United States General Accounting Office
Washington, DC 20548

May 3, 2002

The Honorable Paul S. Sarbanes
Chairman, Committee on Banking,
Housing, and Urban Affairs
United States Senate

Subject: *Accounting Profession: Oversight, Auditor Independence, and Financial Reporting Issues*

Dear Mr. Chairman:

This letter responds to your recent request that we provide our views regarding what steps the Congress should consider taking to strengthen oversight of the accounting profession, auditor independence, and selected financial reporting matters. The sudden and largely unexpected bankruptcy of the Enron Corporation (Enron) and other large corporations' financial reporting restatements have raised questions about the soundness of the current self-regulatory and financial reporting systems and resulted in substantial losses to employees, shareholders, and other investors. These events have also raised a range of questions regarding how such dramatic and unexpected events can happen and the role and capacities of various key players under the existing systems.

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, has a funding mechanism that is dependent upon voluntary contributions from the accounting profession, and has a discipline system that is largely perceived as being ineffective. (Enclosure 1 serves to illustrate the complexity of the current system of regulation and oversight and the stakeholders who rely on the system.)

Simply stated, the current self-regulatory system is broken and oversight of the self-regulatory system by the Securities and Exchange Commission (SEC) has not been effective in addressing these issues to adequately protect the public interest. As a result, given the important role that independent auditors play and various inherent problems in the current self-regulatory system, direct government intervention is needed to statutorily create a new body to oversee the accounting profession's responsibilities for auditing public companies. This step is necessary in order to increase the effectiveness of the audit process and to rebuild public confidence. The new body should be independent of the accounting profession, have significant standards-setting, oversight, and disciplinary authority, be adequately resourced to fulfill its responsibilities, and have sufficient operating flexibility to attract and retain quality leadership and supporting staff.

On the other hand, the concerns relating to the timeliness, relevancy and transparency of the financial reporting model may be best addressed through the SEC working more closely with the Financial Accounting Standards Board (FASB), assuring that the FASB has an adequate and independent source of funding for its operations, and reporting periodically to the Congress in connection with certain FASB matters. If such an approach is not successful in achieving the expected improvements in the financial reporting model in a timely and effective manner, the government can then take further action.

The areas of oversight of the accounting profession, auditor independence, and financial reporting are important on their own, but they also represent interrelated keystones to protecting the public's interest. Failure in any of these areas can place a strain on the entire system. Consequently, 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.

NEW BODY NEEDED TO REGULATE AND OVERSEE THE ACCOUNTING PROFESSION

Enron's failure and a variety of other recent events have brought a direct focus on the ineffectiveness of the current system of regulation and oversight of the accounting profession. Independent auditors have a key role to play in protecting shareholders and the public's interest in our capital market system. They hold a public trust and their actions or inactions can have significant implications on investors, creditors and other users of financial reports. In this regard, auditors must place additional emphasis on whether financial statements are "fairly presented in all material respects" in addition to their traditional emphasis on whether such financial statements are prepared "in accordance with generally accepted accounting principles." Fair presentation requires providing reasonable assurance that major value and risk elements are appropriately reflected in the financial statements and related notes in an understandable fashion. It also requires employing an "economic substance" versus "transaction form" approach to important accounting and reporting issues.

Many proposals are before the Congress to establish a new body to regulate and/or oversee accounting firms that audit public companies. In our view, the Congress should consider the following key factors or criteria in establishing this new body, each of which is critical to its likely effectiveness.

Functions of the New Body

The new body should have direct responsibility and authority for certain critical functions in connection with public accounting firms and their members who audit public companies. These include:

- establishing professional standards (independence standards; quality control standards, auditing standards, and attestation standards). The new body should be authorized to issue professional standards. In that respect, the new body should also be authorized to affirmatively adopt, at its discretion, professional standards, in whole or in part, promulgated by another standard-setting body. In the area of new standards, the new body may choose to require auditor reporting on the effectiveness of internal control over financial reporting in connection with audits of public companies, which is currently not required under existing auditing standards. It may also decide not to affirmatively adopt a standard developed by another standard-setting body but instead issue a modified version of the standard.

