

Prepared Statement of The Honorable Paul Volcker

Chairman of the Trustees of the International Accounting Standards Board;
Chairman of Arthur Andersen's Independent Oversight Board; and
Former Chairman, Board of Governors of the Federal Reserve System
10:00 a.m., Thursday, February 14, 2002 - Dirksen 538

I appreciate this opportunity to meet with you this morning, joining with Sir David Tweedie, Chairman of the International Accounting Standards Board ("IASB").

When this session was arranged some weeks ago, the intention was to concentrate mainly on the relevance of the work of the IASC and its associated bodies to the evident problems besetting the accounting and auditing professions.

Those problems, building over a period of years, have now exploded into a sense of crisis. That crisis is exemplified by the Enron collapse. But Enron is not the only symptom. We have had too many restatements of earnings, too many doubts about "pro forma" earnings, too many sudden charges of billions of dollars to "good will", too many perceived auditing failures accompanying bankruptcies to make us at all comfortable. To the contrary, it has become clear that some fundamental changes and reforms will be required to provide assurance that our financial reporting will be accurate, transparent, and meaningful.

Those qualities are essential attributes of a capital market and financial system in which investors can place confidence and which can efficiently allocate capital. The implications extend far beyond the shores of the United States.

We have long seen our markets, and our accounting systems, as models for the world, a world in which capital should be able to move freely to those places where it can be used most effectively and become a driving force for economic growth and productivity. In fact, a large portion of international capital now flows through our markets. We have been critical of the relative weakness of accounting and auditing standards in many other countries, arguing that those weaknesses have contributed to the volatility, inefficiency and breakdown of the financial systems of so-called emerging economies.

How ironic that, at this point in economic history when the performance of the American economy and financial markets has been so seemingly successful, we are faced with such doubts and questions about a system of accounting and auditing in which we have taken so much pride, threatening the credibility and confidence essential to well functioning markets.

To my mind, we can extract some good news in all of this. Our eyes have been opened to festering issues that have for too long been swept aside or dealt with ineffectively. We now have the opportunity for bringing our performance to a level that matches our words -- to practice what we preach.

For most of my professional life I have been a consumer (sometimes a critical consumer) of accounting and auditing reports rather than a participant in the process.

That began to change when I agreed to chair the newly restructured International Accounting Standards Committee some 18 months ago. The main responsibilities of that Committee — modeled substantially on the Financial Accounting Foundation in the U.S. — are to appoint the standard setting body chaired by Sir David, to obtain finance for its work, and to exercise broad oversight over the effort.

The Committee I chair does not engage in the technical work — we do not set, or advise on, the standards themselves. I am not and never have been an auditor. But as Yogi Berra once said, ‘you can observe quite a lot just by watching’, and there has been a great deal to watch.

I have attached to this statement excerpts from two earlier statements of mine that reflect my growing concerns. The fact is the accounting profession has been hard-pressed to keep up with the growing complexity of business and finance, with its mind-bending complications of abstruse derivatives, seemingly endless varieties of securitizations, and multiplying off balance sheet entities. The new profession of financial engineering is exercising enormous ingenuity in finding ways around established accounting conventions or tax regulations. In the rapidly globalizing world of finance, different accounting standards and methods of enforcement in different jurisdictions present increasing hazards.

Underneath it all, many have a sense that I share: in the midst of the great prosperity and boom of the 1990’s, there has been a certain erosion of professional, managerial, and ethical standards and safeguards. The pressure on management to meet market expectations, to keep earnings rising quarter by quarter or year by year, to measure success by one "bottom line" has led, consciously or not, to compromises at the expense of the public interest in full, accurate, and timely financial reporting.

The Three Pillars

I think of good financial reporting as resting on three pillars:

- Accounting standards setting out with clarity logically consistent and comprehensive "rules of the game" that reasonably reflect underlying economic reality.
- Accounting and auditing practices and policies able to translate those standards into accurate, understandable, and timely reports by individual public companies.
- A legislative and regulatory framework capable of providing and maintaining needed discipline.

Standard Setting

It is the first of those pillars with which I have been directly involved over the past 18 months.

The general case for international accounting standards has been clear for a long time. In a world of global finance, we have strong interest in encouraging high quality standards every place our companies do business. We want to be sure foreign-based companies desiring access to our well-developed market provide the kind of information our investors want and need. We want to avoid distortions in the international flow of capital because of mis-information or lack of information. Not least, a single set of standards would minimize compliance costs for companies and, I believe, assist enforcement.

Our American view has been that those objectives could be substantially attained simply by insisting all companies approaching our markets use U.S. GAAP – that is American accounting principles. But that approach could, in my judgment, never be fully adequate. Other countries will not easily agree "made in America" is necessarily best. Coverage will not be complete or uniform. For instance, Europe will insist on international standards, and many countries will simply be incapable of, or drag their feet on, good quality national standards.

Recent events drive home another point. Taken as a whole, the U.S. standards may indeed still be the most comprehensive and best quality in the world. But plainly, the auditing processes and the standards themselves need review.

Much has been made of the time that standard setters take adapting their standards to current business developments and needs. Conversely, there are claims of inadequate consultation, and those perceiving harm to their interests threaten withdrawal of financial support or lobby their legislators for preemptive action. In such a charged environment, one can see that in the United States, as well as elsewhere, that change is too slow and suspicions of political compromise damage confidence in the process.

