Oversight Hearing on "Accounting and Investor Protection Issues Raised by Enron and Other Public Companies."

**Prepared Statement of The Honorable Richard C. Breeden
Chairman, Securities and Exchange Commission
1989-93**

10:00 a.m., Tuesday, February 12, 2002 - Dirksen 538

Responding to Enron – Strengthening Accounting and Disclosure

Chairman Sarbanes, Senator Gramm, Members of the Committee. It is a great pleasure to appear once again before this Committee. I was privileged to serve as Chairman of the Securities and Exchange Commission from 1989-1993. In total I served for nearly ten years in government posts spanning the administrations of Presidents Reagan, Bush (41) and Clinton.

I began my career in New York City as a corporate finance lawyer. For the past few years I have served as the bankruptcy trustee unraveling what is thought to have been the largest ponzi style fraud in U.S. history, with petition date liabilities to creditors of just over $1 billion. When the case is closed later this year I expect total recoveries will exceed $700 million. As part of that case I built up a public company controlled by our bankruptcy estate and served as its CEO for several years. That company was sold yesterday for just over $100 million for our creditors and other shareholders[2].

After leaving the Commission in 1993, I spent three years as a senior partner at Coopers & Lybrand, LLC., where I coordinated the financial services industry program. I currently serve as an outside director on two boards and audit committees of publicly traded companies, and my firm works as an intensive care specialist for companies experiencing financial distress or crisis. Thus, during my career I have had the occasion to consider the issues of accounting, disclosure and corporate governance as a lawyer, business executive, outside and inside director, accounting firm principal and of course as a regulator.

In 1989, while serving as Assistant to the President for President George H.W. Bush, it was my great privilege to work with the members and staff of this Committee to craft the landmark legislation that ended the savings and loan crisis in America. That was an example of the utmost level of bipartisan cooperation to solve a financial threat to the American economy, and to the savings of tens of millions of our citizens. As a result of our work, the U.S. was able to eliminate the threat to the financial system and to put the savings and loan industry back on the path to solvency. Though I don't think anyone involved in that effort got much credit, from President Bush who provided strong leadership to the members of Congress who worked closely with us and made forthright decisions for America's future. However, we successfully repaired a system that had been devastated by financial corruption, extremely poor business and lending practices, and in some cases outright criminality. Today America has the strongest banking system in the world, and our savings institutions are strong and healthy due in no small part to the legislation that we created together.

With this example in mind, I am optimistic that this Committee has the capacity to play a vital leadership role in devising responses to the events that took place at Enron Corporation and Arthur Andersen ("Andersen"). The collapse of Enron and the parallel shredding of documents and audit failures at Andersen have highlighted weaknesses in our corporate governance, accounting principles, auditing practices, disclosure standards, pension systems and bankruptcy laws, to say nothing of the ethics of some of the major actors.

While it is easy to condemn the abuses that occurred at Enron/Andersen, the difficult task is to design successful reforms. Improving transparency of information in the market, producing better accuracy in audited financial statements and encouraging better governance of both accounting firms and corporations are worthwhile goals, but the trick is how to actually accomplish these objectives. Also, we need to make any improvements without damaging the systems we already have in place, or creating unnecessary costs or overbroad regulation. A group of specific possible improvements are included in this testimony for your consideration. These are phrased as things that the Committee should consider, since there are pros and cons associated with every step, though in my experience they would improve our current system. However, before describing the specific steps, I would like to outline the overall philosophy that I bring to this analysis to give context to the problems these recommendations are meant to address.

OVERVIEW

Overall, the United States has the finest system of accounting and disclosure for publicly traded companies of any country. Our equity markets have historically provided a wonderful opportunity for democratic capitalism that has allowed tens of millions of investors to participate in a broad- based ownership of our economy. For decades public policy in the U.S. has mandated a rule of law for the market to prevent price manipulation, financial fraud, insider abuses and other forms of market corruption. In doing that, the federal government has sought not to limit free markets, but to protect their integrity by precluding attempts to rig markets or dilute market forces through fraud. We have more comprehensive disclosure of business practices, risks and results than any other marketplace, and that policy of "transparency" has served our nation well.

