THE COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

WRITTEN STATEMENT BY LYNN TURNER

MARCH 13, 2002

Chairman Oxley, Congressman LaFalce, Members of the Committee. Thank you for the opportunity to provide comments on H.R. 3763 that addresses issues of vital importance to the U.S. capital markets. My comments draw upon past experience as a certified public accountant and auditor, a business executive, a regulator and an educator.

After receiving degrees from both Colorado State University and the University of Nebraska, I started with the widely respected international accounting firm of Coopers & Lybrand (now PricewaterhouseCoopers) in 1976. I served in various capacities with this firm including as the business unit leader of the high technology audit practice, as an SEC partner responsible for reviewing filings with the Securities and Exchange Commission (SEC), and as an audit engagement partner.

In 1996, I left the firm to take a position as Chief Financial Officer (CFO) and Vice President with Symbios, Inc., a large international manufacturer of semiconductors and storage systems that was a client of the firm. I was appointed as the Chief Accountant of the U.S. Securities and Exchange Commission (SEC) in July of 1998 and served until August of 2001. Now I have the privilege of shaping the minds of students who are the future of the accounting profession, as a professor in the College of Business at Colorado State University (CSU).

In addition to teaching today, I also do limited consulting in the accounting industry and business community.

Why Reliable Numbers are Critical to the Success of the U.S. Capital Markets

Financial numbers are used to report to investors, lenders, regulators and other users of the financial statements, the economic performance of a company. The numbers in the financial statements, just like a score on a college student's test, tell investors how a company has performed in comparison to expectations of management, the markets and competitors. Without these historical numbers, it is difficult, if not impossible, to gauge the future prospects of a company. Without accurate numbers, investors and management are likely to be misled into making make wrong decisions. In essence, those who prepare or aid in the preparation of false and misleading financial statements take away from investors their ability to make their own informed choice as to whether they would invest in a company. When this occurs with increasing frequency, as we have seen in recent months and years, investors question whether they can invest with confidence.

Critical elements must be present in our financial disclosure system if capital markets are to maintain their integrity and the confidence of investors. First, management must prepare financial statements and disclosures that fairly reflect the underlying economics of the business on a consistent, timely basis. Second, the corporate board, principally through the audit committee must oversee the integrity of the financial reporting process. Remember, that financial fraud typically starts with management, and when we look for culpability, we should begin there as well[1]. Third, the independent auditor must perform

[1] Fraudulent Financial Reporting: 1987-1997,*An Analysis of U.S. Public Companies*, 1999, Committee of Sponsoring Organizations of the Treadway Commission (COSO). This study of SEC enforcement actions from January 1987 through December 1997 studied nearly 300 companies involved in alleged financial

a robust, impartial and unbiased audit, designed to ensure the numbers are fairly presented and accurate. Investors rely on an auditor as an independent umpire who calls the numbers as the auditor sees them, not as management desires. Fourth, analysts who play an integral and important role in our financial markets must use the financial information and disclosures to perform their independent analysis of the figures, and arrive at recommendations that investors can read and understand.

I commend the Chairman for his efforts, initiated before Enron became a household word; to bring about badly needed reform to the system of conflicts that exist with analysts, underwriters and Wall Street. As you have so aptly stated Mr. Chairman, we need independent analysis, fueled by a desire to provide investors financial information based on reality, not hype and the potential for underwriting fees, and with plain English stock recommendations that do not require deciphering.

I also commend Congressmen LaFalce and Kanjorski for their foresight when raising a red flag with respect to leaks in our system. Well before Enron investors were left afloat when the once invincible ship Enron hit the Iceberg, these Congressmen met with representatives of the SEC, the Financial Accounting Standards Board (FASB) and the Public Oversight Board (POB) to push for greater resources for the SEC and necessary reforms. I greatly appreciated that support while I was at the SEC.

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

H.R. 3763 has positive elements that will enhance the current financial disclosure system. Furthermore it presents opportunities for additional recommendations to better protect and serve investors.

Reforms set forth in the proposed legislation and in the following testimony will be even more critical if the "Big Five" turn into the "Final Four." The Big Five are some of the world's largest private businesses. They audit approximately 80 percent of all public companies resulting in a significant concentration of business and power within the industry[2]. Further concentration will only result in greater potential for independence conflicts, fewer choices of a firm for a public company and its investors.

It is unquestionably in the best interest of the profession if Andersen continues as a separate firm. I strongly believe that the problems facing the industry today are profession-wide, not just an Andersen issue. This was also the position stated by the Independent Oversight Board of Arthur Andersen LLP on March 11, 2002[3]. In fact I

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fraud. Its findings include that in 83 percent of the cases, the SEC action named the CEO or CFO or both as being associated with the financial fraud.

[2] Data from the Public Accounting Report's Annual Survey of National Accounting Firms – 2001notes the average number of SEC audit clients for a Big Five Accounting firm is 2,574 with a range from 1,802 to 2,975.

[3] Report of the Independent Oversight Board of Arthur Andersen LLP dated March 11, 2002. The members of the Independent Oversight Board include Former Federal Reserve Chairman Paul Volcker,

applaud Andersen for the changes they, or their oversight board chaired by Former Federal Reserve Chairman Paul Volcker have already announced including:

1. Splitting of the auditing and consulting business.

2. Creation of a new Office of Audit quality comprised of senior specialists with the sole mission of driving audit quality.

3. Creating a new independent Office of Ethics and compliance to investigate any concerns of Arthur Andersen partners, employees or individuals from outside the firm relating to issues of audit or auditor quality, integrity, independence and compliance.

