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# PROTECTING THE PUBLIC'S INTEREST

# Considerations for Addressing Selected Regulatory Oversight, Auditing, Corporate Governance, and Financial Reporting Issues

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G A O

Accountability ★ Integrity ★ Reliability

GAO-02-601T

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to share my perspectives on a range of issues emanating from the sudden and largely unexpected bankruptcy of the Enron Corporation (Enron) and financial related activities relating to several other large corporations. These matters have caused a number of accounting profession oversight, auditor independence, corporate governance, and other related issues that are now receiving extensive national attention. The failures of Enron and certain other public companies have resulted in substantial losses to employees, shareholders, and other investors. Certain significant financial statement earnings restatements and the proliferation of pro forma earnings assertions have raised questions about the soundness of the current financial reporting, independent auditing, and corporate governance functions relating to public companies. These events have also raised a range of questions regarding how such dramatic and unexpected events can happen under our current system and the role and capacities of various key players under that system.

To assist the Congress in framing needed reforms, on February 25, 2002, we convened a forum on corporate governance, transparency, and accountability to discuss a variety of systemic issues. These entailed regulatory oversight, auditing, accounting/financial reporting, and corporate governance matters. Forum participants included prominent individuals from federal and state government, the private sector, standards setting and oversight bodies, and a variety of other interested parties. As expected, the forum participants expressed a range of views on these broad topics, which do not necessarily represent our views. However, there was general agreement by the participants that there are no simple solutions, or a single "silver bullet," to resolve the perceived problems that exist. In fact, there was general agreement that while some actions were clearly called for in the wake of Enron and other recent events, care should be taken to ensure that government does not overreact in a manner that could have unintended adverse consequences. This requires a careful balancing of interests with a focus on what is in the best overall interest of the investing public. On March 5, 2002, I issued highlights of the forum meeting, which I would like to enter into the record.[1] Also, on March 5,

[1] *Highlights of GAO's Forum on Corporate Governance, Transparency, and Accountability* (GAO-02-494SP, March 5, 2002).

2002, I testified before the Senate Banking Committee to further elaborate on these issues.[2]

As you requested, my comments today will primarily focus on oversight of the accounting profession and related auditor independence and corporate governance issues raised by Enron's failure. I would also like to take this opportunity to provide our perspectives about the related issue of financial reporting. It should be recognized that these overarching areas are interrelated keystones to protecting the public's interest. Failure in any of these areas can place a strain on the entire system. Any potential actions should be guided by the fundamental principles of having the right incentives for the key parties to do the right thing, adequate transparency to provide reasonable assurance that the right thing will be done, and full accountability if the right thing is not done. These three fundamental principles represent a system of controls that should operate in conjunction with a policy of placing special attention on areas of greatest risk.

The issues raised by Enron's failure are multi-faceted, involving many different problems and players with various roles and responsibilities. In that respect, needed changes to the government's role should vary depending on the specific nature and magnitude of the problem. Specifically, the government's role can range from direct intervention to encouraging certain non-governmental and private-sector entities to take certain steps designed to enhance trust and better protect the public interest. For example, the issues surrounding the accounting profession's current self-regulatory system for auditors involves many players in a fragmented system that is not well coordinated, involves certain conflicts of interest, lacks effective communication, and has a discipline system that is largely perceived as being ineffective. In this case, direct government intervention to statutorily create a new independent federal government body to regulate the accounting profession is needed. On the other hand, the issues concerning corporate governance may be best addressed through the Securities and Exchange Commission (SEC) encouraging the stock exchanges to enhance public companies' listing requirements and promote "best practices" in connection with the boards, key committees, and officers of public companies. If such an approach is not successful in

[2]*Protecting the Public Interest: Selected Governance, Regulatory Oversight, Auditing, Accounting, and Financial Reporting Issues* (GAO-02-483T, March 5, 2002).

achieving the expected corporate behavior, the government can then take further action.

