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GAO FORUM ON GOVERNANCE AND ACCOUNTABILITY

Challenges to Restore Public Confidence in U.S. Corporate Governance and Accountability Systems

GAO-03-419SP

G A O
Accountability★Integrity★Reliability

Highlights

Highlights of GAO-03-419SP

December 9, 2002

Governance and Accountability

Why GAO Convened This Forum

On December 9, 2002, GAO convened a governance and accountability forum to discuss challenges facing regulators, the accounting profession, and boards of directors and management of public companies in effectively implementing the Sarbanes-Oxley Act of 2002 and related regulatory actions to improve public confidence in U.S. corporate governance and accountability systems. Major accountability breakdowns in recent years, exacerbated in the last 2 years by the unprecedented massive breakdowns and bankruptcy of Enron and WorldCom, have contributed to the decline in investor confidence in U.S. capital markets. The forum focused on the four interrelated areas of corporate governance, the financial reporting model, the accounting profession, and regulation and enforcement that the accountability breakdowns have surfaced as critical areas to be strengthened.

Addressing these challenges will involve the public, private, and not-for-profit sectors. In general, there must be the proper incentives, transparency, and accountability mechanisms in place to ensure the effectiveness of any system. As a result, these overarching principles were considered in connection with the issues discussed.

Forum participants included individuals from federal and state government, the private sector, standards setting and oversight bodies, and a variety of other interested parties.

www.gao.gov/cgi-bin/getrpt?GAO-03-419SP.

To view the full report, click on the link above.
For more information, contact Jeffrey C. Steinhoff, Managing Director, Financial Management and Assurance, on (202) 512-2600 or steinhoffj@gao.gov.

Forum Discussion

There was general agreement among the participants that the root causes of the accountability breakdowns are systemic in nature, complex, and will require leadership and alterations to the current models in each of the four interrelated areas to transition to an overall system that is more focused on protecting the public interest and, in that regard, accountability. They also agreed that considerable actions have been taken and/or proposed towards achieving those objectives, but that having the "right people" and "stakeholders" involved was critical to successfully achieve and effectively maintain the necessary reforms. Several other key observations follow:

- Many boards of directors are reassessing their roles and responsibilities and currently it is difficult to determine what is working and what is not working.
- Participants agreed there is no "silver bullet" to enhancing the effectiveness of boards of directors in their role of overseeing management and protecting the public interest. However, for a board to effectively perform its responsibilities, it must have the "right people" who possess an "independent spirit" and are "knowledgeable" of the company/industry and the company's constituencies.
- Little progress has been made moving toward a more comprehensive financial reporting model that would include such information as operating and performance measures and forward-looking information about opportunities, risks, and management's plans.
- The impetus for changing the financial reporting model needs more involvement of investors and other users of financial information as the current model is too driven by those who have historically focused more on the technical aspects of financial reporting, such as accountants, regulators, corporate management, and boards of directors.
- An "artful blend" of principle-based and rule-based accounting standards, as well as a financial reporting model with different tiers of reporting that provides full disclosure, are fundamental changes needed to improve the financial reporting model.
- An "expectation gap" of what an audit is and what users expect continues to exist, especially with the auditor's responsibility for fraud detection.
- Supplementing the traditional financial statement audit with a "forensic audit" as well as with a more informative auditor's report could help to narrow the "expectation gap."
- A strong, viable Securities and Exchange Commission is needed to maintain investor confidence. Concern was raised that the Commission is not fully at that status and that funding issues need to be resolved.
- The new Public Company Accounting Oversight Board needs to officially get up and running with immediate priorities focusing on establishing policies and procedures for performing its disciplinary, inspection, and standard-setting functions.

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The last 2 years witnessed major accountability breakdowns at Enron and WorldCom leading to significant restatements of financial statements and bankruptcy adversely affecting thousands of shareholders and employees. Unfortunately, such failures were not isolated instances as other accountability breakdowns in recent years included Qwest, Tyco, Adelphia, Global Crossing, Waste Management, Micro Strategy, Superior Federal Savings Banks, and Xerox. Although stakeholders of these companies were directly affected by the accountability breakdowns, these failures have cumulatively contributed to the general shaking of investor confidence in U.S. capital markets.

Last year, on February 25, 2002, GAO held a forum to discuss systemic issues related to these accountability failures, such as corporate governance, accounting and reporting, and auditing.[1] Since that time, major reform legislation has been enacted—the Sarbanes-Oxley Act of 2002—and regulators have proposed and/or finalized a number of new requirements to address issues related to the failures. However, much of the regulatory reform action is in process and experience will be needed to evaluate the effectiveness of the changes. Moreover, the changes to date do not address all the issues raised by the accountability breakdowns.

On December 9, 2002, GAO convened a governance and accountability forum for the purpose of identifying past, pending, and proposed actions designed to protect the public interest by

- identifying challenges to improving public confidence in U.S. corporate governance and accountability systems to assist regulators, the accounting profession, and boards of directors and management of public companies to effectively implement the Sarbanes-Oxley Act of 2002 and other related regulatory actions and

- placing special interest on steps designed to enhance independence of the corporate governance system and enhancing the accounting/auditing and attest/assurance models for the 21st century.

[1]U.S. General Accounting Office, *Highlights of GAO's Corporate Governance, Transparency and Accountability Forum*, GAO-02-494SP (Washington, D.C.: March 2002).

Specifically, the forum focused on four interrelated areas—corporate governance, the financial reporting model, the accounting profession, and regulation and enforcement.

The invited participants were from public, private, and not-for-profit entities having extensive experience and subject matter expertise in the accounting profession, corporate governance issues, financial reporting and disclosure models, auditing, accounting, and related regulatory issues. GAO also extended invitations to chairs and ranking minority members of relevant Congressional committees. Over 40 invites attended. As agreed with the participants, the purpose of the discussion was not to reach a consensus, but rather to engage in an open, no attribution-based dialogue. Therefore, this report summarizes the collective discussion and does not necessarily represent the views of any individual participant or GAO.