4. Committing to report to audit committees more comprehensively than currently required and to include quality of results, industry comparisons and performance indicators.

These reforms clearly set a new benchmark all large accounting firms in the profession should be held to by each and every audit committee, and federal and state regulators. They constitute what I would call a "best practice" that more than just Andersen should strive to achieve. However, until the other firms agree to measure up to these new practices, it is likely that Andersen will ironically, provide the highest quality audits.

I also believe we should strive to find ways to encourage Wall Street to quit requesting that audits of companies undertaking an initial public offering be performed by Big Five accounting firms as opposed to other very well qualified firms such as BDO Seidman LLP, Grant Thornton LLP and McGladrey & Pullen, LLP.[4] As we are currently seeing, "deep pockets" are meaningless when an audit does not meet public expectations.

<u>Positive Elements</u>

With respect to H.R. 3763, there are very positive elements of the bill including:

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former U.S. Comptroller General of the United States Charles Bowsher and retired chairman and chief executive of Merck & Co., Inc., Dr. P. Roy Vagelos.

The report states:

> "In making its decisions, the Board has given great weight to the need, in conducting audits, to avoiding the reality or appearance of conflicts of interest that might otherwise arise in firms offering a variety of services. It also recognizes that effective auditing of financial statements requires strong professional discipline, effective training in the complexities of modern finance, and clear recognition of the need for timely, accurate and comprehensive reports to the investing community.
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> There have been lapses in achieving these goals in this country and elsewhere. The difficulties are not confined to Andersen, or to auditing firms, alone."

[4] A survey by SEC staff of proxies filed by 563 Fortune 1000 companies through April 30, 2001 noted only 6 of the companies were audited by a non-Big Five accounting firm.

- The establishment of a public regulatory oversight board (PRO) for the accounting profession under the oversight of the SEC.

- Section 3, Improper Influence On conduct of Audits, making it unlawful for company executives or directors to willfully and improperly influence, coerce, manipulate or mislead the auditor.

- Requiring more timely disclosure of financial information provided all investors receive such information consistent with the current requirements of Regulation FD.

- Electronic disclosure of insider and affiliate transactions including disclosure on the corporate website.

- A prohibition on insider trades during pension fund blackout periods.

- Section 6(C)((2) regarding Alternatives to Be Considered.

- A requirement for the SEC to undertake a study of enforcement actions, which appears to be similar to the study performed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).[5]

- A requirement for the SEC to study rating agencies.

As a partner at a major international accounting firm, I have witnessed company's who attempted and in some cases, succeeded in "brow beating" their auditor. I also recall during my tenure as SEC Chief Accountant, receiving a transcript of a company's call with their analysts.' During the call, a company executive commented about how the audit partner had been prodded and pressured into a larger write-off that later resulted in a restatement. Time and time again we saw such behavior in enforcement actions. In light of Enron and my experience with similar situations, enactment of Section 3 is long overdue. I would urge the committee to ensure the SEC has adequate remedies with respect to enforcement of this provision.

I also support more timely disclosure of financial information that will provide analysts and investors with key indicators of a company's performance, value and trends. Disclosure of key performance indicators or KPI's will go a long way in achieving this goal. The report of the Garten Committee last summer encouraged the SEC to issue a concept release on this subject. We had started work on that project before I left the Commission and I hope the SEC will continue to move forward in this direction.

I do have concerns with respect to more timely disclosures beginning with foreign issuers who now comprise about 10 percent of all issuers. Currently many foreign companies are not required to file quarterly financial statements. The SEC has been more than

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[5] Ibid Footnote1.

accommodating to foreign filers in order to attract them to our capital markets. But it is time these foreign companies be required to file their annual and quarterly financial information consistent with the same requirements for U.S. companies. I would encourage the committee to state that the timely disclosure section applies to all filers with the SEC.

Another concern with timely disclosures involves *when* it is appropriate to make a disclosure. As a CFO, I could make the professional judgment as to whether a matter was material or not. It was my job as an executive to understand how significant issues were. But there were also times when I was not sure if initial information was indicative of a trend that should be disclosed. For example, in the semi-conductor industry one can see swings in the bookings of new business and resultant backlog. These swings often do not happen overnight but rather may develop over time. Likewise, a business does not usually see the value of its assets such as inventory or plant and equipment increase or decrease overnight. A key question that must be addressed is at what point in that timeline is it that management should make that disclosure. If bookings start to go up over a two or three week period, but then drop back down, would it have been proper to have told investors backlog and sales were likely to be going up sometime during the three week period? Financial information is not always black and white.

Timely disclosures may also act to increase the focus of investors, especially institutional investors, on short-term results. Too much focus on short-term results rather than long-term value creation already exists today and is not healthy for companies or the markets. There is too much pressure being exerted on business executives to make their numbers each quarter, and that is contributing to problems we are discussing here today. Perhaps this is an issue the SEC should address in a concept release.

I agree with additional disclosures that are suggested in Section 6(C)(2) and which appear to be modeled after proposals put forward by the SEC. I would note that in particular, with respect to Section 6(C)(2)(C), in 2000, the SEC staff requested the accounting profession undertake a project to provide enhanced guidance on valuation of financial instruments.[6] The American Institute of Certified Public Account have not yet taken up the request of the SEC staff but have been working on useful guidance for valuation of stock options since 1997.

<u>Improving H.R. 3763</u>

I also believe that certain improvements to the Bill would provide for greater protection of the investing public. These improvements will become especially crucial if there are only four major international accounting firms. In that situation any further "Enron" experiences could call into question the ability of the private sector to continue to perform the independent public audit function. These improvements include:

[6] See letter from the Chief Accountant to Ms. Arleen Thomas, Vice President of the American Institute of Certified Public Accountants, dated November 17, 2000 at http://www.sec.gov/info/accuntants/staffletters/valuguid.htm.