In considering changes to the current system that gave rise to Enron and other areas of concern, it will be important that the Congress consider a holistic approach to addressing the range of interrelated issues. It is important to realize that effectively protecting the public interest is a multi-dimensional challenge involving a variety of players and issues. For example, it involves company management, boards and board committees, the accounting profession standard setters, analysts, regulatory oversight agencies, investors, and various other parties. In addition, in the audit area it involves a redefinition of who the client is, various audit scope and responsibility issues, the number of firms, the quality of the firms' quality assurance systems, and the quality of the firm's personnel. It is also important that any responsible governmental bodies, such as the SEC, have adequate resources to fulfill its responsibilities in these areas, which I will briefly address later.

## Regulation and Oversight of the Accounting Profession

The current model for regulation and oversight of the accounting profession involves federal and state regulators and a complex system of self-regulation by the accounting profession. The functions of the model are interrelated and their effectiveness is ultimately dependent upon each component working well. Basically, the current model includes:

- licensing members of the accounting profession to practice within the jurisdiction of a state, as well as issuing rules and regulations governing member conduct, which is done by the various state boards of accountancy;
- setting accounting and auditing standards, which is done by the Financial Accounting Standards Board (FASB) and the Auditing Standards Board (ASB), respectively, through acceptance of the standards by the SEC;
- setting auditor independence rules, which within their various areas of responsibility, have been issued by the American Institute of Certified Public Accountants (AICPA), the SEC, and GAO; and
- oversight and discipline, which is done through a variety of self-regulatory and public regulatory systems (e.g., the AICPA, the SEC, and various state boards of accountancy).

Enron's failure and a variety of other recent events has brought a direct focus on how well the current systems of regulation and oversight of the accounting profession are working in achieving their ultimate objective that the opinions of independent auditors on the fair presentation of financial statements can be relied upon by investors, creditors, and the various other users of financial reports.

The issues currently being raised about the effectiveness of the accounting profession's self-regulatory system are not unique to the collapse of Enron. Other business failures, restatements of financial statements, and the proliferation of pro forma earnings assertions over the past several years have called into question the effectiveness of the current system. A continuing message is that the current self-regulatory system is fragmented, is not well coordinated, and has a disciplinary function that is not timely, nor does it contain effective sanctions, all of which create a public image of ineffectiveness. In addressing these issues, proposals should consider whether overall the system creates the right incentives, transparency, and accountability, and operates proactively to protect the public interest. Also, the links within the self-regulatory system and with the SEC and the various state boards of accountancy (the public regulatory systems) should be considered as these systems are interrelated, and weaknesses in one component can put strain on the other components of the overall system.

I would now like to address some of the more specific areas of the accounting profession's self-regulatory system that should be considered in forming and evaluating proposals to reshape or overhaul the current system.

## Accounting Profession's Current Self-Regulatory System

The accounting profession's current self-regulatory system for public company audits is heavily reliant on the AICPA through a system that is largely composed of volunteers from the accounting profession. This system is used to set auditing standards and auditor independence rules, monitor member public accounting firms for compliance with professional standards, and discipline members who violate auditing standards or independence rules. AICPA staff support the volunteers in conducting their responsibilities. In 1977, the AICPA, in conjunction with the SEC, administratively created the Public Oversight Board (POB) to oversee the peer review system established to monitor member public accounting firms for compliance with professional standards. In 2001, the oversight authority of the POB was expanded to include oversight of the ASB. The

POB had five public members and professional staff, and received its funding from the AICPA.

On January 17, 2002, the SEC Chairman outlined a proposed new self-regulatory structure to oversee the accounting profession. The SEC's proposal provided for creating an oversight body that would include monitoring and discipline functions, have a majority of public members, and be funded through private sources, although no further details were announced.[3] The POB's Chairman and members were critical of the SEC's proposal and expressed concern that the Board was not consulted about the proposal. On January 20, 2002, the POB passed a resolution of intent to terminate its existence no later than March 31, 2002, leaving a critical oversight function in the current self-regulatory system unfilled. However, the POB's Chairman has stated that the Board will work to assist in transitioning the functions of the Board to whatever new regulatory body is established. In that respect, the SEC announced on March 19, 2002, that a Transition Oversight Staff, led by the POB's executive director, will carry out oversight functions of the POB. However, on April 2, 2002, the POB members voted to extend the POB through April 30, 2002, to provide additional time solely to finalize certain POB administrative matters and to facilitate a more orderly transition of oversight activities.