Since the SEC was created in 1934, both Republicans and Democrats have been willing to put teeth into the commitment that our markets will function within the rule of law, and to achieve the values that are embedded in those laws. We believe our markets should be fair and open to all participants, from the smallest individual investor to the largest institutions. We also believe that it is morally wrong to lie, and to seek to profit based on misleading others concerning the truth of your financial statements. We have made such conduct unlawful both because such market corruption is inconsistent with our values as a nation, and also because this conduct harms our economy by driving investors and their liquidity away from the market where it can finance jobs and growth.

Trading on insider information, for example, was unlawful in the U.S. while it was an Olympic sport in other countries. We have not only formally required transparency, but we have devoted real resources to policing the accuracy and relevance of financial statements and the adequacy of disclosure. All of us who have served at the SEC have had the job of putting aside any consideration other than protecting honesty and integrity in our markets, and vindicating the trust of Americans of all walks of life in the fundamental fairness of our markets.

In the Enron/Andersen case, the trust of investors and employees alike was subverted principally by senior executives seeking to enrich themselves by painting a picture of an Enron that evidently did not exist. While the real Enron had lost hundreds of millions of dollars speculating in stocks of other companies and through bad investments of one kind or another, the Enron shown to investors had nothing but successes to its credit. They were supermen not because of good performance, but because they were good at hiding "income statement volatility", also known as losses, behind a wall of accounting tricks. Indeed, with the savings and loans we used to criticize "smoke and mirror" accounting. In those terms Enron burned down the forest, and employed the entire Hall of Mirrors.

The interests of employees, retirees, and investors across the country were thrown under the Enron bus, and from the facts we have seen this appears to have been done deliberately. Of course someone always has to light the fire before the books can be cooked. The spectacle of insiders aware of the deadly risks of the "Raptors" selling securities while encouraging their employees to invest has aroused the indignation of millions, as has the flagrant breach of trust that some of the Enron executives displayed in plundering their own company.

More threatening to the economy than the personal dishonesty of individual executives is the rising question in the markets of whether the accuracy of financial statements can be trusted. If the market loses the ability to trust the accuracy of the financial presentations that auditors certify, the result could be very significant risk premiums or lack of liquidity for other companies. This is serious collateral damage for investment markets, and we have seen this effect in the market over the past few weeks.

Given the stakes, it is very troubling the Andersen is reported to have had very serious doubts about the potential for massive inaccuracy in the statements. Yet they apparently sat on their hands when they could have shared their doubts with the audit committee or refused to acquiesce in the company’s proposed financial presentations. The fact that Andersen had accepted millions of dollars in fees to help design the accounting for the partnerships creates a considerable question of conflict for Andersen in making its audit decisions.

Enron may have won its favorable accounting treatment in part by failing to disclose all the facts to Andersen, or Andersen may have adopted a "hear no evil, see no evil" approach to its audit to avoid the risk that management might have dumped it from an extremely lucrative audit assignment. The timing of the destruction of documents by the Andersen audit team suggests that these individuals may have thought they had something to hide. At a minimum

Andersen was unable to put aside its economic interests to stand up to Enron.

The Critical Role of Auditors

Accountants play a unique role as the scorekeepers of the market economy. While companies in the U.S. don't have to employ a law firm, an underwriter, or other types of professionals, federal law requires a publicly traded company to hire an independent accounting firm to perform an annual audit. In addition to this shared federal monopoly, more than a hundred million investors in the U.S. depend on audited financial statements to make investment decisions. This imbues accounting firms with a high level of public trust, and also explains why there is a strong federal interest in how well the accounting system functions.

Auditors are there to get the numbers right, not to help CEOs or CFOs hide debt, artificially inflate income, and conceal risk. The ultimate objective of the system is for investors, creditors and other participants in the market to have a full and fair picture of the financial condition of the company and its results. Market participants need to be able to understand a company's risk posture and trends in its results. To do that, they have to be able to see the entire picture of a company's financials, not carefully selected pieces. Auditing a financial statement is supposed to be an exercise in sober reality, not abstract art.

Our tools in getting the numbers right include accounting principles that accurately reflect economic substance ("GAAP", or generally accepted accounting principles), auditing standards that detect false numbers ("GAAS", or generally accepted auditing standards), and trained and capable accountants proficient in the application of GAAP and GAAS, backed by firms with sophisticated software, and multiple layers of internal review. The system also relies on the auditor's independence and integrity to apply GAAP and GAAS competently, and irrespective of pressure from the issuer. Enron has exposed weaknesses in every one of these areas.