- Providing that the PRO be:
    - Drawn solely from members of the public, albeit certified public accountants who have not had any financial ties to an accounting firm for some period of time may comprise some minority of the board;
    - Provided with powers to compel testimony and document production on a timely basis;
    - Allowed to conduct its hearings into unprofessional conduct in public as the SEC has done since the late 1980's with its Rule 102(e) proceedings and take timely disciplinary actions;
    - Given the ability to levy civil monetary penalties, in addition to a bar from practice or registration of either the firm or individual involved or both;
    - Provided the authority to issue not only quality control standards, but also auditing standards against which the performance of audits is measured; and
    - Allowed to share documents and information gathered in its investigative process with appropriate state regulators during the course of the investigation so as to streamline the investigative and disciplinary process.
- Enhancing Section 2(C) addressing auditor's independence by including:
    - All of the original provisions of the SEC's rule proposal rather than just those the accounting firms have already agreed to;[7]
    - A requirement for the audit committee to select, retain and when necessary to fire the auditor;
    - A requirement, consistent with the findings of the Panel on Audit Effectiveness and the original SEC rule proposal that the audit committee pre-approve non-audit services;[8] and

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[7] Revision of the Commission's Auditor Independence Requirements, Proposed Rule, June 30, 2000. The rule proposal provided for greater prohibitions than those included in H.R. 3763 such as all legal and expert services. It also required disclosure of whether the audit committee had pre-approved non-audit services. The final rule placed certain restrictions on internal audit outsourcing and set forth certain criteria that must be met before either internal audit outsourcing or information systems consulting services could be provided after the effective date in August 2002 of these provisions of the rule. These are likely to have a significant effect of whether companies would retain their auditor after the effective date to provide such services. Some public companies have already publicly announced they would not retain their auditor for such services.

[8] The Panel on Audit Effectiveness, August 31, 2000, page 117; see recommendation 5.30. This recommendation states: "The Panel recommends that audit committees pre-approve non-audit services that exceed a threshold determined by the committee. This recommendation is consistent with the

  - A provision for mandatory rotation of auditors, which may also be combined with a requirement for mandatory retention of auditors unless the PRO approves a change.

- Modifying Section 6, Improved Transparency of Corporate Disclosures, to require the SEC to modify its rules, provided these improvements to transparency of corporate disclosures are not completed within a specified timeframe by the FASB.[9]

- Adding a statutory requirement that Chief Executive Officers and CFO's should be required to provide a statement to their shareholders vouching for the full and fair disclosure of the company's public disclosure including that the financial statements fairly present the financial condition and operation of the business. Consistent with Section 36 of the Federal Deposit Insurance Corporation Improvement Act of 1991, I would also encourage this statement encompass the requirements for reporting of management's responsibility for internal controls and laws and regulations, the effectiveness of those controls and be accompanied by a reporting requirement for independent public accountants.

- Modify Section 8, Oversight of Financial Disclosures, to provide the necessary appropriations for SEC, including provision for adequate staffing and technology resources to undertake the mandated review requirements.

- With respect to *each* of the studies being mandated, consider requiring each study to include as a part of the study, an evaluation of a sample of actual problem situations. This is consistent with the requirements set forth in Section 10, Study of Enforcement Actions, which are very good.[10]

Let me expand on some of the above comments.

<u>Independent Governance of the Profession</u>

The quality and reliability of financial statements and disclosures provided to investors are ultimately determined by whether there is compliance with the applicable accounting rules. You can write all the accounting rules you want to; you can require sufficient disclosures to fill up a phone book; but unless someone assures investors the established rules are being followed, they are meaningless. That is why we have independent audits.

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recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees regarding auditors' services."

[9] Previous testimony before the Senate Governmental Affairs Committee notes that if Enron had complied with existing Generally Accepted Accounting Principles the Enron financial statements would have included more transparent related party disclosures and certain off-balance sheet transactions would have been included as liabilities on the balance sheet.

[10] It should be noted that Senator Sarbanes, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs in a letter dated January 7, 2002 requested the Comptroller General of the U.S. General Accounting Office perform a study of enforcement cases involving accounting irregularities.

Independent audits provide investors with confidence that the numbers are accurate and reliable.

Since the financial frauds and failures arising from the 1972-73 bear market, including cases such as Penn Central and Equity Funding, the profession has attempted to ensure audit quality through a self-governance process. While some argue that 99.9% of the audits each year are okay, remember that Enron was once one of those 99.9%. The fact is we really don't know how many more audits are like the iceberg below the water level, unseen until it is too late.

What we do know today, is the increasing number of earnings restatements, the number of massive financial frauds, the tens and hundreds in billions of losses to investors and now Enron, accompanied by the almost daily parade of financial reporting issues, highlight a serious question in the minds of investors with respect to the quality of audits.[11] They also strike at the very heart of the credibility of my once esteemed and proud profession. Yet the multitude of organizations often referred to in the press these days as "alphabet soup" do not yield an efficient or effective quality control process.

It is well past time to establish a legislative based, SEC supervised PRO in light of:

- Recent disclosures that the accounting industry has thwarted attempts of the POB to complete in a timely fashion the public reports regarding the Involuntary Look-Back Program previously established in 2000 by the SEC as discussed in its 2000 Annual Report To Congress.

- The American Institute of Certified Public Accountants (AICPA) and profession having cut-off the funding for the POB in spring of 2000 when it attempted to fulfill its mandate to the public and carry out an investigation of the lack of compliance with independence rules.

