Statement of
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H.R. 3763, the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002

Chairman Oxley, Ranking Member LaFalce, Honorable Members of Congress, Ladies and Gentlemen:

I am Barry Melancon, president and CEO of the American Institute of Certified Public Accountants (AICPA). I am pleased to be here today on behalf of the 340,000 members of the AICPA – certified public accountants who work as sole practitioners and in organizations large and small, in every community across the nation, and for the almost 1,000 firms that perform audits for public registrants. I speak today for the CPAs who, day in and day out, are committed to performing their work with the expertise, diligence, and integrity that the public and this committee expect and need.

Thank you for the opportunity to discuss some of the most critical issues facing our financial markets, investors, and corporate stakeholders, as well as the accounting profession and manner in which we serve clients and the public interest. We commend Chairman Oxley, Subcommittee Chairman Baker and their staffs on their thoughtfulness and hard work in introducing H.R. 3763, the subject of today's hearing. Similarly, we appreciate the efforts of Congressman LaFalce and others on the Committee who have advanced various other proposals.

The AICPA looks forward to working with this Committee, Members of Congress, the SEC and the Administration to bring meaningful reform in the wake of the tragedy at Enron.

CPAs across this country and the Members of this Committee share a common goal: to restore faith in the financial reporting system and reassure investors that they have access to the most up-to-date, relevant and accurate financial information.

Our profession has a long history of dedication to maintaining and improving the quality of financial disclosures. We require it, investors demand it, and the strength of our financial markets depends on it. We take that responsibility very seriously.

Our profession has zero tolerance for those who break the rules. We are very serious about that as well.

I would like to be very clear: We heartily support meaningful change because thoughtful improvements are needed. But, we all should be wary of simplistic solutions that can to lead to unintended consequences.

We believe that the public interest demands that any new policy affecting the profession answer four basic questions in the affirmative. We ask that this Committee and Congress evaluate legislative proposals with any eye to this public interest test. The four basic questions we hope that all ask when evaluating a proposal are:

- Will it help investors make informed investment decisions?
- Will it enhance audit quality and the quality of financial reporting?
- Will it increase confidence in the capital markets, our financial reporting system, and the accounting profession?
- Will it be good for America's financial markets and economic growth?

Today, I would like to offer our perspective on a number of the key issues, including those embodied in H.R. 3763, keeping in mind this public interest test.

<u>New Private Sector Regulatory Body</u>

Self-regulation is a hallmark of the manner in which all professionals in the United States monitor themselves. For 25 years, the SEC Practice Section of the AICPA has undertaken this responsibility with regard to auditors of the public statements of public companies.

The idea of a new public regulatory organization for auditors of the financial statements of public companies is a radical change in the accounting profession's landscape, but one that we now embrace, because it meets the public interest test I have just discussed. In today's environment, a robust private sector regulatory body, independent of the accounting profession, and charged with undertaking professional discipline and quality review in this sector, will go a long way toward increasing confidence in the capital markets, our financial reporting system, and the accounting profession.

Equally important, the new private sector organization, with SEC oversight, will provide a structure through which issues related to audit quality, auditor independence, discipline, and other related matters can be addressed and resolved. This approach strikes the appropriate balance between the need for government participation and oversight, and the efficiency and flexibility inherent in the private sector. Such an organization mitigates the need for arbitrary bright line proscriptions and restrictions. The new organization should:

- Perform quality reviews of the activities of accountants who attest to financial statements filed with the SEC
- Enforce compliance by accountants with professional standards applicable to audits of such financial statements
- Discipline accountants for violations of applicable professional standards
- Establish rules deemed necessary for such review and enforcement

It is critically important that the organization have the ability to keep certain information confidential and to compel the production of documents, two tools not currently available to the AICPA. These powers would balance the need to enhance the investigative process with a guarantee of the confidentiality of materials underlying a regulatory review. The reality that materials underlying a review that are privileged may be discoverable and admissible in civil litigation because of disclosure to the AICPA worked to frustrate timely action on self-discipline. Changing that reality will greatly increase the efficacy of any regulatory review

