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."

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Chairman, Securities and Exchange Commission
1975-77

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

INTRODUCTION

Twenty-six years ago I sat before this Committee to explain what the SEC was doing about a corporate scandal that caused a public uproar at least as loud as that now directed at the Enron matter. The focus then was on some 400 U.S. companies that were compelled to disclose that they had made bribes or questionable payments to foreign officials to secure corporate favors. Twenty million dollars said to have been given to the Japanese Prime Minister forced his resignation.

In response, the SEC caused the birth of the mandatory audit committee, substantially increased the auditor's responsibility and mandated new internal controls. There should be no doubt but that those steps greatly advanced the cause of good corporate governance. However, the continuing spate of accounting problems makes it clear that much more is needed.

I have no view to express with regard to the question of whether Enron or its auditors violated any existing regulation or law in the presentation of Enron's financial position. The view I do have is that there are substantial weaknesses in our regulatory system. My testimony will:

- Identify those weaknesses;
- Suggest steps that can be taken to reduce or eliminate them; and
- Ask that other steps ***not*** be taken.

I speak with 32 years of experience with corporate governance: as a former regulator who dealt with those U.S. companies that made questionable payments to foreign officials and with the auditors who failed to cause the disclosure of those payments; service on 14 boards of directors, as a member of 14 audit committees and as Chairman of 7 such committees; and participation in the termination of 8 Chief Executive Officers. Six times we had to report that over $100 million of income had been improperly reported. On one occasion the sum exceeded $3 billion. (Appendix A)

These corporate mishaps will continue until we identify and address the very serious weaknesses that our regulatory system has produced and tolerated for far too long.

First, the system itself needs a major overhaul. The head of NYU's Accounting Department, Paul Brown, put it well:

> ***"It's the old adage of a F.A.S.B. rule. It takes four years to write it, and it takes four minutes for an astute investment banker to get around it."***

Second, it is increasingly clear that the accounting profession is not able ***consistently*** to resist management pressures to permit incomplete or misleading financial statements, and the profession has serious problems in recruiting and keeping the highly qualified professionals that are needed.

Third, the audit committees of too many boards are not exercising the authority given to them or the responsibility expected of them.

The Weaknesses

The Financial System

The financial papers produced dutifully each year by publicly traded companies have become a commodity. Companies produce them largely because they are required to do so. Few CEO's regard this work product as having any intrinsic value. Accounting firms compete for business more on price than on the quality of their personnel or procedures.

If a company does take an interest in the structure of its balance sheet and profit and loss statement, it is far more likely to be caused by a desire to be innovative in how they report their profits than in the quality of the auditor's work. They hire bankers and consultants to design corporate structures that will give them a stronger looking balance sheet and, perhaps, keep the profits and losses of related companies off of their financial papers.

For example, news reports are that Enron spent millions of dollars on Wall Street bankers and management consultants to create a corporate structure that apparently had the effect of keeping both debt and losses out of its own financial picture. The audit partner tasked with understanding such a structure is way over matched. Unless he can find a precise rule or interpretation that frustrates that sophisticated corporate architecture, those Wall Street wizards will prevail.

NYU's accounting department is correct: the existing system, developed over some 70 years by the FASB, the AICPA and the SEC produces rules at horse and buggy speed while the global economy moves at light speed, developing new and exotic financial instruments and corporate structures.

The ultimate weakness is that the system suffers from too many rules. Roman Weil, Professor of Accounting at the Graduate School of Business of the University of Chicago Business School has pointed out that today auditors, confronted with a somewhat different transaction, ask either FASB or the Emerging Issues Task Force (created by FASB and the SEC) for a new rule. Instead of making their own judgment drawn from a conceptual framework, they seek the comfort of specificity (Appendix B). The system has been so precise so many times in saying what cannot be done that it has created an implication that whatever is not prohibited is permitted. In law school this phenomena has long been known as: ***"Expressio unius exclusio alterius".***

This maze of rules has become a challenge to innovative minds to create corporate structures that wend their way through the maze, satisfying all the rules but frustrating the objective of our securities laws.

The sad truth is that the profession has lost sight of the significance of the signature line of the opinions they give to all their clients. That line reads:

> ***"In our opinion, the financial statements [prepared by management] fairly present, in all material respects, the financial position of the company."***

Today that broad statement means only:

"We have looked but have found no material violation of applicable rules and regulations."

Auditors should be more willing to qualify their opinion by saying:

"The company has satisfied all the rules but its financial statements do not fairly present its financial position."

Today, any auditor tempted to qualify his opinion in such a fashion faces the reality that a competing accounting firm may be quite willing to sign an unqualified opinion.

Corporate financial papers also suffer from their reliance on two flawed assumptions:

1. That the present value of assets can be derived reliably from historical costs; and
2. That corporate earnings can smoothly move from quarter to quarter without large ups and downs.