- The AICPA having a weak, if not totally ineffective self-disciplinary group called the Professional Ethics Executive Committee or PEEC. A group that conducts its meetings behind closed doors, that often defers taking action on cases for years at a time, that has no subpoena powers, and that has failed to take action in a number of instances after the SEC has. The AICPA and firms had stated to the SEC and public in press releases towards the end of 2000 that they would work towards increasing the public membership of this organization from the current three out of twenty members. Andersen publicly said it would support an increase in public membership to half of the committee's total membership. Unfortunately, this has become a broken promise.

- The AICPA creating a for-profit portal and web of business relationships called CPA2Biz, and along with a failed attempt at establishing a business consulting credential. It is difficult to understand how a not-for-profit organization can enter

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[11] Study of Restatement Matters – An Analysis of the Industries and Accounting Issues Underlying Public Company Restatements For the Four Years Ended December 31, 2000, Arthur Andersen , 2001. The study notes 116f restatements of financial statements in 1997, 158 restatements in 1998, 216 restatements in 1999 and 233 restatements in 2000.

into this web of for-profit relationships and not create conflicts with the notion of being a public interest self-regulatory organization.

- The POB itself has no disciplinary powers.
- The POB has limited capabilities to ensure auditing standards are written based on meeting the needs of the public for effective audits, as opposed to being written by, and for, the general legal counsels of the firms.
- The Quality Control Inquiry Committee or QCIC that is often trumpeted as investigating alleged audit failures in fact has no subpoena powers. It only has members from the profession, often retired partners from the Big Five "club", lacks members from the public and only looks at documents that are already publicly available. It has recommended cases to the PEEC or Auditing Standards Board (ASB) for further action. Action that too often fails to materialize.

I have heard some say that unless practicing accountants serve on the PRO it will not have the necessary expertise. Yet in the United Kingdom the accounting profession itself recommended a new framework for the independent regulation of the profession that has an independent oversight board, called the "Foundation," without any practicing accountants among its members. I believe you can get many well-qualified public servants who understand audits and will protect investors by drawing from the ranks of former auditors.

I have also heard some say we should consider using one of the existing self-regulatory structures that exist today. However these may well involve organizations where the members themselves have a vested interest in the outcome of accounting and auditing standards. For example members of a stock exchange have a vested interest in the numbers they must report, the disclosures they must make, and the outcome of their audits. This creates a conflict that will not ease investor's fears about the current lack of independence.

One reason for creating a PRO is the need for an active inspection program that can discipline auditors when substandard work is identified. An inspection requires very experienced personnel who are typically partners and managers and who have significant practical experience. These people would be no lower than a GM-15 or Senior Executive Service in the government personnel scale. For a typical accounting firm office, it may take on average of ten reviewers working seven to ten days to perform an inspection. Large offices like those located in major metropolitan areas will take significantly more staff. Given the large accounting firms today have a hundred offices in just the U.S., one can quickly see where it will take significant manpower to perform timely and effective inspections. Being able to attract, competitively compensation and retain such staff will be a challenge for the PRO. However given today's budgetary pressures, this is probably easier accomplished in the PRO as opposed to the SEC.

Improving Audit Quality

The PRO will enhance audit quality through effective independent inspections. Performance of annual on-going independent inspections of the large accounting firms, with perhaps no less than tri-annual inspections of smaller firms who tend to audit fewer public issuers, should overcome the current system of "backslapping" peer reviews. It is interesting to note that today it is perhaps the smaller firms that face the most rigorous reviews. The system of firm on firm reviews by the large firms reminds one of grade school where the rule was "I won't tell on you so long as you don't tell on me." A system that time and time again I questioned the credibility of the reviews being performed. A process that did not examine audits such as Enron or Global Crossings where investors had alleged a failure occurred, and did not mandate that all audits in which a restatement had occurred to be inspected

And when the SEC staff raised questions with the peer reviewers, meaningful and satisfactory responses were generally not forthcoming. The responses we did receive continually sounded like a rationalization of whatever had been done. Yet the public continued to be provided with the blue ribbon seal of approval by the very profession under scrutiny. Eventually this led to the SEC removing the "endorsement" of the peer review process from its Annual Report to Congress in 1999.

Further recommendations continue to need to be implemented to improve audit quality. They include:

- The 200 plus recommendations the Panel on Audit Effectiveness made to the profession and accounting standard setters in August 2000 need to be adopted as proposed, without being watered down. This includes a substantial rewrite of many of the auditing standards to require certain forensic audit procedures be incorporated into each audit, and to put sufficient detail into the standards to ensure they can be enforced. The POB was charged with overseeing the implementation of the Panel's recommendations. I would encourage the GAO undertake that charge, as the POB will soon cease to exist.

- Auditing standards need to be established by an independent standard setting body. No doubt some will argue that you need to have a knowledgeable body of auditors to set auditing standards if you are going to be effective. But keep in mind that for the past twenty plus years, the ASB has been drawn almost exclusively from "knowledgeable" auditors with the major accounting firms. And yet the Board's Statements on Auditing Standards:

    - Result in an audit report to investors that fails to provide an adequate explanation of an audit, such as the fact the auditor may not even have tested internal accounting controls, or while generally accounting rules are followed, aggressive accounting practices have been employed by the company to meet earnings expectations.

    - Today still don't *require* auditors to look at large unusual adjusting journal entries that are a common characteristic of many financial frauds.

