

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

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

**Prepared Statement of The Honorable David S. Ruder  
Chairman, Securities and Exchange Commission  
1987-1989**

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

### **Problems Raised by the Collapse of Enron Corporation**

It is a pleasure to appear again before the Committee on Banking, Housing, and Urban Affairs.

#### **General Comments**

The Enron tragedy calls for investigation, identification of wrong doers, the imposition of penalties, and reform. I strongly believe that allocation of blame should not be made until the facts are known. Nevertheless, based on newspaper accounts of the Enron matter, I believe some reforms are needed.

#### **Summary of Conclusions**

##### **A. Accounting Regulation**

**1. Auditor Independence** The Commission's new Auditor Independence Standards promulgated in November of 2000, should be monitored and improved, particularly in the non-audit services areas of information systems and internal audit.

**2. Supervision of Accounting Audit Practices** The current accounting audit supervisory system now in place under the direction of the Public Oversight Board should be expanded and improved in a setting independent from the accounting profession. Funding should come from the preparers and users of financial statements. Congressional action to secure funding will probably be needed.

**3. Accounting Standards** Promulgation of accounting standards by the Financial Accounting Standards Board under the supervision of the Financial Accounting Foundation works well, but an independent source of financing is desirable.

##### **B. Disclosure**

The SEC's disclosure requirements are a great strength of our capital markets. The Commission is moving promptly to create improvements in areas related to the Enron matter.

##### **C. Corporate Governance**

The managers of U.S. corporations need to embrace a corporate culture emphasizing compliance with accounting regulations and full disclosure of financial conditions. The SEC and the stock exchanges should take steps to encourage such practices. Congress should not legislate in the corporate governance area.

##### **D. The Enforcement Process**

The investigations of wrong doing by the Securities and Exchange Commission and the Justice Department will be thorough and will eventually yield the true facts and appropriate punishment.

##### **E. Pensions**

Congress or the Department of Labor should take steps to prevent 401(k) plan over-investment in employers stock by employees.

#### **F. Derivative Instruments**

Congress should consider regulating the over the counter markets in derivative instruments.

#### **Regulation of Accounting**

In the United States, the accounting profession plays a crucial role in the disclosure process. The investing public has learned to rely upon the accuracy of corporate financial statements prepared and certified by accountants. The regulation of the financial statement preparation and the audit process in this country is the strongest in the world, and I believe the public should continue to have faith in the system. Not only is the current system strong and reliable, but the theory that the faulty financial disclosures in the Enron matter demonstrate an accounting system that is broken and an accounting profession that cannot be trusted is simply wrong. If individual accountants have failed their duty they should be punished, but wayward activities of a few is not proof that the accounting profession is dishonest or negligent. If the accounting regulatory system has faults it should be corrected, but fault finding does not demonstrate that the regulatory system is not working. Nevertheless, it is important to examine current regulation of auditor independence, auditing standard setting, audit practices, and accounting standard setting and make needed changes.

#### **Auditor Independence**

One of the substantial worries regarding the Andersen audit of Enron has been that Andersen not only audited Enron, but also was paid approximately the same amount for non-audit services. It has been reported that in the year 2000 Andersen was paid audit fees of approximately \$25 million and non-audit fees of approximately \$27 million. Comparisons of the amounts of audit fees to non-audit fees for a range of companies and auditors have revealed ratios of non-audit to audit fees ranging as high as nine to one. The expressed general concern is that an audit cannot be objective if the auditor is receiving substantial non-audit fees.

The accounting profession seems to have recognized that management consulting services, which involve accounting firms in helping management make business decisions, should not be performed for an audit client. Three of the Big Five accounting firms (Andersen, Ernst & Young, and KPMG) have now separated their management consulting units from their audit units by contractual splits and spin-offs, and a fourth (PricewaterhouseCoopers) has announced its intention to split off its management consulting unit in a public offering. (Wall Street Journal, p3, January 31, 2002) The fifth firm should also do so, or at least refrain from offering management consulting services to audit clients.

