**Statement of Louis Grumet**
**Executive Director of the New York State Society of Certified Public Accountants**

**Testimony Before the Advisory Committee on the Auditing Profession of U.S. Treasury Department**

**December 3, 2007**

Chairman Levitt, Chairman Nicoliasen and distinguished members of the committee: Thank you for inviting me to testify today about the competition, concentration and independence within the auditing profession.

The issue of competition and concentration is not only related to how many firms are doing public company and other audits but more importantly competition and concentration will ultimately be decided based on the number of sufficiently qualified auditors and the kind of regulatory oversight that ensures quality. The issue of independence is based on the ability of auditors to understand the consequences of independence and thus they must be sufficiently educated.

As a result of corporate financial problems exemplified by Enron and WorldCom, ensuring the sufficient skills, independence, integrity and objectivity of those who conduct audits is more important than ever before. The audit is the exclusive franchise of the public accounting profession and the public's expectation is that CPAs, as licensed professionals, will provide the highest quality auditing services.

Certified Public Accounting is a profession comprised of individuals regulated and licensed by the individual states (actually 54 licensing jurisdictions), but except for the national uniform CPA exam, there is variation among the states for licensing qualifications. For example states differ in minimum education and experience requirements for licensure, in standards for unprofessional conduct, in requirements for continuing professional education and ethics, in cross-state border practice privileges, and in disciplinary procedures and sanctions for violating professional standards.

No national license regulates the auditing of publicly traded companies that operate in a multi-jurisdictional plane. Instead, states issue licenses based on differing education and experience requirements and on a uniform examination. States regulate accounting professionals within the borders of their own states. In a borderless world where there is a convergence of international standards, no mechanism exists that balances the needs of an increasingly global investing public with federal and state regulations.

Where as a strong case can be made for a national license for the CPA profession, I believe there is another solution that comports with our federal system and achieves the public interest goal to obtain the highest quality audits from the CPA profession across this country.

The profession needs one set of professionally developed standards that can be the basis for regulation on a state, national, and international level. What it does not need is 50 jurisdictions setting separate regulations. Despite the fact that US and international auditing and accounting standards appear to be converging, there is no coherent system of regulatory oversight with enforcement power.

Steps must be taken not only to build a coherent mechanism to enforce standards out of the current hodge-podge, but also to ensure that pre-service education prepares auditors to meet the demands required of them in an increasingly complex financial world. We need to address this challenge on two fronts: develop a coherent mechanism to enforce standards and rules; and to develop consistent pre-service education that matches skill preparation to performance.

To enforce coherent standards on a nationwide basis while respecting the individual states' powers to protect their citizenry, an interstate compact could serve as the mechanism for the regulation of the accounting profession.   To ensure that there are sufficient auditors who can deal with the complex needs of a modern economy, there should be a more rigorous system of pre-service education for individuals who will be conducting audits.

## **Interstate Compact as Solution to Regulation of the Auditing Profession**

An interstate compact is a contract between states that allows them to solve multi-state, regional, and national problems through voluntary agreement. Compacts carry the force of law, and compacting states are bound to observe the terms even if they are inconsistent with other state laws. The general purpose of an interstate compact includes: establishing a formal legal relationship among states to address common problems or to promote a common agenda, creating independent, multi-state governmental authorities that can address issues no state has the authority to act unilaterally, and establishing uniform guidelines, standards, or procedures for agencies in the compact's member states.

Notably lacking in accounting and auditing regulation is a mechanism that balances the needs of the public with the needs of the profession, and that coordinates the states and the federal government. Licensing standards are set by the states. The Securities and Exchange

Commission (SEC) and Public Company Accounting Oversight Board (PCAOB) set standards for audits of public companies, while the American Institute of Certified Public Accountants (AICPA) and the Government Accountability Office (GAO) set standards for the balance of entities. An interstate compact provides a coordinating mechanism for this patchwork regulation.

An interstate compact can effectively address who sets accounting and auditing standards for public companies, the private sector, and nonprofit and government entities as well as who enforces those standards. In addition to being the only mechanism that engages the sovereign powers of the states and the federal government, the compact concept can also address problems in areas such as practicing across state lines, standards of professional conduct, and peer review. Congress could also authorize federal participation in the compact so that it covers the PCAOB, SEC, and GAO. The federal government has also joined with the states in a number of compacts such as that which set up the Advisory Commission on Intergovernmental Relations.

