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MALAYSIAN ACCOUNTING REVIEW

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Address all correspondence to:
Journal Administrator
Malaysian Accounting Review
Faculty of Accountancy
Universiti Teknologi MARA
40200 Shah Alam, Selangor, MALAYSIA

e-mail: dr.normah@accountant.com or dbra571@salam.uitm.edu.my

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THE ACCOUNTING WORLD POST-
ENRON, TYCO, VIVENDI, WORLDCOM,
XEROX...:
REFLECTIONS ON BEING PART OF
THE SOLUTION

Shahrokh M. Saudagaran
School of Accounting
Oklahoma State University
401 College of Business Administration
Stillwater, Oklahoma 74078, USA

Abstract

The events of the past year have cast a spotlight on accounting and accountants. While most of the media coverage has related to the problems in the United States, the rest of the world, including Asia, is not exempt from these concerns. The severe losses suffered by investors have resulted in a dramatic decline in confidence in the stock markets. This can have negative long-term effects if the erosion in confidence causes investors to continue to stay away from the markets. There is much that can be done to improve the integrity of financial reporting through greater accountability, the restoration of resources devoted to the audit function, and better corporate governance policies. The current paper discusses the roles of educators and academic accounting association towards improving accounting education and practice in Asia.
INTRODUCTION

During the past year we have experienced a series of financial reporting scandals at some very large corporations. Ironically, many of these problems have occurred in the United States which, until recently, was considered the model for financial reporting and capital market regulation. Enron, Global Crossing, WorldCom, and Xerox, were some of the large US companies where major financial reporting irregularities were recently discovered. The public spotlight and interest in these developments is evident in that in December 2002, Time magazine named three whistle blowers as its Persons of the Year. However, US corporations did not have a monopoly on accounting fraud. Significant accounting and auditing problems have also occurred at corporations based in other jurisdictions. These included Centrica (UK), Vivendi (France), Tyco International (Bermuda), and Shell (UK/Netherlands). This succession of very visible scandals has tarnished the reputation of the accounting profession. More importantly, it has damaged investor’s confidence in corporate executives, cast a shadow over the reliability of corporate financial reports, and raised questions about the audit function in capital markets.

In this article, I discuss how we can go about righting the accounting ship. In the first section, I briefly review the causes and effects of the recent accounting and auditing problems. Next, I suggest some lessons that we might learn from these failures. This is followed by a discussion of how accounting academics can strive to be part of the solution. I conclude with some thoughts on the role that the Asian Academic Accounting Association can play in enhancing the quality of accounting education and research, and thereby accounting practice, in Asia.

CAUSES OF THE FINANCIAL REPORTING PROBLEMS

WALL STREET PRESSURES

Pressure for ever-increasing profits

The economic boom experienced by the United States and many other countries during the second half of the 1990s, led to tremendous pressure from investors for companies to maintain high rates of growth in revenues and earnings. As demonstrated by subsequent events, these expectations were unrealistic over an extended period. In some instances, company management used aggressive accounting in response to these pressures. In yet others, we learn that very questionable accounting was used to inflate earnings and other measures of the company’s performance.

Greater portion of executive compensation coming from stock options

During the past twenty years, corporate executives’ compensation packages in the USA shifted significantly from salary to stock options. From 1992 to the peak of the market in 2000, the top five executive officers in the 1,500 largest U.S. companies saw the paper value of their unexercised options increase to US$80 billion! This represented a 1,000% increase compared to an increase of 350% during the same period in the Standard & Poor’s 500 stock index. There were several reasons for the shift to stock options based compensation. First, stock options were deemed to link senior executives’ pay to performance in that their
compensation would rise or fall with their companies’ stock prices. Second, under the existing accounting standards, stock option compensation was not required to be treated as a business expense. Third, since stock option compensation was typically deferred it allowed cash poor companies, many of which were in the technology industry, to attract top managers without a negative impact on their immediate cash flows. There was almost a sense that stock options were a free good that allowed companies to get something (management talent) for nothing. In fact, stock options did have several costs. At the very least, they impacted stockholders adversely by diluting the companies’ earnings per share. There was little accountability in the numbers and prices of stock options granted since it was more often than not a case of top executives granting it to themselves or to other top executives (through boards of directors compensation committees). In practice, the pay-to-performance link did not occur because when stock prices fell companies simply reduced the grant price of the stock options to the executives. Finally, critics allege that stock based compensation gave senior executives motivation and opportunity to manipulate earnings in order to pump their stock and cash in on their lucrative options at the expense of investors.