Corporate Governance

The participants acknowledged that recent legislative and regulatory reforms in response to issues raised by significant restatements of financial statements and corporate failures were placing greater emphasis on the roles and responsibilities of boards of directors. They noted that many boards are reassessing their roles and responsibilities and, at this time, it is difficult to determine what is working and what is not working. Information on best practices of boards would be useful to help improve board operations, for example in areas of improving communications with management and using external advisors. However, participants generally agreed that there is no "silver bullet" for enhancing the effectiveness of boards of directors in their role of oversight of management and protecting shareholders.

In discussing the role and responsibilities of boards of directors, participants stated that it starts with having the right people on the board who are independent, knowledgeable, and ethical and whose integrity is unquestionable. The basic roles and responsibilities of the board were defined as enhancing shareholder value, assessing and monitoring risk, and ensuring management accountability. It was noted that boards need to do a better job of identifying their constituencies and understanding and addressing their concerns. In addition, board members have a responsibility to educate themselves about the company's operations and plans and to seek advice of external experts, when and as appropriate.

Participants also focused on the roles of the nominating, compensation, and audit committees noting that (1) nominating committees need to

independently identify candidates for board membership rather than "rubber stamp" management's candidates, (2) compensation committees need to focus more on achievements related to the company's long-term strategic objectives and less on short-term accomplishments, such as meeting earnings projections, and (3) audit committees need to work more effectively with the independent auditor as defined by the Sarbanes-Oxley Act of 2002, and not get "tied up" in procedural matters concerned with their legal liabilities as committee members.

Participants stressed that having the "right people" on the board was just as important if not more so than having the right rules. In that respect, it was noted that board members should possess an "independent spirit" to ask the tough and probing questions of management. Participants stated that the existing system for identifying board members might not always be attracting the "right people." For example, it was stated that some board members are serving on too many boards to be effective, and that some board members are serving for personal incentives that could adversely affect their independence. Some participants believed that in today's environment, potential legal liabilities were adversely affecting finding qualified board members. Other participants believed that there is no shortage of qualified board members willing to serve and that the board needed to look beyond the "list of usual suspects."

Financial Reporting

The traditional financial statements, in terms of form and content, have not changed much over the years. The financial reporting model uses a mixture of historical costs and fair value to present a company's transactions. This model has value but fails to meet the broader range of information needs of investors who want more forward-looking information and data that reflect a company's overall performance, risk profile, and expectations for future performance.

Little progress has been made in moving toward a more comprehensive reporting model that would include both financial information (financial statements and related disclosures) and nonfinancial information (such as high-level operating and performance measures used by management and forward-looking information about opportunities, risks, and management's plans). Participants stated that the current model is too driven by accountants, regulators, corporate management, and boards of directors who have historically focused on the technical aspects of financial reporting and are more likely to move slowly and cautiously in making

changes. As a result, the current model has failed to get adequate “traction” to move toward a more comprehensive reporting model.

Going forward, participants believed that the impetus for change to the financial reporting model would have to come more from the investors and other users of financial information who need timely, accurate, and useful information to make value and risk judgments about publicly traded companies. Also, a safe harbor for preparers and auditors of more forward-looking information may be necessary to progress. Other suggestions by participants included moving toward more principle-based accounting rules to provide more substance versus form in reporting. There was general agreement that (1) a combination of principle-based and rule-based standards would be needed and (2) principle-based accounting rules were not a panacea to solve financial reporting problems. In that respect, some participants suggested that standard setters first needed to get the basics right with the current financial reporting model, for example in areas such as accounting for pensions, post-employment benefits, and pro-forma financial statements, to help restore investor confidence. It was also suggested that the financial reporting model have different layers of reporting, while still having full disclosure, coupled with different levels of assurances depending on users’ needs. Such layering would allow a user to “drill down” to the level of detail needed.

The Accounting Profession

An expectation gap between what an audit is and is not continues to exist, especially with regard to the auditor’s responsibility for detecting fraud. Some participants believed a periodic forensic audit may be needed to supplement the traditional financial statement audit to assist in detecting fraud. However, it was recognized that an audit cannot create precision or certainty where such factors do not exist, as financial statements are not as precise as users may believe. In addition, management and audit committees have important roles and responsibilities for internal control to prevent and detect fraud. The Sarbanes-Oxley Act of 2002 will help to close the expectation gap concerning the effectiveness of internal control over financial reporting by requiring management and auditor reporting on these controls. Nonetheless, an expectation gap may still exist as users may be expecting that an audit addresses internal control over the company’s overall operations and performance. Educating users on the terminology of internal control reporting, such as reportable conditions, was also urged so that the users and capital markets do not over react in interpreting the internal control reports.

Participants suggested the need for a new reporting model for auditing, a renewed focus on the quality of auditing, and building more effective working relationships with the audit committee. It was recognized that the standard auditor's report could be made more useful to users who are seeking greater information about what the auditor did and found, as well as expanded assurances. Tiered reporting that would provide expanded optional assurances was suggested. Participants stated that the quality of audits can be adversely affected by "time and fee pressures" that lead to less substantive auditing. Caution was also urged that rotation of audit partners required by the Sarbanes-Oxley Act of 2002 does not have the unintended consequence of adversely affecting the quality of audits through loss of experience with a particular company's operations and financial reporting. It was recognized that confidence in audits needs to be restored not only for investors, but also to attract and retain the best people for the accounting profession over time.

