Consumer Federation of America

Testimony of
Barbara Roper, Director of Investor Protection
Consumer Federation of America

before the
Financial Services Committee
of the U.S. House of Representatives

Regarding H.R. 3763
"The Corporate and Auditing Accountability, Responsibility and Transparency Act"

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I am Barbara Roper, director of investor protection for the Consumer Federation of America. CFA is a non-profit association of more than 290 pro-consumer organizations founded in 1968 to advance the consumer interest through advocacy and education. Ensuring adequate protections for the growing number of Americans who rely on financial markets to save for retirement and other life goals is a top CFA priority.

I would like to thank Chairman Oxley and Ranking Member LaFalce for the opportunity to appear here today to discuss H.R. 3763, "The Corporate and Auditing Accountability, Responsibility and Transparency Act." I also want to thank you and your staffs for seeking out our views as legislation was being drafted. CFA shares your obvious conviction that, in the wake of Enron's sudden, surprise collapse last year and in response to a rising tide of earnings restatements, congressional action is needed to restore investor confidence in the reliability of corporate disclosures.

This legislation recognizes that a variety of factors contributed to the massive investor losses resulting from the Enron collapse, and that none is more important than the failure of the auditors to ensure complete and accurate disclosures. CFA shares that view, which we outlined in a white paper on audit-related issues exposed by the Enron collapse. I have attached that report as an appendix to this testimony. As we note in that report, CFA believes the growing lack of independence in the independent audit is the single most important issue for Congress to deal with to restore investor confidence. Lack of effective auditor oversight is also a pressing problem that must be addressed as part of any comprehensive solution.

Because this legislation fails to deal adequately with central issue of auditor independence, and because it does not do enough to ensure the independence and effectiveness of the auditor oversight mechanism it creates, we believe H.R. 3763 falls short of the comprehensive, strong reforms that the current crisis demands. With strengthening amendments, however, the bill could offer significant progress toward meaningful reform.

Auditor Oversight

The heart of this bill is its proposal to create a professional regulatory body to which all accountants who audit publicly traded companies must belong. CFA strongly agrees that regulatory oversight of auditors must be improved. The current system provides neither a thorough, objective review of audit practices and audit quality, nor a credible threat of timely, forceful punishment for those who fail to fulfill their professional responsibilities. As such, it does not serve as an effective deterrent to shoddy practices, or worse.

CFA believes an independent regulatory body, subject to SEC oversight, can provide effective oversight. To do so, however, it must be completely independent of the accounting industry, be adequately funded, have extensive rule-making and standard-setting authority, and be endowed with strong investigative and enforcement powers. In short, the accounting firms it oversees must not be able to unduly influence its funding, its regulatory agenda, its investigations, or the scope of its authority.

The bill takes important steps in this direction. It specifies, for example, that the professional regulatory organization (PRO) it creates would have the ability to deny firms and individuals the right to audit public companies. That is a meaningful sanction that should help to deter wrong-doing. It also includes provisions designed to provide independent oversight and funding. Unfortunately, much of the language in H.R. 3763 is simply too vague to ensure that these essential standards for effective oversight will be met.

It specifies, for example, that the PRO not be "solely dependent upon members of the accounting profession for [its] funding and operations." But this still leaves a great deal of room for the accounting firms to dominate PRO funding, and to threaten that funding when they object to PRO actions. The legislation should be amended to specify a funding mechanism that is immune from accounting industry domination.

The bill is somewhat stronger on the issue of independent governance. It requires that two-thirds of board members be public members who are not members of the accounting profession. It also requires that the PRO have procedures to minimize, deter, and resolve conflicts of interest involving public members. We support these provisions, but believe the legislation should do more to define tough independence standards for public board members. This is necessary to ensure that these standards are not watered down in the same way that independence standards for corporate board members have been.

We are also concerned that the bill does not clearly specify that the PRO will have authority to set audit standards. As Mr. Turner, who testified here earlier, has stated previously, the current audit standards adopted by AICPA are "so general that, as a practical matter, it's difficult to hold anyone accountable for not following them." We believe that audit standards must be improved, and that this is a job for an independent regulator, not the auditing industry.