**Penalties for failure to meet quarterly earnings forecasts**

Aside from the problems associated with executive compensation, companies were also under tremendous pressure to continuously meet quarterly earnings forecasts in order to maintain their stock prices. In the late 1990s, stock price movements depended as much on the relationship between analysts’ forecasts and reported earnings as on the actual performance. Negative earnings surprises resulted in companies being penalized through a sharp decline in the price of the company’s stock. There is anecdotal evidence suggesting that some corporate executives tried to manipulate earnings expectations downwards and quarterly earnings upwards in order to create positive earnings surprises. In an effort to get away from Wall Street’s obsession with short-term earnings, Coca Cola recently announced that it would no longer provide guidance on its earnings outlook. It asked investors to concentrate on its long-term growth strategies rather than the setting and meeting of quarterly forecasts. Earlier, Gillette had also abandoned the practice of providing guidance on its quarterly earnings outlook.

**WEAK GOVERNANCE**

**Compliant boards of directors**

Weak corporate governance is another factor blamed for the accounting problems. For most of the 1990s, the importance of corporate governance was ignored with many top executives pointing to their stock price performance as proof of sound management. Specifically, many companies lacked a sufficient number of independent members on their boards of directors. Compliant boards of directors did not demand accountability from top executives because of their business or other relationships with them. Compensation committees routinely awarded huge pay packages to CEOs despite their poor performance. Some critics blamed this on the reciprocal arrangements whereby executives served on each other’s boards.
Non-functioning audit committees

The accounting and auditing scandals have also focused attention on the role of corporate audit committees. Critics contend that these committees have been toothless tigers that have not sufficiently performed their stewardship function within the corporate governance structures. Audit committee members are being sued in a number of the highly visible failures such as Enron. Recent corporate governance reforms issued by the New York Stock Exchange (NYSE) require that all audit committee members be independent directors, the chair of the audit committee have financial management or accounting experience, and the audit committee has the sole authority to appoint and dismiss the company's external auditors.

Lack of transparency on financial arrangements

Cases such as Enron, WorldCom, and Tyco International have raised serious questions about the lack of transparency on arrangements between senior executives and the company as well as between affiliated entities (e.g., special purpose entities) and the corporation. For example, Bernie Ebbers, CEO of WorldCom, owed the company $406 million. This included amounts for the construction of his home, family members' personal expenses, and Ebbers' own business ventures. A recent article in the Financial Times (December 20, 2002) describes the situation at WorldCom as follows:

The house of cards started to fall down. With reserves fast running out and “merger magic” accounting now beyond reach, Scott Sullivan, then WorldCom's chief financial officer, embarked on a series of brazen accounting tricks to stem the collapse in the company's share price, according to investigators and someone who has detailed access to WorldCom's accounts. "In 2000, they pulled every rabbit out of the fraud book," the person says. "Bad debt was manipulated. Tax was manipulated. Everything they could do they did. But by the end of 2000, they had run out of tricks."

WEAKENING OF THE AUDIT FUNCTION

Burgeoning fees from consulting activities

Over the past two decades there has been a dramatic shift in the Big Five accounting firms' revenues from consulting services relative to auditing services. In the case of several large corporate clients, the accounting firm's revenues from consulting services dwarfed those from auditing services. This raised questions about the independence of the auditors and led to demands for the large accounting firms to divorce their consulting divisions from their auditing divisions.

Audit function almost a “loss leader” to gain and retain consulting revenues

The growth in consulting revenue led to a situation where audit services were often reduced to being a loss leader for public accounting firms seeking to get a toehold within the larger corporations. The low fees charged for audit services led to a decline in the resources
devoted to audits, which in turn resulted in a decline in the rigor of the audit conducted. One cannot but be amazed at the frequency and magnitude of audit failures that have been exposed in recent years, many of which have resulted in the accounting firms having to pay huge amounts in malpractice settlements.

**Long-term relationships between auditors and clients**

There are several other aspects of the auditor-client relationship that have come under the microscope as a result of the financial reporting problems at large companies. One is the long-term relationship that often exists between auditors and their clients. There is concern that some of these lengthy relationships (sometimes extending over decades) compromise the independence of auditors and impair their ability to independently assess their clients' accounting practices. Another is the revolving door that is often observed between auditors and their clients. It is not uncommon for personnel from audit firms to accept lucrative employment opportunities with client firms that they have been auditing. This again raises questions about the independence of auditors.