- monitoring public accounting firms for compliance with applicable professional standards. For efficiency, except for quality reviews of the largest firms and those firms in which the nature of the audits they perform pose a higher level of risk as determined by the new body, the new body should be authorized to use contractors or accounting firms to perform quality reviews in accordance with standards and processes set by the new body. However, the new body should have final approval authority in connection with any quality review engagements performed by any contractors or accounting firms.

- investigating and disciplining public accounting firms and/or individual auditors of public accounting firms who do not comply with applicable professional standards. Investigations and disciplinary actions of the new body should be in addition to existing investigatory and disciplinary authority that already exists with the SEC and state boards of accountancy.

- establishing various auditor rotation requirements for key public company audit engagement personnel (i.e., primary and second partners, and engagement managers). Related to this function, we believe the new body should undertake a study and report to the Congress on the pros and cons of any mandatory rotation of accounting firms that audit public companies before taking any action with regard to establishing requirements for any mandatory rotation of accounting firms.

Funding for the New Body

The new body should have independent sources of funding by virtue of mandatory, not voluntary, payments. 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 should be required to register with the new body. The new body should have the authority to set annual registration fees and fees for services such as peer reviews of public accounting firms. The fees should be set to recover full costs and sustain the operations of the new body.

<u>Reporting Requirement of the New Body and GAO Access to Records</u>

The new body should report annually to the Congress and the public on the full range of its activities, including coordination with other standard-setting bodies whose standards it so chooses to adopt, setting professional standards, peer reviews 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 access to the records of other entities that the new body has chosen to rely on, such as other standard-setting bodies, and contractors or public accounting firms that conduct quality reviews, to the extent GAO considers necessary to assess the performance of the new body.

<u>Structure of the New Body</u>

The new body should be created by statute and should be independent of the accounting profession. To facilitate operating independently, the new body's board members should be highly qualified and should have authority to set and approve its operating rules. The new body should have independent decision-making authority; however, it should coordinate and communicate its activities with other parties such as the SEC, the various state boards of accountancy, other standard- setters, and GAO, as appropriate. The new body should set its own human resource and other administrative requirements and should be given appropriate flexibility 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 the new body's 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. This approach would help to assure the qualifications and independence of all board members.

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. Ideally, the members of the board should be presidential appointees who are confirmed by the Senate (PASs). However, if the board members are not PASs, the board should be actively overseen by and accountable to a body that is composed of PASs, such as the SEC, in order to assure adequate accountability to the Congress and the public. At a minimum, the chair and vice-chair should serve on a full-time basis. None of the board members should be active accounting profession practitioners, and a majority of board members should not have been accounting profession practitioners within the recent past (e.g., 3 years).

There are several alternative structures that the Congress could choose from in establishing the new body, including creating (1) a new unit within the SEC, (2) an independent government entity within the SEC, (3) an independent government agency outside the SEC, or (4) a non-governmental private-sector entity overseen by the SEC. Each of the above alternative structures have various pros and cons that should be considered in order to assure the credibility and effectiveness of the new body in protecting the public interest. We believe that each of the alternative structures provides an organizational foundation for managing and operating the new body that potentially is workable. For the following reasons, we favor alternatives two and three and believe they have a greater likelihood of success.

Under alternatives one and four, the new body's functions (e.g., establishing professional standards, monitoring, and discipline) would be subject to SEC approval in order to assure that all actions are in the public's interest and appropriate accountability to the Congress and the public. This, however, would increase the SEC's responsibility as well as its workload, for the agency and the Commissioners, both of which are already overloaded. Also, under alternatives one and four the new body's board members would not likely be PASs since under alternative one the SEC Chair and other Commissioners are PASs, and since alternative four involves a non-governmental entity. Therefore, under alternatives one and four, the new body would have less direct accountability to the Congress and the public than a body with board members who are PASs. This limitation could be mitigated to some extent by ensuring that regardless of the structure of the new body that board members are selected from candidates provided by an independent and appropriately qualified nominating committee as previously discussed.

