U.S. Securities and Exchange Commission

Oral Testimony Concerning
Accounting and Investor Protection Issues Raised by Enron and Other Public Companies

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Before the Senate Committee on Banking, Housing and Urban Affairs

March 21, 2002

Mr. Chairman, Senator Gramm, Members of the Committee:

I am pleased to appear here on behalf of the Securities and Exchange Commission. I have followed with enormous interest and admiration the issues this Committee has explored the past two months, and I commend the thoughtful and deliberative approach the Committee has taken, under Chairman Sarbanes' leadership. In the face of crises and their concomitant turmoil, it takes patience and restraint to develop a full legislative record before putting pen to paper. Chairman Sarbanes, I congratulate you on this approach. I also want to thank you, Mr. Chairman, as well as Senator Gramm, and the full Committee, for the strong, bipartisan, support that this Committee has expressed for funding pay parity and our need for additional resources.

My tenure at the SEC is still relatively brief, although some days it seems as if I've been here much longer. Three crises occurring at the outset of my tenure — September 11th, Enron's bankruptcy, and last week's indictment of Arthur Andersen — focused national attention on the need for meaningfully reforms of the laws and rules we administer. Both Congress and the Commission must act — the Commission, through regulation and enforcement, which has the benefit of immediacy and flexibility; and Congress, through legislation, which has the benefit of extending our reach and authority where appropriate. We cannot act independently of one another, or at cross purposes; we must act in concert if we are to restore public confidence in our markets and make the world's best capital markets even better. You have my commitment that we will continue to do precisely that.

At my confirmation hearing, Senator Dodd gave me some sage advice. He said,

> [Y]our job isn't to become the most popular guy in town. It's to be the guy that actually will look at us and tell us . . . no matter how unpopular it may be, that you've got an obligation to do what's really right on behalf of investors in this country.

I'm positive I've satisfied the first prong of Senator Dodd's advice — I'm not "the most popular guy in town"! Today, I hope to satisfy the second prong of Senator Dodd's counsel — I will tell you, in unvarnished tones, what we think must be done to restore public confidence and to repair the critical aspects of our system that have remained broken for far too many years.

In response to recent events, I believe we need to address three overarching reform needs. First, disclosure by public companies must be truly informative and timely. Of course, I should add here it has to be honest. Second, oversight of accountants and the accounting profession must be strengthened and accounting principles that underlie financial disclosures must be made more relevant and comprehensible. Third, the governance of American companies must be upgraded.

We have already taken or announced a large number of significant initiatives:

- First, in cautionary advice issued on December 4, 2001, we provided guidance on the appropriate use of, and limits on, pro forma financials. And we followed that with an enforcement action to back up up our statements.

- We issued further cautionary advice on December 12th, setting forth initial requirements and guidance on the obligations of public companies to disclose critical accounting principles.

- On December 21st, we announced our Staff would monitor annual reports submitted by all Fortune 500 companies in 2002. This initiative significantly refocuses and improves our review program for financial and non-financial disclosures by public companies.

- On January 17th, we announced our preliminary, and I stress preliminary, concept for a new private sector regulatory body to oversee the accounting profession.

- On January 22nd, we identified issues in Management's Discussion and Analysis to be addressed in 2001 fiscal year end reports regarding off-balance sheet financing arrangements.

- On February 4th, the securities industry, and its self-regulators, acting with our guidance, announced proposed rules to create more transparency for analyst recommendations.

- On February 13th, we announced proposals to address aspects of corporate disclosure needing immediate improvement.

- Also on February 13th, we called upon the New York Stock Exchange

and Nasdaq to look at specific components of corporate governance. And they have responded remarkably.

- This past Monday, we released orders and temporary rules in order to assure a continuing and orderly flow of information to investors and the U.S. capital markets, in light of Andersen's indictment.

- On Tuesday of this week, the Commission commenced a formal quasi-legislative investigation into the activities and effects of rating agencies on our capital markets.

- On March 13th, we brought an action against the former CEO of a public company, seeking to recoup bonuses, options and salaries paid for financial performance that was a sham. This was a landmark effort by the Commission's Enforcement Division.

Before turning to the three-pronged approach we believe that you and we must take together, I want to add a word about the need for legislation and additional regulation. I have said many times already that I do not believe that new legislation or new regulations are the key to solving every problem. I do, however, believe that we must respond to a unique crisis of confidence created in our capital markets. I want very much to assist this Committee in developing a sound legislative proposal and to work with you to tailor our concepts of necessary regulations. In short, I support your efforts, Mr. Chairman, and those of the Committee, to take prompt and appropriate steps. Whether or not we always agree on the solutions, this Commission will always agree to assist you in achieving your objectives and implementing your legislative directives.