- Do not provide guidance to auditors on factors an auditor would need to consider in assessing materiality until after the SEC staff issued guidance on this subject in August 1999.
- Still have not provided an auditing standard with authoritative guidance on auditing "cookie jar" reserves despite the request of the SEC staff over two years ago to provide such guidance to help reduce the incidence of improper earnings management.[12]
- Still permit auditors to consult on the design and structuring of transactions which reduce, rather than improve the transparency of disclosures, despite two previous requests from the SEC as well a renewed request in recent weeks to address this abusive practice.
- Have recently adopted a new standard that will set the requirements for auditors documenting their work that still does not require sufficient documentation to permit an independent third party to validate the work auditors have performed.

Simply put, auditing standards today, which are often reviewed and edited by the legal counsels of the firms, are written to protect the interests of the firms, not ensure quality audits that will protect investors. Perhaps the greatest chief accountant of all times, Sandy Burton was way ahead of his time in 1978 when he testified before Congress stating that the current system of setting auditing standards would not serve investor protection.

I do give the current chairman of the ASB credit for trying to improve recently the quality of the auditing standards. Guidance has been forthcoming on topics such as auditing revenues in selected industries as well as financial instruments many companies have invested in. However it has been the age-old story of too little, too late. We need to change the process to one that will develop standards for auditors and provide them with timely guidance before they and investors hit the iceberg. Again I point out that in the new system in the United Kingdom, the establishment of auditing standards has been lifted from the profession itself and been given to a new organization under the auspices of the new independent oversight board.

Auditor's Independence

Auditor's independence has long been a hotly contested issue to the profession and the SEC. But after cases such as Waste Management and Enron, no longer are people asking, "where is the smoking gun." Disclosures of consulting fees that run into tens of millions of dollars and multiples of the audit fees are generating an outcry for action.[13]

[12] Letter from the Chief Accountant to Ms. Debbie Lambert, Chairman of the Auditing Standards Board dated December 9, 1999.

[13] A study by the SEC staff of proxy disclosures by 563 of the Fortune 500 companies in 2001 found that on average, for every dollar of audit fee, companies paid their auditor $2.69 in fees for non-audit services. The range of non-audit fees paid to a company's auditors was from $0 to $32.33 per dollar of audit fees.

Once and for all, we need to adopt rules that will truly protect the independence and integrity of the audit, and gain the public's confidence that the auditor's are working for them, not management. Rules that will ensure investors that with the auditor's seal of approval, they can trust the numbers. To accomplish that, in addition to the changes I already suggested to H.R. 3763, we need to:

- Close the revolving door between the audit firm, its partners and employees, and the company being audited.
- Adopt a rule that allows auditors to provide only audit services to an audit client, unless the audit committee makes a determination and discloses that the services provided by the audit firm are (1) in the best interest of the shareholders, and (2) will improve the quality of the company's financial reporting. This is sometimes referred to as the exclusionary ban approach to auditor's independence.
- Prohibit an independent auditor from assisting a company design and structure transactions, then provide their accounting or tax opinion on what the appropriate accounting is for the transaction, and then audit the accounting for that transaction. This was discussed in the original SEC rule proposal. However, companies and their auditors should be permitted to consult on the proper accounting for a non-hypothetical transaction that the auditor has not designed and structured, as that is a normal and important process in any audit.

Some will argue that a ban on the ability of an auditing firm to provide non-audit services to its audit clients will have a negative impact on the quality of audits or the financial strength of an accounting firm. Others argue that tax services are an integral part of performing an audit. To that I respond that if the service is integral to the audit, then no one should be better situated to make that assessment on behalf of investors than the audit committee. Under the proposed recommendation the audit committee will have the option of agreeing to those services that are in the best interests of the investors.

Trying to make an across the board cut on which of these services will or will not impair an auditor's independence, in a quickly changing business environment, is not a long term solution. As soon as a new statute or rule is adopted, new services will be developed and the issue will reappear.

I also am reminded that during the intense debate on the SEC's proposed rules on auditors independence, the opposition often argued that their inability to provide IT consulting services to their clients would impair their ability to provide a quality audit. But the proxy disclosures have shown that the vast majority of audit clients do not currently engage their auditor for such services. Yet I have not heard a single firm say the audits of these company's are substandard. Why?

The fact that auditors are paid by the management of the companies they audit has also been brought up time and time again in recent months. Some argue that the auditor would never risk their reputation for the fees from a single audit. Yet at the Commission we saw situations, some of which are now public, where the auditors identified the problems with the numbers in the financial statements discussed them and still issued their unqualified reports. In fact, it is not the magnitude of the fee to the firm that matters as much as it is the magnitude of the audit and consulting fees to the profitability of the office or the engagement partner's portfolio of business.

Ellen Seidman, then Director of the Office of Thrift Supervision or OTS, testified before the Senate Committee on Banking, Housing, and urban Affairs on September 11th, 2001 regarding the audit of the failed Superior Bank. In her opening statement the Director stated "Congress or the FBA's [Federal Banking Agencies] could also encourage the AICPA and SEC to establish an 'external auditor rotation requirement'…its adoption would result in a 'fresh look' at the institution from an audit perspective, to the benefit of investors and regulators."

But others will argue that there is greater risk in the first year of an audit, as the auditor has to get an understanding of the business to ensure the proper issues are identified and dealt with.[14] I don't dispute the fact the auditor has a higher learning curve on the first year of an audit. But in all my years in public accounting, I never once heard my former firm or any other firm for that matter, say they did not do what they needed to do, to get the necessary background to perform a proper audit. Perhaps the real fact is, that in some cases, auditors propose a lower fee in the first year of an audit relationship in order to gain the account, and this has a negative impact on the quality of the first year audit.