## Need to Create a New Independent Federal Government Oversight Body

The issues of fragmentation, ineffective communication, and limitations on discipline surrounding the accounting profession's self-regulatory system strongly suggest that the current self-regulatory system is not adequate in effectively protecting the public's interest. We believe these are structural weaknesses that require congressional action. Specifically, we believe that the Congress should create an independent statutory federal government body to oversee financial audits of public companies.

The functions of the new independent body should include:

- establishing professional standards (auditing standards, including standards for attestation and review engagements; independence

[3]Subsequently, on March 21, 2002, the Chairman of the SEC in his statement before the Senate Committee on Banking, Housing, and Urban Affairs provided additional details in a working proposal for creating a new private-sector, independent body, subject to SEC oversight, to regulate the accounting profession in the areas of quality control reviews and disciplinary powers.

standards; and quality control standards) for public accounting firms and their key members who audit public companies;

- inspecting public accounting firms for compliance with applicable professional standards; and
- investigating and disciplining public accounting firms and/or individual auditors of public accounting firms who do not comply with applicable professional standards.

As discussed later, this new body should be independent from but should closely coordinated with the SEC in connection with matters of mutual interest. In addition, we believe that the issues concerning accounting standard-setting can best be addressed by the SEC working more closely with the FASB rather than putting that function under the new body.

## Powers/Authority of the New Body

The powers/authority of the new body should include:

- requiring all public accounting firms and audit partners that audit financial statements, reports, or other documents of public companies that are required to be filed with the SEC to register with the new body;
- issuing professional standards (e.g., independence) along with the authority to adopt or rely on existing auditing standards, including standards for attestation and review engagements, issued by other professional bodies (e.g., the ASB);
- enforcing compliance with professional standards, including appropriate investigative authority (e.g., subpoena power and right to maintain the confidentiality of certain records) and disciplinary powers (e.g., authority to impose fines, penalties, and other sanctions, including suspending or revoking registrations of public accounting firms and individual auditors to perform audits of public companies);
- requiring the new body to coordinate its compliance activities with the SEC and state boards of accountancy;
- requiring auditor reporting on the effectiveness of internal control over financial reporting;

- requiring the new body to promulgate various auditor rotation requirements for key public company audit engagement personnel (i.e., primary and second partners, and engagement managers);

- requiring the new body to study and report to the Congress on the pros and cons of any mandatory rotation of accounting firms that audit public companies, and take appropriate action;

- establishing annual registration fees and possibly inspection fees necessary to fund the activities of the new body on an independent and self-sustaining basis; and

- establishing rules for the operation of the new body.

## Structure of the New Body

The new body should be created by statute as an independent federal government body. To facilitate operating independently, the new body's board members should be highly qualified and independent from the accounting profession, its funding sources should not be dependent on voluntary contributions from the accounting profession, and it should have final approval for setting professional standards and its operating rules. In that respect, the new body would have independent decisionmaking authority from the SEC. It would approve professional standards, set sanctions resulting from disciplinary actions, and establish its operating rules. At the same time, it should coordinate and communicate its activities with the SEC and the various state boards of accountancy. The new body should set its own human resource and other administrative requirements and should be given appropriate flexibility to operate as an independent entity and to provide compensation that is competitive to attract highly competent board members and supporting staff. The new body should also have adequate staff to effectively discharge its responsibilities.

Candidates for board membership could be identified through a nominating committee that could include the Chairman of the Federal Reserve, Chairman of the SEC, the Secretary of the Treasury, and the Comptroller General of the United States.

The number of board members could be 5 or 7 and have stated terms, such as 5 years with a limited renewal option, and the members' initial terms should be staggered to ensure some continuity. The members of the board should be appointed by the President and confirmed by the U.S. Senate. At a minimum, the chair and vice-chair should serve on a full-time basis.