Although a structure that provides direct accountability to the Congress and the public is important in our view, a more critical question regarding the structure of alternatives one and four is whether the SEC has the capacity to effectively take on such an additional workload. Clearly, the SEC has the culture and potential to perform an active oversight role and this would be in line with its current mission. But, does it realistically have the capacity to do so? From a historical perspective, while the SEC has had authority for over 70 years to regulate the public accounting profession under the federal securities laws and regulations related to public companies, it has largely relied on the public accounting profession to regulate itself. It is now apparent that this model has not adequately protected the public's interest. Therefore, the SEC would need to institute a new function within its organization, as called for in alternative one, or a new oversight structure for a private-sector entity outside the SEC, as called for in alternative four, both of which would require additional resources and a significant increase in priority to more directly regulate the accounting profession at a time when the SEC is already facing a range of challenges in fulfilling its current responsibilities. Further, we believe that the SEC also needs to increase the amount of time and attention that it allocates to interacting with the FASB, the stock exchanges, and the investment banking/analyst community.

As we recently reported,[1] the SEC's ability to fulfill its mission has become increasingly strained due, in part, to significant imbalances between the SEC's workload (such as filings, complaints, inquiries, investigations, examinations, and inspections) and staff resources. Although additional resources could help the SEC do more, additional resources alone would not help the SEC address its high staff turnover, which continues to be a major challenge for the agency. About 40 percent of the SEC's staff left the agency between 1998 and 2001 and, as a result, the average level of experience at the SEC has been declining. For example, in 2000, 76 percent of the SEC's examiners had been with the agency less than 3 years. However, we also reported that the SEC has not made effective use of strategic planning and information technology to leverage its limited resources. In addition to putting more strain on the SEC's capacity, alternatives one and four would also likely be less efficient models for the new body to operate under by requiring additional time and attention from the SEC.

Alternative two, which calls for the creation of an independent government entity within the SEC, and alternative three, which calls for the creation of an independent government agency outside the SEC, do not pose the same capacity challenges for the SEC, especially at the Commissioner level, as alternatives one and four. Also, alternatives two and three both meet each of the critical factors outlined above for the structure of the new body. We recognize there may be concern over adding more political appointments that have to be Senate confirmed, as called for under alternatives two and three, given the recent challenges of filling positions that are PASs. However, having an independent entity overseen by PASs serves to significantly enhance the entity's accountability to the Congress and the public.

Of these two alternatives, we favor alternative two as having a greater likelihood of success because the new body would be housed within the SEC and, therefore, could receive administrative support from the SEC, including human resources, payroll, and other administrative support. More importantly, this alternative should better facilitate communication and provide for maximum coordination with the SEC, while also allowing the new body the independence to design its own policies and procedures and systems as it deemed appropriate. In addition, alternative two would not require the Congress to create a separate federal entity. Alternative two would also facilitate a consolidation of the new entity under the SEC in future years if such a consolidation was deemed to be both desirable and appropriate. Therefore, we believe that alternative two has the greatest likelihood of success in terms of potential effectiveness, efficiency, and accountability of the new body. However, as previously stated, each of the alternative structures has merit and can potentially work if properly designed and implemented.

AUDITOR INDEPENDENCE

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

[1] *SEC Operations: Increased Workload Creates Challenges*, (GAO-02-302, March 5, 2002).

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 we strongly believe are in the public's interest, are reflected in the revisions to auditor independence requirements for government audits,[2] which GAO recently issued as part of *Government Auditing Standards*.[3] 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.[4] The standard, among other things, toughens the rules associated with providing nonaudit services and includes a principle-based approach to addressing this issue, supplemented with certain safeguards. The two overarching principles in the standard for nonaudit services are that:

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

[3]*Government Auditing Standards* was first published in 1972 and is commonly referred to as the "Yellow Book," and covers 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.

[4] 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*.

- 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.[5]

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 statutorily created body, which we previously discussed, should be responsible for setting independence standards for audits of public companies, as well as have the

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

authority to discipline members of the accounting profession that violate such standards.

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,[6] 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 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.[7] 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 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

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

[7] 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.

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 GAO considers necessary for it 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 voluntarily 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. We believe that the FASB should have mandatory sources of funding to remove the appearance of any independence issues related to funding FASB. Therefore, the Congress may wish to task the SEC with studying this issue and identifying alternative sources of mandatory 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.

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 and financial reporting 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. 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.