Another argument made is that with five major accounting firms there is already too great a concentration and audit specialization amongst the firms resulting in businesses being limited in their ability to chose a qualified audit firm. Certainly permitting the industry concentration to fall to just four firms will exacerbate this issue. However to-date, approximately 30 firms have chosen to switch from Andersen to another Big Five accounting firm and there has not been a single case that I am aware of where another firm was not ready, willing and able to provide the audit services. In fact, today it appears as if the ambulance is out chasing the injured uninhibited by limited numbers.

Also remember that investors have suffered their largest losses on audits of companies that did not involve an initial audit, but rather an ongoing relationship. Examples include:

- Enron
- Microstrategy
- Cendant
- Rite Aid
- Livent

[14] Ibid Note 1. The COSO study noted that just over 25 percent of the companies involved in the SEC enforcement actions studied changed auditors during the time frame beginning with the last clean financial statement period and ending with the last fraud financial statement period. The average fraud lasted 23.7 months. A majority of the auditor changes occurred during the fraud period and as a result, two auditors were associated with the fraud period.

- Informix
- WR Grace
- Sunbeam
- Lernout and Hauspie
- Xerox
- Lucent
- Oxford Healthcare
- Superior Bank
- HBO McKesson
- Waste Management.

One final argument you will hear against the rotation of audit firms is that they already do an internal rotation of audit partners on the companies they audit. That will probably also be true for some of the above companies. But once a firm has issued a report on the financial statements of a company, there is an inherent conflict in later concluding that the financial statements were wrong. This is especially true if the company has accessed the capital markets using those financial statements and as a result, the accounting firm has significant exposure to litigation in the event of a restatement of the financial statements. By bringing in a new firm every seven years, you get an independent set of eyes looking at the quality of the financial reporting that have no "skin in the game" with respect to the previous accounting.

Engaging Audit Committees

It was in 1940, after the discovery of a large fraud at McKesson Robbins that the Commission first encouraged the establishment of independent audit committees. More recently in 1999, with the strong support of the stock exchanges and the accounting profession, new rules were adopted effective in 2001, that enhance the oversight of the financial reporting, disclosure and audits of public companies.

In light of Enron and questions surrounding the oversight of its audit committee, additional recommendations that can further enhance the vital role and quality of audit committees include:

- The exceptions provided for in the rules of the stock exchanges, which permit an audit committee member who is not independent, should be eliminated.
- The definition of an independent director should be modified to prohibit the company from engaging the director for any services other than those provided as a director, and ban financial payments on behalf of the director, such as contributions to charitable organizations or similar types of payments.

- Companies should be required to provide their audit committees with appropriate training and understanding of the business and its financial reporting to ensure their ability to carry out their obligation to investors.

<u>Enhancing the Quality and Transparency of U.S. Accounting Standards</u>

Let me shift gears and switch to the topic of accounting standards. I believe our financial reporting and disclosure system, including the accounting standards we use in assembling the numbers, remains the best in the world. That is difficult to comprehend in light of Enron, but one only has to examine closely the Asian crisis of a few years back to appreciate the quality of our financial reporting.

But as Enron has aptly demonstrated, the job of improving accounting standards is not complete. Our rules and standard setting process here in the U.S. require significant improvements to provide investors and regulators with greater transparency. Improvements that need to be made include:

- Protecting the independence of the accounting standard setters. Transparency in financial reporting has been negatively affected and impeded when industry or Congress has threatened the independence of the FASB. In recent testimony by the former chairman of the FASB before the Senate Committee on Banking, Housing, and Urban Affairs, he stated that the reason the FASB was not able to issue a final standard that reflected the economic reality of stock options was due to interference from Congress. Some continue to this day to renew this threat with the International Accounting Standards Board (IASB).

- Create an independent "no strings attached" funding mechanism for the FASB. This again could be accomplished by a fee charged to issuers and/or members of the exchanges, all of who greatly benefit from the work of the FASB.

- Revising the structure of the Board of Trustees to one where the board members are all representatives of the public rather than any particular special interest.

  It should also be pointed out that several years ago, after a drawn out discussion with the SEC, the FAF agreed to place a minority of public members on the Board of trustees. However, the FAF has refused the request of the SEC to modify its bylaws to make this change permanent.

- The FASB needs to develop accounting standards that reflect the reality of the actual economics of the underlying transactions. Standards that permit hundreds of billions of dollars in synthetic lease financing and other forms of off balance sheet liabilities to be hid from the eyes of investors; that permit companies to avoid consolidation of special purpose entities for which the company itself has the majority, if not practically all of the risks and rewards; and that result in the value of compensation in the form of stock options to be excluded from the income statement are not transparent standards. They are better described as a chapter from Grimm’s Fairy Tales.

- The FASB needs to develop and implement a project management system that prioritizes the needs of investors, and then establishes accountability and responsibility for meeting those needs in a more timely fashion. For example, in the mid 1970's the SEC asked the FASB to address the issue of whether certain equity instruments like mandatory redeemable preferred stock are a liability or equity. Investors are still waiting today for an answer. In 1978 the Cohen Commission requested the FASB to require disclosure in a single footnote of all the transactions that were affecting the comparability of the financial statements from one period to the next. This is a disclosure that would have gone a long way towards addressing some of the problems created by pro forma earnings but again nothing has been done. In 1982, the FASB undertook a project on consolidation. One of my sons born that year has since graduated from high school. In the meantime, investors are still waiting for an answer, especially for structures, such as special purpose entities (SPEs). In 1985 the SEC asked the FASB to provide guidance for financial instruments, a project still underway today. In 1998 the FASB was asked to provide guidance to reduce some of the abuses of "big bath" charges, but they continue to this day unmitigated. Time and time again the FASB has asked the SEC to defer to it to establish standards. Yet the standards never come. As a result, in the future the SEC should give the FASB a timetable for completion of these standards and if that timetable is not met, the SEC should act promptly to protect investors.