Where the integrity of financial reporting is concerned, the public and the federal government justifiably expect the profession to follow the highest standards. An interstate compact for accounting regulation would focus on states' commonalities, and its statutory basis would help enhance credibility for the profession's regulation.

An interstate compact would establish a formal, legal relationship among states to address their common problems similar to that which was provided by the Interstate Driver's License Compact that has been adopted by 45 states.

The Compact could also coordinate the differences in enforcement actions between SEC registrants and other entities. For example, it would facilitate states enforcement actions against CPA licensees and firms who have been disciplined by the SEC. An interstate compact could be a vehicle to set multi-state or nationwide standards for auditors who do not fall within the purview of the PCAOB, the GAO and other statutory agencies. An interstate compact could define and develop standards that make sense. It could create a legitimate regulatory body that has uniformly administered statutory enforcement power.

Under the U.S. Constitution, Article I, Section 10, states have made compacts among themselves covering issues and activities that include child custody and placement, educational policy, administration of criminal law, use of natural resources, the maintaining of the environment, transportation and utility regulation.

There are currently nearly 200 existing and very successful compacts. They include the Multi-State Tax Compact and the Interstate Compact for Education. Some compacts have been enacted by all 50 states. Every state participates in at least 14 compacts. For example, Massachusetts belongs to 27 compacts.

To date, the most famous of interstate compacts is the New York-New Jersey Port Authority which arose from a 1921 compact between New Jersey and New York. Other recent efforts include the Emergency Management Assistance Compact, the Wildlife Violator Compact and National Crime Prevention Compact.

Though many compacts exist, the one compact that serves as a model for the accounting profession is the Multi-state Licensure Mutual Recognition Model established in 1997. That compact addressed the multi-state licensure issue and allowed nurses to practice across state lines within states that had adopted the interstate compact. That compact addressed disciplinary issues and the use of electronic media for the delivery of multi-state health services, among other issues. Half the states currently participate in this Compact.

The Constitution inhibits Congress from dealing with state issues such as licensing. In addition, states can not regulate interstate commerce. An interstate compact with participation by the federal government could solve the dichotomy by creating interlocking standards that made sense.

Interstate compacts would offer an opportunity for interstate cooperation, underscoring state sovereignty to protect their citizens. An accounting interstate compact would answer the problem of uncoordinated standards governing the accounting profession. It would establish uniform regulations, address multi-state licensing, disciplinary issues and more. The compact would enhance credibility for regulation of the profession by virtue of the procedure that requires it to be enacted by state legislatures in each of the participating states.

The interstate compact could also address the fact that audits are not homogenous. The compact could provide for different standards based on the size and complexity of the entity that is audited. By utilizing a compact the federal government could offer federal licenses to audit publicly traded companies, which would be coordinated with a state license for everything else.

An Interstate compact could allow CPAs to work across political jurisdictions to do what makes sense for the profession and more importantly, for the public it serves.

## National Academy of Auditing for Publicly Traded Companies

Traditionally the preparation for auditing publicly traded, multifaceted and multi-jurisdictional companies has been no different than the training for the auditing of small companies. As the financial world has evolved in a borderless, technologically advanced era, there is an underlying shortage of well-trained auditors to handle the needs of this changing financial world. Training professionals on how to apply their knowledge, skills and abilities to audit large publicly traded companies has been severely lacking in pre-service education. The largest firms teach the skills within their firms but other future auditors are not being taught sufficiently at educational institutions.

The federal government should fund a financial academy, perhaps called the National Academy of Auditing for Publicly Traded Companies, with parallels to the establishment of West Point at a different time in the evolution of our country. President Washington saw the need for a military academy for times of war. In today's world, with the financial security of a nation as important as its physical borders, a financial academy would stave off economic disaster which could result if the public lost faith in the independence, accuracy and efficiency of our financial markets.

The founding of West Point accomplished its mission by developing cadets in four critical areas: intellectual, physical, military, and moral-ethical. Like West Point, the academy would produce stewards of the nation's infrastructure, reinforcing the U.S. economy as the underpinnings of the global economy.