The bill also leaves open the possibility of multiple PROs for accountants. Because of the legislation's relatively vague language on key topics, these organizations could set significantly different standards both for their members and for the PRO's own independence and oversight functions. Because they would likely be financially dependent, at least in part, on attracting members, there is a very real danger that multiple PROs would compete for members by lowering their standards. Such an approach gives the industry an unacceptable degree of potential influence over its regulator. We strongly urge, therefore, that the legislation be rewritten to create a single independent regulatory to which all auditors of publicly traded companies must belong.

If these changes are adopted -- a funding mechanism that is immune to industry influence, tighter independence standards for public board members, clarification of the board's responsibility for setting audit standards, and designation of a single PRO -- this legislation could provide the effective oversight of the accounting profession that is badly needed and long overdue.

Auditor Independence

On the central issue of auditor independence, the legislation is much weaker. It simply directs the SEC by rule to prohibit auditors from providing internal audit and financial information system design or implementation services to their audit clients. In doing so, it codifies steps the major firms have said they would take voluntarily to enhance their independence. There is certainly a benefit to having those prohibitions written into the rule book, as that will prevent backsliding once attention has turned elsewhere. It also represents real progress over where we were in late 2000, when the AICPA and several of the major firms fought vehemently to prevent these same restrictions from being imposed by the SEC.

Again, however, more is needed. The SEC auditor independence rule proposals that form the basis of this provision were crafted at a time when, as many opponents pointed out, we did not have evidence of a significant audit failure resulting from a lack of auditor independence. Now we have that evidence. And what the evidence looks like is thousands of workers out of jobs, with their retirement savings evaporated, and billions of dollars in shareholder money lost.

Furthermore, the original SEC proposal was put forward at a time when there was little concrete evidence regarding the extent of non-audit services provided to audit clients. Members of the industry argued that the magnitude of such services had been exaggerated. But the disclosures that followed passage of the SEC rule have shown that nearly all major companies also hire their auditors for non-audit services, and that they typically pay between two and three times as much for these services as they do for the audit. In some cases, the disparity is far greater. At least one company paid 30 times as much for non-audit services in 2000 as it did for its audit. What reasonable investor would trust that auditor's independence?

Given what we now know about the devastating harm that a failed audit can cause and the pervasiveness of significant consulting-related conflicts, Congress should be looking to address the auditor independence issue more comprehensively than the original SEC proposal attempted to do. Instead, this bill falls short of restoring the protections that were included in the original proposal. First, it fails to restore the stronger language in the original rule proposal on the whole range of non-audit services prohibited under that rule. Second, it does not include the four principles for determining auditor independence that were removed from the final rule.

Furthermore, the supporting materials for the original rule proposal made a strong case for a total ban on all non-audit services. As the proposal noted, this is the only approach that attacks, not just the particular conflicts associated with certain practices, but also the substantial conflicts that arise when other fees start to eclipse revenue from the audit itself. Some services will inevitably fall between the cracks of even the best drafted list of prohibited services. Auditors, who have shown a deep unwillingness to shoulder their responsibility to maintain their independence, will likely conclude that anything that isn't specifically banned is permissible. Finally, a total ban is essential to maintaining the auditor's independence of management. If an accounting firm has, or is seeking, a lucrative consulting contract from company managers, the auditors may come under enormous pressure within their own firm to please those company managers by signing off on questionable accounting practices.

For these reasons, CFA believes a ban on the provision of non-audit services to audit clients is essential. Certain services could be exempt, on a case-by-case basis, if it is shown that these services are closely related to the audit, directly enhance the quality of the audit, benefit investors, and create negligible conflicts of interest for the audit firm. At an absolute minimum, if auditors are allowed to continue to provide certain non-audit services, all such services should have to be directly and independently approved by the audit committee of the board.

In addition, Congress should look beyond the conflicts of interest associated with offering consulting services to clients in crafting real reforms to enhance auditor independence. The lack of independence in the independent audit starts with the fact that auditors are hired, paid, and fired by the audited company. Several proposals have been floated to reduce or eliminate this conflict. CFA has endorsed Rep. Kucinich's bill (H.R. 3795) to create an independent federal auditing bureau within the SEC. Others have suggested that the exchanges could be made responsible for hiring accounting firms to audit the companies that trade there. The idea is that such an approach would minimize the company's financial leverage on the auditor, and that auditors would as a result be more likely to perceive themselves as working for investors, rather than for the audited company. This is an intriguing suggestion, which we believe deserves further exploration.