- The FASB Trustees should undertake to restructure the Emerging Issues Task Force (EITF) of the FASB. The EITF establishes generally accepted accounting principles for many of the new and emerging types of accounting transactions but does not have investor protection and transparency as a key part of its mission statement. Rather it often establishes rules that "grandfather" past accounting practices that are questionable at best. This should surprise no one, as the EITF is comprised solely of members from industry and the accounting profession. The EITF needs major revisions to its charter, should *require* public representation, and as with the IASB, should not be able to pass a new rule without the explicit approval of the FASB.

- The SEC should require disclosure of key performance indicators or KPI’s. KPI’s, such as backlog, plant utilization rates, revenues generated from new product introductions, etc. provide a very powerful and useful tool that gives investors greater predictive capability with respect to trends in the business.

- The SEC proposed new rules to increase the transparency of "reserves" and large write-downs in the value of assets such as plant and equipment and goodwill. As the Association for Investment Management and Research (AIMR) has recently requested, the SEC should quickly issue final rules similar to those proposed.

In recent weeks the AICPA has seemingly laid the problems associated with Enron at the doorstep of the FASB. They have argued that the lack of transparent accounting standards was the cause of Enron’s financial reporting standards. They fail to acknowledge there were problems with the audits while stating the financial reporting model is broken. But as Jack Bogle, the highly respected founder of the Vanguard funds has stated, perhaps it has been the markets and not the model that were wrong. Perhaps the ostrich is once again placing its head in the sand.

Some have said that investors cannot read financial statements today because they are too complex and written in a language difficult to understand. I certainly support Chairman Oxley's and SEC Chairman Pitt's call for plain English financial statements. But at the same time, one cannot ignore the reality of a business world that is much more complex today than when I joined the profession 25 years ago. It is difficult enough for knowledgeable business executives to understand complex business transactions such as derivatives, affiliations of varying shapes and forms including special purpose entities, and Wall Street engineered financing structures. Most people cannot and will not be able to understand some of the financial disclosures today, any more than members of this committee could be expected to understand the workings of a printed circuit board that makes a computer system work. Instead, we all need to be ably to rely on management, the corporate board, independent auditors and analysts to maintain the integrity of the capital markets and provide the financial information that serves as its lifeblood. Management preparing accurate and timely numbers with transparent disclosures, the auditors ensuring the integrity of the numbers, the board overseeing this process and finally the analysts taking the financial information produced by this process and producing a report to investors with their analysis and recommendations.

Another issue being bantered about involves whether today's accounting standards should be principles based rather than detailed rules. This is not the first time this issue has been raised, and I can assure you it will not be the last. The predecessor to the FASB, the Accounting Principles Board (APB) did write some principles based standards. For example, in 1964 the APB issued a standard on accounting for leases. That standard stated in principle that when a lease is an installment purchase of equipment as many are, it should be reported as a liability on the financial statements. But this standard was no more successful than the current detailed FASB rule on getting this off balance sheet debt back on the balance sheet. We also have broad guidance on accounting for property, plant and equipment and the associated depreciation. But that has not stopped the abuses of understating depreciation and then taking large write-offs of assets when it is convenient. The predecessor to the APB issued what some consider broad principles standard for reporting of inventories. But a recent survey by Andersen and a 1999 report by the Committee of Sponsoring Organizations (COSO) illustrate that overstatement of inventories continue to be a major source of earnings misstatements and SEC enforcement cases. And finally, the FASB standard that establishes when many liabilities are to be reflected in the financial statements, Standard No. 5, is a very broad principle standard that has been responsible for such aggressive accounting practices like "big bath" charges and understatement of liabilities for environmental costs. The real issue is not simply one of broad versus narrow detailed rules. It is a cultural issue of a lack of compliance with both the spirit and intent of the standards. It is an issue of professionalism.

One stark reality today is that before the ink dries on a new FASB standard, the investment banking community and accountants are joining forces to find ways to structure transactions to get around the new rules. And while the spirit of a rule may clearly say no, I have heard time and time again from a CFO or auditor, "where in the rules does it say I can't do it." It is time to get away from this mentality and a good starting point would be to prohibit auditors from designing and structuring transactions, such as SPE's, that result in less, rather than more, transparency for those they are reporting to.

Strengthening The SEC

Let me move on to perhaps one of the most important considerations for the U.S. capital markets today. That is ensuring we have an adequately staffed and resourced securities regulator. Today, that does not exist.

There are approximately 12,000 actively traded public companies who file 12,000 annual reports, 36,000 quarterly financial statements, and tens of thousands of initial public offerings, registration statements, proxies, and tender offers. In recent years, the Division of Corporation Finance has been staffed with approximately ninety accountants to review these documents. In the Division of Enforcement, the typical caseload is around two hundred to two hundred and fifty cases. There are approximately twenty to twenty five accountants in the Washington D.C office and maybe another thirty or forty around the country to investigate these cases. In the private sector, it is not unusual that three to four accountants assist in preparing for testimony on a financial fraud case. In a case such as Enron, many more staff would be dedicated to such a project. Finally about twenty to twenty five accountants are working in the Office of the Chief Accountant. This office provides a service to the public accounting firms and companies, similar to what the national accounting and auditing offices of each of the Big Five accounting firms provides to their own audit clients and offices. They also have oversight responsibility for all the activities of those entities in the alphabet soup. Comparatively speaking, the national offices of the Big Five accounting firms are each typically a multiple or two larger than the Office of the Chief Accountant.

