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Alternative Forms of Public Practice: Implications for the Profession

by
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Arthur S. Ainsberg is the chief operating officer of Brahman Partners, a $500 million private investment partnership. Prior to joining Brahman Partners, Mr. Ainsberg was a partner with Richard A. Eisner & Company, LLP. Earlier in his career, he served as chief financial officer of Odyssey Partners and as a vice president at Oppenheimer & Co.

Mr. Ainsberg is a member of the Board of Directors of Nomura Securities, Inc., the American subsidiary of The Nomura Securities Co., the world's largest securities firm. In his advisory role at Nomura, he is chairman of the audit committee and a member of the compliance committee.

In 1997, Mr. Ainsberg was elected to the Board of the District Business Conduct Committee of the National Association of Securities Dealers (NASD). This past year he was named to the Small Firm Advisory Board of the NASD.

In 1994, the Board of Regents of New York State appointed him to the New York State Board of Accountancy. The Board is responsible for establishing and monitoring the licensing, disciplinary, and educational standards for certified public accountants in New York State. In 1998, he was named chairman of the Board.

Mr. Ainsberg has served as a securities arbitrator at the American Arbitration Association, the NASD, and the New York Stock Exchange, Inc. His professional affiliations include the Legal/Compliance and the Financial Management Divisions of the Securities Industry Association, the Wall Street Tax Association, the American Institute of CPAs, and the New York State Society of CPAs.

Mr. Ainsberg received a BBA in accounting and an MBA in finance and investments from Baruch College.

It is a great honor for me to be asked to present the Emanuel Saxe Lecture at Baruch College this evening. As a Baruch student in the 1960s, I had the privilege to know Dr. Saxe personally. He was a towering figure at this College and throughout the profession. For many of us, our first accounting textbook was, of course, *Principles of Accounting* by Tunick & Saxe.

We are here at the beginning of a new millennium, at a time of enormous prosperity for this city and country. Our securities markets are in the midst of the greatest surge in our nation's history. The Internet is changing the world at a breathtaking pace. America's technological prowess is the envy of the world. Industrial American corporations are learning to adjust their business models to deal with the Information Age.

The economic surge we are witnessing has also produced an enormous media surge. Our successes as auditors and accountants are rarely mentioned, but our mistakes as auditors

and accountants are magnified by the press. On a daily basis, our activities are scrutinized by the SEC, state regulators, shareholders, audit committees, and colleagues through the peer review process.

Capitalizing on our mistakes, plaintiffs' lawyers have emerged as effective advocates for institutional and individual investors. Plaintiffs' lawyers have been willing to invest years in complex securities litigation to determine alleged malfeasance by corporations, directors, auditors, and corporate executives. Unfortunately, in certain cases, their allegations have been well founded. Fraud has become page-one news. The Cendant, Sunbeam, and McKesson cases are headline cases, but many other cases have been settled and litigated in the past 10 years at enormous costs to both corporations and their auditors. The recent settlement by Ernst & Young for $335 million in the Cendant Securities litigation matter was a front-page *New York Times* story. It represents one of the largest settlements by an accounting firm in American history.

The accounting profession is also dealing with many changes and challenges. One of these challenges is the structuring of public accounting practices in the 21st century. The enormous changes in the technology, capital, and investment landscape have caused many public accounting firms to take a step backward and ask themselves a series of questions:

- Am I structured so that I can service my clients effectively during this technological and investment boom?
- Do I have the most talented employees servicing my clients?
- How can I compensate my personnel so that they can share in the same benefits of corporate America--including stock options, profit-sharing plans, and deferred compensation plans?
- How can I offer my clients other financial services to enhance my audit and tax practice?
- Where do I get the capital to grow my firm?
- Where do I get the capital to pay my retiring partners and, at the same time, give my younger partners the compensation they deserve?
- How do I obtain the technology resources to maintain my competitive edge in the profession?

In the past, a managing partner facing these questions had few options--a merger with a larger firm, a structured transaction with the younger partners, or maintaining the status quo.