A clear charter is also key to success. The new regulatory body should function primarily as a disciplinary and quality review board rather than as a standards setter

The AICPA's disciplinary and quality review processes have served their purposes well. However, we now accept that it is necessary to move the authority over these two functions to an independent regulatory body such as I have described, unburdened by the legal limitations imposed on the AICPA's process, and able to move quickly and definitively to determine facts and, where appropriate, take remedial and disciplinary action

<u>Audit Quality</u>

The historic shift from the industrial era to the information age has wrought profound change to all elements of our economy, but perhaps none more fundamental than in our capital markets.

New financial instruments, for example, in the area of derivatives, emerge on an ongoing basis. Many of the instruments have become so complicated that understanding and measuring their effect on a business is difficult, and explaining them to a lay investor can be an even greater challenge. Likewise, the vibrancy of our markets is increasingly dependent on the creation of innovative and very flexible business models based on customer and supply chain relationships, operating in shorter and shorter business cycles. Understanding and measuring the impact of such rapid evolution is an equal challenge. New business risks are being created as a consequence, and capturing these risks is even more critical right now as these new models push the boundaries of traditional control.

Simply put, the business and investing environment is more complicated than ever before. The competencies and experience needed to conduct today's audit are vastly broader than they were even a few years ago. And those requirements will be even more far-reaching in years to come.

We ask that you recognize that the SEC disclosure requirements that have fed much of the debate about scope of services features a very narrow definition of audit services, a definition that has not changed since the 1930s, and clearly one that has not kept up with the times. Under the requirement, all services outside of the audit itself – even many of the services that auditors have traditionally performed such as accounting, tax, and assurance services – are put into the "non-audit" service category. Yet, a number of these services are a necessary part of a modern audit. Others "evolved from requests by audit clients for additional services that their auditors seemed best suited or capable of providing," according to a report issued by the POB-appointed Panel on Audit Effectiveness.

This categorization, rooted in the past, does not provide any enlightenment about what both companies and investors need today. We ask that you keep this in mind as you evaluate various proposals built upon these disclosure requirements.

In fact, after more than a year of intensive research, the Panel on Audit Effectiveness found that, in a quarter of the instances where a firm provided both audit and other services to a client, the insight gained from providing so-called non-audit services actually improved audit quality. Significantly, in no instance did the Panel find that the provision of non-audit services reduced audit quality. A very recent study conducted by investigators at the University of Southern California and Texas A&M International University indicates that concerns that non-audit services impair auditor independence are unfounded.

New rules that would narrow the experience brought to the audit are an invitation to disaster. Applying our public interest test, such action would impede audit quality and the quality of financial reporting.

Equally important, audit quality is highly dependent on auditor quality. We must be absolutely sure that we can attract the most competent professionals into our firms – individuals with the knowledge, education, and intellectual capacity to meet the challenges of this complex business environment. The excitement and dynamism of information age companies exert an enormous pull on young people entering the job market. Accounting school enrollments has decreased from 192,000 in 1995-1996, to 143,000 in 1999-2000. And accounting school graduates has decreased from 60,000 to 45,000 over the same period. Like newly minted lawyers and MBAs, young professionals in finance and accounting want to go where the action is. New rules that reinforce an outdated regulatory model and restrict career opportunities in accounting firms are more likely to strangle the auditing profession than nurture it.

Interfering with the marketplace by walling off auditors will have other unfortunate unintended consequences.

- Prohibitions on services would be particularly onerous to smaller companies that may not be able to pay different firms for auditing and other related services.

- It is a very real possibility that restrictions applicable to the activities of auditors of public registrants would be adopted by other government agencies, such as the GAO for Yellow Book audits, federal regulators for their regulated entities, state boards of accountancy, and state regulators. The ripple effect of such action would be very significant, affecting accounting firms of all size in all communities, and potentially driving up costs to government and businesses at every level.