Part of the problem in Enron was the abysmally poor quality of FASB pronouncements concerning off balance sheet liabilities, and the latitude that exists to "accrue" profits out of mathematical models without adequate safeguards to test the validity of the results. The poor quality of these standards gives wide scope for mischief in their interpretation. Another part of the problem, however, was that those with responsibility for insisting on full and fair disclosure by the company appear to have ignored their duties to the investing public.

Even as accounting firms have steadily consolidated into some of the largest businesses in the world, earnings restatements and blown audits appear to be happening with more frequency, and getting bigger. Each of the Big Five has had huge cases where reported earnings either were nonexistent or were substantially overstated. This suggests that there is something in the internal dynamics of the firms themselves that has gotten in the way of audit accuracy and integrity. Clearly we can do a better job and everyone should work together toward that objective.

SUMMARY OF REFORMS

As described above, I recommend that this Committee should ***consider*** a number of steps to make our financial reporting and disclosure system better and more resilient. These would include:

I. Improving Government Oversight of Accounting and Disclosure

1. Strengthen the SEC's resources through expanded budget authority (offset by increased user fees), immediate and continuing funding of pay parity provisions, and addition of 200 new accounting positions. A new division within the SEC, not another private sector body, should be formed to oversee performance of auditors and their firms.
2. Add surveillance and prosecutorial resources at the Justice Department to oversee accounting fraud cases.
3. Simplify criminal and civil standards so that there will be realistic deterrence against accounting abuses through speedy and effective disciplinary cases.
4. Give the SEC authority to suspend accounting firms from accepting new audit clients for limited periods (eg 6 months suspension) where repeated and flagrant audit failures from the same audit firm suggest failure of internal supervision and training. SEC should also have the authority to bar an accounting firm from accepting the renewal of a specific audit engagement where large restatements or other problems have occurred.
5. Give the SEC authority to mandate the retention of "books and records" of accounting firms relating to the audit of publicly traded companies. Make destruction of documents relating to audits of public companies a criminal

offense, and failure to supervise compliance with SEC requirements as well.

6. Mandatory review of all audits when any company files for bankruptcy within defined period of receiving a "clean" audit opinion, or when major restatements occur.
7. Give the SEC enhanced authority over the setting of accounting standards themselves, without politicizing standard-setting. SEC should have authority to mandate deadlines, or to establish standards (or utilize standards from international accounting standards board or other authorities) where it finds FASB pronouncements not to be in the interest of investors.

II. Enhancing Performance and Accountability for Accounting Firms

8. Accounting firms that audit publicly traded companies should be required to have a board of directors with a majority of outside, non-industry directors in a manner similar to current governance of stock exchanges.
9. Consulting activities by accounting firms should be prohibited, save for activities determined by the SEC to be closely related to auditing and that can be performed in a manner determined by the SEC.
10. Cooling off periods should be established for senior auditor personnel prior to employment at audit clients.
11. Risk management and audit quality control programs should be improved within audit firms.
12. Enact statutory affirmative duty to supervise audit personnel for management of audit firms.

III. Improved Accounting and Disclosure Standards

13. Enhance disclosure of "off balance sheet" transactions and debt
14. Enhance disclosure of accrual profits.
15. Enhance disclosure of specific impact of alternative accounting principles.
16. Enhance disclosure of use of "special purpose entity" ("SPE"). All SPEs doing business with an issuer, or whose results will affect the financial statements of the issuer, should be disclosed. Issuers should be required to disclose regularly the identity of any employees who perform services for an SPE, or who receive compensation from, or hold direct or indirect investments in, any SPE. Where any issuer has an SPE that is not accounted for as part of the issuer's financial statements, the issuer should publish its balance sheet, profit and loss statement and cash flow statement as they would appear if the SPE was treated as an "on balance sheet" entity.
17. Enhance disclosure requirements for acts raising conflict of interest concerns involving senior financial personnel or corporate leadership, irrespective of standard "materiality".
18. Speed up disclosure of all stock transactions by senior corporate executives.
19. Consider increased use of cash flow in accounting principles and disclosure.