Corporate Disclosure Reforms

We have begun enhancing our corporate disclosure system. The reforms we contemplate are aimed at improving the quality and timeliness of financial disclosure. The MD&A section of disclosure documents filed with us is meant to be, for investors, a narrative explanation of, and provide the context for, companies' financial statements so they may see the companies in which they invest "through the eyes of management" and understand the risks to a company's earnings and cash flow. MD&A is the cornerstone of our system of corporate disclosure, and it must be improved.

The rule reforms to MD&A that we contemplate include:

i. codifying principles we suggested companies adopt voluntarily in December — requiring companies to identify their most critical accounting policies;

ii. mandating specific disclosures concerning relationships with entities that have a great impact on their financial condition, such as off-balance sheet financing arrangements; and

iii. improving disclosures relating to key trend information, without converting our disclosure system into an attractive nuisance for increased litigation.

In addition to these planned MD&A disclosure reforms, we have in mind two very different initiatives, both of which are still in the conceptual stage, to improve the quality and utility of our corporate disclosure system. First, we believe investors would benefit if companies produce clear and concise financial statements that allow readers to explore whatever layer of detail they wish. This would *not* be an initiative to "dumb down" financial statements, but an effort to give companies the flexibility to produce and disclose financial information in "layers".

Second we can improve the corporate disclosure system by increasing the CEO's individual accountability for his or her company's disclosure. We intend to implement the President's directive to us to require CEOs to certify their company's annual and quarterly filings, in a *meaningful* way. We are also considering rulemaking to require corporations to adopt procedures designed to bring important information to the CEO's attention.

Third, we intend to impose obligations on *companies* to report immediately any transactions by corporate insiders, including transactions with the company. This would quickly address an issue that is circumscribed by statutes and rules — corporate insiders need not file reports of their activities in their company's stock for as long as 40 days, and a few years ago the Commission adopted a rule that permits insiders to delay filing trading reports for up to a year if, as in Enron's case, the trades are directly with the company. While we seek to require faster and better disclosure by rule, a legislative solution here would be very helpful.

Fourth, we intend to expand significantly the list of items to be disclosed by companies between their quarterly and annual reports. At present, only five events require intra-period disclosure — we propose to add about a dozen new significant events to that list.

Over the longer term, we also will implement amendments to the basic framework of the reporting system to require public companies to disclose vital information on a "current" basis. Presently, corporate disclosure provides investors with a still life. We want to provide them with a moving picture.

Corporate Governance Reforms

We also believe that there are a number of ways that corporate governance standards can be improved to strengthen the resolve of honest managers, which has eroded over the years, due in part to increasing pressures to meet elevated expectations. To this end, last month we asked the NYSE and Nasdaq to review their listing standards for important issues, such as officer and director qualifications and codes of conduct for public companies. We separately asked Financial Executives International to review its code of

ethics in light of recent developments. All have responded in the best traditions of the private sector.

Accounting Reforms

Perhaps the most pressing need is reform of our accounting system. We see the need for reform in two areas: the regulation of accountants who audit financial statements of public companies and regulated entities, and the process of setting substantive accounting standards.

The Public Accountability Board

The number of sudden and dramatic reversals of public companies' financial conditions calls into question the regulatory system currently used to oversee the quality of the audits of public company financial statements. Therefore, we propose a new "private sector" regulatory body — the Public Accountability Board — to direct periodic reviews of accounting firms' quality controls for their accounting and auditing practices and also to discipline auditors for incompetent and unethical conduct.

This PAB would replace the system of "self" regulation to which the accounting profession is currently subject (such as the present system of firm-on-firm peer reviews, overseen by the POB under the aegis of the AICPA). There is substantial consensus on this point. Indeed, the AICPA and the major accounting firms have embraced the need for this change to restore public confidence.

The PAB would supplement our own enforcement efforts, by adding a tier of ethical and competence requirements beyond legal prohibitions and requirements. Such two-tier regulation has been successful in the securities industry. While the SEC is well suited to bring actions for fraud and such, private regulation can govern conduct that may not be unlawful, but that should be deemed unethical or incompetent.

We believe the PAB should be composed predominantly of members unaffiliated with the accounting profession. We do, however, believe the public will benefit if the PAB includes some a minority of members from the accounting profession, who would bring necessary expertise to the process. To assure the quality and independence of the members, the selection of the initial group of PAB members should be made by the Commission, and future selections subject to SEC approval.

In addition to independent membership, we believe the PAB should have a secure and independent funding source. We propose a system of involuntary fees to be imposed on all who benefit from financial audits, including, but not limited to the accounting profession.