Importantly, board members should be independent of the accounting profession. In that regard, board members should not be active accounting profession practitioners and a majority of board members must not have been accounting profession practitioners within the recent past (e.g., 3 years).

## Funding for the New Body

The new body should have sources of funding independent of the accounting profession. The new body could have authority to set annual registration fees for public companies. It could also have authority to set fees for services, such as inspections of public accounting firms, and authority to charge for copies of publications, such as professional standards and related guidance. The above fees and charges should be set to recover costs and sustain the operations of the new body.

## Reporting Requirement of the New Body and GAO Access to Records

For accountability, we believe the new body should report annually to the Congress and the public on the full-range of its activities, including setting professional standards, inspections of public accounting firms, and related disciplinary activities. Such reporting also provides the opportunity for the Congress to conduct oversight of the performance of the new body. The Congress also may wish to have GAO review and report on the performance of the new body after the first year of its operations and periodically thereafter. Accordingly, we suggest that the Congress provide GAO not only access to the records of the new body, but also to the records of accounting firms and other professional organizations that may be needed for GAO to assess the performance of the new body.

# The Independent Audit Function

For over 70 years, the public accounting profession, through its independent audit function, has played a critical role in enhancing a financial reporting process that has supported the effective functioning of our domestic capital markets, which are widely viewed as the best in the world. The public's confidence in the reliability of issuers' financial statements, which relies in large part on the role of independent auditors, serves to encourage investment in securities issued by public companies. This sense of confidence depends on reasonable investors perceiving auditors as independent expert professionals who have neither mutual, nor conflicts of, interests in connection with the entities they are auditing. Accordingly, investors and other users expect auditors to bring to the financial reporting process integrity, independence, objectivity, and

technical competence, and to prevent the issuance of misleading financial statements.

Enron's failure and certain other recent events have raised questions concerning whether auditors are living up to the expectations of the investing public; however, similar questions have been raised over a number of years due to significant restatements of financial statements and certain unexpected and costly business failures, such as the savings and loan crisis. Issues debated over the years continue to focus on auditor independence concerns and the auditor's role and responsibilities. Public accounting firms providing nonaudit services to their audit client is one of the issues that has again surfaced by Enron's failure and the large amount of annual fees collected by Enron's independent auditor for nonaudit services.

Auditors have the capability of performing a range of valuable services for their clients, and providing certain nonaudit services can ultimately be beneficial to investors and other interested parties. However, in some circumstances, it is not appropriate for auditors to perform both audit and certain nonaudit services for the same client. In these circumstances, the auditor, the client, or both will have to make a choice as to which of these services the auditor will provide. These concepts, which I strongly believe are in the public's interest, are reflected in the revisions to auditor independence requirements for government audits,[4] which GAO recently issued as part of Government Auditing Standards.[5] The new independence standard has gone through an extensive deliberative process over several years, including extensive public comments and input from my Advisory Council on Government Auditing Standards.[6] The standard, among other things, toughens the rules associated with providing nonaudit services and includes a principle-based approach to addressing this issue, supplemented

[4]*Government Auditing Standard: Amendment No. 3*, *Independence* (GAO-02-388G, January 2002).

[5]*Government Auditing Standards* was first published in 1972 and are commonly referred to as the "Yellow Book," and cover federal entities and those organizations receiving federal funds. Various laws require compliance with the standards in connection with audits of federal entities and funds. Furthermore, many states and local governments and other entities, both domestically and internationally, have voluntarily adopted these standards.

[6]The Advisory Council includes 20 experts in financial and performance auditing and reporting drawn from all levels of government, academia, private enterprise, and public accounting, who advise the Comptroller General on *Government Auditing Standards*.

with certain safeguards. The two overarching principles in the standard for nonaudit services are that:

- auditors should not perform management functions or make management decisions, and

- auditors should not audit their own work or provide nonaudit services in situations where the amounts or services involved are significant or material to the subject matter of the audit.

