

# RIGHT ADVISORY

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## CPAS CAN BE THE BACKBONE OF THE FINANCIAL REPORTING SYSTEM

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### Executive Summary

- ❑ It is impossible to audit-in the quality of financial reporting; there must be standards for preparer quality.
- ❑ While auditors are subject to numerous professional and regulatory requirements, and must be a CPA, preparers are not subject to any similar standards or professional licensing requirements.
- ❑ If the CPA is the only qualified professional to audit financial statements, it stands to follow that the CPA is the only qualified professional to prepare financial statements.
- ❑ The SEC went only half way when it encouraged “financial experts” for audit committees; boards need “accounting experts” as well.
- ❑ The AICPA, SEC and PCAOB should address the quality of the financial preparer system in a manner similar to the quality of the financial audit system.
- ❑ The “Principal Accounting Officer” role in public companies should be defined as to qualifications and organizational stature.
- ❑ The CPA profession should step up to this public interest challenge.

### The Quality Paradox

Sound financial accounting and reporting is a complex endeavor. It requires a high degree of skill and knowledge in business analysis, transaction and reporting systems, internal controls, accounting rules and principles, risk assessment, economic intent and effects, and communications. It takes years of training and practice to develop a broad based expertise, made more difficult by the ever changing complexity of business models, economic conditions, regulations and accounting regimes.

To expect excellence in the financial reporting system, we must require the same quality standards and regulations for preparers that we impose over auditors. It is not sufficient to rely mainly on the audit process. Preparers live with the business reporting challenges every day – auditors generally focus on them periodically. A regulatory system designed around “quality at the source” would be much more effective than one designed around “quality at the review”. A design concept similar to preventive verses detective controls.

It is impossible to “audit in” quality of the financial reporting system. Yet that is where regulation is focused. Most financial reporting “errors” come from lack of experience or lack of knowledge. Most financial reporting “frauds” come from lack of ethics or lack of backbone. Insiders, not external auditors, both cause and detect most financial reporting errors and fraud. Why, then, is it that quality regulation is focused on auditors, and not on preparers? Auditors devote a small amount of time to the financial reporting process compared with preparers.

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### *Why Have We Ignored The Obvious?*

Would you hire an inside chief counsel who is not a licensed attorney? Would you go to an unlicensed medical provider? Would you trust your child's education to teachers with no relevant evidence of subject matter expertise? Yet we permit, some might even encourage, financial reporting executives to carry no recognized credentials. Boards are often unmoved by or uninvolved with the selection of financial reporting executives. No bad news and a clean bill-of-health from external auditors are generally considered evidence that appropriate expertise exists.

Certainly, there are boards and CEOs who recognize the need for credentialed expertise in the area of financial reporting and controls. They do so, however, by acknowledging the obvious business and legal interests of the enterprise, not because the regulatory system requires it. And without the requirement, scores of enterprises (both public and private) elect to rely on external auditors for financial reporting expertise, instead of directly investing in such credentials.

Certified Public Accountants ("CPA") accept an obligation to protect the public interest through competent and ethical professional service – no matter whether that service is through a company or for a client. The key words in CPA are "public" and "accountant". Yet the only regulatory role of a CPA is to be a "public auditor". That role comes with the rigorous quality standards of education and ethics that are imbedded in the CPA profession, and regulated by the Public Company Accounting Oversight Board ("PCAOB"), American Institute of CPAs ("AICPA") and state licensing authorities. It is in the public interest to extend such quality regulations to preparers of financial reports.

### *Accounting Expertise Is Different From Financial Expertise*

There is no doubt that most corporate executives and board members have expertise in financial matters. But it is not correct to assume they have expertise in the accounting and reporting required of a public company. Recent examples are numerous – from the proper accounting for leases, to income taxes, to equity-based compensation, to the fair value of financial instruments, to unclear and uninformative analyses. These matters require expertise beyond the financial merits of a transaction. The accounting and reporting implications are not always intuitive and often require fact-finding, analysis and research - similar to a complex legal issue.

Consequently, public company boards should be required to have their own accounting experts. Today, some boards have members who serve as an accounting expert while others rely on the company, its auditors or accounting consultants. Reliance on non-board experts carries the unnecessary risk that financial information may be reported before engaged experts have reviewed the accounting. The public company reporting process requires dissemination of financial information much more frequently and at greater detail than most outside experts can address in the time needed to be useful to investors. This will become even more evident as the SEC's interactive data project becomes reality.

The regulatory movement to have a named "financial expert" on every public company board of directors was an important betterment to the quality of governance, but falls short of the objective. The objective was to address the quality of financial reporting and communications, which is primarily an expertise held by credentialed, practicing accountants. The regulations should be refined, or revised, to include an "accounting expert" on the board of directors as well. Without accounting and reporting expertise on the board, the quality of an enterprise's primary communication with its stakeholders can be compromised.

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### The Obvious Answer

Financial reporting requires the same expertise and credentials as financial auditing. Professionals involved in financial auditing are required to follow standards of care, of expertise, of ethics, and of continuing education, that is no less necessary for quality financial reporting. In the United States, the only professionals that can lay a legitimate claim to credentialed accounting expertise are licensed Certified Public Accountants. Yet, although the SEC requires financial statement auditors to be CPAs, relatively few CFOs are CPAs and even fewer boards have a CPA as a member.

For some reason, the obvious has been obscured or ignored. Is it that regulators and boards believe “anyone” can do quality financial reporting? Is it that CPAs have found other avenues of interest and earning potential outside of basic financial accounting and reporting? Is the risk too great relative to the rewards and professional gratification? Whatever the reason, it needs to be examined. The AICPA, SEC and PCAOB have overlapping interests in this issue. For when the next financial reporting scandal surfaces, and it will, tough questions about “the quality of the reporting system”, not just the auditing system, will be top of mind. CPAs should step up to the challenge of improving quality of the reporting system, a challenge they are solely qualified to meet.

### A Suggested Regulatory Solution

Under both the Securities Act of 1933 and Securities Exchange Act of 1934, financial reports of public companies require the signature of the “Principle Accounting Officer” (PAO) in addition to the CEO, CFO and a majority of the board. There is currently no definition for, or required qualifications of, the PAO. Consequently, PAOs may not be CPAs and may not even have an accounting education or background. Moreover, they may not be senior in the organization structure or have the requisite access to executives and boards to properly discharge the expected responsibilities.

The role of “Chief Compliance Officer” (Rule 38a-1) in the investment management world provides a model that could be relatively easy to emulate for PAOs. That model includes a definition of qualifications and expectations as well as a reporting relationship to the board that promotes a level of independence. These are key elements that would also work toward the effectiveness of the accountants’ role in the disclosure system – and those accountants should be licensed Certified Public Accountants.

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