Regulation and Enforcement

A strong, viable Securities and Exchange Commission (SEC) is needed to maintain investor confidence in the markets. Participants recognized that the SEC's resources had not kept up with its increased workload over the years. This situation has adversely affected the SEC's ability to adequately enforce the securities laws and also its ability to invest in technology to more efficiently manage its workload. Some participants suggested that the SEC may wish to consider pursuing the status to operate independently in setting its own funding levels, as the Federal Reserve does. It was also suggested that the SEC needed to explore how it is using its enforcement powers, as civil penalties may ultimately be hurting shareholders more than those who have violated the securities laws. In that respect, the SEC should reexamine the amount and targeting of its civil sanctions, its use of criminal statutes, and working effectively with the Department of Justice to put violators behind bars when appropriate.

The new Public Company Accounting Oversight Board (PCAOB) needs to officially get up and running. Suggested priorities for the PCAOB included establishing policies and procedures for disciplinary actions and conducting inspections of registered public accounting firms. Also, decisions need to be made on the setting of standards for auditing, quality control, ethics, and independence. It was also suggested that the PCAOB should evaluate the recent events that have affected the public's confidence in auditors to consider what further actions may be needed beyond those mandated by the Sarbanes-Oxley Act of 2002 and recent regulatory changes and proposals. In addition, the PCAOB needs to work cooperatively with

the SEC and state boards of accountancy. The fragmentation of the regulatory system for the public accounting profession was not completely dealt with by the Sarbanes-Oxley Act of 2002. At a minimum, the PCAOB will need to effectively work with the other public regulators on enforcement/disciplinary matters. Participants generally believed that the provisions of the Sarbanes-Oxley Act of 2002 should be implemented and assessed before the Congress should consider adding any new legislative requirements; however, participants agreed that much can and should be done by other responsible parties, such as by regulatory and self-regulatory bodies, within their existing authority.

GAO Observations

Restoring public trust and confidence in a manner that can be sustained over the long-term will require concerted actions by a variety of parties, including accounting and auditing standard setters, regulators, management and boards of directors of public companies. The Sarbanes-Oxley Act of 2002 provides a strong framework for more effective corporate governance and regulation of the accounting profession. The SEC and the stock exchanges, along with the Financial Accounting Standards Board, have also been actively making progress to address a range of issues raised by the accountability breakdowns. However, the fundamental principles of providing the right incentives, providing adequate transparency, and ensuring appropriate accountability are even more important and relevant as the new structure and reforms are being established.

It is important to recognize that rules alone will not effectively resolve the problems that resulted in massive restatements of financial statements and ultimately bankruptcy of certain public companies. The Congress cannot legislate nor can regulators establish by rule human behavior or integrity to always do the right thing in protecting the public's interest. Public company management needs to set the appropriate "tone at the top" and that culture needs to be carried throughout the company and exhibited by the board of directors in its oversight of management and in its protection of shareholder interests.

The accounting profession needs to vigorously work to rebuild its greatest asset—public trust—in order to restore faith in the integrity and objectivity of the profession. Accounting and auditing standards need to be reexamined to provide enhanced value to users of financial statements, related disclosures, and more comprehensive business reporting. Users of these products will need to step forward to help ensure the value of an

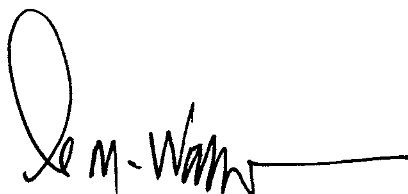
enhanced financial reporting model and related auditor assurances for the effective functioning of U.S. capital markets. Accountants and regulators who have historically driven changes to the financial reporting model do not have the same set of needs as users of financial statements. In that respect, a broader performance and accountability reporting model is needed and should include not just financial statements but also performance and other information necessary to better assess institutional value and risk.

GAO will continue to play a professional, objective, nonpartisan and constructive role in assisting the Congress, regulators, and the accounting profession as initiatives are proposed, agreed upon, and become operational. In that respect, the views of the participants in this forum represent considerable experience in the matters discussed and represent one way in which an independent party, such as GAO, can assist those who define and/or implement policy.

The results of the forum are organized by the major areas of discussion and reflect subsequent comments we received from the participants on a draft of this report. Appendix I provides a list of the participants.

For additional information on our work concerning corporate governance, the accounting profession, financial reporting, and related regulatory matters, please contact Jeffrey C. Steinhoff, Managing Director, Financial Management and Assurance, on (202) 512-2600 or at SteinhoffJ@gao.gov.

I wish to thank each of the participants for taking the time to share their knowledge and to provide their insights and perspectives on the important matters discussed during the forum. I look forward to working with them on these important issues of mutual interest and concern in the future.



David M. Walker
Comptroller General
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Corporate Governance

Defining the Roles and Responsibilities of the Board of Directors

Recent legislative and regulatory initiatives, such as the Sarbanes-Oxley Act of 2002, Securities and Exchange Commission (SEC) proposals and rules, and proposed revised stock exchange listing requirements, have addressed weaknesses in corporate governance exposed by the major financial reporting issues raised by restatements and corporate failures, placing greater emphasis on the roles and responsibilities of boards of directors. Although these reforms are not yet fully in place and not all issues have been addressed, many corporate boards are reassessing their roles. However, participants agreed that there is no "silver bullet" and that it is difficult at this time to say what is working and what is not working.

Participants believed that it is important to continue working toward more effective boards of directors and discussed the importance of clearly defining and, in some cases, redefining, the roles and responsibilities of the board of directors of public companies as a significant measure to help restore investor confidence in the market. The board has a responsibility to enhance shareholder value, assess and monitor risk, and ensure management accountability. In that respect, the operations of the boards should reflect a culture that embraces these responsibilities. In addition to focusing on what accountants, regulators, and corporate management and boards of directors (the "supply side") should do, boards need to focus more on what investors and other users of financial information (the "demand side") want from corporate governance.