Both of the above principles should be applied using a substance over form doctrine. Under the revised standard, auditors are allowed to perform certain nonaudit services provided the services do not violate the above principles; however, in most circumstances certain additional safeguards would have to be met. For example, (1) personnel who perform allowable nonaudit services would be precluded from performing any related audit work, (2) the auditor's work could not be reduced beyond the level that would be appropriate if the nonaudit work were performed by another unrelated party, and (3) certain documentation and quality assurance requirements must be met. The new standard includes an express prohibition regarding auditors providing certain bookkeeping or record keeping services and limits payroll processing and certain other services, all of which are presently permitted under current independence rules of the AICPA. However, our new standard allows the auditor to provide routine advice and technical assistance on an ongoing basis and without being subject to the additional safeguards.

The focus of these changes to the government auditing standards is to better serve the public interest and to maintain a high degree of integrity, objectivity, and independence for audits of government entities and entities that receive federal funding. However, these standards apply only to audits of federal entities and those organizations receiving federal funds, and not to audits of public companies. In the transmittal letter issuing the new independence standard, we expressed our hope that the AICPA would raise its independence standards to those contained in this new standard in order to eliminate any inconsistency between this standard and their current standards. The AICPA's recent statement before another congressional committee that the AICPA will not oppose prohibitions on

auditors providing certain nonaudit services seems to be a step in the right direction.[7]

The independence of public accountants is crucial to the credibility of financial reporting and, in turn, the capital formation process. Auditor independence standards require that the audit organization and the auditor be independent both in fact and in appearance. These standards place responsibility on the auditor and the audit organization to maintain independence so that opinions, conclusions, judgments, and recommendations will be impartial and will be viewed as being impartial by knowledgeable third parties. Because independence standards are fundamental to the independent audit function, as part of its mission, the new independent and statutorily created government body, which I previously discussed, should be responsible for setting independence standards for audits of public companies, as well as the authority to discipline members of the accounting profession that violate such standards.

## Corporate Goverance

First, I want to underscore that serving on the board of directors of a public company is an important and difficult responsibility. That responsibility is especially challenging in the current environment with increased globalization and rapidly evolving technologies having to be addressed while at the same time meeting quarterly earnings projections in order to maintain or raise the market value of the company's stock. These pressures and related executive compensation arrangements unfortunately often translate to a focus on short-term business results. This can create perverse incentives, such as attempts to manage earnings to report favorable short-term financial results, and/or failing to provide adequate transparency in financial reporting that disguises risks, uncertainties, and/or commitments of the reporting entity.

On balance though, the difficulty of serving on a public company's board of directors is not a valid reason for not doing the job right, which means being knowledgeable of the company's business, asking the right questions, and doing the right thing to protect not only shareholders, but also the public's interest. At the same time it is important to strike a reasonable balance between the responsibilities, risks, and rewards of board and key

[7]Testimony of AICPA Chairman before the House Energy and Commerce Committee (Subcommittee on Communications, Trade and Consumer Protection), February 14, 2002.

committee members. To do otherwise would serve to discourage highly qualified persons from serving in these key capacities.

A board member needs to have a clear understanding of who is the client being served. Namely, their client should be the shareholders of the company, and all their actions should be geared accordingly. They should, however, also be aware of the key role that they play in maintaining public confidence in our capital markets system. Audit committees have a particularly important role to play in assuring fair presentation and appropriate accountability of management in connection with financial reporting, internal control, compliance, and related matters. Furthermore, boards and audit committees should have a mutuality of interest with the external auditor to assure that the interest of shareholders are adequately protected.

## Responsibilities of Audit Committees

There are a number of steps that can be taken to enhance the independence of audit committees and their working relationship with the independent auditor to further enhance the effectiveness of the audit in protecting the public's interest. We believe that the SEC in conjunction with the stock exchanges should initially explore such actions. Therefore, any legislative reform could include a requirement for the SEC to work with the stock exchanges to enhance listing requirements for public companies to improve the effectiveness of audit committees and public company auditors, including considering whether and to what extent:

- audit committee members should be both independent of the company and top management and should be qualified in the areas related to their responsibilities such as accounting, auditing, finance, and the SEC reporting requirements;

- audit committees should have access to independent legal counsel and other areas of expertise, such as risk management and financial instruments;