IV. Corporate Reforms

20. Prohibit or require disclosure of conflicts of interest by the CFO or other financial officials
21. Enhance audit committee independence and role
22. Disgorgement of profits from insider stock sales within certain periods of time of corporate bankruptcy filing.
23. Prohibit use of stock or stock options to repay loans to executives or require immediate 8-K disclosure. Require compensation committee explanation in proxy statement of all loans to executives, specify amounts drawn down or repaid, and require shareholder ratification of any loans above a certain level.

V. Bankruptcy Reforms

24. Consider mandatory trusteeship for large bankrupt companies
25. Strengthen the power of bankruptcy trustees to bring actions against professionals, including accountants and lawyers, through express grant of standing irrespective of procedural hurdles at common law

VI. Other Steps

26. Enhance rating agency integrity.
27. Improve independence of stock analysts.

SPECIFIC REFORMS

Improving Government Oversight

<u>Substantially Increase SEC Resources, particularly focused on the accounting area. Add 200 new positions dedicated to detection and prosecution of accounting abuses and discipline of professionals, and provide full funding of pay parity.</u>

For decades the SEC has provided taxpayers with a great value per dollar expended. However, there has been chronic underfunding of the number of trained accounting examiners to review 34 Act filings, as well as to provide other vital oversight over the performance of auditing firms and their personnel. While 100 million Americans invest their savings in the market, and investors in Enron alone lost nearly $80 billion in market value, we spend less than $500 million per year on protecting the market with SEC oversight. The overall budget should ideally be doubled, with new resources directed to accounting specialists and examiners. Among other steps, implementing pay parity is vital, and this should be funded immediately to lower the ruinous rate of attrition among the most experienced accountants and analysts who are most capable of detecting a sophisticated problem.

Our markets are bigger and faster than at any time in history, and our oversight resources have not kept pace with growth in the size of the market and the number of investors. This is particularly true with respect to the resources to analyze financial statements and to challenge accounting presentations that are not justified. Like other big public companies, Enron’s regular filings were sampled every three or four years, while as events showed financial condition can change substantially in a much shorter period. The SEC should have enough staff in the accounting area to review new offerings and periodic filings, as well as to support enforcement cases in the accounting area.

Chairman Pitt has recently recommended a new private sector body to oversee the performance of auditors and accounting firms. A new body to supplement the SEC’s activities may be useful. However, I believe that oversight of the performance of auditors must ultimately come from the SEC itself. The history in this area is quite clear that private sector oversight has failed to make a meaningful impact on audit quality. The big firms will not challenge each other, and neither will the AICPA. Any new private sector group would be inherently too weak to take on an Arthur Andersen and/or a giant issuer. The pressure in any large case involving the major firms is enormous, and this is such serious business that the institutional strength of the SEC is absolutely necessary. An experimental new board, however qualified its members, will have virtually no chance to win the large cases of accounting failure that even the SEC has achieved only rarely over fierce opposition from the industry.

Of course increasing the budget at the SEC is not the only answer to the Enron problem, but it happens to be a necessary and vital step in putting better protections in place for investors in these vital markets.

<u>Add surveillance and prosecutorial resources at the Justice Department to oversee cases involving accounting fraud.</u>

One temptation to cook the books in a large public company is a possible gain measured in tens or hundreds of millions of dollars. It is essential that exposure to jail time be a realistic deterrent backing up the SEC’s efforts. Accounting cases are long and complex for the Justice Department, and require extensive pretrial preparation. These cases also benefit trustees in bankruptcy, and the creditors of failed firms who may recover more funds due to cooperation from criminal defendants. With multiple cases such as Enron and Global Crossing occurring after a long bull market, additional prosecutorial resources would be extremely helpful.

<u>Simplify legal standards and clarify authority to discipline accounting firms and their personnel, and increase potential penalties.</u>

During my time at the Commission, the SEC sought to suspend two partners of Coopers & Lybrand who had been found to have misapplied GAAP by allowing a company to capitalize expenses that should have been expensed, thereby overstating earnings. The audits in question occurred beginning in 1981 when John Shad was Chairman. The disciplinary case brought by the SEC extended from his tenure through 1998, when it was finally dismissed after at least three hearings at the Commission and two appeals to the D.C. Circuit Court of Appeals. Endless litigation took place over the standards the Commission was required to use to discipline accounting professionals. This type of challenge has also been raised in cases seeking to use cease and desist authority to discipline accountants who have failed to properly apply GAAP or GAAS. If disciplinary cases can be tied up in court for 17 years, the law should be clarified so that the Commission can provide realistic and timely discipline in its oversight process.