As you can plainly see, it is physically *impossible* within their current budgetary handcuffs for the SEC staff to carry out their mandate to ensure full disclosure and timely enforcement of the laws and regulations. The Panel on Audit Effectiveness recommended the SEC provide additional resources to combating financial fraud. I hope Congress will respond to the Panel report and provide the necessary funding for doubling the size of the accounting staff in the Division of Corporation Finance and the Office of the Chief Accountant, as well as reasonable compensation levels for existing staff. The SEC Division of Enforcement should also double or triple the number of accountants and attorneys involved with combating financial fraud. Its Financial Fraud Task Force needs to become a permanent fixture within the Division.

The SEC also needs to be provided with the resources to acquire technology that can aid in the electronic screening of filings for potential issues and unusual trends in financial performance. SEC Chairman Pitt has indicated he wishes to hire a qualified Chief Information Officer. This is long overdue and will require additional funds. But new and enhanced technologies can be a powerful, efficient and effective tool in identifying problems at an early date.

The statutory authority of the SEC to undertake certain types of actions should also be evaluated. Recent cases involving Baymark and California Micro Devices have raised serious questions as to whether the standard of recklessness the SEC applies to Rule 102(e) proceedings against accountants, is too high a standard by which to measure unprofessional conduct by an accountant or auditor. Rule 102(e) is the regulation by which the SEC may censure an accountant in a public company or an auditor and deny them the right to practice before the Commission. The rule is used to protect the integrity of the system and processes that are key to efficient markets. It requires that an accountant must be reckless, or have multiple incidences of improper professional conduct in order to be sanctioned. As a result, in cases involving negligence or other unprofessional behavior that is less than recklessness, a 102(e) sanction baring the practice of the accountant before the commission or in a public company cannot be pursued.

It should be noted that some professionals have challenged the SEC with respect to whether a Rule 102(e) proceeding may be initiated against an accountant within a public company, if they are not a currently licensed CPA. Today, many of the CFO's, Controllers and key financial reporting people do not have, or have not maintained a current CPA license. In essence, the lack of current SEC actions pursuant to Rule 102(e) against non-licensed accountants sends a strong message. I think it is the wrong message that CFO's and Controllers are better off without their licenses than they are with them.

Let me switch briefly to the subject of the chief financial and principal accounting officers. Today, CFO's at the major American corporations turn over approximately four times faster than they did at the beginning of the 1990's. And while the turnover ten years ago was often tied to one's retirement, it is much more likely today to be tied to a company missing an earnings estimate. Way too often today the CFO becomes the "fall guy" for such misses while the CEO's, Chief Operating Officers, vice presidents of manufacturing, marketing and other key management positions stay on. And as surveys have shown, it is all too often the CFO who is pressured by other members of management to stir the pot and cook the books. And when the CFO doesn't like the recipe that is handed to him or her, they are shown the door.

As a result, I also believe the SEC should make a change to its rules for Form 8-K. A Form 8-K should be required to be filed whenever a chief financial officer or chief accounting officer is terminated. The report should require disclosure of whether the audit committee approved the termination and whether there were any disagreements regarding financial accounting or disclosure matters. Perhaps a similar disclosure should be required for audit committee members.

Another challenge to the authority and ability of the SEC to enforce the securities laws involves access to the work papers of auditors of foreign issuers, or U.S. issuers with operations audited by a foreign affiliate of the U.S. firm. Time and time again I watched as the public accounting firms failed to provide timely access to the foreign work papers, thereby dragging out the case and hoping it would be dropped due to turnover in the assigned SEC staff. In its international concept release issued in 2000, the SEC noted this was a significant issue it faced in enforcing the SEC's rules. And the SEC is not the only regulator to have been confronted by this issue. In the BCCI case the federal banking regulators also had to endure difficulties in gaining access to the work papers of the foreign affiliates of the accounting firm. With foreign registrants now comprising approximately ten percent of all actively traded companies, either the Congress or SEC should act quickly to protect investors before investors are unwittingly exposed to greater risk.

Finally Section 10A of the Securities Act needs to be modified. Currently auditors are only reporting a small handful of violations of the law. They define their responsibility very narrow to require reporting only when they have identified an illegal act, have unquestionably proved it is an illegal act, and did not resign before they had to report it. As a result, when financial reporting is questioned as it has been at Enron, this narrow definition of the rule will not result in a Section 10A report to the SEC. I think most investors would agree that is a definition that is too narrow and that fails to protect the public.

Closing

Let me close by noting that many of the issues being debated today, are not new. They were raised again and again in Congressional hearings in the 1970's and 1980's. Issues such as the independence of auditors and greater oversight and improved governance of the accounting profession have been debated from sun up to sun down for the last three to four years. And just as the arguments against meaningful reform have not changed during the past thirty years, neither has the implications for investors.

Some propose a cautious approach to solving issues that have cost thousands of Americans their jobs, their savings for retirement or a child's education, their future. These opponents of meaningful and necessary reforms say there are "untended consequences" to taking action. They want to fight reforms and win the war of attrition. They suggest the use of best practices that are just what they imply; the best practices of a few, not all market participants.

The choice before Congress is not an easy one, but it is simple. Chose between the true consequence of "unintended consequences" which is more of the same for one out of two Americans who invest in the markets; or fixing a problem that has lingered for too long, cost too many too much, and that yearns for action, not further debate.

Thank you.