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CONGRATULATIONS TO ARTHUR ANDERSEN:

Why Self-Regulation of the Accounting Industry Doesn't Work

By Lisa Buckser-Schulz

The list is long. Too long. Some of its most recent entries are Waste Management, Sunbeam, Microstrategy, Baptist Foundation of Arizona and, of course, Enron — the latest and greatest in a long line of audit failures. Collectively, those audit failures allowed hundreds of millions of dollars in phony revenues and assets to be reported and, when those companies were forced to restate, billions of dollars in market capitalization were erased. For those of you that are keeping score, each of those companies had the same auditor — Arthur Andersen. With all of the public outcry over Enron and Andersen's involvement in what is undoubtedly one of the biggest accounting frauds of all time, one might think that the regulators that oversee the accounting industry would be all over Andersen, subjecting them to disciplinary measures, requiring them to change their ways. Well, not exactly...

At the same time that the Enron scandal broke with the Company announcing a restatement which obliterated $586 million in revenue over a five year period and subsequently filing the largest bankruptcy petition in history, Andersen was undergoing its required triennial "peer review" by fellow "Big Five" auditor Deloitte and Touche. With full knowledge of the Enron situation in hand, as well as the fact that just a few months earlier Andersen paid an unprecedented $7 million to the SEC to settle a civil fraud complaint arising out of its audits of Waste Management (where Andersen apparently discovered and then acquiesced in Waste Management's fraudulent accounting), Deloitte gave Andersen a glowing review, noting in a December 21, 2001 letter to the firm:

> In our opinion, the system of quality control for the accounting and auditing practice of Arthur Andersen LLP for the year ended August 31, 2001, has been designed to meet the requirements of the quality control standards for an accounting and auditing practice established by the AICPA [American Institute of Certified Public Accountants], and was complied with during the year then ended to provide the firm with reasonable assurance of complying with professional standards.

One week later, with news of Enron's sham accounting practices splashed on the front pages of newspapers across the country, the Chair of the SEC Practice Section ("SECPS") of the AICPA sent the following letter to Joseph Berardino, CEO of Andersen:

> It is my pleasure to notify you that on December 28, 2001, the SECPS Peer Review Committee accepted the report on the most recent peer review of your firm. . . .
>
> As you know, the reviewers opinion was unmodified. *The Committee asked me to convey its congratulations to the firm.* (Emphasis added).

How could the AICPA have sent a letter to Andersen congratulating the firm under the circumstances? Why did similar letters issue to the accounting firms responsible for the now discredited audits of Cendant, Centennial Technologies, and Livent? Why did Ernst & Young rubber stamp PricewaterhouseCoopers' controls for monitoring the independence of its auditors during its 1997 peer review of the firm when an SEC review of Coopers during the same period found immeasurable independence violations and Coopers itself subsequently

Continued on page 2.

WHY SELF-REGULATION DOESN'T WORK

Continued from page 1

admitted that almost half of the firm's 2,698 partners had direct investments in the securities of the firm's clients? The answer is that the present system of regulating the accounting profession does not work. This is hardly surprising. The AICPA, the body currently responsible for monitoring and disciplining accountants, is a private trade association for CPAs. Accountants call it "self-regulation" but what it really means is no regulation at all. The only people charged with keeping accountants honest are accountants themselves and, left to their own devices, they have not been getting the job done.

There are currently two components to the accounting profession's self regulatory system: peer reviews and discipline. While publicly touted as a quality control check on accounting firms, peer reviews are, in actuality, little more than accounting firms patting each other on the back for a job well done. Indeed, in 25 years of self-regulation, there has *never* been a negative review of any large accounting firm. How this can be the case in light of the steady deterioration over the last few years in the quality of audited financial results and the dramatic rise in the number of restatements (464 restatements between 1998 and 2000, which was higher than the previous 10 years combined), can only be attributed to the fact that the system is rigged in favor of protecting the auditor at the expense of the investors who have come to rely on audited financial statements in making their investment decisions.

Peer reviews are simply not designed to take a *critical* look at whether an accounting firm's audit procedures are adequate. For one thing, there is no peer review of audits that are already the subject of litigation or investigation by a governmental authority. That means that audits that have already been identified by others as being problems are shielded from scrutiny. That is how Andersen was able to keep Deloitte from reviewing the Enron audit. In addition, according to Lynn Turner, former Chief Accountant of the SEC, audit partners are told which of their audits are going to be reviewed *before the audit begins.* What auditors aren't going to be on their best behavior knowing that someone is looking over their shoulder?

Further, peer reviewers are told up front that the peer review program "depends on mutual trust and cooperation" and that "disciplinary actions...will be taken only for a failure to cooperate or for deficiencies that are so serious that remedial or corrective actions are not suitable." Accordingly, when a reviewer does find a problem with an audit, it is not brought to the attention of the AICPA. Instead, *the firm under review* is asked to undertake an investigation into its own conduct! If the firm decides to take no action and the reviewer disagrees, the reviewer is cautioned to recognize that it has not audited the financial statements in question. In other words, the benefit of the doubt goes to the firm being reviewed. It should come as no surprise, then, that an SEC investigation into the regulation of the accounting industry conducted under former commissioner Arthur Levitt found that, in performing peer reviews of each other, the Big Five accounting firms repeatedly discovered major flaws in the way audits were conducted, but nevertheless gave each other clean bills of health in public reports of the reviews.

The disciplinary function of the AICPA is also ineffective. Incredibly, no major accounting firm has ever been disciplined by the AICPA. Indeed, less than one out of every five accountants that have been sanctioned by the SEC for unprofessional conduct have been subjected to discipline by the AICPA. Further, even in situations where the AICPA concluded that those members sanctioned by the SEC had actually committed violations, it refused to take public disciplinary action in five out of six cases, choosing instead to close the matter after issuing confidential letters instructing the offenders to take remedial steps such as additional training.

There is no doubt that self-regulation of the accounting profession has been a complete and utter failure. As Sarah Teslik, Executive Director of the Council for Institutional Investors recently wrote on the subject:

> [S]elf regulation does not work. Criminals and other law violators do not self regulate. The fact that we have law enforcement officials, school principals, IRS auditors—even basic corporate audits—show that no one is so naive as to rely on self regulation to police society's most critical functions.

One positive legacy from the Enron debacle may be that self-regulation of the accounting industry may finally be put to rest. Investors and lawmakers alike are clamoring for stronger accountability for the people who have been championed as the gate keepers of honest financial reporting. Even SEC chairman Harvey Pitt, who took office saying that he wanted to usher in a "new era of respect and cooperation" between the SEC and the accounting profession (Pitt represented the AICPA and all of the Big Five accounting firms when he was in private practice), has conceded that more oversight over the accounting profession is needed. Hopefully, the end result will be that a truly independent body with broader disciplinary powers over accountants will be put into place. Until then, investors should not take the attitude that "what you see is what you get" when it comes to audited financial statements.