U.S. SENATE COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS

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

Prepared Statement of The Honorable Harold M. Williams
Chairman, Securities and Exchange Commission
1977-1981

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

Mr. Chairman and Members of the Committee:

Thank you for the invitation to bring my perspective as a former Chairman of the Securities and Exchange Commission to the current concerns about accounting and investor protection issues and their impact on the functioning of our financial markets. I served as Chair of the SEC from 1977 to 1981, having been appointed by President Jimmy Carter. Prior to my service as Chair of the Commission I served as a member of the SEC Advisory Committee on Corporate Disclosure. From the time I left the Commission until 1998 I served as President and Chief Executive Officer of the J. Paul Getty Trust headquartered in Los Angeles. Since then I have been dividing my time between various public service and public policy activities, primarily in education, the arts, and health care and being Of Counsel to the law firm of Skadden, Arps, Slate, Meagher & Flom. The views I express are personal and do not necessarily reflect the views of the firm, or its individual members. Further, as a consequence of the firm's involvement with corporate clients in a number of related matters it would not be appropriate for me to comment, directly or indirectly, on any specific situation.

My comments today will focus on a crisis of confidence unlike any I have experienced in my fifty plus years of involvement in the corporate and financial world. Questions are being raised about the adequacy and integrity of financial reporting by public companies and about whether our financial reporting system can be trusted. Trust is critical to the functioning of the financial markets and the efficient allocation of capital and, ultimately, to the willingness of the public to invest. This is a crisis that cannot be ignored.

Let me begin by disclosing that I am a strong believer in self-regulation coupled with rigorous oversight. The principle is well established in the structure of the self- regulation and SEC oversight of the stock exchanges. Self-regulation, aggressively overseen, can be much more effective in enforcing the spirit of the rules than can a policing agency of government. However, it is evident that the existing structure is not adequate to the task and needs to be redesigned and strengthened. It needs to address auditor independence, accounting standards and rule-making, the composition and duties of corporate boards and audit committees and the objectivity of security analysts and all others whose behavior impact the integrity of our financial markets.

Auditor Independence and Consulting Services

At the center of the crisis – but not alone – is the accounting profession. Events have heightened concerns about whether the profession has, in fact, the requisite degree of independence to discharge its auditing responsibility.

The American Institute of Certified Public Accountants begins its code of conduct with the statement "The distinguishing mark of a profession is acceptance of its responsibility to the public." Indeed, the profession's auditing responsibility is a quasi-public one, deeply infused with the public interest. This raises critical issues. Can an auditor be independent when his client is paying the bill? Can the auditor withstand pressure from the client? What if doing so would mean losing the client for the firm? What would that mean for the firm and for the auditor? Does provision of consulting services further impair independence or the perception of independence?

I am sympathetic to the difficulties involved in the audit process. Auditing has become much more difficult as corporate structures and financing techniques have become more complex. For example, the pricing of risk or the laying off of risk has become an increasingly sophisticated high technology business and it is increasingly difficult for auditors and regulators to assess the risks being assumed by any single institution. I even wonder whether some members of the

profession are up to understanding and dealing with the increased complexity. Certainly, the increased complexity requires greater exercise of judgment and makes auditor independence and insulation from pressures that could compromise it all the more essential.

The case for insisting that an auditor not provide other services to the client it audits is a strong one. Accounting firms have come increasingly to look beyond their traditional audit role to consulting work for their revenues and profitability. In part this is in response to corporate pressures to hold down audit costs and in part to the growth in consulting as a very profitable market. Whether providing consulting services actually impairs independence calls for access to the auditor's state of mind and is virtually impossible to determine. However, the perception that it may is of such concern that it cannot be ignored. Perception is now as important – perhaps more important – than reality.

While I was Chair of the Commission, we introduced a requirement that the proxy material calling for shareholder approval of the selection of the audit firm include information on the non-audit services performed for the company in the prior year. It reflected the Commission's and my concern about the issue at the time. The requirement was eliminated by my successor. It was reintroduced recently under Chairman Levitt.

Even if the auditor does not provide other services to the companies it audits, given who pays the bill, the incentive to keep a well-paying audit client happy would remain powerful.

I would urge the Commission to consider a requirement that a public company retain its auditor for a fixed term with no right to terminate. This could be for five years or perhaps the Biblical seven. After that fixed term, the corporation would be required to change auditors. As a consequence of such a requirement, the auditor would be assured of the assignment and, therefore, would not be threatened with the loss of the client and could exercise truly independent judgment. Under such a system the client would lose its ability to threaten to change auditors if in its judgment the assigned audit team was inadequate. It would also reduce the client's ability to negotiate on fees, and almost certainly the audit would cost more. The required rotation of auditors would also involve the inefficiency of the learning curve for the new auditor. I view all of these potential costs acceptable if it reinforces the auditor's independence and makes the work more comprehensive. The client could be given a right to appeal to a reconstituted independent oversight organization if it believes that it is not well served by its auditor and needs some relief.

Even this proposal would not avoid the issue of providing consulting services to audit clients and the perception that it compromises auditor independence. One solution would be that consulting work not be offered to an audit client. Another would be that the revenues and profits from the audit function and from consulting be segregated so that those engaged in the audit function could not benefit, directly or indirectly, from the profitability of the consulting practice. Still another would be to restrict the consulting services to those few fully consistent with the audit function and independence.

