

**FINALLY, A TIME FOR AUDITING REFORM  
REMARKS BY PAUL A. VOLCKER  
AT THE  
CONFERENCE ON CREDIBLE FINANCIAL DISCLOSURES  
KELLOGG SCHOOL OF MANAGEMENT  
NORTHWESTERN UNIVERSITY  
EVANSTON, ILLINOIS  
JUNE 25, 2002**

Permit me to start by offering congratulations. Whoever decided months ago to schedule this conference at precisely this time deserves a gold star for forecasting. The alarming exposure of a series of financial reporting and auditing lapses in recent months is finally forcing the Congress, the SEC and the investing public to face up to the need for reform. What better opportunity could there be to help form a consensus for action - truly effective and forceful action?

I congratulate too, the Kellogg School itself for maintaining a long-standing commitment to teaching and research in accounting. It has done so at a time when much business education has concentrated on other areas, areas more fashionable and more immediately remunerative for graduates. That tendency, I fear, has contributed to the loss of accounting discipline fundamental to the effective functioning of our market system.

How ironic that we are meeting near Arthur Andersen Hall with the leadership of the Leonard Spacek Professor of Accounting. From all I have learned, the Andersen firm in general, and Leonard Spacek in particular, once represented the best in auditing. Literally emerging from the Northwestern faculty, Arthur Andersen represented rigor and discipline, focused on the central mission of attesting to the fairness and accuracy of the financial reports of its clients.

The sad demise of that once great firm is, I think we must now all realize, not an idiosyncratic, one-off, event. The Enron affair is plainly symptomatic of a larger, systemic problem. The state of the accounting and auditing systems which we have so confidently set out as a standard for all the world is, in fact, deeply troubled.

The concerns extend far beyond the profession of auditing itself. There are important questions of corporate governance, which you will address in this conference, but which I can touch upon only tangentially in my comments. More fundamentally, I think we are seeing the bitter fruit of broader erosion of standards of business and market conduct related to the financial boom and bubble of the 1990's.

From one angle, we in the United States have been in a remarkable era of creative destruction, in one sense rough and tumble capitalism at its best bringing about productivity-transforming innovation in electronic technology and molecular biology. Optimistic visions of a new economic era set the stage for an explosion in financial values. The creation of paper wealth exceeded, so far as I can determine, anything before in human history in relative and absolute terms.

Encouraged by ever imaginative investment bankers yearning for extraordinary fees, companies were bought and sold with great abandon at values largely accounted for as "intangible" or "good will". Some of the best mathematical minds of the new generation turned to the sophisticated new profession of financial engineering, designing ever more complicated financial instruments. The rationale was risk management and exploiting market imperfections. But more and more it has become a game of circumventing accounting conventions and IRS regulations.

Inadvertently or not, the result has been to load balance sheets and income statements with hard to understand and analyze numbers, or worse yet, to take risks off the balance sheet entirely. In the process, too often the rising stock market valuations were interpreted as evidence of special wisdom or competence, justifying executive compensation packages way beyond any earlier norms and relationships.

It was an environment in which incentives for business management to keep reported revenues and earnings growing to meet expectations were amplified. What is now clear, is that insidiously, almost subconsciously, too many companies yielded to the temptation to stretch accounting rules to achieve that result.

I state all that to emphasize the pressures placed on the auditors in their basic function of attesting to financial statements. Moreover, accounting firms themselves were caught up in the environment - - to generate revenues, to participate in the new economy, to stretch their range of services. More and more they saw their future in consulting, where, in the spirit of the time, they felt their partners could "better leverage" their talent and raise their income.