Give the SEC authority to bar accounting firms from accepting new audit engagements for temporary periods, or to order the replacement of an audit firm or to bar it from the next annual renewal of an auditing engagement where there have been large restatements or other serious problems, or the SEC determines that there has not been adequate adherence to GAAP or GAAS.

Where an audit firm experiences repeated audit failures, and has failed to install adequate safeguards for internal controls to prevent blown audits and restatements, the Commission should have the power to suspend the firm's ability to accept new audit engagements until the SEC is satisfied that the internal quality controls of the firm are adequate. This is comparable to the FAA' s authority to revoke an airline's license to provide service, or to ground a type of airliner due to repeated problems. Where a major bankruptcy or restatement has occurred, the SEC should have the ability to require a mandatory rotation of accountants, or to bar the incumbent firm from accepting renewal of the audit mandate.

Give the SEC specific authority to set minimum standards for "books and records" retention by auditors of publicly traded companies.

Given the shredding of documents that transpired at Andersen, the auditing firms should not be allowed to determine what documents they will preserve. These documents may prove vital to both SEC investigations, and also to investor or creditor actions against a company or its auditors in cases of fraud. The SEC should have the authority to specify minimum retention periods for various types of documents by auditors of publicly traded companies, in the same manner as the SEC can prescribe such record retention for broker dealers. Destruction of documents other than in compliance with SEC rules should be a criminal offense, as should be failure to supervise such compliance. Shredding of vital potential evidence should never be allowed.

Mandate reviews of audit performance in any case of bankruptcy or major earnings restatements.

When there is an airplane crash, the NTSB investigates the cause of the crash. Similarly, when a publicly traded company files for bankruptcy or makes a major restatement of earnings, within a specified period of receiving a clean audit opinion, either the SEC or some alternative body should be mandated to conduct a review of the compliance of the audit with GAAP and GAAS and to make its finding public.

Enhance SEC authority over the establishment of accounting standards.

Without politicizing standard-setting, the SEC should have greater say in the establishment of accounting standards by the FASB. Among other things the SEC should have the ability to designate priority actions and to set binding deadlines for FASB action. In addition, the SEC should be able to adopt international accounting standards or standards drafted by other authorities, as well as its own staff, where it finds that FASB standards are not in the interest of investors. The FASB is too slow, standards are too complex, and it is not sufficiently accountable for action.

Enhancing Performance and Accountability of Accounting Firms.

Require Audit Firms to have boards of directors with a majority of outside directors.

Getting to the heart of these problems involves shifting the balance of priorities ***inside*** the auditing firms in the direction of greater concern for getting the numbers right, and for creating healthy governance structures that will open up the highly insular big firms.

One way of shifting internal dynamics in favor of the public trust would be to require that, as a condition of satisfying the "independence" requirements, an auditing firm for a public company must have a board of directors with full power to remove management, to determine compensation, and to set overall policy. At least a majority of the members of such a board should be from outside the firm. As with stock exchanges, there should be a minimum number of "non-industry" directors on each board representing the interests of shareholders and users of the markets. Officers of audit clients should not be eligible to sit on such boards.

For historic, licensing and other reasons, the Big Five operate as limited liability partnerships rather than as corporations. They are by far the largest private business organizations that do not have a real board of directors. Internal governance comes from various committees drawn from within the firm, whose members are elected or chosen by the partners or the CEO. They are generally subordinate to the CEO, not independent of him or her. While it is an axiom of good corporate governance to have a majority (and typically much more than a majority) of independent directors who can among other things hold the CEO accountable for performance of the firm, the large accounting firms may not have ***ANY*** independent directors to provide a wider public perspective or to have the power to remove the CEO.

A board composed of independent directors (with similar standards for independence as a corporate director is required to have) would go a long way to bringing a more balanced approach to how these firms manage conflicts between their legitimate profit interests and their public responsibilities. Ultimately the CEO of any Big Five firm should be subject to getting replaced if the board does not have confidence in the firm's ability to deliver on its professionalism. There should be accountability for performance in audit quality, not just profit per partner, and that accountability at the top would be better exercised by a board of directors rather than the government. When Andersen was agonizing over its doubts regarding Enron's potential accounting fraud in February of 2001, discussing the issues with a board including outside independent directors could certainly have given management a better perspective on the decision they had to make and its potential impact on investors, retirees, and others.