In this context, there is a real opportunity for a reinvigorated international effort. A new highly professional organization is in place. It has strong backing from industry and governments around the world. Given its strong staffing and organizational safeguards, the IASC framework should be able to maintain high credibility. In its key components – the oversight committee I chair, the standard setting board chaired by Sir David, its advisory council and interpretations committee – it can command the best professional advice, international representation, and appropriate independence.

Sir David will speak more directly to the substance and priority of the work. However, I personally want to assure you that our intent is to move beyond compromise among existing standards or convergence for convergence's sake. Instead, we will work with the FASB and standard setters in other countries to choose among, and to adapt the best of, what exists. When necessary, we will innovate and develop new approaches.

Time is a luxury that we cannot afford. We have known for some time, the European Union will require publicly traded EU companies to report their consolidated financial statements according to international accounting standards by 2005. In other countries, there is an evident need for faster progress. And now American experience underscores the urgent need for a fresh look in some crucial areas.

As Sir David will report, the IASB already is considering many of the items in the headlines today – consistency in defining operating earnings and pro-forma

statements, special purpose entities, mark-to-market or "fair value" accounting, and stock options.

You might ask where the FASB fits into the process I describe. I do not believe that we face an "either or" proposition between US GAAP and international standards. In fact, the FASB and IASB are working together on many of these issues with the objective and expectation of reaching the same conclusion. The result should be convergence and significant improvement in both bodies of standards.

Restoring Confidence in the Auditing Profession

Broadly accepted, up-to-date international standards will help discipline the auditing process and encourage effective and consistent enforcement by national and international authorities.

Yet there is no escaping the fact, in the end, the accuracy and reliance of financial reporting lies in the hands of the auditors themselves. They are the ones who must interpret and apply the standards and protect their integrity. They are the ones to which the investing public must look to ask the tough questions, to demand the answers and to faithfully certify that at the end of the day — or the quarter or year — the financial results of a company are fully and clearly reported.

As you are aware, I have recently agreed with Andersen International to chair an Independent Oversight Board, with broad responsibilities to work with the company in reviewing and reforming its auditing practices and policies.

My hope is that, out of the current turmoil and questioning, Arthur Andersen will again assume a position of leadership in the auditing profession right around the world.

I don't minimize the challenge. Auditors individually and the auditing profession generally have been subject to strong and conflicting pressures. Company management urgently wants to meet market expectation to present results in the most favorable light and to demonstrate a consistent pattern of earnings. Too often the emphasis is on finding ways to meet the letter of the technical accounting requirements at the risk of violating the spirit. Large and profitable consulting assignments may, even subconsciously, affect auditor judgment. Companies want to minimize accounting costs. Directors and auditing committees may not be sufficiently knowledgeable or attentive — that is until it's too late.

All this raises questions of the internal management and policies of auditing firms, matters with which I am only beginning to grapple. How can the auditing functions and "technical" accounting decisions be protected from extraneous influence? Can strong safeguards be put in place against other business interests intruding on the auditing process? What are the appropriate limits on non-auditing services performed by an auditing firm to avoid the perception or reality of an unacceptable conflict?

The Enforcement Challenge

High quality standards and improved audit practices should go a long way toward enforcement. However, there are areas where it may be difficult or impossible for any one firm to proceed alone. Hence, there is a need for official regulation.

The United States has the framework for regulation and enforcement in the SEC. Over the years, there have also been repeated efforts to provide oversight by industry or industry/public member boards. By and large, I think we have to conclude that those efforts at self-regulation have been unsatisfactory. Thus, experience strongly suggests that governmental oversight, with investigation and enforcement powers, is necessary to assure discipline.

I can assure you in my roles both at the IASC and Andersen that I will continue to work closely with government officials here and abroad in order to encourage more effective enforcement. One imperative is for governments, including the United States, to provide adequate financial resources to regulators. I also believe this committee will want to explore means for providing more "backbone" for industry oversight, either through legislation or by encouraging exercise of SEC regulatory authority. Better means of identifying professional misconduct, with the possibility of meaningful fines and withdrawal of professional licenses, appears essential.

A positive step in this direction is being taken by the European Union in its effort to rationalize their securities laws and centralize their enforcement. We should encourage other countries, through the International Organization of Securities Commission (IOSCO) and otherwise, to bolster enforcement mechanisms in other countries, developed and emerging alike.

Concluding Comment

The crisis in the accounting and auditing professions is not a matter of the failure of a single company or perceived problems in a single audit. It demands attention to fundamental flaws basically reflecting the growing complexities of capital markets and pressures on individuals and their companies to improve financial results.

To fail to respond to that challenge would indeed have serious implications for maintaining confidence in markets, for the cost of capital and for the global economy.

The United States has long had a leading role among world financial markets, in financial reporting, and in the regulation and surveillance for these markets. Constructive work of your Committee and the Congress will be vital in maintaining that leadership. I also urge that you recognize, in an open and interdependent world economy with increasingly fluid capital markets, effective leadership, must necessarily involve close cooperation with others interested in full, accurate, and timely financial reporting.

The development of truly international accounting standards – building on the best that now exists and responsive to new needs – can be and should be a key element in the needed reforms.

The restructured IASC is in large part a result of initiatives taken by the SEC and supported by the leadership of FASB.

I trust that support will not weaken. Rather, as you examine the implications of the current crisis and the range of appropriate remedies, I hope you will help reinforce the effort to reach international convergence, recognizing its potential for improving accounting and auditing practices in the United States as well as abroad.