Auditor Independence

It is also important that we take steps to ensure that auditors are, and are perceived as being, independent of their audit clients. The Commission adopted rules on auditor independence less than 18 months ago, after considerable study and discussion. A number of the rules have not even become effective yet. The Commission's new requirements provide a framework to be applied to any proposed non-audit service to determine whether it is inconsistent with independence. We believe this is the correct approach. Therefore, we believe these rules should be tested, and reformed if problems are shown to exist.

It is also useful to recall that there were large audit failures long before accounting firms had any significant consulting business; merely mandating the separation of consulting from auditing — to create an "audit only" firm as some have suggested — does not guarantee an "audit failure free" future. For one thing, an "audit only" firm also would be *more dependent*, not less, on their audit clients, and a single, large audit client could exert far more influence on such a firm than is the case with firms that have multiple sources of revenues. Moreover, information that can be gained through consulting engagements often is useful in performing audits.

Auditor independence is a complex subject. It can't be resolved by simplistic solutions. We are opposed to those who say that accounting firms as a whole should be restricted to providing only audit services. That is not the same as saying they should be able to provide both auditing and consulting services for the same client, but even there we urge you to decline to adopt legislation that forecloses our flexibility.

Auditor independence is a dual-faceted problem. Most importantly, those who perform the actual audits must be completely free of any pressures to waver from absolute and meticulous application of accounting principles. When engagement partners are given additional compensation for cross-selling consulting services to the same client, they are exposed to the potential of divided loyalties. We believe these practices need to be banned. At the firm level, the critical goal should be to require and incentivize the firms to supervise and oversee the audit team, to make sure they perform audits not solely within the letter of auditing principles, but at the highest level of integrity. One of the best ways to do this is to have a vigorous quality control review process, something the PAB we propose could do. Each major firm should be reviewed by the PAB every year — not every three years — and be at risk to lose valued clients if their audits aren't deemed to be of top quality, whether or not they comply with minimum standards.

Accounting Standard-Setting

While we have statutory authority to establish accounting standards for public companies, for over 60 years we have looked to the private sector to provide the initiative in establishing accounting principles. We continue to support private sector standard setting. But, the SEC has historically abdicated far too much of its obligation to ensure that accounting standards meet the objectives of the federal securities laws. Consequently, we plan to

take a more active role to ensure that standards are implemented that benefit markets and investors.

Going forward, we plan to use our existing authority to oversee the standard-setting process to ensure that it functions in the best interest of investors by: (i) broadening funding sources and making the funding fees involuntary; (ii) meaningfully participating in the selection of the members of FASB and setting the FASB's agenda; (iii) exercising our authority to review standards actually adopted; and (iv) ensuring that the FASB promulgates principle-based standards, which adapt faster to changing business environment and emphasize overall accuracy and completeness.

Legislative Assistance

There are additional areas where we need the assistance of Congress to implement our initiatives and to take other important steps in improving the integrity, quality and timeliness of the corporate disclosure system.

First, at present, the securities laws authorize us to petition a court if we want to bar officers and directors who break our laws. We could use this tool more effectively and protect investors far more efficiently if we could impose this administratively. This would be akin to our authority to bar individuals from the brokerage industry, and akin to the authority of the banking regulators to bar future service by banking officers and directors.

A related tool is statutory flexibility to seek civil contempt penalties for those who violate prior judicial or administrative sanctions and restrictions. We now must ask the Department of Justice to pursue those cases for us. Also, under existing law, penalties are capped at $120,000 or the "gross amount of pecuniary gain" for each violation, even for fraudulent disclosure violations. We would like to increase this amount, so it is a more meaningful deterrent, and we also would like the authority to impose penalties directly, rather than seeking them through the courts.

The PSLRA

The last area I wanted to address briefly is the Private Securities Litigation Reform Act of 1995. Some have urged its repeal. We think it appropriate to express the Commission's position. Private litigation, when properly formulated, is a very necessary supplement to the SEC's mission. The data to date demonstrates no erosion of investor rights in the PSLRA's wake; we strongly urge you to refrain from making any changes in that legislation in the absence of compelling empirical support.

Conclusion

We look forward to continuing to work with you to make sure that we discharge our obligations prudently, generously and in the spirit with which the federal securities laws were adopted: to protect investors and maintain the integrity of the securities markets. I thank you for the opportunity to

testify today. I ask that my written testimony which unbelievably is even longer than my oral testimony, be made a part of the record. I am pleased to respond to any questions the Committee may have.

http://www.sec.gov/news/testimony/032102oraltshlp.htm

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Modified: 03/21/2002