The accounting profession's self-regulatory system has not effectively fulfilled its responsibilities. In addition, the current model whereby the SEC oversees various self-regulatory organizations in connection with financial reporting and auditing has not worked well, especially in connection with audits of public companies. Further, the SEC is not staffed to take on a more direct role in regulating the accounting profession nor has the SEC strategically managed its limited resources well. Therefore, we strongly believe that a new independent 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 financial reporting. We do, however, believe that the Congress should provide the SEC with direction to address the issues concerning financial reporting as we have previously discussed.

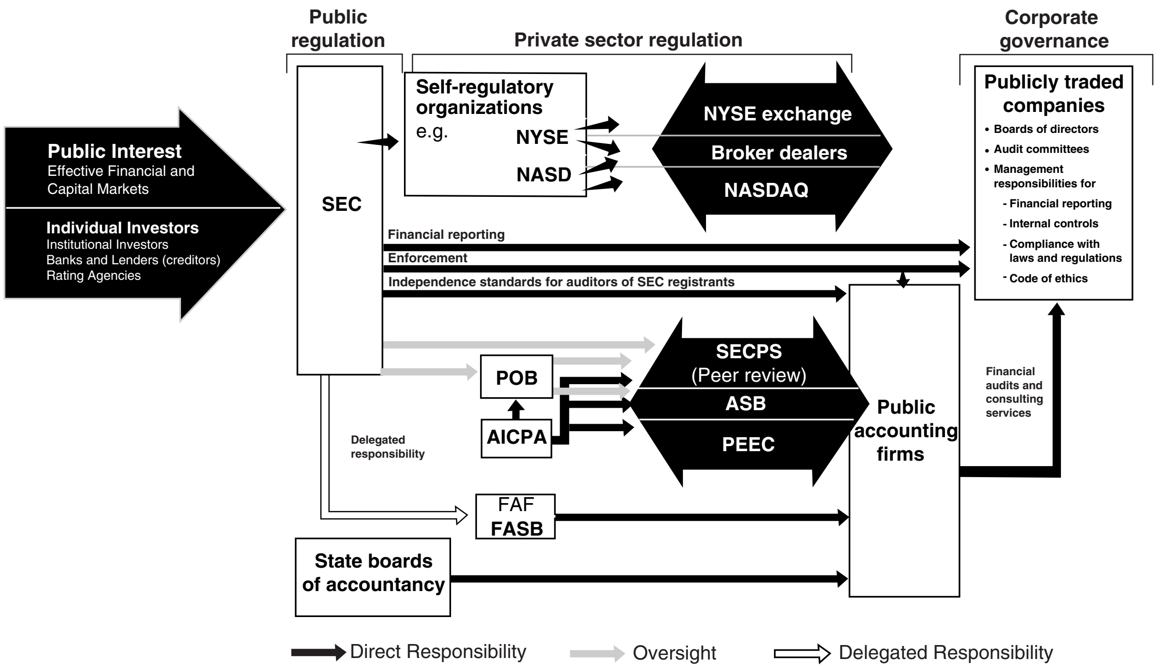
In summary, Enron's recent sudden collapse, coupled with other recent business failures and certain other activities, pose a range of serious issues concerning the accounting profession and financial reporting that should be addressed. The fundamental principles of having the right incentives, adequate transparency, and full accountability provide a good sounding board to evaluate proposals that are advanced. In the end, no matter what improvements are made to strengthen the oversight and independence of the accounting profession and enhance the relevancy and transparency of financial reporting, 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.

We would be pleased to meet with you or other members of the committee to answer any questions that you may have or to provide further assistance.

Sincerely yours,

David M. Walker
Comptroller General
of the United States

Enclosure


Public regulation
Private sector regulation
Corporate governance
Public Interest
Effective Financial and Capital Markets
Individual Investors
Institutional Investors
Banks and Lenders (creditors)
Rating Agencies
SEC
Self-regulatory organizations
e.g.
NYSE
NASD
NYSE exchange
Broker dealers
NASDAQ
Publicly traded companies
• Boards of directors
• Audit committees
• Management responsibilities for
- Financial reporting
- Internal controls
- Compliance with laws and regulations
- Code of ethics
Financial reporting
Enforcement
Independence standards for auditors of SEC registrants
POB
AICPA
SECPS
(Peer review)
ASB
PEEC
Public accounting firms
Financial audits and consulting services
Delegated responsibility
FAF
FASB
State boards of accountancy
Direct Responsibility
Oversight
Delegated Responsibility

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