In order to fulfill its responsibility of effectively overseeing management, the board must have a thorough understanding of the company, its business model and related risks, corporate culture, and the various interests the board represents. Participants believed that the board has a responsibility to educate itself through the use of external advisors or other means and not rely solely on information provided by management. This will better allow the board to raise difficult questions and probe issues to provide input on strategy, assess and manage risk, and hold management accountable for its actions. The time frame needs to be very clear, as creating value is a long-term, not a short-term, process. Investors are not looking for quick schemes that endanger the company.

In addition to its responsibility to oversee management, the board also has a responsibility to shareholders and other stakeholders of the company, such as employees, creditors, and the public. Participants believed that boards need to do a better job of identifying their constituencies and understanding and addressing their concerns. For example, from the

shareholders' point of view, many believe that board structures have not been working properly to both protect shareholders' interests and grow share value. We have become a nation of investors, and boards need to focus attention on the fact that there has been a shift from shareholders not only being individual investors but also institutional investors, such as pension plans and mutual funds, which are acting as fiduciaries for others. Institutional investors may have concerns different from those of individual investors regarding expectations for corporate governance and the role of the board of directors.

Participants also felt that boards needed to reexamine how they are structured and how they operate. Many boards were not perceived to function properly for investor protection, which is a negative reflection on the entire corporate governance process. To some extent, deficiencies in the functioning of boards may have been masked by the effect of a flourishing market and may not have been readily apparent until market downturns began to occur. It is incumbent upon boards to establish processes that are appropriate and effective to restore investor confidence rather than relying on a checklist approach to corporate governance. Participants believed that information on best practices of boards would be useful to help to improve board operations. Some best practices include focusing on improving communications with management and using external advisors. It was also suggested that boards should effectively use the "gatekeepers" (auditors and audit committees) for help in the board's oversight of financial management and reporting activities of the company.

Independent committees of the board of directors, such as the auditing, compensation, and nominating committees, play an important role in effective corporate governance. Audit committees should not only oversee both internal and external auditors, but also be proactively involved in understanding issues related to the complexity of the business, and, when appropriate, challenge management through discussion of choices regarding complex accounting, financial reporting, and auditing issues. In that respect, the role of the audit committee, which in some cases has not been very active or effective in its oversight of management or auditors as related to financial reporting, is evolving into not just financial management oversight, but the overall aspects of the company's financial reporting, such as releases on earnings expectations and quarterly financial reports. In addition, the Sarbanes-Oxley Act of 2002 defines a number of audit committee responsibilities for the hiring, compensation, and oversight of auditors. However, a serious concern exists over whether audit committee members are focusing more on procedural matters to protect

themselves from liability than on improving their competence and effectiveness as a committee. Also, compensation committees need to understand the implications of compensation to provide incentives for management to do the right thing for the company and its shareholders versus themselves. Compensation committees need to focus on executive performance more related to the company's long-term objectives rather than just short-term business results. In addition, nominating committees need to ensure that they identify the right mix of talent to do the job and make it clear to candidates what is expected of them as a board member rather than merely approving candidates identified by management. In that respect, some participants stated that boards are often made up of consensus builders and, in that case, a dominant member of the board could effectively control the board's agenda.

Participants also discussed the importance of providing reasonable transparency of key information, with regard to both financial information of the company and board operations. Boards need to focus on enhancing the quality and reliability of financial reporting, identifying key elements of disclosure, and ensuring that such information is appropriately disclosed to investors and the public. Participants also believed that there is a need for better transparency of board activities to help restore investor confidence, such as reporting on the board's progress against best practices of leading companies[2] noted for the effectiveness of their boards. If the board is not following best practices, it should report why it is not following these practices. The point was also made that successful companies have reinvented themselves through two fundamental focuses—ethics/integrity and respect for people. These behaviors have been demonstrated by long-term successful companies.

Identifying the Right People to Serve on Boards

Participants stressed the importance of independence, both in fact and appearance, as essential for the board to be able to fulfill its responsibilities. Participants expressed the belief that having the right people on the board is just as important if not more so as having the right rules under which the board operates. Nominating committees need to identify competent individuals who possess an "independent spirit" which allows board members to raise difficult questions and probe issues related

[2]One source of information on best practices of leading companies is the 1999 *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.*

to management's decisions to ensure that the company operates honestly and effectively in the shareholders' interest. Even if board members are independent, they can be ineffective as directors if they lack expertise or knowledge relevant to the company and its business. Therefore, board members must also be willing to educate themselves about the company and the risks it faces rather than relying on a checklist mentality of corporate governance requirements issued by the stock exchanges.

Participants also noted that unfortunately, as a result of the recent major financial reporting issues leading to restatements and, in some cases, bankruptcy, board members have focused on the rules and may be concerned more about their personal reputation and financial liability rather than focusing on protecting shareholders' interests and adding shareholder value. Participants expressed concern that disincentives such as legal liabilities, including financial and reputation risks, may limit a board's ability to attract the right people to serve over time.

Participants raised the question whether the current system of selecting directors needs to be reexamined because the existing system from a shareholders' point of view has not been working to get the right people on boards. For example, it was viewed that individuals who serve on numerous boards at the same time and/or who serve for personal incentives, over time lose the "independent spirit" needed to be an effective board member. Participants also stated there is some evidence that the recruiting of directors is being adversely affected by the current environment that is placing ever-increasing demands on board members. Examples were cited of increased premiums for finding qualified board members and such searches needing to identify 15 candidates for a board position just to get one who is willing to serve. Other participants commented that there is no shortage of qualified people to serve on boards of directors. Many people are willing to serve higher goals and the selection process needs to go beyond "its usual pool of suspects." Some participants suggested that perhaps serving as a director on a board should be a salaried position if shareholders were willing to bear the cost. Other participants noted, however, that having salaried board members could be problematic because shareholders would have to be able to hire and fire the directors that would cause great instability and salaried board members may also lack an "independent spirit."