A good precedent for requiring the Big Five and other auditors of publicly traded firms to create boards of directors can be found in the operation of stock markets themselves. Though stock exchanges have generally been mutually-owned institutions with many similarities to partnerships, these organizations have a board of directors, with a 50/50 balance of inside and outside directors. Independent boards is one way we institutionalize a body within each Exchange that is directly concerned with carrying out the exchange's responsibilities to the public.

Prohibit consulting activities by audit firms except where closely related to the performance of audits.

As Chairman Levitt noted repeatedly during his tenure, the pressure to win large consulting fees appears to have eroded auditor independence and professionalism, and it certainly has diverted focus and attention from the difficult job of auditing within the firms.

While each of the Big Five has now announced that it will terminate most consulting activities, the firms may differ in exactly what they will do, and who they will do it for. Competitive pressures may cause firms to minimize the services subject to voluntary restraints. Congress can formalize the separation the firms have already announced by limiting auditing firms to auditing services and other audit-related services as defined by the SEC. At a minimum, the auditing firms should be prohibited from providing financial structuring, investment banking, internal audit, data processing systems, and legal services for audit clients, and perhaps for any client. Audit committees should have the ability to authorize hiring the auditor for consulting services that are audit-related, such as using the auditors for tax or employee benefits planning so long as the fees for such services do not exceed 10-15% of the audit fee itself.

Consider Mandatory Rotation of Audit Engagements.

Though restricting the unhealthy pressure of auditor consulting makes sense, this step alone is not a magic bullet that will fix the deeper problems of the system. We have not yet seen evidence that Andersen's acquiescence to Enron's accounting decisions or its frenzy to destroy documents were driven by the consulting business Andersen performed for Enron, though this was most likely an element of the picture. However, the economic pressures relating to the audit fee itself are just as serious a threat to independence of the auditor, particularly if the firm is stripped of consulting businesses and becomes substantially more dependent on audit revenues than it is today.

There aren't many audit engagements in the world that pay $25 million each year in perpetuity, so Andersen management probably would have stretched as far as it thought was possible to maintain that lucrative annuity. Enron's audit fees to Andersen were probably large enough to make the Enron engagement partner at Andersen one of the firm's highest paid auditors. Thus, even if Andersen had been prohibited from everything other than auditing Enron, Andersen's decisions on the Enron audit could well have been influenced by many of the same pressures.

One means of insulating the audit firms from the pressure of keeping the audit engagement would be to provide for mandatory limits on audit engagements to a specified period of time, such as 5-7 years. This would cause considerable costs and dislocation, and could also have an adverse effect is some cases by displacing knowledgeable audit teams. A less drastic alternative would be to mandate that the audit committee conduct a formal reproposal process at least every 4-5 years, but leaving the decision up to the management and board.

Cooling off Periods

Both Lincoln Savings and Enron hired senior personnel from the audit team in senior financial position. The reward of a senior job could easily weaken audit independence. While we should not create excessive employment barriers, a cooling off period for a senior auditor hired by the issuer for its finance department in a senior capacity would be a defense against subtle pressures resulting from recent service together at the audit firm.

Investing in Audit Quality and Internal Controls

Another issue is the basic organization and control systems of the major firms. Ironically, while most of the firms provide consulting services to evaluate corporate "internal controls", risk management as a discipline is far less developed within the audit firms than would typically be true at a bank or broker dealer. There are large numbers of analytic measures that could be developed to focus a firm’s auditors on areas of special risk. For example, if profit growth is significantly higher than that of a peer group, auditors should at least seek to determine why, and whether extraordinary profits are located in any one area, as was the case with the Kidder Peabody problems a few years ago. If so, the accounting for outsized profits should be double-checked. Where total liabilities off balance sheet exceed a particular amount, such as 5% of assets or debt, then the firms should target special reviews of the qualification for off balance sheet treatment. Other financial ratios, or swings beyond a certain size depending on the outcome of any particular accounting issue, should also be considered for use in trying to identify audit engagements where supplemental resources, including potentially an entire new audit team, should be considered. Congress should encourage the audit firms to do much more in this area, such as by subjecting firms that do not satisfy an SEC review of their quality control program to additional remedial requirements.