I have a mental image of the role of an auditor. He's a kind of umpire or referee, mandated to keep financial reporting within the established rules. Like all umpires, it's not a popular or particularly well paid role relative to the stars of the game. The natural constituency, the investing public, like the fans at a ball park, is not consistently supportive when their individual interests are at stake. Matters of judgment are involved, and perfection in every decision can't be expected. But when the "players", with teams of lawyers and investment bankers, are in alliance to keep reported profits, and not so incidentally the value of fees and stock options on track, the pressures multiply. And if the auditing firm, the umpire, is itself conflicted, judgments almost inevitably will be shaded.

Of course, that is not a fair description of the whole of American business. But we've seen enough to know there is a problem. Doubts - increasing doubts - about the reliability of financial reporting, now appear to be infecting investor decisions and stock valuations themselves.

Plainly, it is time to act - act in the interests of the investing community, of all of us, so to speak, sitting in the stands interested in seeing a fair game -- to support needed reforms in financial reporting.

I realize change - constructive change - is underway in the marketplace.

Directors and audit committees of public companies are surely more sensitive to auditor conflicts and to the implications of "aggressive" accounting practices. CEO's and their CFO's have been put on notice that they should not expect to escape responsibility for lapses in financial controls and reporting. The accounting firms themselves are

surely motivated to review their internal procedures. They have responded - to be sure none too happily - to client and investor concerns by shedding some consulting services, particularly high-tech IT systems work.

The issue we face is whether those reforms in the market can go far enough, and whether they will outlast the current spate of reported scandals. The past record affords little or no comfort on that score. In the face of earlier difficulties, the accounting firms and their trade association have clearly demonstrated their lobbying power and successfully resisted meaningful reform.

I cannot believe it is in the long-term interest of the auditing profession itself that we permit that pattern to be repeated.

Too much is at stake.

At its roots, we are dealing with an issue fundamental to the efficiency and effectiveness of the market for capital in the United States and elsewhere.

Out of the evident crisis, there is opportunity for constructive change.

I do not suggest there is a simple quick fix. Rebuilding faith in financial reporting will take time. It's an intellectual challenge, as well as business and political challenge.

Consider the challenge in terms of each of what I think of as the three pillars of reliable financial reporting:

- First are accounting principles and standards themselves. Do they set out, with clarity, logically consistent and comprehensive "rules of the game", rules that reasonably reflect underlying economic reality?
- Second are the business and auditing practices and policies that implement those accounting standards. Are the standards upheld by the auditors and translated into accurate, understandable, and timely reports by individual public companies?

- Finally are the institutional structures to support reliable accounting and auditing. Is there a framework of legislation, regulation, and corporate governance capable of providing and maintaining needed discipline?

The succession of accounting failures, beginning even before the Enron affair and continuing week by week, indicates unambiguously the need for improvement in every area.

### **Standard Setting**

The general case for international accounting standards has been clear for a long time. In a world of global finance, we have a 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, inconsistent information or lack of information. Not least, a single set of standards would minimize compliance costs for companies.

The United States has in practical effect long taken the position that those objectives could be reached by sticking to our GAAP and demanding that foreign companies wishing access to our large market follow our rules. I'd like to think our oft-stated view that the U.S. standards are the most comprehensive and best quality in the world is still true. But that mantra is no longer unchallenged. What has become indisputable is that standards themselves, national and international, need review: our goal must be not just consistent standards but better standards.

Enron's collapse amply illustrates the range of sophisticated issues before standard setters today - the almost inscrutable complexity of derivatives, options, and other new financial instruments; the emphasis on self-defined pro forma earnings; the subtleties of "fair value" accounting where there is no objective market; the proper treatment of share-based payments and of "special purpose vehicles".

Not surprisingly, it is those same areas that generate intense controversy and where standard setters meet the most resistance. Almost inevitably, there are claims of

inadequate consultation. Those perceiving harm to their interests threaten withdrawal of financial support for the standard setters themselves and even turn to their legislators for preemptive action. In such a charged environment, change in the United States as elsewhere has been slow and suspicions of political compromise have damaged confidence in the process.

