STATEMENT

OF

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BEFORE THE

COMMITTEE ON FINANCIAL SERVICES

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HOUSE OF REPRESENTATIVES

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STATEMENT

We need only to recount the accounting embarrassments of Enron, Global Crossing, and Waste Management in the past few years to know that the regulatory system that has evolved over the past 69 years to protect the investing public has serious deficiencies that need attention. At the same time, we should appreciate the fact that the vast majority of the more than 14,000 publicly traded companies in the United States produce reliable financial statements year after year. We have a good system. No other country comes close to providing the degree of investor protection as does the United States. It deserves the respect it has had for so many years.

As we consider how to strengthen that system, it is useful to remember that its last major strengthening occurred in the middle 1970s in reaction to the fact that some 400 companies were compelled to disclose that they had bribed or made questionable payments to foreign officials. At that time, the SEC stimulated the New York Stock Exchange to compel independent audit committees, substantially increased the responsibilities of auditors and required that publicly traded companies have effective internal financial controls.

Since leaving the SEC in 1977, I have served, at one time or another, on 14 boards of directors, as chairman of 8 audit committees and as an audit committee member of all 14 boards. Six times we wrote off more than $100 million of improperly taken income. Eight times we terminated the Chief Executive Officer (See Appendix A). From those experiences and from my time at the SEC, I suggest substantial weaknesses remain in our system:

- First, the overall system, now reaching the age of 70 years, needs a complete overhaul. The Financial Accounting Standards Board ("FASB") and the American Institute of Certified Accountants ("AICPA") are not tailored to be responsive to the type of accounting issues raised by the Enron, Waste Management and Global Crossing incidents;

- Second, it is increasingly clear that some number of audit partners are not able ***consistently*** to resist management pressures to permit incomplete or misleading financial statements; and

- Finally, the audit committees of too many boards are not exercising the authority given to them or the responsibility expected of them.

H.R. 3763 has the prospect of making substantial improvements in all three areas.

The System

Criticism of the regulatory system that protects the investing public has two principle aspects.

First, whether fair or not, the almost universal view is that peer review of accounting firms is not providing sufficient quality control. Discipline comes primarily from class action and shareholder derivative litigation. The SEC does bring actions against accounting firms and individual accountants, but such actions almost always come after the fact of an accounting failure. The SEC does little preventative work.

The Public Regulatory Organization (a "PRO"), that H.R. 3763 would create, appears to have the authority and responsibility to investigate and assess the quality of an accounting firm before damage is done. Also, a PRO appears to be able to discipline accountants and accounting firms without compromising the primacy of the SEC.

Second, the audit today has become a commodity that does not test the judgment of the auditor to a sufficient degree. Chief Executive Officers see no added value in them and the accounting firms, therefore, compete for the work with price not with quality. There are so many rules with so much precision that there is an implication that whatever is not prohibited is permitted. The auditor is too often reduced to a rule checker looking only for compliance.

The auditor's opinion invariably includes this phrase:

"In our opinion, the financial statements [prepared by management] fairly present, in all material respects, the financial position of the company."

In fact auditors are not exercising the judgment that such an opinion suggests. Instead the above statement usually means only:

"We have found no material violation of applicable rules."

Section 6 of H.R. 3763 would cause both management and auditors to exercise considerable judgment in deciding what key accounting principles are most affecting the apparent financial position of reporting companies. By requiring management to explain how different accounting principles would produce materially different results, the bill would necessarily cause auditors to review such explanations. As I understand Section 6, it provides a legislative endorsement for the SEC's December 12, 2001: Release Nos. 33-8040; 34-45149; FR-60.

In short, H.R. 3763 will require more judgment by the auditor and, thus, should make management more concerned about the quality of the audit staff.

Paul Brown of the Accounting Department of New York University has recently summed up our system:

"***It's an old adage of an FASB rule. It takes four years to write. It takes four minutes for an astute investment banker to get around it."***

H.R. 3763 does not deal specifically with the deficiencies in the FASB process. Professor Weil of the Chicago School of Business describes what needs to change:

"I want accountants to use fundamental concepts in choosing methods and estimates. I want accountants not to hide behind the absence of a specific rule."

This Committee may wish in Section 9 of H.R. 3763 to ask the SEC to review the FASB process.

The Profession

In addition to its other troubles, the accounting profession is not attracting the same talent that came to the profession 20 years ago. Far more people were then entering the profession. Then, significant numbers of them were graduates of our leading business schools but few come from that source now. Yet, the Big 5 accounting firms are now attempting to hire far more CPA's than 20 years ago.

This difficulty of finding top-notch personnel, the difficulty of finding a precise rule to deal with ingenious corporate structures and especially the ***pressing financial***

need to keep clients too often causes audit partner's to allow questionable accounting policies to slip by.