    The fiction of the first point should be self-evident. That is particularly so today

when so large a part of all corporate assets is intangible.

The "smoothing" of earnings has been encouraged by analysts and

tolerated by regulators for many years. To avoid disruptions that are inevitably created by unforeseen circumstances, companies create reserves in flush periods that can fill the gap in a down quarter. When major changes appear on the horizon, companies establish large restructuring reserves to cover the shortfalls in future years.

Investors are often puzzled when the stock of a given company plummets simply because it missed Wall Street forecasts by only a penny or two. The reason, of course, is that analysts know that healthy companies always have a few extra pennies of earnings in their corporate "cookie jar". If the company cannot find a penny in that jar, the analysts assume the company is in far worse shape than known.

Finally, it must be said on this point that unless one has been subjected to a serious corporate meltdown, you cannot possibly appreciate the enormous discretion that management has under GAAP to present its financial position. By changing depreciation schedules, by using different estimates or by adopting different strategies or assumptions, a company can make enormous changes in its annual income. Management too often makes these "top-level" adjustments without adequate disclosure to the public about how much their current earnings depend on such adjustments. A corporate meltdown in which I was involved three years ago was caused by top-level adjustments that accounted for 40% of the company’s total income and led to a corporate admission that billions of dollars of income had been improperly reported.

The Accounting Profession

Any effort to reform the system must understand that the accounting profession is in trouble. It has been caught in a changing world economy in a system that inhibits change. ***The profession is not at all blameless, but the blame is not all theirs***. The fact that the work product of the profession has become a commodity means it is almost impossible for firms to get the same margins on their auditing work as they get on their consulting work. The problem is exacerbated by the fact that too many audit committees see their job as reducing the auditor’s fee rather than increasing the quality of the work. Too many auditing jobs have been bid at a loss with the belief that the loss could be made up by the consulting jobs likely to be given to the firm that has the audit.

One result is that accounting firms cannot attract today the same level of talent that entered the profession 20 or 30 years ago. Significant numbers of graduates from our more prestigious business schools regularly became accountants. No more! Neither the salaries paid nor the career offered is competitive with the future available in management consulting firms, law firms, investment banking, or corporate financial offices.

The combination of financial pressure to keep a client and the difficulty of finding a precise rule to deal with an ingenious corporate structure has too often caused an audit partner to allow a questionable accounting policy to be adopted. Once such a policy is implemented, it can become increasingly difficult for the audit partner to throw it out.

It is so often the case that the questionable policy is of no particular significance when it first passes the auditor’s scrutiny. Whatever transactions are based on such a policy in those years are so small that the audit partner can take comfort in the fact that, overall, the true financial position of the company has not been distorted. After a few years, however, the transactions can multiply and present the audit partner with the realization that a significant corporate risk has been hidden from the public. If he blows the whistle, he will be blamed for allowing the policy in the first place and he will surely lose the client. So, he implores the company to unwind the policy by selling assets at a profit that can offset the concealed losses and hopes for the best.

I do not know if the scene I just painted occurred at Enron. I only know that it could have happened; and I do know that it is an accurate view of events at four companies in which I was involved and that with respect to those companies, we were required, with a restatement, to write off over $100 million of assets that had been improperly recorded as income in prior years. On one of those occasions the write-off exceeded $2 billion.

By no means am I suggesting that the auditors should be excused for such misbehavior because of the pressures on them. What I do argue is that auditors should not allow themselves to be in such a situation. An accounting firm should not accept an engagement unless its partners are certain that the audit committee will protect them from undue management pressure. Seldom will an accounting firm tell the audit committee about a problem first. They try to work out a compromise with management. Often the audit committee does not even know that there was a problem.

In short, the accounting firms have demonstrated far too often that they have more fear that management will replace them than confidence that the audit committee will protect them.

The Directors of the Audit Committee

Since 1977, the investment world has looked to the audit committees of publicly traded companies to protect the integrity of financial disclosure. As I said earlier, the mandatory audit committee was born out of the foreign payment scandals of the early 70's.

Since that time, the audit committee has evolved into an important element of corporate governance. However, the shortcomings are evident:

- Audit committees may consist of people who satisfy the objective criteria of independence, but their election to the board is too often the whim of the CEO, who decides each year who will sit on the audit committee and who will chair it.
- Audit committees too often seek only to reduce the cost of the audit rather than to seek ways to improve its quality. They do not play a sufficient role in determining what the fair fee should be.
- Audit committees seldom ask the auditor if there is a better, fairer, way to present the company's financial position.
- Audit committees seldom play a role in selecting a new audit firm or in approving a change in the partner in charge of the audit. They may well endorse an engagement or the appointment of a new team, but they are not seen as material to the selection process.
- Audit committees seldom establish themselves as the party in charge of the audit.