Duties to Supervise

Another step would be to adopt statutory duties for accounting firms to supervise the conduct of their audit professionals in a manner parallel to the express duty to supervise that broker dealers have for their personnel. This duty to supervise is a very effective tool in overseeing brokerage firms, and it creates accountability for providing oversight that works. Where a firm repeatedly fails to supervise the conduct of audits properly, the SEC should have authority to require a broad range of remedial steps, including suspending the senior supervisory personnel.

Accounting Principles and Disclosure Requirements

Enron shows a weakness both in our accounting principles for off balance sheet transactions, and also in our disclosure policies. The FASB has long had a tortuously slow process for writing accounting standards, somewhat comparable to the pace of a glacier trying to run uphill. In recent years those standards have become enormously complicated too. This leaves a great deal of room for engineered solutions by those seeking to paint a particular picture.

Creative investment bankers and users of derivatives have spent the last ten years developing ways to move financial obligations off the books of corporations in conformity with highly complex standards. Teams of investment bankers and accountants may work years on developing structured transactions to accomplish a form of financing with attractive costs but that is not required to be shown on the balance sheet. Companies may hope that such off balance sheet debt will not be counted by rating agencies or noticed by investors. This does not mean that such activity violates GAAP or is wrong. Asset backed financing provides critical liquidity for many companies, and is very positive for the economy. However, such financings should be shown either on balance sheet or through supplemental disclosure.

From the perspective of ***disclosure policy,*** this may be the easiest problem to fix. Just because GAAP doesn’t require something to show up in the financial statements doesn’t mean it can’t, or shouldn’t, be disclosed. Where a company will have cash flow from a financing, it belongs on its balance sheet, and should certainly be disclosed. Where a debt has to be paid directly or indirectly from a company’s cash flow (or is diverted from cash flow the company would otherwise receive), that debt should be on the balance sheet and disclosed. More realism and less artificiality in financial statements was something I consistently pursued with the FASB during my tenure at the SEC, though I am not sure we made too much progress. Following the cash is a good way to get to the bottom of many mysteries, and highlighting cash flow earnings could provide more reality for investors. Where a company has contingent liabilities, such as Enron’s obligations to deliver stock to some of its partnerships to maintain certain values, the nature of those obligations should be disclosed comprehensively, and the impact of such contingencies under various scenarios should also be disclosed.

Some of Enron’s financing vehicles appear to have been structured to let the company report income that had never occurred, and that might never occur, while essentially arming a neutron bomb in its financial structure. That this was not clearly disclosed, and that nearly 50% of Enron’s assets could have been held off balance sheet, demonstrates that both GAAP and SEC disclosure standards need an expedited review and some fast corrective action to increase transparency. The SEC and FASB should work together to structure an appropriate combination of policies, with more on balance sheet treatment and vastly more disclosure.

Obviously at some point an asset may be sold, with no right to get it back, and without any potential future impact on the Company’s future earnings or operations. However, where transactions are financings in one guise or another, with cash ultimately being realized by a company that in one form or another will be repaid (or that might have to be repaid) out of future operations, then the overall transaction and the risks it entails should be shown either on the balance sheet, or in clear schedules included with the financial statements.

Real Profits, Not Accrual

Sometimes accounting standards are constructed in ways that may be theoretically elegant but work to the disadvantage of investors and give too many opportunities for mischief in the real world. One example of this is "accrual" of profits that haven’t yet arrived in fact, such as "gain on sale" and "mark to model" accounting. Under gain on sale, profits from the spread between interest earned and interest paid over a loan with a term lasting many years are rolled forward to the present when the loan is "sold". The accounting rule takes profit that might never occur and reports it today as if it already happened.

A similar problem exists with many derivative instruments, particularly long duration contracts that are one of a kind, without a trading market to provide a valuation. Enron created many such instruments, and it booked enormous profits on some contracts based on theoretical models that purported to value the cash flows that might occur pursuant to the contracts as much as 10 or more years in the future. Of course if the assumptions that the model uses are bad, the answers will be too – "garbage in, garbage out". An auditor has a difficult job to test the realism of the assumptions used in such valuations. An investor can’t evaluate those assumptions, or know how one company’s models may differ from another’s. The result is that management can use unrealistic assumptions to pump up earnings, possibly enormously. Here earnings will not be comparable from one company to another, due to the differences in modeling that are impossible for investors to spot. Perhaps here all such "profits" should only be taken into income as the assumptions actually occur and the Company realizes the cash flows.