- Such statutory restrictions will substitute informed and reasoned decision-making by companies and their audit committees with government fiat. This is not good for our financial markets or our country's economic growth.

Nevertheless, the profession recognizes that public concern about two particular services – financial system design and implementation, and internal audit outsourcing – has become intense, with a corrosive effect on public confidence. With our public interest test in mind, the profession has concluded that it will not oppose prohibitions on auditors of public companies from providing these two services to audit clients. In the wake of Enron, such prohibitions will help restore public confidence in the profession and the financial reporting system, without posing a significant threat of unintended consequences.

Risk of Creating Audit-Only Accounting Firms

One of the chief concerns from an investor and financial market perspective is the risk that proposals, whether intended or not, could lead to audit-only firms. While at first glance some may find this an appealing prospect, an audit-only firm would create significant economic viability and audit quality concerns.

The biggest threat is the risk to audit quality. We believe any proposal that results in the creation of audit-only firms will inevitably prevent the audit from keeping pace with changes in business models, market dynamics, and the overall economy. The skills and expertise of audit-only accountants will quickly be outpaced by rapid changes in business practices and financial transactions. Lower paid, less skilled accountants may staff audit-only firms, harming the ability of lead audit partners to go toe-to-toe with the modern corporate financial executive. And equally important, auditors cannot prevent the implementation of proposed improper transactions if their role is limited to an annual examination of historical financial statements.

Even though there are no federal proposals to mandate today's accounting firms to restructure themselves into the untested business model of an audit-only firm, some proposals on the table would force us there. For example, if a broad range of non-audit services is prohibited – or if the market is driven to the same conclusion -- there is no economic reason for talented experts offering non-audit services to remain connected to accounting firms. This loss of necessary expertise would be a critical blow to audit quality.

Take, for example, the case of the tax expert on derivatives, whose know-how is needed by the audit team, but who would be walled off from offering services to audit clients. Yet, that individual continues to bear the very significant liability risk associated with the audit function. Under such a scenario, sheer economics would force that individual to break away from the accounting firm. And he or she would not be alone. Faced with the huge liability risks associated with the firm's audit work, but unable to participate fully in the firm's activity, others in similar positions would leave en masse.

Equally important, there are real economic viability questions attached to an audit-only firm. With decreased business opportunities and a much smaller, relatively stagnant economic base over which liability, technology and training costs would be spread, an audit-only firm may very likely find it hard to continue to perform quality audits on an ongoing basis – a very real threat to the future of private sector auditing.

<u>Corporate Governance</u>

The financial reporting process is a complex system of checks and balances featuring:

- The company’s board of directors and its audit committee, which hires independent auditors and oversees the creation of a company's financial statements

- Company management, including internal accountants, who work year round to maintain the company's financial information and, in doing so, prepare the financial statements

- Independent auditors, who perform an audit of the company's financial statements to test management’s assertions regarding the fairness of the reported financial statements.

The financial reporting process also includes many others such as FASB, attorneys, securities analysts, etc.

The SEC has required the board's audit committee to publicly report that it has reviewed and discussed the audited financial statements with management, received disclosures regarding the auditor's independence, and discussed certain key issues with the auditors. The public report must also state that the audit committee has recommended to the board that it include the audited financial statements in the annual report, that the board has adopted a charter for the audit committee, and whether members of the audit committee are independent.

Audit committees should have the sole authority to approve the company's financial statements and required business disclosures in the annual report and other public documents. And the audit committee should be responsible for the hiring and firing of the company's auditor.

Audit committees have recently taken on new obligations to consider non-audit services provided by a company's auditor, and the potential impact on auditor independence. Under ISB No. 1, issued by the Independence Standards Board, the audit committee and the auditor must examine, at least annually, all relationships between the auditor and the company, including the provision of non-audit services that could bear on the independence on the auditor. Additionally, the proxy disclosure requirements resulting from the recent SEC independence rule require annual disclosures about the audit committee's consideration of any allowed non-audit services being compatible with maintaining the accounting firm's independence. We believe these recent measures, in effect for less than a year, appropriately enhance the role of audit committee oversight and should be given a chance to work.