Corporate governance and entity-level controls have become increasingly important in a globally interdependent world. The four critical areas of a proposed financial academy would include: sufficient skills and competencies in professional auditing standards, independence, integrity and objectivity.

During the early days of West Point's commission, its graduates were responsible for the construction of the bulk of the nation's initial railway lines, bridges, harbors and roads. Early graduates of West Point were the precursors to the Army Corp of Engineers.

A financial academy that trained CPAs to audit publicly traded companies would increase competition and inhibit the concentration of resources within the largest CPA firms. Our nation's physical borders are no longer the only borders that require well prepared and well educated sentries. The financial well-being of the nation is linked to the quality of audits of publicly traded companies. The risk of potential audit failures demands that auditing of publicly traded companies must not be left to solely to large CPA firms. A national auditing academy would help protect the country against this risk.

**National Academy for Public Interest Accounting**

On June 22, 2007, the President's Council on Integrity and Efficiency released a "Report on National Single Audit Sampling Project." The Council was comprised of Presidential appointments including the Inspectors General of large federal agencies and representatives of elected state auditors, who examine the actions of agencies to ensure compliance with established governmental policies and detect fraud, waste and abuse. The report's focus was on the quality and usefulness of audits of organizations that receive federal grants in excess of $500,000. According to the report, 51 percent of those audits, all of them performed by CPA firms, were not acceptable.

The particular problems identified in the report made it clear that a number of the small and medium sized firms that audit local governments and nonprofits have insufficient training in the activities of those entities to adequately conduct the audits. The report indicated that the larger firms were doing a better job.

Well functioning local government entities and nonprofit organizations are vital to the public. A lack of training in financial oversight by the elected officials of local governments as well as by the board members of nonprofit organizations underscores a serious problem for the delivery of services to our most needy populations.

Therefore like Annapolis, the federal government should fund a second academy, one that focuses on the auditing of companies and organizations in the publicly funded realm. We need to limit the risk of fraud in these entities and maintain the public trust when it comes to the use of taxpayer money. Taxpayers should not be taking risks when they pay their taxes.

**Completion of Graduate Degree**

The 150 hours of pre-service education required to become a Certified Public Accountant should require completion of graduate-level study. Legislation or regulation has made the 150-hour requirement effective in most states. Where the academy should be a prerequisite for those who audit the largest multi-jurisdictional companies and public interest entities, the completion of a graduate degree would provide an enhanced educational requisite to audit the remaining entities that drive the bulk of the world economy. In 2005, small businesses represented over 90 percent of all the nation's employers.

One of the complaints we hear from accounting firm management is that the extra 30 hours beyond a traditional 120 hour undergraduate degree required does not enhance the entry accounting employees' ability to perform. There is still an insufficient grasp of communication skills and proficiency with higher level concepts. Graduate-level work should promote critical thinking as a requirement for all CPA programs.

There should be many different avenues and tracks to become an auditor. A cookie-cutter approach will not work. However, because an auditor's responsibility is to uncover material misstatements and protect the public, graduate level work that promotes critical thinking would enhance the profession's ability to perform the complex activities that the public expects.  The ability to draw connections through the study of the underlying concepts of accounting, auditing, business law tax and English is of utmost importance.

We need to develop more individuals with a broader and deeper skills set. The financial stability of our nation is interrelated with the goal of a thriving global economy and global peace. With the two financial academies that could act as the flagships of financial education in the country, and the requirement of a graduate level degree for other auditing, the US can fortify its economy as the underpinnings of the global economy.

The requirement of a graduate-level degree should be required for those who pursue auditing. Auditing is the franchise of the CPA. A graduate degree would not only promote critical thinking but it would also foster an environment in which it could take hold and develop.

Not long ago, the public's perception of an auditor was that of a "watchdog," not a friend of business.  We should get back to basics.  Effective regulation of the profession through an interstate compact would serve to better protect the public. In addition, appropriate educational curricula provided by the two National Academies and the requirement of a graduate degree would ensure that auditors are equipped with the skills they need to do the work that is expected of them.  The CPA profession and the public it serves deserve no less.