A less radical notion that has gained some high-powered backers is the idea of requiring periodic mandatory rotation of auditors. When auditors expect to retain an audit client for 20, 30, even 50 years, it is that much harder for them to challenge management aggressively and risk losing that client. After all, they risk losing, not just that year's audit fee, but also a seemingly endless stream of future audit fees. On the other hand, an auditor who knows they are retained for a limited term has significantly less to lose by challenging management. Because we believe mandatory rotation would significantly reduce audit clients' ability to tame their auditors, CFA strongly urges that a mandatory rotation requirement be added to this bill's auditor independence provisions.

Another problem that clearly needs to be addressed is the revolving door that all too often exists between auditors and their audit clients. This was true at Enron, it was true at Waste Management, and it is a common feature in many failed audits. A constant flow of personnel from the auditor to the audit client helps to create an environment in which external auditors are viewed as just another part of the corporate family. Such intimacy is not conducive to true independence. To counteract this problem, auditors should be subject to a cooling off period during which members of the audit team would be prohibited from seeking employment with an audit client. We urge that such a provision be added to the bill.

CFA believes an approach that combines a broad ban on non-audit services, mandatory rotation of auditors, and a cooling off period for auditors would dramatically enhance auditor independence. While Rep. LaFalce's bill, H.R. 3818, does not include a total ban on non-audit services, it contains most of what we believe is necessary to restore a reasonable level of independence to the independent audit.

Furthermore, we believe such dramatic improvements are not just warranted, they are essential to justify restored investor confidence in the reliability of corporate disclosures. After all, the whole point of requiring public companies to obtain an independent audit is to ensure that outside experts have reviewed the company books and determined that they not only comply with the letter of accounting rules but also present a fair and accurate picture of the company's finances. Unless the auditor is free of bias, brings an appropriate level of professional skepticism to the task, and feels free to challenge management decisions, the audit has no more value than if the company were allowed to certify its own books. Any legislation that fails to address this issue comprehensively will have failed to restore real value to the independent audit.

Improved Disclosure

While poor disclosure rules cannot be made a scapegoat for what was clearly a company that was intent on deceiving investors and an auditor that was willing to let them, inadequate disclosure rules clearly contributed to the problem. H.R. 3763 includes a number of provisions to improve the frequency and clarity of corporate disclosures. It requires the SEC to move forward with rules to promote real-time disclosure of key information. It requires the SEC to improve disclosure on some of the key issues that helped bring down Enron -- off-balance sheet transactions and relationships with unconsolidated entities and deals with company insiders on terms other than those that would be likely to be negotiated with third parties. And it requires the SEC to study whether additional changes are needed to make financial statements more useful to investors.

CFA has been supportive of SEC Chairman Harvey Pitt's calls for more timely disclosure of material information. We share his concern that our current system of periodic disclosure often reduces investors to relying on stale information. It seems obvious, but it bears repeating: for a system of disclosure to be useful to investors, it must provide the information they need, in a form they can understand, at a time when it is useful to them. By combining a requirement for more timely disclosure with a requirement for broad dissemination of that information, this legislation will help to improve the value of corporate disclosures to investors. CFA supports this provision of the bill.

CFA also supports requiring better disclosure in the area of off-balance-sheet transactions and relationships with unconsolidated entities. Regardless of whether those improvements are made by the SEC or by FASB, they are clearly badly needed. It was the surprise revelation of Enron's massive indebtedness, and the sudden revelation that there was less to Enron than met the eye, that ultimately sent its stock price plummeting. While such entities apparently often serve legitimate business purposes, companies should not be able to use complex partnership structures and other accounting gimmicks to hide their level of indebtedness from the investing public. Better disclosure rules, enforced by a thorough, independent audit, could have helped to prevent this catastrophe.

CFA also agrees that it would be beneficial to require better disclosure of insider deals. Forced into the light of day, these practices, which have the potential to create massive conflicts of interest between corporate managers and shareholders, are likely to be strictly curtailed, and their most abusive provisions are likely to be eliminated.