As Chairman of the Trustees of the restructured International Accounting Standards Committee, I, together with the other trustees, am responsible for appointing and financing the expert rule-making International Accounting Standards Board. We are dedicated to protecting the independence of its decision-making. Consistent with that duty I am required to resist the temptation to express personal views on the substance of the standards.

What I and the other Trustees can do is urge close collaboration among the international and national standard setters -- notably the U.S. FASB -- and all deliberate speed in those deliberations. I sense the past resistance in the United States to accepting international standards may be diminishing. What is more evident is that much of the rest of the world is prepared to work to that end; in particular, the European Union has made clear its intention to adopt international standards in coming years.

To be successful, and to be accepted in the United States, those standards will need to be of high quality and adapted to the business and financial realities of the 21<sup>st</sup> century. I trust the present efforts at collaboration between the international and national standard-setting boards, including FASB, will provide protection against parochial financial and political pressures undercutting progress.

### **Auditing Approaches and Policies**

One of the main concerns of standard setters here and elsewhere is the extent to which the rules should be set out, and particular applications illustrated, in great detail. That's the present American approach. The alternative - the approach taken in the U.K. - is to emphasize the basic principle at stake, with the auditor responsible for its specific application.

The lesson drawn by many from the Enron debacle, with its abstruse game playing with the technical rules, has been the potential value of the "principle-based" approach. One thing is true for sure. To adopt that approach would be to increase further the burden on the auditor for disciplined, independent and dispassionate judgment.

Those are precisely the qualities that recent developments have brought into question. I fully recognize that neither an entire firm - certainly not an entire profession - should be damned by the weakness of a few, who have given way to the pressures I described. But neither can it simply be a pure coincidence that, within Arthur Andersen itself, the strong emphasis on non-auditing consulting work over the past decade paralleled an ultimately fatal loss of auditing discipline. I've seen enough of its marketing brochures, its compensation policies, its training approach and its emphasis on revenue generation to recognize the conflicts and distractions.

None of that would be a surprise to Leonard Spacek. He preached the professional responsibility of the auditor - the responsibility that justifies his exclusive license to perform the required audit of public companies - is to attest to the "fairness" and accuracy of a client's financial reports to the investing public. Activities that would place that responsibility in jeopardy are simply inappropriate.

### **Legislation, Regulation, and the Structure of Auditing Firms**

The key to auditing reform is adequate support for the essential mission. One important aspect of that need is the willingness of clients to pay fees commensurate with the responsibility inherent in auditing and with attracting the talent required. My reading of the current evidence in that respect is mixed. More broadly, experience strongly suggests that the changes in attitudes and approaches that we are seeing by boards of directors, by management, and by auditing firms themselves will need to be supported and reinforced by legislation if they are to be effective and lasting.

Bills now in the Congress sponsored by Republicans and Democrats appear to accept the logic of a new oversight body, operating under the general authority of the SEC.

Now, the SEC itself has reversed its previous passivity and proposed at its own initiative, and in general terms, an oversight body within its own jurisdiction.

In one way or another, all these approaches reflect the heightened concern about auditing discipline and related areas of corporate governance. But important differences exist among those approaches. These differences are crucial in determining whether we will have meaningful reform. In considering the alternatives, I have urged certain "litmus tests" be applied:

1. Does the proposed legislation provide real independence for the oversight board, with the majority membership representing the public interest rather than industry perspectives, and with an assured flow of financing?
2. Will the new oversight board have the authority to oversee and, as necessary, modify professional auditing standards and controls to assure their adequacy, to conduct investigations and to review particular audits, and to impose or recommend to the SEC a range of penalties ranging from reprimands to fines to loss of license?
3. Will the Board be able to determine limits on consulting or other services provided to audit clients or others when such activities undermine focus on the priority responsibility for disciplined auditing?
4. Does the legislation provide adequate funding for the SEC itself, given the need for skilled and experienced staff, adequate in numbers, to maintain effective review and supervisory responsibilities in today's active and complex market environment?