- audit committees should hire the independent auditors, and work directly with the independent auditors to ensure the appropriate scope of the audit, resolution of key audit issues, compliance with applicable independence standards, and the reasonableness and appropriateness of audit fees. In this regard, audit committees must realize that any attempts to treat audit fees on a commodity basis can serve to increase the risk and reduce the value of the audit to all parties;

- audit committees should pre-approve all significant nonaudit services;
- audit committees should pre-approve the hiring of the public companies' key financial management officials (such as the chief financial officer, chief finance officer or controller) or the providing of financial management services if within the previous 5 years they had any responsibility for auditing the public company's financial statements, reports, or other documents required by the SEC; and
- audit committees should report to the SEC and public on their membership, qualifications, and execution of their duties and responsibilities.

## Responsibilities of Boards of Directors; Nominating, Compensation, Audit or Other Committees; and Management (Officers)

We also believe that the effectiveness of boards of directors and committees, including their working relationship with management of public companies, can be enhanced by the SEC working with the stock exchanges to enhance certain other listing requirements for public companies. In that respect, the SEC could be directed to work with the stock exchanges to consider whether and to what extent:

- audit committees, nominating committees, and compensation committees are qualified, independent, and adequately resourced to perform their responsibilities;
- boards of directors should approve management's code of conduct and any waivers from the code of conduct, and whether any waivers should be reported to the stock exchanges and the SEC;
- boards of directors should approve the hiring of key financial management officials who within the last 2 years had any responsibility for auditing the public company's financial statements, reports, or other documents required by the SEC; and
- CEOs should serve as the chairman of public company boards.

Also, to further protect shareholders and the public interest, the SEC could be directed to report (1) within 180 days from enactment of legislation on other actions it is taking to enhance the overall effectiveness of the current corporate governance structure, and (2) periodically on best practices and recommendations for enhancing the effectiveness of corporate governance to protect both shareholders and the public's interest.

## Analyst Conflict of Interest Issues and Analyst Independence

We believe that the issues raised by Enron's sudden failure and bankruptcy regarding whether analyst's independence from issuers' of stock is affecting their suggested buy and sell recommendations can be addressed by requiring the SEC to work with the National Association of Securities Dealers (NASD) in connection with certain requirements. Accordingly, the SEC could be directed to work with the NASD to consider whether and to what extent:

- the firewalls between analysts and the business end of their firms should be widened to enhance analyst independence and to report to the Congress on the effectiveness of the regulations;
- disclosure of (1) whether the analyst's firm does investment banking, and (2) whether there is a relationship with the company in question should be improved, and whether to report to the Congress on the effectiveness of the requirements; and
- implementing regulations to be enforced through an effective examination program should be required.

## GAO Reporting on the above SEC Requirements

The Congress may wish to have GAO evaluate and report to it one year after enactment of legislation and periodically thereafter on the (1) results of the SEC's working relationship with the stock exchanges to strengthen corporate governance requirements, and (2) results of the SEC's working relationship with the NASD in developing independence and conflict of interest requirements for analysts. Accordingly, we suggest that the Congress provide GAO access to the records of the securities self regulatory organizations, such as the New York Stock Exchange and the NASD, that may be needed for GAO to evaluate the SEC's working relationships with these organizations.

# Financial Reporting

Business financial reporting is critical in promoting an effective allocation of capital among companies. Financial statements, which are at the center of present-day business reporting, must be timely, relevant, and reliable to be useful for decision-making. In our 1996 report on the accounting

profession,[8] we reported that the current financial reporting model does not fully meet users' needs. More recently, we have noted that the current reporting model is not well suited to identify and report on key value and risk elements inherent in our 21st Century knowledge-based economy. The SEC is the primary federal agency currently involved in accounting and auditing requirements for publicly traded companies but has traditionally relied on the private sector for setting standards for financial reporting and independent audits, retaining a largely oversight role. Accordingly, the SEC has accepted rules set by the Financial Accounting Standards Board (FASB)—generally accepted accounting principles (GAAP)—as the primary standard for preparation of financial statements in the private sector.