Today, the options are different. We have witnessed, during the past decade, several large public corporations staking out public accounting firms as an area of opportunity. The two largest companies to do this--American Express Corporation and H&R Block Corporation--are financial conglomerates that are trying to bring together their various resources in a public accounting framework. Their acquisitions of public accounting firms have enabled both American Express and H&R Block to become among the 10 largest accounting firms in the United States.

Another vehicle utilized by accounting firms to change their independent status and achieve public ownership has been the "consolidation" or "roll-up" method. In this case, a public vehicle is formed by merging a group of public accounting firms into a public corporation. The largest factor in the roll-up area is Century Business Services. Their significant acquisitions during the past five years also qualifies Century among the largest accounting firms.

These transactions seem to make economic sense. The firms being acquired receive a

capital infusion, thereby eliminating both "succession" and "capital to grow" problems. It represents an opportunity for staff to be part of a public corporation and, hopefully, enjoy the benefits of public ownership, including stockbased compensation. Their size creates synergies that may be helpful to clients. Finally, the "big company" name may be helpful in attracting new clients.

Just as small- and medium-sized accounting firms undertake to explore alternative business structures, the Big-5 accounting firms are also groping with the problem of continuing rapid growth in consulting while maintaining independence in their auditing practices. Recent transactions will enable Big-5 firms to spin off their consulting practices into public vehicles or divisions of public corporations.

For the regulators, these new alliances by accounting firms are cause for enormous concern. A regulator's concern is in maintaining that most important characteristic of the certified public accountant--independence. What differentiates the CPA from any other professional is his or her independence.

In order to understand the importance of independence, we must trace its history. Following the stock market crash of 1929 and the subsequent depression, Congress enacted the Securities Acts of 1933 and 1934. These two acts form the framework for our current securities laws. These laws, passed during one of the most perilous times in our economic history, were designed to restore investor confidence in our securities markets. An important provision was the establishment of the Securities and Exchange Commission (SEC). Today, these laws are considered the envy of the world. Every nation establishing a modern securities market looks upon our securities laws as the framework for developing its own rules and regulations.

At the heart of these acts was a provision that mandated audit by independent public accountants of financial statements of issuers of publicly held securities. As SEC Commissioner Isaac Hunt recently stated, "the auditor has to be an independent overseer of the integrity of information provided to the capital markets, and this role was granted as a public trust to the profession."

In 1984 the Supreme Court decided the case of U.S. vs. Arthur Young & Co. The case involved the I.R.S. requesting the tax accrual work papers prepared by Arthur Young & Co. for the 1972-1974 audits of Amerada Hess Corp. Arthur Young contended that these work papers were privileged and should not be subject to an I.R.S. subpoena under Section 7602. The District Court previously ruled that the tax accrual work papers were relevant to the I.R.S. investigation of Amerada and refused to recognize an accountantclient privilege that would protect the work papers. Arthur Young appealed to the Court of Appeals. In a split decision, the Court of Appeals ruled that the tax accrual papers were relevant to the I.R.S. investigation of Amerada but held that the public interest in promoting full disclosure to public accountants and, in turn, ensuring the integrity of securities markets required protection for the work that such independent auditors perform for publicly owned companies. The Court of Appeals refused to enforce the I.R.S. summons. The case was appealed by the Solicitor General to the Supreme Court, which granted certiorari. On March 21, 1984, Chief Justice Warren Burger delivered the opinion of the Court. The Supreme Court overturned the U.S. Court of Appeals decision:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as 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. To insulate from disclosure a certified public accountant's interpretations of the client's financial statements would be to ignore the significance of the accountant's role as a disinterested analyst charged with public obligations.

As Harry Truman said, "The buck stops here." Only the independent public accountant has been granted this special watchdog role in society by the Securities and Exchange Commission.

It would be unfortunate if the evolving structures of alternative public practice undermine the enormous trust that accountants have been given. The fact is that the train has left the station without adequate rule changes to ensure the integrity of the independence of the CPA.

As Lynn Turner, chief accountant of the Securities and Exchange Commission, recently stated:

> Today, America's capital markets stand as the most liquid, deep, and efficient markets in the world--markets that have propelled our economy onto a plane where we have no equal. Why have our markets been so successful? In large part because of high quality transparent financial reporting; and nothing has guaranteed that transparency more than the independent audit.