**Political clout of lobbyists for the accounting profession**

Critics of the public accounting profession have pointed to its heavy political lobbying as contributing to the recent accounting scandals. In the late 1990s, when regulators and others attempted to introduce measures intended to address some of the concerns listed above, the lobbyists for the accounting profession fought back vigorously to negate those efforts. Arthur Levitt, chief of the SEC, from 1992 to 2000, was regularly opposed in his efforts in this regard. The AICPA was one of the biggest contributors to political action committees (PACs) in Washington. Thus attempts to create firewalls between auditors and their clients and between the audit and consulting functions were frequently frustrated by lobbyists for the accounting profession.

**Rule-based accounting standards**

The US is generally regarded as having the most detailed authoritative pronouncements on financial reporting. Single accounting standards promulgated by the Financial Accounting Standards Board (FASB) can be hundreds of pages in length. Detractors often refer to this as a cookbook rule-based approach. They criticize it for creating an environment wherein adhering to the letter of the law (and finding loopholes in it) takes precedence over abiding by the spirit of the law. This can often result in financial reports that do not capture the economic substance of transactions even though they are in compliance with the detailed rules. Critics of the U.S. approach have blamed the detailed rule-based accounting standards for the financial reporting problems at major U.S. corporations. They argue that the less detailed principle-based standards used in Continental Europe are a better approach because they first and foremost emphasize the economic reality of the entity in financial reporting.
EFFECTS OF ACCOUNTING SCANDALS

Loss of investor confidence due to financial reporting irregularities

One of the biggest casualties of the financial reporting scandals has been the loss of investor confidence in the integrity of accounting numbers. When investors have reason to doubt the reliability of audited financial statements they are likely to refrain from investing their savings in corporate securities. This has resulted in a significant withdrawal by investors from the securities markets. The stock market indices of most major capital markets experienced sharp declines in 2001 and 2002.

Dramatic decline in stock value

The sharp drop in stock prices as reflected by the dramatic decline of all the major stock indices in the U.S. and elsewhere has caused losses of trillions of dollars in investors' portfolio. In addition to adversely impacting current consumption, it has caused steep reductions in investors' retirement assets, causing many individuals to postpone their retirement plans. Thus the crisis of investor confidence has had an adverse impact on a broad spectrum of the population. Individual and institutional investors in companies such as Enron and WorldCom have suffered particularly heavy losses.

Threats to the self-regulatory nature of accounting in the U.S.

The accounting profession in the U.S. has for the most part been self-regulated. Accounting standards for public companies have been established by private sector bodies such as the FASB and its predecessor organizations. Similarly auditing standards have been set by the AICPA. The recent accounting and auditing failures are giving rise to demands for a greater role by governmental agencies in the setting of accounting and auditing standards. The possible impact of the greater role of governmental agencies in this arena is a matter of opinion. Proponents would argue that recent events have demonstrated that accounting and auditing are too important to be left to the accounting profession, which needs governmental oversight similar to the securities markets. Opponents would point to the country's tax code as a prima facie case against government involvement in setting accounting and auditing standards.

Collapse of Arthur Andersen

One of the more visible and direct effects of the accounting crisis has been the demise of Arthur Andersen, one of the largest international accounting firms. The dissolution of Andersen has had a number of negative impacts. Andersen's 28,000 employees worldwide have lost not only their jobs but also their pensions and other post-employment benefits. It is hard to fathom how the actions of a tiny subset of employees in its Houston office could lead to the destruction of a worldwide organization in a matter of months. Many have questioned the magnitude of the punishment meted out to Andersen by the U.S. authorities, particularly in light of their relative inaction in similar situations in the past. All the media coverage related to Andersen's role in Enron has resulted in tarnishing the image of the accounting profession in general. The jury is still out on the various impacts of Andersen's demise on accounting education including the enrollment in university accounting programs, placement of accounting
majors upon graduation from undergraduate and graduate programs, accounting faculty
development programs, and the financial support provided by Andersen employees and
matched by the Andersen foundation to accounting programs at numerous universities. The
only beneficiaries from the collapse of Andersen might be the remaining large accounting
firms that have succeeded in carving out Andersen’s long list of clients among themselves.
As a result, these firms will experience a significant growth in revenues in a very short period.
However, the flip side of this is that corporations now have even fewer accounting firms to
choose from for their audit, tax, and consulting needs. The reduced competition and new
regulatory requirements are already resulting in accounting firms demanding significantly
higher fees for their services.

