s mandate to include education and licensure, there should be a clear statement that the PCAOB is authorized to gather and share client and audit firm data with academics for research purposes subject to appropriate confidentiality provisions and that any such data are shielded from discovery in litigation. Such a step would help to address the shortage of accounting Ph.D.s in auditing. And, as part of the accreditation process, professional schools of auditing could be expected to educate some number of Ph.D. students helping, too, to address the Ph.D. shortage.

Under the licensure umbrella, the Board would create a national license for auditors of public companies, the CPA – PCA (public company auditor). The Board would partner with the AICPA in adding a fifth and sixth section to the CPA exam. These sections would cover, in greater depth, issues particularly germane to financial accounting, auditing, and ethics for public company auditors. In addition, as part of its inspection process, the Board would specifically inspect the work of candidates for the CPA-PCA license, on a random basis. If individuals knew that the PCAOB might inspect their work, and that this inspection would affect their prospects of licensure, it would have a powerful effect on individual behavior and at a point in one’s career

where the habits being formed may last a lifetime. Upon completion of all six sections of the exam, and after completing two years of public company auditing experience (including possibly having his/her audit work inspected), an individual would be licensed as a CPA-PCA. All individuals in a registered firm at the manager level and above must possess this license. The CPA-PCA license, since it is granted by the PCAOB, would be national, addressing a substantial challenge of state reciprocity that exists today.

I believe that the above model would make the public company auditing profession more attractive to students, and that graduates so educated would be better prepared to serve the public interest. Students would clearly be entering a profession, and the demands of establishing professional schools of auditing and of passing two extra sections of the CPA exam should result in a situation where salary levels would have to rise to attract the needed supply. The combination of being educated like other professions (i.e., separate law and medical schools) and having higher starting salaries should result in more of the best and brightest being attracted to the public company auditing profession.

The need for graduate education for accountants has been recommended by various “blue ribbon” committees for almost 40 years -- now is the time to act. Thank you.