The Public Oversight Board

The Public Oversight Board was created by the profession during my chairmanship as an effort at self-regulation. We expressed concern at the time whether the peer review process administered by the profession would be adequate. But, as believers in the principle of self-regulation, we concluded that the Board should have the opportunity to prove itself. In my opinion, the events over the intervening years have demonstrated that it does not meet the needs and is not adequate. Under the peer review system adopted in 1977, the firms periodically review each other. To my knowledge, there has never been a negative review of a major firm. However, the peer review is not permitted to examine any audits that are subject to litigation. The reviews focus on the adequacy of quality control procedures and do not examine the audits of companies to see if the peer would have arrived at a different conclusion. Peer review has proved itself insufficient. Particularly as the Big Eight has become only the Big Five, peer review in its present form becomes too incestuous. A system needs to be established which is independent of the accounting profession, transparent and able to serve both effective quality control and disciplinary functions.

Further, the Board is not adequately funded and is beholden for its funding to the very people it is supposed to oversee. I suggest that the SEC consider a requirement that a percentage of the audit fees of public companies be assessed to pay for independent oversight, whether it is the Public Oversight Board or a successor body, so that its funding is assured.

I consider Chairman Pitt's public statement encouraging in its recognition that more rigorous and disinterested oversight of the profession is essential. However, the statement needs more definition before we can judge its adequacy or likely effectiveness.

Disclosure and Accounting Principles

The disclosure model itself lacks the necessary clarity and transparency and needs to be critically reviewed and enhanced by the Commission. Our financial accounting and disclosure requirements have not kept up with the rapid evolution of our capital markets and corporate finance. The existing requirements worked well when auditing traditional assets such as plants and equipment, accounts receivable and inventories. They work much less well when dealing, for example, with intangibles and sophisticated financial instruments.

It is not only a matter of numbers. The disclosure of what lies behind the numbers should make transparent and comprehensible the businesses, the risks involved, the economic substance and the accounting methods employed. The company and its auditors should disclose and discuss all significant accounting decisions, choice of accounting methods and judgments affecting the reported results.

Part of the responsibility for inadequate disclosure lies with the accounting principles themselves and the functioning of the Financial Accounting Standards Board (FASB) – the body responsible for establishing accounting principles. GAAP – Generally Accepted Accounting Principles – needs to be reviewed and standard setting improved and accelerated. I believe the functioning of the FASB could be significantly enhanced if its independence could be protected, to withstand the pressures of the business community, the profession and even the Congress. A source of financing that is dependable and not beholden to the profession or to the corporate community would increase the ability of the Board to address more difficult and critical issues in a timely manner.

Rule making itself is very difficult particularly as financial activity and economic transactions become increasingly complicated and sophisticated. For example, the FASB has engaged for a number of years in an effort to create a clear standard for disclosing off-the-books transactions and special purpose entities. They have not been able to come up with a rule acceptable to the business community and the profession. That acceptability should not ultimately be the determining factor.

Some rule making amounts to "closing the barn door." Obviously, this is not something that the corporate community takes lightly because of its potentially negative impact on earnings. An example is the pressure exerted by corporations thru Congress in the mid'90s, that forced the FASB to back down on a proposal to make companies take account of the cost of awarding employee stock options.

I believe the Board should consider and redefine the very amorphous concept of "materiality". Otherwise significant matters can become "immaterial" if the company is large enough.

The crisis in financial reporting is perhaps best captured by the need to reduce the complexity of corporate earnings every quarter to the magic – but uninformative – number called "earnings per share." While at the Commission I thought often of how wonderful, but impossible, it would have been to get rid of it. Perhaps the time has come to consider doing so. Indeed, the very concept of "earnings" has become diluted by the proliferation of use and abuse of "pro-forma earnings", "operating income" and "restructuring charges". Cash flow becomes, in many respects, a more sensitive measure of corporate performance.

Regulating Coherence

A separate issue is the lack of regulatory coherence, particularly since the enactment of the Gramm-Leach-Bliley Act allowed financial services companies to cross the barriers that had existed between firms that could undertake commercial banking, securities underwriting and insurance. A new kind of financial services entity has been authorized, but the regulatory system has not adapted to it. As you know, there are a number of federal regulators. The Federal Reserve licenses a new kind of institution – the financial holding company, but other regulators continue to supervise the individual business units that make it up. The securities markets have the SEC, the commodities and futures markets have the Commodity Futures Trading Corporation, and insurance companies are monitored at the state level. Finally, derivatives are unregulated. Innovations in finance have blurred the historic distinctions between the various institutions. As a result, the supervisory process has not kept up with the changes that have occurred in the financial system. This is a situation that inevitably will create problems unless the various federal regulatory agencies share and implement a common understanding of the rules and behavior expected of the various players who collectively make up the financial markets and determine its integrity and efficiency.

A Caution

As we go about exploring regulatory or statutory solutions, we need to be reminded that the more that problems lead regulators or legislators to impose prescriptive rules, the more people will settle for fulfilling the letter of those rules rather than responding to the broader purpose that they are designed to serve. Rules inevitably leave loopholes that can be

exploited if the attitude is allowed to persist that form is more important than substance or that complying with the letter of the law rather than the spirit is acceptable. At the other extreme, too general a rule lacks guidance and invites overly generous interpretations.

Ultimately, any system can be subverted if the parties undertake to do so, or if the various players in the system let down their guard and fail to act responsibly. In the final analysis, the system works as it should only when all the players honor the spirit as well as the letter of the law.

When everyone involved – management, board members, investment bankers, and security analysts, - are caught up in and benefit from a hot stock, no one is inclined to the thorough questioning that could raise troublesome issues or to be willing to be the skunk at the picnic. The corporate community needs to accept its responsibility to be informative and more forthcoming in its disclosure. Corporate boards of directors and audit committees, the accounting profession, security analysts, stock exchanges and rating agencies, as well as the regulators, each have an essential role to play – a duty – to be alert, ask the difficult questions, to hold each other to account and be held to account and thus assure the adequacy and integrity of the financial information upon which our financial markets depend.

I will be pleased to respond to questions from the Committee.

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