Participants also discussed the appropriateness of the chief executive officer (CEO) serving as chairman of the board of directors, which could present potential conflicts resulting from a single individual functioning in

these dual roles. Some participants believed that separation of the CEO and chairman of the board positions recognizes the differences in their roles and eliminates conflicts in functions. For example, management is responsible for the operations of the company and members of the board in their oversight function should have the ability to challenge the CEO in managing the company. Although the corporate governance community in the United States may not currently be receptive to requiring the separation of the CEO and the chairman of the board, such a practice does exist in the United Kingdom, where apparently there is more receptivity. Therefore, regulators may need to look beyond the United States to consider the merit of whether these positions should be held by different individuals.

Other participants pointed out that not allowing the CEO to also serve as the chairman of the board of directors does not guarantee that problems will be avoided if the board lacks an independent spirit to question management, citing such examples as Enron, Global Crossing, and WorldCom, all of which had a separate CEO and chairman. Some separations of the CEO and chairman functions are successful and others are not. A CEO may lose authority when the position is too diluted. United States firms have been successful because they have had strong leaders running them, and an effective and strong board of directors can counterbalance a strong executive.

Financial Reporting

Little Has Changed with the Financial Reporting Model

Participants commented that traditional financial statements, in terms of their form and content, have not really changed over the years. The model we have today can be traced all the way back to the early 1970s (back to the Trueblood Committee).[3] Participants attributed this lack of change to the financial reporting model being largely driven by the supply side, that is accountants, regulators, and corporate management and boards of directors. Participants referred to a landmark study on financial reporting by the Jenkins Committee[4] as evidence that little has changed. Participants acknowledged that accounting standards have changed to capture fair value in addition to historical value, resulting in a model that is now a mixture of the two, whereas the original financial statement model was based solely on historical costs. However, the majority of the Jenkins Committee's recommendations never got any "traction" to move them forward. The Financial Accounting Standards Board (FASB) has many of these items on its agenda. At the same time, there are many other items on FASB's agenda. Participants felt that if stakeholders were serious about improving the financial reporting model, a group would be established and funded specifically for this purpose. Participants stated that such a group was proposed by the Jenkins Committee, but it was never established. There needs to be a sense of urgency in order to make the investment, commitment, and ultimately change the model. However, one participant questioned that since almost 10 years have gone by since the Jenkins Committee made its recommendations, is there really a demand for change?

[3]The Trueblood Committee (named after the chairman), a group formed by the American Institute of Certified Public Accountants (AICPA) to study the objectives of financial reporting, recommended financial statements that set forth the objectives of financial accounting and reporting and provided a conceptual framework for deliberations about accounting matters. (See the AICPA's *Objectives of Financial Statements*, Report of the Study Group on the Objectives of Financial Statements, October 1973.)

[4]The Jenkins Committee (named after the chairman), a group formed by the AICPA in 1991 to address concerns over the relevance and usefulness of financial reporting, recommended in its 1994 report that standard setters develop a comprehensive reporting model that includes both financial information (financial statements and related disclosures) and nonfinancial information (such as high-level operating data and performance measures used by management, management's analysis of changes in financial and nonfinancial data, and forward-looking information about opportunities, risks, and management's plans). (See the AICPA's *Improving Business Reporting—A Customer Focus: Meeting the Information Needs of Investors and Creditors*, Comprehensive Report of the Special Committee on Financial Reporting, 1994.)

Current Financial Reporting Model Has Limited Value in Today's Business Environment

Some participants agreed that financial statements are an important aspect of overall business reporting, but were concerned that the existing model focuses too much on financial statements rather than on the broad range of information that is needed by investors to make good financial decisions. Other participants commented that financial statements that exist today, while they may be useful to some, are not used very much by investors. Financial statement disclosures are difficult to understand, as though written in a "foreign language." Participants stated that the disclosures must be made more understandable.

However, there is a lot of dialogue taking place today concerning business reporting. For example, regulators are asking what should be disclosed, what is the purpose of financial statements, and how useful are they? What are analysts doing with financial statements? What do analysts use to value stock? Are they using financial statements? If so, what information in the financial statements are they using to value stock? What additional information would assist them in more accurately valuing stock? Participants noted the need to report information about the business model, as users of financial reports first must better understand the entity's business model in order to comprehend financial and nonfinancial information about the entity.

Financial statements today focus on reliability much more than on relevance. Historical information is reliable, but not necessarily relevant. Fair value information is evolving but improvements in reliability are needed. Participants agreed that reliability is fundamental to useful business reporting; however, participants felt that financial reporting would be much more useful if it were expanded to include key performance indicators and measures (including disclosures on how the key measures were chosen). Participants raised questions about the gaps in reporting of intangibles. For example, in a knowledge-based economy, one could argue that the most important assets are people (human capital); however, current financial reporting records investments in people as an expense and liability. Participants agreed that it would be useful if financial reporting recognized people as assets, but raised the difficulty in valuing human capital. Participants generally agreed that there is a demand for both historical and fair value reporting. However, participants felt that FASB needed to better differentiate between the two. In that respect, some participants felt that FASB is marching toward a "fair value" path and cautioned that the fair value reporting model is not always good and needs to be used only where it really makes sense.

Participants acknowledged that financial reporting, in addition to being largely driven by the accounting profession, also has been driven by the legal system, resulting in an overload of information that is too complex and not easily understood. Disclosures that run on for pages are not understandable. Experts are needed to interpret the disclosures and sometimes even they cannot decipher what is being reported. However, participants understand that accountants are taking a risk when they issue an opinion on the financial statements. The litigious environment has also led to a “check box” mentality where it is more important to follow the accounting rules when preparing financial statements than actually reporting the economic substance of the transaction.