The rules and regulations regarding independence were written during a different era. For over 100 years, accounting firms conducted their activities with relative stability. The services provided were primarily audit, tax, and some miscellaneous consulting services. These services were performed by CPAs and staff accountants in organizations entirely owned by CPAs.

Around this organizational framework, regulators created a regulatory cocoon. Among the regulators involved in shaping the rules and regulations were the American Institute of Certified Public Accountants (AICPA). Through its publication of *Professional Standards: Code of Professional Conduct,* the AICPA described the meaning of independence, the related values of integrity and objectivity, and the auditor's obligation to the public. In 1977, the AICPA established the SEC Practice Section. The SEC Practice Section, among its other activities, has been involved in peer review, rotational rules involving engagement partners, and concurring review partner reviews. As previously noted, the SEC has a number of rules and regulations affecting the conduct of the profession. Finally, each state has a State Accounting Board, which oversees the activities of its licensees. State boards mandate the educational, disciplinary, and experience requirements for candidates and licensees in their respective states. In addition to the regulators, most firms have professional manuals that describe both the rules of their respective firms and the professional standards governing independence.

Beginning in the 1970s, a series of legal and regulatory events transformed the profession. First, a series of court decisions permitted accountants to advertise and solicit business. Second, several states permitted CPAs to accept commissions and contingent fees from non-audit clients. Finally, in the 1980s a federal court ruled that CPAs could "hold out" as CPAs regardless of their place of employment, thereby eliminating one element in most state's regulation of the profession. Liberalizing the "holding out" doctrine was crucial to the decision of financial conglomerates to acquire public accounting firms, thereby forming the alternative practice structures we have today.

At the same time that the legal and regulatory framework was evolving, accounting firms

were dramatically expanding the range of their activities beyond traditional audit and tax work. By extending the CPA credential to a vast array of financial consulting services, the quintessential accounting firm was transformed into a financial boutique offering a myriad of consulting services, many of which are conducted and supervised by non-CPAs.

Currently, we are saddled with old rules and new structures. We are concerned that independence could be sacrificed in the name of growth. We have gone from small "mom-and-pop" partnerships to large segments of accounting firms within publicly owned entities, with many non-CPAs being an integral part of CPA organizations.

We have the media ready to pounce on any situation with a "conflict of interest," "independence," or "financial fraud" headline potential. We have regulators looking for answers to a series of extremely complicated ethical questions. Among the questions recently raised by the Independence Standards Board are:

1. To what extent do you believe that relationships between the auditor's employer and the audit client pose a threat to the independence of the auditor? Do you believe that the auditor's employer should be required to observe any of the entity independence restrictions required of the audit firm with respect to audit clients?
2. Should materiality be applied when determining whether the employer's relationship with an audit client impairs the auditor's independence?
3. To what extent do you believe that relationships between the officers and directors of the auditor's employer and the audit client pose a threat to the independence of the auditor?
4. Are there circumstances in which a controlling shareholder of the auditor's employer should observe some or all of the independence restrictions? If so, what are the circumstances and which restrictions should be observed?
5. Are there safeguards that would be effective in protecting auditor independence in "dual employment" situations?
6. Do some of these structures that result in dual employment of the auditor promote auditor independence?
7. Is it appropriate for a Big-5 accounting firm to have public ownership in either the firm itself or in its parent, subsidiary, or investee?
8. Would the independence of a firm be impaired if an audit client or one of its officers or directors owned stock in the audit firm or one of the audit firm's subsidiaries? Would your answer be different if the investment were not material to the investor or if the client-shareholder owned less than 5 or 10 percent of the shares of the public entity?
9. When an audit partner is also an employee of a corporation, should the restrictions applied to the auditor and his or her firm on activities and relationships with audit clients also apply to the corporation?

It is incumbent upon all of us to recognize that independence cannot be sacrificed. Our financial markets mandate that we provide accurate and meaningful reporting to shareholders and creditors.

Our goal should be that the profession, regulators, and standard setters work cohesively to create the appropriate rules for the 21st century that best maintain independence and provide the services the public requires. Finally, we must never forget the enormous role we occupy in this, the greatest nation in history-that of the guardian of the public trust.