LESSONS LEARNED

Need for stronger governance structures

The abuses and mismanagement that have been revealed at companies such as Enron,
WorldCom, and others, highlight the need to make radical improvements in the area of
corporate governance. Rather than turn a blind eye to governance issues, corporate boards
must now confront them head on by addressing some tough issues: What are reasonable
compensation packages for executives? What is the maximum number of corporate boards
that directors can be effective on? What kind of relationships with the company compromise
directors’ stewardship role to shareholders? What are appropriate numbers and prices of
stock options granted senior executives and how should they be accounted for? What percent
of the board of directors should be independent directors? The markets may ultimately be
the driving force that make companies improve their governance structures as more investors
flock to stocks of companies viewed as being well governed and penalize stocks of companies
with poor governance. Organizations such as the New York Stock Exchange have also
issued new governance regulations to enhance the accountability, integrity, and transparency
of corporations.

Stronger checks and balances on executive compensation

Related to the governance issue, is the area of executive compensation. The recent problems
have brought to the fore the need to restore sanity in executive compensation both in terms
of the type of compensation as well as the level of compensation. No longer should compliant
boards have the discretion to grant imperious CEOs gargantuan compensation packages
regardless of the performance of the companies they lead. Rather than rubber-stamp
management, board members should take their stewardship role more seriously and consult
with each other to evaluate the performance of executives of companies on whose boards
they serve. In this area, the new governance regulations of the NYSE stipulate that only
independent directors be allowed to serve on corporate compensation committees.

Need to keep accounting and securities regulation free from political influence

Several commentators, including former SEC chairman, Arthur Levitt, have been critical of
the role played by political lobbying in frustrating efforts to tighten accounting standards on
topics such as stock options. Several politicians were standard bearers for the accounting
industry in its efforts to fend off tighter independence standards proposed by the SEC in the
late 1990s. There is one school that believes that the demise of Arthur Andersen was a result of the summary justice meted out by some in government who wanted to appear tough on the accounting profession lest they be blamed for their prior cozy relationship with accountants. Whether that is the case or not, one hopes that one of the lessons learned from the recent problems will be that accounting and securities regulation should be kept free from political lobbying. The integrity of the capital markets depends on it.

**Need to strengthen the audit function**

The accounting failures inevitably raise questions about the effectiveness of the audit function. Rather than be treated as a loss leader, the audit function should be independent and primary in its own right. The trend towards divorcing audit from consulting may help in this regard. Some of the large auditing firms have already announced their intention to raise their audit fees to reflect the true cost of audits. They have indicated that they will not hesitate to sever relationships with existing clients who are unwilling to pay the higher fees.

**More attention to the role of internal auditors**

Another lesson to be learned from the accounting scandals is the need for greater attention to the internal audit function within large corporations. The internal audit department has the potential to serve as a deterrent and the first line of defense against accounting shenanigans within organizations. Given the impending increase in audit fees, it is also a tool to manage external audit costs. While the internal audit function was diminished in recent years, there is a clear need for it to be strengthened.

**ROLE OF ACCOUNTING EDUCATORS**

As accounting educators, we cannot be blind to the crisis facing the accounting world. We need to engage in serious introspection as to the steps we can take to be part of the solution. For too long, we have focused almost exclusively on technical rules in our courses. This has come at the cost of developing various essential skills, judgment, and, dare I say, any sense of social responsibility. We have assessed our programs in the context of statistics related to the percentage of students that pass the professional qualifying examinations and their placement with major accounting firms and corporations. Like most rational beings, students respond to the reward structure we establish at our universities. Through our pedagogy, testing, and recognition instruments we have conditioned students to focus on getting the "right answer", whether it be in our courses on campus or on the CPA, CA or other professional examinations. The current problems should motivate us to reconsider our approach. In my view, we need to move away from a debits and credits approach towards an accounting education that focuses not only on technical rules but also on producing competent individuals with a functioning moral compass. Our constituents deserve no less.

The academic literature is rich in normative and descriptive articles that provide suggestions and describe the experiences of colleagues that have undertaken changes in their accounting curricula. While a detailed review is beyond the scope of this article, I will briefly list some arenas for constructive change.