We hope that Members of this Committee, Congress and others recognize that it would be harmful to cast a dark cloud over all services outside the statutory audit by establishing the negative presumption that an auditor cannot be independent if any such services are provided to an audit client -- even if that presumption was overridden by an audit committee's affirmative action.

Equally important, audit committees should be composed of outside directors with auditing, accounting or financial experience. It is imperative that individuals making these decisions be independent of management and knowledgeable enough to make educated decisions.

<u>Mandated Audit Firm Rotation</u>

Many independent studies – including those by the Public Oversight Board, the Commission on Auditors' Responsibilities, and the National Commission on Fraudulent Financial Reporting – have looked at the idea of mandatory rotation of audit firms and found that the benefits are clearly outweighed by the associated costs. These studies show that audit failures are three times more likely in the first two years of a client/auditor relationship, and that there is a positive relationship between audit firm tenure and auditor competence.

Adverse effects are caused by a number of factors. The audit firm needs to be familiar with the client's accounting, operations, and internal control systems. A replacement audit firm loses the knowledge, experience, and expertise developed through successive audits over time. As Senator Dodd noted in comments last week, the major accounting firms also often possess industry-specific expertise within firms, with one firm perhaps more dominant in the health care or financial services industry, for example.

The diversion of resources necessary for a registrant to find, retain, and educate a new auditor may also adversely affect the quality of the company's financial reporting and other business activities in the early years. And the audit may suffer from mismatches between characteristics needed by the client and those offered by the new auditor. These mismatches take time to become apparent.

Requiring that companies take on such risks would not pass our public interest test.

Moreover, mandatory audit firm rotation creates an unwarranted restriction on the freedom of companies to choose their own auditors. The determination of the best audit firm for a particular client should rest with the audit committee, which is in the best position to make that decision. To remove this very basic corporate governance role is to send a message to investors that the board and management of public companies is not competent to exercise its governance responsibility.

As a practical matter, with more than 17,000 public company audits, a mandatory rotation would create a significant annual proposal frenzy affecting thousands of audits and creating an unnecessary distraction for corporate leadership. An unintended consequence would be the added difficulty of ensuring timely reporting because audit firms would need to meet a very short learning curve to perform a rigorous audit. We note that the SEC recently announced a proposal to shorten the filing deadline to 60 days.

Member firms of the SEC Practice Section of the AICPA – all firms that conduct audits for publicly traded companies – already are required to take the lead engagement partners off engagements after seven years, for a period of two years, thus prohibiting long-term personal relationships between auditor and client contact.

Finally, I must mention that at one time Greece, Spain and Italy all required mandatory auditor rotation. Greece and Spain dropped the requirement after determining that the concept did not achieve public policy goals. Canada also put in place an audit firm rotation requirement applied to financial institution audits. It, too, dropped the requirement. In short, given the known risks, why follow these failed experiments?

<u>Turning Back Reforms in the Private Securities Litigation Reform Act</u>

In passing the Private Securities Litigation Reform Act (PSLRA), Congress found that the private securities litigation system was too important to the integrity of the capital markets to allow it to be undermined by abusive and meritless lawsuits. Private securities litigation is an indispensable tool for investors to use to recover their losses without having to rely on government action. These lawsuits promote public confidence in our capital markets and deter wrongdoing. Congress enacted the PSLRA because it found significant evidence of abuse in private securities lawsuits, and it felt it was necessary to enact the PSLRA reforms to protect investors and maintain confidence in our capital markets.

Preliminary empirical evidence gathered by the SEC and the Stanford Law School Securities Litigation Clearinghouse indicates that the race to the courthouse, in which lawyers try to seize control of a case by being the first to file suit, appears to have slowed. The complaints filed by plaintiffs now have more factual detail and appear to have more substance. This is demonstrated in several studies that have found that the average settlement value of post-PSLRA claims is up substantially. From 1995 to 1999, the average settlement went from $8.2 million to $47.9 million.