We found that despite the continuing efforts of FASB and the SEC to enhance financial reporting, changes in the business environment, such as the growth in information technology, new types of relationships between companies, and the increasing use of complex business transactions and financial instruments, constantly threaten the relevance of financial statements and pose a formidable challenge for standard setters. A basic limitation of the model is that financial statements present the business entity's financial position and results of its operations largely on the basis of historical costs, which do not fully meet the broad range of user needs for financial information.[9] Enron's failure and the inquiries that have followed have raised many of the same issues about the adequacy of the current financial reporting model, such as the need for additional transparency, clarity, more timely information, and risk-oriented financial reporting.

Among other actions to address the Enron-specific accounting issues, the SEC has requested that the FASB address the specific accounting rules

[8]*The Accounting Profession: Major Issues: Progress and Concerns* (GAO/AIMD-96-98, September 24, 1996).

[9]The accounting and reporting model under generally accepted accounting principles is actually a mixed-attribute model. Although most transactions and balances are measured on the basis of historical cost, which is the amount of cash or its equivalent originally paid to acquire an asset, certain assets and liabilities are reported at current values either in the financial statements or related notes. For example, certain investments in debt and equity securities are currently reported at fair value, receivables are reported at net realizable value, and inventories are reported at the lower of cost or market value. Further, certain industries such as brokerage houses and mutual funds prepare financial statements on a fair value basis.

related to Enron's special purpose entities and related party disclosures. In addition, the SEC Chief Accountant has also raised concerns that the current standard-setting process is too cumbersome and slow and that much of the FASB's guidance is rule-based and too complex. He believes that (1) a principle-based standards will yield a less complex financial reporting paradigm that is more responsive to emerging issues, (2) the FASB needs to be more responsive to accounting standards problems identified by the SEC, and (3) the SEC needs to give the FASB freedom to address the problems, but the SEC needs to monitor projects on an ongoing basis and, if they are languishing, determine why.

We generally agree with the SEC Chief Accountant's assessment. We also believe that the issues surrounding the financial reporting model can be effectively addressed by the SEC, in conjunction with the FASB, without statutorily changing the standard-setting process. However, we do believe that a more active and ongoing interaction between the SEC and the FASB is needed to facilitate a mutual understanding of priorities for standard-setting, realistic goals for achieving expectations, and timely actions to address issues that arise when expectations are not likely to be met. In that regard, the SEC could be directed to:

- reach agreement with the FASB on its standard-setting agenda, approach to resolving accounting issues, and timing for completion of projects;

- monitor the FASB's progress on projects, including taking appropriate actions to resolve issues when projects are not meeting expectations; and

- report annually to the Congress on the FASB's progress in setting standards, along with any recommendations, and the FASB's response to the SEC's recommendations.

The Congress may wish to have GAO evaluate and report to it one year after enactment of legislation and periodically thereafter on the SEC's performance in working with the FASB to improve the timeliness and effectiveness of the accounting standard-setting process. Accordingly, we suggest that the Congress provide GAO access to the records of the FASB that may be needed for GAO to evaluate the SEC's performance in working with the FASB.

The FASB receives about two-thirds of its funding from the sale of publications with the remainder of its funding coming from the accounting profession, industry sources, and others. One of the responsibilities of the FASB's parent organization, the Financial Accounting Foundation, is to raise funds for the FASB and its standard-setting process to supplement the funding that comes from the FASB's sale of publications. Some have questioned whether this is the best arrangement to ensure the independence of the standard-setting process. This issue has been raised by the appropriateness of certain accounting standards related to consolidations, that the FASB has been working on for some time, applicable to Enron's restatement of its financial statements as reported to the SEC by Enron in its November 8, 2001, Form 8-K filing. However, the issue has previously been raised when the FASB has addressed other controversial accounting issues, such as accounting for stock options. Therefore, the Congress may wish to task the SEC with studying this issue and identifying alternative sources of funding to supplement the FASB's sale of publications, including the possibility of imposing fees on registrants and/or firms, and to report to the Congress on its findings and actions taken to address the funding issue.