If an accountant is not recognized by the SEC as independent, the accountant cannot certify a corporation's financial statements. Without a certification those statements cannot be filed with the Commission and the corporation will find it nearly impossible to raise capital. The SEC has taken steps to increase auditor independence. In November of 2000, the SEC published revised Auditor Independence Standards specifying circumstances under which the Commission will not recognize an accountant as independent. (SEC Rel. Nos. 33-7919 and 34-40602, Nov. 21, 2000) The Commission also adopted requirements forcing registrants to disclose for each fiscal year the amount of audit fees and the amount of fees paid to the auditor for non-audit services in two categories: financial information system design and implementation, and all other fees. It also required registrants to disclose whether the audit committee had considered the question whether the provision of non-audit services affected auditor independence.

The Commission specified broad categories of circumstances that will cause an accountant to be treated as not independent. The categories include financial relationships, employment relationships, business relationships, contingent fees, and non-audit services. In the latter category the Commission identified specific categories of prohibited activities (with certain exceptions):

- services,
- financial systems design and implementation,
- appraisal or valuation services,
- actuarial services,
- internal audit services,
- management functions,
- human relations (executive search),
- broker-dealer services,
- and legal services (but tax advice is not included in this category).

The new independence and disclosure rules represent a strong improvement in addressing the auditor independence problem. I believe that the new rules should be given a chance to work. There are categories of non-audit work that create

efficiencies for corporations, such as tax advice and opinions rendered in connection with registered offerings. These categories should be monitored to see whether they impede independence, and in two areas steps should be taken now to strengthen the rules.

The area of financial information services and design is the area most likely to generate the largest non-audit fees. Recently four of the major accounting firms announced their intention to abandon or severely limit information technology services for audit clients.

The Commission's current rules recognize that there may be benefits to the accounting control system if the auditor is allowed to plan, design, and implement internal accounting controls and risk management controls. These areas are fundamental to good accounting systems, and strong arguments can be made that a corporation's auditor should be able to design and install such systems. The Commission should continue to monitor this area.

The Commission's current rules permit design and implementation of a system that aggregates source data underlying the financial statements, but the rules contain significant restrictions on the design and implementation of such systems. This area is not likely to justify exceptions, and the Commission should consider prohibiting this activity.

The Commission's rule regarding internal audit services seems to recognize that outsourcing the internal audit functions to the company's external auditors creates conflicts or appearances of conflicts because the external auditor eventually will be auditing its own work. The Commission should monitor this portion of the rule carefully and consider prohibiting external auditors from engaging in internal auditing, with exceptions for small businesses.

The Commission is to be commended on its new independence rules. Changes in the rules should remain the responsibility of the SEC. Legislation in this area is not needed.

### **Supervision of the Accounting Audit System**

We need to build on the accounting audit supervisory system already in place and expand it to achieve greater independence, with better financing.

Prodded by the SEC, the accounting profession last year reorganized its process for overseeing the audit process. The American Institute of Certified Public Accountants (AICPA), expanded the power of its Public Oversight Board, an independent body, to control the auditing process in the United States. The Board is composed entirely of five public members with no connections to the accounting profession, and is currently headed by Charles Bowsher, the former Comptroller General of the United States, who was head of the General Accounting Office for fifteen years. It is financed through the AICPA budget. Although in January the Board announced its intention to disband, it should remain in existence until other audit supervisory measures are in place.

The POB has power to oversee the promulgation of Generally Accepted Accounting Standards (GAAS) by the AICPA's Auditing Standards Board. It has power to oversee the AICPA's system of monitoring accounting firms compliance with auditing requirements. It has the power to oversee the AICPA's peer review system which requires a triennial review of each firm by a firm of comparable stature. It also has power to oversee the AICPA's Quality Control Inquiry Committee which investigates charges of audit failure and disciplines violators.

The POB has functioned well in the past, and there is much to learn from its organization and operations. However, although the POB's powers have been strengthened, it does not have sufficient budget to allow it to function effectively. It does not have the power to force accounting firms to provide the documents necessary to complete investigations, nor does it have the power to promise that documents received will be protected against discovery in private litigation. It is forced to rely upon the accounting profession itself to engage in enforcement activities. Most important, its connection to the AICPA creates an appearance of control by that body.