In light of this, it is ludicrous to suggest that the PSLRA has let accountants off the hook. One simply has to read the newspaper to see that simply is not true. The past few years have seen record numbers of lawsuits and record settlements from accounting firms. The number of securities class action suits has increased from 188 in 1995 to 209 in 1999.

The PSLRA is working to protect investors today, and we believe that turning back the meaningful reforms within it will hurt, not help, the public. The PSLRA is working as it was intended.

But perhaps most important, this law has nothing to do with the Enron debacle. Many of its original opponents are simply using current events as an opportunity to revisit old – and unproven – arguments. We ask that you look at the facts to see that the law works well and should be upheld.

<u>Corporate Truthfulness</u>

The AICPA supports legislation that would make it unlawful to improperly influence the audit or mislead auditors. If auditors are not provided with complete, relevant and accurate information, no system of regulation can protect investors and ensure proper financial disclosure.

Employment Restrictions

Some recent proposals would place additional restrictions on individuals in a company's audit firm from accepting certain senior positions at the client company. Currently, The Independence Standards Board's Independence Standard No. 3 (July 2000) provides that if the engagement partner joins the client within 1 year of disassociating from the audit firm, the audit must be reviewed separately by a professional in the firm who previously was not involved in the audit in order to make sure the audit team exercised the appropriate skepticism. Additional prohibitions will severely limit the number of firms qualified to perform a company's audit because most major companies today employ financial executives who were previously affiliated with various audit firms. Equally troubling, the proposals would effectively dry up the pool of competent individuals that companies could recruit for senior positions and limit career opportunities for all accountants.

Thinking back to our four essential public policy questions, such restrictions on auditor choice and the pool of competent corporate talent might boost confidence in the short run, but will hurt, not enhance financial reporting in the longer term. Such changes are not in the public interest.

Financial Reporting Reforms

The financial reporting system in the United States established almost 70 years ago to stabilize our markets and protect investors is no longer adequate, or even very relevant. The sweeping changes in our economy and the technologies that drive and support it require an equally sweeping overhaul of our financial reporting system to ensure that investors get the information they need – when they need it – to make informed investment decisions.

Financial reporting reforms such as the following are needed:

- Improved disclosures and more timely reporting to investors in "plain English"
- A requirement for registrants to report on internal controls with independent assurance
- Increased resources for the SEC to effectively oversee financial reporting disclosures.

We also strongly encourage Congress to consider the need for additional assurances on other non-financial information for investors, and a modernization of the current business reporting model.

Today there is a mismatch between the needs of financial statement users and the information they receive, a mismatch that disserves both investors and our capital markets. Efforts to modernize business reporting must be accelerated, including changes that address:

- Unreported intangibles
- Off balance sheet activity
- Non-financial performance indicators
- Forward-looking information
- Enterprise opportunity and risk
- Timely reporting

From a broader perspective, we need to focus on:

- A broader "bandwith" of information for investors, a recommendation long advocated by the profession
- New distribution channels that recognize the ubiquity of the Internet as a communications tool
- Increased financial reporting frequency, and ultimately online, real-time reporting.

The AICPA hopes to work with the members of this committee, Congress, the SEC and the Administration to explore thoroughly and thoughtfully the challenges the current environment poses to protecting the public investor. We support meaningful change that meets the public interest test identified at the outset of this testimony: help investors make informed decisions, enhance the quality of audits and financial reporting, restore confidence in the profession and the reporting system, and spur U.S. economic growth.

We will not support simplistic solutions, and we should all be wary of easy solutions that can lead to unintended consequences. With the public interest in mind, when we see such potential, we will not by shy about pointing it out.

On behalf of CPAs around the country, I thank you for the opportunity to present our views today and commend the committee for what we trust will be a thoughtful approach to these important and complex issues.