Finally, we agree that, beyond these two specific issues that clearly need to be addressed, the SEC should study ways to make financial statements not just more reliable, but also more readable, more complete, and more transparent. Chairman Pitt has expressed a similar concern, even before the Enron case made the issue more pressing. This legislation should help to advance that goal by providing sound guidance on issues for the Commission to pursue.

Enhanced SEC Oversight of Financial Disclosures

CFA believes financial and other disclosures by all issuers should be subject to periodic, thorough reviews by the SEC. We are very encouraged that members of this committee have supported significant increases in SEC funding that are essential if the agency is to fulfill that and other important priorities. We also agree that certain issuers, where the risk to the public is greatest, should be subject to more frequent reviews. Size of market capitalization, level of trading activity, and the number of investors holding a particular security are all factors that should be taken into account in developing a review schedule. However, there may be additional factors that would also be relevant, such as a past history at the company of accounting abuses or membership in an industry that has been particularly prone to aggressive accounting. We believe the legislation should give the SEC more leeway to add factors that would be used in setting an appropriate and realistic review schedule.

Prohibition on Insider Trades During Pension Fund Blackout Periods

No aspect of the Enron disaster has struck more of a chord with the general public than the image of Enron executives profiting handsomely on their stock sales while employees watched their retirement savings evaporate. Prohibiting company executives from selling stock during periods when employees are subject to blackouts should help to ensure that executives don't intentionally time disclosure of bad news when they know a significant block of stock will be blocked from sale. CFA therefore supports this provision of the legislation.

Additional Studies

In addition to specifying the reforms discussed above, the bill calls for additional studies on rules relating to analyst conflicts of interest, corporate governance practices, enforcement actions, and credit rating agencies. CFA believes additional information would be valuable in all these areas to help determine whether additional protections are needed and, if so, what the most effective reforms are likely to be.

This committee, and the Capital Markets Subcommittee, played an extremely valuable role in exposing the conflicts of interest that can bias securities analyst research. Without the high profile attention this committee brought to that issue, it is unlikely we would have seen the strong rule proposals that were recently announced to minimize those conflicts. CFA expects to comment on those rules as they move through the rulemaking process. While we believe the rules represent real progress on this issue, conflicts of this magnitude are difficult to combat. Thus, we agree that it is a good idea to have the SEC review the rules' effectiveness.

We also believe it would be extremely valuable to have this committee conduct the same kind of oversight hearings on credit ratings agencies as it conducted on securities analysts. Having the SEC undertake a study on the issue could provide a good launching point for such hearings. Given the increasingly complex issues that govern determinations of credit-worthiness, the failure of credit rating agencies to provide a timely warning of problems at Enron (and in numerous previous examples), and the growing concentration in the industry, a thorough study is warranted and could be extremely valuable.

The Enron collapse brought to light certain types of accounting practices that result in less than transparent disclosures, and the legislation deals with several of those directly. It also directs the SEC to review and analyze all Commission enforcement actions from the last five years involving violations of reporting requirements and restatements of earnings. The goal of that study is to identify areas of reporting that are most susceptible to fraud, manipulation, or inappropriate earnings management. We believe this is a very useful exercise for the Commission to undertake. It should produce valuable information on types of accounting practices that merit special SEC review as well as accounting rules that may need revision.

Finally, the apparent gross violations of ethical conduct that occurred among Enron managers and the failure of the corporate board to adequately supervise these activities raises serious questions about the adequacy of current corporate governance practices. CFA has concluded, for example, that independence standards for board members should be strengthened and that all audit committee members should have to be independent board members. However, a more comprehensive review of corporate governance practices could reveal numerous additional areas in need of reform. We support both the requirement for a study in this area and the scope of the study proposed in the legislation.

Conclusion

The Enron collapse has understandably shaken investor confidence in the reliability of corporate disclosures and the safeguards our financial system provides to keep company management honest. Only a comprehensive package of reforms, with strong auditor independence and oversight at its heart, will restore that shaken confidence. Though it falls short in several areas, H.R. 3763 could provide the framework for real audit reform. Most of the changes that are needed to strengthen the legislation can be found in H.R. 3818, which was recently introduced by Ranking Member LaFalce and his Democratic colleagues. We urge the Committee members to work together and with the Senate to produce the strongest possible legislation to restore investor confidence and, with it, market stability.

Once again, I want to thank you for inviting me to appear before you today. I will be happy to take any questions.