I believe the POB oversight system should become truly independent. The audit standard creation process and audit review and disciplinary process should be transferred to a new body which will be separate from the AICPA and whose board will be composed entirely of public members who have no connection to the accounting profession. Until that transfer is completed, the POB should remain in existence and the AICPA, including its funding from the AICPA, should provide it with greater financial support.

A new separate Audit Supervisory Board should be modeled on the private sector Financial Accounting Standards Board (FASB) and its supervisory body, the Financial Accounting Foundation. The Board should be subject to oversight by the SEC, which in turn should cooperate with the Board in the investigative area.

The Board should be composed entirely of public members not associated with the profession. It should have appointive, administrative and budget powers, and should oversee three separate functions.

First, an Auditing Standards and Ethics Board composed of persons independent of the accounting profession should promulgate both auditing and ethical performance standards.

Second, an Auditing Quality Control Committee, composed of professional staff members reporting to the Audit Supervisory Board, should oversee internal audit firm practices designed to improve the audit process such as rotation of audit engagements and an internal system for making controversial audit decisions. This unit should also supervise a peer review system conducted by the accounting profession. A peer review system requiring audit firms to inspect the internal audit practices of firms of comparable quality should not be discarded, but that system should be independently inspected and supervised. The accounting profession peer review system has long been supported by the SEC and should continue to be a strong part of the audit regulatory process.

Third, an Audit Disciplinary Committee, also composed of professional staff members reporting to the Audit Supervisory Board, should have the power to inspect firm compliance with audit standards and procedures, investigate allegations of audit failures, impose disciplinary sanctions, and refer matters to the SEC for investigation and discipline. The information it gathers should be privileged from outsiders. Information gathering and privilege questions might be addressed through cooperation with the SEC.

Independent and adequate funding is crucial. An independent body that depends upon sporadic voluntary contributions from industry or the financial community may risk loss of financial support if it takes positions seen as contrary to the best interest of those it regulates.

The financing problem should be addressed by requiring payments by preparers of financial statements (the corporations) and by users of financial statements (institutions such as mutual funds who buy and sell securities, and brokers who advise others regarding securities transactions). The Audit Supervisory Board should have the power to set its own budget subject to oversight by the SEC. Congressional action to secure funding will probably be needed.

I believe in a system of private regulation rather than SEC regulation in the audit area. I am proposing a voluntary private independent organization independent from the accounting profession. If a voluntary private system cannot be established, then Congress should create such a system. In any event I believe the new audit regulatory system should be designed with input from the profession, with strong input and guidance from the SEC. The system should be subject to SEC oversight.

### **Promulgation of Accounting Standards**

Generally Accepted Accounting Principles are promulgated in the U.S. by the Financial Accounting Standards Board, an independent standard setting organization to which the SEC has delegated power to create accounting standards. High quality, transparent, and comparable accounting standards promulgated by the FASB have played a major role in making the U.S. financial markets the best in the world. The FASB private independent standard setting model has been adopted internationally by the private International Accounting Standards Committee, which has appointed an independent International Accounting Standards Board. I have observed the operations of the FASB closely during the last five years as an at large member of its supervisory body, the Financial Accounting Foundation and I am a member of the International Accounting Standards Committee Foundation, which supervises the IASB.

The Chairman of the SEC and others have recently complained that the FASB process for creating standards is too slow, citing the Board's failure to deal extensively with lease financing, special purpose entities, and other off balance sheet financing vehicles. Delays in promulgation are in part due to the care taken by the Board to hear the views of affected parties, especially the business community. The Board can increase the speed of its deliberations, and it is considering ways to do so. It must continue to assess the effects of its proposed standards on business operations.

Despite its attempts to seek the views of the business community, the FASB faces difficulty in obtaining financing from business, which often objects to FASB standards that affect business interests. The FASB is financed through sales of its work product and through contributions by accounting firms and businesses. When businesses do not like the FASB's standards or its process for creating them, they sometimes withdraw financial support, or fail to provide it in the first place. The FASB continually faces difficulties in financing its operations. The accounting profession is supportive, but generally speaking business is not. Institutional investors and investment bankers, who benefit greatly from financial statement disclosures, contribute little to the FAF, creating a classic free rider problem.