One needs to start with the introductory accounting course. Much has been written about the important role that this course can play in attracting the best and brightest into accounting
or in turning them off of accounting altogether. The bookkeeping approach to introducing accounting is detrimental not just because it focuses on the most mundane aspect of accounting but because problems have occurred in the United States which until recently was considered the model for financial reporting and capital market regulation. Enron, Global Crossing, WorldCom, and Xerox, were some of the large US companies where major financial reporting irregularities were recently discovered. The public spotlight and interest in these developments is evident in that in December 2002, Time magazine named three whistle blowers as its Persons of the Year. However, U.S. corporations did not have a. Arguably, accounting offers college graduates the most choices in the nature of work, the type of organization, and the geographic location. Unfortunately, we have often failed to make students aware of these opportunities.

In our upper division courses, the focus has been almost exclusively on accounting rules and getting the right answer. As the body of official pronouncements has grown exponentially over the past two decades this has become a futile and unnecessary exercise. Futile, because we simply do not have enough time to cover the vast body of rules in the limited time available in our programs and unnecessary because with the easy access to these rules through the electronic and other media, professionals no longer need to memorize these rules. Rather we need to help students develop their skills in the areas of research, judgment, communications, group dynamics, and ethical reasoning. These can be achieved through case analysis, individual and group presentations, research projects, and discussion of real world situations that pose ethical dilemmas. We can learn something in this arena from the law school education model wherein students develop these skills rather than memorize the law. The recent accounting scandals certainly provide a wealth of real world cases for use in our classrooms.

ASIAN ACADEMIC ACCOUNTING ASSOCIATION (4A)

The Asian Academic Accounting Association (4A), as the sole Asia-wide professional organization for accounting academics, can contribute towards improving the quality of accounting education and practice in Asia. As members of this young association, we need to work collectively in this regard. There are a number of ways in which we can help build and grow the association. First, each of us can be active in various facets of the association from participating in annual conferences, to helping garner members in our respective universities and countries, to sponsoring outstanding doctoral students for the 4A doctoral colloquium, to volunteering to host the annual conference at our respective universities. Second, we can help in strengthening the financial resources of the 4A through soliciting the support of organizations such as major corporations, public accounting firms, and national or continental associations of accounting professionals. A strong financial base is important for the 4A to be able to fund its various programs. Third, we can and must use the 4A as a forum to identify the common issues we face as accounting educators and to evolve Asian approaches to addressing these issues.

For example, in the area of research, we must try to address research issues that are relevant to Asia. Senior colleagues, such as deans and department heads, can provide leadership in encouraging and rewarding quality research on Asia through reasonable promotion and tenure guidelines. If we are to foster research on issues relevant to Asia we must adjust our reward structures accordingly. This research can be conducted in-country or across countries. The
4A can also provide a useful forum for networking among accounting educators from all over Asia. This has been very successful in Europe where the European Accounting Association has been instrumental in enhancing dialog and interaction among academics from across the continent.

Until now, doctoral accounting programs have received short shrift in Asian universities. Some universities in Asia have a tradition of sending eligible candidates to PhD programs in countries such as Australia, United Kingdom, and the United States. Since this is a very expensive proposition, the number of individuals that can be sent to these programs is limited. By investing in their own doctoral programs, accounting departments in Asian universities can produce a larger number of quality PhDs. Just as importantly, these candidates are more likely to focus on local issues in their research if their mentors are local faculty. The presence of an in-house doctoral program also enhances the research productivity and output within the department. Only too often, one observes colleagues with PhDs from Western universities, doing very little research when they return to Asia because there is a lack of a research environment in their home institution. An in-house doctoral program can alleviate that. The 4A's doctoral colloquium which is being launched in conjunction with the Fourth Annual 4A Conference in Seoul, Korea in October 2003 aims to help enhance the quality of doctoral accounting education in Asia.

SUMMARY AND CONCLUSION

The events of the past year have cast a spotlight on accounting and accountants. While most of the media coverage has related to the problems in the United States, the rest of the world, including Asia, is not exempt from these concerns. The severe losses suffered by investors have resulted in a dramatic decline in confidence in the stock markets. This can have negative long-term effects if the erosion in confidence causes investors to continue to stay away from the markets. There is much that can be done to improve the integrity of financial reporting through greater accountability, the restoration of resources devoted to the audit function, and better corporate governance policies. As educators, we can be part of the solution by making the necessary changes in our curriculum and the pedagogical approaches we use to train future accounting professionals. The Asian Academic Accounting Association can also make important contributions towards improving accounting education and practice in Asia.
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