Considerations for Moving toward a Comprehensive Financial Reporting Model

Participants generally agreed that financial statements are not designed to serve all business needs and that other types of business reporting are needed to assist investors and other users in making decisions. Participants also generally agreed that the demand side (investors and other users of financial information), has not been as involved as it needs to be to make financial reporting more meaningful and understandable. More needs to be done to convince investors and other users to demand different reporting. Voluntary disclosures are rare and only in industries that demand this type of information. The voluntary process has resulted in some movement toward better reporting, but it is very slow moving. Change is going to have to come from the demand side and is going to require a lot of leadership from very influential people. Input from advisory councils may also be beneficial for developing a broader business reporting model. While it is essential that a new model not be driven totally by the supply side (accountants, regulators, corporate management, and boards of directors), there cannot be a disconnect between the supply and demand sides.

Participants also cautioned that we need to move forward patiently toward a new comprehensive reporting model. It was viewed that forward, real-time, qualitative information, all of which would be helpful in predicting future cash flows, may require a safe harbor from liability. It is also important to keep in mind the role of the regulator in this process since the public needs to have confidence in the regulators to enforce rules. Regulators may not be totally supportive of a more comprehensive business model because they are concerned that the information would be based on a lot of judgment and, therefore, lack of precision, which could make enforcement of reporting standards difficult.

Participants discussed the lack of investor confidence in the current financial reporting model and the need to first improve the reliability of financial reporting before adding any new reporting. First, get the basics right, that is, the “blocking and tackling” of financial reporting. Participants cited accounting for pensions, postemployment benefits, and pro-forma financial statements as examples of accounting treatments that need attention before building on any new reporting requirements. Issuers of financial statements who are inappropriately bending the current accounting rules need to know they cannot get away with this anymore.

Participants discussed the merits of replacing accounting rules with principle-based standards to promote more substance versus form in reporting. However, some participants cautioned that principle-based standards should not be viewed as a panacea to solve the problems with financial reporting and could lead to an undesirable situation where you would not have comparability or agreement as to the treatment of similar transactions. Also, stakeholders may not interpret principles consistently, and it is important for stakeholders to have the same conceptual framework as preparers when interpreting a principle. In addition, you would need the right kind of implementation guidance to carry out a principle. Participants agreed that while accounting rules are also needed, there should not be such blind adherence to accounting rules to result in reporting form over substance. Participants offered that an “artful” blend of both principles and rules would be useful. The Employee Retirement Income Security Act (ERISA) was cited as an example of an approach that blended both a principles-based (general fiduciary standards) and rules-based (prohibited transactions) approach to an important issue (retirement security).

Participants also discussed the idea of exploring different levels or layers of reporting while still having full disclosure. Such layering will allow users to get only the information they need. For example, the basic level of reporting would include performance and risk data, an industry layer could include benchmarking information, and a company specific layer could include information management feels it is appropriate to disclose that is not contained in other layers of reporting. Along with this idea is the need to explore different levels of verification or assurances by independent parties based on the users’ need for such verification or assurances. For example, what type of assurances are needed for nonfinanical information and can auditors provide such assurances? Overall, it is critical to get the demand side (investors and other users of financial information) to weigh in on what information they need and want. It is not realistic to only expect

the supply side (accountants, regulators, and corporate management and boards of directors) to come up with the best solutions for improving the financial reporting model.

Although time did not permit its discussion, financial literacy was raised as an important issue that needs addressing. Participants agreed that there clearly is a need for more education and for investor assistance in this area.

The Accounting Profession

An Expectation Gap Exists Concerning the Role of Auditing

The participants discussed the auditor's responsibility for detecting fraud and the meaning of the assurances provided by the auditor's report on the financial statements. These issues have continued to plague the accounting profession since the 1970s despite actions taken by the profession to narrow the so-called "expectation gap" between what the public expects or needs and what auditors can and should reasonably be expected to accomplish.[5] Users often equate a clean audit opinion with a seal of approval that fraud does not exist and annual reports are both complete and accurate. However, auditors do not provide absolute assurance and the scope of the opinion is limited to certain financial-related information. One participant explained that there are a lot of things an audit cannot do. For example, an audit cannot create certainty in an environment where there is no certainty. An audit cannot guarantee precision in an environment where estimates are made. An audit cannot ensure that stock prices will be achieved. We cannot lose sight of the fact that in a risk-taking environment businesses do fail. Auditing is not the "be all" and "end all" to solve the problems in the business place. However, participants generally agreed that while the accounting profession needs to take additional steps to address any misunderstanding as to the limits of an audit, there is room to improve the audit process and auditor reporting.

[5]We reported on this issue in *The Accounting Profession: Major Issues: Progress and Concerns* (GAO/AIMD-96-98, Washington, D.C.: Sept. 24, 1996).

Participants recognized that management has the responsibility for preventing and detecting fraud. At the same time, they agreed that it is fair to expect auditors to provide "reasonable assurance" of detecting any material fraud. Participants discussed the need to mitigate the opportunity and risk for fraud by educating boards of directors and ultimately changing the tone at the top of the company. Some participants liked the idea of auditors periodically performing more of a "forensic-type" audit[6] in which auditors would be more skeptical of management, but cautioned that this approach could have a negative effect on audit quality because management and the auditor might not work as actively together on an ongoing basis. Participants agreed that an adversarial relationship between the auditor and management would not be constructive in that the cooperation of management is critical to both an effective and efficient audit. However, participants agreed that auditors should be more skeptical and should say no and walk away from clients more often than they currently do. The participants applauded the deterrent put in place by the Sarbanes-Oxley Act of 2002, which sends a signal that persons who prepare or attest to fraudulent financial statements can go to jail. This deterrent has raised awareness and conscientiousness within all levels of the financial reporting and auditing process as to the significance of their job in preparing financial statements.