I believe the solution to the financial pressures on the FASB would be to provide a system of financing similar to that which I have suggested for a new POB. FASB should be financed by payments by preparers and users of financial statements. If a voluntary system cannot be established, Congress should enact legislation creating financing for the FASB. If a solution to funding for a new POB can be found that will protect the POB's independence, a similar solution should be found for the FASB.

### **Disclosure Regulation**

As a result of the Enron matter some have questioned whether the SEC's disclosure rules and procedures are adequate. As you know, the Commission's disclosure regulations are very detailed and are widely acknowledged as one of the great strengths of our capital markets. These regulations are not static, and are constantly being improved by the Commission. Chairman Pitt has recently called for changes including a current disclosure system, plain English financial statements, transparent disclosure of key accounting principles and policies, and better description of the relationship of pro forma earnings to earnings reported under GAAP. The Commission recently released a statement about management's discussion and analysis of financial conditions and operations (MD&A), calling for better disclosure, especially in the area of off-balance sheet contracts, trading activities involving non-exchange traded contracts, and contracts with related parties. (Rel. 33-8056, January 22, 2002). I believe the Commission is moving promptly to create improvements in areas related to the Enron matter. No legislation is needed in this area.

### **Corporate Governance**

The primary fault in the Enron failure seems to be poor management. From all accounts it appears that Enron became overly aggressive in its efforts to dominate the energy trading markets, engaged in highly leveraged off balance sheet financing, engaged in extremely aggressive accounting, overstated its earnings, failed to disclose the true nature of its corporate and financial structure, and eventually lost the confidence of its creditors and trading counter parties. Enron management appears to be primarily to blame.

In one sense, the Enron failure is due to a flawed business model. The company followed a path in its energy trading business that was too risky and too dependent upon relationships with other traders and creditors. We may be dealing with a late evidence of the excesses of the technology boom.

However in another sense the Enron problems represent a failure in corporate governance. One striking aspect of this failure is Enron's apparent lack of respect for the accounting system that underlies financial reporting. Enron seems to have purposely attempted to avoid disclosure of its true finances. Instead it should have utilized the accounting system as a means of assisting it to make sound management decisions and as a source of information helping it to provide the securities markets with a truthful statement of financial condition.

In recent years, the SEC has urged corporate Audit Committees to be more responsible, has criticized corporate attitudes toward financial reporting, and has brought enforcement actions regarding management of earnings, over emphasis on pro forma earnings, and failure to follow accounting standards. SEC urgings, criticism, and enforcement actions are important, but the SEC faces difficulties in overcoming management disregard of accounting and financial disclosure obligations. Most of our corporate managers know that the purpose of accounting rules is to create transparency, not obfuscation. And hopefully they know, as Enron teaches, that failure to disclose negative information eventually will cause a severe market reaction. The managers of all of our corporations need to reject a philosophy that seeks to skirt the edges of accounting rules and instead need to embrace a corporate culture of full financial disclosure.

As the investigation of Enron continues, the role of Enron's Board of Directors will be closely examined. What did the Board know and when? What did the Audit Committee know and when? These after the fact questions will seek to assess blame, but they also raise more fundamental questions regarding the proper supervisory roles of the Board and the Audit Committee. I believe the role of the Audit Committee is particularly important. The Audit Committee should understand the corporation's business, ask management hard questions about its strategies, accounting policies, and disclosures, and seek to ensure that disclosures to investors are accurate and complete.

As you know, the Federal Securities Laws do not give the SEC the power to intervene directly in the internal affairs of corporations. In recent years the SEC has urged good corporate governance practices and in some areas, such as executive compensation, has sought improvement by forcing disclosure. I believe the Commission should continue to examine possibilities for improving conduct by imposing disclosure obligations. The stock exchanges have power to force good governance practices through their listing agreements, and they too should be examining possibilities for increasing good corporate governance.

Unfortunately, in the area of corporate governance we are dealing with attitudes. I do not believe it possible for the

government to legislate good morals, and I believe efforts to do so may stifle innovation. Congress should not legislate in this area.