In short, most audit committees do not understand that the auditors will not be truly independent unless they confer that independence on them by the manner in which they oversee the audit process.

What Should Be Done?

About the System

A careful but substantial overhaul of the existing regulatory system is of paramount importance. Failure to act effectively and soon will continue to erode the reputation of our capital markets and further weaken the accounting profession. The SEC, with the support and direction of Congress, must lead a wholesale revamping of the system that regulates the profession. As Professor Weil has written:

> "***I want accountants to use fundamental concepts in choosing accounting methods and estimates. I want accountants not to hide behind the absence of a specific rule. Whatever the detailed rules accountants write, smart managers can construct transactions the rules don't cover."*** (Appendix B)

His call is for a major change in the basic nature of the audit. It would require companies to be far more candid in explaining the real value of their companies; it would place far less emphasis on historical values and far more focus on intrinsic values. The "smoothing" of earnings would end.

A far different oversight structure would be needed, and the training of analysts and particularly accountants, would change.

Ideally, a system would be created that made the audit of real value to management, which would pay far more attention to the quality of the people performing the audit and less attention to its cost.

Such change will not come easy and not early.

There are, however, substantial steps that can be taken immediately, changes that will dramatically reduce the number of Enron type debacles in the future.

Action by the SEC

The SEC needs to make it absolutely clear that the failure to have a competent independent audit committee by itself constitutes a material weakness in the internal controls of a reporting company. A simple statement in any speech by a SEC Chairman will do the job. This unequivocal statement will force the auditors to look into the question of both the independence and the competence of the audit committee. With respect to sitting directors, the auditors would necessarily send a memo to each one asking:

- How did you come to be elected to the Board?
- What social or business relations have you had or do you have with any officer or director of the company?
- What percentage of your annual income is derived from your service on this board, and from any other boards on which you sit?
- What experience or education have you had that is relevant to the responsibilities of an audit committee?
- Who appointed you to the audit committee and who selected the Chairperson of the committee? ***Etc.***

When such a questionnaire is sent, the company's lawyers will undoubtedly advise the company that an independent nominating committee is necessary to both select new directors and to make appointments to the audit committee. If such does not occur, the SEC Chairman can make another speech.

Second, the SEC should widely broadcast the significance of its December 12, 2001 release that gives "Cautionary Advice Regarding Disclosure About Critical Accounting Policies". This release may be the most significant SEC step with respect to corporate governance in decades. In effect, this release requires the auditors to carefully explain the various accounting policies that have been selected by management, the estimates that management is making, and ***how the selection of different policies or estimates could cause the reporting of materially different financial results*** (Appendix C).

This explanation is to be made to the audit committee and is to be placed in "Management's Discussion and Analysis" (the "MD&A").

Had this rule been understood by Enron, its audit committee and Andersen years ago, the current Enron debacle may not have happened. It certainly would have been discovered years earlier.

Third, the SEC must make it quite clear to audit committees that they have the responsibility of protecting the independence of the auditors. This is not a passive assignment. The audit committee must:

- Understand the fee negotiations;
- Lead any effort to select a new firm;
- Initiate interviews for a new audit partner in charge;
- Insist that all disagreements between management and the auditor be exposed to them; and
- Insist that they be made to understand any alternative presentations of the company's financial position that would lessen earnings or debt.

In short, the audit committee's most important task is to make the independent attesting auditor believe that its retention depends ***solely*** on the decision of the audit committee.

Audit committees must have latent authority to hire their own consultants with or without consultation with management. They must insist that all allegations of financial misconduct be conveyed to them immediately. The complaint by Ms. Watkins to Enron's CEO should have been given directly to the audit committee, which should have hired its own counsel to investigate her complaint.

In short, the SEC must give the accounting profession the responsibility and the courage to tell management that:

"Its financial statements <u>do not</u> fairly present the Company's financial

position whether or not there is a rule preventing such presentation."

Action by the Profession

The accounting profession must be made to trust the audit committee. Before taking a new engagement, a firm should be satisfied that their relationship is with the committee, and that all real problems must involve the committee. A firm should not take an engagement unless it is certain of the committee's independence and resolve. The accounting firms must understand that the failure to have an independent, competent audit committee constitutes a material weakness in a company's internal controls. They do not need to wait for the SEC to tell them.

The profession must raise its sights with respect to new hires. It must offer salaries that are competitive with other professions. The profession needs MBA graduates from our better business schools and it needs many of the better students that now go to law, investment banking and management consulting.

The stark fact that our business community must accept is that the profession needs to raise the cost of the audit to get better-educated personnel.

However, until management and Wall Street analysts understand the need for a better trained accountant and the value of a "better" audit, it will be difficult to secure the needed talent for the accounting profession.