[6]The concept of forensic auditing was recently suggested by the Panel on Audit Effectiveness to improve the likelihood that auditors will detect fraudulent financial reporting (see *The Panel on Audit Effectiveness Report and Recommendations*, Aug. 31, 2000). Forensic auditing, as explained by the Panel, would require that auditors undertake an attitudinal shift in their degree of skepticism and presume the possibility of dishonesty at various levels of management, including collusion, overriding of controls, and falsification of documents.

Participants generally viewed the new internal control reporting requirements of the Sarbanes-Oxley Act of 2002 as a good requirement. A participant added that earlier mandatory internal control reporting probably would have surfaced problems with ineffective boards of directors and audit committees.[7] However, participants cautioned that reporting only on internal controls over financial reporting could lead to more of a gap in what investors perceive as the scope of the auditor's work. For example, users of financial reports are interested in a company's overall performance and outlook and, accordingly, would be interested in the effectiveness of internal control over the process that produces that data. In that respect, participants also discussed the need for auditors to expand their focus on internal control to include controls over performance data in order to better meet the needs of investors for assurances on financial statements and for understanding all business risks. Also, new information not only needs to be useful, but also needs to be understood by investors. For example, investors do not understand terminology such as "reportable conditions,"[8] which could result in investors over- or under-reacting to problems. Participants also suggested that the one-page audit opinion should be replaced with "tiered" reporting of audit results, where firms can obtain the level of assurance they desired. For example, in today's environment, audit committees would most likely ask for the deepest "tier" of audit reporting to better carry out their responsibilities.

Participants generally agreed that the profession needs a new reporting model for audits to eliminate the misunderstanding as to what an audit of financial statements is and what its limits are. The participants acknowledged that the financial audit process is largely driven by the accounting profession and suggested that the profession needs to spend more time understanding what the demand side (investors and other users of financial information) needs and wants from auditors. However, the participants recognized that one of the big obstacles for innovation in

[7]This comment was based on the standards and guidance contained in *Internal Control-Integrated Framework*, published by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission, for reporting on the effectiveness of internal control, which addresses a company's control environment including boards of directors and audit committees.

[8]The AICPA's Generally Accepted Auditing Standards defines a reportable condition as a significant deficiency in the design or operation of internal control that could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements.

reforming the audit process and auditor reporting is the auditor's fear of legal liability. One participant added that the current regulatory structure has dampened the profession's spirit for innovation.

More Attention Is Needed on the Quality of Audits

Participants commented that there are good solid audits being performed; however, some participants expressed concern that overall, time and fee pressures both from company management and from within the auditing firms have resulted in less and less auditing, particularly less substantive testing of transactions. In that respect, the financial audit is considered the "loss leader" in many audit organizations with a focus on cutting hours and costs and as a means to obtain consulting engagements. Some participants also pointed out that most of the auditing is currently being performed by inexperienced auditors. Further, several participants cautioned that the auditor rotation rules currently being developed by the regulators could further reduce audit quality by resulting in a loss of continuity, experience, and technical knowledge on an audit.

Participants felt that the profession needs to elevate and restore the importance and the quality of the financial statement audit. Participants stated that the accounting profession needs to candidly discuss what it is doing to improve the audit process to restore public trust. Further, a growing concern for the profession is its ability to attract and retain the best people over time. It was stated that auditors frequently leave the profession early in their careers to join clients, and that over half of CPAs are not practicing public accounting. One participant added that the interest in the profession over the past 10 years has dropped by half, although the recent publicity stemming from Enron and WorldCom, albeit negative, has actually sparked increased interest in the profession. Participants generally agreed that the profession needs to aggressively address the issue of attracting the best people to the profession.

Auditors Need to Strengthen Their Relationship with Others in the Corporate Governance Process

Participants generally agreed that improvements in corporate governance will bring about improvements in auditing. It was viewed that one of the more positive outcomes of the Sarbanes-Oxley Act of 2002 is the relationship the act establishes between the auditor and audit committee by making the audit committee in essence the client, versus company management. Historically, participants felt that auditor communication with audit committees has been variable. Participants generally agreed that auditors should be able to speak more freely, openly, and honestly with

audit committees on risks facing the company and on the appropriateness of the company's accounting policies. Audit committees should be demanding more information from auditors and asking auditors if they have sufficient resources, both in number and expertise, to adequately perform the audit. Audit committees and auditors together can become good safeguards for investors. A point was also made that the role of the internal auditors, specifically their cooperation and coordination with the external auditors and the board of directors, should be improved, which ultimately could improve the quality of financial reporting and the external audit. In addition, disclosures, such as those required to be reported to the SEC on Form 8-K,[9] should be improved to be more transparent and helpful to regulators in determining the reasons and circumstances surrounding auditor changes.

[9]An SEC registrant must file a Form 8-K when its external auditor resigns, declines to stand for reelection, or is dismissed.

Regulation and Enforcement

Providing the SEC with Sufficient Resources to Restore Investor Confidence

Participants uniformly agreed that the nation needs a strong, viable SEC to instill investor confidence in our markets. The SEC plays an important role through its responsibilities to regulate activities of public companies and their auditors and to conduct related enforcement actions, as well as to establish and sustain the new Public Company Accounting Oversight Board (PCAOB) established by the Sarbanes-Oxley Act of 2002 until the PCAOB is certified by the SEC as ready to operate. However, participants noted the SEC may not have been provided with sufficient resources to achieve such results. For example, participants stated that the SEC has recently been operating on a budget of about $450 million.[10] It was noted that although the Senate authorized about $750 million for the SEC for fiscal year 2003, an amount that the Senate believed would be sufficient to implement provisions of the Sarbanes-Oxley legislation to restore investor confidence, the Office of Management and Budget only proposed a funding level of about $500 million.