Section 3 of H.R. 3763 will provide some deterrent to zealous management officials, but real protection for the auditors can only come from a vigilant audit committee: an issue that is discussed below.

Also, Section 2 of H.R. 3763 will restrict the ability of auditors to provide services, other than the audit, to audit clients. The proscription against providing "financial information system design" is constructive. However, the absolute prohibition against providing any internal audit service is both unwise and impractical.

It is unwise because a significant number of publicly traded companies maintain their own internal audit function. In any given year that internal audit force may need to be supplemented for any number of unanticipated and unique reasons. It would be enormously expensive and inefficient to force management to hire a different accounting firm for such sporadic assistance.

Such a rule would be impractical because there is no bright line between the external audit and internal audit tasks. In my experience as chairman or as a member of audit committees that line varies from year to year. Each year, the audit committees on which I sit or have sat oversee a practical allocation of audit tasks between the external and the internal audit staffs. The SEC's rules now permit the external auditor to perform

as much as 40% of the internal audit. So long as there is a separate and effective internal auditor, the SEC's approach is preferable to an absolute ban.

The Committee may wish to consider the fact that the SEC does not specifically require an internal audit. An amendment to Section 9 of H.R. 3763 could ask the President's Working Group to consider this matter.

The Audit Committee

The primary task of the audit committee should be to protect the auditor from the all too common pressure from management to allow a questionable accounting policy to slip by. However:

- Board members are too often chosen by the CEO who also decides who will sit on the audit committee and who will chair it;

- The audit committee members seldom ask the auditor if there is a fairer way to present the company's financial position;

- They seldom play a significant role in selecting a new audit firm; and

- They seldom establish themselves as the party in charge of the audit ***and in charge of retaining the auditor.***

Section 9 of H.R. 3763 asks the President's Working Group to determine "whether the duties and responsibilities of audit committees should be established by the Commission." While this inquiry is appropriate, the Committee may wish to be more forceful in establishing the authority of the audit committee.

As noted above, the mandatory audit committee came into existence just over 25 years ago. It would be timely for the audit committee to have a more formal legal status.

That status would be obtained if the SEC would simply state that the failure to maintain an independent and competent audit committee constitutes a material weakness in a company's internal controls. Such a statement would require the auditors to determine whether such a committee is present and thus ask such questions of board members as:

- How did you get to the Board and on the audit committee, and who selected the Chairperson of the committee?

- What percentage of your annual income is derived from your service on this board or other boards?

- What experience or education have you had that is relevant to the responsibilities of an audit committee?

It should rapidly become apparent that an independent audit committee requires that there be an independent nominating committee.

And, the SEC can make it quite clear that the audit committee's most important task is to make the auditor believe that its retention depends ***solely*** on the decision of the audit committee.

If such steps are taken an accounting firm should not take any engagement unless it is certain of the audit committee's support. With such support, the firms should have the resolve to qualify their opinion when they believe that the financial presentation is deficient notwithstanding the fact that all rules are satisfied.

The Committee may wish to amend Section 9 of H.R. 3763 to ask the President's Working Group to consider these more specific audit committee issues.

Miscellaneous Comments

I have two further suggestions with respect to H.R. 3763.

Section 2 of the bill provides that a PRO be self-funded. I suggest that this may be inappropriate. A body with the regulatory authority of a PRO should not need to "pass the hat." There are few if any large publicly traded companies that could not be affected

by a PRO's regulations. On the one hand, these companies might be tempted to imply that they would withhold support to influence a PRO decision. On the other hand a PRO's authority could intimidate many companies.

It would be preferable for Congress to establish a permanent funding mechanism. A surcharge on all audit fees would be one possibility. Alternatively, Congress could mandate the creation of an endowment sufficient for a PRO's activities and could provide for that endowment in whole or in part. The Congressional grant could be supplemented by contributions from private sources.

Section 8 of H.R. 3763 requires the SEC to periodically review the financial statement of all issuers "with the most actively traded or widely held securities, or the largest market capitalization."

I suggest that a preferable approach would be to give the SEC sufficient funds to create an information system that would identify those companies that are most likely to have an accounting problem. Each of the Big 5 accounting firms have a system that identifies those of their audit clients that are most likely to have such a problem. The SEC, using similar methodology, can identify the same companies and thus better allocate their resources.

Conclusion

The Enron debacle is emblematic of weaknesses in our regulatory system. Andersen is in the headlines, but all accounting firms have had the same kind of troubles. Andersen and the other firms are not blameless, but they do not deserve all the blame. The profession has real problems because of the system that they cannot change by themselves.

The accounting profession is of enormous importance to the United States and to the increasingly global economy in which we exist. As we identify the deficiencies of the accounting profession, we should also acknowledge the responsibility we have to assist it to reform itself.