To the extent possible, the FASB needs to promote the reporting of profits that have already occurred, and to preclude reporting of profits that haven’t happened in fact. Cash flow is a wonderfully "real" barometer of when profit or loss should be recognized, not the ethereal and unreliable "profits" that we allow to be rolled forward and reported today even though they may ultimately never occur.

Corporate Reforms

Prohibit specific conflicts of interest by the CFO or similar finance officials without full disclosure.

The CFO of a publicly traded company occupies a uniquely sensitive position. Both the outside auditors and the audit committee will rely on the CFO to provide financial information, and to highlight areas of concern. If the CFO has a personal financial interest contrary to the Company, or even potentially so, this can defeat our entire system of controls. While state corporation law typically defines the fiduciary duties of officers, Congress should consider prohibiting certain types of financial interests by CFOs and their subordinates, or at least require immediate disclosure of all such interests through an 8-K filing whether or not the amount would otherwise be considered material. The interests created in Enron should never be allowed to occur in a public company.

Enhance audit committee independence and role

Audit committees won’t solve every problem, but they play a very important role. Their role in selecting auditors and overseeing financial conflicts is very important, and overall their roles should be strengthened wherever possible.

Disgorgement of profits from insider stock sales within certain time frames of a corporate bankruptcy.

We have long required officers and directors to disgorge "short swing" profits for purchases and sales within a six month period. We should consider similar disgorgement to the company of any net proceeds of stock sales or option exercises within six months or a year prior to a bankruptcy filing.

Prohibit use of stock to repay insider loans or require immediate disclosure.

The sale of stock back to a failing company to satisfy loans to a CEO or other senior officer robs the company of cash, while shielding such sales from public view and potential insider trading liability. It is not clear why companies allow substantial loans to senior officers, but where these exist repayment should be in cash, not stock. Where stock is used, there should be contemporaneous filing requirements. The SEC should require compensation committees to describe all loan programs and their objectives, as well as collateral and repayment terms, in the annual proxy statement.

Bankruptcy Reforms

Consider mandatory trusteeships for bankruptcies of major size.

Where a bankruptcy above a certain size occurs, Congress should consider whether investors and creditors would not be well served with a mandatory requirement for appointment of a trustee or other fiduciary to oversee reorganization. Alternatively this could be a requirement only if an interim CEO is not appointed by the board. However, where there has been wrongdoing, leaving the incumbent management in place may create new risks, particularly to employees and other unsecured creditors.

Strengthen the power of bankruptcy trustees to bring actions against accountants, attorneys and former officers notwithstanding common law procedural barriers.

In some Circuits, current law restricts the ability of trustees representing defrauded creditors from suing the accountants or lawyers for a company that collapses due to fraud or other wrongdoing, even if the conduct of such professionals violated professional standards, was negligent, or otherwise damaged investors. Actions by trustees or other fiduciaries should provide a major deterrent against professionals who assist someone in defrauding investors and employees, and should not be blocked on common law procedural grounds such as "in pari delicto" or similar defenses relating to the imputation of the company's wrongful actions to the trustee suing on behalf of victims.

Other Steps

Enhance rating agency integrity.

Consider whether standards should be created to protect or enhance the integrity of rating agency decisions.

Improve independence of stock analyst recommendations.

Analyst recommendations should be driven by analysis and fundamentals, not the pursuit of investment banking business for their firms. This is a similar problem to auditors and consulting. New rules have been proposed to address this situation, which the SEC and the industry should continue to pursue until investors have clear disclosure of potential pressures and insofar as possible the integrity of analyst opinions is safeguarded.

Conclusion

To be sure, most of the men and women who work in public accounting are talented, hardworking and honest. Nonetheless, there will be bad apples in any barrel, and there is certainly a need to make sure that we have an adequate practical ability to detect abuses and to provide accountability for performance of audits in accordance with professional standards. We cannot afford to take the risk that anyone auditing major publicly traded companies believes they are beyond accountability for their auditing performance, to say nothing of ethical lapses or even criminal conduct.

Even better would be to follow President Bush's call for a broad national effort to enhance the quality of our accounting and disclosure system. This effort is too important to leave to the accounting profession alone, though all concerned should contribute every idea to the debate so Congress can determine the best mix of policies for the future.