Participants believed that a lack of sufficient funding provides constraints in two areas that are vital to the SEC—staffing and technology. To carry out its important function of restoring investor confidence, the SEC may not always be able to attract the right people and retain them under the existing structure. In addition, to effectively conduct its reviews of public companies, the SEC will require a large technology investment and related training of SEC staff. Participants questioned whether, given the current funding restraints, existing models for generating revenues for the SEC were workable. Participants believe that models that provide temporary resources to SEC, such as through fellowships from the accounting profession, are not the answer to its funding and staffing problems and can raise conflict of interest issues. Accordingly, some participants believed that it is time to think about having the SEC operate independently in setting its own funding levels, like the Federal Reserve, and to let the SEC determine and set its own fees, with industry participation, for the activities it conducts. If the SEC were able to establish its own annual budget and collect fees, the SEC would be better able to conduct its

[10]Prior GAO reports and testimonies discuss SEC resource issues and the need for the SEC to improve its strategic planning to more effectively manage its operations and limited resources. See U.S. General Accounting Office, *SEC Operations: Increased Workload Creates Challenges*, GAO-02-302, Washington, D.C.: Mar. 5, 2002) and U.S. General Accounting Office, *Protecting the Public's Interests: Considerations for Addressing Selected Regulatory Oversight, Auditing, Corporate Governance, and Financial Reporting Issues*, GAO-02-601T, Washington, D.C.: Apr. 9, 2002).

activities, attract the best people, and enhance its technology to more efficiently and effectively operate. Participants noted that even if the SEC were independent regarding its funding, the Congress could still oversee the SEC.

Reconsidering the Existing Approach to Enforcement Actions to Restore Public Confidence

Participants discussed the importance of effective SEC enforcement actions as a means of restoring investor confidence in the markets. The SEC tries to create deterrence and be measured in imposing sanctions. If there are no clear negative consequences to securities violations or wrongdoing, investors may perceive that the system is not working properly. Although the SEC has an array of sanctions available, all SEC enforcement actions are civil based, which ultimately results in shareholders bearing the burden of the costs of legal proceedings and sanctions. Some participants believed that shareholders were benefiting from litigation and questioned the appropriateness of civil-based enforcement actions, citing the fact that shareholders have already been financially hurt by the actions that lead to the sanctions. Participants also discussed whether the right people were being held accountable and whether the SEC's civil-based enforcement actions were sufficient to discourage the bad actors.

Participants raised questions about whether the SEC should reconsider the amount and targeting of its civil sanctions and more frequently use other types of remedies, such as criminal sanctions, to hold people accountable for wrongdoing. In that respect, participants noted that the SEC should be effectively using the option of referring cases when appropriate to the Department of Justice for investigation for possible violation of criminal statues. Participants questioned how well that process was working.

The Sarbanes-Oxley Act of 2002 provides for additional enforcement authority for both the SEC and the newly created PCAOB. In response to the question of whether the Sarbanes-Oxley Act of 2002 should be revisited, participants believed that although ultimately some technical changes to the act may be necessary, the SEC and the PCAOB needed to move forward to implement the act. Also, the SEC and the PCAOB should explore integrating their activities to get the new enforcement mechanisms in place to determine how well they may address some of the issues discussed.

Establishing Priorities for the PCAOB

Participants believed that the PCAOB needs to be quickly set up and establish its priorities so it can begin the difficult task of restoring public confidence. Many participants believed that the PCAOB's most immediate priority should be implementing a disciplinary process to let the public know that failed auditing will be dealt with and trust can be restored. The disciplinary process needs to have the necessary incentive measures to serve as preventative measures before problems can become more serious. Other immediate priorities should be setting up an inspection function of auditors that audit SEC registrants and determining how standards that govern the work of the accounting profession, such as auditor independence rules and standards for conducting audits, should be set. Some participants believed that the existing inspection process could be improved by looking less at the accounting firms' internal systems for quality control and more at the quality of the judgments that were made by the auditors in conducting the audit.

Participants also believed that the PCAOB also needs to evaluate the events that have lead to the lack of public confidence in the markets and take a fresh look going forward. For example, the PCAOB should consider the reasons the accounting profession is organized the way it is, including federal/state regulation such as the licensing structure, reasons accounting firms practice as partnerships, the effects of private litigation, and the structure and role of the state boards of accountancy. Participants also noted that the PCAOB should take advantage of the fact that under the current environment no one has more motivation for getting "bad auditors off the street" than the accounting firms themselves. The accounting firms do remove "bad auditors," but this is accomplished without publicity so that their efforts are not well known.

Participants also believed that a challenge facing the new PCAOB will be dealing with the complex relationship between federal and state governments involved in regulating the accounting profession.[11] Participants identified the need for better communication and sharing of information between federal entities such as the SEC and the new PCAOB and the state licensing and regulating entities. For example, states are often hampered in their ability to take appropriate regulatory actions because

[11]Our report, *The Accounting Profession: Status of Panel on Audit Effectiveness Recommendations to Enhance the Self-Regulatory System* (GAO-02-411, Washington, D.C.: May 15, 2002) discusses the various bodies that regulate the accounting profession.

they do not get referrals from the SEC and the AICPA, or because those organizations have made the information confidential. Also, ongoing litigation impedes information flow. In addition, participants stated that some states have been independently trying to address accountancy reform and, in some cases, have proposed reforms that have gone further than the Sarbanes-Oxley Act of 2002 because they feared that the federal government would not act. This has led to additional inconsistency in requirements between states.

Participants encouraged the SEC and the PCAOB to work closely with the states in taking actions to restore public confidence and ensure an appropriate degree of consistency needed for viable interstate commerce. Some participants suggested that the PCAOB consider the banking industry to provide examples of the integration of federal and state regulation and lessons learned about that structure from the savings and loan and banking crises. Participants noted that with increased globalization of businesses' operations and the need for harmonization of accounting and auditing standards, as well as the need for preemptive measures, there may be more federal involvement such as the Sarbanes-Oxley Act of 2002.

GAO's Governance and Accountability Forum

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