### **The Enforcement Process**

The newspapers and media have been swift to assess blame on those whom they believe are responsible for the Enron problems. Most of the assertions seem to be based upon facts that have yet to be proven.

The Securities and Exchange Commission (SEC), the Justice Department, and Congress have all launched investigations which eventually will yield the true facts. My experience at the SEC teaches me that the Commission will conduct a thorough investigation, using whatever resources are necessary to complete that task, and that it will cooperate with the Justice Department's criminal investigation. When its investigation is complete, the Commission will bring administrative and judicial actions against the wrong doers. The Justice Department may seek criminal penalties.

Much concern has been expressed about alleged insider trading by officers of Enron. In the Enron case insider trading allegations will involve buying or selling securities based upon nonpublic, material corporate information in violation of a fiduciary duty. It may be that the insiders in this case will seek to invoke newly adopted Rule 10b5-1 which provides an affirmative defense if the person entered into a binding contract, plan, or instruction with an independent third person to buy or sell securities. This defense may or may not be available. A condition to using that defense is that the person charged with insider trading was not aware of the material nonpublic information at the time of entering into the contract, plan or instruction. With regard to sales by the Enron officers the question will be whether they were aware of material nonpublic corporate information either at the time of sale or at the time of entering into a Rule 10b 5-1 arrangement.

I believe the Commission has sufficient resources to conduct its Enron investigation and that the Federal Securities Laws provide sufficient basis for successful imposition of sanctions. Allegations regarding misleading statements to the securities markets by Enron, its management, and its accountants are actionable under the SEC's Rule 10b-5. Insider trading allegations are also actionable under that rule. Allegations regarding poor accounting can be treated by the Commission under Rule 102(e) of its rules of practice and other rules. No legislation is needed in this area.

### **Employee 401(k) Plans**

According to newspaper accounts the 401(k) retirement accounts of many Enron employees contained extremely large amounts of Enron common stock. When the Enron stock declined, many employees lost most of their retirement savings. During one period of approximately 30 days the employees were not able to sell their Enron stock because of a change in plan administrator.

The Enron employee pension plan losses resulted from the swift and dramatic fall in Enron market values. The risks that Enron employees faced because of their retirement investments in Enron stock were typical of employees in many U.S. corporations. Many of our corporations encourage their employees to choose company stock as their primary retirement investment. Some companies match purchases of company stock in 401(k) retirement accounts and require that the company contributed stock remain in the retirement accounts for specified periods. Some companies restrict sales of company stock in 401(k) accounts until the employee reaches a specified age.

Although the various restrictions may have prevented a sale of Enron stock during certain periods, the primary problem reflected in the Enron matter is that employees have invested a disproportionate amount of their retirement funds in Enron stock. In doing so they ignored diversification--a fundamental principle of investing. Financially sophisticated investors understand that it is exceedingly risky to invest a large percentage of an investment portfolio in one company because of the risk that the company's stock may suffer large declines. The Enron employees either did not know this theory, chose to ignore it in the belief that Enron stock would continue to climb, or experienced express or implied pressures from the company to own Enron stock.

Retirement funds should not be invested in a risky manner that avoids standard portfolio diversification theory. Employees should be protected from their ignorance, their gambling instincts, and company pressure. Legislation should be passed or rules should be adopted prohibiting employees from owning more than a specified percentage of their company's stock in their retirement accounts, and companies should be prevented from imposing long term restrictions on the sale of stock held in retirement accounts.

The Enron retirement account problem also calls into question proposals to allow workers to manage the investment of a portion of their social security accounts. Should such a proposal be adopted, workers would be subject to problems of

ignorance or bad judgment, and would find themselves subject to pressures regarding investment choice from eager brokers or investment advisers who may not be facilitating the best interests of persons attempting to invest social security retirement monies. Congress should not adopt a social security plan under which worker retirement benefits would be subject to the risks of the securities market.

### **Regulation of Derivative Instruments**

Although the subject is beyond the scope of this testimony, I believe off exchange (over the counter) derivative instrument trading presents both systemic and individual risk. Congress should consider whether legislation is needed in this area.

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