In my judgment, those criteria are fully met only by the Bill passed by the Senate Banking Committee last week at the initiative of its Chairman, Mr. Sarbanes, in a strong bi-partisan vote.

The window of opportunity may be closing. Fall elections shorten the Congressional timetable. We cannot count on industry support. I know there is room for honest debate on some of the specific legislation language. But the main points of a strong oversight body and the elimination of

substantial conflicts should be inviolate to those seriously interested in reform.

The recent initiative of Mr. Pitt, and particularly his crystal clear recognition of the deadly threat to confidence in our financial markets, is a welcome and strong step forward. But I do not believe a regulatory approach, without specific legislative authority, will be satisfactory. It is not only a question about the ability of the SEC under existing law to delegate its authority to impose a range of penalties. More broadly, only fresh legislation is capable of clearly expressing the will of the Congress and the American public for meaningful and lasting reforms.

Given what is at stake for the credibility of our financial reporting, I trust that approach can and will be supported by the Administration and the SEC.

### **Corporate Governance**

I recognize a natural complement to auditing reform is strong corporate governance. Questions in that area form a part of your agenda tomorrow, and I will limit myself to only a few words here.

There is today a consensus on the need for a strong, and technically competent, audit committee made up of independent members of boards of directors. I am also strongly attracted to another concept that seems to be gaining support but is far from a consensus: that is the desirability, for most large and complex public corporations to split responsibilities of the CEO from a non-executive chairman of the board.

Both approaches would, I believe, provide more effective oversight - a reasonable check and balance - on the strong and almost exclusive authority of the CEO typical of many American companies. As our Secretary of the Treasury, Paul O'Neill, has in his characteristically forthright way emphasized, the prime responsibility for financial reporting lies with the boss. It is the CEO that sets the tone, nurtures the culture, and appoints the staff. If and when there is a failure to report fully and accurately he should bear the consequences.

There is much to say for that approach. The question is how to implement it. An independent auditing committee and non-executive chairman can provide a needed element of oversight, a counterweight to the pressures on management to dress up reported results.

More important than either of those particular reforms of corporate governance, in my view, are the excesses and abuses in the use of stock options for management of established public companies. It is not too much to say that an approach originally justified as a means of aligning management with stockholders interests has too often been distorted into a means of aligning stockholders to the interest of management. The value of one-way options capriciously reflects general market influences as much or more than the long-term success of management. In bull markets, they reward even sub-par performance. We have seen instances of huge payoffs even as a company heads for bankruptcy. In my judgment, one-way options simply cannot sensibly be defended in the amounts granted by some companies.

My larger point is that we cannot count on changes in corporate governance to substitute for needed reforms of the accounting and auditing disciplines. After all, boards of directors are, and should be, collegial bodies typically closely attuned to, and sympathetic with, the chief executive officer. They are necessarily heavily dependent on management for information. Their independence and experience is invaluable, particularly on strategic issues and organizational questions. But their attitudes and aptitudes are not those of skeptical auditor, acting at arm's length in the interest of the investment community.

We have today an all too rare opportunity for significant and lasting reforms. The stage is set for an international effort to bring accounting standards up to date. The need for internal change in accounting firms to focus on their auditing responsibilities is better recognized. A legislative process is well underway.

The market itself, visible in its own erratic performance, is calling for action.

There cannot be any point in resisting change, not at the expense of further undermining market confidence. Amid all the pressures to which they are subject, the auditing

profession most of all, needs a clear Congressional restatement of its primary responsibility to the investing public.

Inevitably, the legislative process is both difficult and time constrained. What it particularly needs at this point, is the considered judgment and visible support of those dispassionately and professionally concerned with the guarding the integrity of our financial markets.

What better setting could there be for that effort than here at the Kellogg School, at its Accounting Research Center, carrying on a tradition set long ago in happier days by Arthur Andersen and Leonard Spacek themselves.