Finally, the accounting firms must work with the SEC to create a materially different regulatory structure. Until that day comes, the firms must have the competence and the resolve to qualify their opinion when they believe that, notwithstanding the fact that all rules are satisfied, the financial presentation is lacking.

Action by Audit Committees

Audit committees do not need any releases from the SEC or legislative direction to substantially increase their role. As noted above, audit committees have both the authority and the responsibility to take over the audit process. Any audit committee that wishes to do so can assert that it is ***solely*** responsible for the selection and retention of the outside auditor.

In short, all the weaknesses identified above in the manner in which audit committees are managed can be corrected with a simple change of direction.

The Need for Legislation

All the weaknesses referred to above could be corrected by a concerted effort of industry, the SEC, FASB and the AICPA. And, there are current efforts to do so. Russell Palmer, the former Dean of Wharton and I, with the encouragement of Chairman Levitt, have formed a steering committee (Appendix D) to assist the American Assembly at Columbia University to conduct an Assembly on the future of the accounting profession.

However, the pace of change for corporate governance has been painfully slow. It may well need a legislative push. Congress, with the Administration, could mandate the formation of an informed, effective commission to prepare a reform program within the year.

Congress may wish also to require that:

- ***Corporations of a certain size with publicly traded stock have an effective, independent audit committee in order to avoid a finding that there is a material weakness in the corporation's internal controls;***
- ***Corporations of a certain size have an independent nominating committee with the authority to secure new directors and appoint all members of the audit committee;***
- ***Audit committees be solely responsible for the retention of accounting firms and be responsible for the fees paid them.***

What Should Not Be Done?

In recent days there have been calls for various legislative changes in our securities laws that, in my view, should not be made. They would:

- Prohibit any firm responsible for the annual audit of a firm from performing any consulting type services for the same firm;
- Place term limits on how long accountants can work for a client;
- Require that an independent organization pay for company audits.

The principal objection to all three proposals is that each of them would erode the

authority and the responsibility of the audit committee. For 26 years, audit committees have become more independent and more assertive. As a result, there has been a steady, albeit slow, improvement in corporate governance. Each of the above listed proposals would inevitably erode both the authority and the responsibility of the audit committee.

The more specific objections to each proposal are these:

Consulting

There are four compelling reasons to resist efforts to ban accountants from doing any consulting work for their audit clients:

1. Such a rule will not help the problem and it will divert attention from action that will help. An audit partner who is threatened with the loss of his client is just as likely to yield to undue management pressure whether or not his firm is receiving large consulting contracts. If he or she loses that audit client his or her career is likely at an end. Twelve years ago, I felt compelled to launch a proxy fight to take control of a small NYSE company. I questioned the auditor after we prevailed in the proxy fight and learned from the auditor that there were a large number of questionable policies that he had accepted because of his fear that he would lose the client if he persisted in opposing them. The annual audit fee was under $500,000.
2. The profession is already having a difficult time in attracting qualified personnel. If college graduates are told that there is a blanket prohibition on all "consulting work," they will surely conclude that their work as an accountant will be limited.
3. There is no valid reason to restrict management from using its auditors where their experience with the company can be of real assistance. An alert audit committee can easily protect the company from the pressure of a management that implies that the accountant will lose lucrative consulting fees if it opposes management's accounting policies. The audit committee should, of course, oversee all consulting work done by the external auditing firm. Each committee should require that its approval be necessary before any consulting contract of size is given to the external auditors.
4. We must have some patience. Just last year the SEC required considerable disclosure about consulting fees paid to the external auditor. That rule has caused companies to rethink the manner in which they engage consultants and auditors to decide what kinds of services they wish to offer. At the very least, we should wait to see how these new requirements work before we overtake them with new rules.

Term Limits

Forcing a change of auditors can only lower the quality of audits and increase their costs. The longer an auditor is with a company the more it learns about its personnel, its business and its intrinsic values. To change every several years will simply create a merry-go-round of mediocrity.

An effective audit committee can mandate a rotation of partners in the same firm that can achieve the same result as changing firms.

Payment of Audit Fees by an Independent Organization

There are over 10,000 publicly traded companies in the United States. The overwhelming number of them have a satisfactory relationship with their auditor and their financial statements are all anyone could ask for in terms of fair presentation.

To force all these companies to change their relationship with their auditors because of the misbehavior of a relatively small number of companies would be foolish. We cannot possibly know now whether the change would produce better financial presentations.

Again, the problem seen in cases like Enron can be dealt with if the role of the audit committee is carried out properly.

Conclusion

The accounting profession is of enormous importance to the United States and to the increasingly global economy in which we exist. It is an absolutely essential force in the evolution of so many companies in the emerging economies that seek capital from the developing world. As we acknowledge the deficiencies of the accounting profession, we should also acknowledge the responsibility we have to assist it reform itself.