## The SEC's Ability to Fulfill Its Mission

Over the last decade, securities markets have experienced unprecedented growth and change. Moreover, technology has fundamentally changed the way markets operate and how investors access markets. These changes have made the markets more complex. In addition, the markets have become more international, and legislative changes have resulted in a regulatory framework that requires increased coordination among financial regulators and requires that the SEC regulate a greater range of products. Moreover, as I have discussed, the collapse of Enron and other corporate failures have stimulated an intense debate on the need for broad-based reform in such areas as oversight of the accounting profession, accounting standards, corporate governance, and analysts conflicts of interest issues, all of which could have significant repercussions on the SEC's role and oversight challenges. At the same time, the SEC has been faced with an ever-increasing workload and ongoing human capital challenges, most notably high staff turnover and numerous staff vacancies.

Our recent report[10] discusses these issues and the need for the SEC to improve its strategic planning to more effectively manage its operations and limited resources, and also shows that the growth of SEC resources has not kept pace with the growth in the SEC's workload (such as filings, complaints, inquiries, investigations, examinations, and inspections). We believe that the SEC should be provided with the necessary resources to effectively discharge its current and any increased responsibilities the Congress may give it. And finally, we believe that the SEC should be directed to report annually to the Congress on (1) its strategic plan for carrying out its mission, (2) the adequacy of its resources and how it is effectively managing resources through a risk-oriented approach and prioritization of risks, including effective use of information technology, and (3) any unmet needs including required funding and human resources.

## Closing Comments

The United States has the largest and most respected capital markets in the world. Our capital markets have long enjoyed a reputation of integrity that promotes investor confidence. This is critical to our economy and the economies of other nations given the globalization of commerce. However, this long-standing reputation is now being challenged by some parties. The effectiveness of systems relating to independent audits, financial reporting, and corporate governance, which represent key underpinnings of capital markets and are critical to protecting the public's interest, has been called into question by the failure of Enron and certain other events and practices. Although the human elements can override any system of controls, it is clear that there are a range of actions that are critical to the effective functioning of the system underlying capital markets that require attention by a range of key players. In addition, a strong enforcement function with appropriate civil and criminal sanctions is also needed to ensure effective accountability when key players fail to properly perform their duties and responsibilities.

Today, I have discussed our suggestions to assist the Congress in crafting needed reforms. We strongly believe that a new independent federal government body created by statute to regulate audits of public companies is needed in order to better protect the public's interest. However, currently we do not believe that it is necessary or appropriate for the government to assume direct responsibility for certain other key areas (e.g., financial

[10] *SEC Operations: Increased Workload Creates Challenges*, (GAO-02-3-2, March 5, 2002).

reporting and corporate governance requirements). We do, however, believe that the Congress should provide the SEC with direction to address certain related issues as I have discussed. As is usually the case in issues of this magnitude, complexity, and importance, and as the results of the forum we held last month showed, there is no single "silver bullet" to quickly overhaul, or perhaps even replace, the systems supporting our capital markets. In addition, any major changes will involve some degree of controversy. On balance though, as I have discussed today, additional steps are necessary in order to better protect the public's interest and enhance public confidence in related systems and applicable key players.

In summary, Enron's recent sudden collapse, coupled with other recent business failures and certain other activities, pose a range of serious systemic issues that should be addressed. The fundamental principles of having the right incentives, adequate transparency, and full accountability provide a good sounding board to evaluate proposals that are advanced. A holistic approach is also important as the systems are interrelated and weak links can severely strain their effective functioning. Effectively addressing these issues should be a shared responsibility involving a number of private and public sector parties including top management, boards of directors, various board committees, stock exchanges, the accounting profession, standard setters, regulatory/oversight agencies, analysts, investors, and the Congress. In the end, no matter what system exists, bad actors will do bad things with bad results. We must, however, strive to take steps to minimize the number of such situations and to hold any violators of the system fully accountable for their actions.

Mr. Chairman, this concludes my statement. I would be please to answer any questions you or other members of the committee may have at this time.

## Contacts and Acknowledgments

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